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CDK - Q3 2017 CDK Global Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the CDK Global, Inc. Q3 Earnings Conference Call. (Operator Instructions) I would now like to introduce your host for today's conference, Mr. Taze Rowe. You may begin.

Taze Rowe

Thank you, operator. I'm here today with Brian MacDonald, CDK's CEO; and Al Nietzel, our CFO. Thank you for joining us for our Third Quarter Fiscal 2017 Earnings Call and Webcast. Brian will begin today's call with an overview of our results, followed by the highlights for the quarter. Al will then take you through the details of the third quarter results and our forecast for the remainder of fiscal 2017.

A few items before we start. Throughout today's call, references to financial amounts are on an adjusted basis unless otherwise noted. Reconciliations of the adjusted amounts to the most directly comparable U.S. GAAP amounts are included in this morning's press release and are available on 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 forward in the forward-looking statements.

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

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

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

Thank you, Taze. Good morning, everyone, and thank you for joining us this morning. Today, I'd like to discuss our solid third quarter results, give you an update on our business transformation and then discuss the recent developments at CDK and within the industry.

Third quarter results were very strong and continue to position us well for meeting financial targets. Revenues grew 3%, or 4% on a constant-currency basis. Our EBITDA margin was 32.5%, a 690-basis-point improvement above last year's third quarter.

As anticipated, revenue growth slowed a bit as we lacked strong advertising performance in the prior year, but we still generated impressive profit growth, driven by strong operating performance and the benefit of our transformation plan.

Based on this strong performance, we are increasing our earnings guidance for the remainder of the fiscal year.

Al will provide more details on the quarter and outlook in a few minutes, but first, an update on our transformation plan.

As you can see from our ongoing margin expansion, our transformation continues to make very good progress.

During our third quarter, we made further strides in our MoveUp! work stream in terms of reducing the number of software versions to decrease complexity in the business. I'm pleased to state that our number of versions is now below 800, from approximately 1,500 at the beginning of the program.

We expect further progress in the remainder of the year, with a stretch target to get below 500 versions by the end of the year.

Workforce efficiency and footprint also showed progress in the quarter. We've continued to expand our consolidated services center in Norwood, Ohio, with another class of more than 100 new hires starting in the quarter. We also closed 3 more facilities and have now completed over 2/3 of the total expected closures. We are well on the way to having the right people in the right place to improve service and reduce cost.

Turning to enhance the customer service work stream, we talked a bit last quarter about some of the benefits we saw in the critical calendar year-end period for our dealer base. With the year-end period concluded, I can say that the average we have made in this work stream continued to read through, and we are very pleased with the final results in the period. Customer wait times were reduced by 90% and the number of service interactions fell by 11%, despite a record number of process changes, driven by both regulatory changes and OEMs, as well as an increased user count on our side.

Clearly, this is a sign of improved quality in our products as well as our processes. We will continue to refine our products, tools and processes to drive future improvements for our customers.

The CDK transformation isn't just about work streams and cost savings, but it's about transforming a culture. I'm pleased to note that we recently completed an employee engagement survey of CDK employees that demonstrated improvements in employee engagement over the past 6 months. Most satisfying to me, the highest level of engagement is within our sales organization. The sales team, as you know, is our most direct link to our customers, and they clearly see how the transformation plan is helping customers and providing growth opportunities for the company. Improving service and quality, higher employee engagement and improved financial results show we are balancing our transformation across customers, employees and shareholders.

Now I'd like to highlight a couple of current events from the quarter. First, we are pleased to announce that CDK was recertified as a Cisco Gold Certified Partner for the 10th straight year. CDK is the only DMS provider to hold this certification, and our telephony solution is a significant benefit to our dealers as they manage customer contacts to increase responsiveness and develop leads.

For perspective, CDK now manages a network of 190,000 dealer phones and operates Cisco's largest VPN network, with more than 15,000 wireless access points. We look forward to continuing to work with Cisco to provide a unique value proposition to our dealer base.

Next, the quarter saw a substantial rollout of CDK's next-generation websites. These sites provide customers with a premium experience across all forms of technology, but are specifically optimized for mobile interactions. Mobile interactions now represent nearly 2/3 of all dealer web traffic. We converted 2,500 customer websites to our new platform in the quarter and more than 1,600 of these are now live.

The new sites should help drive both ease-of-use for dealers and improved performance for auto customers as both navigate the increasingly important digital marketplace. We saw a nice increase in our website count in the quarter, both sequentially and versus prior year, and we believe our next-gen websites position us well to compete and win as we move forward.

Lastly, before Al provides more detail on our financial result, I'd like to give you an update on the state of the industry. There's been much discussion in the industry and press about the duration of the current auto sales expansion and the potential for a plateau or downturn in auto sales. We have seen some delays in certain OEM projects and a slight reduction in volumes of our transactional registration and credit check businesses. However, we see the auto retail space remaining healthy. The dealer body remains optimistic and willing to invest to meet consumer demand, and we are providing solutions, which are critical, as dealers adapt to changing consumer behaviors. While everyone in the industry benefits from higher sales, CDK generates significant recurring revenue that helps to insulate us from month-to-month or quarter-to-quarter swings in the seasonally adjusted selling rate. As you can see from the segment breakdown included in our press release and slides, subscription revenues in North America and CDKI International represent approximately 70% of total CDK. In our long-term recurring flows, they're not particularly sensitive to new car sales. Further, pure transaction revenue was less than 8% in the quarter, and even that revenue extends beyond new car sales.

Our transactional revenues are not perfectly correlated with new car sales, and our advertising revenue benefits from secular trends towards digital spend at the expense of traditional media. We remain confident that market conditions will support our ability to meet our financial and business goals.

With that, I'll now turn it over to Al to take you through our results.

Alfred A. Nietzel - *CDK Global, Inc. - CFO and EVP*

Thank you, Brian, and good morning, everyone. As I communicate on each of our calls, my comments for the quarter as well as the fiscal '17 forecast will largely be on an as adjusted non-GAAP basis. Reconciliations between these adjusted results and the most directly comparable GAAP results can be found on the schedules accompanying our earnings release.

Q3 was another solid quarter, with overall revenue growth of 3%, or 4% on a constant-currency basis, as we did face some headwinds from foreign exchange rates, particularly against the pound.

Our Retail Solutions North America segment revenues grew 5%. Increased average revenue per DMS customer site was a driver of this growth, while the combined revenue impacts of DMS site penetration and transactions were basically flat.

The number of customer website -- websites grew 3% on a year-over-year basis, and this represents a continuation of the improvement we saw last quarter, as new wins more than offset residual declines due to certain OEM program changes.

For Advertising North America, revenues grew 2% and were driven by OEM-focused local marketing association advertising spend. The slowdown versus prior quarter related to strong comps as we lapsed significant budget increases from early 2016, coupled with delays in certain OEM-funded programs.

For CDK International, revenues were down 1%, entirely due to unfavorable exchange rates, but grew 5% on a constant-currency basis, primarily from increased revenues per DMS customer site due to additional users.

Site counts were up again, and we saw a 1.3% increase in overall site counts on a year-over-year basis.

Moving from revenues to cost. Cost of revenues on a GAAP basis fell $8 million, or approximately 3% from last year. This was due to lower labor-related cost due to reduced headcount and more favorable geographic labor mix, partially offset by cost associated with our business transformation plan of $12 million, versus $5 million last year, which are shown as pro forma adjustments in our non-GAAP tables, and we a saw growth in advertising cost within the advertising segment.

SG&A on a GAAP basis fell $8 million, or 6% in the quarter. The decrease was driven by lower labor cost, partially offset by transformation cost of $10 million, versus $7 million last year, which are also shown as pro forma adjustments in our non-GAAP tables.

Also shown in the P&L were restructuring expenses of $7 million for the quarter. These primarily represent severance cost incurred in connection with our transformation plan and are reflected as adjustments in our non-GAAP tables.

Interest expense was $15 million for the quarter, compared to $11 million last year, due to the impact of the December 2016 term loan and higher rates on existing debt.

Adjusted earnings before income taxes grew 41%, with pretax margins increasing 660 basis points versus last year.

All 3 of our segments posted strong pretax margin expansion this quarter. RSNA delivered 750 basis points, primarily due to lower cost from our transformation efforts and scale from increased revenues. The advertising segment delivered 170 basis points, driven by lower cost from our business transformation plan. And International printed 620 basis points of expansion, driven by the benefits of our transformation plan, leverage on local currency revenue growth, as well as onetime benefits associated with indirect international taxes and timing of certain benefit accruals.

CDK adjusted EBITDA margin expanded 690 basis points on a year-over-year basis to 32.5%, again, primarily due to benefits from our transformation plan, coupled with the strength in the business and operating leverage on revenue growth.

Net earnings attributable to CDK grew 43% and diluted EPS grew 55% to $0.65 a share, reflecting strong earnings plus the benefits of a lower share count, driven by our return to capital program.

As you saw in our release, we had $3.4 million of tax benefit due to the adoption of the new stock comp standard. This benefited the quarter by approximately $0.02.

Our cash balance was $385 million, of which approximately $245 million is held outside the U.S.

Moving on to the full year forecast for fiscal 2017. The year-over-year comparisons are again on an as adjusted basis. With the strong performance in the quarter, we are raising our outlook for adjusted earnings. We expect revenues to grow approximately 4.5%, which includes a 1-point drag from foreign exchange rates. That implies a slower 2% to 3% growth in the fourth quarter as we lap a strong quarter from last year, but also see some pushouts in OEM-driven advertising opportunities, as well as slight softness in transactions relative to earlier quarters.

We are bringing up the bottom of the ranges of pretax earnings growth to create a range of 24% to 26%, from 23% to 26%. And we expect adjusted EBITDA margin expansion closer to the top of our range of 550 to 575 basis points.

We are reducing our anticipated effective tax rate to 31% to 32%. The decrease in the rate is primarily related to previously realized tax benefits associated with the adoption of a new stock compensation accounting standard on July 1. We still expect our rate -- our tax rate in the fourth quarter to approach 34%.

We are increasing the ranges for both net earnings growth and growth in diluted earnings per share to 29% to 32%, and 38% to 40%, respectively, resulting in an anticipated diluted EPS range of $2.40 to $2.44 a share.

This forecast contemplates further future repurchases, including the settlement of our December ASR and further repurchase activity in the latter part of the fiscal year as we move toward our new leverage targets.

We're pleased that continued execution has allowed us to increase our earnings once again from the original $2.28 to $2.35 guidance we shared with you in August of last year.

We have covered in prior calls, our fourth quarter results will be impacted by incremental interest and stock-based compensation expense. With respect to SBC, we anticipate incremental expense of approximately $15 million versus 2016 as we reach milestones with our transformation plan.

Interest cost will increase up to $10 million versus prior year due to increased borrowing and higher rates on existing debt.

While the stock-based compensation is specific to Q4, increasing interest expense will continue into 2018. We'll be more specific around our FY '18 on our Q4 earnings call in August and our plan to announce what -- and our announced plans to increase leverage to 2.5x to 3x net debt-to-adjusted EBITDA should result in interest expense some $50 million higher in FY '18 versus the current year forecast.

In summary, this strong forecast shows we continue to meet our goals for the year and make significant progress toward our transformation targets to achieve a 35% adjusted EBITDA margin for FY '18 and beyond.

With that, I'll turn it back 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 Matt Pfau from William Blair.

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

First, I wanted to start out on the website business. Nice result you posted there in terms of the increase in websites. Maybe you could just dig a little bit deeper into what's driving that? I mean, there was reorganization and the folding of the website business and with the North America segment. And then also, you released the new next-generation website solution. So is there one of those that's pushing that result in more than the other? Or if it's something else? Any additional detail there would be great.

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

Yes. I would say, Matt, it's really a combination of both. But primarily the next-generation website platform, which our customers like, OEMs like and we're getting a lot of interest in the platform, and we're happy with the migration. And I'd say it's really as much about the -- mostly about the product and less about the organization structure. The organization structure helps, but it's mostly about the product.

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

Got it. And then when we think of those additions that you've been making, is that more of progress in terms of further penetrating your base? I think the last number that you gave out there was somewhere around 30%. Only 30% of your DMS customers were using your website solution. So is that moving that 30% number up? And is that where you're seeing the additions come from?

Alfred A. Nietzel - *CDK Global, Inc. - CFO and EVP*

Yes. Actually, Matt, that number interestingly enough has not, as to date, moved all that appreciably. It's really just the continuation of the programs that we've had to roll out OEM sites due to the benefits of the product that Brian talked about a little earlier.

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

Look, something just to add to that, Matt, I mean, we're reasonably optimistic about being able to continue to grow our website penetration. So as you know, from -- we had a period time where our website counts were decreasing sequentially and decreasing year-over-year. We're now back into growing our websites sequentially in year-over-year, and we're reasonably optimistic that, that trend will continue for a while.

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

Got it. And then if I look at the DMS sites for the Automotive Retail North America segment, it dipped down a little bit again in this quarter. Is that -- I think last quarter, that was attributed to maybe some smaller customers or sites churning off. So is this like a continued trend of that and related to the transformation plan with perhaps being more disciplined in pricing?

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

Yes, I would say you're correct, Matt. I mean, the majority of our losses have been in the lower end of the market. We're not that happy with those losses, quite frankly. And -- but that's where the losses have been, and we'll be looking at actions we can take to help strengthen our position in the lower end of the market.

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

Got it. And then, I guess, just in general on the business, you talked a bit about how customer services have been improving. What have you seen in terms of the impact from that improvement in customer service in relation to churn or retention in other areas of your business?

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

Yes. I would say it's a really product-by-product or category-by-category. I would say we've had some losses in DMS sites in the low end, and that's for a variety of reasons. I would say it's a -- we always say that it's a very competitive market. And when contracts are up for renewal, it's often a competitive process. We continue to win new sites and new dealer groups. Those are very competitive. I'm often personally involved in those and it's a pretty competitive market. I think, certainly the work that we've done around customer service and our products has certainly strengthened our hand in all of those discussions, whether it's renewals or acquisition of the new groups.

Operator

(Operator Instructions) Our next question comes from the line of Gary Prestopino from Barrington.

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

Couple of questions. Brian, you said on the business transformation, the MoveUp! 500 software versions by year-end. I would assume that's calendar year-end, or is that fiscal year-end?

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

Fiscal year-end. That's our stretch target for the end of June.

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

Okay. That's good. And then, in terms of the next-generation website, is it -- is the target to get the majority of your website clients on that system by calendar year-end? Is that feasible?

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

Gary, we haven't really talked about that, that much externally. But I would say that by the end of the fiscal year, the majority of our domestic website customers will be converted. And there's always some laggers because the dealers aren't ready for a conversion. There's some work that they have to do in the conversion as well, so they may not be ready to review the new site and sign off. They may want to push that off. But I think the majority of our domestic websites will be completed by the end of the fiscal year. And then the -- obviously the websites outside the U.S., which are predominantly Canada and Australia, will lag after that.

Alfred A. Nietzel - *CDK Global, Inc. - CFO and EVP*

And Gary, just like the MovingUp! one, it's really about allowing our customers to enjoy the benefits of this new improved websites that have been developed. It's the same strategy.

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

No. Yes, that's fine. I'm just curious on that. And then what's always of interest to us is, it looks like on the -- in the U.S. markets, the average revenue per site continues to show pretty good growth on monthly basis. So is some of that pricing for the base product? Or is it just the majority of that increase, just more uptake of your layered apps?

Alfred A. Nietzel - *CDK Global, Inc. - CFO and EVP*

I mean, Gary, it's a combination of the 2. I think what we witnessed over the course of the last -- I'm almost going to say 15 months or so, is probably a little higher in average revenue per site than we would expect to see go forward, but we have enjoyed some upside on that through a combination of a variety of pricing actions, coupled with penetration of layered applications, which is really the heart of our strategy.

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

Right. And those layered apps, again, would be the -- was it the service now, the inventory? What other ones are -- why don't you just...

Alfred A. Nietzel - *CDK Global, Inc. - CFO and EVP*

Service Edge.

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

Service Edge, yes?

Alfred A. Nietzel - *CDK Global, Inc. - CFO and EVP*

Yes, Service Edge. The telephony solution has done very well. We've got some digital contracting solutions to help ease the process within the F&I office when vehicles are sold, where a lot of activity is digitized, and so forth, to smooth and make that work flow better for dealers, and so forth.

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

Right. And then, up -- of your revenues that are transactional-based, is that basically charging for credit apps at the F&I level on a car's purchase? Is -- or pulling credit app? Is that where most of that transactional revenue is?

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

Yes, that and vehicle registrations, Gary.

Alfred A. Nietzel - *CDK Global, Inc. - CFO and EVP*

It's about half and half for us.

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

There's some equity mining in there, so mining the customers' equity in their vehicle, but it's primarily a credit check and vehicle registration.

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

So -- Okay. So...

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

And as you know -- Gary, and as you know, I should remind the listeners. I mean, those are services that are not just tied to new cars, right? They're tied to traffic in stores. Oftentimes traffic goes up when credit gets tighter because people are shopping to get financed. It also applies to used cars. Used car registrations as well as credit checks for new cars. So it's obviously correlated because we vectored to new car dealerships as opposed to buy here pay here. But it's certainly not just tied 100% to new car starts hiked overall to traffic and volume of new and used at dealerships. And the last thing, Gary, I just think, if you haven't had a chance to do it, I encourage everyone to do it, is take a look at Lexus sites on your mobile phone. That's our product. Cadillac. The majority of Cadillac sites are now on our next-gen platform. So if you take a look at those website platforms on your mobile device and on your desktop, you'll see how they're responsive and you'll see a good display of our product and the result of working closely with our OEM partners.

Alfred A. Nietzel - *CDK Global, Inc. - CFO and EVP*

With that, Brian, that -- those websites, those would be dealer-specific, right? It's not...

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

Yes. Yes, not -- no, exactly. It's not the manufacturer's site. Find your local Lexus and Cadillac dealer. Look at a few different dealers because there may be a few that haven't converted yet. And when you find an old one, which -- when you find the old one and the new one, you'll see the differences, especially on the Lexus sites because those were -- that's -- I'd encourage you to look at both.

Operator

(Operator Instructions) At this time, I'm showing no further questions. I would now like to turn the call back over to Brian MacDonald for closing remarks.

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

Thank you everyone for joining our call this morning. We appreciate your time. We continue to be very excited about the progress of our transformation plan in terms of improving operations and driving financial results. Third quarter results with 690 basis points of EBITDA margin expansion demonstrates the progress we are making. We remain confident we are on track to meet our 2017 goals as we -- as well as our longer-term goals. Thank you, and have a great day.

Operator

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