CDK Global

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Ken Wong: I'm Ken Wong, the Citi SMID vertical software analyst. I'm happy to have with us Al Nietzel, CFO of CDK. He's going to start off with just a quick intro of the company, since this is their, I believe, their first time here at the Citi Technology Conference. And then I'll dive into some questions, and then we'll open it up to Q&A, probably the last 10 to 15 minutes. So everyone start kind of getting those brains stirring, and then, hopefully, have a lively conversation. So with that, I'll pass it over to you, Al.

Al Nietzel: Great. Hit the mike. Thanks, everybody, and welcome, and a pleasure to be here with some new faces around the table. Thanks much.

Let me just give you a little overview of who we are at CDK. We are a leading global provider of software and related services to the auto vertical around the globe. We automate and integrate into a number of different providers within the ecosystem, and it starts with key transaction processing at the dealer level, all the way through from a digital website through to the parts and service space.

We partner with both OEMs and dealers in over 100 countries and have around a 43% share of market here in North America. We are coming on our second year as a standalone public company, and although we've been in business for nearly 40 years, or over 40 years, we were spun out of Automatic Data Processing in September of 2014.

We have over $2 billion in revenue, 60% to 65% which is of a recurring variety on multiyear subscription-based contracts. We have about 10% of our business that is transaction-related, and then we have 20% to 25% of our business that is, although tied to many of the subscription-based contracts, is more of a one-time variety. And we can go into any questions you might have afterwards on that.

We had a CEO succession and CEO transition that took place in March of 2016. We are in the first year of a three-year transformation plan, which is really aimed at significantly improving our profitability profile, while at the same time dramatically improving the customer experience that we have with our many customers. And we've made very good progress after the first year.

Our transformation program is not only about cost takeout. It is also about significantly reducing the complexity that we have in the business and making CDK a much easier company to do business with, which we're doing. We have eight individual work streams with over 200 individual projects, and the goal of our transformation plan from a profitability perspective is to expand our EBITDA margins from a starting point of around 22% to 35% at the end of our fiscal year '18, which ends in June of 2018.

From a financial perspective, we reported our FY16 results on August 3. We had 5% revenue growth over the prior year, with 370 basis points of margin expansion to 26.6%. I provided, or we provided guidance on our fiscal '17, which has us growing revenues at 4% to 5%, and EBITDA margin expansion going to 500 to 550 basis points of margin expansion, to roughly 31.6% to 32.1%.

We also provided a little more specificity around exit rates in fiscal '18, and we will have an exit rate of 36% to 38%, and we also provided a little additional color on fiscal '19, with an exit rate of margin in excess of 40%.

So with that, I think you'll find, as you read about our business, we're in great markets, growing markets, and we're in the lead position, and we'll do our best to continue to extend that lead position.

So with that, Ken?

Ken Wong: Yes, that's fantastic. Great intro. One of the things you touched on, this transformation process. And within there, you've got these eight work streams that you talk about. Are there some lower-hanging fruit amongst those eight? What are some of the areas that you think will be a little more difficult to cross the particular hurdle?

Al Nietzel: Yes, there's really--I would say there's really no work stream that is easy. There are some that are more difficult than others. When you think about a transformation plan that has as many work streams as we're undertaking, it's complicated. And some of the areas that we focused on have what we refer to as longer tails of execution. When you think about revamping your contract to cash process where multiple systems were involved down to fewer systems, it's a lot of significant process reengineering that we're undertaking. That particular work stream takes a little more time, and that's why, in our case, the plan from an execution perspective takes a little longer to see through.

There are a couple of other work streams, specific work streams, that simply just take time as we look at the rebalancing of our workforce, moving from a more decentralized model to a centralized model with fewer physical facilities. That involves a fair amount of resource being moved from one location to another and roles being moved from one location to another. So that takes some time.

I think those are two of the key ones that I'd focus on.

Ken Wong: Got it. And then I think one of the other areas, and you touched on it, I've seen you guys touch on it in past calls, is you guys have, I guess you have a--the relationship with your customer is a little more complicated than you would like. Can you maybe expand a little bit on that, and what are some areas where you guys are looking to improve to help to streamline that process?

Al Nietzel: Yes, I think the example I gave on the quote to cash process is significant, where we have clients that might be getting multiple invoices and multiple bills from me today based on the model that we had in the past. As we think about the ease with which we do business going forward, that quote to cash process will be streamlined dramatically and therefore less complexity.

Some of the areas that have been announced, and in particular with the May announcement that Brian McDonald, our CEO, made about reorganizing the company from less of a business unit to a more functional focus, we had previously six different, let's call it, R&D organizations. Those organizations have been combined under one leader. And what that helps us with is communication with our clients.

We have the same happening within the implementation area. So there are a lot of areas of opportunity that we've identified that we're executing against that will make the experience that our folks have with our clients and customers much more efficient than it was in the past. And those are real value adds in terms of how we bring our solutions to market and how we service our clients as well.

Ken Wong: Got it. And then perhaps circling back a little bit on the transformation, so I think with the transformation, there are a lot of costs coming out. At the same time, you guys laid out a longer-term growth roadmap. How should we--I guess how do we interpret those two, both cost cuts and better growth? How do those interwork?

Al Nietzel: Yes, I mean, we're doing something that some would view as very unique in terms of a very meaningful margin expansion profile at 1,300 basis points over a multiyear period. And we're doing that while we're continuing to extend our market leadership position in terms of growing our business.

Our revenue trajectory is in the 4% to 5% range, and we are working every day to ensure that we're continuing to gain new revenue sources and penetrate our base with additional applications. And also, gain new market share is a key part of what we do as a growth driver, is as you think about, let's keep it in North America, the number of rooftops out there, our goal is to continue to grow the number of clients or customers that use our DMS. And we'll continue to do that while improving the client experience, whether they be improvements in implementation, whether they be improvements in service, and improvement in delivery and so forth.

So it's a balance that all leaders of companies need to make on a regular basis, and we're as acutely focused on driving our revenue growth as we are about improving the financial profile of our company, and I think we're doing both.

Ken Wong: So some of it sounds like it's just, I guess, your relationship with the customer, hopefully, that that improves, that will help drive some incremental growth. How should I think about it from just your go to market, your sales force? It sounds like there, you're going to dial back a little bit as well, consolidate some of the headcount. Do you believe that you're maybe operating a little inefficiently in the past with your sales force? Help me understand kind of why that wouldn't impact your business.

Al Nietzel: Yes, I mean, it's clearly much broader than the sales organization. The sales team that we have is world-class, and we are continuing to invest in the sales channel, and making sure that the client contacts that we have are regular. They might not in every case be as on-the-street per se, because we're utilizing telesales and other methods to communicate with our clients. But we have a high-touch model, where our sales organization faces off against various parts of the dealership to make sure that they know what we have to offer, and our sales team is penetrating the base with more solutions and what-not.

So I think the opportunities for us to continue to grow our business really come in multiple areas. But number one, as I said earlier, is market share. And we have dedicated folks that do nothing but wake up every day to look for conquests. And then we have parts of our sales organization that's focused on penetrating the base with applications that they don't have today with CDK. And those are the two prime vehicles for our drivers of growth.

And we see continued opportunity for those to expand as we look at the universe and we look at the base of our clients that are penetrated with our solutions. We have plenty of upside to continue to grow at the mid- to high-single-digit rate.

Ken Wong: Got it. And then maybe stepping back at a more macro level, so your DMS solutions are sold into the auto world. How should we think about the leverage of your business to auto sales? Is that something where, if that starts to weaken a little bit, that that would impact you guys materially? And why or why not?

Al Nietzel: Yes, I would say we have some sensitivity to new car sales, but it's not particularly large. As I said earlier, that as you think about our $2-plus billion business, about 10% of the business is in transactions, and that's for registering vehicles and running bureaus on people like us who go in to buy vehicles. And if the volume goes up, it feels good when I get a little bit of a lift in terms of more transaction volume. And if it goes down, while I don't like it, it's not significant enough to change what we do and the financial profile of our company.

So it indicates the health of the industry, and in some cases, the propensity of dealers to spend. And frankly, we use that to the customer's and client's advantage, because a lot of our solutions can help them make more money. And ultimately, that's what we try to do, is help car dealers make more money and profitably sell vehicles and service.

Ken Wong: Any examples that you might have for maybe five, five to six years ago when the macro environment did slow down a bit, what impact it had on your business? What did you see across your customers? Was it, I guess, dialing back on seats or attach or what-not?

Al Nietzel: Yes. Yes, I mean, a good proxy, clearly, is what happened in 2008 and 2009, when new car sales went from over 17 million units in the US to around 10 million. And during that period, our revenues were down in the very low single digits. It's in the 2% to 3% range. And that's a testament to the financial profile of the model that we have, where while there was out of businesses and there was some dealer consolidation, we index in the middle to high end of the market. And many of those dealers actually were quite strong. And we fared quite well during that economic crisis that we experienced here in the States. And again, we didn't have huge tie-in to the volume, and therefore, it didn't hurt us as much as perhaps other companies.

Ken Wong: I'll pause for a second, see if there's anything out in the audience. If not, I--Scott?

Unidentified Audience Member: Just a question on the larger goals in the 530s for fiscal year '18, I think 36% to 38%?

Al Nietzel: 36% exit rate. Full year is 35%.

Unidentified Audience Member: Oh, 36%. I'm sorry, excuse me.

Al Nietzel: The exit rate, 36% to 38%.

Unidentified Audience Member: That 35%, what would it be if revenue growth was flat?

Al Nietzel: You know, I haven't modeled it exactly like that. But clearly, part of the lift that we're going to enjoy over the next few years is just because our business is growing and the cost structure is staying flat in terms of areas or going down in others. And so I've clearly got a lift as a result of the revenue trajectory that we're on. But make no mistake; the 250 to 275 of additional EBITDA is really driven by a lot of the programs that I've outlined, or we've outlined, on those eight different work streams.

Unidentified Audience Member: (inaudible – microphone inaccessible)?

Al Nietzel: Actually, consolidation has actually helped us because of who we're indexed with in terms of the bigger players. So when larger customers buy other customers and they're not running a CDK system, what traditionally happens is they come to us rather quickly. It's no different than what I've done on acquisitions. When we buy somebody, their back office and billing pretty much comes into the core very, very quickly, and dealers do the exact same thing.

So while I look macro at the number of dealership points in our country here in the States or in North America, we don't see an increase, or we don't see a precipitous decrease. I mean, our view is that the number of dealership points is probably where it's going to be for the next number of years. However, there will likely be less owners, meaning consolidation within the industry will continue. And so the decision-makers on some of the core applications and the core DMSs will be fewer decision-makers, but the actual dealership points, frankly, would stay the same.

In terms of price, I think the way I would say it is that we, like many other industries, have a tremendous amount of competition, and we also have disrupters that exist in the market. We garner, as a company, across the entire portfolio, about one to two points of pricing per annum, just because of the way the model works and the price increases are scattered. And what we tend to focus on, and what we want to make sure is happening, is that there's a good correlation between value and price. If we have applications that are, frankly, working and working well and saving dealers money, we, in those cases, should be able to garner a certain amount of pricing on it.

But in terms of the overall portfolio for us, think about one to two points of growth per year in terms of pricing.

Unidentified Audience Member: (inaudible – microphone inaccessible)

Ken Wong: Let me just repeat the question since I'm not sure there's a mike back there, but I think just to iterate is why can't your gross margins be much higher than where they are now?

Al Nietzel: Well, they will be much higher than where they are right now, and I think about all the elements of what we have in the gross margin with respect to implementation and servicing our clients. But as you know, there are other elements of the portfolio. I used the transaction businesses as one, right? The bureau business is in there, and those don't have that kind of margin that you expressed, and the same with some of our elements of advertising, which is in gross margins. It's just not going to have traditional software margins.

We have a big share of our portfolio that you rightly describe as opportunity availability. And all of those things you just described, whether it be implementation, whether it be what we're doing in call centers--all of those are elements of programs that we're working through that will see a meaningful improvement in our gross margins. And as you think abut an incremental 250 to 275 of EBITDA coming down for us over the transformation period, the bulk of that is going to be felt in the gross profit area.

So you should expect to see--again, our mix is not like any other--not any other, but it's got very, very strong correlation to other software providers. But ultimately, it's got a little unique element because of some of the things that roll through the gross profit area.

Unidentified Audience Member: (inaudible – microphone inaccessible)

Al Nietzel: Yes, those are things that we do today. I mean, not all of it, but we do elements of our training remotely, whether it be domestically or offshore. I mean, those are just things that we do. So we've expressed what our profile is going to look like over the next few years. We have a long way to go before we get there, and we have confidence that our company will be able to achieve the goals that we've set forward, not just for '18, but as we've expressed, a little further into '19. And ultimately, we're not going to go to sleep when we get there. There will be things that we'll do because the business does have some inherent scale, that we would expect to see improvements as we go forward.

Unidentified Audience Member: Has any of the sort of strategic activity around DealerTrack or cars.com or any other sort of competitors up there impacted your ability to gain share in marketing services or in this product?

Al Nietzel: We have, as I think everyone knows, a very competitive landscape. There are a number of competitors, including Cox Automotive and others, that play in the ecosystem in a very meaningful way. There hasn't been anything that I've seen that has been prohibiting us from continuing to gain share as well as, as I said before, penetrate our base. I think a key focal point that we have right now is really in the digital side of the house with websites. I've talked publicly about the loss of exclusivity with certain OEMs, that it makes the comparisons a little challenging right now. We've got another quarter or so to go.

But ultimately, we would want to see our competitive position within the website space, because that is a very key part of other services that are taking place right now for dealers in terms of the convergence of both brick-and-mortar and online experience. And having a digital asset and getting further penetration of our websites is really going to be a key focal point, and it is for both our sales team as well as our leadership team.

Ken Wong: I wanted to touch a little bit on the consolidation question there. So you mentioned typically you view those as a positive to your business. Who do you guys typically run into, where if it's a consolidation and a customer goes in the other direction, who are those competitors? And typically, what causes a customer to move away from you guys to maybe a competitor's platform when there is consolidation?

Al Nietzel: Yes. I mean, when there's consolidation or what we call buy-sell in the industry, we lose some as well as we gain. We've gained more than we've lost through consolidation. The question about why do clients choose to come to CDK, I see it as three main elements that drive those decisions.

One is clients agree with us, and they agree with our strategic direction on what we're doing to transform the automotive retail experience, and that's something that is attractive to them. They've got proof sources in other clients who have used our solution, particularly on the high end of the market and elsewhere, that like what we do and are pleased with the services we provide. And that goes around, and people find that out, and people come to us as a result of that.

Two, we view the relationship that we have with clients as really a true partnership. And I think, as someone had mentioned, many of the dealership groups don't have large IT departments. We're their backbone for a mission-critical product and solutions, and we're there for them. And that's a key part of why they come our way.

And then ultimately, price becomes an element of a decision to move, and we're aggressive where we need to be aggressive to continue to gain share. And that's a key part of the value prop that we bring to the party.

So the folks that are in the mix, generally, is clearly Reynolds and Reynolds. We've got DealerTrack and their Arkona brand. There's Auto/Mate, AutoSoft. There's a variety of other providers at varying ends of the spectrum in terms of sophistication, in terms of product offering that we run in against. But we've, I think, done fairly well from a share perspective.

Unidentified Audience Member: (inaudible – microphone inaccessible)

Al Nietzel: Yes, I mean, I haven't seen anything appreciable in the transaction-related businesses. I mentioned earlier that our sensitivity to it is less than other companies. It might be more directly tied to SARS. And for us, the traffic in the dealership, as well as both new and used cars, drive the transaction businesses. And it's healthy. the industry still is healthy. I mean, no one knows what new car volume is going to be. The outlook still looks fairly healthy. And so if it's down a bit, I don't love it. But if it's down a little bit and if it's up, I enjoy some of that upside. So not a whole bunch from my side.

Ken Wong: So two-thirds of your business is North America based. Just wondering what kind of plans you have internationally. What are some of the hurdles that you might encounter there? And is this more of an organic or an inorganic approach?

Al Nietzel: No, we have an international business that for us is a little over $300 million. The strong dollar has kind of tamped that down a little bit the last couple of years. But we believe that our international business is a key part of the portfolio, and our expectation is will continue to be a contributor to the overall mix of what we offer at CDK. And I think there's traditional hurdles that you have with the international operation. But we've, I think, weathered the storms that we've seen in western Europe the last couple of years. The business is on great footing. The financials that you all see have a margin profile in that business that's growing.

I think one of the challenges that we'll have is I think, personally, there will be more opportunities internationally. And as we work through the transformation period, we're going to have to balance the speed with which we perhaps take advantage of those opportunities, and then balancing the margin profile objectives that we have as a company. So we like those opportunities in a big way, frankly, in terms of international. It's a key part of the portfolio.

Ken Wong: And on international, when I think about that, that two-thirds or that one-third mix--does that shift closer to, let's say, 40%? Is this something that you guys hope to be, again, materially more than that at some point?

Al Nietzel: In terms of the margin profile, Ken?

Ken Wong: Just in terms of--

Al Nietzel: The mix of the business? You know, we haven't thought of it quite that way, but we do know that the international business can and will be a more meaningful part of the overall portfolio as the years unfold. The pace with which we can do it will be gaited a little bit by the programs we have underway with the transformation plan. But today it's in the 15% range, and we think it can be more than that, clearly. But we haven't set a goal that says it's going to be 40% of the portfolio. We want it to grow and to enhance the overall profitability of the enterprise in time.

Ken Wong: So you guys have essentially three key business units, from what I see. How should I think about the investments in those particular areas? Where is there outsize investments and opportunity for growth, in your eyes?

Al Nietzel: We look at, and I used international as an example, and that could be an area that we choose to make some investments in. But we look at the overall portfolio in a way that maximizes return on capital and ultimately will enhance the overall margins of CDK.

The priorities that we have are really centered around layered application penetration within the base of our clients that we have. I talked a little bit about the digital business. We're putting a lot of investment behind what we refer to as connected store, which is essentially putting capabilities to do more buying online on a website. That's a key part of what we're trying to continue to invest in. I talked about the website penetration as not exactly where we want it to be, so there's a lot of focus around website growth and trying to garner more sales in websites.

And clearly, the international business is more an OEM or manufacturing-driven model. And we're continuing to leverage relationships with OEMs to garner opportunities in the markets that we compete in. So all of those are key investment area opportunities for us, and we continue to focus on them.

Unidentified Audience Member: (inaudible – microphone inaccessible)

Al Nietzel: Yes, good question. I mean, the focus on the business is really about--the prime focus is really about organic growth. We have a great, great collection of assets with our core, with our website business as well as international. But we are open to, and continue to look at, acquisition opportunities that complement the core offering. We don't anticipate any of those to be a substantive variety. They'd be more of a tuck-in nature. If we can get to market quicker with a solution from a third party that we can acquire, that's fine. If we can invest the time in development to do it ourselves, that's fine, too. But the prime focus is really about the organic growth. It's leveraging and stitching--not stitching, but combining the assets that we have in a more effective way to take advantage of the opportunities we have.

And websites is a great example, because the overlap of clients that take a CDK website that also have a CDK DMS is relatively low--I mean, way lower than we want it. So we think there's very good opportunities. It's below 30%, and that's something that we look to expand in a meaningful way.

Unidentified Audience Member: Following up a little bit more on that, there's no maximum--you mentioned tuck-in relative to something that's more larger scale. There's no--would something north of $1 billion be out of the question, or it sort of depends on the situation?

Al Nietzel: I mean, I will never say never, but that's not something in the immediate horizon. I mean, we've talked publicly about more of the product tuck-ins. Right now, as I think about geographic expansion, for example, we spent a lot of years acquiring DMS providers in other parts of the globe. We don't need to do that right now. There's one area that we potentially could, but we'd prefer to bring our own solution down where that is so that we don't have another DMS that we have to integrate and so forth, because that doesn't give us the scale as a provider that we want.

So it would really be a product that complements what we do or a product that is better than ours and we can integrate pretty quickly. So that's kind of where our heads are focused right now.

Ken Wong: You guys recently talked about bringing back $1 billion to shareholders by the end of calendar year '16. How should we think about just the overall, kind of the broader capital return philosophy that you've got?

Al Nietzel: Yes, I mean, it's a very topical item. I mean, I think most of the audience knows that we announced a $1 billion return program that was supposed to have taken place over a two-year period. We accelerated it one full year so that it will be completed by December 31 of 2016. I've got $630 million or so that's been done. And so you should expect further actions over the course of the next quarter, before 12/31. And it's an area that Brian, the CEO, and myself are working with the Board on now. And it's something that, in terms of the longer-term return policy and capital structure and ratios and so forth, be prepared to talk about it, likely some time in our third quarter, which is the first quarter of calendar year '17. You know, we've got a lot to do between now and then, and we're formulating a lot of those strategies and so forth right now. So expect it after the turn of the calendar year, is what I'd say.

Ken Wong: So I guess kind of just building on that a little bit, so clearly, you guys are kind of working towards what the next step is. But on the whole, I guess investors are always kind of looking for what's next, right? So you pulled that forward by a year. I guess, should the general thinking be, is there a certain, I guess, a certain percent of cash flow you're looking to possibly return? Is it more of a return, return on investment type of a line of thinking?

Al Nietzel: The way I would think about it at this point, until we talk about it at the beginning of next year, is that we've already articulated what our cash needs for the company are in terms of how much cash I need to have on hand to run the business. We're not going to sit on it; we're going to do something with it. We're going to be ever increasing our level of free cash flow through the benefits of the transformation plan. And I think, as shareholders, you should expect that that capital will be returned. We just haven't worked through what all those specifics are, but I think the way to think about it safely is that we're not intending to build enormous cash balances to do something with. We'll have a program that we'll be able to articulate what we're going to do. However, I want to leave a certain amount of financial flexibility for M&A activity, that if it arises, I'm in a position to take advantage of it.

Ken Wong: Got it. Any other questions? Otherwise, I've got one last one to close this thing up with. So my last question is just a little, circling all the way back a bit to when you mentioned you guys are no longer part of ADP. Just wondering, in terms of kind of part of this transformation, how much of that was held back from you being part of a larger parent entity? Are there certain things now you feel you can do that you weren't able to do, either earlier on in the process, and obviously, when you were part of a kind of a broader entity?

Al Nietzel: Yes, I don't know if I would say we were restricted from doing anything. And to me, it's like, not irrelevant, but at the end of the day, we are where we are right now. We as a team are executing against a substantive plan that has moving margins from 22% to 35%. It's nice having the control to do what we want to do with our Board and with the team. And I think we're going to continue to do those things that extend our market leadership position and attract investors and do those things that are needed.

Ken Wong: Got it. All right, last chance. Going once--

Al Nietzel: Going once, going twice.

Ken Wong: And done. Al, thank you very much. Appreciate the time.

Al Nietzel: Thank you. Thanks very much, guys.