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CDK Global

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STEPHANIE DAVIS: All right. Let's get started. For those that don't know me, my name is Stephanie Davis and I cover CDK here at J.P. Morgan. With us from CDK we have the whole team, we have Brian MacDonald the CEO, and Al Nietzel the CFO, Jen Gaumond in the audience, IR. We're going to consider our fireside chat format. We'll kick off with some questions, then we'll open up to the audience.

To start out, Brian, can you give us an introduction to the company for newcomers, and update on the business following your fiscal third quarter.

BRIAN MACDONALD: Thank you. CDK is the leading automotive software company. We operate in over a hundred countries. Our business, though, is primarily North American. Here in the United States we have the predominant market share in the dealer management services area. The company was spun off from ADP just under two years ago. It was basically a part of ADP since its inception.

In the first year as a public company, CDK undertook a pretty comprehensive consulting review of its cost and the cost structure, and as part of that announced a transformation plan. The transformation plan basically has a target in fiscal year 2018 of increasing margins, EBITDA margins, to 35 percent.

The start of this journey, the company was at roughly 22 percent. In the first year, which we'll be closing up on in this quarter, we've guided to about 350 basis points of EBITDA percentage improvement in the first year. We're well on our way in having a transformation, and having a pretty positive results thus far. Revenue continues to grow, the EBITDA margins continue to grow. With that, we'll open it up for questions.

STEPHANIE: All right. I'll start. This is a timely fireside chat. You guys announced a reorg yesterday. Can you tell us your thought process on the new structure, and how this plays into the business transformation plan?

BRIAN: We announced a major reorganization of the company yesterday, in large part that's very customer driven. We have, we see from the customers, a real need to bring together the assets that we have from the traditional dealer management systems, for lack of a better word. I'll call it a legacy business, and our digital assets. Five years ago we bought a digital company called Cobalt, which does websites and other services around websites.

Whether that's search engine optimization, digital advertising, reputation management, etc. Increasingly, we see our customers, dealers wanting these assets more integrated.

If you think about a world in the future where people start their buying experience online which is what happens today, but also completing their purchase online. We want to bring these assets closer together for the benefit of our customers.

The fact of the matter also is that we have a pretty complicated organization. The company has done historically a lot of acquisitions and we have a lot of legacy complexity. For example, in the current structure which is changing July 1st, we have seven R&D organizations reporting to six different places. We have five sales organizations.

We have a lot of embedded complexity in the company for a lot of historical reasons and partly also because of the way we're organized. By reorganizing the company allows us to service our customers better.

Today, customers often get two different bills from us. They may have two different sales people calling on them. Their products don't integrate that well across the suite that we have, and by changing our organization, we'll better facilitate our approach to customers. We'll also be able to improve our cost structure as a result of that.

Pretty major reorganization for the company yesterday and really one that will help us drive better customer experience as well as drive better product integration.

STEPHANIE: In the press release, you said that this reorg was included in the transformation plan and couldn't really be achieved without it. It sounds like the seven R&D organizations, those five sales teams, those are part of it.

Is there anything else that you can help wrap our minds around how to do that?

BRIAN: Sure. We'll have less executives as part of the reorganization. We'll have higher spans of control. We'll have a global R&D organization so we can leverage our global scale and get cost savings around use of tools.

Today, we often replicate the use of certain tools or processes at different places in the organization because we have multiple organizations doing the same thing. Global R&D is a big part of the reorganization -- global product management, a more effective sales structure. We'll also have less executives as part of the reorganization and higher spans of control.

STEPHANIE: Does this reorg mean that you'll be able to increase your pace of margin expansion, or maybe even hit that target at 35 percent earlier than 2018?

BRIAN: We have a target of 35 percent margin in 2018. I remind everybody that we started at roughly 22 percent. It's a pretty big lift to take your margins from 22 percent to 35 percent. All the things that we are doing including the reorg are meant to get us there. Today we are in the 27 range.

Basically we are not changing our targets. Obviously if we can do things faster we'll do them. Today we are not formally changing our targets of getting to 35 percent in 2018. We are moving as quickly as we can, and making a lot of changes, and making very good progress.

If you look at how we've guided this year, this year we'll grow our EBITDA margins about 350 basis points, which is a good step on the journey from going from 22 to 35.

STEPHANIE: Combining digital and ARNA, will there be any impact to your geographic footprint in the Northwest or is that something that's not yet on the table, because I know Cobalt historically from that?

BRIAN: No, we plan to maintain a significant presence in Seattle. We have very talent people there and we don't have any plans to make any change in the footprint there.

STEPHANIE: Then looking at the KPIs, I know historically there's actually been a very low penetration of your digital solutions into your ARNA client base. How should we think about that going forward now that they are combined? As we still going to get a website count or is there going to be a new metric to look at?

BRIAN: If you look at our earnings release a week or two ago you'll see that we've been more transparent about the transformation program. Those of you that have come to one on ones with myself and Al will see we are pretty transparent. We are obviously changing our organization structure.

Our goal is not to make investors feel like we are making ourselves more opaque. We have a commitment to be transparent and that's my style. We'll continue to do that. The number of key KPIs like number of websites and those things which help investors, there's no plan to change those in our reporting once we get the org up and running.

Just to be clear we'll report Q4, which is the quarter ending June 30th exactly as we report today. The first change in reporting structure that investors will see will be for our first quarter, which ends September 30th.

STEPHANIE: Always like to make my life easier. You are coming up in your first six months at CDK, where do you see the biggest near term and long term opportunities at the company and what benchmarks would you want to accomplish by your first year?

BRIAN: For me, I've already hit a couple of them. We made some very big improvements in our service levels, which we talked about in our investor call. We've had dramatic improvements in our service levels over 80 percent in the first quarter going into the second quarter.

Today our service response times are in the mid nineties relative to our targets for service levels. I also wanted to redesign the organization, because as I said our organization was overly complex and that drives a lot of complexity around our products, number of versions etc., much of which we disclosed in our last earnings release as we laid out the transformation plan.

We've announced the organization yesterday. We have some more work to do to work through that in June, and it will be up and running in July 1st. Those are some pretty big proof points in my first few months. We'll just continue to truck along and get the results.

STEPHANIE: Work with your transformation plan. How should we think about the timeline? I'm considering the work streams that you introduced in the last quarter.

AL NIETZEL: The transformation plan was outlined in June of last year is really on track. What we communicated at the beginning of our fiscal year '16 was that we were going to be driving incremental benefits to the tune of around $45 million this year meaning '16. We are in as Brian said our fourth quarter right now.

The call a couple of weeks back we communicated that the benefits of the transformation plan are going to be closer to $50 million. We are getting some lift in terms of our ability exceed the goals that we set for this year in '16. Our reorg that was done is really one of the key enablers to help us achieve the objectives and to give us more confidence that that can occur.

We're going to continue to execute. And as we've committed that we will continue to provide the kind of transparency against those work streams in terms of the progress we're making.

Some of them are-I don't want to say easy-but some of them can be achieved quicker than others. There are some key ones relative to the moving up work stream as we talked about that entail a lot of heavy lifting because of the sheer number of versions of our software that we have. Communicated, we have over 1,500 versions of software spread across around 70 plus products, and rationalizing that just takes some time.

We know that once that progress is being made that our organization will continue to get more and more efficient. And our plan is the 1,300 bases points for margin expansion. We've overcommitted against year one. The exit rate for our fourth quarter of this year should give us a good stepping off point for fiscal year 17 that when we layer on execution against additional programs, we feel that the plan is really quite achievable.

STEPHANIE: You touched on this, but what are really the nearest term opportunities we can think about? And what's more long term like moving up?

AL: There's a couple of the work streams and it came up a little earlier about the Seattle operation. We're communicating the need to maintain certain presences in certain geographic locations, but those footprints will be smaller.

What we're doing in a very thoughtful way as we tool up resources in both our Cinci operation that was announced a while back as well leveraging offshore capabilities. We can't allow our service levels and other deliverables to diminish as we're working through the transition.

As we think about the workforce mobilization efforts, that's a program that takes time. We're seeing some really good benefits from that. We're also seeing some good benefits from some of the disciplines we put in place around pricing.

That was an area as we thought about how we enabled or allowed discount bans to swing more widely than we would have preferred. Those have been tightened up dramatically and we're seeing some lift come through from those levers as well.

Some of the other programs that we've talked about, the number of systems that we have to get an order in the system to ultimately build through RFP to billing. Those take a little time, and we're going from 12 systems to a lot less in that order of cash process, and that one is going to take some effort to get through.

We're on track. To those programs that we can accelerate, we will. Our intention is to get the benefits of the program realized as quickly as we can, and the team is working diligently to make that happen.

STEPHANIE: All right. Thanks for the caller. When you add up the pieces of the business transformation plan that you gave in 3Q earnings, you get a broader range of $240 million to $ 300 million in cost savings. What are the puts and takes that would put you on the low end or the high end of the range?

BRIAN: It's really execution. I mean, it really comes down to executing. Some of these are harder than others, as you'd imagine. As Al mentioned, going from 12 different systems from where you make a quote to a customer to actually billing a customer, we have 12 systems in between that process which are very old and clunky. That's just hard work. It takes some time to change those out.

The real balancing act is executing all of these things more or less in parallel. Much like in life some of them turn out to be a little better than you expected and some of them turn out to be not as good as you expected. That's how the portfolio will play out.

Underneath those work streams which we detailed for investors in our earnings call, there are 200 projects. There are 200 projects that we're working on. Some of them are obviously bigger than others, and every one of those projects has a project owner, a business plan, and investment required to do it, an interlock of what other people or what other organizations are required.

To make this change in a company, to increase your margins 1,300 bases points off a base of 22 percent is no small task. I can tell you, I've worked in multiple companies and multiple industries, and it's no small task to make the magnitude of changes internally to get that level of margin improvement.

You think about underneath that you have 200 projects, every one of those projects has to be mapped to, "OK, I can't do item number X until Al has achieved item number Y." All of those things have to be mapped out and choreographed to execute all the margin.

As Al said, some of them will go a little faster. Some of them may turn out to be a little bit more difficult than we anticipated, but to be very clear with investors we're confident about our ability to meet the plan and targets that we've set forth.

You should see that in our quarterly results as we move along and see progress each and every quarter. Life is not a straight line. Life is never perfect, and, sure, occasionally we're have a quarter that doesn't look like we've made much progress, but across the trend line you should see us moving our margins up as we continue to grow the top line as well.

You'll see good progress over the next 8 to 10 quarters as we execute the transformation.

STEPHANIE: Cost was a really big focus on the transformation. Could you talk a little bit to what's fix versus variable in your call space and what is embedded in your cost [inaudible 17:13]?

AL: When we think about our overall cost structure and I think about things like the overall OpEx and our gross margins, there are elements of the product portfolio and of the offering. I'll use a couple of examples because I think they illustrate it. In X number of states we do computer vehicle registration to tag title and license your vehicle, that's a straight variable cost on that business.

We do the same with the credit bureau business. Experian, Equifax to you as a bureau gets run. There's a variable cost element of it. In the advertising business-because people know that we have a digital asset. That Google fees and whatnot are straight variable.

What we would expect to see, and I think we've talked about this when we launched our transformation plan is that we would expect to see good leverage coming from the SGNA space, number one. We would expect to see good leverage coming from some of the OpEx areas as we think about the programs that we're executing, particularly in terms of improving the implementation process in some of the items that Brian talked about on the service.

One of the messages that we really try to convey to both our employees as well as our clients is that the opportunity to improve our performance, both from a service and delivery perspective, in addition to moving the margins up are not events that are one or the other. We can do both because there's good opportunities to scale the business in a different manner than we do today.

We would expect to see good scale in the business, particularly in SG&A and in some of the areas of the operating expense, as well.

STEPHANIE: When you think about the opportunity to accelerate the transformation plan -- I know that's been brought up a lot -- what would the puts and takes be of a one year versus a three year plan?

BRIAN: We have a three year plan, so let's be clear on that. We have a three year plan. Inside of the three year plan, there's things that will happen each year. Some of them will get checked off earlier along the way.

Some of them will take the full three years. We have a three year plan. We have a margin target of 35 percent, which is a 1,300 basis point improvement from where we started. We're executing against that. You'll see the benefits of that each and every quarter.

STEPHANIE: Do you think there would be any value in accelerating the plan, the way some investors have suggested?

BRIAN: There's nobody more incented to accelerate the components of the plan more than the management team. Every day, we come to work, and we think about how we can do things faster. That's one of my three cultural mantras, is I call it need for speed.

Every day, we come to work, and we think about what we can do faster, what we can do more of, how we can go further. That's a consistent journey. We've laid out a pretty comprehensive plan, and we're executing against that.

STEPHANIE: Thinking about pricing, how much room do you have in pricing of your products versus your peers?

AL: I've told people this before, and I'm involved in a number of transactions personally. The pricing is an area that we continue to look at. It's an area that we continue to fight with competitors in our space, because there are multiple competitors that we compete with.

Each and every single transaction, whether it be a layered application, or whether it be a switch-out, if they choose to shop the DMS, becomes a competitive fight. We very diligently look at all the elements of our portfolio, and do our best to maximize lift that we can get from a pricing side.

We do it day in, day out. Across our $2 billion portfolio, previously we garner about one percent or so of price across the overall portfolio. As we've exited, or we're entering the magnitude of the transformation period, that price element is more like a point and a half to two points, in terms of lift.

It's brought about as a result of more of the discount band eliminations that we had, and tightening of those controls, and leveraging our pricing power in those areas where we can, and so forth.

STEPHANIE: Can you talk about which areas where you have pricing power, looking through the segments? What is it in ARNA, Al, versus digital?

AL: The international arena, we don't have as much of the pricing elasticity. A lot of those are contractual, and tied to CPI. There isn't as much of opportunity that we see internationally on that. The digital business is highly competitive, as I think most in the group know.

The subscription elements of the revenue stream, we do have some pricing power. We take marginal price increases on websites, and some SEO, and procare services. The bulk of the pricing power that we do have is in the core business within North America.

Not the whole portfolio can be price increased, clearly. There are certain elements of it that are mandated. The computer vehicle registration example is one, where it's mandated by the state. Bureaus, not so much.

It's the subscription-based revenues that we can price increase, whether it be contractual or otherwise. That's the area of the business where we have the elasticity.

STEPHANIE: Do you have any other further pockets of opportunity, such as the integrations opportunity?

BRIAN: I would say there's opportunity for a lot of improvement in CDK. There's nothing that we're not taking a hard look at. The fact that we have 200 projects tells you that we're not leaving many stones unturned.

There are no sacred cows in the company to look at or to approach. We just did a major reorganization, a major redesign. If there's opportunity there, I can assure you we're going to go get it. You can look at my background, and some of the things I've done in other companies and other industries.

Investors should feel assured that if there's an opportunity there, we're going to go, and try to get it.

STEPHANIE: I know it's still early days, but could you size the kind of lift that you're getting from the integrations opportunity?

BRIAN: No. We report our results quarterly. We laid out for you a number of work streams, and what the dollar values are. We'll be having a quarterly call to talk about Q4 soon enough.

AL: Embedded within the work streams that we've articulated are various levers that we pull with respect to price across the portfolio.

STEPHANIE: I'll have one more question before I open up to the audience. One of the big themes among the other DMS players of NADA Convention was this greater focus on the upmarket, which is your traditional bread and butter. What do you view as your moat against these new entrants?

AL: These are great customers. CDK made a great strategic decision many years ago, which was to really penetrate the bigger dealer groups. Those groups are getting bigger. That drags volume to us, and market share to us, very naturally.

Those customers are clearly focused on service technology. Of course, we have long term contracts with them, but we have to earn their business every day, which we're very focused on doing. We just had a major win with the Hendrick Group, which is validation of our strategy, and our approach with these large dealer groups.

As they grow, we help facilitate their growth. If they buy 18 stores, and they're not CDK stores, we jump through hoops to help them get those stores onto their system. They're really important customers to us, and we know it's really important to them to get those new 18 stores onto their system.

As they grow, we help facilitate their growth, and we grow with them. We're very happy with that strategy in that part of the market.

STEPHANIE: Using the Hendrick one as an example, what was your secret sauce behind that land?

AL: Our team has been working on a relationship with Hendrick over a long time. These are really relationship businesses. Our team has been working on a relationship with Hendrick for many, many years.

That's a very big decision for someone of the magnitude of Hendrick to make, to come over to us. Our team worked on it pretty hard for multiple years, quite frankly. At the end of our day, it's our product suite, and what we can bring that makes the difference.

Fortunately for us, there's a proof statement. They're coming over to us, and we'll take the next year or so to ramp them up.

STEPHANIE: With that, we'll open up to Q&A. As a reminder, there is also the portal that you can use for tablet questions.

AUDIENCE MEMBER: Can you talk a little bit about product extension, what might be coming in the future, beyond the focus on reorg?

BRIAN: We have a pretty good position in the core DMS. Call our market share low 40 percent. We had layered apps that basically attached to the DMS. There's opportunities for us to grow our penetration levels around those as we move forward here in the future.

I see that in areas like service edge, our inventory tools. We have good opportunity to grow our penetration around those layered apps.

AL: Maybe connected store is another one that's coming, as you read about the digitization, as well as the online experience mirroring the brick and mortar experience. Embedding elements of the DMS into the website, so that when folks are beginning their journey, they can do a lot of those transacting online, so that to the penny, when they come in, the payment's the same.

One of the worst things that can happen is you say online, "Your payment's $379." You come in the store, and they say, "We were kidding. It's more like four and a quarter." The tools that we've integrated into the website in pilot now enable that transaction to happen to the penny, which is very beneficial for the dealer.

AUDIENCE MEMBER: North America DMS sites have been down sequentially two of the last three quarters. Clearly, as investors, we like getting that margin lift from doing fewer installs. How are you balancing revenue growth, and wanting to still be a share gainer in your core business, versus the cost of losing money on installs?

AL: I would view the sequential decline as really an anomaly. Don't be trending that out. We had a list of clients in Canada that had a relatively small package of integration into the OEMs. Relatively low price point, so you'll see that we continue to still get a lift in the average revenue per site.

I wouldn't trend that one out necessarily. We are continuing to see good growth. The Hendrick example is one that we'll start to see some of the lift over time with that. Do we lose business? Yeah, we lose business.

It tends to be on more the lower end of the market. Our focus is really to continue to gain new sites in all of our channels, including RE International, as well as in the adjacent seaside. It's more of an anomaly.

We'll still penetrate the base with layered apps, as was referenced to your left.

AUDIENCE MEMBER: I was just wondering -- I guess we'll see in the next proxy -- how management incentives are structured to hit some of the targets around either 35 percent EBITDA margin or otherwise?

BRIAN: The question's how is management compensated around the 35 percent EBITDA target. Management is directly compensated, tied to those 35 percent targets. The management team was awarded equity grants in September of last year, with a certain structure built around that, the 35 percent targets.

I joined the company in December, and my specific request was to have the same set of targets as the management team. I want to ride with the management team, and I want the management team to ride with me, and those targets around the 35 percent.

STEPHANIE: Any other questions, or I'll continue? Thinking about the saturation of the domestic market, the next leg of growth -- and you mentioned this -- will come from greater penetration of your layered apps. Where do you see the greatest attach rate opportunity?

BRIAN: We have a good product around inventory management. Connected store, as Al mentioned, we have beta sites for that now at a number of dealerships, which is being very well-received. That is a good opportunity for us.

Our service products, there's a number of them, quite frankly. As Al mentioned, when we look across our penetration of layered apps, that they're not that high, quite frankly. And it's an opportunity for us to grow those, which will be one of our focuses over the coming years.

STEPHANIE: Could you size the penetration level? Is it 20 percent? 30 percent? 50 percent?

AL: Largely sub. Some of them there obviously is a gamut. Some are in the 30s. Some are in the single digits. It's a real dispersion of penetration rates. Quite frankly, I think they can all move up, and that's got to be a focus of ours. We've got some product issues to work on. That will help.

We've got some sales structures to work on, which will help, but it's clearly an opportunity for us, especially with the penetration. I mean, we've done a very good land grab in the DMS space. We're very embedded there with low 40 percent market share. There's a vertical opportunity for us to grow the penetration around the embedded base we have.

AL: One of the real benefits of the re-org that Brian announced yesterday is really leveraging the digital capabilities in terms of a sales force with the DMS side. And you'd be surprised at how low a penetration we have -- meaning we, CDK -- of the digital assets within our core. It's less than 30 percent.

There's tremendous overlap opportunities that we have, and with the combining of the sales organizations that was announced yesterday, we see that as a leverage point for us to really have a dealer that has our core coupled with the digital assets to have a real pointed differentiation in the market. And that's really a focal point in terms of the focus on sales.

STEPHANIE: Still a lot of runway left. Shifting gears and thinking about the RE business, you have a much broader geographic scope than a lot of your peers. Could you talk to the global OEM contracts that keep you in certain geographies or if there's any kind of value in having this broad geographic base?

BRIAN: Outside the United States, the OEMs tend to have much more influence over the dealer body and what dealer management system they use. So for example, it's not abnormal for an OEM to mandate in a country, Spain or Portugal, pick whatever country you like, that every one of their dealers in that country would use that DMS.

We have a very good product. We have good penetration, a number of countries with Mercedes-Benz, BMW, real marque customers. Jaguar Land Rover. We think there's some good upside there in the shorter term in the next year or two. There's a lot of embedded complexity in Europe as well. And consolidating operations there in Prague and back offices and doing a number of things of that nature.

For the next year or two, we're growing margins there. We have a 25 percent EBITDA margin target for Europe, which is up from probably 15 or so in the last two years. We're making good progress on that. So fundamentally we have a good product. We tend to follow the OEMs just because of the way the business works outside of the United States and Canada, but we think there's good upside there.

STEPHANIE: All right. Thank you, guys. That's all the time we have left. Al, Brian, thank you for coming out.

BRIAN: Thank you.

AL: Thank you so much.

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