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CDK - CDK Global Inc at Nasdaq Investor Program

EVENT DATE/TIME: NOVEMBER 29, 2016 / 3:00PM GMT

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PRESENTATION

Brian Essex - *Morgan Stanley - Analyst*

Okay. We'll start this off. So good afternoon, everyone. I'm Brian Essex, Morgan Stanley's vertical software analyst. With me today I have Al Nietzel, CFO of CDK Software.

And for those that are not familiar with the Company, maybe the best thing to do is maybe start off with a little introduction around a little background of the Company and what you do (inaudible).

Al Nietzel - *CDK Global, Inc. - EVP & CFO*

Sure. Good afternoon, everybody. I'm Al Nietzel, CFO of CDK. Just a brief overview of our Company, we're a leading technology provider of solutions for the automotive retail channel throughout the globe. We basically provide services from accounting part service inventory through the development of websites coupled with placement of ads and so forth on behalf of dealers.

We just reached our two-year anniversary as a public enterprise, a little over. We were part of Automatic Data Processing for almost 40-some years. Good business. We've outlined a major transformation plan over the course of last year. We're one year into it. It's a three-year plan that's aimed at improving the financial profile of the Company from a 22% EBITDA margin up to 35%.

We operate in about 100 countries in terms of providing services for our clients. The transformation plan is expected to be completed at the end of our fiscal 2018. We've got eight significant work streams, again aimed at improving the financial profile of the Company.

From a financial perspective, we reported our FY 2016 results in August. We had a 5% revenue growth trajectory, about 370 basis points of EBITDA margin expansion, we reported our first-quarter results just recently and we had substantial margin expansion of around 590 basis points.

We provided our -- reaffirmed our guidance for fiscal 2017 which is 4% to 5% revenue growth and we expanded our margin projection to 525 basis points to 575 basis points. And we also just provided a little bit of exit rates for both FY 2018 as well as beyond, 36% to 38% to the end of 2018 and 40% as we exit 2019. So, well on our way.

Brian Essex - *Morgan Stanley - Analyst*

Great. For such a new public company, a pretty substantial market cap and part of that's enabled by the spin. Maybe could you discuss, maybe touch on the spin and what it's enabled you to do and how you are different now that you emerge as a public company?

Al Nietzel - *CDK Global, Inc. - EVP & CFO*

Yes, sure. I think first ADP, Automatic Data Processing, is a rich horizontal play with human capital and payroll processing services for all verticals. We are a deep, horizontal and automotive and accordingly we're able to really support a fit and focused mantra and I think it's proven to be pretty helpful for both the Company as well as for investors.

It really gave us an opportunity to take a real fresh look at how we operate and what we can do to be better, and I think we're executing against that through the first year. Long way to go yet, but we're executing it well.

Brian Essex - *Morgan Stanley - Analyst*

And it's kind of an interesting market that you operate in. I mean, there is primarily three large -- really two large [venders] in the market of which you are one. I mean, how do you see the market competitively? Who do you typically bump into? And maybe on the end markets it's a consolidating dealership market, particularly in the US, how do you see yourself maintaining your growth rate in that environment?

Al Nietzel - *CDK Global, Inc. - EVP & CFO*

We think about -- it's a very -- most of the industries it's a competitive set of players that we're up against. In the US, primarily North America, there's really three players. It's ourselves, it's Reynolds & Reynolds, another company, a private company, and the Cox Automotive Group that has a collection of assets that we compete against.

The industry is competitive and it will continue to be for a long time in our view. There is, Brian to your comment, a continued consolidation that's occurring within the industry, meaning the number of dealership rooftops, while it's relatively flat at, call it, 17,600 rooftops in the US, there is actually a consolidation of owners. So the number of owners is actually getting fewer in that the large companies are tending to buy other players and that plays to our advantage, frankly, because we are indexed particularly well at the medium to high end of the market in terms of our market share. And I think we continue to enjoy some of the benefits through consolidation because as acquisitions in the industry occur if they're not on our -- quote -- DMS, Dealer Management System, which is really the ERP for the car dealership, they tend to come our way relatively soon. So that plays to our advantage.

In terms of growth, we like to think of growth coming at least through the transformation plan in kind of three main areas. I mean, one is we will continue to enjoy market share wins both domestically as well as internationally and we like to get a point or so per annum as a result of market share increases. And the real strategy that we have is about layered application penetration. So as we gain a new customer and new client, we like to add additional products and services onto the core, whether they'd be application specific for service area, application specific for managing inventory, CRM solutions, we have an integrated phone solution that we can offer dealers that tends to work well and we look forward to two to three points of growth per annum for layered application penetration. And then we do have some ability price wise and we look for another point or two per annum across the entire portfolio from pricing.

Brian Essex - *Morgan Stanley - Analyst*

From a competitive perspective, there are some vendors that play at the smaller end of the scale. I mean, how many are there and do you see those vendors at a disadvantage you bump into them or see anyone emerging as maybe an incremental competitor in the market?

Al Nietzel - *CDK Global, Inc. - EVP & CFO*

Yes, I think, again domestically, meaning domestically in the US it's the same players. There's a few other on the kind of lower end of the market that serve one and two point stores. Internationally, it's a far more fragmented business. Each country could have multiple DMS providers and the relationships that we enjoy with the OEMs or the manufacturer, it's more of an OEM endorse model. So you get the ability to offer your DMS in market and that endorsement needs to come from the manufacturer, unlike the North America market where it's more of a franchise dealer market. So, the competitive array on both the DMS as well as the layered applications is fairly fierce and we have to prove our value every day.

Brian Essex - *Morgan Stanley - Analyst*

Okay. And you touched on briefly difference between the North America and European markets. North American growth, I think, seems to be a little bit better. How do you see things in Europe? Do you see a recovery there? How much does that matter for your plan going forward?

Al Nietzel - *CDK Global, Inc. - EVP & CFO*

We are, in our view, underpenetrated in the international markets outside North America and feels that we could do more. And we believe that it's part of an important ecosystem that we want to continue to play in and continue to grow.

Our business internationally is a bit over $300 million right now and we think there is good opportunities for that to be a strong contributor to both our topline growth and our aspirations relative to the margin goals that we've set for ourselves, so a key part.

And we think that economically, particularly in Western Europe, where it seems to be at a little bit of a trough and therefore a nice platform for us to grow. There's been a lot of consolidation in Central Europe in particular, but we think Asia Pac markets I think can continue to grow as well.

Brian Essex - *Morgan Stanley - Analyst*

Okay. And one of the questions I always get when people are taking their first look at CDK is when you talk about the auto market people talk about SAAR and how many autos are sold and I think that's columnist exception versus the way that your model works. Maybe help us understand primary drivers of growth and pricing in your model and how that may or may not be impacted by automotive sales cycles.

Al Nietzel - *CDK Global, Inc. - EVP & CFO*

Yes, I mean that the new car sales activity which is referred to as SAAR is an important indicator for the health of the industry. Our model is not particularly susceptible to transactions. Transactions are good when they're going up, but transactions across our portfolio only represent about 10% of the revenue and it really is a better indication of what the health of the market is.

And I think one of the indicators that we have that can kind of demonstrate the resiliency of the model is really what happened in 2008, 2009 when the US auto market went from some 17 million units to 10 million units. Our revenues during that period were down marginally in the 3% range. Because of the stickiness of the solution, the critical nature of the solution, we are the ERP for the car dealerships. And therefore, it's quite necessary obviously, I think we fared well with that. And it really gives us an opportunity when the market is tighter to be going proactively at the dealers to show how our solutions can help them save money and run their operation more efficiently. So for us, it's actually been a good thing.

Brian Essex - *Morgan Stanley - Analyst*

Okay, great. And then, Brian, your CEO, noted on your last earnings call that in competitive situations dealers tend to be economically driven. How much of the renewal or purchase consideration is economics as opposed to feature functionality of your platform?

Al Nietzel - *CDK Global, Inc. - EVP & CFO*

It's probably a little bit of both, but I think the comment that our Brian made on the call is that yes it's very competitive. Car dealers make decisions based on economics obviously, but there is also an important element to buy into the strategic vision that we have about how the automotive retail industry is changing and how we at CDK can help our dealers cope with that change, manage their operation as efficiently and operationally well as they can. And I think we've seen that play out over the course of the last -- over the last few years. So the economics and the financials are one part of the deal or transaction. But it's also strategic vision, it's about the partnership that we have with the dealers and I think that plays well for us.

Brian Essex - *Morgan Stanley - Analyst*

Great. And next, I mean, you mentioned your transformation process that you've announced. Maybe we can spend a little bit of time on that. I mean, there's a lot to it. Maybe if you can highlight maybe the most salient points of that process and where you stand now and what's left to accomplish with the transformation plan.

Al Nietzel - *CDK Global, Inc. - EVP & CFO*

Yes, we announced a fairly significant transformation plan in June of 2015 which is year one of the three-year plan. There is eight significant work streams, they are published work streams in terms of what we're working on. I think the results kind of speak for themselves that over the course of the last 15 or so months we've been able to substantially improve financial profile of the Company through the benefits of the various work streams. While at the same time continuing to grow the business and in our view continue to extend our market leadership position. It's really about things like removing silos, creating centers of excellence that can allow for a different type of scale, challenging ourselves in terms of spans and layers of the organization and doing things just to streamline the organization in a far more effective way. I think, again, we're well on our way. There is more work to do. There is a work streams that are particularly hard. One that we call moving up, which is reducing the number of versions of our software, that's a very tricky program because -- and we don't want to put our clients in play by forcing a migration, if you know what I mean. So, we're making good progress, reduced the number of work streams, -- sorry, reduced the number of versions, but we still have a fair amount to go.

Brian Essex - *Morgan Stanley - Analyst*

And maybe on the point of reducing the number of versions you have in the market, I mean how far along are you and how long is that process? (multiple speakers)

Al Nietzel - *CDK Global, Inc. - EVP & CFO*

I don't know if that ever ends. But we talked about having a little over 1,500 versions of our software layered applications plus the core. We've reduced it by about a third already. So we're down below 1,000. However those were I would categorize as the easier ones, things that would happen behind the curtain that didn't necessarily impact the clients or the workflow. The next level of those activities are going to be a little more challenging and they are going to take some time. And we've identified that that particular extreme has a longer tail on it and we don't expect that to be completed really until 2018 or even 2019.

Brian Essex - *Morgan Stanley - Analyst*

What tends to be difficult about that last bit, is it maybe they are on premise versus cloud or they require more training or it's more of on the ERP side of things than the peripheral marketing side, what do those look like?

Al Nietzel - *CDK Global, Inc. - EVP & CFO*

The things that make it challenging is it can create a change in the workflow. So, if we have a version of our software that a client or customers are used to how they do their job and the newer version of it has a different UI that requires change to the way they do their work, those are the things that create more engagement with the clients and therefore could take a little longer to execute. So that's really the prime difference.

Brian Essex - *Morgan Stanley - Analyst*

Got it. And then maybe we can touch on other parts of this transformation effort in terms of the way the dealerships experience it. What are those conversations like when you go to a dealership and you need to migrate them to a new version of software, you need to change something -- change something that they're used to, how does that conversation transpire?

Al Nietzel - *CDK Global, Inc. - EVP & CFO*

Yes, I think the early stages of elements of the work streams have really, in most cases, benefited the clients more because we're making improvements to the service delivery model both in implementation as well as in service. As it relates to the versioning, as I said earlier, Brian, those changes that we've made have been more behind the curtain thus far. The next level of changes will involve more engagement with the client. But ultimately it's really about our newest and latest version of the software is better. It allows for more efficient workflow and a better experience for their employees as well as as ours obviously. So it's really positive, even though it could be difficult to do particularly if the workflow is changing.

Brian Essex - *Morgan Stanley - Analyst*

And then you've outlined along with that transformation program, I guess, a little over a year, year and a half ago on your Analyst Day you kind of set out some cost savings and margin expansion targets. Of the savings you are benefiting from, how much are you reinvesting in the business and where exactly are you investing?

Al Nietzel - *CDK Global, Inc. - EVP & CFO*

Yes, the areas that we're putting money in right now are really in the development side of the house, in R&D. One of the real benefits of reducing the number of versions of your software is you don't have to spend scarce R&D dollars on maintaining existing code to multiple versions. And so the money can be put into applications that benefit the service area. We're investing pretty heavily right now into inventory to manage the inventory of dealers in terms of pricing. There's a fair amount of investment going into the digital side of the business with making the both online as well as brick and mortar experience similar. So we're trying and are putting a lot of our applications onto website so that the experience for most people can be done at home and they can do more of the transaction online and that's a heavy investment area for us.

Brian Essex - *Morgan Stanley - Analyst*

Got it. And then I just wanted to kind of touch too on the kind of layered application side, I mean, if I can just follow up on that. Is there a good way to measure what the attach rate is within in your customer base? And some of what your software does is pretty interesting both from the service side as well as parts in inventory into the marketing. I mean, how -- is that attach rate improving and do you have kind of goals around what that could potentially be?

Al Nietzel - *CDK Global, Inc. - EVP & CFO*

Yes, I mean, it's all kind of authored into our growth strategy of getting 2 to 3 points of revenue growth through layered application penetration. And what I'd just remind is that there is core functionality within the ERP or the DMS system, but there are add-on applications that provide much greater efficiency in some cases, particularly in the service areas. And we think that the headroom for growth within the applications are high. As we think about both inventory, CRM, service applications, [collecting the apps], on average they are about 20% penetrated in terms of our base, some higher, some lower. And we have some internal metrics that are looking at what we measure in terms of attach rates to try to get our clients to take on more and more of our layered applications. And we've got some areas of opportunity in our view.

Brian Essex - *Morgan Stanley - Analyst*

Okay. And I think you mentioned before that you've taken guidance up. You have a pretty healthy exit rate outline for EBITDA margins for fiscal 2018. Maybe help us understand what some of the core drivers are and how high do you think gross margins can get, I guess, from a target model perspective?

Al Nietzel - *CDK Global, Inc. - EVP & CFO*

We've announced a plan that has an average for 2018, our fiscal 2018, of 35%. We've got an exit rate in 2018 of 36% to 38% and then an exit rate in 2019 of 40%. So our view is that 40% is a decent threshold. We will enjoy some scale post that as the revenue continues to grow. What we're really attempting to do both internally as well as externally is not change the dialog from one of margin to one of EBITDA growth and we've got incentive plans that are driving both of those levers. And we'd like to see the revenue trajectory post transformation plan to be a little richer than 4% to 5% and we will focus a lot of energies around what do we do to get once all the activities inside the Company have stabilized and so forth we get back to a little higher revenue trajectory and a model that scales a bit on the bottom. I'm not going to talk about the ceiling perhaps, but we get to 40% we will talk about what we do after we get to 40%.

Brian Essex - *Morgan Stanley - Analyst*

Okay. And then you've also recently changed the way you report your financials in terms of the business segments that you're reporting. Could you maybe help us understand the drivers for that change, why the change in methodology and what that means for reporting going forward?

Al Nietzel - *CDK Global, Inc. - EVP & CFO*

I mean we had a new CEO, Brian MacDonald came in. He has been with us for about a year. And shortly after his arrival, we did a fairly substantive reorganization, which again was aimed at eliminating silos and better focusing on the customer experience. And in conjunction with that we changed our segment reporting so that the elements of the digital business that were of more a onetime advertising variety were broken out separately. And other parts of the digital business that were more subscription based fell into the core, which was called -- which is now Retail Solutions North America. It really reflects our both go-to-market strategy and what we're trying to do to leverage our core customer base with more website and subscription-based services.

The advertising business has with it a much different margin profile because of the pass-through expenses with Google and Bing and Yahoo! and what not because we're placing ads on behalf of OEMs and dealers and I think that makes a lot more sense in terms of being able to explain what the profile of the business is. The financial characteristics of advertising are far different than the core in terms of its margin profile and we think it's just sensible in terms of how we've reorged the Company.

Brian Essex - *Morgan Stanley - Analyst*

Great. As part of the plan you highlighted, I think it was in the summer of 2015, when you had the margin expansion, also with that came a renewed focus or a focus on improving or enhancing shareholder return. You had a number of different initiatives that you highlighted. Could you maybe walk us through some of those initiatives? And included in that is more recently a completion or nearing the completion of returning $1 billion in capital to shareholders. How do you think about shareholder return in light of those initiatives and then what's next after this completion of this $1 billion capital return plan?

Al Nietzel - *CDK Global, Inc. - EVP & CFO*

We had announced $1 billion return program that too have taken place over a two-year period which supposed to have been completed at the end of calendar year 2017. And with the confidence that we have in our ability to execute against the transformation plan plus normal financial flexibility that the business model provides, we accelerated that return program by a year and we're just about finished executing against that $1 billion return program. As I said on the last earnings call, we will be announcing on our second quarter earnings call what the longer-term financial profile in terms of leverage and return represents, but suffice to say that we're going to continue to utilize our financial flexibility for both M&A as well as continued return of capital to shareholders.

Brian Essex - *Morgan Stanley - Analyst*

Okay, great. And the clocks tell me we have about five minutes left. So want to give an opportunity if there is anyone in the audience that might have a question. If you do have a question, just raise your hand and hopefully I'll see you and then we can kind of reach out.

I want to touch real quickly on lot of what's been in the news over the past year and a half or so has been activist investment in the Company. Can you talk about how you balance your relationship with the activists to return capital versus the need to drive longer-term shareholder value and what those conversations are like?

Al Nietzel - *CDK Global, Inc. - EVP & CFO*

Yes, I mean, we've had an interesting shareholder registry since we've separated from our parent and the dialog and relationships that we have with our investor base is very, very productive. Candidly we see eye to eye on most issues. And while it's always a balancing act that we tend to strike, the things that we're doing are really aligned with specific shareholders as well as other shareholders. So, our continued focus on growing the business, expanding the margins, and returning capital are fairly consistent with what the shareholder base is asking.

Brian Essex - *Morgan Stanley - Analyst*

Do you have a -- with respect to capital investment in the platform, I know you had some leverage, you also have good cash flow, how do you -- what are your priorities in terms of capital allocation as you kind of balance those priorities?

Al Nietzel - *CDK Global, Inc. - EVP & CFO*

I mean, as we've -- we've said that 70% to 80% of free cash flow is going to be provided back to shareholders. We do not have a particularly capital-intensive business. So there's not a whole bunch to use there. I mean, first priority is really going to be continue to be invest in the business. We are going to engage in certain M&A activity. And then we have about a 1% yield on a dividend and we talked about a cash balance that's required to run the business. And the delta between free cash flow generation, cash needed to run the business coupled with the leverage target we'll essentially be able to determine what we'll do for buyback. So I mean, investing in the business, M&A activity and return of capital is where we go.

Brian Essex - *Morgan Stanley - Analyst*

With respect to M&A, do you have a particular objective of what you might acquire and how might you look at potential target? Would it be something transformational or would it be tuck-in IP or geographical expansion?

Al Nietzel - *CDK Global, Inc. - EVP & CFO*

Our focus is really about more a tuck-in type acquisition that fills out part of the portfolio that we might not be as strong as we'd like to be that gets us to market a little quicker than perhaps we could do by developing ourselves. I don't see anything in the horizon that I would categorize as, Brian, transformational. It's not like we're going to add another leg.

We've got a good geographic reach as it is. The only place that we really don't have a presence is in South America. Right now that's probably not going to be in the cards. But as we think about the other countries that we serve, we're in over 100 countries with our solution and providing it to clients. So I think that's product tuck-ins, perhaps a digital asset internationally, those are kind of where we are looking.

Brian Essex - *Morgan Stanley - Analyst*

Okay. I want to ask also on -- in terms of when we look at your performance geographically, another question that's come up, when you look at the performance in Europe, and it's a little bit economically slower than the US right now, the question has been asked do you need to be in Europe. How do you think about either the geographies or the OEMs that you support and how that might drive value for the platform in the long-term?

Al Nietzel - *CDK Global, Inc. - EVP & CFO*

I mean, we strongly believe that having relationships on a global basis with the OEMs is a key part of long-term value creation. Our international business, while not as big as we'd like it to be right now, we believe that's a great focal point for us to continue to grow and it will be an important part and is an important part of relationships that we've developed over time with the manufacturers because the manufacturers drive a lot of the endorsements and decisioning internationally and we believe having a platform that can scale there is very, very important as they expand or as they consolidate because they have a lot of DMS providers right now and all their back-end systems have to be fed by those local providers and the less of those providers they have, the more scale they can enjoy as well. So we think it's a vital part of our strategy.

Brian Essex - *Morgan Stanley - Analyst*

Okay. [I need to ask quick] one more. I know you don't break out how much OEM revenue versus dealership revenue, but if you could help us understand the breadth of what you offer to both the OEMs and the dealerships and how they're connected, I think that will help maybe tie everything together?

Al Nietzel - *CDK Global, Inc. - EVP & CFO*

Yes, I mean essentially the bulk of our revenue is paid by the franchise dealers around the globe. The OEMs certainly are a vital part of what we see internationally. I think the thing where it's starting to stitch together more is on the digital side where manufacturers are trying to get eyeballs of consumers onto their websites to get that experience going and then it pushes them down into a dealership around the globe. So, I think that's where the combination of brick and mortar and online is really a kind of coming together in a more meaningful way and will be more so over the course of the next five years.

Brian Essex - *Morgan Stanley - Analyst*

Okay, great. With that, I think we're at the end of our allotted time. So, Al, thank you very much. I appreciate it.

Al Nietzel - *CDK Global, Inc. - EVP & CFO*

Appreciate it.
