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NUAN - Q2 2017 Nuance Communications Inc Earnings Call

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OVERVIEW:

Co. reported 2Q17 non-GAAP revenues of $511.1m and EPS of $0.43.

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CORPORATE PARTICIPANTS

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to Nuance's Second Quarter Fiscal 2017 Conference Call. (Operator Instructions) As a reminder, this conference is being recorded. With us today from Nuance are Chairman and CEO, Paul Ricci; CFO, Dan Tempesta; EVP of Corporate Strategy and Development, Bruce Bowden; and Director of Investor Relations, Christine Marchuska. Now I would like to turn the call over to Ms. Marchuska. Please go ahead.

Christine Marchuska

Thank you. Before we begin, I'll remind everyone, our discussion this afternoon includes predictions, estimates, expectations and other forward-looking statements. These statements are subject to risks and uncertainties that could cause material differences in our actual results. Please refer to our recent SEC filings for a discussion of these risks.

All references to income statement results are non-GAAP, unless otherwise stated. And as noted in our press release, we issued a set of prepared remarks in advance of this call, which are available on our website. Those remarks are intended to serve in place of extended formal comments, and we will not repeat them here.

I will now turn the call over to Paul.

Paul A. Ricci - *Nuance Communications, Inc. - Chairman and CEO*

Good afternoon, everyone. Before taking your questions, I'd like to address several highlights from our earnings report. We continued our momentum from the first fiscal quarter to deliver robust results in the second quarter across all of our financial metrics. Net new bookings grew more than 30% year-over-year, sustaining our overperformance of bookings in the first quarter of 2017. We reported non-GAAP revenue of $511.1 million and of particular note, returned to organic revenue growth. Importantly, our recurring revenues achieved 75% in the quarter, up 300 basis points from the same quarter last year, and cloud and hosting revenues reached 40% of total revenues in the quarter.

Our gross margins and operating margins exceeded our internal expectations owing to our revenue performance and continued focus on expense management and productivity. EPS is $0.43, exceeded our guidance, reflecting our revenue performance and cost discipline. Finally, cash flows remained strong at $125.4 million.

In summary, we're pleased with the financial performance for the second quarter and the first half of the fiscal year. In addition to our financial results, we're especially pleased with the robust pipeline for our advanced solutions, including our Enterprise omnichannel offerings, which use conversational artificial intelligence to deliver superior customer service.

The demand among automotive manufacturers for our AI capabilities remains unabated. And the pipeline for our Dragon Medical cloud solutions, now augmented with realtime analytics to support the physician, continues to be exceptionally strong.

Overall, the increased adoption of these advanced offerings in key verticals and the continued demand for our domain expertise contributed to another robust net new bookings quarter and provided a very full pipeline for the second half of the year.

Therefore, we are raising our guidance for net new bookings growth from the previous target range of 2% to 6% for the full year FY '17 to a revised range of 6% to 10%. Based on our revenue performance for the first half and the increased composition of recurring revenues, we've also raised the midpoint of our full year revenue guidance.

This improved bookings and revenue guidance is based on confidence in our sustained performance, including our expectations as we noted in our comments last quarter that our Healthcare and Mobile segments have the potential for overperformance for the full fiscal year, offset in part by a continuation of the sluggish results we've seen in Imaging year-to-date.

Margin and earnings in our first 2 quarters also benefited from expense discipline and our ongoing focus on our transformation program. Although some of the benefits of this discipline will carry into the second half, we should note that our overperformance in bookings this fiscal year carries with it additional sales and commission of expenses of about $0.02 per share. Additionally, we will need to materially increase our headcount in our Automotive business in the second half to serve the robust Automotive bookings this year and to ensure that we can serve our customer commitments and address the pipeline of opportunities for fiscal year '18.

We're also adding expenses in this half, such as cloud infrastructure, which will allow us to achieve additional transformation savings in FY '18.

In closing, let me comment that we will continue our transformation program throughout the remainder of fiscal '17 and into fiscal '18 with the twin goals of improving our efficiency and redirecting expenditures towards our highest growth businesses. As we've indicated previously, we expect to reinvest most of these ongoing savings towards further growth in order to sustain our organic growth this year and to further improve our growth rate in FY '18 as we've previously guided.

With that, we'd be pleased to take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question will come from Tavis McCourt with Raymond James.

Tavis Christian McCourt - *Raymond James & Associates, Inc., Research Division - Research Analyst*

Paul, in the prepared remarks, you talked a bit about strength in a few different Enterprise product categories. But clearly, it's been the segment that's had the strongest organic growth really now for 4 more quarters. And I guess, maybe if you can dig into some of the detail, what the demand drivers there are and how sustainable you think this level of organic growth could be. And then a quick financial question on the guidance. I think for the full year, you indicated CapEx of $50 million to $60 million, which is a bit back-half weighted, and so I guess my question is, is that conservatism or is that also part of the spending in auto or elsewhere to support some of the growth you expect in '18?

Paul A. Ricci - *Nuance Communications, Inc. - Chairman and CEO*

Okay. With respect to the Enterprise question first, what's driving the performance in our Enterprise business is a combination of our differentiation in self-service and the breadth of our vision in serving omnichannel solutions. I think that is a durable differentiation for us, and I think it's serving a durable demand. We're seeing success across the product line, including our on-premise solutions, our voice biometric solutions and our digital omnichannel cloud solutions. Customers are going through a transformation of their customer service operations to fully embrace this omnichannel vision, and we're in the early innings of that vision. So I think the opportunity in the market remains large, and our position is distinct, so I think it is a sustainable opportunity for us. With respect to the capital question, I think it's a reasonable estimate for the amount of capital expenditures this year. Capital expenditures may pick up a bit in the second half, including investments in our cloud infrastructure for fiscal '18, very important, and investments in some process automation investments that we're also making.

Tavis Christian McCourt - *Raymond James & Associates, Inc., Research Division - Research Analyst*

And Dan, if I read correctly so that the change in the accrued non-GAAP tax rate has no impact on cash flow from operations, so even though the guidance for cash flow from ops as a percentage of non-GAAP net income is higher than the actual guidance for cash flow from operations is similar or the same? Is that the right way to think about it?

Daniel D. Tempesta - *Nuance Communications, Inc. - CFO and EVP*

Yes. That's actually, Tavis, that's a good way to think about it. But since you asked, and I assume others may have questions as well, let me take this opportunity to address the question more broadly. So beginning in the quarter, we are changing our method of calculating our non-GAAP tax provision. While it will impact the reported non-GAAP net income and earnings per share, I do want to stress the point you just raised that there'll be no change in the cash or tax economics of the business. So historically, we have utilized a cash tax method to derive our non-GAAP earnings. We felt this approach best informed investors of our tax economics, given our large U.S. NOLs and the fact that we have not been a U.S. federal taxpayer because of these NOLs. Now based on the most recent interpretation from the SEC, we will show a non-GAAP tax provision that is based on our non-GAAP profits. So effectively, we'll be adding back any nontax -- any tax effect from the non-GAAP adjustments, and we will also assume we will enjoy -- not enjoy the benefits of the NOLs. So this approach will result in a higher tax rate in our non-GAAP earnings. For example, under the approach, the new approach, we'll have approximately 31% in 2017, and that compares to a tax rate of 5% to 6% under the old cash tax rate. So we've incorporated some of these tables in the prepared remarks to help you understand that. And as we look forward over the next 3 years, we would assume a 31% tax rate under the new method and a rate of 6% to 7% on a cash tax basis, so a little bit higher than the 5% to 6% that we've reported historically due to some additional revenues that we've been talking about in Brazil and in China as well but still a 6% to 7% over the foreseeable future.

Tavis Christian McCourt - *Raymond James & Associates, Inc., Research Division - Research Analyst*

Can you remind me what the actual dollar amount of the tax loss carryforward is at present?

Daniel D. Tempesta - *Nuance Communications, Inc. - CFO and EVP*

Sure. At the end of 2016, it was around $630 million. And then the last thing I'll mention is we're going to keep on reporting cash taxes on a supplemental basis, so we're not going to include that in the actual earnings calculation and the net income calculation. We will include that in the narrative because there are a number of analysts and investors that use that in their models.

Operator

Our next question will come from Ian Strgar with UBS.

Ian Franc Strgar - *UBS Investment Bank, Research Division - Associate Director and Equity Research Associate, Technology - Software*

Paul, can you update us on how the search for a new CEO is going for when you -- for when you're retiring, I believe, in early 2018?

Paul A. Ricci - *Nuance Communications, Inc. - Chairman and CEO*

Yes. The board has formed a search committee, and it's really only in its preliminary activity, so we have no significant progress to report but we will keep you apprised as the board completes its work.

Ian Franc Strgar - *UBS Investment Bank, Research Division - Associate Director and Equity Research Associate, Technology - Software*

Okay. Got it. And operating margins came in really strong for the quarter. Can you maybe just elaborate a little bit on what led to being able to get over 30% operating margins? And then maybe -- and then maybe would you give us what you think your long-term target for where Nuance can get for operating margins in 2018 and beyond? I mean, is this a mid-30s percent operating margin business over the long term?

Paul A. Ricci - *Nuance Communications, Inc. - Chairman and CEO*

Let's see. A couple of questions, let me take them in turn. Our operating margins enjoyed the benefit of some overachievement in our gross margins, the benefit, of course, of our overachievement in revenues and good cost discipline up and down our operating expense lines. The second part of your question -- what we have said previously is that, first, we expect margins to be in the range of 28% to 29% this year. We've confirmed that in today's comments. And we've previously suggested that we'll see a modest increase in operating margins as we look ahead to next year, reminding investors that we have significant cost savings engineered into our business in '17 and in '18 but that it is our intention to direct the preponderance of those savings towards growth opportunities with the goal of continuing to lift our organic growth rate in '18 and then again in '19. So I think you should think of it as modest margin improvement as we look ahead over the next 3 years with focus on improving the top line and growth.

Ian Franc Strgar - *UBS Investment Bank, Research Division - Associate Director and Equity Research Associate, Technology - Software*

Okay. Got it. And if I could just squeeze 1 more in, the sales reorg in Imaging, can you guys just talk about where that's at and how quickly we might expect the growth rates in Imaging to bounce back?

Paul A. Ricci - *Nuance Communications, Inc. - Chairman and CEO*

Well, they've done a lot of work in Imaging during the second quarter and made a lot of progress. I think we're going to see the benefits of that progress in the second half. Revenues could be relatively flat in the second half and bookings performance, I believe, will look up from where it's been in the first half. So I think we've turned a corner, but it will take some time to work the effect of those changes through the system. So I think this is a year in which we should expect to see the remediation with a goal of stabilization and setting up for growth next year based on additional sales investments we're making over the second half of this year and product investments we're also making in the business over the second half of this year.

Operator

Our next question will come from Sanjit Singh with Morgan Stanley.

Joshua Phillip Baer - *Morgan Stanley, Research Division - Research Associate*

This is Josh on for Sanjit. You talked about a material increase in headcount in Automotive, wondering if you could expand a little more on where you're investing there.

Paul A. Ricci - *Nuance Communications, Inc. - Chairman and CEO*

We're investing significantly in our services, Automotive services organization in order to fulfill on the bookings that we've seen in the later half of '16 and have seen in '17 and expect to see -- continue to see throughout '17. We simply have to -- we simply have a greater -- need a greater capacity in our Automotive business to serve customer obligations that we've been fortunate enough to win. We're also investing in R&D to accelerate the evolution of the Automotive product plan in the desire to serve the vision we have of the connected car in 2020.

Joshua Phillip Baer - *Morgan Stanley, Research Division - Research Associate*

Great. And when you talk about a return to growth in FY '18 in Healthcare segment, is that on a reported or organic basis?

Paul A. Ricci - *Nuance Communications, Inc. - Chairman and CEO*

We're referring to organic.

Operator

We'll go next to Nandan Amladi with Deutsche Bank.

Nandan Amladi - *Deutsche Bank AG, Research Division - Research Analyst*

So Paul, what has changed in the quality and the close rates of the pipeline relative to sort of this time last year when bookings have been a lot softer? Is it that the demand environment has changed? Is it that your product is now more competitive? Can you characterize what might be helping that?

Paul A. Ricci - *Nuance Communications, Inc. - Chairman and CEO*

Well, with as varied set of markets as we have, one would have to answer that question specifically in each market. But I think if we try to look generally across the company, I think that the overall interest in the kind of intelligent solutions we build has grown as visibility around the opportunity and the potential of those solutions has increased. I think our investments in our go-to-market approaches has -- beginning in the later half of last year has paid dividends for us, and I do think our product investments are allowing us to effectively target opportunities. A good example of that, of course, would be the robust reception around Dragon Medical One, which has only been in the market for, I think, 15 -- 12 to 18 months now.

Nandan Amladi - *Deutsche Bank AG, Research Division - Research Analyst*

And sort of related question specific to Healthcare as you look at the product mix that you're selling today, how much of the contributions coming from new products on the Clintegrity and CDI side, relative to you just mentioned Dragon Medical, has had pretty strong uptake? So if you think about new versus upsell into the base, what does that mix look like today versus a year ago?

Paul A. Ricci - *Nuance Communications, Inc. - Chairman and CEO*

I don't have a precise number for what the relative contribution of new versus installed of existing customer is compared to a year ago. I apologize. I do know that we're doing quite well in cultivating new customers in that business, and I think that's part of what's contributing to the quality of the pipeline we have in Healthcare, which, although, I have not commented on specifically is really extraordinary pipeline right now for us.

Operator

Our next question is from Jeff Van Rhee with Craig-Hallum.

Jeffrey Van Rhee - *Craig-Hallum Capital Group LLC, Research Division - Partner and Senior Research Analyst*

Paul, as it relates to, I guess, start with the auto side. Obviously, you're working on your models, but just any changes in win rates at this point?

Paul A. Ricci - *Nuance Communications, Inc. - Chairman and CEO*

So we've been very fortunate in customer support for our solutions, and we win a very strong majority of solutions, and that has been true for some time and continues to be so.

Jeffrey Van Rhee - *Craig-Hallum Capital Group LLC, Research Division - Partner and Senior Research Analyst*

And then with respect to Dragon, how far are we -- I think you had suggested in the commentary we're kind of through the bulk of this transition to a recurring model from new sales. I'm just curious, specific to the installed premise customers, what kind of data set have you built so far in terms of being able to convert them from maintenance payers to actually full-paying subscription users on the new offering?

Paul A. Ricci - *Nuance Communications, Inc. - Chairman and CEO*

I don't have the percentage of that off the top of my head. We -- I think our comments were meant to suggest that the downward pressure on revenues from the Dragon transition is significantly behind us. It's mostly behind us at this point.

Jeffrey Van Rhee - *Craig-Hallum Capital Group LLC, Research Division - Partner and Senior Research Analyst*

Okay. And then, I guess, lastly on the handset side. It sounded as though that is one of the areas where you're calling out the declines are over, or at least the worst of them are over. Can you just talk about both the rev rec and the sequential improvement in revenues there, and then also, bookings, just a little bit of an overview on what's going on in the handset space?

Paul A. Ricci - *Nuance Communications, Inc. - Chairman and CEO*

Well, of course, the Mobile numbers we publish are composite of the Automotive, the handset and smartphone and IoT and the mobile operator segment. And the handset -- the smartphone business is in decline as we've discussed now for some time. And we expect that particular subsegment to continue to decline. It is going to be offset by the growth of IoT opportunities we've mentioned, such as smart home, but that's a relatively small business today, but the performance of that business is being driven by the other 2 subsegments, Automotive and mobile operators.

Jeffrey Van Rhee - *Craig-Hallum Capital Group LLC, Research Division - Partner and Senior Research Analyst*

Great. Understood. And then lastly, Paul, any even modest tweaks at the edges in terms of likely uses of capital? You're obviously generating some great cash flows here and getting better.

Paul A. Ricci - *Nuance Communications, Inc. - Chairman and CEO*

I think we've indicated in over several quarters now that we have a balanced agenda of share buybacks, debt reduction and modest acquisitions, and I think that remains our approach.

Daniel D. Tempesta - *Nuance Communications, Inc. - CFO and EVP*

Jeff, let me just remind you, too. We did, with the recent convert, we did, we raised -- we bought back $100 million, which matched our plan for the year. And with the capital -- the earlier capital transactions, we will have -- once we settle the convert that's due in November, we would've taken down our debt balances by about $150 million. So that really is supporting what we've talked about.

Operator

Our next question is from Saket Kalia with Barclays.

Saket Kalia - *Barclays PLC, Research Division - Senior Analyst*

Joined a few minute late, so apologies if these were already asked. Maybe first for you, Dan, in the prepared remarks, we called out the Cablevision and Roku wins in the quarter. Can you talk to whether those benefited the Mobile business or Mobile revenues at all here in the second quarter? And just maybe broadly speaking, can you remind us how the revenue models for these types of customers in that smart home vertical work mechanically?

Daniel D. Tempesta - *Nuance Communications, Inc. - CFO and EVP*

Sure. I think those 2 were just bookings, and they didn't contribute to the revenues this quarter. The smart home can work a number of ways. It can work in when -- it can work with an active user per month. And so if a person uses the system, then we'll get paid per month for that usage. It can work on a per device approach, so, but it's usually transactional based on usage.

Saket Kalia - *Barclays PLC, Research Division - Senior Analyst*

That's helpful. And then maybe for my follow-up for you, Paul. Paul, you mentioned in response to another question the strong performance in Dragon Medical One. We certainly see it in the bookings commentary in Healthcare. Can you just talk qualitatively about where this is coming from? I mean, you've got such dominant share in that vertical in that market. So is the success of Dragon Medical One coming from winning new customers? Is it taking share, maybe upgrading existing customers? How do you think about the robust performance there?

Paul A. Ricci - *Nuance Communications, Inc. - Chairman and CEO*

I think we are converting existing customers around a broader vision of integrated clinical documentation based on cloud platform. I think we are winning new customers, some of whom are competitive customers. And I think we are expanding more successfully into the middle market. I think it's a combination of those 3 things.

Operator

We now have a question from Tom Roderick with Stifel.

Thomas Michael Roderick - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

So Paul, I've got a 2-part question for you here related to acquisitions. The first here, can you help us understand what sort of contributions TouchCommerce is having on the Enterprise business there? I mean, it looks like the organic growth has been great, both with and without TouchCommerce over the last 4 quarters. I know you've only had them for a few quarters of that, so talk about how that's impacting the numbers, and then if you wouldn't mind giving us a sense of sort of what to expect in that segment organically as you lap that and the comps will get tougher. And then the second part of the question here is it looks like there's a $50 million use of cash for acquisitions in the quarter. I think the mCarbon Tech deal was reported back in February. Can you talk a little bit about what you got there and how you expect that to contribute to the business for the remainder of this year?

Paul A. Ricci - *Nuance Communications, Inc. - Chairman and CEO*

Last year, when we bought TouchCommerce, I believe we gave an indication that TouchCommerce would contribute about $70 million in this year's financial plan, and it is on target to achieve that number, and so that's a reasonable number for you to work with. The -- I think the mCarbon contribution over the course of this year is immaterial.

Daniel D. Tempesta - *Nuance Communications, Inc. - CFO and EVP*

Yes. And the $50 million that you relate to is not related to mCarbon it was -- the mCarbon was a small piece of that. We also did a purchase of some IP.

Thomas Michael Roderick - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

Perfect. That's helpful. A much bigger picture question here for you, Paul, as you think about the Automotive segment, I know it's much too early to expect any contribution of that business from the autonomous and semiautonomous vehicle segment, but how do you think about how you want to see the business invest in that opportunity over the next 12 to 24 months? Do you think about that as a big opportunity for Nuance as you look out 3 to 5 years? Or is it too early to even consider making investments in the R&D side there?

Paul A. Ricci - *Nuance Communications, Inc. - Chairman and CEO*

Well, it's not our plan to join a very crowded field in the technologies associated directly with autonomous driving. But the automotive manufacturers, as you know, see a transformation going on in the vision of the automobile in the near to medium future that includes a far more robust connected car, in part, to enjoy the benefits of more autonomous driving. And we do participate in that vision of a connected car, and that I think is -- relates to the investments I was referring to earlier. We're doing very well in that business, and it remains a major focus of growth for us as we look out over the 3-year horizon.

Operator

And our final question will come from David Hynes with Canaccord.

David E. Hynes - *Canaccord Genuity Limited, Research Division - Analyst*

Just one for me. Paul, you outlined some of the reactive expense growth, right, commission support infrastructure. The business has really been kind of in expense management mode here for the last couple of years, curious kind of what the -- with the improved bookings growth environment and I'm sure you're going to start thinking about budgeting for '18 soon, I mean, does this at all change kind of how you're thinking about, maybe, proactive spend growth investments to kind of sustain what we're seeing? Or do you think you can kind of keep up with the bookings growth guidance, kind of, at the expense levels that you're running the business now? How are you thinking about that longer term?

Paul A. Ricci - *Nuance Communications, Inc. - Chairman and CEO*

It's a good question, and we were careful in our prepared remarks and reiterated in my opening comments that we are having to lay expenses into the business to ensure that we take advantage of the opportunities that are in front of us, and our strength in our bookings performance only confirms for us the wisdom of pursuing those investments. And we said earlier this year that we were going to pursue growth investments and that if we saw positive reinforcement from that, that we would continue to do that and that is a plan we're on.

Operator

Thank you. Please go ahead with any closing remarks.

Paul A. Ricci - *Nuance Communications, Inc. - Chairman and CEO*

Okay. Thank you very much for joining us this quarter. We look forward to speaking to you again next quarter.

Operator

Thank you. And ladies and gentlemen, this conference will be available for replay after 7 p.m. today until midnight May 23. You may access the AT&T Executive Playback Service at any time by dialing 1 (800) 475-6701 and entering the access code 421039. International callers dial (320) 365-3844 using the same access code 421039. That does conclude our conference for today. Thank you for your participation and for using AT&T Executive Teleconference. You may now disconnect.
