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NUAN - Q1 2017 Nuance Communications Inc Earnings Call

EVENT DATE/TIME: FEBRUARY 07, 2017 / 10:00PM GMT

OVERVIEW:

Co. reported 1Q17 non-GAAP revenues of \$496m and non-GAAP EPS of \$0.35.



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CORPORATE PARTICIPANTS

Christine Marchuska *Nuance Communications, Inc. - Director of IR*

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

Dan Tempesta *Nuance Communications, Inc. - CFO*

Bruce Bowden *Nuance Communications, Inc. - EVP of Corporate Strategy and Development*

CONFERENCE CALL PARTICIPANTS

Saket Kalia *Barclays - Analyst*

Jeff Van Rhee *Craig-Hallum Capital Group - Analyst*

Tavis McCourt *Raymond James - Analyst*

Hans Affadowalla *Morgan Stanley - Analyst*

Ian Strgar *UBS - Analyst*

Parker Lane *Stifel Nicolaus - Analyst*

PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to Nuance's first-quarter FY17 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.

At this time, I would like to turn the call over to Ms. Marchuska. Please go ahead.

Christine Marchuska - *Nuance Communications, Inc. - Director of IR*

Thank you. Before we begin, I 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. 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 Ricci - *Nuance Communications, Inc. - Chairman and CEO*

Good afternoon, everyone (technical difficulty) --.



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Sorry, Mr. Ricci, we have lost your sound all of a sudden.

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

Can you hear me now?

Operator

Yes, I can. Thank you.

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

First, we delivered a strong first quarter, with solid performance across our key financial metrics. Net new bookings for the quarter were up 23% compared to Q1 2016. We reported Q1 non-GAAP revenue of \$496 million and EPS of \$0.35, both metrics meeting the high end of our guidance range. Recurring revenue increased to 73%, up 600 basis points from a year ago. Cash flow from operations remains strong at 122% of non-GAAP net income.

Second, we advanced the initiatives that we have articulated in recent quarters. In particular, we have made continued progress on our transformation program that is designed to strengthen our portfolio, improve operations, and enhance revenue growth. As part of these initiatives, we continue to advance our solutions portfolio with offerings that combine our core voice and language solutions with new capabilities for artificial intelligence and analytics. Examples include Dragon Medical Advisor, our enhanced Dragon Drive solution, and our omnichannel enterprise offerings, which also incorporate security and biometrics. In addition, we are expanding addressable opportunities with further investments in targeted geographies and vertical markets. This broader portfolio, along with these other market investments, has enhanced overall demand for our offerings, contributed to our robust net new bookings, and strengthened our pipeline.

Looking ahead, our performance in Q1 has increased our confidence in our full-year 2017 financial objectives. Over the balance of the year, we see the opportunity to overachieve in our healthcare business, and to overachieve as well in our mobile business, especially based upon the contributions from our automotive and mobile operator business lines. We expect that our enterprise business will achieve our full-year expectations. And we anticipate the sum of all these trends will offset the underperformance in imaging that will likely persist for a couple of quarters, as our operational remediation takes hold there. For margins and earnings, we will continue our transformation program with focus on incremental cost savings, additional leverage in our data center infrastructure, and disciplined hiring.

In closing, and as referenced in our prepared remarks, the combination of these initiatives and trends in bookings, revenue, and cost, lead to our outlook for Q2 and provide further confidence in our FY17 targets.

We will now take your questions.

QUESTIONS AND ANSWERS**Operator**

(Operator Instructions)

Saket Kalia, Barclays.



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Saket Kalia - Barclays - Analyst

Thanks for taking my questions here. First maybe I could start with you, Dan. Can you just talk quantitatively or qualitatively, however you prefer, about Dragon Medical subscription bookings versus perpetual and what the average duration on those subscription bookings has looked like?

Dan Tempesta - Nuance Communications, Inc. - CFO

Sure. Of course, historically we used to really book only the Dragon Medical perpetual licensing, but that has since much reduced over the last three quarters. There will always be some customers, whether they are smaller customers or certain emerging geographies, where we continue to book the perpetual licenses, but that really is shifting.

The last three quarters have seen that shift and most recently I would say the majority of our units booked have been in the cloud offering. That is either a cloud standalone offering or integrated with our HIM offering and those are usually five-year in term.

Saket Kalia - Barclays - Analyst

Got it. Got it. As for my follow-up, for you, Paul, just moving to the mobile and consumer business, we have all gotten questions about Amazon Alexa and Google Home and I want to ask the question a slightly different way. Do you find that these devices, especially given your comments about some strength in mobile, do you find that these devices are driving more interest from other consumer electronics manufacturers to embed voice recognition? How are they thinking about insourcing that versus outsourcing that, if that make sense?

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

Yes. The answer to your question is yes. The interest in voice and language solutions in electronic devices has, as you know, been high for some time but this last year has seen an increased interest and an increased level of design work going on for perspective devices that are going to be coming out of the next couple of years. Of course, an area of intense focus and interest for us has been the automotive vertical broadly and this and the recent attention voice has only served to accelerate the investments that are going on within the automotive business.

A secondary focus for us has been telecommunications and cable operators who are looking to deploy voice-related solutions, particularly around entertainment in the home. Then there are a range of specific specialties within emerging IoT which have also -- we have referenced in previous quarters that has an accelerated and interest as well.

Saket Kalia - Barclays - Analyst

Great. That is very helpful. Thanks, guys.

Operator

Thank you. Jeff Van Rhee, Craig-Hallum.

Jeff Van Rhee - Craig-Hallum Capital Group - Analyst

A couple for me. Paul, on the net new number, very good, obviously very good on the quarter and you highlighted the areas that are driving the growth or lagging. I'm curious in terms of variance compared to expectations, not looking for quantification, but just any outliers in terms of the strength in bookings and weakness in bookings versus expectations.

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

Well, healthcare was quite robust in its bookings performance in the quarter. Enterprise was quite robust as well. But generally speaking, we had a fairly strong bookings quarter everywhere except for in imaging.

Jeff Van Rhee - Craig-Hallum Capital Group - Analyst

While you're on it, touch on imaging. It sounds like you said there's some remediation things in the works there. Can you talk about the remediation effects and why you think that can fix the situation and kind of along those lines how you think about that segment longer-term growth rate?

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

We made a series of changes in our go-to-market approach in imaging related to account coverage compensation, sales structure at the beginning of the fiscal year, which taken together have created distraction and disruption in our bookings and revenue flow in that business. We are altering those and remediating those and unwinding some of them, but as you know, that has to be done thoughtfully and with -- over time. What we don't believe is that we have a fundamental change in the demand in the business but just in the way we are addressing the business and we believe it will take a couple of quarters to work through those.

Jeff Van Rhee - Craig-Hallum Capital Group - Analyst

Got it. On the enterprise side, obviously the top-line performance is just outstanding here. You touched on it briefly in terms of what is driving it. I'm curious to your thoughts on the sustainability. We are up into this teens growth range and just kind of where we are in the sort of the market opportunity for that segment, its ability to sustain that growth.

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

Well, as you point out, it has an ambitious plan for FY17. We are off to a good start in FY17. We will have to continue our momentum in bookings and our progress with channels and the deployment of our new products in order to achieve the full-year plan, but that is our expectations as we sit here today.

Jeff Van Rhee - Craig-Hallum Capital Group - Analyst

Okay. One last brief one, if I could. Health, you talked about in the out year that it will return to growth on an annual basis. Slicing it a little more thinly, if you are willing, Dragon has been big the headwind in the early part of this year. Is it conceivable or even probable that healthcare could return to growth in the second half of the fiscal year?

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

Well, I think I want to stick with our original forecast. I did reference in my opening remarks that healthcare is off to a very strong start and we do see the opportunity to over achieve. I don't think I want to provide more forecasted granularity with respect to the growth rate in healthcare in the second-half quarters.

Jeff Van Rhee - Craig-Hallum Capital Group - Analyst

Fair enough. Thanks for taking my questions.

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Operator

Thank you. Tavis McCourt, Raymond James.

Tavis McCourt - Raymond James - Analyst

Thanks for taking my questions. My first one is on the mobile segment. I think for a couple of quarters now you have referenced you expect the device segment within there to get back to some level stability. Would that suggest that mobile overall should start growing organically since the service provider and auto, I suspect, are growing nicely, or are there other pieces of the business that are still going to keep that declining even as we look into later this year and 2018?

Secondly, on the cash flow, Dan, I guess trying to get a sense of the sustainability of being able to generating operating cash flow ahead of the adjusted net income. Obviously, you have done it quite nicely the last couple of years. It looks like a lot of that has been driven by really strong deferred revenues and a reasonably good networking capital management. Any comments you would have around sustainability of that trend as we look maybe beyond 2017 would be helpful. Thanks.

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

Do you want to take the cash flow first?

Dan Tempesta - Nuance Communications, Inc. - CFO

Sure. Cash flow, you are correct. We had a really strong cash flow quarter, 122% of our non-GAAP net income. We guided at the beginning of the year 110%. I would encourage you to think of it that way.

You are right. You can't keep up that trend for that long given the size of our deferred revenue at this point. Q1 has historically been a pretty strong quarter because we do have some strong cash collections that come in from the fourth quarter and some large contracts. Longer term, I think a lower percentage is the way to think of it.

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

With respect to your first question, we have said previously that the mobile business incorporates our automotive business line, which is the largest proportion of mobile. Our mobile operator services and our devices business, which is made up primarily, but not exclusively, of handsets, and as you referenced and we have noted previously, we see secular decline in the handset contributions and that weight on the business in 2016 and continues to weigh on the business in 2017.

It is the case that the overall proportion of that becomes smaller as we go through this year and so the growth factors in the other business lines begin to look more attractive. I do not want to provide growth estimates for mobile in 2018 at this point.

Tavis McCourt - Raymond James - Analyst

Great. Paul, is there any -- moving over to enterprise, obviously very strong this quarter and frankly it looks like it has been as strong the last couple of quarters, there was there pretty big strategic event, I would think, this quarter the Chapter 11 filing by Avaya. Do you expect that have a positive or negative impact to your call center business within enterprise? Thanks.

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

Avaya has been a good partner of ours and continues to be good partner of ours. I do not anticipate any effect from the bankruptcy in terms of our relationship with them.

Operator

Was that all, Mr. McCourt?

Tavis McCourt - Raymond James - Analyst

Yes. I am good. Thanks.

Operator

Thank you. Sanjit Singh, Morgan Stanley.

Hans Affadowalla - Morgan Stanley - Analyst

This is Hans [Affadowalla] in for Sanjit Singh. Could you give a little bit more color on what is driving the consistent double-digit growth in the enterprise? Who do you most often compete against and who are you taking share from in this market?

Bruce Bowden - Nuance Communications, Inc. - EVP of Corporate Strategy and Development

Yes, this is Bruce. The growth of enterprise business has been pretty broad-based. We have a number of different businesses there.

The traditional business is on-prem, basically inbound automated voice and that has experienced a really nice resurgence, both in terms of license revenues and also the surrounding professional service revenues. In addition to that, really good growth of our on-demand offering and including from the live chat piece that we've just recently added with our TouchCommerce acquisition. Then we have a number of offerings around Nina, which is our automated virtual assistant.

The bookings for Nina have been good over the last couple of years and many of those deployments are coming online with large global companies and we're starting to see revenue pick up from there. It is really quite broad-based.

In terms of competition, frankly, our most frequent competitor is for the company that we're selling to not go forward with a deployment of this kind that they decide to hold off on this kind of innovation and wait for a little while. Frontal competitors are relatively diverse and nichey in this space.

Hans Affadowalla - Morgan Stanley - Analyst

One follow-up question, if I may. Apologies if I missed this, but what were the sources of sales disruption in the imaging business and when should we start to see this rebound?

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

Yes. What I mentioned a few minutes ago was that we made a number of changes in our approach to the imaging market and that included changes in our sales compensation, changes in the structure of our sales organization, changes in account coverage. All those taken together, while done

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with good intentions, have had a disruptive effect upon our bookings and revenue. It will take a couple of quarters to work through the best -- the remediation as we unwind some of those changes and make modifications necessary to get back to the fundamental demand of the business.

Hans Affadowalla - *Morgan Stanley - Analyst*

That's all for me. Thank you.

Operator

Thank you. Ian Strgar, UBS.

Ian Strgar - *UBS - Analyst*

Thanks for taking my question. First, on the net new bookings came in really strong in the quarter but you guys left the full-year guidance for that metric unchanged. I know it's a metric that has been volatile quarter to quarter, but can you guys just kind of talk through the gives and takes there and just if some business was pulled forward into Q1 and that's why you're not revising it up?

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

The reason we are not revising it is that we've consistently encouraged investors to look at net new bookings on an annual basis and to look at the change in net new bookings on an annual basis. We've done that because we have enough large-scale deals that it's difficult to predict the timing of those deals.

You may recall that in the early part of last year, we seemed challenged to achieve our net new bookings target but in fact we did achieve our net new bookings target on a full-year basis. This year, we are off to a terrific start but we would need more time and -- before we want to change the target and so our encouragement remains for investors to stay focused on the guidance range we gave on a full-year basis.

Ian Strgar - *UBS - Analyst*

Okay. Understood. One more if I may. You guys hit the high end of your annual guidance this quarter for total percentage of revenue that's recurring at 73%. Are you guys expecting that to kind of bounce around for the remainder of the quarter or is it possible that you guys over achieve on that metric and that could lead to a growth out performance in the back half of the year?

Bruce Bowden - *Nuance Communications, Inc. - EVP of Corporate Strategy and Development*

Yes. Good question. This is Bruce. Again, there, I think we would encourage you to look at our maintained level of guidance at about 73%, 72%, 73% for the year. There can be some variability in this.

There is timing of the part of our business that does remain heavier on the perpetual license side that happens over the course of the year. It will likely bounce around a little bit and average out. Our best view right now is that it will average out at the level that we previously indicated.

Ian Strgar - *UBS - Analyst*

Okay. Thanks for the color, guys.

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Operator

Thank you. Tom Roderick, Stifel.

Parker Lane - Stifel Nicolaus - Analyst

It's actually Parker Lane in for Tom Roderick. Thanks for taking my question. I was just wondering if you could comment on the contribution that TouchCommerce had in the quarter on top-line performance and bookings and how the process of that integration of their solution and selling into your existing base has gone to date? Thanks.

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

Sure. When we bought TouchCommerce, we indicated to you all that it was running at a revenue run rate of about \$50 million a year and that we expected it to grow to around \$70 million this year. It's doing very well against that pace, so it is a strong contributor to growth. We had also told you, I think, that it would -- if you do the math on that, it's \$20 million, which is an additional 1% on our organic growth rate the way we calculate organic growth. We are tracking very well against that plan.

In terms of how it is doing commercially on the ground, we do have nice wins for TouchCommerce. The fundamental value proposition of this idea that you can first try to steer a chat toward automated treatment that but then automatically be able to default to an agent and resolve the call efficiently seems to have good traction in the marketplace.

Parker Lane - Stifel Nicolaus - Analyst

All right. Thank you.

Operator

Thank you and please go ahead with any closing remarks.

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

All right, then. We thank you all for joining us this quarter and we look forward to speaking to you again next quarter. Thank you.

Operator

Thank you, and ladies and gentlemen, that does conclude our conference for today. Thank you for your participation and for using AT&T executive teleconference. You may now disconnect.



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