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NUAN - Q4 2017 Nuance Communications Inc Earnings Call

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OVERVIEW:

Co. reported 4Q17 results. Expects 2018 organic revenue growth to be 2-4%.

CORPORATE PARTICIPANTS

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to Nuance's Fourth Quarter and Full Year Fiscal 2017 Conference Call. As a reminder, this conference is being recorded. With us today from Nuance are Chairman and CEO, Paul Ricci; CFO, Dan Tempesta; and Head of Investor Relations, Christine Marchuska. At this time, I would like to turn the call over to Ms. Marchuska. Please, go ahead.

Christine Marchuska

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. 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 the 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 & CEO*

Thank you, Christine, and good afternoon, everyone. Before taking your questions, I'd like to highlight a few key points regarding our FY '17 results, outline our expectations for FY '18 and provide preliminary thoughts on FY '19.

I want to begin by noting that I am pleased with how Nuance completed its fiscal 2017. As you know, in June, we were the victims of a cyber attack, which had a significant impact on our performance in Q4. Absent the incident, we completed an excellent year operationally, strategically and financially. Notwithstanding the malware incident, we performed well against several key metrics. We delivered net new bookings at the high end of our guidance range at 10% for fiscal '17. Additionally, our Healthcare business delivered its best net new bookings quarter in history in Q4 despite the challenges this segment faced as it recovered from the malware. We outperformed our post-incident expectations. Notably, we had favorable outcomes for our Q4 and FY '17 revenue and EPS incident impacts as compared to the malware impact guidance we provided in Q3, and we met our recurring revenue target of 73% as we saw a continued momentum across our growth businesses.

Our fiscal year '17 performance provides further evidence that our strategic focus on evolving our business to conversational AI and predictive analytics-based solutions is generating demand in our key vertical markets. Worth noting is that our total pipeline metric grew by $900 million or an increase of about 30% during fiscal year '17. Throughout the year, we accelerated important product initiatives in each of our segments. For example, in Healthcare, we continued our shift to the cloud with Dragon Medical, launched new virtual assistant capabilities, enhanced our offerings in analytics, critical result management and workflow optimization in Diagnostics, and just yesterday, introduced with NVIDIA, the world's first open marketplace for AI algorithms in radiology.

In Enterprise, we continued the rapid expansion to omnichannel engagement, powered by AI and analytics, and added new facial and behavioral capabilities to our voice biometrics portfolio. And in Mobile, we accelerated our automotive 2020 product initiative and delivered outstanding customer deployments to make the connected car a reality for leading automakers, again, making automotive an excellent growth business for Nuance.

We expect to build on our momentum, capitalize on the new AI-based solutions and benefit from favorable market trends as we enter our new fiscal year. As you saw in our earnings material, we reiterated our growth expectation for 2018 of organic revenue growth between 2% and 4%. We have confidence in our revenue projection based on the growing volume of our pipeline, our bookings performance of 2017, the compounding effect of our recurring revenue streams and, importantly, a turning point whereby our growing revenue streams are now outpacing our declining streams.

For several years, we've managed a shift in our revenue streams and addressed several declining businesses while investing in longer-term growth opportunities. For example, we've managed the erosion of our HIM solutions in Healthcare as we concurrently built our Dragon Medical clinical documentation improvement in Diagnostics business lines. By the end of 2018, Dragon Medical will eclipse transcription as the largest revenue contributor in Healthcare, where its growth will more than offset the erosion expected in HIM.

Similarly in Mobile, automotive now comprises the lion's share of the segment's revenue, approximately 63% with a double-digit growth rate. In addition to these effects, we anticipated revenue growth from our CDI offerings, our mobile services business and new releases for our Imaging solutions. Our Imaging business, it's worth noting, is slated for fiscal '18 the most robust set of new product offerings in the division's history. Along with our strong revenue projections, we expect continued favorable trends in our booking performance and forecast net new bookings growth between 5% to 7% in FY '18, which you will note is somewhat above the initial guidance range for our FY '17 net bookings growth, which we provided at this time last year. Bookings will be led by an expansion of our Enterprise omnichannel and voice biometrics solutions, the continued growth of our automotive business and the adoption of our Dragon Medical cloud solution. We expect that margins will increase from FY '17 levels, but we note that in FY '18, they will be flat or slightly down from our pre-incident levels as we accommodate additional investments in our enhanced security posture and infrastructure following the incident.

As you saw in our prepared remarks, we've embarked upon a multiyear organizational and productivity initiative focused on increasing investments in our growth businesses, building on our previously successful efficiency programs. We will use these efficiencies to fund our increasing investments in AI and our expansion of our go-to-market resources in our key vertical markets and to deliver steady year-over-year margin improvements. This initiative, along with our enhanced pipeline, our booking trajectory, the relative strength of our growth businesses and the diminishing effect of our declining businesses, has encouraged us to provide initial thoughts about fiscal year '19. In particular, we expect our growth businesses to further outpace our declining businesses, which should improve organic growth rates to between 3% and 5% in fiscal year '19 with each segment contributing to overall growth. We expect similar performance to FY '18 for net new bookings with strong contributions from automotive, Dragon Medical cloud and Enterprise omnichannel solutions. And as we put the incident farther behind us, we expect operating margin expansion of approximately 50 basis points, while gross margins will remain at similar levels to FY '18.

Overall, our efforts have set us on the path for steadily increasing growth while balancing the use of productivity gains between funding growth and enabling operating margin expansion.

Finally, I wish to comment briefly on the topic of CEO succession. As I've mentioned previously, the board and the search committee have, in recent quarters, initiated a process to evaluate both internal and external candidates. The committee has made progress in that process and expects to complete its work prior to the end of March. You can expect a further update after the first of the year.

In closing, I'd like to reiterate that fiscal 2017 was a remarkable year for Nuance, one that bore witness to numerous milestones amidst our recovery from a devastating malware attack. I'm confident we exited fiscal '17 as a stronger organization, owing both to our success and the challenge we endured. Now as we begin the new year, the combination of our investment in new solutions, our position in key vertical markets, the strength of our growth businesses and our deep customer relationships will allow us to recognize our potential for fiscal '18 and the years ahead. And we're now pleased to take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And the first question comes from Saket Kalia from Barclays Capital.

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

Dan, maybe just to start with you. It looks like the impact of the malware incident this quarter was much better than expected and luckily, that's carrying forward to next year. Just to level set, can you just talk about what sort of dollar impact you're assuming from the malware impact -- from the malware incident in FY '18?

Daniel D. Tempesta - *Nuance Communications, Inc. - Executive VP & CFO*

Sure. Yes, first of all, the incident impact in Q4 was better than expected. In '18, we originally expected an impact to revenue around $70 million. I would say, because of the better performance, we would expect an estimated impact of around $60 million to $65 million in 2018.

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

That's great. That's great. Maybe for my follow-up for you, Paul, more of a segment question on the Healthcare business. It felt like the critical data improvement, or CDI solutions, had a particularly good bookings quarter. Can you just talk about if that's something that's coming from just continued optimization that hospitals are constantly doing? Or is there maybe something industry-wide or regulatory-driven that's perhaps driving strength in CDI?

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

Yes. We did have a good year in CDI, and bookings were particularly strong. It is driven, in fact, by both of those trends within hospitals. There is regulatory pressure on hospitals to improve the quality of documentation and to reduce errors. Those errors affect patient outcomes. And as you know, that's a central focus in health care right now. There's also, of course, enormous pressure on hospitals' business models to further optimize, and CDI improves the efficiency of the entire clinical documentation chain, and so benefits in that way as well.

Operator

The next question comes from Sanjit Singh from Morgan Stanley.

Sanjit Kumar Singh - *Morgan Stanley, Research Division - VP*

Dan, I have a quick question on margins. So I think relative to the Q3 update, margins are a little bit down. I think it was sort of in that originally 27 to 27.5 range and now it's sort of down like 50 basis points. Can you just give us some insight on where those incremental investments are going or what drove the slight downtick in margins?

Daniel D. Tempesta - *Nuance Communications, Inc. - Executive VP & CFO*

Sure. You are right. We're guiding for the year 26.5% to 27% operating margins. I would say from the trajectory that we're on in 2017 to that landing point, you can think about it as about 100 basis points are impacted by malware and in updating the environment, the security environment, and another 100 basis points are for a number of investment areas, particularly in auto R&D as well as in Enterprise. So those are the 2 main drivers of the adjustment.

Sanjit Kumar Singh - *Morgan Stanley, Research Division - VP*

Got it. And I do appreciate your initial sort of commentary on fiscal year '19 and also sort of breaking out the automotive contribution for fiscal year '17. So we think about durable growth, obviously, automotive is going to be one of the major components of that. So in terms of thinking about the durability of your automotive business as we think about 2020 and 2021 sort of design wins, what gives you the confidence that you're going to be able to continue to secure those wins? Obviously, Alexa making some inroads within some OEMs. What's sort of the stickiness or the value proposition that you guys are working on to secure those wins going forward?

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

I should note that 2020 and '21 design wins are the wins that we have been doing of late, so it is a business where one signs contracts well in advance of the shipment of the cars, so we are already having success with design wins in that time period. But more generally to your question, our business model in automotive has been driven by our close alignment with the automotive manufacturers and helping them present the digital experience that they seek inside the car, consistent with the overall design parameters and experience that they're trying to evoke with their brand. We've said in the past and continue to believe that the automotive manufacturers will accommodate the digital lives that drivers bring in to the car from other platforms, but that doesn't mean that they are going to abandon their own investments and their own initiatives in building a complete solution. And that seems to be the strong message we get from the cars -- from the automotive manufacturers. It seems to be consistent with the success rate we're having in winning designs.

Operator

The next question comes from Jeff Van Rhee from Craig-Hallum.

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

Paul, with respect to AI, machine learning, just take that a few steps further, would you? I mean, I know you're deploying and it's kind of central to a lot of things and within a lot of product sets, but in terms of its ability to drive the revenue line, sort of narrow our focus a little bit here. What are the solutions and the actual use cases of AI that you think are going to be most impactful in the next 12, 24 months?

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

Well, I want to start by noting that machine learning has been a central focal point of the -- at the frontier of the evolution of speech technology itself, so we've been using deep learning in improving the capabilities of our speech technology for some number of years, equally importantly in the expansion to natural language processing, which, of course, has been the extension that we've -- of that technology that we've been focused on for the last several years. And as we move to a more conversational AI that includes interactions and dialogue, that will continue to be the case. But there are other use cases, such as CDI, the radiology use cases we talked about, the application of machine learning to the virtual assistant solutions in enterprise customer management, customer service and, of course, in automotive as well. So our solutions, as my comments in recent quarters and this quarter have suggested, are increasingly focused on specializing for the vertical markets for solving and taking advantage of the rich data sets that are in those markets and providing analytics and more complete solutions around that data.

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

Okay. And I guess, just shifting gears, the new role, EVP Business Transformation with Tom Beaudoin's return, can you take that a few steps further? It talks about -- you talk about rationalization of business portfolio and a few of the other kind of core things you're going to be focusing on there. Just why now and why those particular areas of focus?

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

Well, this initiative is really an attempt to build upon the initiative that we undertook a couple of years ago and had considerable success with, and that initiative was designed to improve margins and to free investments to produce growth. And as you've seen in our forecast today, we've had some success in that. We are seeking to redouble our efforts in that regard to free more funds from existing expenditures that we can use to drive further investments in the conversational AI agenda that I just mentioned as well as further investments in the vertical markets, such as the financial services market, where we've done so well in our Enterprise business, the telecommunications market that spans initiatives in both our Enterprise and Mobile business, and the automotive and Healthcare markets, of course. So we want to fund investments in those 2 areas because we believe that will drive further growth, and we want to create the opportunity for margin expansion. And to do that, there's a lot of optimization it has to go on, not just cost-cutting, but realignment to take advantage of synergies within the company and to bring accentuation to certain areas such as, for example, our automotive business, which we think has such durability that we want to pursue greater growth there.

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

And I guess just last one from me, it looks like you're pointing to roughly $400 million-ish in free cash flow. Just thoughts if there's any shifts in terms of how that free cash flow is likely to be deployed as you go through fiscal '18.

Daniel D. Tempesta - *Nuance Communications, Inc. - Executive VP & CFO*

I think the previous plan around capital allocation in a balanced manner is still the plan between attractive stock repurchase prices, repurchasing the debt and then some cash for M&A.

Operator

The next question comes from the line of Nandan Amladi with Deutsche Bank.

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

So Paul, building a little bit on the previous question around the transformation, would it be fair to say that the previous $125 million OpEx program was really more cost focused, and now you're also focusing a little bit more on growth opportunities?

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

Well, when we started -- it's a good question. When we started that initiative, it was primarily cost focused. As we migrated through it, about a year into it, we began to talk about channeling some of that into growth opportunities. We pointed to our bookings growth and some of the expansions that we funded last year that we've outlined previously. It is the case in this instance that we want to try to accelerate the growth potential for the business while defending and expanding our margins steadily -- gradually and steadily over the next couple of years.

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

And then on the AI marketplace that you announced yesterday, how many developers are there in the specialized fields like Healthcare? Clearly, your announcement yesterday was on the Healthcare front. I would imagine it's a broader initiative. Historically, you built most of these applications yourselves. What was the impetus to open it up?

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

Well, this initiative that we announced yesterday is exclusively focused on Healthcare today and it is -- and in particular, it is focused on the diagnostics and radiology market within Healthcare. The advent of machine learning has, as many people pointed out and as we pointed out yesterday, democratized the ability to create new solutions from data sets. There are a lot of resources available in -- deep learning resources available and using in this case the NVIDIA platform and the reach that Nuance has in its radiology reporting platform in PowerScribe and its image sharing platform in PowerShare, we can enable a broad set of radiologists who want to innovate algorithms based on deep-learning technologies and their data sets and provide an infrastructure where they can get visibility for those algorithms, get validations for those algorithms and establish a marketplace for those algorithms. So we think that there's going to be a lot of work within the radiology industry to develop those algorithms based on insights that individual and groups of radiologists have based on their data.

Operator

The next question comes from the line of Tom Roderick from Stifel.

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

Paul, can you just take a few minutes here to talk a little bit more about the mechanics of how the malware outage actually impacted revenue stream and how it's impacted the way you guys think about it? So certainly, there was the period of time where you couldn't offer services, so I think we all get that. But as it relates to certain customers perhaps moving transactional volumes to other systems or reputational risk and some share loss, can you just kind of talk through the impact of the different ways that the revenue streams have been impacted and how you're thinking about any customer churn that's come out of this?

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

Yes. Well, we reported, I think, an expectation through Q3 and Q4 of about $85 million -- I'm looking to Dan for confirmation -- of revenue loss on those 2 quarters due to the outage itself, due to customer credits.

Daniel D. Tempesta - *Nuance Communications, Inc. - Executive VP & CFO*

And the final number -- that was originally what we were guiding to, but the final number was $68 million.

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

Yes. So we reported -- we forecasted $85 million. The final number was just below $70 million, and that was due to customer credits and the outage and some volume loss to both -- to early migration to Dragon Medical and to competitive offerings. And I think what Dan said earlier was that the effect we had expected in '18 was about $70 million, but now look closer to $60 million to $65 million.

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

Okay. Okay. That's helpful. So, Dan, following up on that as it impacts the gross margins and the way we should see that play out, so you guys have laid out an expectation for gross margins to expand, I think, about 120 basis points for the year. If I look at the EPS guide for Q1, it would seem to suggest that there is either a drop in gross margins in Q1 or some OpEx that we ought to be aware of. Can you kind of take us through the progression of gross margins and OpEx as we go through the year and how you're thinking about layering those in?

Daniel D. Tempesta - *Nuance Communications, Inc. - Executive VP & CFO*

Yes. I think the first thing I would say is gross margins we're projecting for the year to be around 63%, which is consistent. Of course, last year, we have the effects of malware pulling those -- that margin down, but we think we get back to 63%. When you think about gross margins, we're still seeing a shift to -- away from licensing and towards Hosting and Professional Services, but we're able to maintain that 63% because we're gaining leverage in those hosted offerings, and the margins are improving there. So that trend continues. As far as operating margins, in general, they will ramp through the year. Q1 has historically -- and this quarter, in particular, is a lower operating margin, but that will get back to the higher level as we progress through the year.

Operator

The next question comes from the line of David Hynes with Canaccord.

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

Maybe one more follow-up on the malware incident. Dan, any more color you can give that helps us reconcile the difference between the cash flow impact and the revenue impact? The gap was a little wider than I was expecting.

Daniel D. Tempesta - *Nuance Communications, Inc. - Executive VP & CFO*

Yes. I think when you think about cash flows, we certainly saw significant shortfalls in collections. Number one, that was due to the loss production that we saw in June, July and early August. That level of cash flow would otherwise have been collected. Two, as Paul alluded to, we gave credits, and we had to work through credits with our customers. And some of those credits happened in the quarter. Of course, the majority happened in the quarter, but that caused our customers to defer payments until the credit process was resolved. So I think the combination of those 3 had a significant impact on our collections. In addition, as we noted last quarter, there were significant costs we had to incur, onetime costs in the quarter, to remediate and restore, and we paid a fair amount of those expenses in the quarter as well. So the combination of those, all those items make up the predominance of the shortfall.

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

So should we expect any different linearity in terms of the way cash comes in, in fiscal '18?

Daniel D. Tempesta - *Nuance Communications, Inc. - Executive VP & CFO*

So in Q1, yes. The answer is yes. We're going to have a little bit of a shortfall carryover in Q1. But then in Q2, Q3 and Q4, we would expect it to be more aligned with the percentage averages that we provided in the call remarks. But in Q1, we still have some expenses to pay that happened in Q4.

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

Yes. Got it. And then, Paul, the 30% pipeline metric growth, I don't recall you sharing that in the past. That's helpful. Can you maybe help kind of frame that growth across your segments? I mean, where does it feel like the most incremental opportunity has been created?

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

Well, without quantifying it, I can say that the major contributors included, notably, automotive, voice biometrics, Dragon Medical cloud, our CDI. And generally, our Enterprise pipeline was very strong.

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

Yes. Okay. So spread across the growth businesses. And then last, maybe the M*Modal litigation that was announced recently. Can you kind of speak to the claims there? And then maybe more broadly, as the strategy on patent enforcement going forward, I mean, is this an area where we should expect Nuance to be more aggressive? Or how are you thinking about it?

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

I don't want to talk in any detail about the specific litigation with M*Modal. I'll say, generally, that it is our interest and our intent to enforce respect for our intellectual property. We've talked about that previously. There's been a lot of investor questions about that, and you should see this in that broader light.

Operator

And the next question comes from the line of Tavis McCourt with Raymond James.

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

I've got a few of them. First on the Enterprise business, growth has been pretty good all year, but the margins are down to 30% or so. And I think in the prepared remarks, you talked about kind of transition to cloud there. I guess, what is -- is there a margin run rate that you think that bottoms out? Or do you think that segment is in kind of a growth phase where we should expect margins to continue to trend down as long as it's growing?

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

Well, it's still a business delivering attractive margins in comparison to benchmarks in that market. The margins have declined for 2 reasons. One has been to the transition to digital cloud revenues, which are -- which do have a lower gross margin, and secondly, the increased investments to fund the growth that we've been talking about this afternoon. It's possible that there's some additional modest margin decline, but it's probably in the realm of where it should be.

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

Okay. Cool. And then back on the commentary around 30% pipeline growth, you've got a lot of businesses where you're bidding reasonably complex Professional Services latent contracts, and it appears demand is reasonably high across a lot of segments. So I guess, how do you incent your business-level managers to have the right economics on these deals? And is there any sign of customers getting less price sensitive as demand for some of these AI applications increases?

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

Well, with respect to the first question, we have plenty of focus inside the company on incentives and discipline around Professional Services margins. We aren't perfect there, and there are areas of the business that -- for which the performance is better than other areas, but the trend has generally been quite good. And I think we have a lot of experience that allow us to remediate the areas where it's not as good. With respect to the pricing question, it really depends on the market. There are some segments in which there is more pricing freedom and some in which there is less, and it's difficult, given the breadth of markets we're in to generalize about that.

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

Fair enough. And then a housekeeping one for Dan. Dan, I think you're implementing 606 revenue rec in 2019. Any update on the likely impact of that, given kind of the broad nature of your business?

Daniel D. Tempesta - *Nuance Communications, Inc. - Executive VP & CFO*

I think the answer continues to be the same. We certainly are going to be impacted quite significantly. The revenue stream that's going to be most impacted is going to be the term licenses. So we have a number of different offerings that have term licenses, and that will -- if you're familiar with 606, that will accelerate. So that will be the largest area. There will be smaller areas across the rest of the portfolio, but that's the largest.

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

Fair enough. And the guidance for recurring revenue of about 73% for next year, pretty similar to this year, should we read into that about this transition nearing its end? Or is that just kind of a rounding error?

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

Well, there's a number of things contributing to that being somewhat flat this year. One, of course, is the loss of recurring revenues in the HIM segment, so that's a significant offset. The second is the growth in our on-premise voice biometrics business, which, of course, is a very attractive business to us, but is not recurring in revenues. And the second -- and the final is the growth in Professional Services related to your earlier question.

Operator

There are no further questions in queue at this time. Please proceed.

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

Okay. Well, we thank you for joining us this quarter, and we look forward to speaking to you again next quarter. Take care.

Operator

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