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CSGS - Q3 2016 CSG Systems International Inc Earnings Call

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PRESENTATION

Operator

Good day and welcome to the CSG Systems International third-quarter 2016 earnings announcement conference call.

(Operator Instructions)

At this time I would like to turn the conference over to Liz Bauer, IR. Please go ahead.

Liz Bauer - *CSG Systems International Inc. - IR*

Thank you Destiny, and thanks to everyone for joining us. Today's discussion will contain a number of forward-looking statements. These will include, but are not limited to, statements regarding our projected financial results, our ability to meet our clients needs through our products, services, and performance, and our ability to successfully convert the backlog of customer accounts onto our solutions in a timely manner.

While these statements reflect our best current judgment, they are subject to risks and uncertainties that could cause our actual results to differ materially. Please note that these forward-looking statements reflect our opinions, only as of the date of this call, and we undertake no obligation to revise or publicly release any revision to these forward-looking statements in light of new or future events. In addition to factors noted during this call, a more comprehensive discussion of our risk factors can be found in today's press release, as well as our most recently filed 10-K and 10-Q which are all available on the Investor Relations section of our website.

Also, we will discuss certain financial information that is not prepared in accordance with GAAP. We believe that these non-GAAP financial measures, when reviewed in conjunction with our GAAP financial measures, provide investors with greater transparency to the information used by our management team in our financial and operational decision-making. For more information regarding our use of non-GAAP financial measures, we refer you to today's earnings release and non-GAAP reconciliation tables on our website, which will also be furnished to the SEC on form 8-K.

With me today on the phone are Bret Griess, Chief Executive Officer, and Randy Wiese our Chief Financial Officer. With that I would now like to turn the call over to Bret.

Bret Griess - *CSG Systems International Inc. - President and CEO*

Thank you Liz, and thank you all for joining us today. Today I will review our third-quarter results, and provide you with an update on how we're executing to our plan to drive top-line revenue growth in the future.

For the third quarter of 2016, we grew revenues to $189 million, a 1% increase over last year's third-quarter results. And, we grew our non-GAAP earnings per share 4% to $0.75 per share, versus the same quarter in 2015. We are very proud of the great execution and the strength of our business model to deliver such a sound quarter. We remain committed to making smart short-term and long-term investments to fuel our strategy of serving communication service providers globally.

Over the past several quarters, we have stated that we will be increasing our investments in our people, our products, and our clients, all aimed at generating long-term future revenue growth and earnings. As a result, our long-term non-GAAP operating margin remains unchanged at our historic target of 18% to 20%.

Now moving on to the business, I am really pleased with how we are executing in a challenging environment. We are continuing to move market share, we are expanding our reach into the broadband and cable space globally, and we are strengthening and lengthening our revenues with global tier 1 operators. Over the past nine months, we are seeing a sharper focus, increased accountability, and a greater sense of urgency around driving the right type of revenue growth as a result of our realignment and additions to our leadership team.

In our broadband, cable, and satellite markets we continue to take market share from our competitors. Since our last earnings call, Comcast has converted more residential customers onto our ACP platform, away from a competitor's legacy platform. We completed two more conversions over the past three months, resulting in moving 1.5 million new customers onto our platform. Year to date we have converted just under 2 million customer accounts, in line with our expectations.

So far, since we were awarded Comcast's consolidated business in July 2014, we've converted approximately 5.8 million customers, or close to 60% of those accounts, that were being processed on a competitor solution. This is a pretty amazing feat, and something CSG does better than any company out there.

We have some of the broadest and deepest conversion experience in the industry. Over the years, we've converted customers off of 50 unique billing platforms. We believe that this skill set and domain knowledge within our employee base, will continue to be a differentiator and help mitigate client risk as other operators look to consolidate or modernize their back-office operations.

This past quarter, we also made progress in expanding our cable footprint globally, with a win and South America. Cablevision Argentina selected our Workforce Express solution to automate their field technician workforce.

Simply put, our Workforce Express solution gets the field technicians with the right skills and equipment, routed to the right customer at the right time. Clients that use this solution today have seen a substantial reduction in their operating costs and a significant increase in our customer satisfaction ratings. Cablevision Argentina is the largest cable TV operator in the country, serving more than 3 million customers with over 4,000 cable field technicians.

Wins like this reflect our strategy of taking key portfolio of assets that we've grown in North America to the global markets where we can add value. Additionally, wins like this allow us to demonstrate how we can help drive increased profits and customer engagement and satisfaction at our customer locations, and open the door for us to do more for these operators. Expanding our cable footprint globally is an area where we are focused in investing in.

Moving on, the carrier market continues to make good progress. I recently described this portion of our business as more of a turnaround. After two hard years of realigning and reorganizing our go-to-market and delivery approaches, in addition to the hard work of our employees around the globe, I no longer look at this is a turnaround business. I view it as an area of our company that is well-positioned to grow revenues and profits going forward thanks to the fact that we have over 400 customers in the neighborhood of 400 to 500 clients around the world that depend upon us every day. And we are focused on establishing stronger relationships within targeted customer accounts, so that we can become much more than just a software supplier and more of a trusted partner.

We want to convert what has traditionally been a very transaction-based relationship into one similar to our North American model in which we are working side-by-side with our clients, helping them to achieve their goals. This past quarter we made significant progress in achieving those goals.

First, we expanded our relationship with Telstra, a leading communications provider in Australia. You may recall that two years ago, we were awarded a transformation project to consolidate a number of different competitors and in-house billing systems onto our single-view platform for their enterprise services. Based upon our great work with this transformation, Telstra expanded their relationship with us this quarter. We are now providing business process support through a five-year managed services arrangement. This is another great example of how we are able to grow our business with a provider when we are able to get in, and help the customer drive increased efficiencies and improve customer satisfaction.

In addition, we signed another managed-services contract with GCI, an Alaska telecom provider, to implement and run our mediation platform for the next seven years. As you can imagine, our goal is to go in, prove ourselves as a trusted and reliable partner, and look for additional opportunities to help GCI successfully execute on their business objectives.

These managed-services wins are important for a number of reasons. They leverage our expertise in running large-scale complex systems. They allow us to do what we do best, deliver value to our customers. They allow us to identify additional opportunities to broaden our footprint within our clients operations, and they allow us to build upon our history of turning recurring revenues into solid earnings. I am very pleased with the progress we are making here to strengthen and lengthen our client relationships, and the revenue that comes with that.

Now let's talk about the over-the-top, or OTT market as we call it, which continues to generate a lot of buzz and excitement, ahead of it being a meaningful part of our revenue story. Early on, we saw that this market was going to explode with lots of new entrants. Our belief all along has been that while thousands of new content and digital services companies are entering the market, there are only be a handful of companies that will provide a customer experience that is differentiated with a business model that is sustainable.

Our work with companies ranging from the major Hollywood studios, to cable companies, to major sports and entertainment brands, to global big box retailers, is helping set us apart from other competitors. Understanding how the end consumer wants to consume and pay for digital services is complex, and requires an expertise in enabling a much larger ecosystem, or set of partners. Understanding this business model innovation, how all the pieces of ecosystem come together, and how to monetize it for our clients while satisfying their end-users demands, this is where we excel.

Finally, we feel good about the organizational structure and the people that we have put in place to drive this business forward. By aligning all of our products, services, and people around our three markets that are in a different stages-of-evolution; from one that is well-established, to one that has been any turnaround phase and is starting to turn the corner, to one that is in its infancy in an emerging market, we are making great progress.

With this alignment, we're seeing a more intimate understanding and working relationship with our clients. a sharper focus on the challenges and opportunities that exist within the various markets, and an increased accountability from our front-line employees all the way to our leaders, and most importantly, an increased sense of urgency to engage and problem solve with our clients.

This alignment leverages our strengths as a collective team, and reinforces why we like our business, and why we believe our fundamentals are strong. We have unrivaled domain expertise in the broadband and video markets, and it's getting stronger. We work with some of the largest and most innovative communication service providers in the world, and we've greatly improved our business footing there in that space.

We have proven technology and a solid reputation for operating our solutions really well. We have a financially sound company. We generate strong cash flow and have a strong balance sheet, which gives us tremendous flexibility for investing in our people, our solutions, our clients, and still return capital to our shareholders; each of which, we are very committed to.

And most important, we have a talented and dedicated employee base all over the world, who are committed to helping our clients and our company achieve greatness. And we are committed to investing to continue to grow that talent base to solve challenges to help our customers meet their goals. And finally, I want to thank our customers who put their faith in us by asking us to do more for them to help them achieve their goals, and our employees who work tirelessly on behalf of our customers. With that, I will turn it over to Randy to review our third-quarter financial results.

Randy Wiese - *CSG Systems International Inc. - EVP and CFO*

Thank you Bret, and welcome all of you on the call today to discuss our financial results for the third quarter, as well as our outlook for the remainder of 2016. We are pleased with our continued solid results for this year, as well as the progress we are making to strengthen our business for the long term.

Now I would like to walk you through the financial results in more detail. Total revenues for the third quarter were $189 million, an increase of 1% over the same period last year. Sequentially, revenues were down slightly from the second quarter.

Our cloud and related solutions grew 5% from last year's third quarter, which was driven largely by the continued conversions of customer accounts onto our cloud solutions, and increased revenue from recurring managed services arrangements. This strength helped to offset the softness we continue to experience in our software and services revenues, as we continue to transition this portion of our business into a more recurring revenue model.

Moving on, our non-GAAP operating income for the third quarter was $44 million, with a margin of approximately 23%. This stronger-than-expected performance for the quarter, reflects the solid fundamentals of our business, and a much slower-than-anticipated start to certain strategic investments planned for the second half of 2016, which I will talk about more later when I provide our outlook for the remainder of the year.

GAAP operating income for the quarter was $37 million, or a margin of 19%. For the third quarter, our non-GAAP adjusted EBITDA was $51 million, or 27% of total revenues.

Our stronger-than-expected operating performance helped us deliver non-GAAP EPS for the third quarter of $0.75, which compares to $0.72 for the same period last year, which represents a 4% increase. Our non-GAAP effective income tax rate was 37% for the quarter. Our GAAP EPS for the third quarter was $0.55, which compares to $0.50 for the same period last year.

Now onto our balance sheet and cash flows, we generated $9 million of cash flow from operations and $6 million of free cash flow for the quarter. Year to date, we have generated $60 million of cash flow from operations, and $48 million of free cash flow. The lighter cash flows for the quarter were due to a timing delay in receiving payments from a large client at quarter end.

Our fundamental strength in generating strong and consistent cash flows from our operating activities remains intact. Overall, we ended the quarter with $266 million of cash and short-term investments, a decrease of $21 million from the second quarter. The decrease in cash this quarter relates mostly to additional repurchases of our 2010 convertible debt, as part of our refinancing of this instrument from earlier this year. The remaining amount of this instrument still outstanding has a current estimated settlement value of around $60 million, and has an ultimate maturity date of March 2017.

Moving on, year to date we paid $18 million in dividends, which reflects an increase of 6% at our quarterly dividend rate over last year. We did not repurchase any additional shares this quarter, therefore, our year to date share buybacks remain at approximately $10 million.

Let's move along to our discussion of 2016 guidance. Overall, our guidance has improved from last quarter, reflecting the strength of our third quarter results and our expectations for the remainder of the year. We now expect our 2016 revenues to come in between $755 million to $760 million, which is towards the top end of our previous range, as a result of us making good progress on key deals, and our successful conversion of new customer accounts onto our solutions over the last quarter.

Our strong operating performance to date and the slower start to second half of the year investments, as I noted earlier, should leave us in the 22% non-GAAP operating margin range for the year, up substantially from our prior guidance. Our long-term non-GAAP operating margin remains in the 18% to 20% range, as we believe this provides a good balance between delivering healthy returns to the bottom line, while still having the resources available for a meaningful investments, to ensure the long-term health of our business. While we have been operating about this range for the last year, we view this more as a timing issue and not a change in our fundamental operating model goal.

We remain committed to make investments aimed at generating long-term future revenue and cash flow growth. These future investments will fall within the following categories: first, additional R&D dollars for the advancement of our Ascendon and ACP cloud-based solutions, second, additional dollars to expand our go-to-market capabilities across our entire business, and finally, additional platform investments that will continue to drive the operational excellence, scale, and security of our cloud solutions that this dynamic market has come to expect.

While we expect our operating margin percentage decrease in the fourth quarter as we gain further momentum on our planned investments, our execution on the pace and the level of these investments over the next several quarters, will determine how quickly we fall within our target operating margin range on a more sustained basis.

Moving on, because of our higher-than-expected operating margin for the year, we are increasing our 2016 non-GAAP EPS guidance range to $2.79 to $2.89, with represents a $0.20 increase over our previous guidance. Our non-GAAP effective income tax rate remains unchanged at 37%, and outstanding shares are unchanged at 33.1 million shares. In addition, we now expect non-GAAP adjusted EBITDA to be within the range of $194 million to $200 million.

Finally, we are narrowing our range of cash flows to $110 million to $120 million for the year, which assumes more normal working capital levels by the end of the here. Our capital expenditures for the year are expected to range between $15 million to $20 million.

Overall, we are pleased with our continued ability to move market share, strengthen and lengthen our revenues, and continue to invest to accelerate revenue growth. We believe the strength of our business model allows us to continue to invest in our future while creating long-term value for our shareholders, our clients, and our employees. With that I will turn it over to the operator for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

We will take our first question from Tom Roderick, from Stifel.

Matt VanVliet - *Stifel Nicolaus - Analyst*

Hello guys thanks Matt VanVliet, on for Tom this afternoon. I guess first question -- great to hear that you expanded the Telstra contract. I was wondering if you could give us a little bit more detail in terms of what the expansion means? Is it geographic based? Is it more functionality? Or is it just an extension of the terms? Any color there would be great.

Bret Griess - *CSG Systems International Inc. - President and CEO*

Yes, Tom this is Bret. We appreciate you being on the call, Matt, but what it means is there is additional feature functionality or additional services that we are providing in that space. And it's really one of those things that's tied to our core competencies that we talk about. It's getting in, understanding the client's business, and helping them to do it over time. And like any partnership, when you build that trust, it can help to extend that partnership. So it's more feature functionality of services we're delivering, but it also extends the term, and it extends the amount of the revenue in a very healthy fashion along those lines. So the reality is, it's right in line with our stated strategy that we're looking to take globally, which is to strengthen and relate, and lengthen those relationships with our clients.

Matt VanVliet - *Stifel Nicolaus - Analyst*

All right great. And then on the gross margin front, we saw the less deterioration there than, I think, we were expecting and even the processing went up. I was curious what the impact in the quarter specifically was to the expected repricing on the Time Warner stubs, and what we should think about for the fourth quarter.

Randy Wiese - *CSG Systems International Inc. - EVP and CFO*

I will take that one Matt. We had stated last quarter, and it's still current for the year, is about $5 million revenue and margin hit for the last six month of the year, so half of that would have had this quarter. Our expectations for the remainder of the year, as a stated in my comments, that we had a very solid quarter of execution, we got a slower start to some of the investments than we anticipated. I think we will gain some momentum on those heading into the fourth quarter, so I think you should look for us to maybe start falling more in line with our long-term target margin range in the fourth quarter.

Matt VanVliet - *Stifel Nicolaus - Analyst*

All right, great. And then looking at the geographic performance, it seemed pretty much in line with the last few quarters. I was wondering if you had any additional color in terms of how Europe was performing. We've heard some weakness from some companies and not so much from others. I was curious what you guys are seeing there, and then how some of the macro issues are impacting the APAC business, in particular.

Bret Griess - *CSG Systems International Inc. - President and CEO*

Yes, the macro issues, of course, are all out there and we all see those and hear about them in the big news sources, as we go through there. But it's performing. We've got folks on the ground with customers, and so we've got a pretty good understanding of how it's going to perform. I wouldn't say that there's great growth anywhere on the planet there.

We are seeing the continual pressures from a macro-economic perspective, and being in uncharted territory from a monetary policy basis, but those same types of headwinds are also creating some tailwinds, where we get some good opportunities from it. So in APAC, you heard it was a good quarter with us from Telstra, but that really isn't about the quarter that's about the years of investment and trying to understand their business and work with them. We are working to the same thing with other customers in the APAC market, and the same thing goes from in EMEA. We understand there are a lot of those larger pressures, but our teams are on the ground working closely with them.

So I wouldn't say there was any great tailwind that moved us along in the European marketplace, or a great headwind that slowed us down. We stay extremely focused on solving customer problems with our great employees.

Matt VanVliet - *Stifel Nicolaus - Analyst*

All right, great. Thank you.

Operator

We'll go next to Howard Smith, from First Analysis. Please go ahead.

Howard Smith - *First Analysis Securities - Analyst*

Thank you for taking my questions. First, in regards to the carrier business. You've declared victory on the turn around, and now can focus on just growing the business. Is it the Telstra wins and a couple wins, or the reorganization or combination of things? Maybe a little more detail on what you saw in the last quarter or few months, that have you making that statement that kind of the turn around is complete?

Bret Griess - *CSG Systems International Inc. - President and CEO*

You bet Howard. And, by the way thanks for being on the call. We appreciate you being here, especially with all the great things happening in Chicago tonight.

The overall, I wouldn't tie it directly to the quarter. I would say that the timing just happened to fall in this quarter. A phenomenal effort has been underway from the last 18 months to 24 months, to make sure that we were executing in a very solid fashion to make it a healthy business. So along the course about 18 months to 24 months, the teams have focused diligently on the costs, and also on the client arrangements that we had, that we don't want to do business if doesn't make sense for our customer or for our business. And so, that great focus over that time period helps us to bring it into the point where we are ready to declared it a success from turn-around and get back to focusing on growing the business.

Howard Smith - *First Analysis Securities - Analyst*

Great. I appreciate that. And then as you have some success in converting some of these previously, maybe, software-oriented deals to cloud and related services -- these long-term managed services. Does the way we think about the seasonality on software and services and related on maintenance, change significantly? I usually think of that having a nice spike at year-end in Q4, but should we think of that as more muted going forward, because of this kind of change in business model?

Bret Griess - *CSG Systems International Inc. - President and CEO*

I think to a certain degree, Howard. I think you know as long as we are still selling software and services you always have that natural end of year buying pattern around capacity upgrades, and things of that nature. So I think you'll see a little bit, but it may get muted from the standpoint of the degree of magnitude between quarters. But, I think, we are still in the software business, and we will still have that to a certain degree.

Howard Smith - *First Analysis Securities - Analyst*

Okay. Thank you.

Operator

(Operator Instructions)

And, it appears that there are no further questions at this time.

Bret Griess - *CSG Systems International Inc. - President and CEO*

Well then, we will take one last opportunity to say thank you to everybody for being on the call, especially any clients that happened to be there, or our great employee base. We are extremely excited about the strength of the business mode, and the future and what we've got in place, and it's thanks to those customers and those employees. And thank you to everybody else on the call for taking the time to be here. We appreciate your interest.

Operator

And this does conclude your teleconference for today. Thank you for your participation. You may disconnect at any time.