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CSGS - Q4 2016 CSG Systems International Inc Earnings Call

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Matt VanVliet *Stifel Nicolaus - Analyst*

PRESENTATION

Operator

Good day, and welcome to the CSG Systems International fourth-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, ma'am.

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

Thank you, Wendy, 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 client's needs through our products, services and performance, and our ability to successfully convert the backlog of customer account 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 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 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 the non-GAAP reconciliation table located 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. - CEO*

Thank you, Liz, and thank you all for joining us today. I'm pleased to report that we executed well in 2016, and are beginning to see the positive impact for many of the new initiatives that we have put in place. But first, let's review our 2016 performance.

Full-year revenues of $761 million exceeded the top of our revenue guidance, and non-GAAP earnings of $2.79 per share were in line with guidance. While we had an extremely strong year, in particular on the bottom line, I am most pleased that we grew our revenues after years of flat revenues.

Entering 2017, we have more momentum and visibility in our recurring revenues than ever before. This visibility fuels our confidence in investing ahead of the curve to drive future accelerated revenue growth.

Today I would like to provide you with some highlights from our fourth quarter, as well as provide you with my assessment as to how we have performed as a management team in creating long-term shareholder value. First, Comcast converted another 1 million residential customers onto our ACP platform, away from a competitor's legacy platform. In 2016 alone, we have converted just under 3 million Comcast customer accounts, ahead of our expectations going into the year. So far, we have converted approximately 7 million customers in less than two and half years, without any delays or disruptions in service.

The fact that we continue to successfully convert their customers onto our platform without disruption of service or any hiccups is a testament to the unique skills that our employees and their's bring to the table. No one does it better than us, and it shows. We are pleased that when it comes to Comcast residential customers, CSG is their partner of choice. As we move into 2017, we're optimistic that we will continue to earn Comcast's trust and business as a partner who delivers true value and solutions that help them compete and win in a highly competitive marketplace.

Next, we signed a new cable and broadband client this past quarter, Buckeye Broadband, further extending our leadership position in this dynamic market. Buckeye will utilize our cloud-based ACP platform to deliver a more differentiated experience to their customers, while at the same time driving operational efficiencies.

In addition, last month, DISH introduced their AirTV services at CES. We are pleased to announce that their AirTV leverages our Ascendon platform, to make it easy for consumers to explore and buy the service, and easily pay for video content on the go. CSG deployed Ascendon in less than a month, enabling DISH to quickly begin earning revenues from its new innovative OTT service. DISH's AirTV service solves the problem that most consumers have with OTT services -- not being able to watch your local network stations, like CBS, NBC and ABC, along with Netflix and other Internet-streaming services. We are pleased to have earned the opportunity to help a creative and innovative service provider like DISH roll out this new and differentiated service to consumers across the nation.

Next, we signed our first significant Ascendon contract in Europe, with TalkTalk, the UK-based communications services provider. TalkTalk will utilize Ascendon to roll out their Internet TV services. This is exactly what our Ascendon platform was created to do, and is reinventing video for the future in people's businesses. In addition, TalkTalk has signed a managed services contract in which CSG will manage the implementation and day-to-day operations of the solution on their behalf. TalkTalk is a perfect example of how our overall strategy is playing out.

When we bought an international software business a few years ago, one of our goals was to take what we do really well in North America, which is run large, complex revenue management solutions on behalf of our clients, and leverage that expertise with carriers around the world. Another goal was to take our experience of running solutions in both a private and the public cloud to those same carriers. Well, today we are doing just that. We have many managed services clients and clients using our award-winning cloud-based Ascendon solution on multiple continents around the world.

The final highlight I would like to discuss is the work we are doing with a major media and entertainment company. Last year, you may recall that we helped this company launch their first OTT offering of books, music, videos and more in the United Kingdom, with our Ascendon SaaS-based platform. Last December, just in time for the holidays, they added live streaming of their TV channels.

With the integration of live TV and other promotional activities this past month, they have doubled the number of customer sign-ups to this service. Again, exactly what our Ascendon platform was developed to do in helping our clients drive new revenues and subscriber growth. Ascendon's agility and flexibility allows them to trial different approaches, packages and promotions on a daily, weekly or monthly basis, while at the same time evolving quickly to drive health and growth in their business.

Next, I would like to share with you my perspective on how we have done in delivering on the strategies that we outlined at the beginning of 2016, beyond the financial metrics. Last February, I outlined five key priorities that this management team would focus on to continue to drive long-term shareholder value. If I were grading our performance, I would give us a B. And here is my rationale behind that grade.

First, we said that we would align our organization to intensify our focus on growing our client relationships. We executed very well on this initiative. We reduced the number of layers in our organization. We moved the decision-making process closer to our clients.

And we added proven professionals, both on-site at our clients' operations and in our Company, to help nurture and grow these relationships. This alignment and focus enabled us to grow existing and new client relationships, as is evidenced by the fact that we converted 3 million new customers onto our ACP platform. And we signed new multi-year managed service agreements with our carrier clients and new cable logos.

Second, we said that we would increase our investments in our cloud-based solutions and go-to-market strategies. While we've made progress here, it was not at the pace that we would have liked. We increased the investments in our go-to-market strategies, in particular in sales and marketing. These investments include solutions training for our entire sales organization around the globe; the development of new sales tools and materials for our various solutions, including Ascendon; and an increased sales and services focus on key accounts. However, our increased R&D investments in our Ascendon platform lagged our original expectations, as we took the appropriate time to ensure that we had the right people in place to execute on our plans.

Third, we said we would take a more focused and targeted approach to growing our cable and satellite position globally. We are making solid progress here. We implemented our industry-leading workforce automation and management solution at Cablevision Argentina. Having this solution used by 4,000 cable technicians outside the US opens the doors and referencability for other opportunities with communication service providers around the world. In addition, we have added sales professionals and partners with strong domain expertise and relationships, to expand our capabilities globally.

And finally, our Ascendon solution is opening doors for us with operators who are looking for a highly flexible and agile solution that can help them launch new digital services in less than 90 days. Like we have done with DISH, Bell Canada, EastLink, portions of Comcast, and others, who can drive their businesses into next-generation solutions, yet not have to undertake high-risk, complete back-office transformation. Another testament to the power of our Ascendon platform to solve real business challenges. Our insights, experience and disruptive thinking in this evolving digital landscape is gaining traction, both with new and existing customers.

And fourth, we said that we would improve the performance of our international business. We have made very solid progress here. We improved our overall cost structure and operating performance, while also focusing our investments in those areas where we see the greatest future returns. We signed significant managed services engagements with key tier 1 providers on two different continents this year -- MTN in South Africa and Telstra in Australia.

In addition, we signed several managed services engagements with tier 2 and tier 3 operators. Importantly, this adds stability and diversification, in addition to our very strong North American business. As a result of these efforts, we have significantly improved the performance of our international operations. We have a great foundation to drive growth in the carrier market, both on the top and bottom line.

And finally, we said we would continue to pursue over-the-top providers in a highly targeted manner with our Ascendon cloud-based solution. Our experience in the space has created a key differentiator for us in the market, and is gaining momentum with our current clients, as is evidenced by the work we do with Xfinity on Campus, Bell Canada's CraveTV, EastLink and DISH AirTV.

Going into 2017, you should expect us to focus on the following. First, continuing to drive top-line revenue growth, in particular through our cloud-based and managed service offerings. Second, expanding our broadband and cable footprint globally, and getting broader and deeper in our carrier clients' operations.

Third, investing in our platforms and go-to-market strategies, in particular around our Ascendon SaaS-based solution. And fourth, continue our relentless focus on executing extremely well on behalf of our clients. Our proven reputation for doing what we say we're going to do has served us and our customers very well in a highly competitive business environment.

So as we enter this new year, I really like the position we have put ourselves in to continue to drive long-term shareholder value. We have an enviable business model, and strong fundamentals that are true value creators. We have unrivaled domain expertise in the broadband and video markets, and it is getting stronger. We work with some of the largest and most innovative communication service providers in the world. We've added new logos to this list, and we've greatly improved our leadership position here.

We have proven technology and a solid reputation for operating our solutions really well. And are feathering in next-generation solutions that help advance our customers into future business models, while helping to manage the risks associated with complete transformations.

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 and our clients, and still return capital to our shareholders -- as is evidenced by the 7% increase in our dividends announced today. Each of which we are very committed to.

And most important, we have talented and dedicated employees all over the world who are committed to helping our clients and our Company achieve greatness. And we're committed to investing to continue to grow that talent base, to solve challenges to help our customers meet their goals.

Before I hand it over to Randy to review our financial results and 2017 guidance, I want to thank our employees for their hard work, passion and commitment to helping our clients succeed. And to our clients for putting their trust in our Company, to help them deliver. With that, I'll turn it over to Randy.

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

Thank you, Bret, and welcome to all of you on the call today to discuss our financial results for the fourth quarter and our and full-year 2016 results, as well as our outlook for 2017. We are pleased with our solid results for this year, the success in extending our global market share, and the progress we're making to accelerate our top-line growth. Now on to the details.

Total revenues for the fourth quarter were $195 million, a decrease of 1% from the same period last year. Sequentially, revenues were up 3% from the third quarter. Total revenues for the full year of 2016 were $761 million, an increase of 1% over last year, and slightly above our full-year expectations.

Our cloud and related solutions revenue grew 5% over last year. This was driven largely by the migration of new customer accounts onto our cloud solutions, and the increased revenues from our recurring managed services offerings, which grew itself by over 60% from last year. This strength helped offset our expected decrease in software and services revenues, as we continue to transition this part of our business into a more predictable recurring revenue model.

Moving on, we finished the year with strong operating results. Our fourth-quarter non-GAAP operating income was $34 million, with a margin of 17%. We finished the year with $164 million in non-GAAP operating income, with the full-year margin of 22%. Our lower margin percentage for the quarter was in line with our expectations, and was driven by our planned increased investments aimed at our long-term business growth, and was coupled with higher levels of employee incentive compensation earned in the quarter. GAAP operating income for the fourth quarter was $25 million, our margin of 13%. GAAP operating income for the year was $133 million, our margin of 17%.

Moving on, our non-GAAP adjusted EBITDA was $42 million for the fourth quarter. And for the full year, it came in at $195 million, or 26% of our total revenues. Non-GAAP EPS for the fourth quarter was $0.57, allowing us to finish in line with our full-year expectations at $2.79, which represents a 6% increase over last year's $2.62. Our non-GAAP effective income tax rate was 37% for the year. Our GAAP EPS for the fourth quarter was $0.38. GAAP EPS for the full year was $1.90, which compares to $1.87 for the same period last year.

Overall, we had a very strong financial operating performance for the year. We ended the year with $276 million of cash and short-term investments. We generated $25 million of cash flow from operations, and $22 million of free cash flow for the quarter. For the full year, we generated $84 million of cash flow from operations, and $70 million of free cash flow.

Our overall cash flow from operations came in lighter than we expected, mainly due to unanticipated year-end working capital, timing fluctuations, and a payment made at the end of the year as part of our closure of several years of outstanding tax audits with the IRS. Our ability to generate strong consistent cash flows from operating activities continues as one of our fundamental business strengths. This, plus our strong balance sheet, positions us well for future growth opportunities.

Moving on, for the year, we paid over $24 million in dividends, which represents an increase of 6% in our per-share dividend rate over last year. In addition, our full-year share buybacks totalled approximately $12 million.

Let's move on to our forward view for 2017. We remain focused on driving revenue growth and delivering solid operating results. We are very confident in the strength of our Company, allowing us to make investments in our business while still returning capital to our shareholders. Along that line, we're pleased to announce that we will be increasing our first-quarter dividend by approximately 7%.

With that, let's move on to the numbers. We expect our 2017 revenues to come in between $760 million to $785 million. This is driven mainly by expected continued growth in our cloud-based solutions and managed services offerings. Our business model remains strong. We now generate close to 90% of our annual revenues from recurring sources.

We anticipate our non-GAAP operating margin to be at the low end of our target range of 18% to 20%. We believe our target range provides a good balance between delivering healthy returns to the bottom line, while still having the resources available for meaningful investments to ensure the long-term strength of our business. We have shown a willingness and good judgment to operate both above and below this target range by balancing current business conditions and our long-term opportunities.

Moving on, our 2017 non-GAAP EPS guidance range is $2.33 to $2.49, which represents a year-over-year decline, due to the heightened level of our planned investments for 2017. Our non-GAAP effective income tax rate remains unchanged at 37%. We anticipate our outstanding shares to be approximately 33.1 million shares, consistent with our 2016 level. In addition, we expect non-GAAP adjusted EBITDA to be within the range of $170 million to $179 million.

Finally, we expect a range for cash flows of $100 million to $120 million for the year, which assumes more normal capital working levels between years. After a relatively light year of capital expenditures, we expect to return to more normal investment levels of $20 million to $25 million in 2017.

In summary, we are pleased with our continued transformation of our already-strong business model. Today we generate around 90% of our revenues from highly visible, multi-year relationships with communication service providers around the globe. Just a few years ago, only 84% of revenues were recurring in nature.

We have accomplished this by investing in our people, products and solutions -- all aimed at moving market share and strengthening and lengthening our relationships with our clients. We believe that a highly visible, recurring and profitable business model that is growing creates long-term value for our shareholders, our clients and our employees. With that, I'll turn it over to the operator for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Tom Roderick, Stifel Nicolaus.

Matt VanVliet - *Stifel Nicolaus - Analyst*

Yes, hi. Matt VanVliet on for Tom today. Thanks for taking my question. I guess first off, on the cash flows, you talked about some impact from unexpected working capital timing. Could you just maybe elaborate a little bit more on that, and whether or not you think that will reverse into next year? And if so, it would seem like the cash flow guidance might be a little light, given the fact that you could make that up in the first quarter or so.

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

Yes, good observation. The working capital lines I was referring to were really around accounts receivable -- by far the largest piece. We had one client that would have typically paid at the end of the year that paid us just a couple days after, and a couple other clients who had been paying on a very consistent basis also slid that across the end of the year.

So your observations about our ability to outperform at higher level in 2017 are well -- is a good observation. But we stayed relatively conservative. So if we have good performance on those receivables, we have a good chance to outperform our cash flow, but we stayed conservative on our view.

Matt VanVliet - *Stifel Nicolaus - Analyst*

And then in terms of the middle P&L investments, Bret, I think you had talked about R&D investments were at least behind plan most of the year. Is there a lot of catch-up that you now have, that's causing a pretty substantial guide down in operating margins? I know we've talked about for a while here that you're going to invest in the business. But I think the level to which you guys are guiding has taken us a little bit by surprise here. How much of the R&D is catch-up, and how much additional on maybe the sales and marketing side, even relative to 2016 levels, are you expecting?

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

Yes, Matt, there is a bit it that's catch-up from an outlay of it. We continue to believe that 18% to 20% is a healthy range to run this business. We plan to continue to do exactly what we say. You know, R&D won't solve for the future on its own. So we're balancing some of those investments in R&D, our brand management, our solutioning, and our people, so that our people going to market have a very good understanding on the ground with the customers, solving their business problems with our solutions.

And it is incredibly exciting to see some of the very initial investments start to pay off and the tractions start to come. So we will continue to talk to the 18% to 20%, and then deliver in that 18% to 20%, as we said.

Matt VanVliet - *Stifel Nicolaus - Analyst*

And then looking at some of the international markets, year over year, both Europe and APAC had a pretty decent decline, at least in the quarter. What can we maybe attribute that to? And how should we think about those two markets moving into 2017?

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

You know, there's a great deal of uncertainty all over the planet as we move forward. Some of that decline has come from, as Randy mentioned, some of the software activity that is happening. But what is exciting to see is our ability to transform many of those agreements into the managed services agreement, to get the longer-term revenue and the longer-term relationships in place with our clients.

So there are those declines, but is exciting to see the business becoming healthier and more solid as we move forward through that process. And the incredibly strong underlying business model allows us to still go through increasing our dividend at 7%, and make those investments as we push forward.

Matt VanVliet - *Stifel Nicolaus - Analyst*

Great, thank you.

Operator

(Operator Instructions)

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

Wendy, I think we are good.

Operator

Yes, it does not look like we have any further questions at this time, so will hand it back to you, Liz.

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

Well, I would step in and just take a moment here to say thank you to everybody for being on the call, to our employees, our shareholders, and of course, our customers, through that process. You continue to support CSG in these incredibly dynamic times in our industry and allow us to have a hugely strong business model, where we can invest in growth for the future and can continue to deliver back to our shareholders a great return and a solid 7% dividend increase for this year. It's an exciting time at CSG to see the strategy start to play out and the positive traction. So thank you to everybody involved with that success, and thank you for your time today.

Operator

This does conclude today's program. Thank you for your participation. You may disconnect at any time.
