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CSGS - Q2 2016 CSG Systems International Inc Earnings Call

EVENT DATE/TIME: AUGUST 03, 2016 / 9:00PM GMT

THOMSON REUTERS

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PRESENTATION

Operator

Good day, and welcome to the CSG Systems International second-quarter 2016 earnings announcement conference call. All participants are in a listen-only mode. A question-and-answer session will follow today's presentation and instructions will be provided at that time. At this time, I would like to turn the conference over to Liz Bauer, Senior Vice President, Chief Communications and Investor Relations Officer. Please go ahead ma'am.

Liz Bauer - *CSG Systems International, Inc.*

Thank you Lynn, 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 customers 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 in 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, our Chief Executive Officer, and Randy Wiese, our Chief Financial Officer.

Bret Griess - *CSG Systems International, Inc.*

Thank you, Liz, and thank you all for joining us today. Today I'll review our second-quarter results, share with you what we are seeing in the market as we meet with service providers around the globe, discuss the actions we are taking to position us for continued success, and then turn it over to Randy to review our financial results in more detail. So with that, let's move on to our financial results.

For the second quarter of 2016, we grew revenues 4% over last year's second-quarter results to $190 million, grew our non-GAAP earnings per share 15% over the same period last year to $0.70 per share, and maintained our industry-leading non-GAAP operating margins. These solid results are driven by continued market share gains in our broadband, cable, and satellite business and solid expense management across our entire business. Our teams converted over 600,000 customers off of competitors' legacy billing systems and onto our Advanced Convergent Platform. Our successful conversion record and domain expertise is unmatched in our industry, something we take great pride in.

Our strong execution really positions us well for further investments in our business to drive future topline growth opportunities. And it should be noted that we delivered non-GAAP earnings of $0.70 per share without the benefit of buying back stock this quarter, a topic I will address later in my remarks.

Next, I'd like to share observations from recent meetings with our clients who range from well-established communication service providers all the way to new entrants. First, there seems to be a significant shift in what operators are being asked to do to compete and thrive in today's consumer driven world. Many of these providers have grown through acquisitions, and as a result have a variety of legacy back-office systems, software products, customized solutions and hardware assets in place serving the immediate needs of their customers while at the same time minimizing the risk associated with any change to these systems. Remember, these systems are at the heart of billing for and collecting an operator's cash flows.

But now the game has changed. Instead of competing against a traditional known telco or cable or satellite provider, they are competing against brands that Millennials have grown up with and love, like Apple, Google and Amazon. These companies play by different rules and are less encumbered by legacy operations.

In order to compete, operators are reallocating investments away from traditional IT and back-office solutions into new solutions that leverage and optimize new technologies and enable them to scale up or down quickly based on consumer reaction to new product offerings. They are looking for business partners to help them optimize their operations, help drive costs out and help them implement good processes and standardization across their platforms to help drive a more consistent and enduring customer experience, much like MTN South Africa is having us due for them with both their wholesale and residential businesses. They are looking for solutions that allow them to launch new digital services fast, scale fast and fail fast, again, based on consumer response to these new services, much like how one of the world's leading family entertainment and media enterprises is doing by utilizing our Ascendon platform to help deliver various monthly subscription services ranging from their catalog of movies and e-books to their online flagship sporting content.

It's an exciting time, and at the same time a challenging time. Earlier this year, I laid out three key objectives aimed at helping our Company realize its full potential over the long-term. They included aligning the organization to grow our leadership position in key markets, adjusting how we execute to drive profitable growth, and then prioritizing our efforts and our investments.

I am pleased with the progress we've made so far. We have aligned the organization so that we are much more customer focused and streamlined our management structure to move decision-making closer to the customer.

Now that our leadership team is in place, we have started increasing our investments in our operational platforms, new solutions like our award winning Ascendon digital services monetization platform, and in our employees to ensure that they have the right skills and talents to deliver for our customers whose business is changing radically. And we've evaluated our cost structure overall to ensure that we are operating in an efficient, effective, and profitable manner, and spending our money in areas of greatest strategic importance. You can see this come through this quarter in our software and services areas in which we have targeted efficiencies and cost improvements to help improve the financial performance of our carrier business.

In addition, we view one of our key responsibilities as being to allocate our capital in ways that drive long-term shareholder value. We believe this includes a good balance of returning cash to shareholders while still investing in the future growth of our Company.

Let me share my current views a bit more in depth on this topic. First, we have a solid dividend in place that returns 25-plus% of our free cash flow to shareholders. Second, we historically have bought back shares to offset the dilution associated with our employee equity compensation programs. These two items are fundamental to our policy of returning cash to our shareholders, and we remain firmly committed to continuing them. After this, we look for ways to smartly allocate our capital, which may include strategic repurchases of our stock and/or strategic investments back into the business generally in the form of R&D and/or M&A.

Eight months into my tenure as CEO, I get more and more excited about the opportunities that I am seeing in the marketplace where we can effectively deploy capital to grow our business. As a result, I plan to go back to a more balanced approach in allocating our capital between strategic share buybacks and investing our capital into the business. This means a change to our previously announced increased share buyback program. Let me provide you with some context.

Based on the opportunities that we are seeing in the market, we believe that taking a more balanced approach gives us the dry powder to be thoughtful and more strategic with our investments to drive profitable, organic and inorganic growth over the long-term while maintaining returning 25-plus% of our free cash flow to shareholders.

I am committed to pursue long-term shareholder value creation. In order to do so, and we will constantly monitor our investments for the best return, evaluate our operations to ensure that we are performing in the most effective manner for our clients, and listen to the market.

The objectives that I've laid out for our Company are not a one-and-done. In a dynamic business environment, they require constant attention and focus in order to take advantage of the many opportunities that will presence themselves to increase our value to our customers, our employees and our shareholders.

Finally, before I turn it over to Randy to review our financial performance in more detail, I want to reinforce why I like our business and why we believe our fundamentals are strong. We have unrivaled domain expertise in the cable and video markets. We work with some of the largest and most innovative communication service providers in the world. We have proven technology and a solid reputation for operating our solutions really well. And as I shared earlier, our clients are telling us that we have a truly differentiated solution with our Ascendon platform.

We are in the early stages and making solid progress in transforming a traditionally transactional and unpredictable software business model into a recurring revenue business with long-term, predicable and visible revenues and, more important, strong customer relationships in our international carrier business. We are in the early stages. We have a financially sound company. We generate strong free cash flow and have a strong balance sheet. 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.

With that, I'll turn it over to Randy to review our financial performance for the second quarter and our expectations for the remainder of the year.

Randy Wiese - *CSG Systems International, Inc.*

Thank you Bret, and welcome to all of you on the call today to discuss our financial results for the second 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'd like to walk you through our financial results in more detail. Total revenues for the second quarter were $190 million, an increase of 4% over the same period last year. Sequentially, revenues for the quarter increased 2%. Our cloud related solutions grew 6% from last year's second quarter, which was driven largely by the continued conversion of new customer accounts onto our cloud solutions. This strength helped to offset the headwinds we continue to experience in our software and services revenues.

Moving on, our non-GAAP operating income for the second quarter was $42 million with a margin of approximately 22%. Our current strong operating margin profile reflects the benefits of the scale we have achieved as we have grown the number of customers on our cloud solutions, the benefits from the disciplined management of our cost structure, and investment allocations we have made over the last year or so. The strength of our business model leaves us well-positioned to make the long-term investments necessary to grow our business in the future. I will address this point later in my guidance comments.

GAAP operating income for the quarter was $29 million, or a margin of 15%. For the second quarter, our non-GAAP adjusted EBITDA was $50 million, or 26% of total revenues. Non-GAAP EPS for the second quarter was $0.70, which compares to $0.61 for the same period last year with a non-GAAP effective income tax rate of 37% for the quarter. This represents a 15% increase over last year's -- the second quarter of 2015 in our non-GAAP EPS.

For the second quarter, our GAAP EPS was $0.33, which compares to $0.39 for the same period last year. The decline here was driven by our restructuring and reorganization activities along with a recorded loss on the repurchase of our 2010 convertible debt, both of which are excluded from our non-GAAP results.

Now onto our balance sheet and cash flows. We generated $40 million of cash flow from operations and $36 million of free cash flow for the quarter. Year-to-date, we have generated $51 million of cash flow from operations and $42 million of free cash flow. Overall, we ended the quarter with $287 million of cash and short-term investments, a decrease of $98 million from the first quarter. The decrease in cash this quarter relates mostly to additional repurchases of our 2010 convertible debt as part of a (inaudible) this instrument from earlier this year. The remaining amount of this interest -- instrument still outstanding has a current estimated settlement value of around $80 million and has an ultimate maturity date of March 2017.

Moving on, for the first half of the year, we paid $12 million in dividends, which represents an increase of 6% in 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 $10 million.

We continue to evaluate the best use of our cash to drive long-term shareholder value. As Bret mentioned earlier, going forward, we intend to follow a more balanced approach in allocating our capital between share buybacks and investments in our business than we have over the last year and a half. We are fortunate that we can return a meaningful amount of cash to our shareholders, and at the same time use our balance sheet to take advantage of opportunities that may arise in a highly volatile and dynamic market.

Let's move along to our discussion of 2016 guidance. Overall, our guidance is relatively unchanged. Because of our solid performance to date and the recurring revenue profile of our business, we are tightening the bottom end of our revenue range. For 2016, we now expect revenues of $745 million to $760 million, an improvement of $10 million on the bottom end of our previous range.

Moving on to our operating performance expectations, we currently anticipate our full-year non-GAAP operating margin to be in the approximate 20% to 21% range, which represents a slight improvement from our previous outlook. Consistent with our initial guidance this year, we anticipated strong margins in the first half of 2016 as we expected the headwinds from the Charter Time Warner merger and several of our strategic investments to fall more in the back half of the year. These investments will include the following key items: additional R&D dollars for the advancement of our solutions at a greater level and more accelerated pace; improvements in our go-to-market capabilities around our next generation Ascendon platform; and investments that will continue to drive the operational excellence, scale and security of our cloud solutions. This guidance implies that our second-half 2016 non-GAAP operating margin will be more towards the bottom end of our long-term targeted operating range of 18% to 20%. We continue to believe this range provides a good mix of returns to the bottom line while still providing investment opportunities to grow our business.

Moving on, our 2016 non-GAAP EPS guidance remains unchanged at $2.59 to $2.69 with a non-GAAP effective income tax rate of 37%. The higher operating margin expectations I mentioned earlier are essentially offset by higher anticipated share counts and an increase in nonoperating expenses tied to foreign currency movements, such that our EPS guidance remains unchanged for the year. We now expect non-GAAP adjusted EBITDA to be within the range of $184 million to $188 million, a slight increase from our previous expectations. And finally, we are maintaining our range for cash flows from operations of $110 million to $130 million for the year with expected capital expenditures of around $20 million.

Overall, we are pleased with the continued progress we are making to drive bottom-line results while also positioning the Company to achieve its full potential. We believe that the strength of our business model, including highly recurring annual revenues, profitable operations, and strong cash flows, allows us to continue to create 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.

Tom Roderick - *Stifel Nicolaus - Analyst*

Good afternoon. Thanks for taking my questions. So nice improvement in terms of the guided range kind of tightening up like you said on the low end, sort of $10 million higher on the revenue range. Can you just walk through a couple of the different impacts of that? And maybe the three I'm thinking about here is existing conversions from Comcast, the later closing and the impact associated than you might have earlier expected with Time Warner and Charter. And then just it looks from my perspective, even though you mentioned some headwinds, the software and services businesses seems like it did a little bit better than expected in the quarter. So maybe you can address those three or other elements that are encouraging you to raise the range.

Randy Wiese - *CSG Systems International, Inc.*

I'll take that one, Tom. On the conversions, nothing has really changed from the beginning of the year when we established our guidance. We had said we expected to do $1 million to $2 million conversions for the year, and we are on track for that. So that hasn't changed.

As it relates to Charter Time Warner, it closed about midyear, which was pretty close to our expectations, so, again, no big movements really as a result of that event.

And on the software and services side, that's probably the primary reason why you see the bottom end come up as we see greater visibility into the projects, how we are completing those projects, how those are going through the sales cycle. That's probably the one I would point to as the main reason why the bottom line -- or the bottom end came up on the range.

Tom Roderick - *Stifel Nicolaus - Analyst*

Good. Let me address software and services then with my second question here. Just MTN is kind of an interesting case study as a really nice managed services contract that you guys have now expanded. I would love to hear what the competitive area looks like out there, period, if there's any change to that, any change to pricing pressures. But now that you're getting sort of better referenceability under your belts with some of these larger customers that you've been implementing, how is that helping you out in the field? How did it play out in the extension there at MTN?

Bret Griess - *CSG Systems International, Inc.*

It does help out quite a bit as we work to build that referenceability. That's directly aligned with our strategy in the lines of moving that software business to the recurring revenue, and also the recurring relationship, I would call it, because the longer we are embedded, the more we become partners with our customers in that environment. So that one was highly competitive as we worked our way through it, but the history of what we had built with the smaller agreement with them in advance helped to build upon that because, as we traditionally say, we like to say what we do then do what we say. And that helps to add value.

So when you look at Telstra, when you look at MTN, when you look at some of the others, our strategy is starting to play out there and the referenceability gives us more credibility when we are talking to other customers in other parts of the world. It is a very dynamic market now, as you are aware, and everyone is aware, with the business climate that's out there. But that dynamic market is leading to a lot of activity, and we like how we are positioned, both with the domain knowledge of running the managed services. And then when you put the leading future platform with Ascendon on top of it, we can bring a great deal of value. So we won't get too far out over our skis, but we saw that as a very big win aligning to our strategy and helping us to take that lumpy business and turn it into the true value business that CSG likes to bear.

Tom Roderick - *Stifel Nicolaus - Analyst*

Great, so good job on that. Bret, let me throw the last one at you here again. I apologize. I was kind of writing fast and furiously. But I want to make sure I've got your comments straight with respect to the share buyback program and your desire to sort of deploy that capital in an investment platform a little bit differently. So, can you go through your comments again from the standpoint of your desire to invest perhaps more aggressively in the business, what you see are the areas with the underlying opportunity to accelerate growth and where you would like to put those dollars?

Bret Griess - *CSG Systems International, Inc.*

I figured that would be a question. The thing that I will tell you first and foremost, we are committed to driving shareholder value. 100% that will be a focus as we move forward. That being said, we have seen a 60% appreciation over the last 18 months in our share price. We still think that there's great opportunities. And not only do we think there's great opportunities, but we've built a world-class leadership team here. And by bringing a couple of people to the table that are new, we are getting some different perspectives. And so we want to vet those fully so that we are sure we are looking at how best to use those capital dollars for R&D, for M&A, and for share buybacks. So we are not stepping away from any of them. We are just committed to the fact that we are going to drive shareholder value and we are going to be thoughtful in our decision-making for where we put those dollars, and we are going to work to be sure we are driving long-term shareholder value when we invest them.

Tom Roderick - *Stifel Nicolaus - Analyst*

Got you, very helpful. Thank you guys. Nice job.

Operator

(Operator Instructions). Howard Smith, First Analysis.

Howard Smith - *First Analysis Securities - Analyst*

Good afternoon. Thank you for taking my question. Let me start, I just want to clarify on the capital allocation, you went through some of the rationale of things. I just want to make sure -- you had $84 million left on an accelerated program, and it sounds like, with the result of re-thinking the deployment, that is not going to take place, that is not anticipated to take place. But is it still the intent to repurchase shares to offset the growth in shares from stock-based comp, or is that also kind of --

Bret Griess - *CSG Systems International, Inc.*

I would reiterate that again and try to -- we are 100% committed to that, that we will continue to work to do that to remove any dilution in the process.

Howard Smith - *First Analysis Securities - Analyst*

Okay. So kind of -- and then the dividends, so similar to where it was before the accelerated program.

And then maybe a question for Randy. I'm trying to understand some of the movement in the cost of services. Some of those lines for example, processing related, jumped sequentially more than it has in many quarters, and just a phenomenal job of reducing the cost of software and services despite the strength in the revenue. So is there an allocation between those that has changed a little bit or moved around or maybe you could help me with some of the puts and takes?

Randy Wiese - *CSG Systems International, Inc.*

No, I think you look at it kind of as what I would call somewhat normal quarterly movements. If you look at the margin, I think the margin on the cloud services probably still is close to 53% or 54%, probably down a couple of percentage points from the previous quarter. I would really just look at those as kind of the mix of revenues going through the timing and conversion, so nothing unusual that I would call out there at all.

On the software and services, the margin on that can gravitate in the 30%s to 35% to 40%. I think you saw a little pop this quarter, probably 45% margin is what you're referring to. Think of that again just as timing of various projects as they come through the cycle and nothing of great significance.

You can see we've done a pretty good job. If you look at the cost of goods sold as it relates to software and services has come down pretty well over the last 18 months generally, just because of some very, very targeted improvements in that area once we brought Phil Yoo on about a year or so ago.

Bret Griess - *CSG Systems International, Inc.*

I was going to say I appreciate you calling that out, Howard, because it was phenomenal, the team effort and the focus and the approach that they all to get us to that point. So I appreciate you seeing that, recognizing it.

Randy Wiese - *CSG Systems International, Inc.*

Just as a closing point, it's nothing I would call out as something that you should look at from a trend. It's just some good trending I think over time as the performance and nothing I would call out that you should consider the second half of the year.

Howard Smith - *First Analysis Securities - Analyst*

Okay, that's very helpful. I'll leave it there for now. Thank you.

Operator

We have no further questions at this time. I would like to turn the program back over.

Bret Griess - *CSG Systems International, Inc.*

Just one last thank you to everybody for being on the call today, and to our customers, because they are what make our business in combination with the phenomenal employees we have, so thank you, everybody, for being here and we'll talk to you next quarter.

Operator

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