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CSGS - Q1 2016 CSG Systems International Inc Earnings Call

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Operator

Tom Roderick *Stifel Nicolaus - Analyst*

Howard Smith *First Analysis - Analyst*

PRESENTATION

Operator

Good day, and welcome to the CSG Systems International First Quarter 2016 Earnings Announcements Conference Call. Today's conference is being recorded. 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, Investor Relations. Please go ahead.

Liz Bauer - *CSG Systems International Incorporated - IR*

Thank you, [Tasha], 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 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.

With that, I'll turn the call over to Bret.

Bret Griess - *CSG Systems International Incorporated - CEO*

Thank you, Liz, and thank you all for joining us today. Today, I'm going to cover our results for the first quarter and then review the actions we have taken to position our Company for continued success. And at the end of my comments, I will turn it over to Randy to review our financial results in greater detail.

So let's begin. For the first quarter of 2016, we reported revenues of $186 million, best in industry leading non-GAAP operating margins of over 20% and non-GAAP earnings of $0.77 per share. The strength of our earnings is driven by our solid execution over the last year and really positions us well for further investments in our business to drive future growth opportunities.

We have had some solid activity since our last earnings announcement, including converting approximately 650,000 subscribers off of multiple competitors' billing systems and onto our Advanced Convergent platform. Helping Sony Pictures' Home Entertainment launch their first ever combined hardware and app offering pushing 4K content to consumers. Every Sony Bravia 4K TV has our app embedded in the home screen allowing consumers to buy and stream 4K content on their TV moving forward, and watching ESPN Cricket Pass and over-the-top packaging of sports content for the second year after its successful introduction last year.

Moving on, I'd like to review the actions we've taken to help our Company realize its full potential over the longer term. Last quarter, I told you that we would focus on three key activities aimed at achieving this goal. They included aligning the organization to grow our leadership position in key markets, prioritizing our efforts and our investments and adjusting how we execute to drive profitable growth. I'm pleased with the progress we've made in a very short period. We've strengthened our bench both in terms of our leadership team and our Board and we've aligned our organization to intensify our focus on expanding our client list and relationships in key markets, positioning us well for profitable growth -- revenue growth in the future.

Let's begin with the talent that's joined CSG. First, we added a proven technology and communications industry veteran, Marwan Fawaz, to our Board. Marwan has worked for industry leaders like Google Motorola Mobility, Charter Communications, Adelphia and Media One. He has first-hand knowledge of the strategic markets that we serve and the challenges that they are facing. He brings the technology expertise to our Board that will be greatly valued and additive.

Next, we brought in Brian Shepherd, a proven and trusted executive in our space and the communications industry in whole, to focus on accelerating the growth and strategic direction of our global broadband cable and satellite business. I've known Brian for many years from his days with Amdocs and DST Innovis and he has -- when he was one of our most fierce competitors. I'm pleased to have him on our team leading our efforts here. I'm excited about the level of passion and innovative thinking that he brings, not only to our clients' business, but to CSG as well.

With Brian's addition, we rounded out much of my leadership team and have aligned the organization around our three key markets. First, the global broadband cable and satellite market, which Brian leads in which we're the leader in North America, but have a very small presence internationally. My goal over the next several years is for us to expand our footprint in this market, both here in the US and abroad through an increased focus and diligence in those areas.

Second, the global carrier market. This will be run by another proven and successful telecommunications leader, Phil Yoo. We brought Phil Yoo back to our Company a little over a year ago to set the strategic direction for the delivery of our services to telcos and wireless providers and to improve the performance of our international business. Now he takes on a broader role that includes driving future topline revenue growth with existing and new telecom providers around the world.

And finally, the global over-the-top market, which Kent Steffen leads. Kent is a recognized visionary and expert in this market and was the catalyst and strategic thinking behind our Ascendon investment and solution, our early-mover advantage in the digital services space that's provided a key differentiator for us and built on our strong heritage in monetizing video and content through a variety of business models.

Next I'd like to share some consistent themes that I've heard from clients and prospects as I've met with them over the past several months. These themes include, clients like doing business with our people. They appreciate the fact that our employees have strong domain expertise, act like true partners versus vendors and have strong points of view about where the industry is going and what an operator can do to be successful and relevant in the future. Both clients and prospects told me that we have a differentiated platform and digital domain expertise with Ascendon, but we haven't done a good enough job in marketing it within the industry or to our clients.

And finally, our clients reinforced that their businesses are changing and they need help. They are experimenting with new business models and they're trialing new ways to engage and interact with their own customers. This represents a tremendous opportunity for us and we are now aligned to be more responsive than ever to help them achieve their goals. This input will strongly influence how we focus and prioritize our investments going forward to bring more value to this industry.

First, you should expect an increased focus in our Ascendon platform. This is not just in the form of pure R&D spend, but in our go-to-market strategies as well. We had a former CIO of a major wireless provider sum it up best. No one wants a 4G network and a 1G back office system. Well, our Ascendon platform solves that problem. Today, service providers are trialing new offerings and new business models without having to undertake a major transformation to their back-office infrastructure. Our Ascendon platform enables them to prove out the business cases associated with these new digital offerings and business models. And when they are ready to transform their back office solutions to drive a more customer-centric holistic experience across their entire portfolio of products and services, we'll be ready for them with our cloud-based next-generation solution, regardless of the service or pace.

Next, we are taking a more target approach to the market. We have over 400 clients across the globe who are going through some type of evolution, whether that be in overcoming the challenges they face and competing against new entrants, reallocating their cost away from traditional and declining lines of business to new revenue generating streams, rationalizing their billing and customer care solutions as a result of consolidation or experimenting with new products and services in order to be relevant and increasingly complex, customer-driven and demanding communications in entertainment ecosystem.

Our business units are taking a holistic approach to our targeting, not just making this a sales exercise, but a cross-functional business approach to understanding our customers' key challenges and endpoints and providing them with the services and solutions to be successful. With our strong domain expertise in video and digital services, and our reputation for doing what we say we will do in a partner-oriented fashion, I believe we have an opportunity to expand our footprint within our existing client base in a highly prioritized and targeted fashion. And finally, we're investing in those areas that continue to drive our operational excellence, scale and innovation.

And realizing our full potential also means ensuring that we are optimizing our balance sheet so that we can be more opportunistic. In March, we refinanced our convertible debt to provide us with more favorable terms from a debt and equity perspective, as well as improve flexibility over a much longer period of time.

Finally, before I turn it over to Randy to review our financial performance in more detail, I want to reinforce why we 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 ours Ascendon platform. We have a financially sound company and we generate strong free cash flow and have a strong balance sheet. And most import, 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 first quarter and our expectations for the remainder of the year.

Randy Wiese - *CSG Systems International Incorporated - CFO*

Thank you, Bret and welcome to all of you on the call today to discuss our financial results for the first quarter as well as our outlook for the remainder of 2016. We are pleased with the solid start to the year, especially in light of the challenging business environment.

Now I'd like to walk you through our financial results in more detail. Total revenues for the first quarter were $186 million, consistent with the same period last year, in spite of a $2 million negative impact from foreign currency movement this quarter. Sequentially, revenues for the quarter decreased 6%, mainly due to our seasonally higher fourth quarter software and services revenues. Our cloud and related services revenues grew 4% from last year's first quarter, which was driven largely by the migration of new customer accounts on to our cloud solutions. This strength helped to offset the headwinds we continue experience in our software and services revenues.

Our non-GAAP operating income for the first quarter was $44 million with a margin of approximately 24%. GAAP operating income for the quarter was $41 million or a margin of 22%. These strong margins are a result of our execution on several fronts over the last year or so, summarized as follows. First, the scale benefits increase in the number of customer accounts and clients on our various revenue management and content monetization solutions. Second, better alignment of our investments with our revenue opportunities; and finally, several cost structure improvements.

The strength of our business model provides us with various operating and investing opportunities with a very strong operating margin in the first quarter, but we remain committed to making the long-term investments necessary to grow our business in the future. I will provide more color on this topic when I go through our 2016 guidance later in my comments.

Moving on, for the first quarter, our non-GAAP adjusted EBITDA was $52 million or 28% of total revenues. Our non-GAAP effective income tax rate for the quarter was 37%. Non-GAAP EPS for the first quarter was $0.77, which compares to $0.51 for the same period last year. This represents significant year-over-year non-GAAP EPS growth, driven in large part by our improved operating performance. GAAP EPS for the first quarter was $0.64.

And now on to our balance sheet and cash flows. We generated $11 million of cash flow from operations and $5 million of free cash flow for the quarter. Our first quarter is typically our lowest quarterly cash flow generation for the year, as our prior year's accrued employee incentive compensation is paid in March. Overall, we ended the quarter with $385 million of cash and short-term investments, an increase of $144 million from the fourth quarter. This large increase relates mostly to timing around the refinancing of our previously outstanding $150 million par value convertible debt during the first quarter, summarized as follows.

In March, we made the decision to refinance our existing convertible debt with the new issuance of $230 million of par value convertible debt. Since then, we've used about $200 million of the proceeds to repurchase close to 70% of our previously outstanding convertible debt. The remaining 30% outstanding has an estimated settlement value of around $86 million as of today. We intend to monitor and evaluate how best to settle this remaining amount, which has an ultimate maturity date of March 2017.

Our decision to refinance our convertible debt was driven by various market and strategic business considerations for CSG and provided us with the following benefits. First, we have replaced a significant portion to our capital structure that was maturing in March 2017 with another high-quality convertible debt instrument that has its real first put and call date six years up. Second, this will allow us to eliminate the substantial EPS dilution related to our previously outstanding convertible debt, as that debt is retired. And finally, this refinancing of it solidifies our capital structure at a reasonable cost, providing us with a solid -- with a strong capital base and continued access to liquidity, which provides us with options to invest in our business.

Moving on, we continue to return cash to our shareholders during the quarter. First, we paid over $6 million in dividends, at this level, we expect to pay dividends of around $24 million for 2016, which represents a quarterly dividend increase of 6% over last year. Second, we repurchased approximately $10 million of shares during the first quarter to the use of our existing 10b5-1 plan. To date, we have repurchased about $66 million of our stock over the last five quarters at a weighted average price of around $32 per share. This is about 45% of our planned $150 million repurchase program we announced last year. So we are pretty much on pace to accomplish this over the three years we initially targeted.

We anticipate an increase in our daily trading levels and the related stock price volatility that we experienced in the first quarter as a result of our convertible debt refinancing resulted in us not going forward with an accelerated stock repurchase plan or ASR plan as we have previously expected. Because of these trade volatilities, we thought best to avoid an ASR plan at this time as this would have limited our near-term ability to exercise prudent judgment in executing our multi-year repurchase strategy. Our intent is to complete our $150 million of buybacks within the three-year timeframe we initially targeted with the timing, pace and the amount of our buybacks continue to be dependent on Company and market dynamics.

In summary, our strong capital structure and business model and our capital allocation policy allows us to have the financial resources to make meaningful distribution to shareholders, while also maintaining the flexibility to invest in our business. With these actions in mind, let's move along to our discussion of 2016 guidance.

Overall, we are maintaining our previous non-GAAP full-year guidance. For 2016, we continue to expect revenues of $735 million to $760 million. Before I move forward with our guidance around our expected operating performance for the remainder of the year, let me provide a quick reminder that our long-term planning expectation is to operate within our target non-GAAP operating margin range of 18% to 20%, as we believe this provides a good mix of returns to the bottom line, while still providing adequate investments back into the business.

We have shown that we will operate above or below this level as we go through different business cycles. Most recently, we have been above the top end of our range based on our strong execution over the last year or so and in advance of our next round of investments in the business. When we set our 2016 original guidance, we anticipated strong margins in the early part of 2016, while we focused our attention on aligning our organization and bringing on additional talent. Now that we have our management team in place and reorganized around key markets, we are ready to make investments in the business at the amount and at the pace we anticipated when we set our initial guidance.

These planned investments include such things as 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 an increased focus in those areas that will continue to drive our operational excellence, scale and innovation. These planned investments when combined with the headwinds we anticipate when the Charter, Time Warner merger closes, are expected to result in a full-year 2016 non-GAAP operating margin in the 20% range. While this implies a decline from the strong margin results we experienced in the first quarter, it demonstrates our commitment to invest in our business and pursue future growth opportunities.

Moving on, we continue to expect our full-year 2016 non-GAAP effective income tax rate to be 37%. Our 2016 non-GAAP EPS guidance range remains at $2.59 to $2.69. The additional interest cost related to our convertible debt refinancing I mentioned earlier, have essentially been offset by the lower dilution from buying back some of our previously outstanding convertible debt and thus the refinancing event has little overall impact to our EPS expectations for 2016.

We continue to expect non-GAAP adjusted EBITDA to be within the range of $177 million to $182 million or 24% of expected total revenues. We are maintaining our range for cash flows from operations of $110 million to $130 million for the year and expect capital expenditures of around $20 million for the year.

Overall, we are pleased with the continued progress we are making to drive bottom line results, while also focusing our attention towards improving our business and our future growth opportunities. We believe that the strength of our business model, which includes highly recurring annual revenues, profitable operations and strong cash flows allows us to maintain our favorable capital allocation strategy, while providing sufficient capital to invest in the future of the Company. The effective balance between management of our capital structure and investments in our business enables 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

Thank you. (Operator Instructions) Tom Roderick, Stifel.

Tom Roderick - *Stifel Nicolaus - Analyst*

Hi guys, good afternoon. So Bret, let me (inaudible) the first question at you here, you've had now a whole quarter under your belt, and I know this is your second call. So I guess last quarter you came on and said, you should expect us to invest and we haven't quite seen that yet. But Randy certainly discussed some of those opportunities and where you'll look to put that money to work. I am curious now that you've strengthened your balance sheet even more, what your current thinking and philosophy towards M&A works within this context of investing and to the extent that you would like to see the product build out, perhaps combination of organic and M&A, where do you see opportunities in the product side? Thanks.

Bret Griess - *CSG Systems International Incorporated - CEO*

Thanks, Tom. I appreciate you being on today. Yes, going through the first quarter and it's kind of an interesting thing after 20 years of being here feeling new in the role, but it's 20 years of running to get to the starting line, which is what -- the way I feel the new CEO role is. But to answer your question more directly, is that the first quarter what I really did is just strengthen my affirmation in the business and how strong the business is and the business model is and what that does, and the strengthening of the balance sheet really gives us the opportunity to be smart about the decisioning when we go through it similar to the discussions that Randy shared on the ASR. We can be prudent and we can be smart, the part that we're not going to take our eye off of is being relevant and growing the topline. So we are absolutely focused on that. We're aligning the team to focus on that and what that's doing is the organization is getting closer and closer to the marketplace and to our customers. And the closer we get to our customers, the more we hear about their challenges which create opportunities for us to help solve them.

We're very open-minded to the M&A activity, but it's going to be wise M&A that we've been (inaudible) for and/or incredibly opportunistic. So we're keeping an open eye to the opportunistic items right now and we're working diligently through the potential investments along the lines of build, buy or partner and either way we're going to do it with a focus on our markets and our investors so that we're sure that we solve for them. So we're open minded and we'll look for those opportunities to solve for the market.

Tom Roderick - *Stifel Nicolaus - Analyst*

And, Bret, I know you've had a lot of experience on both the software side of business as well as the cable MSO side of the business. As you think about where you want to apply those investment dollars, how do you think about the prospects for the international software side of the business? You've certainly highlighted the opportunity in managed services, but it appears the global framework for software continues to be a bit challenging, continues to be a bit price sensitive. As you think about putting more investment dollars to work, how do you think about the prospects of those two markets and where would you rather see more of those dollars go?

Bret Griess - *CSG Systems International Incorporated - CEO*

Well, Tom, we see those markets somewhat coming together as far as the overall IP, video and telco space as those start to blend where you see the OTT players, being the cable companies and vice versa. However, completely agree of what you're saying about the challenges to software in the international market space and the evolution of those business models. So we're incredibly focused on creating longer term, more recurring in nature relationships with our clients internationally, which allows us to be very sticky and I don't know (inaudible) additional opportunities for us to help them solve their problems and capitalize on the opportunities in the market.

So the managed services internationally is still something we're very committed to. We've had good traction with that and the more time we spend with our customers in solving their problems, the more interest we're getting from them, the more they're coming to us saying, wow, you can do that. So we know our heritage, our heritage was in cable in North America, but we're leveraging what we learned in that domain expertise internationally, and you're going to see us continue to focus on our heritage and honor that, but we're pretty inspired by the opportunities that it presents for us internationally, but what we won't do is we won't allow it to be [dumb] business either for our shareholders or for ourselves. So we're being thoughtful and the investments will be balanced, but it will be in that focus for our heritage with driving the future.

Tom Roderick - *Stifel Nicolaus - Analyst*

And maybe one last follow-up for that topic. The notion of convergence of the two markets certainly seems like Ascendon is right at the convergence of those two. Talk a little bit more, if you don't mind, about what the international receptivity for Ascendon has looked like? How that helps you get international with potentially both telco and cable clients and what the ramp around investments in that product line ought to look like?

Bret Griess - *CSG Systems International Incorporated - CEO*

Yes. As a cloud-based digital platform, it really opens it up because the opportunities that we're seeing in some of the customers where we're actually utilizing the Ascendon platform in Europe as we mentioned last quarter for a content provider to distribute video that they're then tying digital services to that, meaning additional things like (inaudible) and other activities, what that does is, once we get to success with them, it starts to prove out the value in that market. And when we were able to take a victory for our client there and share that, then clients all over the world see that, and we start seeing more interest in it as we go that helps to build.

So we're not going to do, if you build it, they will come, activity, but what we will do is continue to invest in Ascendon, which isn't about the international market and it's not about the North American market, it's about the global market. And it positions us well to put our investments in Ascendon to solve for a much broader market, answer our customers' business challenges to help them to be successful and we're getting traction. And traditionally, we've made these up starts internationally and then we come back to you later and talk to you about the challenges, but we're starting to get some traction on it. So I'm not going to over-commit to international versus North American cable, but what I will commit to you is we're going to continue to invest in the Ascendon platform and we're going to leverage it in the markets where we can bring success to their business and ours.

Operator

(Operator Instructions) Howard Smith, First Analysis.

Howard Smith - *First Analysis - Analyst*

Yes, good afternoon. Kind of following up on some of the Ascendon commentary. You, Bret are putting a greater emphasis on this product both at domestic and international, kind of a global basis. Where are you in terms of rolling this out from a marketing and sales standpoint to the broad, your 400 customers? Have they all seen it and had initial discussions or have you really been kind of getting your internal packaging correct and your team and everything, and the bulk of that effort is taking place throughout 2016 and to next year, just where are you in terms of your conversation with your customers?

Bret Griess - *CSG Systems International Incorporated - CEO*

It's a combination of those things that you just referenced as far as an internal versus external and as I mentioned, we have not done the best of jobs with marketing into the market and we have been positioning a great deal within the internal activities as we go through it. If you're truly -- I'm just putting a thumbnail up in the air here right now, if you're looking at the customers that have seen it and gotten a deep debrief on it, my gut feeling is it's 15% to 20%. We're barely starting to get out into that area and each time we do, we're getting more and more positive feedback in that area. However, we're also going to be very wise about how we go after that market, but we see great potential and opportunity.

The other thing I would share with you is, this is not a -- we're just going to swap out everything we've got to move to the next generation platform, this is the next-generation platform that brings incredible flexibility and digital opportunity to our customers. And so we deploy it when it makes sense for them. Some of them are using it in tandem with the legacy platforms as we go through. We will never put our customers through a forced march, we will work very hard to support their businesses and drive it forward. So we're very early in the going to the market, use the metaphor you choose, the second inning of the game or the first quarter of the game, whatever it is, but we're just really getting into the market area and we're going to get closer to our customers to understand more about their business challenges and their architecture. They each have their own different technological architectures and we don't want to go in there thinking we're the geniuses, so we work with them to deliver on the areas that we do have great domain expertise on. So early in the market activity with it, but getting great traction with it and we'll continue to serve our customers.

Howard Smith - *First Analysis - Analyst*

Great, I appreciate that. And just following up with maybe a numbers question for Randy. That comment on kind of future buyback activity or share price move, but kind of with where things stand today with your repurchases already done for the convert, what are you thinking in terms, and I apologize if it's in the press release, kind of share count for Q2 and for the year as a whole?

Randy Wiese - *CSG Systems International Incorporated - CFO*

Yes. For Q2, we don't provide quarterly guidance, we provided full year, Howard. So our full year guidance I believe was 32.7 million shares. So which is down about, I believe about 750,000 from the original guidance with a lot of different factors in there driving that, it's the buyback of the converts, it's the stock price increase, it's the -- not doing the ASRs, there's a lot of different factors in there, but I think it was 32.7 million was the number we use for the full year.

Operator

(Operator Instructions) Tom Roderick, Stifel.

Tom Roderick - *Stifel Nicolaus - Analyst*

Hey, Randy, we'll keep you busy while you got the mic here. Kind of curious how you would suggest we model in the timing, I know it's a bit of guess work here relative to Time Warner and Charter, but obviously there is going to be sort of a one-time step down on both revenue and profitability. I think previously we were of the mindset that we do that sort of all in Q2, and then through the rest of the year. So can you remind us as to what you expect the annual hit to -- or the annualized hit to revenues and profitability ought to look like? And when you might suggest we start [tuck-in] that into our models here?

Randy Wiese - *CSG Systems International Incorporated - CFO*

Yes. I'll give you just the impact of 2016 and then you can annualize it for -- if you want to use it for 2017. But the impact to 2016 is expected to be about a $5 million revenue headwind and profitability headwind. And that we should start -- and should go somewhat ratably, so whenever the deal closes, and Charter decides to merge the contract, so I would look at the either the month of the merger or the month following the merger and then run it ratably across the end of the year, okay? Right now, I think in the $5 million, I think I'm assuming seven months, I believe. Seven months or eight months, I can't remember sure, but it's -- that will get you pretty close.

Bret Griess - *CSG Systems International Incorporated - CEO*

All right, with no more questions, we'll go ahead and bring this to a close. I'd be remiss though in closing the call, if I didn't say thank you to everybody for being here. Thank you to all of our customers for their continued business and most importantly, thank you to our incredible employees for their passion and their efforts to continue to solve for our customers' challenges and opportunities we move forward. So thanks, guys. We appreciate it.

Operator

Thank you. This does conclude today's conference. You may now disconnect your lines, and have a wonderful day.
