ARI Network Services, Inc. Q4 2016 Earnings Conference Call
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C: Matthew Zomboracz; ARI Network Services, Inc.; Corporate Controller
C: Roy W. Olivier; ARI Network Services, Inc.; CEO
C: Bill Nurthen; ARI Network Services, Inc.; CFO

P: Louie Toma; Craig-Hallum Capital Group LLC; Analyst
P: Gary Prestopino; Barrington Research Associates, Inc.; Analyst
P: Avi Fisher; Long Cast Advisers; Shareholder
P: Ed Woo; Ascendiant Capital Markets LLC; Analyst

+++ presentation
Operator: Good day, everyone, and welcome to the ARI Network Services Fiscal Fourth Quarter and Fiscal Year Ending 2016 Earnings Conference Call. (Operator Instructions) As a reminder, this conference call is being recorded.

I would now like to turn the call over to Matthew Zomboracz, ARI's Corporate Controller. Please go ahead.

Matthew Zomboracz: Thank you for joining us today to discuss our fourth quarter and fiscal year ending 2016 financial results. With me today on the call are Roy W. Olivier, Chief Executive Officer; and Bill Nurthen, Chief Financial Officer.

After prepared remarks, we will open up the call to a Q&A session. Please note that we are also webcasting this call on our Investor Relations website at investor.arinet.com. The earnings press release was issued earlier and is also posted on the Investor Relations website.

Before I turn the call over to management, I'd like to remind everyone that during today's call, including the Q&A session, we will make forward-looking statements regarding expected revenue, earnings, future plans, opportunities and other expectations of the company. These estimates and plans and other forward-looking statements involve known and unknown risks and uncertainties that may cause actual results to differ materially from those expressed or implied on the call. These risks are detailed in our most recent annual report on Form 10-K. As such, it may be amended or supplemented by subsequent quarterly reports on Form 10-Q or other reports filed with the Securities and Exchange Commission. The statements made during this conference call are based upon information known to ARI as of the date and time of this call. ARI assumes no obligation to update the information presented in today's call.

During today's call, we will also discuss non-GAAP financial measures, including EBITDA and adjusted EBITDA. These measures, when used in combination with GAAP results, provide us with additional analytical tools that allow us to better understand our

business. A reconciliation of GAAP to non-GAAP measures can be found on our Investor Relations website.

With that, I'd like to turn the call over to Roy W. Olivier, ARI's President and Chief Executive Officer.

Roy W. Olivier: Thanks, Matt, and thanks all of you on the line for participating in today's call. Overall, it was a great year for ARI, and I'm delighted with our results. We continue to execute well around our strategy of expanding our total addressable markets, creating and launching new products, raising our average revenue per dealer and executing on acquisitions that align with our strategy.

For the full year, we reported record revenues, operating income, cash flow and adjusted EBITDA. We continued to pose strong new sales bookings as a result of the strong U.S. economy in fiscal 2016, however, there were two results that did not meet my expectations, organic growth and churn, which Bill and I will discuss in more detail later in the call.

ARI's average share price for the fourth quarter was $4.35, up 38% from the same period last time -- last year. We will discuss these items in more detail, but for now, I'll turn the call over to Bill to go over the financials in detail and then I'll be back to comment on our strategic progress and outlook.

Bill Nurthen: Thanks, Roy, and good afternoon to everyone listening on the call. I will now share with you some more details regarding our financial results for the fourth quarter and fiscal year ending July 31, 2016.

As Roy noted, fiscal 2016 was in many respects another record year for ARI. In fiscal 2016, we focused on integrating the three acquisitions we completed in the prior fiscal year and, as a result, we're able to achieve record results in revenues, operating income, cash flow and adjusted EBITDA.

Before I go through some of the financial details, I wanted to remind everyone that we closed the DCi acquisition in our prior fiscal year on July 13, 2015. As a result, when comparing Q4 to last year and fiscal 2016 to fiscal 2015, we only had about half of months of DCi's operations in the prior year.

Total revenues for the fourth quarter were $12.2 million, which compares to $10.9 million in the same period last year. The year-over-year increase was driven by revenue from the DCi acquisition as well as organic revenue growth. Year-over-year, the total growth was 12%, and we estimate the organic growth, once you strip out the acquisitions, was approximately 4%.

That said, our growth was offset by a decline in nonrecurring revenues, which we intentionally de-emphasized in our business. As a result, when you look at the recurring revenue only, the total growth was 15.8% and the organic growth rate was approximately

8%. In Q4, we experienced organic growth in recurring revenues across all four of our core offerings of lead generation and eCommerce websites, eCatalog, business management software and digital marketing services, with the most notable organic growth occurring in digital marketing services revenue, which more than doubled.

Breaking down revenue by product for the fourth quarter. Lead generation website revenue for the quarter was $6.2 million compared with $5.9 million in the prior year, eCatalog revenue was $4.4 million compared with $3.6 million in the prior year. Business management software revenue was $700,000 compared with $800,000 in the prior year, digital marketing revenue was $700,000 compared with $300,000 in the prior year. Lastly, our other revenue was $200,000, which was flat compared to the prior year.

Looking at all of fiscal year 2016, total revenue for the fiscal year was $47.7 million compared to $40.4 million in fiscal 2015, an increase of 17.9%. The year-over-year revenue growth is primarily attributable to the TCS, TASCO and DCi acquisitions completed in fiscal 2015 as well as organic growth in all four of our core product offerings. The overall organic growth rate was about 4%, but again, the organic growth rate in recurring revenue was much higher at approximately 7%.

One of the more notable takeaways from our fiscal 2016 revenue performance was the growth in recurring revenues. We intentionally de-emphasized nonrecurring and especially professional services-type revenue in our business model and in our compensation plans associated with those revenues and, as a result, did about $600,000 less in professional services revenue in fiscal 2016 compared with fiscal 2015.

Recurring revenues in fiscal 2016 grew 20.4% overall and represented 92.1% of revenue versus 90.2% in the prior year. We believe the organic growth rate we achieved in recurring revenues is more indicative of our longer-term overall organic growth rate as we continue to de-emphasize nonrecurring and nonstrategic revenue.

Turning to profitability. Fiscal 2016 was another record-setting year for ARI as growth in profitability continued to outpace our revenue growth.

Looking at gross profit, our gross profit was $9.9 million in Q4 or 80.9% of revenue compared to $9 million or 82.5% in the same period last year. The decline in margin performance for the quarter was due to an increase in the direct labor component of our cost of sales as we dedicated more resource time to fulfilling on our sales backlog as well as migrating certain of our clients off older web platforms. The margin was also impacted by an increase in digital marketing service revenue, which tends to have a lower gross margin than our other recurring offerings.

For fiscal year 2016, gross profit improved to $38.9 million or 81.5% of revenue compared to $33.1 million or 81.9% of revenue in the prior year. The overall increase was due to our revenue growth, and the margin decline was due to the same factors that I noted related to the margin decline in the fourth quarter. We anticipate that our gross margin may continue to be in the lower end of our normal 80% to 82% range as we

continue to migrate website customers between platforms and increase our digital marketing revenues.

In Q4, we experienced our seventh straight quarter of operating profit improvement. The firm recorded an operating profit in the fourth quarter of $942,000 or 7.7% of revenue versus an operating profit of $686,000 or 6.3% in the same period last year. The year-over-year increase of 37% was principally a result of continued scaling on the sales and marketing and general and administrative lines of the business.

In looking at each of the operating lines in our P&L, with the exception of software development, the aggregate increase in each of those lines continues to be largely attributed to the expense base brought on with the recent acquisitions, offset by efficiencies we either have identified in our business or recognized through the integration of these acquisitions.

Our operating profit for fiscal year 2016 was $3.5 million or 7.4% of revenue compared with $2.3 million or 5% -- 0.7% of revenue in fiscal 2015. The increase of 53.2% represented a record operating income performance for the firm. The increase in operating profit for the fiscal year was primarily driven by efficiencies on the sales and marketing line as we were able to increase total sales bookings in fiscal 2016 despite having less sales headcount.

Looking at pretax profit. Interest expense remains relatively flat, and as a result, our pretax profit continues to increase at a higher rate than the increases in our operating profit. Pretax profit for the quarter was $837,000 versus pretax profit of $573,000 in the prior year, a 46.1% increase. For fiscal year 2016, pretax profit was $3.1 million versus $1.9 million in fiscal 2015, a 64% increase.

From an earnings per share perspective, we were pleased to see the firm post EPS for fiscal year 2016 of $0.10 per share versus $0.07 per share in the prior year.

Looking at adjusted EBITDA for Q4. Similar to operating profit, we posted our seventh consecutive quarter of improvement and another record quarter as adjusted EBITDA was $2.2 million in the fourth quarter of '16 or 18% of revenue compared to $1.8 million or 16.5% of revenue in the same period last year.

As I mentioned at the beginning of my script, this fiscal year, we really focused on integrating three acquisitions we completed in fiscal 2015. We also made investments in our products and in our India office, which we think will drive revenue growth and scale in the longer term.

Despite these investments, in fiscal year 2016, we were able to increase our adjusted EBITDA 29% and also increase the margin. Adjusted EBITDA for fiscal 2016 was $8.5 million or 17.8% of revenue compared with $6.6 million or 16.3% of revenue in fiscal 2015.

Turning to cash flow. Despite making investments that I noted, we were able to increase our cash flow and free cash flow in both Q4 and for fiscal year 2016. For Q4, for the first time in our history, we produced back-to-back quarters of over $2 million in cash flow from operations. Cash flow from operations in Q4 was $2.2 million versus $1.7 million in the same period last year. Free cash flow, which we calculate as cash flow from operations less capital expenditures and software capitalization, was $1.2 million in Q4 compared with $1.1 million in the same period last year.

Looking at fiscal year 2016, cash flow from operations was $7.7 million versus $6.3 million in the prior year. Free cash flow was $4.9 million compared with $4.2 million in the prior year. Cash flow performance in fiscal 2016 was also notable because during the fiscal year, we were able to transition many of our customers from annual billing to monthly billing. We were able to improve cash flow, while at the same time undergoing this change, and believe it is a change that will help us in the long run as it can help reduce customer churn.

As we look at the balance sheet, our theme for fiscal year 2016 was to continue improving our balance sheet to set us up better to complete future acquisitions. We focused on integrating the acquisitions from fiscal 2015 and on driving cash flow while paying down debt. As our fiscal year ending -- as of our fiscal year ending 2016, the firm reported cash and cash equivalents of $5.1 million compared to $2.3 million at the end of fiscal year 2015.

Looking at debt. As of the end of the fiscal year, there was not an outstanding balance on our line of credit. Total debt, which we calculated as debt from our line of credit, notes payable and capital lease obligations, was $9.2 million at the end of the year versus $10.8 million a year ago. The company's debt-to-equity ratio stood at 31.3% versus 40.1% at the end of last year.

To give some further perspective on the improvement in our balance sheet through the fiscal year, it's important to note that we entered the year with debt, net of cash on hand, of $8.5 million and exited the year with net debt of $4.1 million, a remarkable improvement of almost $4.5 million for fiscal 2016.

In conclusion, it has been a very strong year for ARI. As noted, we focused the year on integrating the three acquisitions we completed in fiscal 2015. We also made significant investments in developing our next-generation products and establishing our office in India to build scale for the future. We were able to make these investments while at the same time, improving our earnings and margins and also dramatically improving our balance sheet.

As we look ahead to fiscal 2017, we are still making some of those investments that I previously discussed, most notably in continuing to increase scale in our India office. In addition, I think it is safe to assume that we will also be looking to resume our acquisition activities in fiscal 2017, and we'll have additional legal expense associated with that.

Lastly, you probably have seen some of the recent proxy announcements and issues. There will be additional legal expense and Annual Meeting expense related to that, which is not in our budget model and will impact us in the first half of the year. As a result, we may experience adjusted EBITDA in the first half of the year that is relatively flat compared to the prior year. That said, we expect to see significant improvement in the second half of the year as these nonrecurring costs dissipate and as we begin to realize the efficiencies related to our India office as well as our new products going live.

All this being considered, we expect improvement in adjusted EBITDA for fiscal year 2017 over fiscal year 2016 and anticipate that it will be another record year for ARI.

I will now turn the call back over to Roy.

Roy W. Olivier: Thanks, Bill. Before I get into details, I want to reiterate our strategy in how we got to where we are today. Today, ARI is a SaaS platform business helping manufacturers and dealers in selective vertical market sell more stuff. It is our intention to be the leader in omnichannel retailing as it applies to our markets by helping our customers navigate the growing trend of researching online and buying in store. We are excited about the shift in consumer behavior and believe that we are in the best position to help dealers in our markets capitalize and benefit from this shift.

We have spent the last several years executing on a strategy to increase our total addressable market, or TAM, increase the number of solutions we offer, increase our average revenue per dealer and to execute on acquisitions that align with our strategy. We continue to have ambitions to grow ARI to over $100 million in revenues by fiscal 2021 and expand our adjusted EBITDA margins in the low- to mid-20s.

I believe that during fiscal 2016, we made progress in each area. First, we have continued to focus on the three acquisitions we closed in fiscal 2015, which expanded our markets to include wheel and tire, auto aftermarket service centers and aftermarket auto performance parts. Those new markets have helped us increase our total addressable market from 25,000 U.S. customers a few years ago to over 150,000 customers today. As a result, we have increased our new bookings, a measure of the annual contract value of new sales and up-sells from $9.7 million in fiscal 2015 to $11.6 million in fiscal 2016. This has helped us increase the number of subscribers of our recurring revenue products from 15,071 to 16,589, which translates to about a 10% increase during the same period.

During fiscal 2016, we invested in extensions and upgrades to our current products and developed new products which laid the groundwork for our future. As we have discussed, we have completed a new eCatalog product called Data Manager RT, which is in final beta testing now. It extends our total addressable market with manufacturers who build complex equipment that require repair from a service or dealer network. This product dramatically reduces the amount of time it takes a manufacturer to develop and deploy technical documentation, and we believe it can drive new organic growth in our eCatalog business. We also rewrote our current e-commerce and lead generation platform, which was released 60 days ago and is in beta testing now with a major upgrade

being released this week. We expect this platform to reduce our cost to deliver and maintain our customers.

I would expect to see the revenue impact of these two new products in the second half of fiscal 2017.

For last month and the next few months, ARI is participating in the major annual trade shows for the vertical markets we serve. We are showcasing our dealership for the future concept, where we are demonstrating the use of beacon technology to track consumers in store and market to them based on their online history or where they are in the store. We demonstrated a Parts Bar concept where customers in the store can browse and buy parts, garments and accessories in kiosks while they are waiting for dealer personnel to help them.

Finally, we showed a new B2C mobile application that is a platform for that dealer to target market to their customers based on several criteria. I'm pleased to report that the Parts Bar and the mobile application were big hits with dealers of the first few shows. These product investments, in addition to other operational improvements, are reflected in strong new bookings and churn. Our churn rate for the year was slightly down. While I was disappointed in our annual churn rate, our churn rate for Q4 was 13.1%, the lowest level in seven quarters.

Regarding average revenue per dealer. We continue to see good success with our newer higher average revenue per dealer products. Digital marketing and business management software continue to post strong year-over-year growth followed by lead gen and eCommerce websites.

Turning to acquisitions. We spent all of fiscal 2016 integrating the acquisitions we closed in fiscal 2015. Overall, those have gone well and have met our expectations. Acquisitions continue to be part of our long-term plan, and we have been very active, particularly in the second half of fiscal 2016, evaluating business opportunities that fit our strategic profile. That profile continues to be looking for businesses that have a footprint in our markets or potentially new markets we're not in, businesses that extend or expand the solutions we offer to help dealers sell more stuff and those that are immediately or shortly accretive to ARI's EBITDA. We remain excited about the number of opportunities we see out there at reasonable valuations. The improvements in our EBITDA and cash flows that Bill discussed have put ARI in a better position to fund any new opportunities with senior debt and cash than we ever have been.

We have now grown revenues significantly every year I've been at ARI, and we've shown a dramatic improvement in cash flows and EBITDA that puts us in a great position to continue that profitable growth going forward. In summary, we have made and expect to continue to make significant progress in terms of growing the business on both the top and bottom line. I am confident that fiscal 2017 will be another record for ARI in all respects.

With that, let me open up the call for your questions. Operator, please instruct our listeners how to queue up.

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Operator: (Operator Instructions) Our first question is from Louie Toma with Craig-Hallum Capital. Your line is open.

Louie Toma: I just had a couple of questions, and I'm not sure if I missed this, but did I hear you correctly, you said the recurring revenues, the organic growth for recurring revenues was 7%?

Bill Nurthen: Yes, that's correct. That's 7% for fiscal year 2016, about 8% for Q4 over Q4 last year.

Louie Toma: But didn't you say that the overall organic growth was 4%?

Bill Nurthen: That was including both recurring and nonrecurring revenues, that was the total organic growth rate. And then, if you are just looking at the recurring revenue organic growth rate, that's where the 7% and 8% numbers come from.

Louie Toma: I guess I'm missing the math because if recurring revenues is 93% of revenues, then if that's 7%, then I don't how you get to a 4% overall number. If the difference is only 7% -- the additional 7% of nonrecurring revenues.

Bill Nurthen: Yes, well, [recall], for the year, it was about 92% was the recurring revenue, and that recurring revenue was 92% for fiscal year '16. When you look at, again, if you strip out the acquisitions and you look at just the recurring revenue, organic growth rate, that is more of those numbers.

Louie Toma: Okay, so the acquisitions is what's missing at the math?

Bill Nurthen: Yes.

Louie Toma: Okay, great. Can you talk a little bit about how the CDK and the Toro partnerships are going, give an update on how that's progressing?

Roy W. Olivier: Yes, I can start that. Toro, as a reminder, started in December, January of -- well, December of 2015, January 2016. We had a strong selling season through spring. We have a slow down in the summer, and it starts to pick up now. So Bill's probably got the exact numbers, but we've been pleased with the program so far and we're starting to see kind of the fall sales traction. But during the summer months, it slowed down and that's normal because most of our dealers are very busy in the summer servicing their customers. So our typical selling season is spring and fall. But we remain excited about Toro and it's had pretty good sales velocity.

In terms of CDK, that program is still relatively new. We have, on the AccessorySmart agreement already signed up a record number of customers through that program. I would also add that it's not quite as -- it's not quite as large a number as I'd like it to be, but people tell me I'm not happy with any sales number unless they're bigger.

So the AccessorySmart side is going pretty well. The web platform side is still in its infancy. Don't really have a lot of sales results. We have a development team that is dedicated to working on what we call the Pro level integration or PLI for CDK. That's where we will have a very unique feature set between -- or feature set for a dealer that's using the CDK business management system and the ARI web platform.

We will be finished with the PLI by the end of this calendar year, and we should start to see deployments of that in the first quarter. And that should accelerate the sales rate quite a bit because we'll be able to demonstrate the unique things that, that's going to offer to a dealer that they can't get anywhere else with any other platform. But, summary, AccessorySmart is going well. Web platform is still in its infancy.

Louie Toma: Great. And one last thing, in terms of potential acquisitions, how large of an acquisition can you do given your capital structure?

Bill Nurthen: Yes, sure. We've looked at that. Certainly, if you look at the acquisitions that we've done in fiscal '15, I think all of those acquisitions are acquisitions that we can do in our existing capital structure. Recall the -- when I say our existing capital structure, I should back up and say, that's without issuing further equity. I think we can do those deals with a combination of some increased debt and cash on hand. The largest of those deals was TCS, which was a little under $10 million. I think we have a capability to go even a little bit higher than that, somewhere between $10 million and $15 million pretty comfortably with some debt refinancing cash.

Operator: And our next question is from Gary Prestopino with Barrington. Your line is open.

Gary Prestopino: I was trying to write as quickly as I could. Did you say bookings in Q4 were 11.6 versus 9.7? Or is that for the full year?

Roy W. Olivier: Oh, that's for the full year.

Gary Prestopino: Okay. And then new subscribers were 16,589 versus 15,000 and change. Is that correct?

Roy W. Olivier: Let me pull back to that page.

Bill Nurthen: Yes.

Roy W. Olivier: Yes, that's 15,071 and 16,589.

Gary Prestopino: Okay. And then, Roy, you talked about a number of products in the script, and I went down to the motorcycle show and saw some of them. But could you just maybe, in kind of a chronological order, just very briefly list them their order of importance and magnitude as to what they can do for you and when they should start rolling out?

Roy W. Olivier: Well, I think potentially the biggest revenue impact, churn impact product, is the new eCommerce lead gen platform, the internal code name for that product is [Domino]. The deployed product, you've probably heard us refer to in the past as Endeavor. Domino would ultimately replace Endeavor, so we would ultimately move customers over to Domino. Domino is a complete rewrite of the product. It gets rid of a lot of the technical debt, the product is much, much faster. In test, it appears that it will have a much higher conversion rate of visitors to e-commerce sales or visitors to leads. And so as we continue to work and deploy that product, we're very bullish on its ability to reduce churn and accelerate our sales velocity in that segment. And that is our largest revenue-generating segment today. As you know, it's over 50% of our revenue.

So I think that's probably one of the most important investments we've made. I would say second to that is probably DataManager because even though DataManager itself may not generate the kind of revenue that PartSmart, our broadly deployed eCatalog solution provides, it feeds PartSmart. It's kind of the product that sits upstream from that and feeds it. So I think it will drive some sales and manufacturers which will drive additional revenue for us and the data syndication downstream, which is B2B and B2C catalog data for websites or for parts counter use. And that product's built global out of the box for international use. It's also built to expand into vertical markets that we're not in today.

So I think, potentially, if we can execute from a sales perspective, that product can drive some additional revenues for manufacturers and can bring some additional opportunities for us to sell additional data sets into dealers. So I think that's number two.

The other three products I mentioned in the call, which is [Parts Bar], [Beacon] and the B2B mobile app -- I'm sorry, the B2C mobile app, Parts Bar is a revenue generator. We've been showing very early, we call minimum viable product, MVP of that product. We don't have a feel yet for what the revenue is for that, but I can tell you the dealer reception of it was very, very strong, stronger than we thought because all the dealers recognize on a Saturday morning, they've got 20 consumers in there and one guy at the parts counter, two people working at the dealership, and they simply can't service everybody there, number one. And number two, they only have a certain number of products in stock, so having an endless aisle Parts Bar that lets consumers buy stuff while they're waiting to be waited on, we think could be a big hit, but I don't have a feel yet for how big that's going to be.

The B2C website, frankly, we will give away free. So every one of our 7,000 plus dealers that are using our website platform will have an Android and iOS version of their product in the App Store or the Android App Store. So you'll be able to search for Royce

motorcycle dealership, download the app, and be able to monitor inventory, and eventually, you'll be able to shop OEM and aftermarket parts, garments and accessories, add them to a cart and check out.

That product is really targeted toward future revenue and immediate churn reduction. The concept being if we have 600 to 1,000 consumers that downloaded your application and you own a motorcycle dealership, if you switch off of our e-commerce or lead gen platform, all of those mobile apps no longer work. So it's kind of building a network that will go away in the event that your dealer decides to churn out of our business. And short term, we think it will have a positive impact on churn.

Long term, it gives us a marketing platform where we're using geo fencing and every time you drive within 5 miles of that dealer, your phone is going to buzz with a $5 coupon for PG&A or service. We'll be able to target market to you based on your preferences, what kind of bike you own, what kind of gear you wear, and it's going to be just the next step in a highly targeted marketing toward consumers that own certain products and have certain interests. So today, it's a give away, but in the future, I think we'll be able to monetize the marketing aspect of it and the eCommerce PG&A sales aspect of it.

Third product, Beacon. Very, very early in the product life cycle. A lot of dealers didn't really understand what its use was. I think it's going to be a year or two before we start to get that product in the mainstream, but I'm firmly committed that it's the future of retail, and that's literally helping dealers understand who's standing where in their dealership, what are they looking at, being able to push notifications to them if they're in a helmet area, about helmets that are on sale and, frankly, disrupt people that are showcasing in a dealership and shopping on Amazon while they're standing there. Being able to use the beacons to do that, I think, is going to be the future. So I don't know if that helps, probably more info than you wanted.

Gary Prestopino: No, no, that's fine. I guess the question I would have is these things are going to slowly rollout in fiscal '17, except with the beacon, which you said is going to be a little bit longer. And are you looking for incremental revenue growth in your -- what you're projecting for, for fiscal '17 from any of these products or not?

Roy W. Olivier: We are looking for incremental revenue growth from DataManager and Domino. We don't know what incremental revenue growth to expect out of the three really kind of leading edge products at this point.

Bill Nurthen: Yes, I think the one thing -- just real quick on that consumer app, that's definitely a churn mitigation type of product as well as -- again, it just makes our website products stickier.

Operator: And our next question is from Avi Fisher with Long Cast Advisers. Your line is open.

Avi Fisher: Two questions in one sort of. First, if your bookings are up 20% year-over-year, why are you talking about kind of flat EBITDA in the first half? And second of all, when I look at your total support costs, which is yours kind of sales and marketing -- I'm sorry, customer support and software development, we're seeing that growth faster than revenue. When do you expect that to invert? Thanks.

Bill Nurthen: Sure. Yes, so again, I'm looking at the flat EBITDA. As I said, it's primarily three things affecting that. One is the cost of the India operations as we scale that business. That business was nonexistent in Q1 of last year. Costs are roughly $50,000 a month, they're about $150,000 in a quarter, maybe a little bit more than that today. And we have not -- we're not sort of expecting to see efficiencies there until the back half of the year.

Secondly, we've talked about resuming our acquisition activities in fiscal 2017. We did not have any of those activities in the prior year, and so we will have some additional legal expense associated with acquisitions. I think that's very likely this year and very likely as we sort of ramp that up in the first part of this year. So again, those costs could be significant as you guys should know.

And then third, we talked about some of the costs associated with the proxy matter. It's not a cost that we had really budgeted for in our planning model. We don't have a feel for what that will be, but it could be significant. And again it's not something we really planned for, nor is it something that we think we want to cut expense elsewhere to offset. So those are really what's driving that sort of flattish outlook for the first half of the year. I will say, we remain confident about the second half of the year. And also, as those costs dissipate as well as the full year being an improvement over the prior year.

Avi Fisher: So I guess, so with bookings up 20%, shouldn't that offset some of the additional costs? Are you seeing any flex in pricing? Are you seeing any flex in volumes?

Bill Nurthen: Well, I think the other thing to remember is that bookings were up that much, but we also had churn of about 15.1% annualized for the year. And so that's also offsetting it, but again, that's something we're working on reducing. And we finally saw a good performance in Q4 and are expecting -- well, I shouldn't say, we're off to a good start so far in Q1 as well with respect to churn.

And then just customer operation support and software development. Customer operation support, the India initiative is targeted at reducing the expense on that line. So that's really what we're looking to get some margin points out of as that scales. And that's also been kind of just to date where the acquisition cost -- most of the acquisition we've done, that's where their costs are, and so that's why we're seeing some increases there, but that's what that initiative is aimed at.

Software development, I don't see it increasing dramatically here, but I do think, we're comfortable with the elevated increase in spending here as we have some ability to spend

more on our products, again, towards keeping them relevant and churn mitigation and that's somewhat intentional. So we think we can get scale on the other lines and keep that one relatively flat.

Avi Fisher: Could the India cost drive revenues or purely in efficiency [driver]?

Bill Nurthen: I think what happened -- it's more of a scale thing. As revenues grow, we will be able to be -- to fulfill on those revenues at a cheaper rate. And so we'll have some scale there. We also have the ability to get -- part of our customer operations and support cost today is that we're supporting four to five website platforms right now. And so part of what those resources are doing are migrating customers to our newer platforms. And as we do that, we can decommission the old platforms and reduce some of the support cost associated with them.

Avi Fisher: Cool. And just to squeeze in one more. Any impact from the Polaris recall on the dealer for your clients? Thanks so much.

Roy W. Olivier: Yes, this is Roy. I actually specifically asked our Head of Sales about that. We have not seen any downside associated with the recall. If anything, Polaris is obviously bear hugging all their dealers, trying to kind of offset the disappointment of some of these recalls. And as a result, they're investing a little bit more in lead gen platform and eCommerce and digital marketing. So there certainly has not been a negative impact on our business and there potentially could be a slight positive impact as Polaris agrees to kind of fund more and help dealers to offset some of the damage that the recalls have done.

Operator: And our next question is from Ed Woo with Ascendiant Capital. Your line is open.

Ed Woo: I just had a follow-up question. You mentioned that gross margin may come in a little bit at the lower end of your 80% to 82%. Was there a specific time frame for when that would be?

Bill Nurthen: Well, I think it has been running lower. In the past couple of quarters, it's been below 81%. We did see a little improvement from Q3 to Q4. Q3 was pretty depressed because we were in the throes of fulfilling on that sales backlog. But I think we're going to stay in that range and stay closer to 80% than to 82% primarily because of two things. One is that direct labor component that I noted, and that really has to do with fulfilling backlog and also migrating those customers that I spoke about. So migrating people off older web platforms on the newer ones. That will drive up the direct labor component. Also as our digital marketing services revenue grows, that drives both the direct labor component and what we classify is our other cost to sales component, which really has to do with some third-party cost that we pay associated with fulfillment. So there are some white label things we do in digital marketing that have a lower gross margin. So those are the reasons I think we'll stay in the lower end of that range.

I think that said, we don't expect that to affect the overall adjusted EBITDA margins very much as some of those -- ultimately, some of those costs are going to be offset by cost in the customer ops support bucket.

Ed Woo: Great. And then going back to your India operations and also kind of your strategy for international, when do you think you may turn the India operations from just I guess cost and R&D platform to more of, I guess, product development and revenue enhancement area?

Roy W. Olivier: Well, just to be clear, there's kind of two functions that we do in India today. One is our back-office operations function associated with standing up new customer sites or editing existing customer sites. So we have a fairly large team there that's been in training. They are standing up new sites now, and for probably the next few months, they'll be working on migrating customers from Endeavor to Domino, our old web platform to our new platform. Over time, as that team gets more and more efficient then gets more and more skilled, then they'll start to pick up more new customer deployment and editing existing customer deployment.

Just to reiterate some of my previous comments, customers will not be talking to India. They'll be calling our Milwaukee office or our Duluth office, having a discussion with somebody and that work will be done overnight in India.

So in terms of when will it materially impact our cost structure specifically, customer ops and support, it's certainly in the second half of the year. We haven't really targeted the quarter yet. But certainly Bill and I would like to do it as soon as it's practical to do that.

The second thing we do in India is we do have a software development team there. The office was really put in place primarily for back-office operations, not software development. However, we do -- we have built out a team there. It is ultimately intended that, that team pick up work that is currently being done by third-party contractors that are not ARI employees. And it would also be at a substantial shift in the cost structure.

Again, that team is coming up to speed. We track the development velocity. It's an agile development environment. We track the velocity of the team. That team actually is doing really, really well, and I suspect it may actually impact our cost structure earlier than the back-office operations because they're coming up to speed faster than we expected. Does that help?

Ed Woo: Yes, it does.

Operator: We do have a follow-up from Gary Prestopino with Barrington.

Gary Prestopino: Yes, I just -- did you give a number for bookings for the quarter?

Bill Nurthen: No, I don't believe we did. I can get you --

Roy W. Olivier: We didn't, but we can do so right now, I think.

Gary Prestopino: Yes, what were they up year-over-year?

Bill Nurthen: So basically, year-over-year -- or the quarter was 2.4 million in total bookings. Year-over-year, just for on a quarterly basis, that was up about 8%.

Gary Prestopino: 8%. Okay, and then -- I'm sorry, Roy, did you have --

Roy W. Olivier: I was going to say, that's total bookings. So that includes dealer, software and OEM. And to put some of Bill's comments about recurring revenue, nonrecurring revenue in context, OEM bookings were down significantly, but dealer bookings were up, which is the recurring revenue that we want. So dealer bookings were up significantly.

Bill Nurthen: It's about 13% improvement on dealer bookings year-over-year.

Gary Prestopino: That's what I was going to ask you. Where -- in which of these buckets is the nonrecurring revenue? Is it just spread across all those buckets?

Bill Nurthen: Yes, primarily in the OEM bucket, which is a lot of professional -- tends to be a lot of professional services type work, and again as I mentioned, we did about $600,000 less of professional services revenue in fiscal '16 than '15. And then the others is the software bookings. A good number of our software bookings remain perpetual license bookings. We take the perpetual license, and we count that as nonrecurring. The number does go into the total bookings number, and any maintenance support that's paid on a monthly basis falls into the recurring revenue number.

Gary Prestopino: Yes, but I'm talking about in terms of on your income statement when you break it down by product categories, lead gen, eCatalog, business management, digital marketing, does the nonrecurring revenue, is that spread across all these buckets?

Bill Nurthen: Yes, yes. All the revenue streams have a component that's nonrecurring.

Gary Prestopino: All right. So given that you kind of alluded to in the press release that you've improved your churn a little bit, I mean, and your recurring growth, I think, recurring revenue growth was about 4% overall in the quarter, right, and about 8% on recurring, I mean, what kind of revenue growth should we be looking at this year? Should it be somewhere in the high single-digits, mid-single digits?

Bill Nurthen: Yes, I think I would say mid- to high. I mean, we are sort of operating, if you look at some of the history, we've been organically to-date around 4% to 5%. We've been growing the recurring piece around 7% to 8%. And as I said, I think we're going to start to trend closer to that recurring revenue piece because it is becoming a larger and larger proportion of the revenue. So hopefully that helps, but I think, again, not quite that full amount there, but getting closer to that recurring revenue growth rate.

Gary Prestopino: Okay. And then I would assume, you've got a pretty good pipeline of acquisitions if you're kind of looking at it from a budgeting standpoint of that there will be expenses related to acquisitions?

Bill Nurthen: Yes, I don't know if you want to comment as well, Roy, but even though we did not do acquisitions last year, we didn't stop looking at them and reviewing some of our pipeline of opportunities. I don't know if you want to --

Roy W. Olivier: Yes, I mean, I think I've said before, we've done -- we looked at, I think, 400 deals to do the 15 we've done. At any given a point in time, we probably have 15 to 20 opportunities that were in various stages of evaluation. So we've kind of slowed those conversations down, obviously, in the first half of fiscal 2016. But we, of course, have picked it up as we entered the second half of the year and the first quarter of fiscal 2017. So there's a lot of good opportunities out there and the pipeline is pretty full.

Operator: (Operator Instructions) And we do have a follow up from Avi Fisher with Long Cast Advisers. Your line is open.

Avi Fisher: Roy, are you getting any feedback from any large shareholders that support this proxies that's filed?

Roy W. Olivier: We don't have any public comments on the proxy at this time. We're certainly looking at it and evaluating it. And we do, of course, have frequent communications with all our large shareholders. But we'll have an announcement at some point in the future about our position on that.

Avi Fisher: Well, I've been a shareholder of your company for a long time, and I'd like to at least address my fellow shareholders to draw their attention to the work you've been doing in generating free cash flow and allocating that to high-return investments. And that any effort to stop that which would happen in a sale of a company would be a factor of short-term investing. And I'm an investor for the long term, and I see a lot of opportunity in what you guys are doing, and I hope we defeat this proxy. Thank you.

Roy W. Olivier: I appreciate the comments.

Bill Nurthen: Thanks, Avi.

Operator: And I'm not showing any further questions. I'll turn the call back over to Roy W. Olivier for closing remarks.

Roy W. Olivier: Thank you again for joining us on today's call, and we look forward to talking to you in a few weeks at the conclusion of Q1. Have a great evening.

Operator: Ladies and gentlemen, this does conclude the program, and you may now disconnect. Everyone, have a great day.