ARI Network Second Quarter Fiscal 2017 Conference Call and Webcast
March 9, 2017

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: Ed Woo; Ascendiant Capital Markets; Analyst

Presentation

Operator: Good day, ladies and gentlemen. Welcome to the ARI Network second quarter fiscal year 2017 conference call and webcast. (Operator Instructions) As a reminder, this conference is being recorded.

I would now like to introduce your host for today's conference Matthew Zomboracz, ARI's Corporate Controller. Sir, you may begin.

Matthew Zomboracz: Thank you for joining us today to discuss our second quarter of fiscal year 2017 financial results. With me on the call today 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 today's call, including the Q&A session, we may 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, maybe 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 call are based on 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 to all of you on the line for participating in today's call. We continue to make progress executing on our FY2017 plan and continue to see improvement in some areas of the business notably churning cash flow. 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 second quarter, we reported record revenues and I'm very excited to report the churn improvement that we saw during the last quarter of FY2016 and the first quarter of FY2017 continued throughout the quarter. We had a strong quarter and bookings, which tied for our second best quarter in history. However, we are accustomed to growing bookings year-over-year at a higher pace and continue to see in some headwinds in expanding new bookings versus the previous year. One comment I will make is that bookings net of churn, or net bookings, are showing more significant growth.

We will discuss these items in more detail, but for now, I'll turn the call over to Bill to go over the financials and detail, and then I'll be back to comment further.

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 second quarter of fiscal 2017, which ended on January 31, 2017. Before, I go through some of the financial details I wanted to remind everyone that we closed the acquisition of Auction123 on November 1, 2016.

This was the first day of our second quarter and therefore there is a full quarter of Auction123's operations represented in the Q2 results. Also as a point of reference we have classified the Auction123 recurring revenue under our Lead Generation and eCommerce website product offering and the non-recurring component of its revenue under our other revenue category.

Total revenues for the first quarter were $13.2 million, which compares to $11.8 million in the same period last year. Year-over-year, the total growth was 12.7%, of which approximately 4% was organic. Recurring revenue comprised 91.4% of revenue in the second quarter, compared to 91.6% of revenue in the prior year. Recurring revenue grew 12.5% year-over-year and the organic growth rate in our recurring revenues was approximately 6%.

From a recurring revenue perspective, our growth continues to be driven by our Lead Generation and eCommerce websites offering as well as our digital marketing services offering, the latter of which more than doubled year-over-year for the third straight quarter. Recurring revenues in eCatalog product and in our business management software were relatively flat. As I noted on prior calls, we churned a large business management customer last year due to them being acquired, and that customer accounted for approximately $30,000 of monthly revenue. That churn is essentially anniversaried as of the end of Q2, and as such we expect to resume organic growth and business management software recurring revenues starting next quarter.

Breaking down total revenue by product for the second quarter, Lead Generation Website revenue for the quarter was $7.2 million, compared with $5.9 million in the prior year. eCatalog revenue was $4.4 million, compared with $4.4 million in the prior year. Business Management Software was $700,000 compared with $900,000 in the prior year, Digital Marketing revenue was $700,000 compared with $400,000 in the prior year. Lastly, our Other Revenue was $300,000, compared with $200,000 last year.

Looking ahead we expect to grow at a higher organic growth rate as compared to the second quarters' numbers the Q2 revenue number was impacted by $200,000 year-over-year decline in non-recurring business management software perpetual license revenue, which can be lumpy due to its longer sales cycle.

Q2, however, was our strongest quarter in the last five quarters for software license bookings and we will recognize that revenue through the back half of the year. We also expect the reduction in churn we have been experiencing over the last three quarters to begin to positively affect the organic number.

Turning to profitability, there are a couple high level points I wanted to mention. First, we picked up approximately $1 million or $250,000 on a quarterly basis of non-cash depreciation and amortization charges related to the valuation accounting associated with the acquisition of Auction123.

On a quarterly basis, these charges are being expensed approximately $80,000 as software amortization through the cost of Sales Line, and the remaining portion on the depreciation and amortization line of our P&L. These charges will be similar in future quarters as we amortize the balances associated with the acquisition accounting.

Second, in the second quarter, we also expensed approximately $200,000 in non-recurring proxy contest and acquisition related costs. On a side note, the proxy matter concluded in January with our Annual Meeting, which was held on January 5, 2017. Looking at gross profit, our gross profit was $10.6 million in Q2 or 80.3% of revenue, compared to $9.7 million or 82.4% of revenue in the same period last year.

The decline in margin performance for the quarter was primarily due to the Auction123 gross margin, which runs lower than our normal run rate when you add in the software amortization expense I previously noted. The margin also continues to be impacted by an increase in digital marketing services revenue, which tends to have a lower gross margin than our other recurring offerings.

Lastly, we outsourced some labor on a professional services engagement, which also affected the margin. Going forward we expect the gross margin to increase in the second half of the year as we have been successful in reducing some of the third-party vendor cost that flow through our cost of Sales Line through synergies that have come from the acquisition of Auction123.

Turning to operating profit, the firm recorded an operating profit in the quarter of $672,000 or 5.1% of revenue versus an operating profit of $873,000 or 7.4% in the same period last year. The year-over-year decrease was largely due to the roughly $250,000 in non-cash depreciation and amortization charges associated with the acquisition of Auction123. Additionally, the quarter was also impacted by the approximately $200,000 in proxy and acquisition related costs that I previously mentioned.

Looking a little deeper at some of the operational lines in our P&L compared to last year, sales and marketing is an area where we continue to gain efficiency and scale. The incremental expense on this line is essentially all attributable to the sales and marketing expense brought on with the Auction123 acquisition.

Customer operations and support was up approximately $457,000 year-over-year, primarily due to the expenses associated with bringing on Auction123, as well as the growth of our India operations. The number was also impact by some increases in IT resource and infrastructure expenses as we build this out to support our new products and the growth in our customer base and organization.

A side note on that we are beginning to see some effects from the scaling of our India operation, and that should begin to positively impact our cash flow and profitability as we move in the back half of the year. Software development was up $241,000 year-over-year, the increase primarily related to the new expenses associated with bringing on Auction123, however there is some -- also some spends here associated with increased software development headcount in our India office.

General and administrative expense was up $234,000, this line is where we book to the proxy and acquisition related costs. Lastly, the increase in depreciation and amortization was due to the charges I previously noted that were associated with the acquisition of Auction123.

Looking at pretax profit, our pretax profit for the quarter was $455,000 versus a pretax profit of $753,000 in the prior year. Our interest expense was up about $100,000 year-over-year, due to the senior debt brought on to close the Auction123 acquisition.Net income for the quarter was $242,000 or $0.01 per share compared with net income of $448,000 or $0.03 per share in the prior year. One thing I will note is that our tax rate for the quarter was 46.8% compared with 40.5% in the same period last year.

I would like to take a quick moment here to make some comments on our operating profit and EPS. As previously discussed, these numbers were impacted this quarter by the approximately $250,000 in non-cash depreciation and amortization charges, associated with the acquisition of Auction123 and the $200,000 in nonrecurring proxy and acquisition related charges. The latter of these charges is behind us.

We will continue however to amortize the balances associated with the Auction123 acquisition. That said, it is still our goal to grow operating profit and EPS year-over-year inclusive of all these charges. We believe the margin expansion in the second half of the year will give us an opportunity to do that, especially from an operating profit perspective.

The EPS will be a little more of a stretch; however the EPS will be helped by a lowering of our tax rate, which should occur as our India operation becomes more profitable. Further, we are also working on some tax projects that could produce additional EPS upside, in the next quarter in the form of a reduced tax rate.

Turning to adjusted EBITDA, obviously this result was not affected by the non-cash depreciation and amortization charges associated with Auction123. Adjusted EBITDA hit a record high for the company at $2,213,000 in Q2 or 16.7% of revenue compared with $2,095,000 -- or 17.8% of revenue in the same period last year.

The adjusted EBITDA performance was impacted by and is inclusive of $200,000 in proxy and acquisition related expenses. So it was nice to set a new company high despite incurring these costs. I will discuss our outlook and how we expected adjusted EBITDA to trend for the remainder of fiscal 2017 later in the call.

Taking a look at cash flow, Q2 is seasonally the time of our lowest cash flow generation. That said, we had a very strong performance this quarter as cash flow from operations was $2 million compared with $1.2 million in the same period last year. Free cash flow which we calculated cash flow from operations less capital expenditures and software capitalization was also very strong at $1.5 million in Q2, compared with $600,000 in the same period last year.

I will note that there is some one time upside benefit in the cash flow number that came from the working capital balances we inherited from the Auction123 acquisition. Auction123 paid down about $400,000 in payables prior to the transaction close, which we were anticipating would be on the closing balance sheet.

As a result the cash flow performance in the quarter was affected positively by this $400,000 payment. However, that said even when stripping the impact of this out, the cash flow performance was still at 30% plus improvement over last year, and the free cash flow improvement was even more impressive.

On a side note, as a result of Auction123 paying down those payables, they will receive a payment of roughly $600,000 in addition to their $250,000 pullback payment next quarter, in accordance with how the working capital calculation works in the asset purchase agreement. All this being said, the fiscal year ending balance sheet guidance I gave on the last quarter's call remains intact. I will reiterate that guidance again when I discuss the balance sheet.

Final note on cash flow is that, Q3 a seasonally our best time for cash flow generation. So we're looking to build nicely on our performance through the first half of the year. Also, the scaling of our software development capability in the India office has allowed us to decommission some outsourced software development labor, which we're working on capitalized software development projects. As a result, we expect the cost of our capitalized software to come down in the second half of the year allowing our free cash flow to grow at a higher pace year-over-year than our overall cash flow from operations.

Looking at the balance sheet, I wanted to start by first recapping where we stood at the close of the Auction123 acquisition on the November 1, 2016. You may recall that we financed the transaction with a little over $2 million in excess cash flow and through our refinancing of our senior debt with Silicon Valley Bank, which added about $8.2 million to our debt -- bringing the senior debt balance to $13 million.

We estimated at that time that our total debt balance, which we defined as debt from our line of credit, notes payable, and capital lease obligations was roughly $16.8 million and that we had a cash balance of approximately $3.4 million resulting in net debt of $13.4 million. The cash flow performance in the quarter helped us to raise our cash balance in producing significant decline in our net debt

As a result, as of quarter end on January 31, 2017, our cash and cash equivalents were $4.6 million and our debt balance was $16.3 million or our net debt of approximately $11.8 million. As of the end of Q2, there was not an outstanding balance on our line of credit. As we look ahead and consider our expected cash flow, the working capital adjustment payment I previously mentioned, and our debt payment schedule, we anticipate by our fiscal year end on July 31, 2017 that our cash balance will be back above $5 million and our net debt will be below $10 million.

In conclusion, as Roy noted in the press release, we are very pleased with where we stand halfway through our fiscal year. We have made good progress in scaling our India office and have put a great deal of the non-recurring acquisition and proxy-related costs behind us.

From an adjusted EBITDA perspective, we were hoping to be flat year-over-year at this point and we have come out a little bit ahead of that. As we look ahead, the outlook that I provided on our last earnings call remains the same.

For the second half of the fiscal year, we believe adjusted EBITDA can outperform the prior year both in aggregate and from a margin perspective and that the outperformance should allow us to produce similar margins for fiscal 2017 compared to fiscal 2016 despite the charges we incurred in the first half of the year. We are also targeting an adjusted EBITDA annualized run rate of over $10 million for the second half of the year.

Lastly, we believe the margin expansion is such that we also have a chance to improve operating income and EPS year-over-year, despite the depreciation and amortization charges associated with the acquisition of Auction123. In summary, we remain confident that this will be another record year in many respects 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 take a minute to reiterate our strategy and how we got to where we are now. Today, ARI's SaaS platform business helping manufacturers and dealers in selected vertical markets sell more stuff. It is our intention to be the leader in omni-channel 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 we believe we are in the best position to help dealers in our markets capitalize and benefit from the 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 execute on acquisitions in line with our strategy.

We continue to have ambitions to grow ARI over $100 million revenues by FY2021 and expand our adjusted EBITDA margins into the low to mid-20s. I believe that during FY2016 and in the first two quarters of FY2017 we made good progress in each area. First, we've continued to focus on the acquisitions we closed in FY2015, which expanded our markets to include automotive tire and wheel, dealer business management software and related tools, auto aftermarket service centers and aftermarket auto performance parts.

Those new markets have helped us increase our TAM from 25,000 US customers a few years ago, to over 150,000 today. In addition, our acquisition of Auction123 provides us with in excess of 60,000 dealers to increase our TAM to over 210,000 dealers.

Based on this, we estimate our current TAM to be in excess of $2 billion that is a US dealer-only number, based on current products in current markets -- it does not include opportunities outside the US with OEMs or distributors or with new products like analytics or advertising.

During FY2016, we invested in extensions and upgrades to our current products and develop new products which lay the groundwork for our future and we continued that investment in the first quarter. As we have discussed, we completed a new eCatalog product called Data Manager RT, which has completed final testing and is now being deployed for selected OEMs.

We continue to be excited about the opportunity this product brings and believe it will extend our TAM with manufacturers who build complex equipment that require service from a service or dealer network. As a reminder, 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 revenue growth in our eCatalog business.

We also reported last quarter that we rewrote our current eCommerce and Lead Generation platform, which has been in beta testing with a major upgrade that we did release in November. I am also delighted to report that we now have several hundred customers operating on the platform, who are very happy with the performance, so far. To that point, we recently completed a head-to-head test of this platform versus our largest competitor in the space, and we outperformed their platform in all key areas.

For example, in our most recent test, we improved lead volume from 22% to 74% in the test dealers. We will be expanding the sales, marketing and messaging effort around this product starting April 6, and remain bullish about its prospects to reduce churn and accelerate new bookings and up-sells. As I mentioned in our last call, I expect to see the financial impact of these two new products in the second half of FY2017.

The product investments we have been making and the other operational improvements we have made are starting to positively impact our churn rates. I am excited to report that our churn rate for the quarter was 12.2%, down from 15.6% last year. If we remove the impact of Auction123, the churn rate would have been 11.3% versus 15.6% last year. We are pleased with our progress in this area and we will continue to focus on improving our products and services to drive down this important metric.

We continue to be very excited about the opportunity that came with the Auction123 acquisition and continue to make good progress integrating the company and its products. We have communicated in the past that it was our intent to use the scale we have demonstrated in our model to fund acquisitions minimal dilution. Auction123 was a good example of that, as Bill discussed -- it was funded entirely through senior debt and cash. We did not issue any stock associated with this transaction.

As a reminder, Auction123 has over 1,000 customers in several vertical markets using their technology to list new and used inventory in many of the major online marketplaces. Their platform integrates with dealer business management systems and website platforms to automatically pick up inventory, create product detail pages and feed them to places like eBay, Craigslist, CycleTrader and more.

The TAM for Auction123 products and services is in excess of 60,000 dealers. In addition, Auction123 services a few 100 dealers in ARI's core vertical markets. And as I mentioned, we have made immediate investments in Auction123 to drive more growth out of this platform. We have assigned a sales manager and a team and started selling their products using our proven sales model in January.

I'm excited about the opportunity to grow this business both in ARI's core verticals, but in the auto dealership vertical as well. I'm also pleased to report that during Q2, as Bill noted, we successfully replaced a current ARI white-labeled offering with the Auction123 solution for several hundred dealers. We expect that replacement to generate over $400,000 in annual cost reductions going forward.

New bookings for the quarter were substantially the same as last year at $3.2 million, which if you recall from last year was a record quarterly booking number for the firm. While dealer bookings are up on a trailing 12-month basis as I noted before, the increase is not as significant as we had hoped, as we continue to see some slowdown in some vertical markets. We are watching this closely as we enter the spring selling season which is typically our best bookings months.

As I mentioned earlier, our net new bookings is running ahead of last year due to lower churn rates. We have begun actively cross-selling ARI products into DCi's base of customers and the program has been very promising to date. In fact, our leading indicators which are dials to appointments, appointment met rate and demos-to-sale rate are far and away the highest of any other verticals. This suggests the opportunity for ARIs products is strong in that base of customers.

We've also expanded Auction123 sales team and start to cross selling ARI customer -- ARI products into that base. The early returns also suggest a good fit for our products and we're excited about the new bookings we are seeing in those markets.

We have now grown revenues significantly every year I've been at ARI and we expect FY2017 to be no different. We are targeting revenues between $53 million and $55 million and, as Bill noted, we expect our adjusted EBITDA margin to be in line with FY2016, in spite of the additional costs he discussed.

We continue to show improvements in cash flows and adjusted EBITDA and we will continue to focus on generating those, in order to position the company to continue to execute on our strategy without diluting shareholders. I continue to believe we're in a great position to continue that profitable growth going forward.

As I said in our last call, our entire management team and board believe that delivering a superior return to our shareholders and maximizing shareholder value is our primary report card. We are very proud to have delivered an average annual return to shareholders of 25% since 2008, and we wake up every day with the intent of continuing that trend and are not close minded to any viable options that can help us achieve that end.

In summary, we're very pleased with our progress and excited about the opportunities in front of us, we will continue to work hard every day to maximize shareholder value. We have made -- and expect to continue to make -- significant progress in terms of growing the business both on the top and bottom line. As Bill noted, we both remain confident that FY2017 will be another record year for ARI in many respects.

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

Operator: (Operator instructions) Our first question comes from Ed Woo with Ascendiant Capital. Your question please.

Ed Woo: Thank you for taking my question. I wanted to talk about the acquisition of Auction123. I know it closed right at beginning of the quarter, but in terms of integration, how quickly do you think you'll get it up to speed in terms of integrated with rest of the company? And also, I know we're supposed to limit ourselves to one question, but the follow-up would be, in terms of what you're seeing out there in terms of the opportunity to do another type of acquisitions within the next year?

Roy W. Olivier: In terms of your first question, the two primary integration points that were priorities post-close were sales and integrating and taking some cost out of the business related to the white label solution we had in place before the acquisition. As I mentioned, we have completed the replacement of the white label solution, which we expect to generate in excess of $400,000 in savings, and so that's complete.

On the sales side, we have, in fact, spun up some additional sales resources and sales management. They've been trained, they're actively selling today, and we're pleased and excited with the progress they've made.

Beyond that, we're not actually planning on extensive integration. For example, we're not going to have their development group report into our development CTO. That business will continue to be run by a VP general manager and the operating units in there will report to that VP general manager. We're simply using our proven sales model to help kind of accelerate the sales velocity of that business. Does that answer your first question?

Ed Woo: Yes, thank you. (Multiple speakers) opportunities.

Roy W. Olivier: Yes, in terms of your second question, we continue to have a very active pipeline. We typically have 20, 25 deals in various stages in the area at any given point in time. And we continue to find interesting opportunities and interesting valuations. We don't -- we obviously typically don't comment on business dev activities until we have something to report, but there's a lot of opportunities out there that are interesting. Anything you want to that, Bill?

Bill Nurthen: Yes. I think, just financially the cash flow and EBITDA expansion in the second half will help with that. We've been pretty consistent to date at bringing down our net debt over $1 million a quarter. And so, the more that we just continue to do that and bring that number down, the more it frees us up financially to continue to do deals with debt and cash flow.

Ed Woo: Great. Well, thank you and good luck.

Operator: (Operator Instructions) I'm showing no further questions in queue.

Roy W. Olivier: Well, thank you again for joining us on today's call, and we look forward to talking to you at the conclusion of the current quarter. Have a great evening.

Operator: Thank you, ladies and gentlemen, for joining today's conference. This does conclude the conference. You may now disconnect.