Event ID: 139876038813
Event Name: Q3 2015 ARI Network Services Inc Earnings Call
Event Date: 2015-06-11T20:30:00 UTC
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ARI Network Services Inc.
June 11, 2015

C: Steven Hooser; Three Part Advisors; IR
C: Roy W. Olivier; ARI Network Services; President, CEO
C: William A. Nurthen; ARI Network Services; CFO

P: Edward Woo; Ascendiant Capital; Analyst
P: R. Gregg Hillman; First Wilshire; Analyst
P: Kevin Dede; H.C. Wainwright; Analyst

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Operator: Good day, everyone, and welcome to the ARI Network Services Third Quarter Fiscal Year Ending 2015 Earnings Conference Call. Today's conference is being recorded. I would now like to turn the call over to Steven Hooser, ARI's Investor Relations representative. Please go ahead.

Steven Hooser: Thank you, Andrew. Thank you, everyone, for joining us today to discuss our third quarter fiscal year ending 2015 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 for a Q&A session. Please note that we are also Webcasting this call on our Investor Relations Web site at investor.arinet.com. The earnings press release was issued earlier and is also posted on the Investors Relations Web site.

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 may make forward-looking statements regarding expected revenues, 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.

The risks are detailed in our most recent annual report on Form 10-K, as such, and maybe amended or supplemented by subsequent quarterly reports on Form 10-Q or other reports filed with the Securities and Exchange Commission. These 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. 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 Web site and within the earnings release.

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

Roy W. Olivier: Thanks, Steven, and thank you for participating in today's call. We appreciate your time and your continued interest in ARI. Overall our results for the third quarter were very good and exceeded my expectations in many areas.

We continue to achieve record revenues, breaking $10.3 million during the quarter. We improved our gross margins and reduced our overall cost structure, resulting in an operating income for the quarter that was $675,000, which was more than all of fiscal '14. This also resulted in net income for the quarter of $339,000, outperforming our annual results for fiscal '13 and fiscal '14.

We also had a very strong quarter resulting in new bookings being in excess of $2 million and we believe that all of this is a result of having the right strategy in place and executing well against our operating plan. Virtually all of our sales groups posted impressive new bookings with automotive wheel and tire being number one in terms of new booking dollars. Home medical equipment and outdoor power were a close second and third with the latter showing very strong year-over-year growth as a result of the new product enhancements we rolled out at the end of Q1. A combination of strong sales execution and a strong general U.S. economy has resulted in a record quarter in terms of new bookings.

The TCS integration continues to go well and our merged tire and wheel business is operating at a very high level. In a little over three years we have built this business via acquired and organic growth from zero to now more than 25% of our overall revenue. Those numbers are without the potential impact of TASCO, which we will be working to integrate into the business during Q4.

I continue to be very excited about our remaining quarter of fiscal '15 and the first half of fiscal '16 in terms of new business opportunities, but for now I will turn the call over to Bill to go over the financials in detail and then I will be back to comment further on our strategic progress and outlook. Bill?

William A. Nurthen: Thanks, Roy, and good afternoon to everyone listening on the call. Before I go through our Q3 results I would like to summarize for everyone our performance on a trailing 12 months basis, which includes our Q3 numbers.

Over the last 12 months we have now generated over $38 million in revenue, over $2 million in operating profit, $5.8 million in EBITDA and $5.9 million in cash flow from operations. These are tremendous increases over our fiscal 2013 and fiscal 2014 performances and we believe this is indicative of the scale that exists in the business as it continues to grow.

I will now share with you some more details regarding our financial results for the third quarter of our fiscal year which ended on April 30, 2015. Before I go through some of the financial details I wanted to remind everyone that we closed the TASCO acquisition on April 27, 2015. The acquisition did have some effect on our legal expenses in the quarter. However, given that our quarter ends on April 30th the impact of TASCO's operations on our results for the third quarter was immaterial.

Total revenues for the third quarter were $10.3 million, which compares to $8.2 million in the same period last year and $10.1 million in the prior quarter. The year-over-year increase of 25.7% is attributable to the incorporation of the TCS transaction as well as organic growth.

We experienced organic growth in our Web site and lead generation businesses. Sequentially, the growth was also driven by those businesses as well as a quarter-over-quarter increase in business management software revenue.

Recurring revenues were $9.3 million compared to $7.6 million in the same period last year and $9.2 million in the prior quarter. Recurring revenues represented 90.5% of total revenues for the three months ended April 30, 2015 versus 93.3% in the same period last year and 90.7% in the prior quarter.

The primary reasons for the year-over-year decline in the percentage of recurring revenue are that TCS has a lower mix of recurring revenues and our professional services revenue in the quarter was roughly $80,000 higher than the prior year.

Turning to profitability; Q3 was another strong quarter for us from a profitability perspective. Our gross profit improved to $8.5 million or 82.7% of revenue compared to $6.6 million or 80.9% in the same period last year and $8.3 million or 81.6% of revenue in the prior quarter.

The growth in gross profit on a year-over-year basis and a sequential basis is primarily attributable to our revenue growth. This is particularly notable on a year-over-year basis as the gross profit number is in excess of last year's overall revenue number.

The year-over-year growth in gross margin is largely due to reduction is software amortization expense. Sequentially the gross margin improved due to a reduction in software amortization expense as well as a reduction in contracted labor used to fulfill professional services revenue in the quarter.

The company recorded an operating profit this quarter of $675,000 or 6.6% of revenue versus $365,000 in the same period last year and $670,000 in the prior quarter. The improvement year-over-year, which represented an 84.9% increase, is primarily a result of a reduction of sales and marketing expense and customer operations expense and some port expense as a percentage of revenue as our revenue growth outpaced our expenditures in both of those areas.

Sequentially, the operating profit was relatively flat. However Q2 was a strong performance and Q3 was even stronger when you consider we incurred over $100,000 of cost in the quarter associated with the TASCO acquisition.

The quarterly operating profit of $675,000 marks our highest operating profit since the third quarter of our fiscal 2011. Below the operating line, interest expense was up $55,000 year-over-year as a result of the refinancing of our term loan and the issuance of a seller note associated with the TCS transaction.

Sequentially, interest was down $17,000 as a result of the company paying down debt in Q2 and Q3. From a pretax profit perspective we experienced increases both year-over-year and sequentially. Pretax profit was $582,000 versus $313,000 in the prior year and $534,000 in the prior quarter.

From an earnings per share perspective, net income more than doubled from a year ago to $339,000 or $0.02 per diluted share compared to $160,000 or $0.01 per share a year ago and $260,000 or $0.02 per share in the prior quarter. The quarterly net income performance was our highest since the fourth quarter of fiscal 2012.

Looking at EBITDA, EBITDA increased 28.9% to $1.6 million in the third quarter compared to $1.3 million in the same period last year and $1.6 million in the prior quarter. Our EBITDA margin was 15.8% compared to 15.4% in the prior year and 16.1% in the prior quarter. If you remove the impact of legal and accounting charges in the quarter related to acquisitions the EBITDA margin would have been 17%.

Turning to cash flow, this is seasonally a strong time for cash flow for us and Q3 did not disappoint. Cash from operations in the quarter was $1.9 million compared with $1 million in the same period last year and $1.1 million in the prior quarter.

This is now our fifth straight quarter of over $1 million in cash flow from operations and over the last 12 months we have now posted over $5.9 million in cash flow from operations. The quarterly and trailing 12 month results are particularly impressive when you consider for both fiscal years 2013 and 2014 we posted cash flow from operations result of $2.4 million.

Additionally, our trailing 12 months performance now exceeds our trailing 12 months EBITDA performance, which we believe is indicative of the high quality in our reported earnings.

Free cash flow, which we calculate as cash flow from operations plus capital expenditures and software capitalization was $1.4 million for the period versus $500,000 in the same period last year to $500,000 in the prior quarter.

For the trailing 12 months we have now recorded over $4 million of free cash flow. As we look ahead to Q4, I think it will be difficult to repeat the performance of Q3 as Q3 is seasonally our best time and our collections group did a great job in Q3 in getting our ageing very current. That said we believe our trailing 12 months performance is indicative of the cash flow potential in the business.

As we turn to the balance sheet, subsequent to quarter end, we completed an underwritten equity offering of our common stock. I will talk about that in a moment. However, I wanted to remind everyone that our balance sheet at quarter end does not include any of the impacts of that offering. Looking at the quarter our cash flow performance in Q3 allowed us to pay down close to $1 million in debt prior to drawing on the line for the TASCO transaction while still increasing our overall cash balance.

The cash balance at the end of Q3 was $2.2 million versus $1.7 million at the end of Q2. Recall that when we did the TCS transaction in September of last year we drew down on our line of credit about $2.1 million to finance that transaction.

In the third quarter we fully paid down those borrowings out of our free cash flow. We subsequently drew down $1.75 million on the line of credit to fund the TASCO transaction and that is where the balance of our line of credit stood at quarter end.

Total debt, which we calculate as debt from our line of credit, notes payable and capital lease obligations was $10.8 million as of quarter end versus $10 million at the end of Q2 with the increase being attributable to the TASCO transaction. The company's debt-to-equity ratio at the end of Q3 stood at 50.8% compared with 49.6% at the end of last quarter.

Finally in-line with our acquisition strategy we announced in May that we completed an underwritten offering of approximately 1.76 million shares of our common stock for which we anticipate net proceeds of $4.7 million.

The offering closed on May 12 and a pro forma of our balance sheet at transaction closing would indicate a cash balance of approximately $5.1 million, debt of $8.9 million with no outstanding balance on the line of credit and shares outstanding of roughly $16.9 million.

As we look ahead to Q4, we continue to see promising growth opportunities both in the core ARI business as well as within the newly acquired businesses in automotive tire and wheel and believe our overall growth and profitability prospects remain intact. In-line with our acquisition strategy we anticipate making some one-time investments in the quarter which will impact profitability in Q4.

First, I think it is fair to assume that we will be conducting some acquisition-related activities which will impact the quarter. Second, we are making some investments to update our systems to enable them to be more scalable for acquisition integration. Among these investments are implementation of single CRM system across the entire company, upgrading our existing ERP system and making some investments in technology to scale our publishing operations.

While some of the systems cost will be capitalized, some will hit the P&L and we anticipate that all of these investments could impact profitability in the quarter by about $250,000.

That said the free cash flow we have generate has provided us the opportunity to make these investments and while it will impact the near term quarter we are excited about the long-term growth prospects and efficiency they will bring to our business.

In conclusion, we are very pleased with our performance in Q3 and over the last 12 months. To recap, over the last 12 months we have now generated over $38 million in revenue, over $2 million in operating profit, $5.8 million in EBITDA and $5.9 million in cash flow from operations. These are tremendous increases over our fiscal 2013 and 2014 performances and we remained excited about the prospects ahead. I will now turn the call back over to Roy.

Roy W. Olivier: Thank you, Bill. To start, I'd like to update you on some of the key accomplishments since our last call. During the quarter, we continued to onboard new customers in all areas of the business; new bookings set an all-time record with $2 million in bookings, an increase of 18% over the previous year; dealer sales reported strong year-over-year new bookings in almost all vertical markets, with international, marine and outdoor power being particularly strong in the third quarter.

Changes we have made to our international operation are showing results and the major product updates we released at the end of Q1 improved our competitive position in marine and outdoor power that is now showing up in new sales bookings. We also closed engagements with three major outdoor power customers to help them sell more parts to their dealers and their consumers.

We secured an agreement to help a marine manufacturer update their consumer facing Web site to improve leads for their products. We won a top product award from boating industry. We closed an engagement to help an electric vehicle manufacturer in Europe provide parts information to their dealers and customers in order to improve customer satisfaction and increase part sales.

And finally, we acquired TASCO Corporation as part of our strategy to obtain and build market share in the wheel and tire and aftermarket auto service business. It was another busy quarter for the ARI team.

Before I discuss our progress on our key performance indicators and strategy, I'd like to quickly review our growth strategy. As we have discussed previously we expect to grow ARI through a combination of organic growth and acquisitions that are in line with our strategy. We expect almost half of that growth to be organic and the remaining coming through strategic acquisitions.

Given our current market share in many of the markets we serve, we expect organic growth in our current verticals to primarily be driven by automotive wheel and tire and the home medical equipment vertical and from the sales of our digital marketing services into all verticals.

We also continue to plan on launching a solution suite into the automotive aftermarket service segment. We believe that ARI software and digital marketing solutions provide a powerful value proposition in new and existing vertical markets.

Within the markets we currently serve, we think about growing them in three ways. First, we focus on having new customers or new logos. A majority of our sales and marketing spend is dedicated to onboarding new customers. Second, we have a team that focuses on upsells with the intent of raising our average revenue per dealer across our base.

Examples of upsells including adding new catalog content through existing customers or adding new features like our new mobile application or marketplace feed solution. During the quarter we posted our best new bookings quarter ever, delivering $2 million in new bookings. We continue to see strong new bookings as well as new bookings growth over last year.

As we have said before we plan on continuing to invest in adding sales people to take market share as long as economic conditions support it and it generates results, as long as the payback period that we refer to as our [PAC] ratio remains under an 18 month payback and especially when it is under 12 months, which it was in Q3, we will continue to invest in growing our market share. That said we do not expect our total sales and marketing spend as a percentage of revenue to grow at the same rate as revenues.

Finally, we spent considerable time on reducing churn. This is the measurement in dollars of customers that do not renew their subscription. Some of the new updates and new features discussed earlier in the call are specifically targeted toward improving the ROI of the dealer and ultimately reducing ARI's churn rates.

While we have successfully reduced churn over the past four years our annualized churn rate in Q3 was slightly higher than our expectations at 15.9%, which is below last year and last quarter. The higher than planned churn rate has been a drag on organic growth for the quarter and prevented us from hitting our target of low double-digit growth. This was the only disappointing metric in our otherwise outstanding results.

As previously mentioned, the TCS acquisition continues to deliver strong results. Their performance is in excess of our plan and we continue to see strong new bookings in Web sites and dealer business management system software. In short, we continued nice progress against the strategic pillars we've discussed on previous calls and we believe that our leading indicators point to another record year for ARI in almost all respects.

We have completed two acquisitions in the past 12 months and we have indicated that we expect to close another in the near term. We believe that our current plan puts the company in a strong position for fiscal '16 and beyond, both in terms of solid operating results and putting the company in a position to leverage our senior debt capacity for future acquisitions.

We also continue to see a lot of new sales and business development opportunities and we will continue to aggressively pursue these to the extent they are consistent with our overall strategy. I remain very excited and bullish about our prospects for the last quarter of fiscal '15 and the first half of fiscal '16. With that let me open up the call for your questions. Operator, please instruct our listeners on how to queue up.

Q&A

Operator: Thank you. (Operator Instructions). And our first question or comment comes from Ed Woo with Ascendiant Capital. Your line is now open.

Edward Woo: Yes, thank you for -- as well as congratulations on a very great quarter. I did have a question, you mentioned about some of the movements you are doing in international. Should we expect more news over the next year on your focus and expansion in that area and do you see opportunities not just in Europe but also in Asia or emerging markets?

Roy W. Olivier: That's a great question. I mean we do continue to see -- we do expect to continue to see some improved new bookings performance and ultimately revenue from our European operation.

That said, every year as we prioritize where we are investing for growth in the future we typically are investing in projects that will drive growth in the domestic market and we don't make a tremendous amount of investments in Europe. So I don't expect Europe to suddenly start to double or triple in size but I do expect continued stronger new bookings and ultimately stronger revenue.

As far as your question in terms of Asia, Asia Pac and other markets, we see a few opportunities there but we don't put a lot of emphasis on growing that part of our business. We do have one international rep that covers that market, we do have some customers there.

And in the last 12 months we actually did a press release on a content agreement with a manufacturer in China, but it's not a high focus area for us now. We feel like we have got more opportunities to drive organic growth by making investments in our domestic market than we see for the international markets.

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

Roy W. Olivier: Thank you.

Operator: (Operator Instructions). And our next question or comment comes from the line of Gregg Hillman with First Wilshire. Sir, your line is now open.

R. Gregg Hillman: Yes, good afternoon gentlemen. Bill, I didn't understand your comments earlier about spending in the fourth quarter. You said there will be some acquisition activity and then spending on systems, ERP upgrades, but does that mean the spend on acquisition activity which are carrying over from your prior acquisitions, or is that spend on new -- like due diligence for new acquisitions?

William A. Nurthen: Yes, sure, it's related to new acquisitions and I think as we indicated when we did the equity offering it was really in line with our execution strategy. So what I was essentially indicating there was that I think it's safe to assume that we are working on new acquisition opportunities and some of the due diligence accounting and legal costs associated with that will impact Q4.

R. Gregg Hillman: OK, and then in some of the verticals you are looking at would be the things that Roy said about wheel and tire and durable medical equipment, is that correct?

William A. Nurthen: Yes, I don't think there is too much we can really talk about. But I do think yes, everybody we have communicated to everybody what we think are our growth markets and it would be ideal to acquire some targets in those markets to help us to gain share in those markets. I don't know if you want to add anything to that, Roy.

Roy W. Olivier: No, I think, Bill nailed it; I mean we've said that we're focused on growth markets and while we look at a lot of opportunities we spend a little more time and energy looking at things in aftermarket, auto service, wheel and tire and home medical equipment.

R. Gregg Hillman: OK and if you could -- do you provide any training at home medical equipment, for the dealers maybe to get more in disposable catheters or something like that and to help them help the customer. Do you go deep enough in that vertical to be able to do that?

Roy W. Olivier: Today we don't -- I mean today what we're doing is automating the supply chain and helping those small service locations in cities all across America have an online presence, so that their ultimate patient customer can not only see what their hours of operations are, but can go on there and literally search for catheters or search for wheelchairs or search for information and shop online.

As we can grow that business and that business gets more scale then we will look at adding additional services and maybe that's one of them but today we're really focused on executing the integration or building out if you will that supply chain and then helping those 25,000 service providers have an online presence.

R. Gregg Hillman: OK, and then is your sales team dedicated to the verticals or just the sales team person do wheel and tire and that durable medical, for example.

Roy W. Olivier: No, they are dedicated by vertical; it is very unusual that we move somebody from one vertical to another.

R. Gregg Hillman: OK, and then how many vertical sales teams do you have right now? It was wheel and tire, durable medical equipment and what else would the other ones?

Roy W. Olivier: Off the top of my head we have Marine RV, we have outdoor power, we have power sports, we have medical equipment, we have wheel and tire, we have catalog. Catalog actually is not a vertical obviously but catalog is common with the catalog team selling across all verticals, but all they sell is catalog. There don't sell any lead generation or ecommerce stuff and is that all of them, Bill, is that 17.

William A. Nurthen: That's correct. Yes.

R. Gregg Hillman: And what's the total number of sales people you have right now?

Roy W. Olivier: Bill?

William A. Nurthen: Yes, sure, what we call quota-carrying sales members is around 90 and most of that is dedicated to new sales. Some of that is dedicated to retention and upsells, and then a very small component of that is dedicated to sales within the larger OEM relationships.

R. Gregg Hillman: Have you been able to upgrade telesales, because there is a lot of territory to cover for all those people. Do you have like a (inaudible) do sales, too, over the phone, to sign-up some, I don't know, medical equipment dealers?

Roy W. Olivier: Well, all of our sales approach is telesales. So our guys spend 85% of their life on the phone. The other 10% to 15% of their time they're attending trade shows, association shows or they may a few times a year go to a city like L.A. and spend five days in a car and try to hit two-three dealers a day for that five-day period. But a vast majority of their activities are by phone.

R. Gregg Hillman: OK. And there are any of various locations for these people they could -- they don't have to work out of the home office?

Roy W. Olivier: Actually all of our sales people per se are either in Milwaukee or in Duluth, Minnesota. So some of those teams I mentioned are in Milwaukee, some of those teams I mentioned are in Duluth, Minnesota.

William A. Nurthen: Yes, and we now have some in Tennessee as well.

Roy W. Olivier: That's true.

R. Gregg Hillman: OK, great. And then of the time it takes to get new sales, you mentioned, you are looking for an 18 month payback period. What do you mean by that? That's for the salaries that you're investing in these people as to what they're bringing in or something like that?

Roy W. Olivier: Yes, two answers, your first question was how long does it take to get them productive, for a dealer sales rep it takes about 90 to 120 days to know whether or not they are going to work out or not and they literally start hitting their numbers in that timeframe.

And in terms of what does that payback period mean, it is the total expenditures in sales and marketing divided by the amount of recurring revenue brought in by that person. So it's not just salary; it's salary plus fringe, plus marketing people, plus any marketing expenditures.

And what we are typically looking forward is under a one year payback, under 18 months is good, under 12 months is where we typically would continue to add more sales people. Bill, anything you want to add to that?

William A. Nurthen: No, I think that that represents it accurately.

R. Gregg Hillman: OK, so you have the metric down pretty good, for all the costs included. OK, well I will get back in queue. Thanks very much.

Roy W. Olivier: Thank you.

Operator: (Operator Instructions). And our next question or comment comes from the line of Kevin Dede with H.C. Wainwright. Sir, your line is now open.

Kevin Dede: Thanks Roy, Bill I was curious, I know the churn objective is a top priority for you. I was wondering if you wouldn't mind -- I know we've talked about this in the past, I was wondering if you wouldn't mind just highlighting some of the key policies you are hoping or have enacted, the timeline on full enactment of those and when you think we'll start to see real improvement there?

Yes, I understand by your comments that churn was up last year and I know there is some room to go. I am just kind of wondering when we'll start to see and what your eventual target is as well.

Roy W. Olivier: Yes, good question I mean churn jumped really in Q2 as a result of some significant customers switching from a direct model where we sold multiple license to that customer and they gave it dealers to switch into more of a dealer model. So we lost that revenue and it will of course will impact, not just Q2 but it will affect Q3, Q4 and Q1.

So we can expect to see churn a bit higher for the next three quarters as we burn off that event that happened at the beginning of Q2 or at the very end of Q1.

In terms of what we are doing to improve churn, it's a combination of things. Number one we are reviewing the number of customer service and retention people we have per dealer.

So in other words, do we have one person responsible for 200 dealers or 2,000 dealers and we are adding some headcount in that area and frankly we are not expecting to have incremental cost there. We're going to move some people from other parts of the organization to bring down the number of customers that each one of our retention people have to support.

Number two is we spent a tremendous amount of time looking at our product roadmap, looking at our priorities and looking at customer feedback that was having an impact on churn and actually during the last quarter and we spun up a third development team to help accelerate some of the product roadmap items that we think will have a nice impact on churn.

Things that make the product faster, things that improve the results when people are searching for things there in their cart, things that will improve the lead generation of how many times people are looking at a bike or a boat or RV and say sending more info which generates another lead for the dealer.

So I think as we -- and we did a nice -- a May release software release, we have a June software release, we have an August release and a September release and as those releases happen I think the product is just going to get better and better and better.

It's going to have an impact on new sales rate because it's going to make us more competitive when we are competing for that new sale and I think it ultimately will have an impact on churn because the product will be faster, drive more leads and drive more ecommerce sales. Bill anything you want to add to that?

William A. Nurthen: No, I think that's good.

Kevin Dede: OK great. And you mentioned that you expect to integrate TASCO through the fourth quarter and I am curious why you made that comment and what are the factors that, just -- I guess what are the factors that are driving that decision?

Roy W. Olivier: Well, I think what I was trying to say there is like last quarter I said that the integration of TCS is doing well and it's kind of hard given the fact that TASCO was only bought three days before the end of the quarter to report any progress or not on integrating them.

So while the activities that are going on are going well and we haven't seen any major issues it's hard to comment on how that integration is going until we report on Q4 because then we'll have a full three months, not only how is the integration going, how is integrating the sales team going, how is integrating the backend platform going, like accounting and moving accounting into our accounting system and that sort of thing, but we'll also be able to intelligently comment about their sales velocity and whether or not it's on track and whether or not it's new bookings.

So it was nothing other than my clumsy way of trying to say I don't have a lot to report on TASCO since it was acquired only a few weeks ago and three days before the end of the quarter, but we'll be reporting on that in Q4.

Kevin Dede: OK. So, my question was clumsy as well. I understand that your integration policy of late is really not to integrate, I'm just kind of wondering, how you plan on sort of folding that into TCS and I understand that's where the ARI wheel and tire has gone. So I'm just kind of curious on how you're looking at that I guess.

Roy W. Olivier: Yes, that's a good question. First off we're of course moving their cash management and their billing and that sort of thing into Bill's organization in Milwaukee. However, their sales team, their operations team, their software developer teams now report through Barry Reece in our wheel and tire group.

He's had already an off-site planning meeting with their entire organization to kind of lay out what their sales structure is going to look like, who is on what team, get those guys working together and they're starting to execute on our sales plan.

So there is not a lot of integration in terms of we're not trying to tightly integrate every function in their business into our business, but we're getting the management chart of the organizational chart lines drawn, we're getting people in our rooms to have discussions about what's our 12, 24, 36 month go-to market strategy and who is responsible for doing what. And now we're kind of moving into execution mode.

The only integration that we're doing there that's similar to stuff we've done in the distant past, where we were looking for very tight integration is in cash and management and accounting, which we are moving into Milwaukee.

Kevin Dede: Right, OK. That makes sense. Last question for me before I hop back in the queue, probably more for Bill, what's your gross margin target now that you're pushing 83% and do you think that some of the investments that you talked about, I'll circle back and ask more about that but I'm just kind of curious where your target is and where do you think you'll be able to consistently keep the business.

William A. Nurthen: Sure. I know we're very pleased with where Q3 ended up. It is an all-time high for gross margin in the recent history of the business, I think going back 10 years or so. So I don't think we're looking to increase that much more significantly.

We did have some amortization on some of our older software products that basically became fully amortized in the quarter, and that also helped to drive the increase. But from here, I don't think we would see a significant uptick and I think for future profitability and scale down the line that will be coming down more in the operating expenses lines.

Kevin Dede: OK. Thanks gentlemen. I'll hop back in.

Roy W. Olivier: Thank you.

Operator: And our next question or comment comes from the line of Greg Hillman with First Wilshire Securities. Sir, your line is now open.

R. Gregg Hillman: Thanks. Could you just talk about your software development cost on a go forward basis, or -- and I guess CapEx, both those things are necessary to support the growth plans that you envision, what would those two things be do you think, in terms of absolute dollars?

Roy W. Olivier: Bill you want to start that.

William A. Nurthen: Sure. I think our development costs, just looking at quarter-over-quarter and year-over-year they were up again. They have been increasing, they were up again about $30K quarter-over-quarter and they're up about $400,000 year-over-year. Of that $400,000 year-over-year about $300,000 of that was just incorporation of TCS. I think one of the drivers of the increase that you're seeing in the development is that, that the portion that's going to capitalized cost has come down.

And again I said it's about -- down about $125,000 year-over-year and down about $100K sequentially. And as you know the time can fluctuate, the capitalized time can fluctuate depending upon the nature of the work that we're doing and the decline that we've seen over the last 12 months is really related to development work on new products that were largely completed in fiscal '14 and rolling off of those development projects.

It should be noted though that despite the reduced capitalized cost, this does not mean that we're not working on new products. It just means that there is less work that's met the criteria for capitalization. So in Q2 the capitalized cost was actually very low, it was one of our lowest, at least in the last five years.

So while the overall trend is down, I would expect that to bounce up a bit overtime, as we've reached technological feasibility on some new products and are ramping up some of our development efforts to combat churn as Roy noted. So I think we've seen an increase here, and we ended the quarter about $1.1 million, and I see it staying pretty quiet there on a P&L impact basis.

R. Gregg Hillman: OK, I mean, you got just depreciation and amortization also. So more or less, if what was it for nine months for amortization, I think it was 1.56 and depreciation and amortization was 1.24. Would depreciation amortization, will that stay the same or we will have that to go up and you say software is about right where it is right now.

Roy W. Olivier: Well, staying on this, there is two forms, there is the software amortization which flows through our gross margin. And that has essentially leveled off to a new level.

So if you look at quarter-over-quarter, I think we're about down about $90,000 on that leveling off. So that can -- the existing core products that we have, that's kind of the new run rate although as we do more acquisitions there could be some more expense that flows through there, but that's sort of the new run rate there.

Similar point on the depreciation and amortization that flows through the operating expense line, which was $465,000 this quarter and up about $57,000 over the prior quarter.

That has kind of a ramped up to a new level and that ramping up to the new level is really associated with adding on the closing balance sheet and some of the intangible assets associated with the TCS transaction. So I think that item is more at a steady state but again could be affected by future acquisitions which require us to book some intangible assets.

R. Gregg Hillman: OK, great, thank you.

Operator: And we have a follow-up question or comment coming from the line of Kevin Dede with H.C. Wainwright. Sir, your line is now open.

Kevin Dede: Great, OK. Back to investments, Bill you talked about $0.25 million and talked about ERP system. And there was a couple of other things you mentioned. I am just kind a wondering how, I mean how you see that sort of falling out and does that go into general and admin and is that sort of the way you look at it?

William A. Nurthen: Yes, yes I think most likely it's going to hit the G&A line and those cost we're recording, one was the legal aspect and then one was related to looking at new acquisitions, and the other was the systems cost. I think with the systems cost it's really a couple of things.

First, we want to scale our systems for acquisition integration and right now we have people working in multiple CRM systems and that doesn't really make sense when we're trying to maximize synergies from cross selling and into making informed sales processes. So that's what we're looking to do there.

And second just if you look at just the last, almost the last three years we've now nearly doubled the size of the business and we've really haven't done a lot of significant updates to our system. So we're also looking to make an update to our existing ERP system to bring it to the most current version and again to help to scale with some of those, bringing in new acquisition.

So that -- all that said we think that will hit about $250,000 on the expense line for Q4.

The other thing I would stress is we want to do this in an economical and timely manner and we think we can. These cash flows are, at the end of the day as I said low six figures and these are not major overhauls of our systems or major customized implementations. These are really bringing our systems up their current version so they can better scale.

Kevin Dede: OK, and you're not expecting to see that on an ongoing basis. That's more of a one and done kind of thing, that's fourth quarter.

William A. Nurthen: Yes, we're looking to get what I would say most of the P&L impact, I think will be in the fourth quarter. I think with the implementation of the CRM system some of that will flow into Q1 of next year.

However, some of that will also be capitalized from a balance sheet perspective. These, as I said, these are a -- there was two ways to go here; one was to go with implementing brand new systems and trying to go through a much longer and much more expensive process.

The other was to really tweak and improve our existing systems and bring them to their most current versions, which again is the lower risk, lower cost and quicker way to do it. And we actually feel what we planned out there that will definitely give us the scale to onboard new acquisitions much quicker and to make as an example, our billing operations, our order entry operations much more efficient.

Kevin Dede: OK, so on that CRM, it will be universal across TASCO, once they are fully onboard and TCS, wheel and tire array, OK across the whole system.

William A. Nurthen: Right, they are already working in the same system.

Kevin Dede: Great, OK. Well you talked a little bit about seasonality. I was wondering and you also mentioned wheel and tire, was that 25%, what of sales for the third quarter, did I catch that correctly?

Roy W. Olivier: Yes, 25% of our revenues now are derived from that single vertical wheel and tire.

Kevin Dede: Impressive. So can you talk to seasonality, again I guess in light of what goes on in wheel and tire, I mean I would think that it might not be so great, I guess during the April quarter, maybe more July and October, I guess the sort of the way that I was looking at. Could you just sort of give us your interpretation?

Roy W. Olivier: Yes, I would have to go pull some numbers on wheel and tire specifically as it relates to seasonality I mean my off the cuff gut feel would be that it probably doesn't have a lot of seasonality in terms of new bookings simply because when you need tires, you need tires, unlike marine, power sports where this is their peak time of the year. We typically can't get dealers on the phone in the summer because they are so busy servicing you, who is looking to buy a boat or a motorcycle.

And so if you look at our new bookings we typically in Q4 have relatively soft new bookings and then they pick-up very strong in our fiscal Q1 but I have a perception that wheel and tires is not that way but I would have to go back and look at the numbers to confirm that my perception was right. But Bill you want to add anything to that?

William A. Nurthen: Yes, I don't think we see a strong seasonality in the P&L aspect of it. Seasonally our tire and wheel business this is a time of good cash flow from us because there are some annual payers in the tire and wheel business that do pay in this Q3 and that also contributed to the cash flow performance.

Kevin Dede: OK. I know you both commented on an impending deal. I was wondering if you could just look down the pipeline a little bit further. I know you are also trying to position systems that you can onboard new acquisitions as well.

I guess I hadn't expected anything new until toward the end of the year and here you are racking them up left and right, I am just kind of wondering if that's pretty much the way it's going to be or is there any indication you can give us one way or the other on that?

Roy W. Olivier: I don't think we can comment a lot other than to say if we do go ahead and execute another acquisition in the near term then we've acquired obviously three companies in a 12 month period of time.

We're going to have a lot of work to do ensure that we are able to execute on the operating plan that we have in place for ARI as well as integrate where it needs to be integrated and execute on the overall operating plan of these new companies.

So I suspect that we won't be doing anything imminently following any announcement that might happen in the near term for a while. At that stage I think we'll need to spend two, three quarters heads down executing on the plan and then start to look for interesting opportunities in a material way, kind of midway or around the third quarter of next year.

Now that said if something very interesting comes along because we are constantly talking to people, we constantly have opportunities in the air then we might do something. But I can tell you right now we are definitely very near our capacity in terms of our ability to integrate and execute on our operating plan given the amount of acquisitions we have completed and the one that we have indicated we may do.

Kevin Dede: Right, OK, so it's time to sit back and digest a little bit, got it. Could you talk a little bit about valuations and how you're sort of seeing that trend, given that the overall economy appears to be improving?

Roy W. Olivier: We see valuations all over the board. I mean, we see people that think they are more valuable than sales force, as a multiple of revenue and we see people that have more reasonable view of their valuation is.

So when you look at the recent deals, TCS we paid a little bit of premium from a multiple point of view because it was a 30% growth business. We are not looking at a lot of business that are 30% growth business. So you know the valuations typically are a bit lower there. Bill anything you want to add to that?

William A. Nurthen: Not really, I think we are placing a high value, as we look ahead now we are placing a high value on EBITDA the entity and then traditionally we are looking at valuation metrics of both revenue and EBITDA.

Some of the more recent things we have been looking at are more EBITDA focused and we are putting more valuation on EBITDA because again as Roy alluded to that allows us to leverage our senior debt capacity to do deals in the future without having to issue equity.

Kevin Dede: OK, that's sort of my last question Bill, since you're on [queue], you paid your line of credit down, but then you also added to, what I guess was TASCO but on the balance sheet it shows there is long-term and I am just kind of wondering what the parameters are around that.

William A. Nurthen: Sure. Yes, so it's long-term on the balance sheet because the line of credit's actually not due till September of 2016. So it's not due within a year. Just to clarify we drew on that line of credit to fund the TASCO acquisition but then we did the offering on May 12th. So the balance of the line of credit today is zero.

Kevin Dede: OK. So does that mean it's been -- that 1.7 product that you are showing long-term has been paid off, is that what you are implying?

William A. Nurthen: Yes, it's on as long-term because it's not due for over a year but we paid it off and to recap pro forma post equity offering worth about $5.1 million of cash, nothing on the line of the credit and about $8.9 million on debt.

Kevin Dede: OK. All right, so that's kind of where you are sitting now and then we will see at the end of the year and reevaluate at that point, right?

William A. Nurthen: Yes, correct.

Kevin Dede: Great, OK. Thanks very much gentlemen for entertaining the questions.

Roy W. Olivier: Thank you.

William A. Nurthen: Thanks, Kevin.

Operator: And I am showing no further questions or comments at this time. So with that said, I would like to turn the conference back over to Mr. Roy Olivier for closing remarks.

Roy W. Olivier: Thank you. And thank you again for joining us on today's call. We look forward to discussing our Q4 and fiscal year end 2015 results with you soon. Have a great evening.

Operator: Ladies and gentlemen, thank you for participating in today's conference call. This concludes the program.