ARI Network Third Quarter Fiscal 2016 Conference Call and Webcast
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C: Bill Nurthen; ARI Network Services, Inc.; CFO

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PRESENTATION

Operator: Good day, everyone, and welcome to the ARI Network Services' third quarter year ending 2016 earnings conference call. At this time all participants are in a listen-only mode. Later we will have a question-and-answer session and instructions will be given at that time.

(Operator Instructions)

As a reminder, 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, Bridget, and thank you everyone for joining us to discuss our third quarter fiscal year ending 2016 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 Investors 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 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, and 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 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 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 now like to turn the call over to Roy W. Olivier, ARI's President and Chief Executive Officer. Roy?

Roy W. Olivier: Thanks, Steven. And good afternoon and thanks to all of you for taking time to participate in today's call. Results for the third quarter exceeded my expectations in many areas and reinforced that we are making progress executing our strategy. We have continued to invest in extending the functionality of our core products and creating new products and services to drive growth. For the first time in the Company's history, our trailing 12-month new bookings exceeded $11 million; and for the second time in the Company's history, we closed over $3 million in new quarterly bookings. As a reminder, bookings are the annual contract value, or ACV, of sales to new customers and upsells to existing customers.

I feel that the success in new bookings is a reflection of the strength and value of our new offerings. We grew our recurring revenue subscriber count in virtually all vertical markets, having added over 1,000 new subscribers, paying subscribers, in the first three quarters of the year and our sales pipeline looks very strong even as we enter what is typically our slow selling season. All of this has resulted in an improvement in our organic growth during the quarter and should help us end the year on a positive note. During the quarter, we had several announcements including two awards for the new rebooted digital marketing offerings, two new RV relationships, renewed our partnership with Brunswick and more.

Digital marketing had the strongest quarter in the Company's history both in terms of new bookings and revenue, with revenues improving 38% over Q2. The two RV relationships represent an addressable market of 2,000 dealers for our lead generation and website platform products. We have been working on a new RV offering which just launched, and we expect to see additional bookings and revenues in that market as we go into FY17.

During last quarter's call, we discussed a partnership with CDK Global where they would resell our accessory smart products. We are still in the free trial phase of that offerings which ends in July, but early returns are promising and we remain very excited about this program and other opportunities to expand both of our businesses. We continue to make great progress with the Toro relationship we discussed in the last quarter's call. Toro new bookings were over two times the Q2 numbers and the total sales since the inception of the program is now approaching $500,000 in annual contract value.

The 4,200 websites were deployed in under 90 days and are now live. We are very excited about this program and we are already working to introduce it to our other customers and prospects.

I am also particularly excited about the product investments we have been making during this year, and I believe they will deliver significant revenues as we go into fiscal 2017. Just a few years ago, we were spending 10.1% of revenue in pre-technology feasibility software development, or about $2.4 million annualized. On a trailing 12-month basis, we have spent about $5 million in software development. We have several active projects, including extending and improving our core website lead gen and e-commerce platform, developing a new next-generation version of that product, and developing the next generation of our core eCatalog technology. The first item, extending and improving our platform, is pretty obvious and has resulted in a substantial increase, in some cases a triple digit increase in leads to our dealers. These improvements have resulted in strong new bookings this year and improved churn.

We remain committed to building and delivering the best platform for lead generation and e-commerce in the markets we serve. The second item is a total rewrite of that platform. The purpose of that rewrite is to address the technical depth that is a result of developing that platform over the last ten years. We expect this effort to result in another sizable improvement in lead generation and e-commerce sales for our customers, a substantial improvement in the time it takes us and our customers to set up new installations or update existing installations, and a much better customer experience in terms of speed to find what they are looking for.

In short, we expected to be the platform for the future, improve our sales velocity, reduce churn, and cut our costs to on-board and maintain customers. The initial release of this project is scheduled for September of this year, and I'm very excited about it positioning us to take the customer online experience to the next level. In terms of eCatalog, we have spent the last year developing the next generation publishing tools that we expect to dramatically reduce the amount of time it takes our OEM customers and our internal teams to create new content and update older content. What previously took days or weeks will now take seconds or minutes with this new platform. We developed this as a global solution from day one and designed it for use in the markets we serve as well as any other market where the equipment is complex and requires repair.

It will allow us or our OEM customers to create catalogs from engineering files created by OEMs, engineering, or PLM systems in seconds or minutes. The product was designed to help ARI and its customers create new catalog content and update existing content at a fraction of the cost of current technology. It was also designed to appeal to any manufacturer globally that uses TLM software to design their systems and has a need to provide downstream service and parts information to a service organization. In short, it will open up many new prospects and vertical markets for our eCatalog offerings.

As we discussed in the last call, we had several one-time events impact churn during the quarter. Those events were a large customer that was acquired, a large non-strategic customer exit, and cleaning up customers during the billing migration that Bill has addressed in the past few calls.

The annualized churn rate for the quarter was 18.7% due to those items. However, adjusted for one-time events, our churn rate for the quarter was 14.4%; an improvement sequentially and versus Q3 last year. We expect in Q4 that our churn will return to more normalized levels. In addition, we are seeing improvement in our core dealer churn numbers and this will continue to be one of our top 3 metrics that we invest in improving and will remain an area of focus as we move forward.

Last quarter, we reported that we have been building a backlog because our operations and delivery teams could not keep pace with new bookings. While we have shown improvement during the quarter, we are still not where we want to be. We continue to build out capacity in the US and India to lower our backlog and cost structure. While our overall numbers for the quarter were quite good, our revenues would have been even higher had we been able to deliver all customers in under 30 days, which is our target.

As we discussed in the last call, one of those initiatives resulted in opening an office in New Delhi, India. Almost a year ago we assigned a senior operation resource to investigate building additional capacity in India, we conducted a comprehensive review of the options and hired a VP General Manager in November and have continued to add staff. We now have an operations team up and running in India; the leader of that team was trained in our Duluth office for three weeks and one of our senior US resources is in New Delhi now completing that team's training. We expect this team to start working on our backlog in the next few weeks.

I do want to remind everyone that this will not have a large impact short-term given the time it takes to fill vacancies in India, but we are confident that this will help us build out a cost-effective way to accelerate our development and operational velocity in the future. Long-term, we are very excited about the efficiency and scale this office will bring to our business.

Next I'd like to address ARI's long-term opportunity. Before I turn the call over to Bill for a detailed review of our numbers, please join me in congratulating Bill for being the winner of the Milwaukee Business Journal's CFO of the Year in 2016. I'm sure you'll agree that he's done a great job for ARI and its shareholders. Bill?

Bill Nurthen: Thank you, Roy, and I appreciate the comment. Good afternoon to everyone listening on the call. I'll now share with you some more details regarding our financial results for the third quarter of fiscal 2016 which ended on April 30, 2016.

Before I go through some of the financial details, I wanted to remind everyone that we acquired TASCO at the end of Q3 last year and DCi towards the end of Q4 last year, so it should be noted that the operations of those transactions are included in our Q3 fiscal 2016 results, but are not included in the comparable prior year. With those items noted, I will now go through the Q3 fiscal 2016 results.

Total revenues for the third quarter were $12 million which compares to $10.3 million in the same period last year and $11.8 million in the prior quarter. The year-over-year increase was driven by revenue from the DCi and TASCO acquisitions as well as organic revenue growth. Year-over-year the total growth was 16.6% and we estimate the organic growth, once you strip out the acquisitions, was approximately 5%.

That said, our growth was offset by a decline in non-recurring revenues which we have intentionally deemphasized in our business. As a result, when you look at recurring revenue only, the organic growth rate was over 7%. We did experience organic recurring revenue growth across all four of our core offerings at lead generation and e-commerce websites, eCatalog, business management software and digital marketing services with the most notable organic growth in digital marketing services which almost doubled on a recurring revenue basis.

Looking at revenue on a quarter-to-quarter sequential basis, our growth was primarily driven by strong results in recurring revenues for lead generation websites and digital marketing services as we started to fulfill on the significant sales backlog generated in the first half of the year. This growth was offset by a decline in non-recurring business management software license revenue. Given the perpetual nature of these licenses, the revenue generated in this product offering can vary quarter-to-quarter. Recurring revenues from Q3 were $11.1 million compared to $9.3 million in the same period last year and $10.8 million in the prior quarter.

Recurring revenues represented 92.2% of total revenue for the three months ended April 30, 2016 versus 90.5% in the same period last year and 91.6% in the prior quarter. The increases, both year-over-year and sequentially in the mix of recurring revenue is attributed to our continued emphasis on recurring revenue growth, which has surpassed our overall growth.

Lastly in regards to revenue, on prior calls some have asked that I break out the revenue by products, so I will do that now. Lead Generation and Website Revenue for the quarter was $6.1 million compared with $5.8 million in the prior year and $5.9 million in the prior quarter. eCatalog revenue was $4.5 million compared with $3.4 million in the prior year and $4.4 million in the prior quarter. The significant year-over-year increase in eCatalog is largely related to the addition of DCi's catalog revenue.

Business management software revenue was $700,000 compared with $600,000 in the prior year and $900,000 in the prior quarter. Digital marketing revenue was $500,000 compared with $300,000 in the prior year and $400,000 in the prior quarter. Lastly, our other revenue was $200,000, which was flat compared to the prior year and quarter.
Turning to profitability, we continued to experience significant improvements in our year-over-year numbers. Through the first nine months of this year, operating income has increased 59.8% and adjusted EBITDA has improved by 31.9%.

Looking at gross profit, our gross profit was $9.7 million, or 80.5% of revenue, compared to $8.5 million or 82.7% in the same period last year and $9.7 million or 82.4% of revenue in the prior quarter. Sequentially, the decline in margin performance for the quarter was due to an increase in the direct labor component of our cost of sales as dedicated more resource time to filling on our sales backlog as well as migrating certain of our clients hold their web platforms.

Margin was also impacted by an increase in professional service revenue, which was primarily fulfilled by a sub-contractor, as well as the increase in digital marketing services revenue, which tends to have a lower gross margin than our other recurring offerings. Year-over-year, the margin decrease was due to the reasons I just mentioned and the overall increase in gross profit dollars was simply related to our revenue growth.

The Firm recorded an operating profit this quarter of 921,000 or 7.7% of revenue versus an operating profit of 675,000 in the same period last year and 873,000 in the prior quarter. The year-over-year increase of 36.4% was principally a result of continued scaling on the sales and marketing and general administrative lines of the business.
And looking at each of the operating lines on our P&L, with the exception of software development, the aggregate increase in each of those lines remains largely attributed to the expense-base brought on with the recent acquisitions, offset by efficiencies we have either identified in our business or recognized through the integration of these acquisitions.

Quarter-over-quarter, we experienced a $48,000 improvement in operating profit; while our gross profit declined by $38,000, this was offset by a reduction of $86,000 in operating expenses as more of our overall expenses were allocated to the cost of sales line. We also have heavy resource time allocated to two new significant product roll-outs, which Roy mentioned, which we have reached technological feasibility, which resulted in a modest increase in the capitalized software development.

Pre-tax profit for the quarter was $816,000 versus a pre-tax profit of $582,000 in the prior year and $753,000 in the prior quarter. The year-over-year increase was 40.2%.

From an earnings-per-share perspective, net income for Q3 was $448,000 or $0.03 per share compared to a net income of $339,000 or $0.02 per share a year ago and $448,000 or $0.03 per share in the prior quarter. Sequentially, the net income was flat due to a higher tax rate in Q3, as Q3 is seasonally the time where we receive a great of payments, which typically drive an increase in deferred revenue, which resulted in an increase in our tax rate.

Looking at adjusted EBITDA, adjusted EBITDA was a record high of $2.2 million in the third quarter of 2016 compared to $1.7 million in the same period last year and $2.1 million in the prior quarter. Once again, our adjusted EBITDA grew at a substantially greater rate than our revenue as Q3 showed a nice improvement over the prior year with adjusted EBITDA improving by 26.5%.

The adjusted EBITDA margin was 18.2%, compared to 16.8% in Q3 of last year and 17.8% in the prior quarter. This is the first time the adjusted EBITDA margin has topped 18% since the first quarter of our fiscal 2013. For the first nine months of the year, the Firm has now produced adjusted EBITDA of $6.3 million versus $4.7 million in the first nine months of last year.

Turning to cash flow, Q3 is seasonally the time of our best cash flow and it did not disappoint. Cash flow from operations for the quarter was $2.6 million compared to $1.9 million in the same period last year and $1.2 million in the prior quarter. The quarterly cash flow performance was an all-time high for the Company, as I mentioned in the press release, it was more cash flow than we produced in all of our fiscal 2014, not quite two years ago. On a trailing 12-month basis, our cash flow from operations now stands at $7.3 million compared with $5.9 million a year ago.

Turning to free cash flow, we were able to set a new high for free cash flow as well despite the higher software capitalization outflows in the quarter. Free cash flow, which we calculate as cash flow from operations, plus capital expenditures and software capitalization was $1.9 million for the period versus $1.4 million in the same period last year, and $605,000 in the prior quarter.

An important thing to note is that our accounts payable balance is about $192,000 lower than it was in Q3 of last year, and is at its lowest level since the third quarter of fiscal 2014. So we posted record cash flow in Q3 despite a heavy pay down of our bills.

As we look ahead to Q4, it is seasonally a strong period of cash flow, but not as strong as Q3. Regardless, we are aiming to improve on our Q4 performance from last year and post another increase in our trailing 12-months performance as we close out the fiscal year.

As we look to the balance sheet, our strong cash flow performance in the quarter continued to improve our balance sheet. The balance of cash and cash equivalent increased in Q3 to $4.4 million at quarter end from $3.2 million last quarter and compared with $2.3 million at the end of fiscal 2015.

Looking at debt, our line of credit remains clean as the balance was zero at quarter end. Total debt, which we calculate as debt from our line of credit, notes payable and capital lease obligations was $9.6 million at the end of the third quarter compared with a balance of $10 million at the end of Q2. Given the reduction of debt and the increase in our cash balance, our net debt now stands are $5.1 million versus $6.8 million at the end of Q2 and net debt of $8.5 million in our fiscal year end for 2015. The Company's debt to equity ratio stood at 33.3% versus 35.4% at the end of Q2 and 40.1% at the end of fiscal 2015.

If you recall from our prior conference calls, we were targeting $4 million of cash and net debt of $5.2 million for our fiscal year end. Given the strong cash flow performance in Q3, we have achieved our fiscal year-end balance sheet goals a quarter ahead of schedule. We aim to improve up on these numbers in Q4 and that will position us very well to take advantage of future investment opportunities that align with our growth strategies.

In conclusion, in Q3 we exceeded our profit and cash flow expectations, and has been the case each quarter this year as we have experienced tremendous improvement in the first nine months of the fiscal year versus our prior fiscal year. This improvement has also translated into an improvement in our trailing 12-months numbers. On a trailing 12-month basis, we have now generated operating income of $3.3 million, adjusted EBITDA of $8.1 million, which is a 17.5% margin, and cash flow from operations of $7.3 million. When you compare these to our prior trailing 12 month numbers as well as to our fiscal 2015 numbers, these are all meaningful improvement.

As we look ahead to Q4, I want to make a few points. First, we had another quarter of strong sales bookings. This means we will continue to apply resources into translating those bookings into revenue as quickly as possible. And as such, I suspect that will continue to impact the gross margin in a way similar to what we experienced in Q3. The flipside of that is that we are aiming to maintain organic growth rates in Q4 similar to what we experienced in Q3. Second, as I noted previously, our profit performance in the first nine months of the year has exceeded our expectations. We anticipated that there would be some investments in Q3 that would prevent us from improving upon our Q2 performance.

While we did make some of those investments and still improved upon our performance, some of those investments did not hit in Q3 from a timing perspective, and as a result will likely materialize in Q4. These investments include, among other things, our ongoing investment in our India office, consulting fees to upgrade and optimize our data centers and the rollout and go live of our enterprise-wide CRM system.

While we do not anticipate our trailing 12 months adjusted EBITDA numbers to decline in Q4, I want to note that the improvement will likely not be as dramatic as the improvement we experienced in each of the first three quarters of the fiscal year. All this being considered, we measure our performance internally on a fiscal year basis and believe that these investments are prudent as they relate to our long-term growth strategy. Further, notwithstanding the investments, we remain on track for a solid close to our fiscal year, a fiscal year which we believe will have validated our strategy and demonstrated the earnings and cash flow leverage that exist in our business.

I will now turn the call back over to Roy.

Roy W. Olivier: Thanks, Bill. In the last quarter's call, we provided an overview of our strategic intent to help dealers leverage and capitalize on the omnichannel shopping trends that are being driven by today's shoppers. I will not repeat that detail here, but I do want to reinforce that I think ARI is uniquely positioned given our dealer footprint and longstanding relationships in the markets we serve, to capitalize on that trend and to grow our business as we help dealers grow theirs.

If you would like additional detail on our strategy, feel free to ask during the Q&A or reference last quarter's conference call script that is available on our Investor website at investor.arinet.com.

We are committed to executing on our four-point growth plan, which includes adding new vertical markets to increase our total addressable market, or TAM, adding new products and services that help our dealers sell more stuff, increase the average revenue per dealer or customer through innovative new features and content and to execute acquisitions that are consistent with our strategy. We have been executing on this plan for several years and I think this quarter's results along with our trailing 12 month results reinforce that we continue to be successful and shows the leverage in our business model.

In conclusion, let me say again that I am very inspired about our future. Over the past few years, we have worked hard to scale ARI in order to position it for future growth. Just a few years ago, we had 38 sales and marketing resources. Today, we have 118. In that same timeframe, we have doubled investments in developing and extending our products. Our product management and software development teams are truly developing some amazing technology that I believe will have a substantial positive impact on our customers and ultimately results in growth and profits for our shareholders.

You have heard me say it before, and I will say it again: I am more excited about our future prospects than I have ever been. At this time, let me open up the call for your questions.

Operator, please instruct our listeners how to queue up.

Q&A

Operator: (Operator Instructions) Louie Toma with Craig-Hallum Capital.

(Louie Toma): This is Eric filling in for Louie today. Thanks for taking my question. First one I have regarding the CDK agreement; could you talk about the conversion rate that you guys have been seeing or anticipating once the trial ends?

Roy W. Olivier: We haven't really discussed publicly what we have been seeing, and frankly, we don't have an expectation because we've never done a project like this in the past. They have over 2,000 power sports dealers that are prospects for the product. All those dealers are prospects for this product, but we have not done this kind of project and don't really have an expectation in terms of conversion rate.

(Louie Toma): And then second, regarding the Toro deal. So of the 4,200 dealers that Toro has, I am just wondering approximately how many were already ARI customers?

Roy W. Olivier: I honestly don't have that number either. I mean, we obviously had some multi-line outdoor power dealers that carry Toro. I don't know whether it was 100 or 300, just probably between 100 and 300, but I don't have an exact number.

Do you, Bill?

Bill Nurthen: No, I think it was about 200 or so.

Operator: Gary Prestopino with Barrington Research.

Gary Prestopino: I am trying to, with this Toro agreement, I am going to follow up on the last question. I mean, how many dealers have you signed up for the products so far since you've put it out? Can you tell us that?

Bill Nurthen: Yeah. Since we started the program itself again, we added like we said a few hundred before, but since we started the program we've signed up about 138 dealers.

Gary Prestopino: And it's only been, really, like one quarter and a month, right? Since from the time that you've actually had this out in the market, right?

Bill Nurthen: Correct.

Gary Prestopino: And then could you maybe tell us –for the nine-month period, you signed 1,000 new recurring revenue subscribers; could you tell us what you signed in this quarter and versus last quarter versus Q3 of 2015?

Roy W. Olivier: We started tracking that number just at the – we've basically compiled that number at the end of our fiscal 2015 because we wanted to start to track it in fiscal 2016. So we really only have the number as of the end of the nine months of this year, which is, again, we grew about 1,000 dealers from the start of the year fiscal year through to the end of Q3. There was improvement in that number between Q2 and Q3. If you give me a second, I can try to look that up.

Gary Prestopino: And then, Roy, I want you to maybe elaborate a little bit more on the – I guess the ecommerce lead gen, that re-write off your platform. Is that the one that you are re-writing?

Roy W. Olivier: Yes, our core lead gen platform and e-commerce platform today is internally it's called Endeavor, and we continue to invest in making Endeavor a faster and more leads – that sort of thing. That's the product I was referring to when I said we were extending the capability of our existing product.

In parallel, we are doing a re-write of that product. The re-write is internally code named Domino, and Domino is a product that will openly replace Endeavor. It'll be our platform for the future. It is written to be a responsive design platform. It will be much, much faster. It actually will drive much more leads. It has a tremendous amount of flexibility to be able to appeal the different vertical markets as we continue to import medical data and [the] entire data and other types of data. And it also is going to have significant impact on our cost structure to deliver and maintain new customers.

When we took a look at making Endeavor more efficient and re-writing it with modern technology and addressing the technical depth that has built into that platform over the last 10 years as you've had developers write it, we decided just to re-write it from scratch.

So we've had that project actually going on in parallel to our ongoing development for the last year. I haven't talked about it much, but it is now coming to an end. It's release 1.0, which would be what we refer to as Storefront, will be launched here in the next few months. It will go live in September. And we're pretty excited about it. I think it's going to be the next-generation platform. It's going to significantly improve lead flow to the dealers, should significantly improve conversion rates to e-commerce as we launch the e-commerce part of it, and it's going to have a huge impact on our cost structure long-term.

It's a big project, we've got a lot of people working on it; made significant investments in it, and now we are within a couple of months of launching it.

Gary Prestopino: Okay, so – sorry Bill, go ahead.

Bill Nurthen: I was just going to follow-up on your last question. So the subscriber count was a little over 15,000 at the end of our fiscal year last year. It sits about close to 16,200 at the end of Q3 and that number between Q1, Q3 increased by about 400 subscribers.

Gary Prestopino: And then just with this new re-write and what you are putting out there, you have the Endeavor platform and then you are going to have the Storefront platform. I would suppose you've still got to support the Endeavor platform or is the goal is everybody is going to get ported on to the Storefront platform and you are going to upsell?

Roy W. Olivier: It is the latter, just to be clear, that's not going to happen overnight. I think what you'll see is a project that we begin in August that will start porting dealers over, August or September, so we will begin porting dealers over to Domino which is the name of the new platform and that process will take a minimum of 12 months, it might take a little bit longer than that.

But that migration effort is not going to be incremental to our cost structure today. We've had a plan to do that for a long time, and we will be porting those guys over to Domino and then eventually we will retire and cut down Endeavor and all the data center that goes along with it.

Operator: Ed Woo with Ascendiant Capital.

Ed Woo: My first question is on, in terms of just on the macro environment out there, what are you seeing with some of your customers – I know we're heading into the summer season, some of your – especially your ATVs dealers probably seeing higher business. But have you seen and noticed any significant changes so far?

Roy W. Olivier: In terms of macro environment it does vary by vertical market; the weather-driven markets are doing pretty well right now because I don't know how it is where you are, but we've had a pretty good spring here in Wisconsin and pretty good weather and we've seen a lot of that across country.

So outdoor power dealers are reporting pretty nice sales. On the other hand, when we look for example the power sports market, new units is slightly down over last year, but service and parts are typically up. So we've seen a little bit of softness in power sports, so it varies a little bit market-to-market, but overall our dealers have had a pretty good year. They continue to report a lot of traffic and a lot of activity, which is the reason we're going into our [full] selling season because they are too busy for us to get a hold of. But like I said, it varies a little bit by market, but overall the economy in the vertical markets we serve continues to be pretty good.

Ed Woo: And then the next question I have is you mentioned you guys have a little bit of a backlog you guys are trying to convert bookings into, I guess, revenues. Has that slowed the way your [points] are trying to build up your backlog and get more customers just to sign up, or has that not been affected yet?

Roy W. Olivier: No, it has not been affected. We don't slowdown sales for almost any reason. We let those guys go do what they do and then our job is to figure out how to build the infrastructure to get their sales delivered.

So to-date it has not been an issue. The bigger concern to me I think and Bill, has been has that backlog has gotten a little bit bigger, are we going to churn out people out of the backlog? In other words, before they go live are they going to exit because they don't want to wait? So far we've not seen any kind of material increase in customers exiting pre-go-live but after they were sold. But we continue to be very focused on either third-party resources or additional resources within ARI to make sure we get that backlog back down.

And the trend of – we refer to this whole project, the backlog thing as WIP, work in progress, and the general historical trend and I get a graph every Monday about it is going down. It is not going down as fast as probably I would like, but the people say I am impatient even though I don't think I am. So it is going down, it's going in the right direction. We just got to keep executing and get it back down to everybody's deliver within 30 days.

Bill Nurthen: Yeah, just to add on that; the backlog itself really peaked in March of this year and since then has been coming down and it's not coming down because we're taking the foot off the gas from a sales perspective, it's because we've been throwing some more resources at bringing it down. So we do feel like the trend is in the right direction and we are rolling out people faster today.

Ed Woo: And going back to your, I guess, development or investment in India, when do you think it will be fully up and running and everything's effecting – how soon do you think that could happen?

Roy W. Olivier: Keep in mind; we have built out that office. It has 60 seats in it, so it's a fairly large footprint. We have a half a dozen people there now, so it depends on what you mean by fully operational.

We have a, what we call, a web dev. It's an operation's team that spins up new customers and does that through existing customers. That exists today. It's a relatively small team. That team will continue to hire into it to make more and more capacity, because we will have migration projects as I mentioned a few minutes ago as well as additional new customers that we need to ramp up.

We are in fact recruiting additional teams to do different things in that office, but it’s going to take time, especially when you get into the software development side of the business, a lot of times there is three four months lead time before we can get somebody there.

We have a small operational capability there now. That will expand, I think, pretty quickly from here, but some of these other projects are going to take months before we have team to execute on whatever the priority is for that team. Our thinking is a large operational team to support cost structure, we will eventually have a third development team there that works on web platform; Domino and Endeavor. We will have a mobile team there and we will have some additional teams there over time, but this is going to happen over a long period of time. We're not going to have 60 people in six months. Probably we won’t have 60 people in a year. We will just slowly continue to add to that team as we have needs and as it makes sense financially to do so.

Operator: Gregg Hillman with First Wilshire Securities.

Gregg Hillman: The business management side, has the competition come out with any products lately for wheel and tire for example?

Roy W. Olivier: Yeah, I mean, wheel and tire has continued to develop both their point of sale offering as well as their web platform offering. They did launch some digital marketing products and actually a lot of the revenue increase and new bookings increase I described in my comments. So we’re proud of the wheel and tire team. So they continue to develop some very cool extensions to existing functionality plus new digital marketing offerings and that sort of thing.

So yeah, they continue to launch new things and have some very interesting mobile apps in development now.

Gregg Hillman: And are you going to make a greater effort, concerted effort, to get it to auto aftermarket, or is that a couple of years off?

Roy W. Olivier: No. I think, as you know, we bought DCi about nine months ago. They have a tremendous catalog of aftermarket performance parts and they have literally 10,000 to 20,000 downstream independent jobbers that are prospects for our website and our point of sale systems. We have been intentionally let DCi run standalone without making the investments to make that happen during the first half of this fiscal year, because we wanted to make sure that business was delivering the financial results that we expected them to deliver.

As we go into our FY17, we will be making the investments to put their data into our web platform products and put their data into point of sale and cross selling those products into their installed-base. Those revenues, we expect to start materializing in FY17; we won't see much of that in Q4, but that's where we’ll jumpstart their sales growth by taking their data, putting it in to two of our products and starting cross selling into their base.

Gregg Hillman: And could you give me another update on medical and what’s going there in terms of your ability to make content in medical? And also, do you have any business management offerings in medical?

Roy W. Olivier: We do not have any business management offerings in medical. We continue to pursue the strategy of integrating with the larger footprint business management systems in the medical industry, the biggest of which is a company called Brightree.

In terms of content, we did attend the McKesson medical show here about two weeks ago. We have loaded McKesson data, we showed it at the show to their national sales force and a lot of their management team; very successful show, a lot of excitement around the product. And as we launch that product and start selling it in earnest, which will happen here in late June, July, I hope to see accelerated sales velocity in medical.

Medical continues to do, I would describe it as I guess a steady consistent job of bringing on new customers and up selling existing customers, but McKesson is the largest player really in the medical space. They're larger than any other opportunity we have by significant margin and the McKesson dataset when we take that to market, I would expect to see accelerated sales velocity in that team.

Gregg Hillman: And I take it that you will, and you're the first vendor to do that, to have a digital catalog in the medical space?

Roy W. Olivier: Yes. We're McKesson's only partner to-date.

Gregg Hillman: And how many medical dealers are there? There's like, I forget, 15,000, 20,000, a fairly large number?

Roy W. Olivier: There is about 25,000 service providers in the US; realistically, probably 15,000 to 18,000 of those are prospects for our products, the remainder are kind of lifestyle businesses and are too small.

Gregg Hillman: So those are two – those are the three big growth areas on a go forward basis, auto aftermarket, wheel and tire, and medical? Is that right?

Roy W. Olivier: We continue to think those are the fastest growth areas, but we continue to see growth in every market we're in, but markets where we have 40%, 50% share, we are expecting single-digit growth, the markets you are talking about, we are expecting double-digit growth. Or actually, in some cases, more than that.

Operator: Avi Fisher with Long Cast Advisers.

Avi Fisher: Just two quick questions. One is the sale in your business really works when the churn rate comes down and obviously you are spending on the churn. The customer ops and support numbers are up, but what is the normal churn number, what target churn are you going for?

Bill Nurthen: Yes. I mean, I think I've said in the past that sub 10% would be world-class. I think realistic for us is probably 11%, 12% and that's an overall churn rate, because some of our products today are under 10%. I think we have a product that's actually running under 8% or runs 8% periodically looking at it on a quarterly basis.

But other products are higher than that. For example, our initial offerings in digital marketing have been up for renewal over the last few quarters. We have got very high churn there because, frankly, we didn't get the product offering right.

The new rebooted offerings that I mentioned in my comments that have had very strong new bookings in sales, those we expect to have a much lower churn rate. In the web platform business, our dealer churn rates are actually pretty good. They're where I would expect them to be, but some of the non-strategic customers, distributors, larger OEM customers that we consider to be non-strategic, which frankly are one customer but a lot of revenue, I've turned out that have impacted our churn rates this year in addition to the one-time events that I referred to in my comments.

To answer your question, I'd love to get it 11% to 12% overall and then re-evaluate and see if we can get it below 10%. I think given the nature of our business and the nature of dealers' tendency to want to try new things to drive leads into their dealership or try new sales and marketing approaches, the churn in that part of our business is always going to be a bit higher than for example, catalog, where we have very low churn or point of sale where we have very low to no churn.

Avi Fisher: So it sounds like the lowest churn businesses are catalog and point of sale?

Bill Nurthen: Yes. Point of sale, very, very low because as you might imagine, people don't like to switch accounting systems because it is a nightmare. Catalog is very, very low and, frankly, one of the reasons we have acquired a couple of point of sale companies and we are working hard to form deep strategic partnerships with DMS providers is we think if we are deeply integrated into the DMS and there is real value in that integration, that is a differentiator that will reduce churn with the web platform product.

Avi Fisher: And then moving on to the second question, it sounds like you have more work than you can put together within 30 days. I guess I'm curious as you add more offerings and I imagine the complexity of the work you do increases, is 30 days the right target?

I mean, it's terrible to over sell and under deliver. So I'm curious how the complexity of your products is getting the way of delivering it on time or is it just the volume of the product that's getting the way of delivery on time?

Roy W. Olivier: It's a very well diversified product. I mean, catalog, frankly, if you buy a catalog, we have you set up in 24 hours, it's on its way to you or we've given you a login and it's a kind of no-brainer instant turn it on. If you buy a web platform product, either for lead gen or e-commerce, there is a design component where we work with you to design it the way you want it to look. There is a build component and then there is a review and go live component. The design component – actually, all three of those components together are today about 13 to 15 hours of work. The next-generation platforms will get those well into the sub-10 hour range.

So the total time to turn somebody on is only 10 to 15 hours, but the challenge and the reason it might run over 30 days is either we're backlogged and can't get to that first step, or frankly, most commonly, we have built the product, we have sent it to the dealer for review and we are going back and forth with the dealer who also don't have time to look at it, because he is busy selling motorcycles and we end up in a prolonged review process.

In fact, if you look at our kind of backlog by those buckets, you see a tremendous number of dealers that are in that review process where they sit there for weeks in some cases because the dealers don't have time to do the review. So we actually can spin up a dealer literally in two days if we have the dealer's attention. But in many cases, there is phone calls going back and forth, messages being let, meetings that are not being met and dealers get busy and they are like, hey, call me next week.

So I think sub-30 days is realistically possible and we do survey every dealer when we are done with our implementation to understand whether or not they are happy or not, and I completely get the concept of under commit and over deliver and we try to do that in all of our products every day.

Avi Fisher: Just to be clear, and the next-generation system will make it easier for you and the dealer to get the system up and running more quickly?

Roy W. Olivier: It's going to make it way easier to get it up and running and it's going to make it way easier to make modifications if you want to change something, and frankly, the system is going to be a lot more flexible.

So, there is a lot of things that a dealer might ask to do today and the answer is, well, the platform don't really support that. Next gen platform is going to have a tremendous amount of flexibility to do things that today we couldn't do in addition to being able to do the stuff we do today a lot faster.

Avi Fisher: And that rolls out in September 2016?

Roy W. Olivier: Yes. First release is what we call storefront and that will be September of this year, just a few months, and then e-commerce will follow up on that and that will be later in the calendar year, might be early next calendar year.

Avi Fisher: And is it expected that this new platform not only will speed the delivery of the product, but also reduce churn?

Roy W. Olivier: Absolutely. Because we know from customers who turn their feedback, some of it is related to lost flexibility, some of it is related speed, some of it is related to I'm not getting up leads, and this platform is designed to address all those things.

Avi Fisher: And just to clarify, and so I fully understand that e-commerce, so you have the storefronts rollout and then the e-commerce rollout. Does that e-commerce rollout include a point-of-sale service?

Roy W. Olivier: No.

Avi Fisher: Right. That's what I thought. Okay, I appreciate the questions. Thank you.

Operator: (Operator Instructions) Gary Prestopino with Barrington Research.

Gary Prestopino: Yes. Just a quick question on the gross margin, do you expect the year-over-year erosion to continue in to at least the first and second quarter of next year, Bill?

Bill Nurthen: Yes. I think as I said, definitely for Q4, I think in Q1, it is likely that it will continue. I would be hoping by Q2, we'd start to see it move back in the other direction, although I don't think necessarily that we'll scale completely back up to the old range because as I said, part of the component there is the digital marketing services, which have a little bit lower gross margin and so as those continue to be more and more of the revenue, that will impact the margin a little bit.

Gary Prestopino: Okay. Thank you.

Bill Nurthen: I was going to say I wanted to clarify one earlier question on the Toro dealers, we actually had about close to 400 dealers in the Toro prior to starting the program, so we have a little over 500 today.

Some of the confusion there is that the – actually, the new dealers are signing up at a much higher ticket than the older dealers because of the co-op that they are getting from the program. So in the newer signups, we are getting much more annual contract value out of fewer dealers. So just wanted to clarify that point as well.

Operator: Thank you. I'm not showing any further questions. I will now turn the call back over to Mr. Olivier for closing remarks.

Roy W. Olivier: Well, thank you again for joining us today. We look forward to talking to you at the conclusion of the current quarter and have a great evening.

Operator: Ladies and gentlemen, this does conclude the program and you may now disconnect.