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NCR - Q2 2017 NCR Corp Earnings Call

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OVERVIEW:

Co. reported 2Q17 YoverY constant-currency revenue growth of 3%. Expects 2017 revenues to be $6.63-6.75b, GAAP EPS to be $2.20-2.32 and non-GAAP EPS to be $3.32-3.42. Expects 3Q17 adjusted constant-currency revenues to be flat to up 2% and non-GAAP EPS to be $0.88-0.93.

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PRESENTATION

Operator

Good day, and welcome to the NCR Corporation Second Quarter Fiscal Year 2017 Earnings Conference Call. Today's conference is being recorded. At this time, I would like to turn the conference over to Mr. Michael Nelson, Vice President of Investor Relations. Please go ahead.

Michael Gary Nelson - *NCR Corporation - VP of IR*

Good afternoon, and thank you for joining our Second Quarter 2017 Earnings Call. Joining me on the call today as our host is Bill Nuti, Chairman and CEO; along with Mark Benjamin, President and COO; Bob Fishman, CFO; and Paul Langenbahn, EVP, Software. After prepared remarks, Bill, Mark, Bob and Paul will take your questions.

Before we get started, let me remind you that our presentation and discussions will include forward-looking statements. These statements reflect our current expectations and beliefs, but they're subject to risks and uncertainties that could cause actual results to differ materially from those expectations. These risks and uncertainties are described in our earnings release and our periodic filings with the SEC, including our annual report.

On today's call, we will also be discussing certain non-GAAP financial measures. These non-GAAP measures are described and reconciled to their GAAP counterparts in the presentation materials and on the Investor Relations page of our website. A replay of this call will be available later today on our website, ncr.com.

With that, I would now like to turn the call over to Mark.

Mark D. Benjamin - *NCR Corporation - President and COO*

Thank you, Michael, and thanks to everyone for joining us today for our second quarter conference call. I'll begin by highlighting key developments and performance metrics for our business during the quarter. Bob will then walk you through the financials in further detail as well as discuss our outlook. Then Bill, Paul, Bob and I will take your questions.

Our Q2 results were in line with our expectations, and today we are reaffirming our full year guidance. When we think about our performance this quarter, 2 words come to mind: diversification and execution. We are clearly benefiting from the diversity of our revenue streams from both a solution and market perspective, which has kept us on track to achieve our full year guidance.

Our Software revenues continue to expand, including 9% growth in cloud revenues, along with a 13% increase in net ACV. We have built a roughly $2 billion software business, including almost $600 million in cloud revenues coming from customers across financial, retail and hospitality markets. Today, we are balancing scale and efficiency gains with continued investments in innovation, particularly in our omni-channel platform, which I'll talk about more in a few minutes. We had a terrific quarter in our Services segment as the hard work we announced in 2016 is paying dividends in the form of improved efficiency, higher productivity and increasing customer loyalty. Solid execution by the team helped drive impressive gross margin rate expansion during the quarter.

And in Hardware, our global leadership in self-checkout and point-of-sale solutions offset lower ATM sales in the quarter as anticipated. We continue to take ATM market share and view the ATM market as largely flat to slightly up total market globally over the next couple of years, with several secular drivers of growth, including a Windows 10 upgrade cycle and, of course, Branch Transformation. Our diversified hardware portfolio and growth of other smart-edge devices support continued Hardware segment growth. Our sales teams continue to approach our customers with a total solution that allows them to achieve their omni-channel goals, including the seamless convergence of physical and digital consumer channels. Our solutions directly correlate to helping our customers drive higher revenue growth, market share gains, increased productivity and a contemporary user experience required to compete in today's rapidly evolving digital and mobile world.

Slide 4 shows a snapshot of our financial performance. Revenue was up 3% on a constant-currency basis and within our guidance range, driven by higher revenue across each of our business segments. Our revenue growth was also aided by the further expansion of our recurring revenue, which was up 4% constant currency and now comprises 45% of our total revenue. Recurring revenue will continue to be an important theme, particularly cloud revenue, as we strive to grow our cloud business double digits in 2018, on our way to higher growth long term. We are committed to a cloud-first approach to our business.

Our non-GAAP gross margin rate expanded 150 basis points on a constant-currency basis to 30.1%. As you know, margin expansion has been a significant area of focus here at NCR, and our performance this quarter speaks to our strong execution and the value our customers place on our solutions. Our diverse set of offerings is driving demand globally, and our focus on productivity and scale in each of our businesses is bearing fruit. Over time, as we have said before, Software growth will outpace total revenue growth and at higher margins, which will positively influence margin expansion. Non-GAAP EPS came in above the high end of our guidance range, and on a constant-currency basis, was up 13% year-over-year. Lastly, free cash flow was as expected, and we remain confident in achieving our full year free cash flow guidance.

Moving now to Slide 5. NCR has a clear solution-driven strategy across Software, Services and Hardware anchored to our omni-channel platform and strategic offers of omni-channel software, channel transformation and digital enablement. Our solutions are software-driven and complemented by an intelligent set of edge platforms as well as comprehensive services. We have millions of smart-edge platforms deployed today, self-checkout, various modalities of point-of-sale, ATMs, branch terminals and SaaS applications residing on third-party hardware devices, and each are performing a critical function while capturing valuable data.

The smart edge is being redefined. We are embracing the Internet of Things, mobile devices, cloud technology and machine learning, all with a focus on capturing data. Data is the fuel for the new economy and will be the secret sauce for growth, as well as competitive advantage across enterprises around the world. NCR will provide the omni-channel decision support software platform which allows us to turn data into powerful actionable insight and takes advantage of our incredible position in the edge.

Helping our customers utilize the data and make it actionable in real time is important to NCR taking the next step in our transition. Our future is about decision support and providing actionable insights that enable the employees and customers of our customers to make better, faster decisions. We design, deliver, optimize and accelerate our customers' digital transformation, helping to deliver a new consumer experience. Our goal is to lead that revolution, not follow.

Innovation and commitment to our customers have long been among NCR's core values. As we look across our markets today, we see the next levels of revenue growth, productivity improvements, customer satisfaction and loyalty gains. We power roughly 700 million transactions every day. With each of those transactions comes applicable data and insight, both for our customers as well as for NCR. We see the future for NCR as adding decision support capabilities. Each of those transactions through our systems offer a valuable opportunity for us to provide actionable insight and monetize that data. We are a trusted partner for our customers and have established track records of delivering value as we help them address the challenges facing their businesses.

Extending our capabilities to include data is a key area of investment today as we look to continue being the critical solutions provider our customers need. We are focused on adding insight, predictive analytics and cognitive technology, so customers can better engage and understand their customers, drive improved loyalty and more effectively compete in a rapidly evolving and highly competitive world.

Within Hospitality, rapid technology changes and changing consumer demands have created an opportunity for restaurants to find new guests and incremental revenue streams, get them to come back more frequently and spend more when they do. As a result, the right technology platform can help create a memorable end-to-end omni-channel dining experience. Delivery platforms are quickly gaining popularity as a channel for many restaurant operators. To enable our customers to provide a better overall ordering and delivery experience, NCR has signed an agreement with a leading marketplace provider, DoorDash, to offer a seamlessly integrated solution into our Aloha platform of sale. We expect the integration to be available in the next few months.

While we continue to pursue additional partnerships with more providers on a global basis, we are excited to be working with DoorDash and its industry-leading roster of top-tier restaurant partners to launch the Aloha integration later this year. The successes we have had to date is the result of aligning our solutions portfolio with market demand and is evidenced by recent customer wins. These include National Australia Bank or NAB, which chose NCR to help dramatically transform its branches, blend digital and physical channels and create connected consumer experiences. NAB will leverage NCR's CxBanking software platform to create a true multichannel 2.0 experience across their retail bank network, including developing a new payments infrastructure, which will allow NAB to deploy innovative services across their channels more effectively. NAB will also count on NCR to manage their retail bank infrastructure, ensuring high service levels and exceptional customer experience.

Also, in Financial Services, we will be deploying ATMs and cash management solutions with Bradesco in Brazil. On the Retail side, Lowe's Home Improvement will continue deploying our self-checkout solutions to provide an improved consumer experience. Lastly, we continue to receive notable recognition for our global leadership in the markets we serve. This includes NCR being named a leader in the IDC Marketplace: 2017 North American Mobile Banking and Payments Report (sic) [IDC MarketScape: 2017 North American Mobile Banking and Payments report], in large part to our wide range of integrated omni-channel banking solutions. Also, NCR is leading the world in self-checkout and is the #1 supplier of ePOS in North America, according to the latest research from RBR.

With that, I'll turn it over to Bob, who will walk through our financial performance and outlook in more detail. Bob?

Robert P. Fishman - *NCR Corporation - CFO, CAO and EVP*

Thank you, Mark. Slide 6 shows a summary of our segment results for the second quarter, with increases in revenue across all our segments highlighting the diversity of our revenue streams. The key driver for revenue growth across each segment was continued demand for NCR's channel transformation solutions.

Our gross margin performance is also indicative of the diversification of our business, with margin expansion in our Services and Hardware segments driving total gross margin higher. The overall gross margin rate expansion reflects strong execution, the results of our strategic focus on business transformation, a positive revenue mix, efficiency and scale gains.

We'll now dive into details of each segment. Slide 7 shows our Software results. Software-related revenue increased 3% year-over-year, driven by an acceleration in cloud revenue growth, which increased 9% due to prior period bookings. We are also pleased with the continued momentum of new cloud bookings in the quarter, as reflected by net ACV of $18 million, up 13% from the prior year. Digital enablement and channel transformation continued to drive cloud, with strong growth for our digital banking solution, Connected Payments, NCR Silver and our mobile ordering platform. Professional Services revenue increased 5% on a constant-currency basis also due to strength in channel transformation and digital enablement solutions. And software maintenance showed positive growth of 1% constant currency.

Our software license revenue declined due to unattached software license revenue that is now expected in the back half of the year. Software gross margin rate was down due to the mix of Software revenue, partially offset by improved efficiency and scale in software maintenance and cloud. We expect margin for the Software segment to expand in the second half of the year due to increased contribution of software license revenue and continued improvement in software maintenance and cloud margins.

Turning to Slide 8. Services had a strong quarter with 4% revenue growth and gross margin rate expansion of 410 basis points, excluding the impacts of foreign currency movements. The 4% revenue increase was driven by hardware maintenance growth as a result of improving channel transformation trends combined with increased managed and implementation services. We also benefited from market share gains, driven by key competitive takeaways in the quarter. We are pleased with the higher file value, which is the backlog metric for our Services business.

Services gross margin rate expansion was as a result of business process improvement initiatives and a mix shift towards higher-value managed services. Our investment in big data analytics, predictive monitoring and customer on-boarding are allowing customer service cases to be resolved more efficiently while reducing dispatches. Incremental Services margin expansion remains a key focus as we execute our strategy.

Turning to Slide 9. Hardware revenue was up 1%, excluding IPS and FX, due to continued growth in channel transformation, particularly in the retail and hospitality industries. The key drivers to Hardware revenue growth were self-checkout, which increased 37%; and point-of-sale, which increased 20%. SCO and POS revenues increased due to store transformation growth, which continues to gain momentum globally as consumer preferences shift. Our new point-of-sale hardware portfolio continues to gain market share, with solid demand for both our ePOS and mPOS solutions.

ATM revenue was down as expected due to delayed conversion cycles in the ATM business. We expect ATM revenue to improve in the fourth quarter as larger customer rollouts take place. We continue to see a very favorable response to the global launch of our 80 Series, which we see as a competitive differentiator. We remain on track to achieve our product certification goals as we advance our global deployments throughout 2017.

Hardware gross margin rate improved 70 basis points as we are gaining scale from new product introductions. Additionally, recent market share gains across our Hardware portfolio are expected to drive incremental higher-margin attached revenue and recurring revenue streams in the future.

On Slide 10, you can see free cash flow for the quarter. Free cash flow was $18 million in Q2 2017, down from $55 million in the prior year. The decrease was due to higher working capital as we plan for increased revenue in the second half of the year. On a year-to-date basis, free cash flow was $6 million compared to $26 million in the prior year. Lower free cash flow in the first half of the year is typical at NCR as revenue and profit build throughout the year. We are confident in our 2017 free cash flow guidance, which remains unchanged at $500 million to $525 million or approximately 95% to 100% of non-GAAP net income.

Slide 11 shows our net debt-to-EBITDA metric, with a net debt leverage ratio of 2.6x for Q2 2017, which is a significant improvement from the 3.1x at Q2 2016. NCR remains committed to a balanced capital allocation strategy. We anticipate strong free cash flow for the remainder of the year, which will enable us to reduce our leverage multiple throughout the year.

On Slide 12, you will find our full year 2017 guidance. We are reaffirming our full year 2017 revenue, non-GAAP and GAAP diluted earnings per share and free cash flow guidance. Revenue guidance is expected to be $6.63 billion to $6.75 billion. We expect revenue growth of 1% to 3% as reported and 4% to 6% adjusted constant currency. We are including expected FX headwinds on revenue of approximately $25 million.

Our non-GAAP EPS is expected to be $3.32 to $3.42 for the year or growth of 10% to 13% versus the prior year on a constant-currency basis. Our GAAP EPS guidance is expected to be $2.20 to $2.32. Our free cash flow is expected to be in the range of $500 million to $525 million or approximately 95% to 100% of non-GAAP net income.

Slide 13 shows our reaffirmed revenue guidance by segment for the full year. Software is expected to grow 6% to 7% on a constant-currency basis, with cloud expected to grow at a similar rate. Services is expected to grow 2% to 4%, and Hardware is expected to grow 3% to 6%.

Slide 14 includes our Q3 2017 guidance. We expect revenue to be flat to up 2% adjusted constant currency. Our non-GAAP EPS is expected to be $0.88 to $0.93 or up 4% to 9% from the prior year. Our guidance also includes FX headwinds of $10 million in revenue and $0.02 in diluted EPS.

On Slide 15, you can see our revenue and EPS trending over the last 3 years. Using the midpoint of our guidance range, the implied guidance for the fourth quarter is in line with previous years. Fourth quarter revenue represents 29% of the full year compared to 28% last year and is supported by our backlog and funnel at the end of the second quarter. Our EPS is trending more favorable than last year mainly due to the benefit of the share repurchases earlier in the year. This trending analysis and the momentum in the business provides us with confidence in achieving our full year guidance.

With that, I'll turn it over to Mark for closing comments.

Mark D. Benjamin - *NCR Corporation - President and COO*

Thanks, Bob. In closing, we had a solid quarter and we are on track to achieve our full year goals. We are confident in our outlook given our backlog and key metrics, which remain strong. We remain a global leader in omni-channel software, channel transformation and digital enablement, which will continue to be strong growth drivers for our business moving forward.

Today, our solutions are aligned with major market trends and customer demands, and we need to continue innovating in order to maintain that leadership edge and provide customers with competitive differentiation.

We successfully drove gross margin expansion this quarter, and this will remain a key area of focus as we aim to achieve higher Software and cloud revenues while also advancing our business transformation initiatives as we build a more efficient NCR. Of course, our success is not possible without the commitment, drive and passion of the entire NCR team, who spend every day focused on customer success. Overall, I'm excited about NCR's future given our global leadership in the key areas impacting our customers today as well as our commitment to becoming a leader in transaction insight via the large number of NCR's smart-edge devices deployed today and the 700 million transactions we power each day.

That concludes our prepared remarks. Joining Bob and me for Q&A are Bill Nuti and Paul Langenbahn, Head of our Software business.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) We'll go first to Katy Huberty with Morgan Stanley.

Kathryn Lynn Huberty - *Morgan Stanley, Research Division - MD and Research Analyst*

With the second quarter revenue results and third quarter guidance, you're essentially pushing $70 million of revenue into the December quarter, which calls for a 15% sequential growth versus normal seasonality of around 6% over the last 3 years. So just would love to get your thoughts as to why you're so confident around the fourth quarter given some of the delayed Software sales, continued weak ATM sales and then just also the fact that you did bring down the ex currency revenue by about $40 million for the full year.

Robert P. Fishman - *NCR Corporation - CFO, CAO and EVP*

Yes, Katy, it's Bob. We included a trending chart in the presentation that showed that the fourth quarter has very typical percentage of revenue, around 29%. On that same page, you can kind of do the math on the year-over-year growth in the fourth quarter, which is around 8%, 7% FX-neutral. So we're looking at 7% up for the midpoint in the fourth quarter. We feel confident with that revenue. Starting point is our backlog that we're at now, plus the backlog we expect to be at -- entering the fourth quarter supports that revenue growth. We're also seeing significantly improved conversion rates in the fourth quarter as larger customer rollouts happen. When we look at the funnel as well, we're comfortable that the opportunities exist within there. And then the recurring revenue has been growing nicely for us. So all of those suggest confidence within the revenue guidance. It's pretty consistent with what we've talked about, Katy. It's Software growing in the high single digits. It's Services growing 4% to 5%, and it's Hardware growth consistent with the backlog position that we'll be in. I will say this, that in the fourth quarter, we do face tougher compares in the ATM and the self-checkout side, so you will see strong POS growth in the fourth quarter, which is really what we've seen throughout the year. There's a number of driving factors around Windows 10 replacing our point-of-sale solution that's given us good growth in that area as well. So with all of those factors, we believe the 7% FX-neutral type growth in Q4 is very achievable.

Kathryn Lynn Huberty - *Morgan Stanley, Research Division - MD and Research Analyst*

And just as a follow-up, where is backlog year-on-year at the end of the second quarter? And then specifically for ATMs, did backlog grow year-on-year or is it still down, you have to grow it in the third quarter?

Robert P. Fishman - *NCR Corporation - CFO, CAO and EVP*

Yes. Overall, for us, backlog is up low single digits going into Q3, and then it'll be higher going into the fourth quarter. On the Hardware side, backlog is up going into the third quarter, again, low to mid-single digits. The other thing that I'll mention in terms of back half revenue is we did see a number of software license deals push from the second quarter into the back half of the year. So that would be another reason why we feel confident that we'll achieve the guidance.

Paul Langenbahn - *NCR Corporation - EVP of Global Software*

Yes. And Katy, this is Paul.

Kathryn Lynn Huberty - *Morgan Stanley, Research Division - MD and Research Analyst*

And why do you think...

Paul Langenbahn - *NCR Corporation - EVP of Global Software*

Sorry.

Kathryn Lynn Huberty - *Morgan Stanley, Research Division - MD and Research Analyst*

I was just going to ask maybe you can comment on it, why -- just why you think the software license deals pushed out of the second quarter.

Paul Langenbahn - *NCR Corporation - EVP of Global Software*

Yes, Katy. This is Paul. Couple of things, and I'll comment on that. First of all, we are obviously really pleased with the continued growth in our cloud business, which that, combined with our software maintenance business, now puts our -- the recurring portion of our Software business over 50% of our revenues. If we look at the deals that we would have loved to have had in Q2 that pushed into the back half, they're very specific customer deals, where we understand the buying process and we've got a lot of visibility into closing them in the back half of the year. So when I look at continued growth in our cloud business, continued improvement in our software maintenance business, I look at backlog in Professional Services and then the visibility I have into our enterprise software deals, I feel pretty good about the back half of the year from a Software perspective.

Operator

We'll go next to Paul Coster with JPMorgan.

Paul Coster - *JP Morgan Chase & Co, Research Division - Senior Analyst, Alternative Energy, and Applied and Emerging Technologies*

So following on from Katy's, really, which is what sort of proportion of the 4Q visibility originates in 1 or 2 customers? Is it highly concentrated? And is that what gives you the confidence?

Mark D. Benjamin - *NCR Corporation - President and COO*

Paul, this is Mark. So thanks for the question. So no, fourth quarter isn't skewed towards 1 or 2 specific clients. I think what Paul just expressed with our software license pushed to the back half, it was a handful of customers that we know quite well. We're confident that they'll materialize in the back half. But on the overall, again, as Bob and Paul indicated, the backlog, the visibility we have, the order visibility we have and the mix of the backlog supports, really, our back half. And we realize this fourth quarter, heavier than we'd like, but again, given the visibility and where we sit today, we feel good. Not 1 or 2 clients.

Paul Coster - *JP Morgan Chase & Co, Research Division - Senior Analyst, Alternative Energy, and Applied and Emerging Technologies*

Okay. And then thanks to diversification and some share gain, your delayed conversion cycle on the ATM side seems to have had much less impact on you than it has had on your peer. That said, it is a common theme. What is it that could be causing the ATM adoption to be delayed moderately? Because, at least speaking about my own firm, they seem to be pressing on ahead with their deployment very aggressively, so I can't quite figure out what the issue is here.

Mark D. Benjamin - *NCR Corporation - President and COO*

Yes. So Paul, I mean, I think the diversification point you make is really an important aspect of our results and our performance that we're very proud of. Certainly, some ATM pressures in the quarter and move -- still on the third quarter. But our diversification, we grew Hardware in the quarter up 1%, with ATMs down, as you see. So I think it's truly a testament, I think, to the diversification of the business. As far as ATMs in any type of slowdown we see, certainly, there's a bit of softness that we've seen as far as the rollouts. But as we said last quarter, it's essentially same story as last year. First half, back half year with the larger FIs that impact our growth rates. But given we're able to still grow revenues 3%, Services up 4% and Hardware up 1%, it's a very good story regarding the NCR diversification.

Robert P. Fishman - *NCR Corporation - CFO, CAO and EVP*

Yes. And I would add to that, that -- and Paul, I would just add to that quickly here that even with the softer ATM market, we saw significant gross margin rate and operating margin expansion, good EPS growth in the quarter. So again, speaks to the diversification of the revenue streams and very consistent with the model of margin expansion that we built.

Paul Coster - *JP Morgan Chase & Co, Research Division - Senior Analyst, Alternative Energy, and Applied and Emerging Technologies*

Yes, okay. I get the point that you're doing well on a relative basis, and you're diversified, and this is a normal purchasing pattern. But you've also talked of delayed conversion cycle, and so that implies that something shifted backwards on the ATM purchasing front, and that applies also to your peer. I'm just wondering what is the underlying cause for that, if there is one?

Robert P. Fishman - *NCR Corporation - CFO, CAO and EVP*

Yes. Paul, I mean, I think it's a mix, I think, that we continue to have conversions and rollouts with our customers. In some cases, they're going, perhaps, more slowly than they had anticipated. But again, we see some, I'd say, secular opportunities ahead in the near and midterm, not just Branch Transformation driving some of that. We see a Windows 10 upgrade that's going to be taking hold in the industry relative to Financial Services. So it's a hard one to give you any specific answer of. But just a little bit of softness here in Q2 and Q3, the backlogs are still good. The order flow is still good. Our customers are buying from NCR. We are taking share in the market, and our conversions will take hold in the back half.

Operator

We'll go next to Ian Zaffino with Oppenheimer.

Ian Alton Zaffino - *Oppenheimer & Co. Inc., Research Division - MD and Senior Analyst*

And not to beat a dead horse on this, but as far as the delays, were the delays in the rollout of the backlog or what was supposed to go into the backlog? And then I have a follow-up.

Mark D. Benjamin - *NCR Corporation - President and COO*

Yes. So it was a little hard to understand. So if I heard you correctly, it was more around are we seeing delays of what's in the backlog roll or delays of what's...

Ian Alton Zaffino - *Oppenheimer & Co. Inc., Research Division - MD and Senior Analyst*

Yes. Right, right So with the delays coming that was in the backlog, that was supposed to be worked out and shipped? Or was it stuff that you thought that was going to go into the backlog that never materialized into the backlog?

Mark D. Benjamin - *NCR Corporation - President and COO*

Yes. It's more around the fact that it's in the backlog and the conversion rates are lower in Q2 and Q3. And then conversion rates start to normalize in the fourth quarter for us.

Ian Alton Zaffino - *Oppenheimer & Co. Inc., Research Division - MD and Senior Analyst*

Okay. And then also on -- go on, sorry.

Mark D. Benjamin - *NCR Corporation - President and COO*

Yes. Again, I think we anticipated some of this in our guidance, the conversion of the backlog just being a little more extended than we anticipated. But again, it was a back half story for us, as we indicated last quarter.

Ian Alton Zaffino - *Oppenheimer & Co. Inc., Research Division - MD and Senior Analyst*

Okay. And then you've been talking a lot about the Windows 10. Can you actually give us an idea of what you're going to be doing in that and what the impact might be? What are you actually supplying, et cetera?

Mark D. Benjamin - *NCR Corporation - President and COO*

Yes. So NCR goes through these cycles throughout its -- the markets we serve, so not an unusual event. Typically, when we have a refresh cycle when it comes to software or even hardware refresh cycles, Windows is a good example that we've gone through before. So we're able to go back to our customers and transition them and upgrade them to the newer kits. So we would see an uplift in ATM revenues driven from that, and we'll -- we're already in market with Windows 10 compatible units and kits, and we'll continue to drive a refresh cycle that will gain momentum, really, essentially throughout the summer into the fall.

Robert P. Fishman - *NCR Corporation - CFO, CAO and EVP*

And I would add on the point-of-sale side on what we're seeing. What we're seeing is -- within the retailers is that if they know the Windows 10 is coming, they're trying to get ahead of it. They're looking at our refresh product line and basically investing earlier than waiting a couple of years. So that's been a nice driver for us on the point-of-sale side.

Ian Alton Zaffino - *Oppenheimer & Co. Inc., Research Division - MD and Senior Analyst*

Okay. And then, Bob, can you just comment about uses of cash flow as far as, I think you talked in the past about maybe doing some type of regular dividend or maybe getting the board onboard within the regular dividend. Is that still kind of in the offing or more buybacks? Just give us an idea of what you're thinking there.

Robert P. Fishman - *NCR Corporation - CFO, CAO and EVP*

Yes. We'll drive significant free cash flow in the back half of the year. We'll delever down to the low 2s, and it gives the board a lot of optionality in the upcoming meetings. For now, we are basically consistent with our balanced capital allocation strategy. We did our share repurchase earlier in the year, over 50% of our free cash flow, continue to delever, and then the board will consider share repurchase, dividend at the board meetings later this year.

Operator

We'll go next to Dan Kurnos with The Benchmark Company.

Daniel Louis Kurnos - *The Benchmark Company, LLC, Research Division - MD*

Just a couple for me. First, it's probably too early to ask this question. But are you guys getting any feedback from clients, customers after all the news that your closest competitors put out, obviously, investing more heavily in software, and they've talked about trying to turn the corner and winning back some of the market share you guys obviously took. So just curious if you're seeing any changes to the competitive landscape. And then I'll follow up on POS.

Mark D. Benjamin - *NCR Corporation - President and COO*

So Dan, thanks for the question. So we continue to execute against, really, the strategy of growing NCR as a solution-enabled company, with Software today at a $2 billion business, growing quite nicely and making great margin contributions. So and we consider our Hardware and Services business really as additive solutions that help drive overall growth rate. So competitively speaking, we continue to take share, really, across all of the categories we have, as you know, Dan, a very successful Hardware business in Retail and in Hospitality. And those solutions are also driven by NCR Software. We continue to expand our Software business into multiple channels of -- and you see that in our growth of point-of-sale with our Hospitality. You heard me comment on our expansion with DoorDash on the food delivery and aggregator side in my opening comments. Happy to also report we've also struck an agreement with GrubHub. So we continue to drive our solutions that are a very healthy mix of Software, Hardware and Services combined. And I'd say competitively, that's fairly unique, and we're quite proud of that.

Daniel Louis Kurnos - *The Benchmark Company, LLC, Research Division - MD*

And then since you brought up the POS side, just a couple things for me. Obviously, it sounds like some of that is driven just by general market trends, whether it's Windows 10 or something else. I'm curious on 2 fronts: one, if you think it's there's sort of just an underlying shift towards mobile-based solutions that maybe you weren't anticipating, if it's possible that -- we've clearly seen incremental footprint reduction on the Retail side, probably more than most were anticipating, and if that's causing maybe a consideration of going more towards a mobile solution and reducing physical hardware count. I'm curious if you think that that's the case and how long you think the POS strength will last.

Mark D. Benjamin - *NCR Corporation - President and COO*

Yes. Dan, our POS strength is really a combination of, a, we lead the market on a global basis, and we continue to take share, I'd say, more on a traditional ePOS basis. Our expansion of multiple modalities of point-of-sale, mobile POS, our expansion of kiosk, in-store continue to help grow the number. We're very excited around the PCR space with our solution that we refer to as OPTIC that is, in large part, a new segment for us that we're doing very well in. We commented around Speedway as an in-quarter win. So I'd say our growth in the point-of-sale across, really, Retail and Hospitality is really the expansion of solutions, the expansion of the software and the different industries within them driving the growth.

Daniel Louis Kurnos - *The Benchmark Company, LLC, Research Division - MD*

Great. And then maybe just one more if I could. Since you brought it up, and I don't want to put the cart before the horse here, again, probably too early, but you talked about the data solution. We know that that's kind of been maybe on the horizon as another possible leg to the stool as it were. Is that kind of what you were thinking in your commentary sort of long term? And can you maybe give us a sense of is that in the plans 12 months or is it a much longer horizon?

Paul Langenbahn - *NCR Corporation - EVP of Global Software*

Yes. Dan, this is Paul Langenbahn. So when you think of the omni-channel decision support platform that Mark spoke to, think of a couple of things. So think of it as kind of the next step in the evolution of the omni-channel platform we've been talking to for quite some time. Remember, what the omni-channel platform does is it really allows our customers to integrate all these previously disintegrated channels, right, for consistent consumer experiences. But it also creates one version of the truth for all the data. So now instead of consumer data, loyalty data, inventory data lying in all these disparate channels for e-commerce, point-of-sale, self-checkout, mobile, et cetera, it's all residing in one place with one version of the truth. And once that starts to happen, we can start then adding capabilities around AI, cognitive to take that data and provide much more real-time and useful insight to our customers. So it's an evolution of what we've been investing in for the last 5 or 6 years, and it'll be one of the -- it's becoming a big area of investment in our -- this year, and our customers are embracing the idea wholeheartedly.

Daniel Louis Kurnos - *The Benchmark Company, LLC, Research Division - MD*

But no third-party monetization anytime soon, I assume.

Paul Langenbahn - *NCR Corporation - EVP of Global Software*

Well, yes. Think of it this way. In great many cases, our data is, first, our customers' data. And so our first job is to make their data more valuable to them, and through that, we monetize the data through our customers. There are other cases where we have access to properly anonymized data that's very useful both in creating solutions for our customers, where, for instance, we can tell an independent restaurant not only how he's performing against his own site same day last year, but how he's competing against his competitors, anonymized, of course, today. So that's an example of taking the data and making it useful for the customers. That same anonymized data is, of course, useful to many other stakeholders in the ecosystem. And where it's appropriate, we'll pursue that. But first and foremost, our customers' data is our customers' data, and we make it more actionable and useful for them.

Operator

(Operator Instructions) We'll go next to Kartik Mehta with Northcoast Research.

Kartik Mehta - *Northcoast Research Partners, LLC - Executive MD, Director of Research, Principal & Equity Research Analyst*

Bob, you talked about having pretty good confidence in the third and fourth quarter revenue. I'm wondering, the amount of orders you have, how much more do you need to sell or the revenue do you need to hedge your guidance? I guess, how much is already on the books? And so is that the reason for your confidence? Because you have a lot -- majority. So I guess what percentage is already in the hand?

Robert P. Fishman - *NCR Corporation - CFO, CAO and EVP*

It's pretty consistent with the way we've talked about the business. In any given quarter, we start a quarter with roughly 90% of the revenue. Then we have roughly 10%, what we call sell-and-bill. When we look 2 quarters out, we have coverage of around 75% to 80% of the revenue. So to cover the remaining 20%, it's a combination of sell-and-bill in Q4 but also orders that we'll take in the third quarter. I will mention that we've built our Q4 forecast around what we think are quite conservative order forecast in the third quarter. That leaves us with the backlog that we need to drive the fourth quarter revenue. So again, a combination of closing on the deals that slipped from the second quarter, improved conversion rate, the insight that we have into the backlog gets us comfortable around that fourth quarter revenue.

Kartik Mehta - *Northcoast Research Partners, LLC - Executive MD, Director of Research, Principal & Equity Research Analyst*

And then maybe more for Paul. I'm wondering, as you look at your Software business, how dependent is the growth of that business on your Hardware business? So what kind of growth do you need in the Hardware business in 2017 to achieve your guidance? And just how you think about dependency on Hardware for your Software business.

Robert P. Fishman - *NCR Corporation - CFO, CAO and EVP*

Yes. So Kartik, it's a great question. We're really pleased you asked that. If you look at the breakdown of Software, roughly 2/3 of our Software we refer to as unattached. So you could think of it as non-hardware related in the market. Plus we have our cloud business as well as the other aspects of our Software line. So Paul maybe could add some color. But I would look at it as the attached as a line to Hardware, and you saw that in the quarter around ATM and attached. But it's roughly 2/3 unattached at the Hardware.

Paul Langenbahn - *NCR Corporation - EVP of Global Software*

Software story, Kartik, this is Paul, is very similar to the overall NCR story. It's one of diversification. So I look at the Software business, as Mark said, I look at my cloud and my software maintenance business, which is half in our revenues, with a high level of confidence. I look at the PS business, which is 30% of the Software business, that's got a very predictable order-backlog conversion rate. And that -- we know within a pretty tight range where that's going to be a quarter out. And then you look at our software license business, and we've grown to where -- a year ago, we had been talking about 50% of that business being attached and kind of tied to Hardware. And now we're down in the mid-30s in terms of a percentage. So it's like the rest of NCR. It's very much a story of diversification, and a very large percentage of the Software business stands on its own and is really up to our Software business to execute it.

Mark D. Benjamin - *NCR Corporation - President and COO*

That's right. And Kartik, a good example of that is cloud. You see, in the quarter, cloud revenue up 9%, with net ACV up 13%. So you can start to do the math. And just to refresh your memory, the net ACV is really the cloud backlog that converts, call it, within a year or so, 8 to 12 months of a conversion cycle. So you can really start to look out and look at NCR and our Software businesses. In this example, cloud really getting to a double-digit growth, which, as you know, is a recurring revenue stream and a much higher margin stream for us. So anyway, that's a little more color than maybe you asked, Kartik, but thought we'd give you the full response.

Kartik Mehta - *Northcoast Research Partners, LLC - Executive MD, Director of Research, Principal & Equity Research Analyst*

Yes. No, no, that was helpful. And just one last question. Mark, at the beginning, you talked about the ATM market, you think, is probably going to be flat to up 1%. And at least for the first half, I look at your results and Diebold's results, and you're not 100% of the market but a significant portion of the market. So right now, it would require a pretty good back half just for the industry. And I'm wondering, is that what you're anticipating at the back half, where the industry is just going to be very strong and this is just one of those years where you're just going to see a lot of revenue for ATM come in, in the second half?

Mark D. Benjamin - *NCR Corporation - President and COO*

Well, I mean, we said at the beginning of the year, this year will be like previous years when it comes to the back half. I think that, as we said, kind of a flattish to 1% to 2% ATM market growth. We know we're taking share. We know we're competitively winning. So I would see that, for the near to midterm, kind of relative growth rates in that range, Kartik, for the next couple years, if you will. Again, I mentioned the secular. You could call them headwinds in the current moment, but we see potential tailwinds with, as we mentioned, not just Branch Transformation, which is still early days. And as you know, we really lead that market. But really, the Windows and just the ATM cycle refresh, actual hardware refresh cycle ahead of us.

Robert P. Fishman - *NCR Corporation - CFO, CAO and EVP*

Yes, Kartik, this is Bob. Just to clarify, Mark's comments were around the next couple of years, low single-digit type growth, led by Windows 10, Branch Transformation. There's no doubt that this year is proving to be softer than that. So the guidance that we give suggests that the ATM revenue will improve in the fourth quarter, Hardware revenue will grow for NCR. But again, for a 2017 view, it's lower growth than the next couple of years.

Mark D. Benjamin - *NCR Corporation - President and COO*

Yes. I mean, again, it's a diversification story, Kartik, with NCR. Given the ATM pressures that are not just in the results but, as you know, in the market, we're still going to grow our Hardware business. We did in the quarter. We'll grow at full year. And it's, again, a testament to the diversification of the business.

Operator

We'll go next to Matt Summerville with Alembic Global Advisors.

Matt J. Summerville - *Alembic Global Advisors - MD and Senior Analyst*

A couple questions. First, I want to talk about the Software business for a minute. The margin performance there in the second quarter, if I just go back and look at the few years of data that's available, this is the lowest-margin second quarter you've had on record since you started reporting this way. How much license revenue got pushed out of Q2 into the back half of the year? And what does NCR need to do to really start seeing sustained operating leverage in the Software segment and a real step function improvement in margins here? I think we've been talking about this for a while, and it just -- we're not seeing it yet.

Mark D. Benjamin - *NCR Corporation - President and COO*

Yes, Matt, thanks for the question. So again, first of all, let me say we're very confident in our ability to grow revenues and margins in this business over time. And like any on the enterprise license side, that business can be a little lumpy. I think we can actually decrease that lumpiness over time as we continue to invest in our sales force, sales enablement, go-to-market. So first of all, I think we can improve that. But think of the license -- I'm sorry, think of the revenue growth and margin challenge in the quarter both being essentially the same thing, and that was license revenue (inaudible) million that pushed to the back half of the year, and that would flow through essentially at 95% gross margin. So that's essentially where the challenge came from. So for me, all the foundational elements of the Software business are really tracking well. Our investments around omni-channel have proven to be the right ones. We were out in front of the market. We're getting good cloud growth. Software maintenance growth will come in the back half of the year. We actually improved our margins in cloud and software maintenance, which are 2 of the most important areas. And so really, the one missing ingredient for me in the quarter was top line on software license, and as that corrects in the back half of the year, that will flow through at a very high percentage rate and really change the margin picture for Software. Does that help?

Matt J. Summerville - *Alembic Global Advisors - MD and Senior Analyst*

Yes, that was a helpful answer. And then...

Paul Langenbahn - *NCR Corporation - EVP of Global Software*

And all of that obviously true over the long term as well. We've made a lot of investments in this business, and revenue growth on those investments flows through at a very high margin rate.

Matt J. Summerville - *Alembic Global Advisors - MD and Senior Analyst*

Understood. And then maybe just to get back to the question that I think people are looking for a firm answer on. Specifically, maybe the better way to ask it is, what are the top 2 or 3 reasons your bank customers are saying is causing them to pause, slow rollouts, slow conversions? Is Branch Transformation sort of fizzled out for the time being? Are these banks just willing to sweat their assets until we start to get closer to this Windows 7 to Windows 10 conversion? I mean, clearly, this industry has hit an air pocket, if you will, and we're just looking for a better understanding in terms of the feedback you're specifically getting as to why that is.

Mark D. Benjamin - *NCR Corporation - President and COO*

Yes, Matt. So no, we have a number of large rollouts, again, large financial institutions that we've been working with for many years at this point. So I would say that we view it just as a conversion softness of the backlog, if you will, the timing. I would say that we have not hit a slowdown in

Branch Transformation. I think, quite honestly, we see a lot of momentum building relative to our sales force, relative to our competitive wins, relative to our market share gains. And we also -- as we did roll out our new fleet, we did really across all of our markets. But in the financial market, our new Series 80 machine, that's getting great acceptance. And so no, the answer is it's some large customer rollouts in backlog with NCR fleet in the field just taking shape, something we knew about entering the year and as we did in the previous year.

Matt J. Summerville - *Alembic Global Advisors - MD and Senior Analyst*

And then maybe just one follow-up just on the Services operating margin performance. I don't have the number specifically in front of me, but I think it was up 300 or 400 basis points on a year-over-year basis. Now that is a real step function improvement there. Is this a new sort of norm for that business? Is this margin rate sustainable? Did you have a particularly favorable mix of business in Q2, and we shouldn't expect that and we should maybe look for it to revert to a more "normalized" level? And if so, Bob, maybe what is that normalized level?

Robert P. Fishman - *NCR Corporation - CFO, CAO and EVP*

Yes. Again, we were very proud of the margin expansion led by Services, up 410 basis points, Matt, in the second quarter. Think of it as quite a bit of runway to go on margin expansion. So you will continue to see maybe not 410 basis points, but significant margin expansion in the Services business as we work through this year, next year and really after that. So there's a number of things going on there. We've invested heavily in terms of remote diagnostics and predictive big data. We continue to drive more efficiency around our service calls. The quality of our service delivery has improved significantly as well. So overall, we're really hitting on, really, on all notes in the second quarter and continue to see Services margin expansion in the future.

Operator

And with no further questions in the phone queue, I would like to turn the call back over to Bill Nuti for any additional or closing remarks.

William R. Nuti - *NCR Corporation - Chairman and CEO*

No, thank you all, and see you all in September.

Operator

This does conclude today's conference. We thank you for your participation. You may now disconnect.
