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NCR - Q3 2017 NCR Corp Earnings Call

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OVERVIEW:

Co. reported 3Q17 non-GAAP EPS of $0.93. Expects 2017 revenue to be $6.475-6.525b, GAAP diluted EPS to be $1.97-2.09 and non-GAAP diluted EPS to be $3.10-3.20. Expects 4Q17 revenue to be down 3-6% on a constant currency basis and non-GAAP EPS to be $0.83-0.93.

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PRESENTATION

Operator

Good day, and welcome to the NCR Corporation Third Quarter Fiscal Year 2017 Earnings Conference. 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, sir.

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

Good afternoon, and thank you for joining our third 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 & CEO*

Thank you, Michael, and thanks to everyone for joining us today for our third 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 updated outlook. Then Bill, Paul, Bob and I will take your questions.

Our Q3 results were mixed with EPS at the high end of our guidance range and revenue at the low end of the range. The softness in revenue was largely driven by our ATM business where we saw weakness in some of our markets, in addition to some specific large customer delays in spending, which I referenced last quarter. Unfortunately, these specific accounts have not accelerated to the levels we had anticipated, making our back half more challenging than expected.

The ATM market continues to be impacted by large customer delays in spending in North America, weakness in India, the Middle East and Africa and a more gradual conversion to the Windows 10 rollout. These challenges have led to lower order volumes, and as a result, we are reducing our full year financial targets given the fourth quarter will be lower than we expected.

I continue to be encouraged about NCR's position among its well-diversified portfolio of industries we serve as well as the mix shift we are executing upon to become a solution company, leveraging our strength in Software and Services. This strategy began well before my arrival and was a key attraction for me joining the storied company, and I continue to drive our strategy forward with our long-term ambitions being key.

Two important data points to remember that show the success NCR has is: one, increasing our recurring revenue stream, which now accounts for 44% of our total revenues; and two, we have close to a $2 billion annual revenue Software business across our industry verticals, accompanied by strong solution and industry diversification.

While we are disappointed in our reduced outlook, we did have a number of bright spots this quarter, including earnings per share that came in at the high end of our guidance range due to disciplined cost control. We also continued to generate diversified revenue streams, including cloud revenue growth of 5% and net ACV up 37%. We also drove significant margin expansion in Services as our Services transformation, also known internally as M1, are capturing efficiencies and driving profitable growth.

We remain confident that our overall strategy, market approach and diversified solutions portfolio are aligned with the long-term trends in each of our markets. While we are experiencing some near-term challenges related to the ATM market in certain geographies, we are optimistic we have the right strategy and our solution offerings are aligned with major market trends and customer demands.

I, along with my leadership team as well as our team around the globe, are keenly focused on improving execution, increasing recurring revenues and continuing to build scale as we navigate near-term headwinds and rollout delays, primarily in the ATM market. Our key goal is to build momentum and accelerate growth in 2018.

Slide 4 shows a snapshot of our financial performance. Revenue was down 1% in the third quarter and finished at the low end of our guidance range. Revenue performance was driven by growth in our Software and Services business, offset by lower Hardware revenue. While this is not where we expected to be, we continue to show the value of a diversified business portfolio serving multiple industry segments.

As I mentioned, we saw an acceleration of recurring revenue growth, which increased 4% and comprised 44% of our total revenue in the quarter. Recurring revenue remains a key priority, particularly as we continue to expand our cloud-based solution offerings and strive to accelerate the growth of our cloud business.

Our non-GAAP gross margin rate contracted 10 basis points to 29.2%. This was primarily due to lower software license revenue and decreased Hardware margins, offset by continued focus on productivity improvements in our Services segment. However, our non-GAAP operating margin rate expanded 40 basis points to 14.1% due to continued focus on expense management, including lower employee-related expenses.

Capturing margin expansion and profitable growth remains significant priorities as we continue to expand our higher-margin Software revenues. Within Hardware, we are taking a disciplined approach, balancing market share gains with profitability. We continue to execute on our strategy to accelerate our Software growth faster than overall revenue growth, which drives further margin expansion.

Non-GAAP EPS was $0.93 and came in at the high end of our guidance range and, on a constant currency basis, was up 7% year-over-year.

Free cash flow was $45 million due to higher working capital in the third quarter, which we expect improve in the fourth quarter.

Moving to Slide 5, which outlines the solution-focused strategy. We are executing against these critical areas transforming global business and consumer interactions: omni-channel software, channel transformation and digital enablement.

Our solutions portfolio is software driven as the future of our Financial Services, Retail and Hospitality markets will increasingly rely on decision-support platforms that can capture and provide actionable customer insights. The near- and long-term focus and investment priorities of our customers across all of our markets remain strongly aligned with our offerings and strategy.

Businesses are increasingly turning to our solutions and capabilities as NCR delivers proven value to our customers, and we are becoming an increasingly critical partner in the supply chain. This is evident in the petroleum and convenience retail markets, where we remain enthusiastic for NCR OPTIC, our outdoor payment terminal and interactive customer interface. OPTIC is seeing solid adoption trends due to its smart edge capabilities, ease of use and ability to deliver consistent consumer experience across all pumps.

This solution, along with our open omni-channel software platform, allows companies to bring to market growth revenue drivers and enhance the shopper experience at the pump through media content management, food offerings and seamless loyalty program integration. We had several key wins in this space during the quarter, including Speedway, the nation's second-largest company-owned and operated convenience store chain with approximately 2,730 stores located in 21 states. OPTIC is a great example of how NCR is bringing to market innovative new technologies and expanding our addressable market.

We are excited about this new line of business, and the early success we are having with large customers are encouraging signs of widespread customer adoption.

We had a strong quarter for our point-of-sale solutions, including one in the petroleum and convenience market with QuikTrip, a 550-plus store chain across Wisconsin and Minnesota. Additionally, we strengthened our long-term relationship with Bashas', a 115-site grocery retailer based in Arizona with a point-of-sale hardware win, which complements our existing Software and Service solutions already in place. Our expanded relationship with Bashas' speaks to the power and benefits of our full solution suite and the impact it can have on our customers' business capabilities.

We also continue to see a very favorable response to the global launch of our 80 Series, which we see as a competitive differentiator. BankDhofar in Oman went through a full replacement of a competitor's machine to NCR's 80 Series ATM. The bank implemented integrated contactless payment for all of their new machines as well as deployed Interactive Teller services and NCR Software and Services solutions.

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 - Executive VP, CFO & CAO*

Thank you, Mark. Slide 6 shows a summary of our segment results for the third quarter with increases in Software revenue of 2% and Services revenue of 3% and a decrease in Hardware revenue of 7% constant currency.

Gross margin in our Services segment expanded 460 basis points, mostly offsetting the impact of the decline of 540 basis points in our Hardware segment and 70 basis points in our Software segment. We will get into the details as we go through each segment.

Slide 7 shows our Software results. Software revenue increased 2% year-over-year driven by cloud revenue growth, which increased 5% year-over-year. Sequential cloud revenue growth accelerated, demonstrating the strength in our cloud business. We are also pleased with the continued momentum of new cloud bookings in the quarter as reflected by net ACV of $16 million, up 37% from the prior year.

Software license experienced an 11% decline as a result of a large unattached license sale in the prior year, combined with lower software license revenues attached to Hardware. However, unattached software license remains an area of strength, up 17% year-to-date, and is expected to be up significantly for the full year 2017.

Professional Services revenue increased 6% on a constant-currency basis due to strength in channel transformation and digital enablement solutions. Software maintenance also showed continued growth of 3% and accelerated sequential growth.

Software gross margin rate was down due to lower software license revenue. The decrease in software license revenue was largely offset by our continued execution on strategic priorities to improve efficiency and scale in our software maintenance and cloud businesses. We expect margin for the Software segment to increase over time as we see improved performance in software license revenues, and we continue to expand software maintenance and cloud margins.

Turning to Slide 8. Services had a strong quarter with 3% revenue growth and gross margin rate expansion of 460 basis points. The revenue increase was driven by expansion in our annuity services with continued hardware maintenance growth, reflecting channel transformation trends and demand for managed and implementation services. We are pleased with the higher file value, which is the backlog metric for our Services business.

Consistent with prior periods, Services gross margin rate expanded 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 onboarding continue to reduce the number of repair dispatches and allow customer service cases to be resolved more efficiently, increasing margins in the Services segment. Incremental Services margin expansion remains a key focus as we execute our strategy.

Turning to Slide 9. Hardware revenue was down 7%, excluding FX, due to lower ATM revenues and the timing of self-checkout rollouts. Our point-of-sale hardware portfolio continues to show strength, growing 18%, reflecting market share gains and the introduction of a new 4-core omni-channel solution in the petroleum and convenience market.

ATM revenue was down 17% in the third quarter after being up 11% in Q3 of the prior year. This was a little softer than we expected as the ATM market continues to be impacted by large customer delays in spending in North America, weakness in the Middle East and Africa and the upcoming Windows 10 conversion. As a reminder, North America has been impacted by lower-than-typical revenue relating to several large banks.

Self-checkout revenue was down in the period. However, we expect it to regain momentum and grow sequentially in Q4 driven by large customer rollouts amid global demand. As a reminder, self-checkout revenue was up 86% in Q3 of last year. Hardware gross margin rate declined due to lower ATM and self-checkout volume and new product introductions.

On Slide 10, you can see free cash flow for the quarter. Free cash flow was $45 million, down from $153 million in the prior year. The decrease was due to higher working capital in the third quarter of 2017, which we expect to improve in the fourth quarter. Our revised 2017 free cash flow guidance is $440 million to $470 million or approximately 90% to 95% of non-GAAP net income. The lower free cash flow is due to the decrease in our revenue guidance, which we'll cover on a later slide.

Slide 11 shows our net debt-to-EBITDA metric with a net debt leverage ratio of 2.5x for Q3 2017, which represents continued improvement throughout 2017 and when compared to the 2.8x at Q3 2016. NCR remains committed to a balanced capital allocation strategy. We anticipate strong free cash flow for the remainder of the year, which should enable us to reduce our leverage multiple as we close the year.

On Slide 12, you will find our full year 2017 guidance, which has been revised based on our expectations for the fourth quarter. We are lowering our full year 2017 revenue earnings per share and free cash flow guidance. We now expect revenue of $6.475 billion to $6.525 billion due primarily to lower expected revenue in ATMs and software license attached to hardware.

We now expect GAAP diluted earnings per share to be $1.97 to $2.09 and non-GAAP diluted earnings per share to be $3.10 to $3.20. The reduced EPS guidance is a result of the operating income flow-through on the lower Hardware and Software revenue, partially offset by improved other income and expense and favorable share count.

Slide 13 shows our revised revenue guidance by segment for the full year. Software is now expected to grow 2% to 3% on a constant-currency basis. The revised software guidance is primarily the result of lower software license revenue attached to hardware. Cloud is expected to grow approximately 6%, which represents accelerated sequential growth of approximately $5 million in the fourth quarter.

Services is expected to grow 3%, in line with previous expectations. Hardware is now expected to be down 2% to 3% due to lower ATM revenue. We had previously expected ATM revenue to ramp in Q4 but now expect relatively flat revenue compared to Q3 due to the reasons previously mentioned. Total revenue is expected to be up 1% on an adjusted constant-currency basis.

Slide 14 includes our Q4 2017 guidance. We expect revenue to be down 3% to 6% on a constant-currency basis. I will outline Q4 revenue guidance in more detail on the following chart. Our non-GAAP EPS is expected to be $0.83 to $0.93, down from the prior year due to lower overall revenue, including attached software licenses. Our guidance also includes an FX benefit of $40 million in revenue and $0.08 in diluted earnings per share.

The tax rate in Q4 is expected to be 27% compared to 17% in the same period last year due to discrete tax benefits in the prior year. The full year tax rate guidance remains unchanged at 25%. Additionally, for Q4, we have assumed OIE of approximately $56 million and a share count of 155 million.

Slide 15 shows our revenue guidance by segment for Q4. Software is expected to be down 4% to flat compared to an increase of 10% in the same period the prior year, primarily the result of lower software license attached to hardware. Services is expected to be relatively flat due to the timing of implementation services.

Hardware is expected to be down 8% to 13% driven by a decline in ATM revenue of approximately 30%, partially offset by growth in point-of-sale and self-checkout. The Hardware segment is facing difficult comparisons with revenue up 30% in Q4 of last year, including ATM growth of 29%. Total revenue is expected to be down 3% to 6% on a constant-currency basis.

Slide 16 shows our segment results year-to-date and is a snapshot of our progress towards transforming into a Software and Services-led business. Software revenue was up 4%, Services revenue was up 4%, and Hardware revenue was up 1%.

Within Software, cloud growth is up 7% and trending towards double-digit revenue growth with net ACV growth of 26%. Our focus on selling software independent of a hardware sale is paying dividends with unattached software license up 17% year-to-date. Recurring revenue for the year is 45% of total revenue, up 100 basis points year-over-year.

The growth in Software revenue continues to drive an increase in operating income as the Software segment is our highest gross margin business at roughly 50% and represents the largest component of our operating income at 66% of our total operating income year-to-date. Services margins have expanded 330 basis points year-to-date and reflects the execution of our business process improvement initiatives.

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

Mark D. Benjamin - *NCR Corporation - President & CEO*

Thanks, Bob. In closing, we realized this is a sobering quarter, and I'm not taking it lightly. However, I want you to know my thoughts in NCR as this week I celebrate my 1-year anniversary. You can count on me and this team to be laser-focused on execution. I believe we have the right vision and strategy, and we are at the very important phase in our journey with execution being critical.

I'm often asked, now that I'm 1-year in, how I'm feeling about the opportunity. I can confidently tell you, as I've told our 33,000-plus NCR associates, I'm more excited about our strategy and vision today than I was when I joined the company 1 year ago. And I see an incredible, exciting future.

NCR is a different company today than it was just 3 years ago, and our current course and strategic path will continue to shape, in fact, to reshape NCR into the future. We have powerful underlying assets, which we view as our competitive advantage necessary to be successful, including a $600 million a year cloud business that continues to grow and recurring revenue that comprises 45% of total revenue.

We will remain focused on executing our strategy that limits our P&L dependency on ATMs while maintaining our market-leading solutions and excellent win rates in that market. While we are disappointed in the need to revise our outlook, our solutions offerings and software-driven strategy remain closely aligned with the disruptive factors that continue to transform how businesses operate and interact with consumers.

Moving forward, we are placing significant emphasis on driving improved execution across our entire organization by also continuing to implement business improvement initiatives that will unlock incremental margin growth opportunities. A good example of this and something we referenced earlier is our Services transformation, which is driving solid revenue growth and impressive margin improvements that we believe will continue to take hold. We have similar programs launched or in the process of being launched, and we are committed to taking a new and fresh look at every aspect of our business.

The strategy remains. The long-term growth drivers of our business remain omni-channel software, channel transformation and digital enablement. We also continue to successfully execute critical components of our strategy as evidenced by ongoing cloud and net ACV growth as well as further services margin expansion.

Despite some near-term challenges, we remain enthusiastic about NCR's future, our long-term growth potential and our expertise and offerings addressing the megatrends impacting our markets. We entered the fourth quarter with a focus on our sales funnel, orders and execution as we look to drive momentum and accelerate growth in 2018.

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 will take our first question from Paul Coster with JPMorgan.

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

I think the last quarter yielded you an opportunity to derisk the year, but you stuck with this very significant year-end ramp, and people were skeptical about it [you're on]. And I think you paid the price here. And I'm not even sure I understand what went wrong on the Hardware side.

Are you saying that you had tough year-on-year comps? Well, that was known way in advance, right? Or are you saying that something has happened to delay projects with large customers? And if it's the latter, how much visibility do you have in the first half of '18 regarding those projects?

Mark D. Benjamin - *NCR Corporation - President & CEO*

Thanks for the question, Paul. This is Mark. Let me start out by saying there is truly no one more disappointed than me here today to report these results and change our full year guidance. And within the year, we've been talking about a back-half story, which was exactly what we had performed with in 2016. And we remain certainly confident in that materializing in the third and fourth quarter.

What we saw here in the third quarter was really a number of different things that led us to an order decrease to what we had anticipated in the back half that obviously flows through to revenues. One other factors being some of our large North American-based customers really putting off their spending relative to ATMs in the back half of the year, which we had anticipated materializing.

These customers are long-term NCR customers. They remain our customers. They remain committed to the programs. We've been in place with them for many years. It's just a question right now when they'll ramp back up their spending, which we believe is just a question of when, not a question of if.

We saw some pressure in the quarter, Paul, in the Middle East, certainly around Africa and some other markets where we saw some softness in the market that we really hadn't encountered as well as we were very, I think, responsible as far as chasing growth opportunities that was profitable versus where we couldn't attach our Software and our Services solutions.

We were also more optimistic perhaps than we should have been on the Windows 10 conversion cycle, which is beginning to ramp up. However, we're seeing a very slow, gradual pace to the financial institutions, really making that part of their 2017 operations. So we also will see the benefit of that. That will ultimately become a tailwind for us some time in 2018.

So we're certainly disappointed in the result. We felt that we had the opportunities for the full year. However, we just saw some weakness in our orders. We also mentioned in previous quarters a slowdown of our backlog conversion that we thought would also accelerate a bit better in the back half of the year, and we're still seeing some sluggishness, if you will, impacting fourth quarter revenue, so. Bob?

Robert P. Fishman - *NCR Corporation - Executive VP, CFO & CAO*

Yes. No, I agree. If I could attach some numbers to what Mark just said. From an orders perspective, orders were down roughly $100 million in the third quarter from what we expected. And then when we rolled up the Q4 forecast, orders were down another $230 million. So that's $330 million for the full year. When I translate that to revenue, think of that $330 million impacting roughly $150 million of revenue.

And then in terms of the lower backlog conversion rate that Mark spoke to, think of that as another $50 million. So our guidance has come down from a midpoint around $190 million to $200 million. Think of it really as being $150 million from the lower orders and $50 million from the lower backlog conversion rates.

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

And nothing that you said translates into better visibility regarding the first half '18 and the recovery in hardware and attached software question.

Mark D. Benjamin - *NCR Corporation - President & CEO*

Yes. No, I mean, it's a little early, Paul. And certainly, I don't want to make the same mistake, perhaps, but we're not going to talk about our 2018 guidance quite yet. We do expect to end the fourth quarter with a backlog that is up into the year. And we do feel that the comps, obviously, will become easier for NCR in 2018.

But we continue to stay very focused, Paul, on our sales execution, our order growth. Certainly, we're disappointed in adjusting as we have in the fourth quarter to the numbers that Bob just shared. We believe our 2018 will get going and will move in with a -- with an up backlog.

Robert P. Fishman - *NCR Corporation - Executive VP, CFO & CAO*

And just to reinforce what Mark just said, when we look at the ATM business going into 2018, there's a number of factors that suggest that we have more confidence in the year. I look at it as in 2017, we were coming off a 2016 year where ATMs were up 5%. In 2017, ATMs will be down roughly 20%. So the compare going into '18 is significantly better.

In addition, the pushouts that we mentioned in North America into 2018 will help as we work through the year. The Windows 10 should be an accelerator for us in the back half of the year from an ATM perspective. We will also have our 80 Series start to ramp. The 80 Series is orderable today in 33 countries, and another 16 countries are in progress. And then finally, there are a number of new product introductions that will help increase demand. So again, those are some of the reasons why we feel ATM business will be stronger in 2018.

Operator

(Operator Instructions) We'll take our next question from Katy Huberty with Morgan Stanley.

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

Just following up on the ATM deal delays, could you specifically address what you think is going on in North America? It just seems a bit odd that bank earnings and stock prices are expanding and yet they're deciding to delay deals despite the fact that they're committed to these projects.

So what's the communication you're getting from customers? Are they waiting for regulatory change or interest rate increases or something to dislodge the budgets? Are they sort of stuck in the mud around branch transformation planning? Just any color around why you think North America budgets aren't coming through in the ATM space. And then I have a few follow-ups.

Mark D. Benjamin - *NCR Corporation - President & CEO*

Sure, sure. Okay, Katy, this is Mark. So I mean, I think you mentioned many of the reasons impacting specific financial institutions. As you know, we do business with really all of them. I would say, in large part, there is a slowness around what they're focused on in their own businesses today. Some are going through some restructurings on their own. Some are other -- under other pressures.

So we continue to work with those customers. We continue to drive revenues. We continue to convert existing backlogs, but there is certainly, I still think, some sense around policy within the U.S. I think there is a number of distractions taking place that have slowed some of the spending down on the Retail side.

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

Okay. And then, if you just think longer term, you just had a quarter where ATM orders were weak, a slowdown in self-checkout, and you missed the software license number, which just speaks to the attached between the Hardware and the Software and ultimately, the Services businesses. Do you think you can grow revenue if Hardware doesn't recover? Or is the attached between the 3 businesses is just so great that you absolutely have to grow revenue in order to grow the overall top line?

Mark D. Benjamin - *NCR Corporation - President & CEO*

Yes. So I'll start, Katy, with the answer, and then I'll hand it off to Paul to cover some of the Software aspects. But I wouldn't read into this as an overall NCR story. Our self-checkout business, while under a tough comp and perhaps, a little lighter quarter than we expected, we have great visibility into that business into the pipe as far as order growth as well as backlog, and we continue to essentially be the market leader with a very strong share that continues to do well in our Retail space.

Our point-of-sale Hardware business, the results are quite impressive in the quarter. We mentioned our OPTIC solution that gets included with our point-of-sale solution, an entire new industry for NCR that addresses the 4 [court] or the PCR space. So no, I think we can continue to grow. I think, certainly, the ATM pressure is quite high. And as you mentioned accurately, the attached rate of software that flows through on any of our ATM mix, obviously, impacts the ability of the business to grow. So I'll let Paul touch on some of the software mix of attached and unattached and as he sees fit.

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

Yes. Thanks, Mark. Katy, one of the things that I'm actually very encouraged about is the year-to-date growth in our unattached Software business, which now accounts year-to-date for around 2/3 of our software license. So compare that back just a few years ago, it was more like 1/3. So that's kind of flipped, which shows the degree to which NCR has become less dependent on the ATM end markets to grow our other revenue streams.

I look at our cloud business, think of that last year as a low double -- low single-digit grower, accelerating to mid- to high single digits this year. And we're pretty confident it's on its way to double-digit growth. That's completely disconnected from the ATM business. And even our Professional Services had a really good kind of mid-single-digit grower quarter.

So we're growing a number of revenue streams that happened be our highest profit revenue streams in the business. And the way I think about it, as we continue to transform the company, these revenue streams become more and more important, and the ATM business becomes more of a nice to have for us. So I'm encouraged. It's a little hard to see in the overall business right now, but I'm really encouraged with how the parts of the Software business that aren't connected to the ATM are performing.

Robert P. Fishman - *NCR Corporation - Executive VP, CFO & CAO*

I would agree with that, Katy, just to add a little bit more information to it. There's a lot of pieces that have done very well this year. It's really isolated to an ATM business that'll be down close to 20% and then an unattached -- I'm sorry, an attached software license number that's also roughly down 20%.

So if you believe some of the things I mentioned a couple of minutes ago around the ATM business doing better in '18, call that low single digits, then the attached Software revenue improves, and then you're left with all of the things Paul mentioned, the Services margin expansion, the cloud margin expansion, the software maintenance margin expansion, and we can get back on track.

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

Okay. And just 2 other quick ones. I'll ask them together. Bob, if you could give us the year-on-year backlog change for ATMs go and point-of-sale, that would be helpful. And then Services margins were up 460 basis points year-on-year, which is great, and you've had a few quarters in a row of the trend, so it seems sustainable.

But is it possible to break down that margin expansion between how much is it just mix shift to annuity with higher margin, which might move around quarter-to-quarter versus how much of that 460 basis points was structural actions that you've taken to drive efficiency in the business?

Robert P. Fishman - *NCR Corporation - Executive VP, CFO & CAO*

Yes, sure. So we enter Q3 with backlog down roughly -- we enter Q4, I should say, with backlog down roughly 1%. We'll end the year with backlog up. So again, that positions ourselves well for the start of the year. On the Hardware, think of Hardware as being roughly flat, but you've got ATM -- I'm sorry, Hardware backlog being roughly flat in that you've got a very strong backlogs in self-checkout and point-of-sale, and then lower backlogs to support the ATM business, which is why we're seeing the decline in Q4 for ATMs. But overall, the good news is backlog up going into 2018.

On the Services margin, I would say that we're having more sustainable change in Services margin around a lot of the programs that we've been investing in, and I'll let Mark speak to the M1 program is what we call it internally. But these are things around remote, predictive, a lot of the technology investments we've made. So really, the mix of Services revenue, the higher value services will help, but it's more of the cost structure that's driving the margin improvement now. Mark, could you have anything further to add around M1?

Mark D. Benjamin - *NCR Corporation - President & CEO*

No, I think you took all the good comments around M1. But Katy, I think it's a very good question, and we have seen sequential improvements quarter after quarter with our Services margin as well as the growth on the revenues there. I would repeat what Bob said that it's largely around our efficiency programs.

Perhaps now a term you've heard twice in the call what we refer to internally as M1. It stands for Mission 1. It's really taking a very large part in NCR's business and really modernizing it with how we face our customer base, how we service them, the efficiency and the cost that they drive for the business and provide upside.

It's still early days of managed service, quite honestly. We think we have a very good opportunities ahead to continue to grow revenues with a fully outsourced managed service. But again, as Bob mentioned, it's largely just, I think, really our programs around modernizing our Services infrastructure and the way we go to market.

Robert P. Fishman - *NCR Corporation - Executive VP, CFO & CAO*

I think the final comment I would make around backlog is we are looking more at comprehensive backlog, which will include our cloud business, our file value. And when we look at all of the pieces, we've got roughly 60% to 65% of our revenue covered starting the year. So as we drive more recurring revenue, that's captured in our file value and our enterprise ACV, and that's a good starting point for us.

Operator

Our next question will come from Ian Zaffino with Oppenheimer.

Mark Zhang - *Oppenheimer & Co. Inc., Research Division - Associate*

This is Mark, on for Ian. So I guess, most of my questions have been answered. So in regards to just quickly on the backlog again. You saw delays driven by, I guess, delays in the rollout of the volume that are set to be shipped or, I guess, like more of a volume that hasn't really materialized yet.

Mark D. Benjamin - *NCR Corporation - President & CEO*

Yes, so I'll let Bob perhaps give you more of a digital answer on the backlog. So Mark, the backlog really is part of the challenge we face as far as the pace on which that converts to revenues, and we've mentioned this in previous quarters.

Within the quarter, we also have a segment of our orders that we actually bill within the same -- in the same time that we sell them. So it's really a combination of the backlog conversion plus the orders that actually create revenues at the same time that we sell them. So it's really a combination of the 2. And do you want to add, Bob, any digital component or breakdown of that?

Robert P. Fishman - *NCR Corporation - Executive VP, CFO & CAO*

Well, I would just add. To put numbers to that, I would go back to what I said at the beginning of the Q&A. The orders came down for the full year roughly $330 million. There was $150 million of revenue impact associated with that, and then from a backlog conversion rate, I think of $50 million, so that gives you the drop in the midpoint of our guidance.

Mark Zhang - *Oppenheimer & Co. Inc., Research Division - Associate*

Okay, got you. That's very helpful. And then just a quick follow-up, I guess, like in terms of, I guess, capital allocation and free cash flow spend, is there any, I guess, like updates given that free cash flow is down a bit from previous guidance?

Robert P. Fishman - *NCR Corporation - Executive VP, CFO & CAO*

Yes. From a free cash flow perspective, we're guiding to 90% to 95% of adjusted net income, which would be a $440 million to $470 million. We'll drive a lot of cash flow in the fourth quarter. We're confident that we'll achieve those numbers.

One is last year, we drove $450 million of free cash flow in the fourth quarter compared to $400 million this year. So based on that, it looks very achievable. My AR balance is also higher going into Q4 this year versus last year. When I look at the working capital metrics, they're very consistent with what we've done in the past.

And then throughout the year, we've implemented a number of process improvements within quote-to-cash, which include getting our bills out the door more timely and more accurately, being able to improve on our services billings, improve linearity in fourth quarter is going to help us as well as teaming with the sales teams on some of these large accounts.

So we do feel good about the free cash flow that we'll drive in the fourth quarter. I realize the 90% to 95% is a little lower than what we guided. We'll get back to 95% to 100% in 2018. The challenge for me in the fourth quarter is not enough time to, of course, correct to get back to that rate but still pleased with the 90% to 95%.

What will be do with that free cash flow? We'll continue to maintain a balanced capital allocation strategy. I think the good news is there's lots of options for the board. We have a $300 million authorization program that's out there that gives the board a lot of opportunity to repurchase shares if they would like. So again, a lot of flexibility from that perspective.

Operator

Our next question will come from Kartik Mehta with Northcoast Research.

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

Bob, I was hoping you might be able to dig into the service revenue a little bit. I was trying to figure out what percentage of your servicing revenue today is implementation revenue.

Robert P. Fishman - *NCR Corporation - Executive VP, CFO & CAO*

For...

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

For the ATM...

Robert P. Fishman - *NCR Corporation - Executive VP, CFO & CAO*

Implementation. Yes, implementation revenue or another way, installation revenue, is roughly 20% of our Services business. So that's the installation piece. It's more onetime in nature.

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

So if you look at the service revenue that was down about 15%, I think, for the quarter for the ATM business, is that all related to the fact that you just had fewer machines to install?

Robert P. Fishman - *NCR Corporation - Executive VP, CFO & CAO*

And you're looking at which piece, Kartik?

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

I was just looking at the service revenue for the ATM business. I was just trying to figure out why the service revenue...

Mark D. Benjamin - *NCR Corporation - President & CEO*

So Kartik, this is Mark. So without having the numbers you're looking at, but there is a relationship that obviously, you're speaking to that directly ties into ATM, hardware and what we refer to as transaction services, which is the implementation. So the answer is yes.

Robert P. Fishman - *NCR Corporation - Executive VP, CFO & CAO*

Yes. The way, Kartik, and I'm not sure where you're getting the [PFCF], but the overall Services revenue was actually up 3% in Q3. Now we're guiding to roughly flat in Q4, and that is because of the installation revenue being lower because of the ATM business.

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

And then, Mark, I just wanted to get your comments on the Middle East. Were you saying that maybe the market is growing, but you decided not to participate because it was too competitive and that would have been not margins you were looking for in the ATM business? Or in the Middle East, Africa just the ATM market is -- overall ATM market is down?

Mark D. Benjamin - *NCR Corporation - President & CEO*

Yes. No, so it's hard to really, I think, totally break down deal by deal, Kartik. We did see overall order softness in the Middle East and Africa. We remain very aggressive in those parts of the world. My comments really around chasing the right profitable deals is that, as you know, our strategy has been to attach higher margin recurring revenues, Software, Professional Services, Hardware maintenance services when we have the chance to sell Hardware.

And I'd say that we did see a little bit of opportunities that we didn't pursue that didn't have those traits, if you will. So to sell ATM at a loss without being able to attach Services or Software really is not a business that we're in or chasing today. So that does put a little bit of pressure on the orders. But quite honestly, it's not something new for us, and it just added, I think, in a tough quarter a little more pressure.

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

And then just one last question, Mark. I just want to go back to your original statement and make sure I heard you right. Would it be fair to say that these large orders that they're delays and they're not cancellations at this point in time? Is that a fair statement, do you think, for the ATM orders?

Mark D. Benjamin - *NCR Corporation - President & CEO*

Yes, Kartik. I think that's very fair. Yes, these customers continue to be very good customers of NCR as we continue to service them very well. Our quality is very high. The 80 Series that we've mentioned throughout the call is a very exciting opportunity for our large customers and midsized and regional customers really worldwide today.

Our Services quality, so part of the margin improvements that we're seeing in Services is the continued relationships with our customers, the value that we're providing them at high quality. So again, it's disappointing, and we're certainly looking forward in driving the right programs, but the customers really remain very committed to NCR.

Operator

Our next question will come from Dan Kurnos with The Benchmark Company.

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

Just a quick housekeeping question on the Software side. Just looking at the guide for Q4, even bringing down attached 35% as you have in the deck, if there's still some delta there to the downside. I know you guys talked about some licenses getting pushed out into Q4. I'm wondering if maybe on the unattached side if there's some delays there or if it's just some flow-through from the other pieces of the business that you already called out.

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

Yes. And this is Paul. I'll take that. We talked in earlier call about, I think, $15 million of unattached pushing to the back half. Our goal was to see half of that in Q3, and that did materialize. In Q3 we had a pretty tough compare there, we were up 26% last year.

So we're up, I think I mentioned earlier, 17% year-on-year. We expect to wind the year up in the unattached side in about that range. So it really is overwhelmingly an attached and attached to ATMs story for us in terms of our guidance. That's the big challenge for us.

Robert P. Fishman - *NCR Corporation - Executive VP, CFO & CAO*

Yes. I would add to that. Unattached will have a good quarter, Dan. Professional Services, because it can be tied somewhat to the ATM business, will likely be roughly flat in the quarter.

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

Got it. That's helpful. And then just higher level, maybe if you guys could give a little more color. I know you talked about having good visibility in SCO, but just sort of what the softness was there just in the quarter?

And we have seen some smaller independents making some inroads in QSR, particularly in self-serve and SCO. And so I'm just wondering how you're sort of seeing some of the larger logos going with either some smaller players and how you're going to sort of maybe try to attack that marketplace, which still seems like a good opportunity for you guys.

Mark D. Benjamin - *NCR Corporation - President & CEO*

Yes. So we appreciate the question. So just on the self-checkout question, again, I wouldn't read really anything into the quarter. It was a little lighter than we expected. We'll get back to kind of that $100 million or so run rate next quarter and really going forward, we continue to truly have a great position there.

On the QSR side, that business, our hospitality business has really been a darling for NCR for many years, and we continue to really grow that business nicely. So our solutions in the market are very competitive. We serve the down market, which I think is probably part of your question, some of the new entrants. We serve that down market with a solution in NCR Silver really where it's a cloud solution, all online, ordered and delivered. So we continue to obviously compete well. We have a great advantage in the market with our great customer base. Paul, you want to...

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

Yes. Just, Dan, the other thing I'd mentioned is on the self-service aspect in the quick service restaurant markets, which you may have been referring to, we've got some really important new product introductions that are coming out, so we've actually released our self-service software for quick service. That's being piloted by several brands you recognize today.

And we also have a new product introduction that will hit early in the year on the Hardware side for self-service in quick-serve restaurants. So we got all the customer relationships. We certainly got the heritage and the domain expertise around self-service. And I think as you see that market continue to develop in the restaurant space, expect NCR to be an important player there as well.

Robert P. Fishman - *NCR Corporation - Executive VP, CFO & CAO*

Yes, just to attach some numbers to it, you'll remember, Dan, that the SCO business grew 88% last year. It has the opportunity here to grow high teens for the year. So again, another good SCO year in 2017.

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

Got it. That's helpful. And then I don't know if this is the right question to ask now in sort of in light of sort of your commentary. Obviously, when we spoke last, Mark, we were talking, and I know you've talked about this in the past, about thinking about end of licensing products and product cycles.

I don't know if this sort of the landscape has changed, the way you're going about that, or if there are still certain verticals where you think you can kind of juice either Hardware or Software sales as you consider -- as you continue to kind of rightsize your product portfolio.

Mark D. Benjamin - *NCR Corporation - President & CEO*

Yes. No, I appreciate that, Dan, and certainly, we are committed to good end-of-life, narrowing our product suite and making the right investments, and we have discussed that. I would say that the energy around proper PLM and end-of-life is gaining momentum here. Certainly, as we navigate the rest of the year, you'll certainly hear more about that from NCR, really, in the first quarter I'd imagine at a potential's Investor Day where we can cover that in greater detail.

But certainly, the disappointment we have here with the changed guidance, I think, is, in some ways, a good wake-up call for many of us here at NCR is really to accelerate the programs around narrowing investment that perhaps is on end-of-life solutions or legacy solutions and really focus more narrowly on our strategic platforms for the future.

Operator

We'll take our next question from Matt Summerville with Alembic Global Advisors.

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

I have 2 or 3 questions here. Bob, can you help me square up your comments on orders? So basically, you had $100 million coming out of the book for Q3, $230 million out of Q4. How are you going to end with a year-over-year higher backlog?

And I guess, like just to my next point, you have the opportunity, an open forum, now to sort of talk about the early part of '18. Given that the backlog orientation of the ATM business, does that not mean that you guys will have a relatively soft start to 2018? Isn't that how we should be thinking about it at this point?

Robert P. Fishman - *NCR Corporation - Executive VP, CFO & CAO*

Yes. On those 2 questions, you'll remember, Matt, last year, orders grew 46% in the fourth quarter. Even with the $230 million bring-down in the fourth quarter, orders will be slightly down. And then when you combine that with the revenue being down, the math ends up saying backlog up going into the year. So again, facing a really tough order compare and being able to start the year with backlog up. I don't think we want to comment at this point around what Q1 or Q2 looks like. I will just reiterate that the ATM business will not be down 20% next year. We're looking right now low single digits, perhaps better.

That then allows the attached Software revenue to grow. In addition to that, all of the good things we talked about: cloud starting to grow double digits; unattached software license, over 2/3 of our software license, and that's growing mid-teens. You've got a self-checkout and a point-of-sale business that continued to have lots of market demand. So again, for me, 2017, the disappointment was in ATMs and attached software. It won't be nearly that bad in '18, and we'll have the backlog that we need to start the year to set us up for where we want to be.

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

And then something else you guys can maybe square up for me. In light of, I think, Mark's comment about making sure you guys chase profitable deals, on a sequential basis, your Hardware revenues are up, and -- but your operating profit goes from being positive to a loss. If I even look on a year-on-year basis, you're down 40 in revenue, down 30 in profit. The decrementals are huge. So what isn't working in the Hardware business? Is it mix? Is it a bunch of money you're pouring in the new products? What is the issue here with profitability?

Robert P. Fishman - *NCR Corporation - Executive VP, CFO & CAO*

It comes down to mix. We've talked before a little bit about the mix of a big customer, smaller customers, country, regional mix, SCO versus point-of-sale versus ATMs. So again, that is our issue, mix, in this particular quarter.

Mark D. Benjamin - *NCR Corporation - President & CEO*

Yes, Matt, it's also, I think, as Bob is alluding to, just not to miss, it's really also around volume. So a significant near-term disappointment will drive obvious pressures on cost relative to volume. As we've said in previous quarters, we really turned over most of our solutions over the past, call it, year. So new product introductions really across all of the markets we serve tend to add costs certainly when the volume doesn't materialize that you expect. So just some pressures included with what Bob mentioned.

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

And again, just one more point to maybe Paul's question earlier in the call. Coming out of Q2, in early July, you had the #1 ATM player in North America significantly take down guidance, calling -- talking about a lot of the same things you're talking about. You spent a lot of time on your second quarter call trying to sort of allay fears, convince everyone that maybe this wasn't an industry sort of issue. I guess, I'm trying to understand between late July and the end of September, what specifically happened?

What customer conversations were you having then that all of a sudden just disappeared? I guess, at the end of the day, I don't know why you guys just didn't take a pretty good haircut to your numbers last quarter. I'm confused why this is happening now. I guess, at the end of the day, that's my comment and/or question.

Mark D. Benjamin - *NCR Corporation - President & CEO*

All right, Matt, this is Mark. I think it's a fair question, so we'll do our best to tell you why that was the case. Within the third quarter, we had some order weakness to the tune, as Bob highlighted, to $100 million. And while that's significant, it doesn't necessarily materialize at the beginning of a quarter. So these orders take place throughout the quarter, and in fact, certainly when it comes to Hardware, we tend to see it happen later in the quarter.

Our pipelines and the sales force confidence was still high at that point in as far as achieving the quarter, but they missed. And then we rolled up our forecast, essentially, Matt, last week for the fourth quarter and obviously had some surprises with what we would see throughout the fourth quarter.

We -- while Diebold we have a lot of respect for, we don't consider them a proxy for our business, whatsoever. We consider ourselves far more diversified as a company. In fact, more than 50% of our revenue today are non-ATM or non-Financial Services-related revenues. So I think we're a very different business. We obviously are disappointed but nothing in July or August that we saw in the business relative to your question on a competitor's results really changed our confidence in execution.

I think, by the way, while we're disappointed in the results in the quarter, we had a significant miss certainly now for the full year in ATMs, but we'll still perform nicely on other parts of the business. While I'm not so sure that if we were exclusively and ATM business, we'd be able to succeed that way. So hopefully, I'm answering your question, Matt. Happy to take a follow-up.

Operator

That does conclude today's question-and-answer session. Mr. Mark Benjamin, at this time, I will turn the conference back to you for any additional or closing remarks.

Mark D. Benjamin - *NCR Corporation - President & CEO*

Okay. Well, I just wanted to thank everyone for joining us today. And again, while we're disappointed in the results and the change of our full year guidance here in the fourth quarter, we remain incredibly confident in our strategic priorities, our market position and the support we get every day from our great customers and our 33,000 NCR associates. So thank you for joining us today.

Operator

This concludes today's conference. Thank you for your participation. You may now disconnect.
