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NCR - Q1 2016 NCR Corp Earnings Call

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OVERVIEW:

NCR reported 1Q16 non-GAAP EPS of $0.38. Expects 2016 revenues, including expected sale of IPS at May-end, to be $6.25-6.35b and non-GAAP EPS to be $2.90-3.00. 2Q16 non-GAAP EPS is expected to be $0.60-0.65.

CORPORATE PARTICIPANTS

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Bill Nuti *NCR Corporation - Chairman, CEO and President*

Bob Fishman *NCR Corporation - SVP, CFO and CAO*

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Michael Bayer *NCR Corporation - SVP and President of NCR Retail*

CONFERENCE CALL PARTICIPANTS

Kartik Mehta *Northcoast Research - Analyst*

Paul Coster *JPMorgan - Analyst*

Matt Summerville *Alembic Global Advisors - Analyst*

Aaron Turner *Wedbush Securities - Analyst*

PRESENTATION

Operator

Good day, everyone. Welcome to the NCR Corporation first-quarter fiscal year 2016 earnings conference. Today's call is being recorded.

At this time, I'd like to turn the conference over to Mr. Gavin Bell, Vice President of Investor Relations. Please go ahead, Sir.

Gavin Bell - *NCR Corporation - VP of IR*

Good afternoon, and thank you for joining our first-quarter 2016 earnings call. Joining me on the call today and offering opening remarks are Bill Nuti, Chairman and Chief Executive Officer; and Bob Fishman, Chief Financial Officer. Additionally, available on the call today for Q&A are Andy Heyman, Senior Vice President and President, Financial Services; Michael Bayer, Senior Vice President and President, Retail Solutions; and Paul Langenbahn, Senior Vice President and President of Hospitality.

Our presentations and discussions today include forecasts and statements that are considered forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995. While these statements reflect our current outlook, expectations and beliefs, they are subject to a number of risks and uncertainties that could cause actual results to vary materially. These risks and uncertainties are described in our earnings release and our periodic filings with the SEC, including our Annual Report to stockholders.

On today's call, we will be referring to presentation materials posted on our website. We will also be discussing certain non-GAAP financial information, such as free cash flow, and results from operations, excluding the impact of special items. Reconciliation of these non-GAAP financial measures to the most directly comparable GAAP measures and other information concerning such measures are included in the presentation materials and in our earnings release.

These are also available on the Investor Relations section of NCR's website. A replay of the call will be available later today on our website, NCR.com.

With that, I would like to turn the call over to Bill Nuti.

Bill Nuti - *NCR Corporation - Chairman, CEO and President*

Thank you, Gavin, and good afternoon, everyone. Bob will take you through the financials in one moment, but I wanted to provide my perspective on Q1. NCR got off to a solid start in 2016. Revenue and cash flow came in as we expected, while operating income and EPS were ahead of our expectations, largely on the back of higher software growth and improving productivity.

That being said, there were no surprises in Q1, and the results do not change our thesis on our potential 2016. On the positive side, I was encouraged by Q1 orders. The mix of those orders, including double-digit software order growth, a growing backlog, higher services file value, and momentum in a number of our strategic solution offers, such as branch store and restaurant transformation as well as unified commerce, and payments and security.

Additionally, we made more progress than I expected on our business transformation initiative. Focused on eliminating waste and increasing productivity, reengineering outdated business practices, and making the associated savings obtainable while simultaneously reinvesting and self-funding required growth investments. On the latter point, the Blackstone relationship has been a significant net positive and we appreciate the access to their resources, assistance and scale.

On the constructive side, I was disappointed with ATM volume and margins in the quarter. While we expected these results, we were collectively driving towards strict goals in these areas and did not achieve them. That said, ATM volume in the backlog remains strong. The large distributed programs are now beginning to roll out, and this will improve revenue growth in Q2 and the back-half of 2016.

As for margins, once (inaudible) brought us ramped to higher volumes, and our costs come down commensurate with that volume, we should see solid improvement. Additionally, the strategic agreement we are announcing today with Wells Fargo is truly a bellwether moment for NCR. It is also a sign of things to come as customers around the world begin to contemplate moving to a single vendor, and to our strategy with NCR.

As we move through the script today, we acknowledge that a change in incentive reporting may require more of our time. Because of that, we are dedicated to providing more context on today's call and use more of our time over the coming months. We are enthusiastic about this change in reporting and are already seeing benefit internally. These are the right metrics NCR will focus on, and we hope that you see that as you become more accustomed to these changes.

Overall, despite the obvious macroeconomic and FX challenges, all global multinational technology companies are facing, I was pleased with where we landed in Q1 and remain optimistic about our potential, including an increase in revenue and EPS guidance that Bob will talk about in a moment.

I will now turn the call over to Bob Fishman to review the results. Bob?

Bob Fishman - *NCR Corporation - SVP, CFO and CAO*

Thank you, Bill. Slide 4 shows our financial highlights for Q1. Revenue was down 2% on an as-reported basis due to currency headwinds and in line with the guidance we provided in February. Revenue was slightly up on a constant currency basis. Our recurring revenue increased 3% in Q1 and 7% constant currency.

As a reminder, NCR's recurring revenue includes hardware and software maintenance as well as cloud revenues. At the end of Q1, recurring revenue reached 48% of our total revenue. And, as you know, we focus on this metric because this particular basket of revenue generates higher margins than total enterprise margins, and is a better indicator of the sustainability of future revenues and margins.

Looking at margins, Q1 operational gross margin was 27.4%, which was down 20 basis points as reported and 60 basis points constant currency. This was primarily driven by lower hardware margins, which we expect to improve later in the year as unit volume increases and new product introduction ramps up.

We also expect improvement from increased productivity and efficiency gains. Q1 non-GAAP EPS was $0.38, above the top end of our guidance range we previously provided, and included $0.04 negative impact from pension expense and OIE that I will cover in more detail on the next slide.

Lastly, free cash flow was as expected, due to higher working capital requirements to support revenue later in the year.

Slide 5 shows our Q1 operational results on an as-reported and constant currency basis. I will provide more detail on revenue and gross margin on the segment charts. Expenses were lower by $4 million and reflected responsible expense management in the quarter. The year-over-year decrease in non-GAAP operating income is primarily related to $5 million of additional pension expense in the current quarter.

As discussed at our recent Analyst Day, we are now including ongoing pension expense in our operating results, and this will negatively impact the year-over-year compares throughout 2016 for both operating income and EPS. Additionally, in Q1, we completed the amend and extend of our credit facility, which was described in our recently filed 8-K. As a result, we were required to write off $4 million of deferred financing fees, which is included in interest expense.

Non-GAAP EPS was $0.38 and included a negative impact of $0.04 from pension expense and the deferred financing fees write-off. The next slide shows our Q1 GAAP results. The reconciling items include acquisition-related amortization of intangibles, acquisition-related costs, and restructuring transformation costs. For a reconciliation of non-GAAP to GAAP results, please refer to the supplementary materials at the end of this presentation.

Slide 7 shows our new segment reporting for 2016, as discussed during our Analyst Day in March. As a reminder, software includes software license, software maintenance, cloud, and professional services. Services include hardware maintenance, implementation and managed services; and hardware includes ATMs, self-checkout, point-of-sale, and our interactive printer solutions business.

As you can see, our mix of revenue continues to improve, with software and services comprising 67% of total revenue in the first quarter as compared to 63% last year. In part, this change in mix is attributable to lower hardware sales in Q1. However, and importantly, continued software growth above overall enterprise growth is an important indicator of the strategic shift in revenue we aspire to achieve, along with corresponding margin expansion.

On slide 8, you will see our software update. On a constant currency basis, revenue was up 3%, led by growth in software license and software maintenance revenue. Software license revenue, even though up, was negatively impacted by software attach on lower ATM unit volume.

With that said, an important and growing part of our software license revenue is sold independent of hardware. We call that unattached software license, and consider this metric important to our long-term success in software. The unattached license revenue grew to 56% of total license revenue, up from 55% in the prior-year. Although cloud revenue was flat, higher overall net annual contract value suggests a return to revenue growth in late 2016, with more normalized growth in 2017.

Professional services was down in the quarter, due to a low starting backlog position. However, professional services orders were up significantly on the back of a number of omnichannel software wins.

Operating income was down $2 million, driven by higher revenue offset by software mix and $2 million of higher expenses. We saw strong performance in a number of our strategic solutions, such as branch store and restaurant transformation, unified commerce, and payments and security. Our hospitality industry also continues to demonstrate solid growth in cloud ACV revenue and application sites.

We also are beginning to experience momentum in omnichannel solutions with unified commerce wins at Foodstuffs, the Atlanta Falcons, My Basket, Checkers, Island Restaurants, and California Pizza Kitchen.

The next slide shows our services Q1 results. Revenue was up 8% on a constant currency basis due to growth in hardware maintenance, managed and implementation services. Operating income was down $2 million due to higher revenue, offset by lower margins on implementation services revenue and $4 million of higher expenses. We saw managed and implementation services growth due to our focus on improving the customer experience in several of our strategic solution areas. We also experienced growth in third-party implementation services and new higher-margin service offers.

To improve our cost structure in the future, as well as deliver improved customer service, we created a new regional logistics hub, and continue to improve our big data analytics capability, which enables customer calls to be handled more efficiently.

Finally, our services file value, which represents 12 months of recurring hardware maintenance revenue, is up year-over-year.

Turning to slide 10, hardware revenue was down 9% on a constant currency basis. ATM revenue was down 17% constant currency. While Q1 ATM revenue was lower than expected, ATM backlog is up significantly entering Q2. And along with higher revenue and improved backlog conversion, this will contribute to a better second-half of 2016.

Branch transformation hardware revenue was up in the quarter, and we remain on track to achieve our 2016 objectives. Self-checkout revenue increased significantly, due to our customers' initial rollouts of their longer-term store transformation programs, a new product upgrade cycle, and expansion into new geographies.

We had important store transformation wins with Kmart, Oshcon, Smith SuperValu, Tomlin, Magnet, and SaudiMac. Point-of-sale revenue was lower due to Q1 seasonality and some shift to self-checkout, as the density of self-checkout improves the front end of retail. Point-of-sale growth in restaurants was driven by new wins, customer growth, and product refreshes.

In the first quarter, operating income was down $3 million due to lower revenue and gross margin rate. The gross margin rate was negatively impacted by higher initial expenses from the rollout of a new ATM product family and macroeconomic challenges in certain countries. The negative operating income in the first quarter is largely due to seasonally lower revenue in our fixed cost base. This is typical in Q1, where we see lower profit early in the year, and higher profit as revenue ramps in the back-half of the year.

During Q1, we entered into a long-term strategic partnership with Wells Fargo, and we signed our largest deals ever in US CFI and Mexico. There is more information and more detail coming out on the Wells Fargo contract over the next 30 to 45 days. Additionally, global demand in self-checkout will continue to be driven by store transformation growth, expansion into new markets, the refresh cycle to our new platform, and changes in labor rates expected to go into effect in early 2017.

Finally, we continue to invest in, develop and release innovative new product offers, including a new ATM product family, as well as new self-checkout and point-of-sale platforms.

The next slide shows our revenue by region. In Q1, we saw growth in the Americas region, driven by growth in the software and services segments, partially offset by declines in the hardware segment. The Europe, Middle East, Africa and Asia-PAC regions saw macroeconomic challenges in certain countries.

On slide 12, you can see free cash flow for the quarter, which was in line with our expectations. Q1 2016 was a free cash outflow of $29 million compared to free cash flow of $24 million in Q1 2015. The decrease was due to higher working capital as we planned for increased revenues later in the year. We are reaffirming our 2016 free cash flow guidance of $425 million to $475 million.

Capital expenditures and spend on discontinued operations are on track to achieve our full-year goal. And while spend on discontinued operations was a bit higher in Q1, this is impacted by the timing of expenses and recoveries. We expect cash flow from operations to improve as revenue and profit build throughout the year.

Slide 13 shows our net debt to EBITDA metric, with a net debt leverage ratio of 3.2 times for Q1 2016. The increase in the leverage ratio from Q4 2015 is related to the common stock repurchases in the quarter.

On slide 14, you will find Q2 2016 guidance. Normalizing for the sale of IPS, which we expect at the end of May, revenue is expected to be flat as reported and up 2% constant currency. This includes a negative FX impact of approximately 2 points or $25 million. Our non-GAAP EPS is expected to be $0.60 to $0.65 for the quarter. We expect $0.02 of negative EPS impact from unfavorable foreign currency headwinds and pension expense.

Hardware margins will continue to be challenged in Q2, with improved profitability expected in the back-half of the year. For Q2 2016, we have assumed OIE of $50 million, an effective tax rate of 28%, and a share count of [154 million] compared to OIE of $45 million, an effective tax rate of 27%, and a share count of [172 million] in Q2 2015.

Slide 15 includes our improved full-year 2016 guidance. Our revised revenue guidance, including the expected sale of IPS at the end of May, is $6.25 billion to $6.35 billion, and our non-GAAP EPS guidance is $2.90 to $3.00. Our free cash flow guidance remains $425 million to $475 million.

We are now expecting foreign currency headwinds of $75 million versus 2015, with an EPS impact of $0.05. This is a better FX environment than expected at the start of the year. The revenue headwind has improved by $60 million and EPS has improved by $0.05. Including the FX headwind and higher pension expense, we expect $0.10 of negative EPS impact for the year. Normalizing for the sale of IPS, revenue is expected to be up 2% to 3% as reported, and up 3% to 4% constant currency.

For the 2016 revised guidance, we have assumed OIE of $205 million to $210 million, an effective tax rate of 25%, and a share count of [157 million] compared to OIE of $196 million, an effective tax rate of 23%, and a share count of [172 million] in 2015. The OIE guidance is higher by $5 million to $10 million from our previous guidance, due to the $4 million write-off of deferred financing fees and higher foreign currency impacts.

Slide 16 shows our expected revenue growth by segment for the full year, adjusted for the expected impact of unfavorable foreign currency headwinds and the pending sale of the IPS business. Software revenue is expected to grow 4% to 5% constant currency for the full-year after growing 3% in the first quarter. Services revenue is expected to grow 3% to 4% constant currency for the full-year.

Hardware revenue is expected to grow 1% to 3% constant currency for the full-year after being down 9% in the first quarter. This reflects the improved backlog position and higher conversion rates in the back-half of the year.

You can see on slide 17 our revenue, operating income and EPS trending over the last three years. As expected, the guidance is more backend-loaded in 2016. While the revenue trending is similar to prior-year, we are showing approximately $60 million higher revenue in the back-half than what we have seen historically. This increase is supported by our strong backlog, higher conversion rates, file value, and funnel at the end of the first quarter.

Our operating income is higher than what we have done over the last three years, and is supported by the higher revenue growth, including higher software revenue, improved hardware margin rates, and continued progress with our business transformation initiatives. Our EPS is higher than the last three years, mainly due to the higher operating income in the back-half of 2016, and the benefit of the share repurchases.

Overall, we expected a slower start to the year and have gained growing confidence through our performance in the first quarter that we are on track to deliver our increased guidance.

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

Bill Nuti - *NCR Corporation - Chairman, CEO and President*

Thank you, Bob. In summary, Q1 results are the [net proceeding] (technical difficulty) and guidance. Like any quarter, there were things that went well and areas for improvement. However, on balance, Q1 was a good start to 2015, and I am incrementally more positive on the year due to solid orders, software mix, a higher backlog, and services [vol] value, omnichannel solutions action, and the effects of our business transformation initiative.

Ultimately, these are the factors that give us the confidence to raise our revenue and the EPS guidance on the year. Before I dismount for questions, we spent considerable time at the Investor Day last month on the maturity of the omnichannel market, and so it is becoming increasingly maintained across multiple industries and on a global basis.

I am pleased to say that there were a number of important signposts in our Q1 results that validate the continued maturation and growth of the omnichannel market. For example, much of NCR's Q1 software order and revenue growth can be attributed directly to omnichannel implementations, applications, or upgrades.

Additionally, the significant growth of self-checkout correlates to the beginning of the retail store transformation cycle. In fact, we are seeing similar trends in branch transformation from retail banks and hospitality transformation in quick service and fast casual dining. We are even seen early signs of small and medium-sized businesses wanting to get onboard.

Moreover, strategic relationships like Wells Fargo are directly focused on our customers improving their omnichannel experience for their customers and their team members. Everywhere we look in our P&L, the influence of omnichannel is growing and making an impact. As we look ahead to the omnichannel market, it's important to note that NCR is on the forefront of helping our customers respond to disruptive changes in globalization, digitization, consumerism, and the Internet of Things.

It is estimated that by 2020, 75% of businesses will have digital transformations underway, largely involving channel integration and transformational technologies. However, only 30% of these efforts are predicted to be successful. As businesses evolve, the need to keep up with, and ultimately lead, a new era of connected markets is a promise. Channel integration and transformation to the realignment of or new investment in technology and business models to more effectively engage digital customers at every touchpoint in the customer journey.

NCR is a pioneer in the channel integration and transformation of space, both physical and digital, and the organic (technical difficulty) investments we have made today are paying off. As the need to update legacy technology strategies and business process methodologies becomes even more prevalent, we are now in a position to lead the way in keeping up with the fast pace of change in a rapidly evolving world.

Operator, we will now open up the call for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Kartik Mehta, Northcoast Research.

Kartik Mehta - *Northcoast Research - Analyst*

Good afternoon, Bill. Good afternoon, Bob. You talked about the ATM business, Bill, maybe not meeting your expectations. And I'm just wondering -- is there any particular geography? Or do you think this is more a case of just ordering taking longer than you anticipated?

Bill Nuti - *NCR Corporation - Chairman, CEO and President*

What I talked about, Kartik, was the fact that at the beginning of Q1 we had established higher goals for ourselves internally. First is what the backlog would suggest (inaudible). And I thought we could get $10 million, maybe $20 million more of revenue moved into Q1 from Q2 and Q3 by working with our customers on some acceleration of their rollout.

That did not happen. So the good news is, is that the backlog for ATMs now is up about 19% year-over-year. So we have a very strong ATM hardware backlog. But in Q1, that would have also driven revenues higher and software attach higher. So for us, we established some set goals. We would have liked to have gotten there -- I'm not disappointed in the effort and not surprised by the outcome. In fact, we did a little bit better than we thought we would at the beginning of Q1. But again, good news is on the backlog going into Q2 and Q3.

Kartik Mehta - *Northcoast Research - Analyst*

And then, Bill, it seems as though services is continuing to do well. If you broke that out between ATM and retail, or however else you would want to break it out, could you talk about the parts that are doing well? Maybe the parts where you'd like to see improvement, if there are any?

Bill Nuti - *NCR Corporation - Chairman, CEO and President*

Yes, Bob.

Bob Fishman - *NCR Corporation - SVP, CFO and CAO*

The way that, Kartik, we like to look at the services business is really in terms of hardware maintenance, implementation services, managed services -- those are the buckets that we're looking at -- all had very solid quarter in Q1. Implementation services -- we are starting to do more third-party implementation services. The hardware maintenance growth was up because the file value was up.

And then the managed services is just a growing trend that we're seeing across really all the industries. So we saw good growth, Kartik, across all those three lines of business.

Kartik Mehta - *Northcoast Research - Analyst*

Perfect. And then, Bill, just one last question. You talked about maybe -- or Bob you talked about some headwinds, economic headwinds, maybe in Europe. But I don't know if you said EMEA, I apologize. I just was -- I was hoping you could talk about which countries you are seeing that? And if you've seen any improvement throughout the quarter?

Bill Nuti - *NCR Corporation - Chairman, CEO and President*

Yes, really year-over-year, Kartik, the headwinds we saw mainly pertain to the ATM space. And they really came in the form of the following. The year-over-year compares in Turkey were way off -- meaning Turkey in Q1 2015 had a great quarter. Q1 2016 was weak.

The oil markets of the Middle East and Africa are all challenged right now. So we are seeing some issues in Middle East and Africa, but they are, in my view, non-cyclical in that I expect them to return to some level of growth here in the back0half of the year overall. But when you look across all that businesses, it really was the ATM space in Q1 where we saw geographic challenges. All other lines did quite well.

Kartik Mehta - *Northcoast Research - Analyst*

Thank you very much.

Bill Nuti - *NCR Corporation - Chairman, CEO and President*

You're welcome.

Operator

Paul Coster, JPMorgan.

Paul Coster - *JPMorgan - Analyst*

Just a few quick questions. The first one is -- it sounds good that you've got a strategic win with Wells Fargo, but surely other retail banks now will be looking at that somewhat skeptically with a view to perhaps going in a different direction to differentiate. Isn't there a risk now of Balkanization? I realize you haven't disclosed much information yet but sort of prima fascia, it sounds like it could work both ways.

Bill Nuti - *NCR Corporation - Chairman, CEO and President*

Paul, you might think that on the surface, Paul, but for us, we are seeing interest from all of our large customers to go down a very similar path. I would not want to paint the Wells Fargo partnership as anything more than a large bank and a large innovative fin-tech provider coming together and working on their behalf to provide their customers and their team members with great solutions. We're looking at doing that with other large banks around the world.

Andy Heyman, you may have some comments on that?

Andy Heyman - *NCR Corporation - SVP and President of Financial Services*

Yes. Thanks, Bill. Welcome, Paul. I think it's bigger than just the big bank space. I think what we're seeing is a growing trend based on the desire for significant retail network transformation to simplify the technology infrastructure, to enable the cost improvements and the revenue growth that financial institutions are striving to achieve. And whether it's big banks or small banks, whether it's the United States or the rest of the world, the trend is growing.

To your question about, well, could this provide a tailwind for competitors? As we see the competitive landscape shaking out, we see this trend is highly favorable, especially as our top two competitors merge by the end of this quarter. So we are optimistic about this trend. And time will tell if that optimism proves out.

But we like a lot of what we see; just like Wells, we had a similar win with our largest deal ever in Mexico. We had our largest deal ever on the same formula in the community financial institution space in the United States. And we are seeing that demand pick up globally.

Paul Coster - *JPMorgan - Analyst*

Okay. A couple of things on a couple of points on the guidance. Bob, you talked to a couple of times about the add-back of pension fund expense being higher than expected. Did you actually mean that? Or do you mean that -- I mean, I don't think the pension expense has actually gone up versus prior expectations. It's just that now we have to add it back because you are not using NPOI -- is that the correct interpretation of what you were saying?

Bob Fishman - *NCR Corporation - SVP, CFO and CAO*

Yes. The best way to think about that, Paul, is there is roughly, now that we've recapped the financials to include pension expense and no longer have NPOI, there's $10 million of pension expense in the full-year in 2015, and around $20 million in 2016. So think of it as a full-year $10 million headwind -- $5 million of that came in Q1, because you will remember in Q2 of last year, that's when we sold the overfunded pension plan in London.

So as we get to the later quarters, you'll have less of a difference for the full-year at $10 million. And for Q1, it was $5 million.

Paul Coster - *JPMorgan - Analyst*

Okay. Got it. All right. And then, well, I've got a bunch of questions but I'll just round it out with one big one, which is, why raise the full-year guidance at the moment? It didn't seem to me to be necessary in view of the -- sort of across the first and second quarter, it was an okay start for the year, but no reason at this point in time to raise the bar on yourselves.

Bob Fishman - *NCR Corporation - SVP, CFO and CAO*

Well, we rose it because we had a significant [beat] in Q1. We feel good about the balance of the year. FX was moving in our direction for the first time in a while, even though we did see some OIE headwinds. So when we put all of that together and looked at the backlog, looked at file value and funnel, we had growing confidence, and that allowed us to increase the guidance and send a stronger signal.

Bill Nuti - *NCR Corporation - Chairman, CEO and President*

Yes, Paul, I would add a few things from my point of view. We had a very solid start to the year in overall orders, and in particular, software orders -- they were up about 11% year-over-year, driven by software licenses and [EPS]. So the mix of our orders were very good and order growth was solid overall.

The backlog coming into Q2 now is up about 6% year-over-year now and very, very solid. And we are anticipating a solid Q2 in terms of orders and -- as well, and in particular, software orders. We have good file value. File value growth is solid on the year. And so when you do the math on all of that, and higher conversion of a very big hardware backlog right now in the back-half, it was actually responsible of us to raise guidance.

Paul Coster - *JPMorgan - Analyst*

Very good. Thank you.

Operator

(Operator Instructions) Matt Summerville, Alembic Global Advisors.

Matt Summerville - *Alembic Global Advisors - Analyst*

First of all, just with respect to the ATM business, you mentioned launching a new family of machines. Can you talk about how the timing of that rollout or availability is going to look as we progress throughout 2016? And then what you think are the top maybe three or four differentiating factors versus your competitors?

Bill Nuti - *NCR Corporation - Chairman, CEO and President*

Sure, Matt. Andy, why don't you take that one?

Andy Heyman - *NCR Corporation - SVP and President of Financial Services*

Okay. Matt, just so you know, this is a very big deal for us. And it's been several years in the making from an R&D perspective, and was a centerpiece in the Wells strategic relationship that we signed in the first quarter, and several other big relationships in the quarter as well.

In the first quarter, we shipped a couple-of-hundred units, so it's fully baked now. We're not talking about labs and pilots; we're in deployment mode now. We will be shipping many thousands this year. So we have -- it's passed all of the key certifications and other quality tests that you would want to see.

In terms of what's different about this, it's a few things. First of all, very much future-proof capabilities in terms of supporting omnichannel needs -- things like video-ready, NFC-ready -- those kinds of things. The industrial design on the units is thought of by our customers as a differentiation, more Apple-like, if you will, in terms of its industrial design. That's a second key.

The third area is availability. This significantly improves the availability both because the deposit reliability and speed, and the cash dispense capabilities are world-class, and really disrupt ourselves in terms of where we were already the leaders with our current generations. This leapfrogs ourselves and anybody else's designs in terms of what's going on in the industry.

So those differentiations have been crucial. I'll just give you one stat as we're seeing it in the field right now. If you can imagine the throughput we measure in high density moments, think of it as, on a given busy day, 2,000 transactions moving up to 4,000 transactions. So you can imagine cost per transaction significantly changing in very high-volume situations. So lots of benefits for customers that help them both grow revenues and control costs in a highly secure way.

Matt Summerville - *Alembic Global Advisors - Analyst*

And then just as my follow-up --

Bob Fishman - *NCR Corporation - SVP, CFO and CAO*

Matt, this is Bob. I just wanted to make mention that a lot of these pieces are interconnected. We've spent capital over the last couple of years; capital was down in Q1 because we're going to have a record number of new product introductions across NCR -- not just in ATMs but self-checkout platform, point-of-sale.

As those products ramp, we really have a fresh start in terms of taking costs out of the product. And so while you might see margins challenged initially, as we ramp through the year, margin rates will improve, primarily in hardware margins and ATMs. So it all fits together as this product revenue starts to grow.

Matt Summerville - *Alembic Global Advisors - Analyst*

Got it. And then just as a follow-up, kind of a similar question with respect to retail in either point-of-sale -- more so self-checkout -- you mentioned the changes coming in, in labor rates. And I'm sure we've all sort of seen that.

What do you think that does to the adoption curve, the level of conversion, if you will, of non-self checkout lanes to self-checkout lanes? And what are the conversations you're having with your customers suggesting about that? When is that inflection, if you will -- if it's not happening already -- when is that coming?

Bill Nuti - *NCR Corporation - Chairman, CEO and President*

Yes, Matt. It's a great question. We are seeing that now. Candidly, the biggest driver for self -checkout today is that it is a component of a retail store's overall store transformation initiative -- meaning if you were to go speak with the CIOs of mass merchandisers of large grocery stores, of convenience stores, you'll find that within 10 years, a very high correlation of them expect that the number of lanes that are currently assisted -- meaning people are there checking you out -- will go from about 80% today down to about 5% 10 years from now.

Now there will be a number of modalities of what we call self-checkout today that will feature prominently in that store transformation solution. We offer a complete solution set. Self-checkout is a component of that solution. For example, mobile point-of-sale, mobile check-out, click and collect, cash management, loyalty, retail one, and a whole host of our software solutions above and beyond that, are a part of that solution.

Now labor rates is causing -- as a function -- causing a number of our customers to even more so speed up that transition. So that 10-year horizon that I thought would play out is now probably five to seven years. As the labor rates rise -- not just in the US, but in terms of inflation around the world, we are now seeing self-checkout being sold in markets like Russia, for example, in a high degree of volume in other markets. We never saw self-checkout seller again.

So, Michael Bayer, do you have other comments on that?

Michael Bayer - *NCR Corporation - SVP and President of NCR Retail*

Yes, Bill. Matt, I would add to what Bill already outlined, that there's also some factors which were not so much on the forefront of the thinking of our customers, like availability of labor. In a lot of the top 20 to 50 cities around the world, availability of labor to work at the cash register is a big issue for the retailers. It's also the question of efficiency of labor with ongoing disruption of employees, who do self-replenishment or other work, being called again and again back to the cash register.

Compare -- combine that with the young generation of people who are much more technology-savvy and want to do it their own way, and with the global increase in opening hours, you see a business case to self-checkout introduction and customers who don't have self-checkout today. But you also see now the move to higher density checkout solutions in our installed customer base. So all of that comes together. And with the product portfolio we have, as well as our specialist sales force and a global reach, we are, I think, on the forefront at this moment.

Bill Nuti - *NCR Corporation - Chairman, CEO and President*

And, Matt, just to put this in perspective for you, in Q1, order growth for SCO -- self-checkout -- was 100% year-over-year. It doubled. So we saw -- on a big number, by the way -- so we saw a very significant increase in customer traction -- again, mainly in line with what we expected in terms of store transformation, but no doubt the density of the lanes will move more aggressively to a more self-checkout modality as a result of higher labor rates.

Matt Summerville - *Alembic Global Advisors - Analyst*

Great. Thanks a lot, guys.

Bill Nuti - *NCR Corporation - Chairman, CEO and President*

Thanks.

Operator

Gil Luria, Wedbush Securities.

Aaron Turner - *Wedbush Securities - Analyst*

Hi, guys. This is Aaron on for Gil. Just a quick one from me. Regarding free cash flow, how do you foresee the seasonality of cash flow for this year? And specifically what percent do you think we'll see in Q4?

Bob Fishman - *NCR Corporation - SVP, CFO and CAO*

Yes, this is Bob. We typically see a negative free cash flow in the first quarter. We actually beat our internal plan in the first quarter and free cash flow with an outflow primarily because of the working capital build.

When I look at the next three quarters of the year, last year, we did roughly $385 million of free cash flow. We'll do $480 million this year to get to the midpoint. I feel good that all the trends are headed in the right direction. So we've got CapEx being lower. We'll have another very good year with cash tax rate.

There's no one-time items -- disk ops is lower. Overall, it comes down to the back-half of revenue and profit. So it's hard for me to forecast the exact number in Q4, but I will say that I'm very comfortable with how the year is playing out and I'm confident within the guidance range.

Aaron Turner - *Wedbush Securities - Analyst*

Got it. Thank you.

Operator

And our final question will be from a follow-up from Paul Coster.

Paul Coster - *JPMorgan - Analyst*

So just drilling down into the software for a moment. You talked of, I believe, an increase in backlog. What was the composition of that backlog, particularly in terms of the licensing versus maintenance? And the attach versus non-attach? And what does that have -- what does that imply in terms of future gross margins for that segment?

Bill Nuti - *NCR Corporation - Chairman, CEO and President*

Yes, the license backlog growth, Paul, was up mid-single digits at the time. Think about PS also being up in the quarter slightly as well. So the main driver of backlog growth for us going into Q2 is software license. And that's based on a strong Q1 order growth in that period.

Now about a little over half of our revenue in Q1 in software license was unattached. As the volume of hardware grows for ATMs and self-checkout in the back-half -- and both will grow significantly over Q1 -- the attach for that will also grow for us. So the opportunity we have is to overachieve our unattached forecast in the back-half. And really that's our stretched target for the year. Because by itself, the attach flow-through in the back-half is quite high.

Paul Coster - *JPMorgan - Analyst*

Which is the better margin business? The attached or the unattached?

Bill Nuti - *NCR Corporation - Chairman, CEO and President*

They are both about the same, Paul. They are both about the same. They are both in the mid-to-high-50s on a software license.

Bob Fishman - *NCR Corporation - SVP, CFO and CAO*

Yes, I would say the software license piece is probably even higher than that, because it's typically only carrying the software and more from the previous year. So I would say that the software license, when you look at the four streams within software, software license is probably 80% to 90% in terms of the gross margin. There can be some third-party element to that, but overall, that's our highest margin stream.

Paul Coster - *JPMorgan - Analyst*

Got it. All right. So the second-half looks like it's going to be pretty strong, but we have heard a variation on this story before. What are the risks that we might see some push-outs of projects, for instance?

Bill Nuti - *NCR Corporation - Chairman, CEO and President*

You know, Paul, I think we were in similar circumstances last year and we did what we said we were going to do, even a little bit higher than that. So we feel like we are in the same seasonality position we are in.

I think Bob and I have incrementally more confidence this year, given our order flow-through, software orders, backlog, file value, and frankly, the fast pace at which we're driving up our business transformation initiative.

But Bob, you may have other thoughts on that?

Bob Fishman - *NCR Corporation - SVP, CFO and CAO*

Yes, there's a few strengths in our favor in the back-half of the year. Certainly we are lapping -- to Bill's point, we've got the higher volume, but we are also lapping those conversion rates that troubled us in Q3 and Q4 of last year around the backlog flow-through. So, conversion rates will be better as well.

And then I've been pleased with the overall transformation initiatives. You'll remember at Analyst Day, we said we were going down three paths. We said we were engaging the help of Alex Partners to do an eight-week full-body-scan of what we call Quick Strike. That eight-week analysis ends this Friday. And we've received, and will be implementing, a number of performance improvements around sales enablement services, and software transformation, and cost take-out.

The other initiative that's been launched is zero-based budgeting, which will drive end-year savings but also give us a runaway over the next couple of years. And then, finally, we've been going after cost of goods and hardware, and cost of services within our overall services platform for end-year savings.

So those three initiatives are driving improvements in the back-half of the year, but also give us the runway for the next couple of years and the project plans to execute on that.

Bill Nuti - *NCR Corporation - Chairman, CEO and President*

And you know, Paul, on conversion rates, a very interesting factoid for you is that while conversion rates of our backlog will go up in the back-half of this year, we are modeling them actually to be down from 2014. So, they have not yet returned to normalized conversion rates. They might, and that might be upside; and they might not. So right now, we are modeling based on our customers' rollout schedules, an increase in the conversion rate, which is still below 2014.

Paul Coster - *JPMorgan - Analyst*

Got it. Thank you very much.

Bill Nuti - *NCR Corporation - Chairman, CEO and President*

Thanks.

Operator

And I'll turn the conference back to you all for closing remarks.

Bill Nuti - *NCR Corporation - Chairman, CEO and President*

Well, thank you all for joining us. I do want to tell you that we have a number of investor events coming up in the next two months. We intend to be quite visible in the market and look for continual out there. So thank you again for joining us. We'll see you in July. Bye bye.

Operator

And that will conclude today's conference. Thank you all for joining us.