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HURN - Q4 2016 Huron Consulting Group Inc Earnings Call

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PRESENTATION

Operator

Good afternoon, ladies and gentlemen, and welcome to Huron Consulting Group's webcast to discuss financial results for the fourth quarter and full-year 2016. (Operator Instructions) As a reminder, this conference call is being recorded.

Before we begin, I would like to point all of you to the disclosure at the end of the Company's news release for information about any forward-looking statements that may be made or discussed on this call. The news release is posted on Huron's website. Please review that information, along with the filings with the SEC, for a disclosure of factors that may impact subjects discussed in this afternoon's webcast.

The Company will be discussing one or more non-GAAP financial measures. Please look at the earnings release and on Huron's website for all of the disclosures required by the SEC, including reconciliation to the most comparable GAAP numbers.

And now I would like to turn the call over to Jim Roth, Chief Executive Officer and President of Huron Consulting Group. Mr. Roth, please go ahead.

Jim Roth - *Huron Consulting Group Inc. - CEO and President*

Good afternoon and welcome to Huron Consulting Group's fourth-quarter and full-year 2016 earnings call. With me today is John Kelly, our Chief Financial Officer, and Mark Hussey, our Chief Operating Officer.

Last week we pre-released our estimated Q4 2016 results and 2017 guidance in order to provide context for 2017 expectations in light of our recently announced acquisition of growth strategy firm, Innosight. Today we will provide some additional color around our fourth-quarter performance and our expectations for 2017.

On a full-year basis, Healthcare segment revenues declined 5% from 2015. On an organic basis, Healthcare revenues decreased approximately 10% for the year. The year-over-year decline was primarily attributable to our Revenue Cycle Solution, which saw a rapid reduction in revenue during the second half of 2016 and to a lesser extent our Cost and Clinical Solution. Healthcare revenues in Q4 2016 declined approximately 14% over the same period in 2015. As I indicated on last week's call, the decline in revenue and earnings in the fourth quarter was primarily driven by our Revenue Cycle Solution and again to a lesser extent our Cost and Clinical Solution.

As noted earlier, the transition toward smaller, more discrete engagements, fewer performance-based fees, and the uncertainty around the Affordable Care Act are collectively impacting the growth and margins of our Healthcare business. Given these trends, we remain cautious about projecting growth for this business in the near term. However, we believe the prospects for our Healthcare business remain positive over the long term.

Our Education and Life Sciences, or ELS segment, achieved solid growth of approximately 7% in 2016 on a full-year basis over 2015 results. Within the segment, however, our performance was maxed. Our Education business saw continued strong demand across all solutions, achieving strong organic revenue growth year over year. Our cloud-based technology services, which we have been investing in over recent years, continue to perform well. We have made progress in quickly scaling our cloud-based resources to meet the growing needs of our higher education clients as they look to adopt cloud strategies and redesign their business processes.

We also continue to grow our student lifecycle offering in response to constituent demand for improved student progression metrics and the desire to enhance the services offered to the student population.

Our Life Sciences business was challenged to continue the strong growth seen in 2015, finishing the year with revenues below 2015 levels.

Similar to our Healthcare and Education businesses, we continue to broaden our offerings to meet the increasing needs of the Life Sciences industry.

In January, we acquired Pope Woodhead & Associates, which strengthens our strategy and marketing access capabilities for the Life Sciences industry. Pharmaceutical companies are continuing to evolve to succeed in the global marketplace in which they operate and are focused on making informed drug development and commercialization investments. As a result, our clients continue to seek assistance in identifying and executing the ideal strategies that will position them to provide the best access for their portfolio of medicines to address the needs of patients in various markets. Pope Woodhead brings to Huron additional depth and experience as we continue to grow our skills and expertise to meet the evolving needs of our clients.

Pope Woodhead also provides us with the additional scale and platform to further penetrate European markets and meet the needs of our multinational clients. We are thrilled to have them join the Huron team.

Turning to our Business Advisory segment, on a full-year basis, the Business Advisory segment revenues grew approximately 48% year over year, inclusive of our acquisition of the US assets of ADI Strategies and the full-year impact of the 2015 Rittman Mead India and Cloud62 acquisitions. Organic growth for the segment was 8%.

Within the segment, our enterprise solutions and analytics, or ES&A, practice experienced only modest organic revenue growth in 2016 as one of our vendor partners realigned its sales organization, causing some subsequent disruption to the sale of our implementation services during the year. We believe that this softness is transitory and will subside as legacy on-premise applications are moved to the cloud. This disruption was primarily -- was partially offset by strong performance in our salesforce business and growing momentum in our business intelligence and analytics offerings.

The legacy business advisory practice achieved strong organic growth in 2016. Over the last few years, we have actively expanded our service offerings in this business and grown beyond solely serving troubled organizations. These complementary capabilities and our increasing expertise in several industries, including oil and gas, helped us achieve success in 2016 and we believe will continue to provide new avenues of growth in the future.

As we have mentioned on recent calls, collaboration among our industry verticals and our capabilities businesses in the Business Advisory segment is core to Huron's strategy. We finished 2016 with 22% of total Business Advisory segment revenues generated within the Healthcare, Education, and Life Sciences industries. Our ability to collaborate across segments in a meaningful and consistent manner provides a competitive advantage for Huron, and we expect the magnitude of this collaboration will increase in coming years.

Now let me turn to our expectations for 2017. Today, we affirm our previously announced 2017 guidance. Revenue guidance for the year is $750 million to $790 million, and adjusted diluted earnings per share guidance is $2.40 to $2.70. The midpoint of our guidance reflects the mid-single digit revenue growth and a decline in EPS of approximately 20%.

Now let me turn it over to John for a more detailed discussion of our financial results. John?

John Kelly - *Huron Consulting Group Inc. - EVP, CFO and Treasurer*

Thank you, Jim, and good afternoon, everyone. Before I begin, please note that I will be discussing non-GAAP financial measures such as EBITDA, adjusted EBITDA, adjusted net income, adjusted EPS, and free cash flow. Our press release, 10-K, and Investor Relations page on the Huron website have reconciliations of these non-GAAP measures to the most comparable GAAP measures, along with a discussion of why management uses these non-GAAP measures.

Our recent acquisition of Pope Woodhead & Associates and pending acquisition of Innosight are not included in our fourth-quarter financial results. Pope Woodhead will be included in the Education and Life Sciences segment beginning in the first quarter of 2017. After close, Innosight will be included in the Business Advisory segment for reporting purposes. We anticipate the acquisition of Innosight will close in March 2017.

In addition, we now expect the acquisition of the international business of ADI Strategies to close in the first half of 2015 -- 2017, at which time it will be included in our Business Advisory segment.

Now let me walk you through some of the key financial results for the quarter.

Revenues from continuing operations for the fourth quarter of 2016 were $178.1 million, down 3.8% from $185.1 million in the same quarter of 2015. Revenues for the fourth quarter of 2016 reflect our acquisitions of MyRounding, the US business of ADI Strategies, and HSM, which in aggregate generated $14.5 million of revenue during the quarter.

On an organicbasis, revenue declined 11.6%, primarily driven by a reduction in revenues in our Revenue Cycle and, to a lesser extent, our Cost and Clinical Solutions in the Healthcare segment.

Net income from continuing operations was $4.2 million or $0.19 per diluted share in the fourth quarter of 2016 compared to $32.5 million or $1.44 per share in the same quarter in the prior year.

The reduction in net income over the prior year period is primarily attributable to the favorable tax impact of our check-the-box election related to two wholly-owned foreign subsidiaries in the fourth quarter of 2015, a decrease in operating margin in our Healthcare segment, and favorable settlements from two cases recorded in the fourth quarter of 2015. As it relates to the Healthcare segment's operating margin, we made the strategic decision to maintain a base level of bonus funding in the Healthcare segment to incent our top performers.

On a full-year basis, net income from continuing operations was $39.5 million or $1.84 per diluted share in 2016 compared to $61.9 million or $2.74 per diluted share in 2015. Our effective income tax rate in the fourth quarter of 2016 was 4.1%, which was significantly lower than the statutory rate, primarily due to valuation allowance reductions and state tax true-ups, partially offset by nondeductible business expenses.

By comparison, our effective income tax rate in the fourth quarter of 2015 was 0%, primarily due to the Company's previously mentioned check-the-box election, which resulted in a one-time tax benefit of $12.3 million. On a full-year basis, our effective income tax rate for 2016 was 33.3%, which was lower than the statutory rate inclusive of state income taxes, primarily due to the valuation allowance reductions and nonrecurring favorable state tax true-ups.

Adjusted EBITDA from continuing operations was $23.7 million in Q4 2016 or 13.3% of revenues compared to $40 million in Q4 2015 or 21.6% of revenues. On a full-year basis, adjusted EBITDA from continuing operations as a percentage of revenues decreased to 17.7% compared to 19.9% in 2015. Adjusted non-GAAP net income from continuing operations was $12.5 million or $0.58 per diluted share in the fourth quarter of 2016 compared to $21.1 million or $0.94 per diluted share in the same period of 2015. For the full-year 2016, adjusted non-GAAP net income from continuing operations was $68.7 million or $3.21 per share compared with $67.6 million or $2.99 per share in 2015.

Now I will make a few comments about the performance of each of our operating segments.

The Healthcare segment generated 56.9% of total Company revenues during the fourth quarter of 2016. This segment posted revenues of $101.4 million for the fourth quarter of 2016, down $16.9 million or 14.3% from the fourth quarter of 2015. Revenues for the fourth quarter of 2016 included $5.8 million from our acquisitions of MyRounding and HSM. Excluding these acquisitions, organic revenue decreased 19.2% compared to the year ago quarter, primarily due to continued softness in our Revenue Cycle and to a lesser extent our Cost and Clinical Solutions.

Performance-based fees in Q4 2016 were $14.7 million compared to $12.6 million in the same quarter last year. On a full-year basis, healthcare revenue decreased 5%. On an organic basis, revenue decreased approximately 10% for the year. Performance-based fees for the full-year 2016 were $57.2 million compared to $52.3 million in 2015. Operating income margin for Healthcare was 28.3% for Q4 2016 compared to 40.1% for the same quarter in 2015. The year-over-year decline in margin was primarily due to the reduction in segment revenues and restructuring charges related to a workforce adjustment made during the quarter. Utilization for the fourth quarter of 2016 was 72.4% compared to 82.7% reported in Q4 2015.

The Education and Life Sciences, or ELS, segment generated 25.2% in total Company revenues during the fourth quarter of 2016. The segment posted revenues of $44.9 million in Q4 2016, up $1.9 million or 4.4% from the fourth quarter of 2015. On a full-year basis, ELS revenue increased to 6.6% versus the prior year. As Jim noted, our Education business performed well in 2015, and we continue to see strong demand across all of our education service offerings. The operating income margin for ELS was 17.4% for Q4 2016 compared to 20.4% for the same quarter in 2015. Utilization for the fourth quarter of 2016 was 60.9% compared to 74.4% reported in Q4 2015.

The decline in margin was primarily due to our ongoing cloud-based ERP investment. On a full-year basis, operating margin was 24.2% compared to 26.3% in 2015.

The Business Advisory segment generated 17.9% of total Company revenues during the fourth quarter of 2016. The segment posted revenues of $31.8 million in Q4 2016, up $8 million or 33.7% from the fourth quarter of 2015. Revenues for the fourth quarter of 2016 included $8.7 million from our acquisition of the US business of ADI Strategies. The quarter-over-quarter decline in organic revenues is primarily attributable to contingent fee timing related to our broker-dealer business.

On a full-year basis, the Business Advisory segment revenues grew 47.5% year over year and included the acquisition of the US business of ADI Strategies and the full-year impact of the 2015 Rittman Mead India and Cloud62 acquisitions.

On an organic basis, Business Advisory revenue growth was approximately 8% for the full year.

Operating income margin for the Business Advisory segment was 16.1% for Q4 2016 compared to 24.2% for the same quarter in 2015. On a full-year basis, operating margin was 20% compared to 23.2% in 2015. The decline in margin for both the quarter and the year was primarily due to higher salaries and related expenses as a percentage of revenues, reflecting the shift of revenue mix towards a relatively lower margin ES&A business as it grows at a faster pace. Other corporate expenses not allocated at the segment level were $27.3 million in Q4 2016 compared with $28.4 million in Q4 2015.

Now turning to the balance sheet and cash flows. DSO came in at 57 days for the fourth quarter of 2016 compared to 63 days for the third quarter of 2016. Total debt includes both the $250 million face value of convertible notes and $68 million in senior bank debt for total debt of $318 million. We finished the year with cash of $17 million for net debt of $301 million. This was a $44 million improvement over Q3 2016 and an increase of $17 million compared to the end of 2015. Our leverage ratio at the end of the year was approximately 2.3 times adjusted EBITDA.

Cash flow from operations for the year was $128 million. In 2016, we used $69 million of our cash to invest in acquisitions, $55 million of share repurchases, and $14 million of capital expenditures.

Now let me reaffirm our 2017 guidance. The recent acquisition of Pope Woodhead and the pending acquisition of Innosight are included in our guidance range. With that said, for the full-year 2017, we anticipate revenues before reimbursable expenses in a range of $750 million to $790 million. EBITDA and adjusted EBITDA in a range of $112.5 million to $124.5 million. Net income in a range of $18 million to $25 million. Adjusted non-GAAP net income in the range of $52 million to $59 million. And, finally, GAAP EPS between $0.85 and $1.15 and adjusted non-GAAP EPS in a range of $2.40 to $2.70.

Assuming the midpoint of our guidance range, we expect cash flows from operations to be in a range of $115 million to $125 million, and capital expenditures are expected to be approximately $25 million for free cash flows in a range of $90 million to $100 million net of cash taxes and interest and excluding non-cash stock compensation.

Weighted average diluted share counts for 2017 are expected to be $21.8 million. The guidance assumes no share repurchases, but we do have $35.1 million remaining on the $125 million authorization.

Finally, with respect to taxes, you should assume an effective tax rate of approximately 41%.

Let me add some color to our guidance, starting with revenue. The midpoint of the revenue range reflects a 6% increase from 2016 revenue of $726 million. Embedded in the guidance range are expected performance-based fees in the Healthcare segment in a range of $20 million to $30 million.

Our outlook for the Healthcare segment is for revenues to decline in the low double-digit range. This projected decline reflects the wind down of some large projects during the first half of 2017 and reduced visibility in the pipeline four our Revenue Cycle Solution. We expect 2017 healthcare operating margins to be approximately 34% to 35% as we continue to deliver smaller engagements. Lower margins reflect the anticipated lower level of contingent fees and a shift in business mix to lower margin technology services within the healthcare practice following our acquisition of HSM Consulting.

In the Education and Life Sciences segment, we expect low double-digit revenue growth for 2017, and we expect operating margins will be approximately 23% to 24%. We will continue to invest in our cloud-based ERP capabilities to take advantage of the growing market opportunities.

In Business Advisory, we expect to see mid to high teen revenue growth for 2017, and we expect our operating margins in this segment to be in a range of approximately 21% to 22%.

Turning to the total Company, Huron's adjusted EBITDA margin is expected to be in the range of 15.0% to 15.8%, a decrease of 190 to 270 basis points compared to 2016. This primarily reflects the decline in projected healthcare segment margins and a shift in our overall revenue mix as the growth in our Education and Life Sciences and Business Advisory segments is expected to outpace the growth in Healthcare, which has historically been our highest margin business.

Our 2017 adjusted EPS at the midpoint of the range is $2.55, reflecting a decline of approximately 20%.

In addition to the margin factors discussed above, we are anticipating our tax rate to return to historically normal levels in 2017, accounting for a decrease of approximately $0.15 per share at the midpoint of guidance. Our 2016 rate benefited from a valuation allowance reversal and nonrecurring favorable state tax true-ups.

In addition, our 2017 tax rate will be negatively impacted by the new stock compensation rules.

As a closing reminder, with respect to adjusted EBITDA, adjusted net income, and adjusted EPS, there are several items that you will need to consider when reconciling these non-GAAP measures to comparable GAAP measures. The reconciliation schedules that we included in our press release will help you walk through these reconciliations.

Thanks, everyone. I would now like to open up the call to questions. Operator?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Tim McHugh, William Blair & Company.

Tim McHugh - *William Blair & Company - Analyst*

Just to make sure I heard the number right, the contingent fees, was that $20 million to $30 million that you said for next year?

John Kelly - *Huron Consulting Group Inc. - EVP, CFO and Treasurer*

Yes, that's correct.

Tim McHugh - *William Blair & Company - Analyst*

Okay. And I guess just to follow up because that's, I guess, an even bigger number than I would have thought, you've talked about revenues -- I know a lot of the engagements are tied because that's where you get the contingent fees from. So the weakness there, I guess it plays through, but is there more -- is this just timing of weakness and I guess we are now going to see that in contingent fees next year in terms of the pace of new engagements, or is this more of a structural shift in, I guess, how you would deliver work in that segment?

Jim Roth - *Huron Consulting Group Inc. - CEO and President*

Tim, it's Jim. I think it's more of a structural shift. I think with the -- there was a very strong correlation between the larger the job was, the more likely it was to have some performance-based fees associated with it as the average prices -- as the average size has come down significantly. I think there isn't as much pressure on our clients to look for performance-based fees. So I think if we're going to have a large $25 million, $30 million, $35 million project or greater, I think there was always a tendency for the clients to want to have some portion of that be contingent. When they are smaller, it's just not necessary. So I think this is structural as long as we don't have larger engagements in our portfolio.

Tim McHugh - *William Blair & Company - Analyst*

Okay. And another part of it, the -- I guess the education margin, what changed as much in the fourth quarter, though? It seemed the shift to cloud and so forth seemed to have been happening all year, but it seems like the margin really stepped back here late in the year.

John Kelly - *Huron Consulting Group Inc. - EVP, CFO and Treasurer*

Yes, so, Tim, I would say it is really two things. If you look at the cloud impact during the fourth quarter, it was probably its heaviest. We had a pickup in revenue related to the cloud in the fourth quarter, and that revenue at this point is still coming through at a relatively lower margin.

Mark Hussey - *Huron Consulting Group Inc. - COO*

On a full-year basis, the margin was really in line with what we expected on a full-year basis as well.

John Kelly - *Huron Consulting Group Inc. - EVP, CFO and Treasurer*

That's right.

Tim McHugh - *William Blair & Company - Analyst*

And then on Business Advisory, I guess -- or it seems organic was negative there this quarter. I know you talked about one specific area that is weak. Have you seen improvement in that [ERP] practice, or I guess what gives you confidence, I guess, in that turning around as you think about 2017?

Jim Roth - *Huron Consulting Group Inc. - CEO and President*

We have -- well, I think the mix of the service offerings that we have in that segment are still reasonably strong. I think we got hit a little bit by one of the vendors' changes in the business, which has slowed down the sales process among our clients. I think we do expect it to be improved in 2017. We don't have direct visibility into it right now, but the market certainly seems to have firmed. And so we feel good about the guidance that we have right now for that part of the business.

John Kelly - *Huron Consulting Group Inc. - EVP, CFO and Treasurer*

It's John. One thing I would point out is we did have a, for the size of that practice anyway, relatively large contingent fee come through during the fourth quarter of 2015, and we just didn't have one of those come through in 2016. So that's actually a pretty significant factor in it quarter over quarter.

Jim Roth - *Huron Consulting Group Inc. - CEO and President*

In the legacy business.

Tim McHugh - *William Blair & Company - Analyst*

Okay. And just one other one to slip in, I guess. Studer, what was the growth of that business? I didn't hear it mentioned.

John Kelly - *Huron Consulting Group Inc. - EVP, CFO and Treasurer*

I know it was about mid-single digits for the year -- full year.

Tim McHugh - *William Blair & Company - Analyst*

For full year. Okay. Alright. Thank you.

Operator

Tobey Sommer, SunTrust.

Kwan Kim - *SunTrust Robinson Humphrey - Analyst*

Hi. This Kwan Kim on for Tobey. Thank you for taking my question.

I was wondering if you could provide some color on your utilization assumption for each segment in 2017? Thank you.

John Kelly - *Huron Consulting Group Inc. - EVP, CFO and Treasurer*

Sure. For Healthcare, our expectation right now is for utilization that is relatively consistent with 2016 in the 77% area. From an ELS perspective, we are projecting higher utilization in 2017 than 2016. We expect it to be in the neighborhood of 70% -- low 70%, 72%, 73%, in that neighborhood. And then from a Business Advisory perspective, we expect it to be relatively consistent with 2016, so in the 73% to 74% area.

Kwan Kim - *SunTrust Robinson Humphrey - Analyst*

Got it. Thank you.

Operator

Randy Reece, Avondale Partners.

Randy Reece - *Avondale Partners - Analyst*

Could you give a figure for a success fee revenue for Healthcare in the fourth quarter?

John Kelly - *Huron Consulting Group Inc. - EVP, CFO and Treasurer*

For Q4, Randy, it was $14.7 million.

Randy Reece - *Avondale Partners - Analyst*

Very good. It's the -- you talked about the impact on the tax rate of the change in accounting for stock-based compensation. Is there going to be a quarter of the year where there would be an exaggerated negative impact, or will it be fairly consistent through the year?

John Kelly - *Huron Consulting Group Inc. - EVP, CFO and Treasurer*

That's a good question, Randy. It's going to be -- the heaviest impact will be in the first quarter.

Randy Reece - *Avondale Partners - Analyst*

So should we expect a significantly higher tax rate in the first quarter versus the rest the year. How did you come up with the 41% number?

John Kelly - *Huron Consulting Group Inc. - EVP, CFO and Treasurer*

The 41% is the blended rate for the entire year, but we would expect it probably to be at its highest during the first quarter and then blending out lower throughout the rest of the year to arrive at a full year of approximately 41%.

Randy Reece - *Avondale Partners - Analyst*

All right. That helps. When we are looking at the significant change in Healthcare headcount and then we have an acquisition coming in, I was wondering if you could give me a feel for how to trend out expectations for billable consulting headcount in Healthcare this year?

Jim Roth - *Huron Consulting Group Inc. - CEO and President*

I think in Healthcare -- Randy, this is Jim. I think in Healthcare, at this point until we get more visibility on the growth rates, I think we're going to be relatively flattish. It may be up or down a little bit. There certainly are areas that we may be hiring in, but I think until we get a little bit more visibility in the revenue, we are going to be pretty conservative in terms of growth.

Randy Reece - *Avondale Partners - Analyst*

You talked about the weakest part of the business late in the year was Revenue Cycle. Do you have a feel for how close that business is, maybe, to reaching a trough run rate?

Jim Roth - *Huron Consulting Group Inc. - CEO and President*

Well, that's hard to say. We had a pretty precipitous drop-off late in the year, and we have seen some indications of some strengthening in the market, Randy. But I will tell you, given the pace at which things fell off in the second half, I don't -- one of the reasons we took the approach we did guidance right now was we just need to see more before we get comfort about returning to growth. So right now, our guidance anticipates a continued reduction in the organic growth rate in healthcare for a bit, and I think we just have to wait and see how things play out.

Randy Reece - *Avondale Partners - Analyst*

With your guidance, at what point in time did you include the pending acquisition? Where does it enter into the numbers guidance-wise?

John Kelly - *Huron Consulting Group Inc. - EVP, CFO and Treasurer*

It enters in in March, Randy.

Randy Reece - *Avondale Partners - Analyst*

In March?

John Kelly - *Huron Consulting Group Inc. - EVP, CFO and Treasurer*

So basically the assumption in the guidance is that you have one month of the acquisition.

Randy Reece - *Avondale Partners - Analyst*

All right. Good. Thank you very much.

Operator

Mr. Roth, we have concluded the allotted time for this call. I would like to turn the conference back over to you.

Jim Roth - *Huron Consulting Group Inc. - CEO and President*

Thank you for spending time with us this afternoon. We look forward to speaking with you at our Investor Day on Tuesday and again in April when we announce our first-quarter results. Have a good evening.

Operator

That concludes today's conference call. Thank you, everyone, for your participation.