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HURN - Q2 2018 Huron Consulting Group Inc Earnings Call

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CORPORATE PARTICIPANTS

C. Mark Hussey *Huron Consulting Group Inc. - EVP & COO*

James H. Roth *Huron Consulting Group Inc. - President, CEO & Director*

John D. Kelly *Huron Consulting Group Inc. - Executive VP, CFO & Treasurer*

CONFERENCE CALL PARTICIPANTS

Kwan Hong Kim *SunTrust Robinson Humphrey, Inc., Research Division - Associate*

Timothy John McHugh *William Blair & Company L.L.C., Research Division - Partner & Global Services Analyst*

William Sutherland *The Benchmark Company, LLC, Research Division - Equity Analyst*

PRESENTATION

Operator

Good afternoon, ladies and gentlemen, and welcome to Huron Consulting Group's webcast to discuss financial results for the second quarter 2018. (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 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.

James H. Roth - *Huron Consulting Group Inc. - President, CEO & Director*

Good afternoon, and welcome to Huron Consulting Group's Second Quarter 2018 Earnings Call. With me today is John Kelly, our Chief Financial Officer; and Mark Hussey, our Chief Operating Officer.

Revenues grew 9% over the prior year quarter and 2% sequentially driven by organic growth in each of our 3 operating segments. Our second quarter performance reflects solid demand for our services, and we remain encouraged about our prospects for continued growth during the remainder of 2018. Although we are still in the early days of our multiyear organic growth strategy, I am pleased to report signs of progress this quarter. As I previously shared with you, we believe that the strategic actions we are taking to facilitate organic growth will improve shareholder value as our transformational efforts gain further traction. I will now provide a brief overview of the performance for each segment and then John will add color to the financials.

Let me begin with Healthcare. During the second quarter, Healthcare segment revenues increased 10% organically compared to the prior year quarter. The quarter-over-quarter increase in revenues was primarily attributable to our performance improvement and technology services solutions. Over the past year, our Healthcare team, under Mark Hussey's leadership, has developed new delivery models that are more responsive to the evolving health care marketplace. We have also unified our go-to-market strategy and made an investment in sales, operations and support to drive increased productivity and efficiency in our selling model as we accommodate a larger number of smaller, more discrete engagements. We also expanded the breadth of our offerings within the Healthcare business and collaboration across other Huron businesses. As our second quarter results indicate, we believe success from these efforts is beginning to come to fruition.

Conditions remain favorable for continued growth in the health care market. Our pipeline continues to increase and reflects a robust mix of demand for our diverse offerings in the market. As a reminder, when our work begins with an assessment phase, it is typically delivered at lower margins, but frequently leads to initial engagements and subsequently to follow-on work as well.

Our performance improvement solution is vibrant and our technology services teams have been providing a broad array of solutions to our Healthcare clients, including EHR optimization, cloud-based ERP implementation and strategic reporting and analytics. Huron has a unique competitive advantage in its ability to combine a collective set of competencies with our long-standing relationships, deep industry expertise and a reputation for delivering value. Together, we believe these attributes will put us back on track to achieve sustainable growth in our Healthcare segment.

Turning now to the Business Advisory segment. Revenues grew 6% organically over Q2 2017 primarily driven by the legacy Business Advisory, enterprise solutions and analytics or ES&A and strategy and innovation businesses. The ES&A business grew revenues organically in the upper single-digit range over the prior year quarter largely stemming from our core Enterprise Performance Management solution. Since its founding in 2013, this business has grown in its capabilities in a short period of time to position the practice as an end-to-end technology services provider, often successfully competing against much larger firms. With our collective EPM, ERP, business intelligence and CRM offerings, we help our clients make more informed decisions as they transform their organizations to compete in challenging market environments. Within this business, we are building the next level operations needed to enable ES&A to efficiently scale and continue to deliver high-quality services as we execute larger, more complex engagements and position this business for its next chapter of growth.

The legacy Business Advisory practice grew revenues organically in the low double-digit range over the first half of 2017 inclusive of several contingent fees recognized during the second quarter. In line with our focus on collaboration as part of our strategic plan, we invested in our broker-dealer solution during the quarter to build greater depth in our Healthcare M&A offerings. While this business continues to provide services to numerous commercial sectors, we are highly focused on growing our Healthcare M&A capabilities. We believe the combination of Huron's strategy, operations and M&A offerings, coupled with deep industry expertise, will further position us as the premier transformation partner to an expanding array of Healthcare clients.

The strategy and innovation business also grew organically in the mid-teen range over the second quarter of 2017. Innosight's future back and dual transformation approach to strategy continues to resonate with clients, including in the health care, life sciences, financial services and retail and consumer goods industries.

Finally, excluding the impact of the divestiture of the compliance and operations business in Q2 of last year, the Life Sciences business was down slightly quarter-over-quarter.

In the second quarter of 2018, the Business Advisory segment generated approximately 29% of its total revenues in the health care and education industries, building on the strength of our deep industry expertise and broad, strategic, financial and technical competencies.

Turning now to Education. Education segment revenues in the second quarter of 2018 grew 10% organically over the same period in 2017 primarily driven by solid growth in our research solution. The rapid pace of change across the higher education landscape, combined with increasingly competitive academic and research environments, is creating demand that we believe will continue to grow for the foreseeable future. To support this demand, we continue to make investments in our people. We are accelerating the hiring of resources and in the technology areas of the Education business, we are also executing our focus on transitioning our skills from on-premise to cloud-based technologies. We believe this business remains well positioned to address the increasingly complex and competitive challenges facing higher education and research institutions.

Let me now turn to our 2018 guidance. As our press release indicates, we are increasing our annual revenue guidance to $755 million to $775 million and narrowing and lowering our GAAP earnings per share guidance to $0.85 to $1.05. And on a non-GAAP adjusted basis, our updated EPS guidance is $2 to $2.20. We raised our revenue guidance to reflect the current and anticipated demand for our services across all segments. We narrowed our EPS guidance around the low end of our previously stated range, reflecting the strategic investments we continue to make in our business to position the company for sustainable growth. The narrowing of our EPS guidance was also due to pressure on our full year tax rate, primarily attributable to the impact of our share-based compensation. We remain focused on driving long-term shareholder value through organic growth, which we anticipate will lead to improved profitability over time. As stated on prior earnings calls, if 2018 goals are met, the cost of restoring bonuses to competitive levels to retain talent impacts our current year margins. We strongly believe that this action is essential to executing our organic growth strategy and benefits our shareholders over the long term by retaining our high-performing, revenue-generating professionals as we compete in the increasing war for talent in a growing U.S. economy.

We continue to believe 2018 will be a baseline from which we can sustainably grow our margins in the future consistent with our long-term financial objectives. We are highly focused on increasing margins by driving deeper operational efficiencies across our business segments and leveraging our G&A as we continue to organically grow our revenues. We anticipate that our margins will begin to improve in 2019 consistent with our strategic plan. We are focused on establishing a strong foundation from which we can grow organically. Although we recognize we have more work to do, the past 2 quarters have provided us with some preliminary comfort that the base has been established and we believe that we are now at a point where growth in our business should be more sustainable. Similarly, we have internal expectations to achieve meaningful improvements in our margins in the years ahead as we pursue our organic growth strategy.

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

John D. Kelly - *Huron Consulting Group Inc. - Executive VP, CFO & 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-Q 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 and why management believes they provide useful information to investors regarding our financial condition and operating results. Also, unless otherwise stated, my comments today are all on a continuing operations basis.

Now let me walk you through some of the key financial results for the quarter. Revenues for the second quarter of 2018 increased 8.9% to $197.5 million compared to $181.4 million in the same quarter of 2017. The increase in revenues in the quarter was driven by organic growth across all 3 segments. Net income was $5.9 million or $0.27 per diluted share in the second quarter of 2018 compared to net loss of $150.5 million or $7 per diluted share in the same quarter last year. The net loss was primarily attributable to the $210 million noncash pretax goodwill impairment charge recorded in the second quarter of 2017 related to our Healthcare segment.

Our effective income tax rate in the second quarter of 2018 was 30.4% compared to 26.2% a year ago. Our effective tax rate for Q2 of this year was higher than the statutory rate inclusive of state income taxes due to nondeductible business expenses.

Adjusted EBITDA was $24.7 million in Q2 2018 or 12.5% of revenues compared to $24.5 million in Q2 2017 or 13.5% of revenues.

Adjusted non-GAAP net income was $12.8 million or $0.58 per diluted share in the second quarter of 2018 compared to $10.6 million or $0.49 per diluted share in the same period of 2017.

Now I'll make a few comments about the performance of each of our operating segments. The Healthcare segment generated 46% of total company revenues during the second quarter of 2018. This segment posted revenues of $91.5 million for the second quarter of 2018, up $8.3 million or 9.9% from the second quarter of 2017. This increase in revenues is primarily attributable to the increase in demand for our performance improvement and technology services solutions, partially offset by a decline in revenue for Studer Group primarily related to cancellations during the first half of 2017. Performance-based fees in Q2 2018 were $9.2 million compared to $4.5 million in the same quarter last year. Our full year expectation for the range of performance-based fees is now $30 million to $40 million. Operating income margin for Healthcare was 29.6% for Q2 2018 compared to 28.4% in the same quarter in 2017. The year-over-year increase in operating margin was primarily attributable to revenue growth that outpaced expenses. We expect full year operating income margin for the Healthcare segment to be in the low 30% range.

The Business Advisory segment generated 29% of total company revenues in the second quarter. The segment posted revenues of $57.7 million for the second quarter of 2018, an increase of 6.4% compared to $54.3 million in Q2 2017. The operating income margin for Business Advisory was 24.6% for Q2 2018 compared to 22.5% for the same quarter in 2017. The increase in operating income margin in the quarter is primarily attributable to a decrease in salaries and related expenses as a percentage of revenues and reflects $2.3 million of success fees earned by our legacy Business Advisory practice during the quarter as well as improved performance by a relatively higher-margin Innosight practice. We continue to expect full year operating income margin for the Business Advisory segment to be in the 22% to 23% range.

The Education segment generated 25% of total company revenues during the second quarter of 2018. The segment posted record quarterly revenues of $48.3 million in Q2 2018, an increase of 10% compared to revenues for Q2 of 2017 of $43.9 million. The operating income margin for Education segment was 23.3% for Q2 2018 compared to 28.4% for the same quarter in 2017. The decrease in operating income margin in the quarter was primarily attributable to increase in salaries and related expenses for our revenue-generating professionals and promotion and marketing expenses both as a percentage of revenue. I also want to highlight that we made several investments in client projects to ensure we achieve transformational success for our clients and develop strong referral sources for future cloud engagements. These investments had an impact on our bill rates during the quarter, but we do not believe this will be an ongoing trend. We expect that our efforts on these projects will benefit future projects with similar scopes of work. We expect full year Education segment operating income margin to be in the 24% to 26% range.

Other corporate expenses not allocated at the segment level were $31.2 million in Q2 2018 compared with $30.7 million in Q2 2017.

Now turning to the balance sheet and cash flows. DSO came in at 64 days in the second quarter of 2018 compared to 67 days for the first quarter of 2018 and 59 days for the fourth quarter of 2017. The increase in DSO from the fourth quarter reflects the impact of certain projects where contractually scheduled billings are set to occur and be collected during the second half of 2018.

Total debt includes the $250 million face value of convertible notes, $110.5 million in senior bank debt and a $5 million promissory note for total debt of $365.5 million. We finished the quarter with cash of $10 million for net debt of $355.5 million, a decrease of approximately $31.5 million compared to net debt of $387 million as of the end of the first quarter. We ended Q2 2018 with a leverage ratio, as defined in our recently amended and extended senior secured credit agreement, of approximately 3.4x adjusted EBITDA. Consistent with prior comments, we expect our leverage ratio to be below 3.0x by the end of the year.

Cash provided by operating activities for the quarter was $43.2 million. We continue to expect cash from operating activities for the year of $95 million to $105 million. Less capital expenditures of roughly $15 million, we continue to expect free cash flow for the year of $80 million to $90 million, net of cash taxes and interest and excluding noncash stock compensation.

We now expect our full year effective tax rate to be 32% to 34%, reflecting the headwind of share-based awards vesting during 2018 at a lower price than the original grant date price.

Finally, as Jim noted, we are raising our full year 2018 revenue guidance to $755 million to $775 million. In addition, we are updating our net income range to $19.5 million to $22.5 million and earnings per share range to $0.85 to $1.05 per share.

On a non-GAAP basis, we are narrowing our adjusted EBITDA guidance to $87 million to $93 million and adjusted non-GAAP earnings per share guidance to $2 to $2.20 per share. Our earnings guidance reflects the strategic investments we continue to make in our business to position the company for continued growth in 2019 as well as the higher effective tax rate than originally forecasted.

We believe we have now stabilized the Healthcare business and are in a position to accelerate a discrete number of initiatives across the company to support our future growth. As Jim mentioned, we are highly focused on driving long-term shareholder value through organic growth and margin expansion.

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 walk you through these reconciliations.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) The first question comes from Tim McHugh of William Blair.

Timothy John McHugh - *William Blair & Company L.L.C., Research Division - Partner & Global Services Analyst*

Could you just, I guess, maybe talk a little bit more about the expenses? And I know you talked about some decisions you made or I guess, areas you invested in. But I guess just coming off the first quarter where expenses were a lot higher than expected and I think you kind of said it was consistent with what you expected at that time. So did opportunities come up throughout the quarter? I guess, walk us through maybe the thought process on spending levels at this point and the pace at which you're making investments?

John D. Kelly - *Huron Consulting Group Inc. - Executive VP, CFO & Treasurer*

Sure, Tim. This is John. I'll start. As the year has progressed and the business evolved and as we've started to execute on our organic growth strategy, these investments do represent incremental expenses that we believe are driving current and future growth and are ultimately going to add value and contribute to margin expansion over time. Just some examples within Healthcare, we're making investments in sales resources and client assessments. Within Education, we're investing in cloud resources and related training. And then within the Business Advisory segment, we've invested in Healthcare M&A resources as well as supporting infrastructure for our ES&A team. So I believe that all these items are going to lead to revenue growth and that our margins are going to expand over time.

Timothy John McHugh - *William Blair & Company L.L.C., Research Division - Partner & Global Services Analyst*

I guess maybe just a follow-up, can you, I guess, quantify the size of all those? I think a little bit probably just given the magnitude of the revenue strength, surprising that you can't fund it with that amount of revenue?

John D. Kelly - *Huron Consulting Group Inc. - Executive VP, CFO & Treasurer*

In total, we estimate these items are approximately a 50 basis point headwind to our full year EBITDA margin. I'll also note that we incurred modest operating loss in the Middle East during the first 4 months of the year prior to our sale of this business. That was probably about a 20 basis point headwind on the first half. So we don't expect to incur any more losses related to the Middle East at this point.

Timothy John McHugh - *William Blair & Company L.L.C., Research Division - Partner & Global Services Analyst*

Okay. And then just on that one, what's the drag to revenue now as you sold that business in the second quarter?

John D. Kelly - *Huron Consulting Group Inc. - Executive VP, CFO & Treasurer*

It's very minimal, Tim. The entire revenue for the first 6 months was very low single digit million dollars.

Operator

Our next question comes from the line of Tobey Sommer of SunTrust.

Kwan Hong Kim - *SunTrust Robinson Humphrey, Inc., Research Division - Associate*

This is Kwan Kim on for Tobey. First, could you talk about the $7 million litigation item on the income statement for the quarter?

John D. Kelly - *Huron Consulting Group Inc. - Executive VP, CFO & Treasurer*

Yes. There's really 2 components within that item that get adjusted out. We had a $2.5 million gain related to the settlement of a legal case during the quarter. We collected the cash during the quarter. And then we had an adjustment to the fair value of our earn-out liability for another $4 million. And those 2 items together total probably that $7 million that you're looking at. Now as it relates to the earn-out's fair value exercise, we do that every quarter. And that's probably something that we expect to be volatile over time. It's likely that, that may go up or down as we progress through the year.

Kwan Hong Kim - *SunTrust Robinson Humphrey, Inc., Research Division - Associate*

Okay. And on the use of cash, is debt reduction still the most likely use of cash over the next 4 quarters?

John D. Kelly - *Huron Consulting Group Inc. - Executive VP, CFO & Treasurer*

It is.

Kwan Hong Kim - *SunTrust Robinson Humphrey, Inc., Research Division - Associate*

So that you're targeting below 3.0?

John D. Kelly - *Huron Consulting Group Inc. - Executive VP, CFO & Treasurer*

It is, Kwan. I would say that definitely remains the priority certainly through the back half of the year. We expect to be below 3x by the end of the year. We'll have our bonus payouts during the first quarter next year so you'll likely see an increase in borrowings during that quarter, but then we expect to get below 3x again shortly thereafter.

Kwan Hong Kim - *SunTrust Robinson Humphrey, Inc., Research Division - Associate*

Okay. And on the Education margin, that's down year-over-year, you said that's a result of higher salary. Are bonuses part of that increase in expenses or is it just purely salary?

John D. Kelly - *Huron Consulting Group Inc. - Executive VP, CFO & Treasurer*

That salary comment really relates to the increase in headcount year-over-year. We've had a significant increase in headcount as we build for organic growth. I'd say the primary driver of the decrease in bill rates and then that impacted margins for the quarter was we did have several large projects when we made some resource investments during the quarter to ensure success for our clients on those projects. And we think that's going to be a good foundation for those types of projects for us in the future. And we don't necessarily expect those items to repeat going forward.

Kwan Hong Kim - *SunTrust Robinson Humphrey, Inc., Research Division - Associate*

Okay. And lastly, is the 7% year-over-year consultant headcount growth in the second quarter a good proxy for your annual plans or will the summer hiring season change the rate of growth?

John D. Kelly - *Huron Consulting Group Inc. - Executive VP, CFO & Treasurer*

I'd say from a headcount growth perspective, I think that's a good proxy, generally speaking.

Operator

Our next question comes from Bill Sutherland of Benchmark.

William Sutherland - *The Benchmark Company, LLC, Research Division - Equity Analyst*

Jim Roth, can you talk a little bit about the breadth that you're increasing in the Healthcare capabilities beyond your bread-and-butter?

James H. Roth - *Huron Consulting Group Inc. - President, CEO & Director*

Yes. So I'm going to actually let Mark handle most of that, but just as a reminder, it wasn't that long ago that a majority of our work, our capabilities in that business were really strictly around performance improvement and revenue cycle. And even though those are still very prominent parts of our business, the team in the last couple of years has dramatically changed the business through a very significant transformation. Mark is probably the best one to talk about that. Mark, you want to handle that part of it?

C. Mark Hussey - *Huron Consulting Group Inc. - EVP & COO*

Sure. Bill, so the way I would describe what we've done in Healthcare is really bring this whole notion of flexible delivery models to -- based on really the client's concept of the problems they're trying to solve. And within really 4 pillars of how we go to market, we have strategy, innovation, which largely has been Innosight and very successful on that side. Our leadership component in patient experience, which is around Studer Group, technology services, which is around our EHR services and then our traditional performance improvement, which is revenue cycle and cost and clinical. In each of those areas, what I would characterize is that the ability to really unlock value by bringing them together in different ways to differentiate has been one element of success. And then I think just in general, having a much more flexible focus to the market, which is often leading to perhaps a little bit smaller engagement sizes, which is perfectly fine, but then it also sets the stage for follow-on work as well. So it's actually gone pretty well. And then outside of the Healthcare practice, we continue to focus on the other businesses that sell into Healthcare. Jim mentioned the M&A capability in the broker-dealer in Healthcare. That continues to be a bright spot early on in the evolution of that. And then our ES&A practice, which actually has worked a lot on more of the advanced analytics and those kinds of technical applications, those are also being brought into Healthcare on a collaborative basis.

William Sutherland - *The Benchmark Company, LLC, Research Division - Equity Analyst*

Specifically on Studer, are they doing better quarter-over-quarter? Is this just a year-over-year issue in the second quarter?

John D. Kelly - *Huron Consulting Group Inc. - Executive VP, CFO & Treasurer*

Yes. From revenue perspective, Bill, I'd say sequentially, they did do a little bit better Q2 versus Q1. I'd say they're still performing during the year in line with what our expectations for the full year was, really no change there from a financial perspective. And to your point, it is just a year-over-year headwind related to some of the cancellations that we talked about a year ago.

C. Mark Hussey - *Huron Consulting Group Inc. - EVP & COO*

Go ahead, Bill.

William Sutherland - *The Benchmark Company, LLC, Research Division - Equity Analyst*

I was just going to say, so the cancel rate there has kind of normalized for Studer?

C. Mark Hussey - *Huron Consulting Group Inc. - EVP & COO*

Yes. So let me add some color to John's comment. Things have stabilized dramatically. I think when we described this a year ago, it was some of the more large national systems that were doing some in-sourcing and the like. And we largely worked through the impact of that, but what we're doing with Studer Group in many respects, they have this -- as the market is shifting and just like we're talking about flexible delivery models in some of the other areas of the business, within Studer really is very much the same concept. And that is starting to take hold and accelerate. And really as we look at where this business is going, really not only within the acute market, but really outside of just the pure acute market as well, in the pre-acute as well as post-acute settings. We think we've got -- continue to have very attractive opportunities for this business.

William Sutherland - *The Benchmark Company, LLC, Research Division - Equity Analyst*

Great. And then just the last one. Kind of curious how much impact the pressures that are emerging across the -- particularly the hospital sector relative to the reimbursement side and the cost side and then just competitive issues in general. Is this leading to more inquiries or are they kind of like a little frozen in place at the moment? I'm kind of curious kind of the status of the market.

C. Mark Hussey - *Huron Consulting Group Inc. - EVP & COO*

No. I think the pipeline is good. I would say the market uncertainties are playing in a way that's been favorable for the business, for our business. I think there's continuing pressure on reimbursements. There's rising costs. You look at the amount of staffing labor that's going into the health care market at higher costs. There's a shortage of nursing. I mean, there's all kinds of just structural issues right now that, I think, are driving the needs for our services. And right now I don't see that there's any global solution that's going to change that in the short term. So I would say our clients are taking a very comprehensive and broad view of their businesses, and that's leading to opportunities in technology, in leadership, in performance improvement as well as strategy.

Operator

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

James H. Roth - *Huron Consulting Group Inc. - President, CEO & Director*

Thank you for spending time with us this afternoon. We look forward to speaking with you again in October when we announce our third quarter results. Have a good evening.

Operator

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