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TOM2.AS - Q2 2019 TomTom NV Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to TomTom's Second Quarter and Half Year 2019 Earnings Conference Call. (Operator Instructions) Please note that this conference is being recorded.

I would now like to turn the conference over to your host for today, Bruno Priuli, Investor Relations Officer. You may begin.

Bruno Priuli - *TomTom N.V. - IR Officer*

Thank you, operator. Good afternoon, and welcome to our conference call during which we will discuss our operational and financial highlights for the second quarter and half year 2019.

With me today are Harold Goddijn, our CEO; and Taco Titulaer, our CFO. We will start today's call with Harold, who will discuss the key operational developments, followed by a more detailed look at the financial results from Taco. We will then take your questions.

As usual, I would like to point out that safe harbor applies.

And with that, Harold, I would like to hand it over to you.

Harold C. A. Goddijn - *TomTom N.V. - Co-Founder, Chairman of the Management Board & CEO*

Yes, thank you very much, Bruno. Welcome, ladies and gentlemen. Thank you for joining us today. The positive revenue trend continued into the second quarter. Location Technology was growing with 25% year-on-year and free cash flow from operation was an inflow of EUR 16 million for the quarter. Taco will provide further information on the financial highlights and the outlook for the year later during this presentation. I will discuss the key operationals for this quarter.

We finalized the Telematics divestment to Bridgestone and returned close to 90% of the net cash proceeds to shareholders. We received EUR 873 million from the operation, which amounts to a net gain in our P&L of EUR 807 million. We are now a more focused company with clear priorities and a simplified operating model.

Our map-making platform matured further during the quarter. We made a record 1.9 billion modifications inmap database in a single month, which is a record. Investments in machine learning resulted in a higher degree of automation, faster cycle timesand lower operational costs per modification.

For our technology customers, we launched much improved Maps SDK for web applications during the WeAreDevelopers World Congress in Berlin. Our Maps SDK allows clients to add maps, search, routing, traffic, geofencing and other functionality to their website applications, allowing them to easily add store locations, route planners and other features.

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On the next slide, I'd like to take the opportunity to give you a brief overview on our wins in the year. As we look back on first half of the year, we're excited about the opportunity we see from automated driving, improved levels of car connectivity, electrification, but also for Maps APIs.

Automated driving technology is generating significant interest in new detailed maps that will help to transform the way we think about driving. ADAS, or advanced driver assistance systems, are starting to become mainstream and will play a crucial role in preparing the technology for high degrees of automation, eventually leading to the autonomous car.

Electrified vehicles are also becoming mainstream within the next couple of years and new data and software-based services for route-dependent range charge planning.

We've made good progress in developing products that will strengthen our competitive position.

In automated driving, we won the first 2 HD map deals that came to the market earlier this year and being operational, building on an early user base is important for us as it allows us to collect user feedback and sensor data, which are both crucial to further develop our product offerings and for winning new contracts. We are currently progressing in our development road map, increasing automation and productivity of both ADAS and HD map-making systems and we are growing our coverage.

In our connected navigation and electric vehicle solutions, we announced new deals earlier this year with Volkswagen Group, Nissan, FCA and MG. And we also launched a new service, TomTom IQ Maps, which is a mechanism that allows for seamless over-the-air map updates for in-dash navigation systems.

In Maps APIs, we extended and matured our partnership with Microsoft, and we think that's a strong proof point of the competitiveness of our product portfolio. We have also improved our APIs on our own developer portal.

This concludes my part of presentation. I am now handing over to Taco for a detailed overview of the financials.

Taco J. F. Titulaer - *TomTom N.V. - Member of Management Board & CFO*

Thank you, Harold. Let me take a couple of comments on the financials and the outlook for the year and then we can go to the Q&A.

In the second quarter of 2019, we reported group revenue of EUR 211 million, which is 12% higher compared with last year. The driver of this growth is the Location Technology business, which grew 25% year-on-year to EUR 116 million, which represents 55% of the revenue.

Let me go through the businesses one by one. Automotive revenue was up by 21% to EUR 76 million in the quarter. This is combination of higher volumes from existing customers and NRE revenue, which is revenue related to integration activities for our Automotive customers andis recognized in the P&L at the start of production of car lines.

We expect Automotive to grow with close to 15% for the full year. We expect less NRE revenue recognition in the second half of the year, which will have a positive effect on our gross margin.

Then, Enterprise revenue. It was up at 34% to EUR 40 million in the quarter, mainly due to the expansion of our partnership with Microsoft. For the full year, we expect to grow at more than 20%.

Consumer revenue was flat in the quarter at EUR 95 million. The strong start of the year was result of the replacement sales due to the GPS week numberrollover issue, which impacted older generation devices and pulled forward demand for our PNDs. For the year as a whole, we expect a slowerpace of decline compared to our previous guidance and it's now around minus 15%.

Gross margin for the quarter was 67% compared with 70% in Q2 2018. The year-on-year decrease was caused by the start of production of various car models of our Automotive customers, which triggers an uptick in revenue, but also the release of capitalized contract costs associated with customization and integration activities, the so-called NRE. For the full year, we expect the gross margin of at least 70%.

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Total operating expenses in the quarter was EUR 225 million, an increase of EUR 104 million compared with the same quarter last year, mainly due to the increased amortization related to the Tele Atlas acquisition back in 2008. I will come back on that when I discuss the outlook.

Apart from a higher D&A, the R&D expenses increased due to higher personnel costs to support our growing Location Technology business.

Then EBITDA. It decreased by 31% in the quarter to EUR 31 million and EBITDA margin of 15%. As explained during the 2019 outlook presented in February, we shifted CapEx to OpEx cash spending due to the maturity of our map products.

CapEx declined by 64% in the first half of the year from EUR 42 million in 2018 to EUR 15 million in 2019.

Free cash flow before financing, excluding the net cash inflow from the Telematics transaction, was an inflow of EUR 16 million in the quarter, which is flat year-on-year. The higher cash generated from operations was offset by higher tax cash out. Year-to-date, we increased our cash position with EUR 120 million. We now have EUR 372 million of cash and no debt. The increase is mainly due to the net cash inflow of the Telematics transaction after the capital repayment to shareholders. We expect the full year cash position to be well over EUR 400 million.

Our deferred revenue position is now EUR 297 million compared with EUR 281 million at the end of 2018. The increase is driven by Automotive deferred revenue, offset by releases of the deferred revenue position in Consumer and in Enterprise.

Let's now continue to the next slide to have a look on the Automotive operational numbers. As you know, there is a difference between revenue we invoice and the revenue we report, the latter tends to be lower in a growing business as we follow IFRS 15 accounting standards. As shown before, this slide highlights the operational revenue of Automotive. Operational revenue is the reported revenue plus the net change in the deferred and unbilled revenue positions.

Automotive operational revenue increased by 26% year-on-year to EUR 90 million. For the full year, we expect operational revenueto increase with around 20%.

I would now like to comment on the 2019 guidance on the next slide. We are updating our full year outlook. Let me reiterate some of the elements. We now expect group revenue to total EUR 700 million, of which EUR 435 million from Location Technology revenue. Location Technology revenue is expected to grow by around 17% year-on-year due to the ramp-up of existing Automotive contracts and the extension of a partnership in Enterprise. Consumer is expected to decline by 15% year-on-year. This is at a slower pace than initially anticipated as the GPS week rollover issue pulls forwardreplacement sales.

Gross margin of at least 70% in the year. In 2019, we expect the total D&A to amount to EUR 290 million, of which nearly EUR 210 million is due to the acquisition-related amortization. For 2020, we expect roughly the same amount as in 2019. As of 2021, we expect total D&A to drop to around EUR 75 million. The acquisition-related amortization will be by then close to nil. The acquisition-related amortization is excluded from theadjusted earnings per share calculation.

I would now like to comment on the adjusted earnings per share and the free cash flow as a percentage of revenue in the next 2 slides.

The 2019 adjusted earnings per share outlook is unchanged at EUR 0.15. The share consolidation reduced the weighted average of diluted shares from 233 million to 169 million for the full year 2019. Although the effect of the expected increase of revenue on a lower number of shares was offset by a further shift from CapEx to OpEx due to the maturity of our map products as well as a higher unbilled revenue position.

To conclude, I would now like to comment on the seasonality of our free cash flow in the next slide. The first half of the year was an expected cash outflow due to the natural seasonality of our business, as the beginning of the year is marked by settlement of personnel and other liabilities, while the second half sees a higher volume of customer payments. For the full year, we expect free cash flow as a percentage of revenue to be around 9%. The slight decrease in the outlook is a result of a higher unbilled revenue position, which impacts the timing of cash inflow.

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Operator, we would now like to start with Q&A session.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And your first question comes from the line of Wim Gille.

Wim Gille - *ABN AMRO Bank N.V., Research Division - Head of Research & Equity Research Analyst*

Can you hear me?

Harold C. A. Goddijn - *TomTom N.V. - Co-Founder, Chairman of the Management Board & CEO*

Yes, we can hear your, Wim.

Wim Gille - *ABN AMRO Bank N.V., Research Division - Head of Research & Equity Research Analyst*

A couple of questions from my side. First of all on the, let's say, change in the capitalization policy and the change in the amortization related to Tele Atlas and then more regarding the timing, why here and now. So why didn't you make the decision back in the fourth quarter because now people have to digest, let's say, 2 big changes, I would say, in the accounting in a short period of time? So why didn't you do this back in the fourth quarter in one big go? And also in the same line of thought, why didn't you decide to just amortize and impair the whole total this year rather than do it in 2 years? And why don't you do it now? That's kind of the first question.

The second question, still related to D&A. You mentioned during the prepared remarks that the D&A profile post all the changes. So as of 2021, would amount to about EUR 75 million, but your CapEx is more closer to EUR 35 million. So should we just model for that gap between D&A and CapEx in 2021 to close in a matter of 6 years? Is that the way to look at it or will that reduce in a step-by-step or in a quicker way? So that is kind of the D&A questions.

Then on the operational side, I think you're making great progress or at least you mentioned great progress in your SD Map moving from, let's say, 59 million kilometers in the last update to 67 now and moving from 183 countries to 194. And also you made 1.9 billion automatic changes versus 1.5 billion in the previous guidance. So can you tell us where do you think you stand vis-à-vis the competition on the SD Maps and the significant operational improvements that you're making in that area? And can you also give us a bit of feeling on the progress you're making on the HD Maps, which obviously is much more important for the future? And then I've got 2 more follow-ups, but let's start with these 2 first.

Taco J. F. Titulaer - *TomTom N.V. - Member of Management Board & CFO*

Let me dive into the D&A questions. Indeed, as of 2021, we expect D&A to decline to EUR 75 million. CapEx this year is expected to be roughly EUR 35 million. If all things are equal, which never happens obviously, but then you could also say that CapEx is EUR 35 million in 2021. The gap between these 2 will narrow, indeed, but not completely close because there is also something in between, related to IFRS 16, which is our lease liabilities of EUR 15 million in total. So over time, our D&A will come down, but not completely to the EUR 35 million.

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The discussions on accelerating the amortization of our Tele Atlas acquisition were started early this year and that's also why in Q2 you see the accelerated amortization also from Q1 in there. They took several months to conclude, and we have concluded it in Q2. Yes, with hindsight, things could also always be at a different time, but this is what it is. We started the discussion at the start of Q1 and it took several months to conclude. And it was agreed that we would reduce the useful life of the asset from 20 to 12 years or from the remaining 10 to 2 years, and not write it all off in one go in Q2.

Wim Gille - *ABN AMRO Bank N.V., Research Division - Head of Research & Equity Research Analyst*

Is there any reason why the accountant didn't allow you to do so? Because, I mean, you're just cleaning up the balance sheet, which I think is a good thing, but it doesn't add any value to kind of make it in 2 years? Or is it just what the accountant told you to do and we have to live with it?

Taco J. F. Titulaer - *TomTom N.V. - Member of Management Board & CFO*

We think this is the right decision. And we take advice of our counsel, obviously, but we stand with our decision to do this in 2 years.

Harold C. A. Goddijn - *TomTom N.V. - Co-Founder, Chairman of the Management Board & CEO*

I think, you're right on the SD Map, good progress in terms of both coverage but also productivity. Total spend onmaps is now declining, but we get more coverage faster at a lower price per kilometer. So we're happy with that. we see further improvements on the horizon in SD map making. The level of automation is increasing, and yes, we're quite happy about these results. They have been planned for. We have finally started to see significant improvements as a result of investments in technology in the last 3, 4 years.

So you asked me, how are we doing compared to competition? Difficult to say. We don't have full transparency, but we do believe that we have an efficient operation here and probably the most efficient map-making platform. Although there are no hard numbers to support that obviously because competition is keeping that hidden obviously for commercial reasons. But we think we're doing well. Map quality is good, coverage is increasing and the level of automation keeps going up.

On the HD Map, it's a different process. The process leads itself for high degrees of automation, higher than in SD Maps actually, and we're working on the process to fully and automatically process those maps. We're not there yet. There is still quite a bit of manual labor involved, but we're ironing that out, that won't happen overnight, but we do believe we can reach a state where HD Map production can be automated to a very high degree. And that is important because we're now covering the major roads and the closed access roads. There will also be demand to expand that coverage as adding a lot of kilometers, and we need to be ready to be able to process that in a highly automated way in order to control cost. But again, I'm kind of happy where we are, but there is more to be done, especially on the HD Map production cycle.

Wim Gille - *ABN AMRO Bank N.V., Research Division - Head of Research & Equity Research Analyst*

And regarding the HD Map production cycle, when would you expect that to finish, i.e., when will you...

Harold C. A. Goddijn - *TomTom N.V. - Co-Founder, Chairman of the Management Board & CEO*

Well, there are 2 elements. So there is the initial HD map-making process where you cover roads for the first time, that is within reach, but the next level of sophistication will be updating that map and updating that map based on sensor data, video data that we can get out of the car and from other sources, and that is a bit further down the road. So all in all, it's not an investment in production technology that will come to 0 any time soon. I fully expect that over the years to come, we will continue to invest in production engineering.

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Wim Gille - *ABN AMRO Bank N.V., Research Division - Head of Research & Equity Research Analyst*

Good, good. And then my last question would be on Azure. The migration to Azure has been completed, as I understand, but if I look at Bing Maps and whatever, I still see your competitor listed in the footnotes. So when do you think Microsoft will be ready to have the TomTom products on its entire platform? And in relation to, let's say, your integration within Azure, can you also tell us a bit on what you see in terms of adoption amongst the developer community? Also at the conference that you attended in Berlin recently, do you see any progress on the number of developers that are linking into the platform?

Harold C. A. Goddijn - *TomTom N.V. - Co-Founder, Chairman of the Management Board & CEO*

Yes, I think, if you look at the partnership with Microsoft, we have 2 important initiatives underway. First is powering Azure, Location Technology with our maps APIs. That's done. The Azure Maps APIs are based on TomTom technology wrapped around our APIs. Development of those APIs will continue obviously, but that transition has happened.

On the Bing side, that's not yet the case. That will take more time before their own location services platform. The Bing platform will run on TomTom content, but we're working on the preparation for that. So if you say the transition to Azure has been finalized, I don't know exactly what you mean by that, but this is not yet the case for the Bing mapping platform. That will happen in the future.

Wim Gille - *ABN AMRO Bank N.V., Research Division - Head of Research & Equity Research Analyst*

Good.

Harold C. A. Goddijn - *TomTom N.V. - Co-Founder, Chairman of the Management Board & CEO*

We're happy with the progress in adoption. It's still a relatively small user base. It takes time to build up that community, but we see good interest and good wins. So we like what we're seeing, but to develop it in a sizable business will take time, and that is fully to be expected. Those are products that are part of other people's applications. Those applications need to be built. They need to be redesigned to accommodate our APIs. But the beauty, of course, is that it is a sticky product. We continue to grow, and hopefully, those developers will stay with us for a very, very long time.

Operator

Your next question comes from the line of Marc Hesselink.

Marc Hesselink - *ING Groep N.V., Research Division - Research Analyst*

Firstly, the change in the guidance. Can you talk a little bit about some underlying things? Firstly, your gross margin guidance is unchanged. However, in the line there is more Consumer and maybe a bit more in the NRE what you already explained. I would say that normally that would be negative for the mix. So does it mean that there's an underlying improvement in some of the elements?

And also relating back to that, related to the P&L, you gave a bridge on the underlying EPS. Given that I think the unbilled revenues is more of a timing issue than anything else, so can we read that the underlying improvement of your EPS guidance is EUR 0.10? Or is that because the OpEx and CapEx is also just accounting changes, is that fair to say? Then the second question is on what you're seeing in Automotive in the order book, and I know you don't give the order book on a quarterly basis anymore, but could you say something as a trends, is your book-to-bill still well above 1 or what are you seeing there? And also you have a small increase in the guidance on Automotive. So what's happening there, as in what's the reason for the increase on that number? Is that there is a higher adoption rate or probably something else?

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Taco J. F. Titulaer - *TomTom N.V. - Member of Management Board & CFO*

So let me take the first part of your questions. On gross margin, the NRE was not unexpected. The fact that, that caused an increase of our revenue and a decrease of our gross margin, that was not expected. So we stand with our guidance of gross margin of north of 70%. We only mentioned it to explain why the gross margin in Q2 this year was lower than the gross margin in Q2 last year. So this was not unexpected, what was unexpected was the tailwind that we saw in Consumer, that's true. So indeed, if we sell more hardware relatively in the mix, that could havesome pressure on gross margin, but well, the guidance for the full year of gross margin north of 70% simply still stands and apparently, we have enough headroom there to continue with that guidance.

On the adjusted earnings per share, it is indeed. We said EUR 0.15 and we ended up with EUR 0.15. There are some elements in there that are positive, like the share consolidation and the business performance. Other things are more timing of cash, when you receive cash indeed, and the split between CapEx and OpEx. it's hard to say what it would have been if everything would not have happened, but indeed, it is true that the business performance also articulated in our guidance uplift, since it has been stronger than at the start of the year. What was your last question again?

Marc Hesselink - *ING Groep N.V., Research Division - Research Analyst*

Automotive...

Taco J. F. Titulaer - *TomTom N.V. - Member of Management Board & CFO*

The order intake?

Marc Hesselink - *ING Groep N.V., Research Division - Research Analyst*

Yes, so combination of things. So one, we see that you have a small increase in the revenue guidance for Automotive. So what is driving that? Is that higher uptick? Also maybe in the light of that, over the last couple of years, I think the actual revenues that you reported in Automotive has been more than every year than you initially thought. So that momentum has been stronger, I think, than you initially guided at the beginning of the year. It seems that we see something similar again today. So I would like to understand what's under the radar there?

Harold C. A. Goddijn - *TomTom N.V. - Co-Founder, Chairman of the Management Board & CEO*

Well, I don't think there's anything under the radar apart from the fact that the take rates of our products end up higher than initially expected. So it's not related to unforeseen large customer programs because we see those coming years in advance, but it is just related to actual take rates. So the royalties that we collect is a factor of our market position, car sales but also take rates. Especially the latter, the last 2 to 3 years continues to be higher than earlier indication that we also receive from the car industry and what we can report.

Marc Hesselink - *ING Groep N.V., Research Division - Research Analyst*

Okay, clear. And then the Automotive order book, is that something you can say about it? It is still well above 1 book-to-bill or...

Harold C. A. Goddijn - *TomTom N.V. - Co-Founder, Chairman of the Management Board & CEO*

The order intake is developing according to plan. As you know, we don't give detailed information about the absolute value of the intake until later, but we are doing what we're supposed to be doing.

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Marc Hesselink - *ING Groep N.V., Research Division - Research Analyst*

Okay. And then maybe as a final question, your cash position, you guided to be well above EUR 400 million again. It's a bit of a recurring theme, I guess, but anything you can say about that? Or you want to keep that large position?

Taco J. F. Titulaer - *TomTom N.V. - Member of the Management Board & CFO*

Yes, for now we want to. It's only 2 months ago or less than 2 months ago that we gave back EUR 750 million to our shareholders. But indeed, the status now is that we want to keep that position for moments when we have to accelerate investment or when there are opportunities in the markets that we want to pursue.

Marc Hesselink - *ING Groep N.V., Research Division - Research Analyst*

Okay, clear. And then the Automotive order book, is that something you can say about it? It is still well above 1 book-to-bill or...

Operator

(Operator Instructions) There are currently no questions at this time, sir.

Bruno Priuli - *TomTom N.V. - IR Officer*

As there are no further questions, I would like to thank you all for joining us this afternoon. Operator, you can close the call.

Operator

Thank you, sir. This concludes today's presentation. Thank you for participating. You may now disconnect.

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