Nuance Communications

Nuance and Cerence Management Conference Call

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PRESENTATION

Operator:

Good afternoon. My name is Jason and I will be your conference operator today. At this time, I would like to welcome everyone to the Nuance and Cerence Management Conference Call. All lines have been placed on mute to prevent any background noise. If you should need assistance during the call, please press star, zero on your telephone keypad and an operator will come back to assist you. Thank you.

Mr. Jeff Van Rhee from Craig-Hallum, you may begin your conference.

Jeff Van Rhee:

All right, great. Thanks, everybody, for taking the time today. Hopefully we can put everybody's time to good use. I think we will. Very pressing issues going on as most of you on here clearly know.

For those of you that are not familiar with myself, I'm Jeff Van Rhee. I cover software for Craig-Hallum. It's our pleasure today to have the team with Cerence. We have Sanjay Dhawan, CEO; CFO Mark Gallenberger; new Head of IR Richard Girdanian (phon), and then on the Nuance side we have CFO Dan Tempesta and Tracy Krumme on the IR side.

Just to set a little bit of background and a little bit of ground rules and then we'll jump right into the content, I've covered Nuance for let's call it 15-plus years now and certainly with the spin of Cerence going on issue on Monday, getting a lot of interest from both new and existing—new, potential Cerence holders as well as existing and potential new Nuance holders. To head of a lot of the questions that are happening, we thought this would be a very timely opportunity.

(Inaudible) start of the call, I'm going to start and give a very brief introduction; we'll do the Safe Harbor and then I think we're going to jump through with Sanjay for maybe 15 or 20 minutes or so, let him give you the business overview. Mark will walk through a series of financial questions that we've pulled together here, and then lastly, just to be clear, you should have these instructions. If you don't, I'm going to moderate the call. If you have questions, email them to me. It's jvanrhee, J-V-A-N-R-H-E-E, at craig-hallum.com. Give them to me. I will try to cluster these into common themes and see what we can't do to get them addressed.

With that, I want to welcome Richard Girdanian who just joined Cerence as the Head of IR and I'm going to turn it over to Richard briefly for him to give us the Safe Harbor statement.

Richard Yerganian:

Thanks, Jeff. Before we begin I would like to remind everyone that our discussion includes predictions, estimates, expectations, and other forward-looking statements. These statements are subject to risks and uncertainties that can cause material differences in our results. Please refer to our recent SEC filings for a discussion of these results. All references to income statement results are non-GAAP unless otherwise stated.

All SEC documents and information related to Cerence can be found on the Cerence Resource Center in the Nuance (Inaudible) Investor section. Thank you.

Jeff Van Rhee:

Sounds good. Thanks, Richard.

Sanjay, why don't we jump in because I think people certainly want to hear from you primarily, and then we obviously have a lot of things that Mark needs to discuss as well. Just jumping in, I guess, with you joining the firm, give us just maybe two minutes of your background and most importantly I think people want to understand why you're here; what drew you here? Talk about where you're coming from and why you're here to maybe kick things off.

Sanjay Dhawan:

Sure, Jeff. Thank you. Good morning, good afternoon everyone. My name is Sanjay Dhawan and I'm extremely excited to take on Cerence as its new CEO. Just as a quick background, about 30-plus years in business. Engineer by education, I have two degrees, but over the last 23-plus years I have basically led four different companies as its president/CEO. My last company was acquired by Harman in 2015. Harman, as you know, is one of the large Tier 1s in the automotive segment and they bought my last company in April of 2015. Post that acquisition I was running the new software platforms and services business of Harman called Harman Connected Services as its president and later on was also named as the CTO across all of Harman, Harman's four divisions.

That, very briefly, is what my background is. In terms of, Jeff, your question why here, I think automotive space is going through a huge transformation. Cars are going to get more connected. Cars are going to get more autonomous. Cars are going to get more electric. Cars are going to get more shared with this the whole architecture of the vehicle is changing. Voice and voice platforms are becoming more and more embedded inside the car with regards to the interaction mechanism because voice is interesting in our living rooms, in our family rooms, in our kitchen tables, talking to Alexa or Google and others, but in a car it's absolutely necessary because you want the drivers to be focused on driving and not playing with touch screens and knobs and buttons and so on and so forth.

As a leader in the voice space, Cerence, we plan to kind of innovate further and kind of, A, maintain our leadership position in voice, but also as the car becomes more digital, kind of increase our ARPU inside the car by providing more interesting functions to our OEM customers.

Jeff Van Rhee:

That's perfect. That's a great introduction. I think just to start at the logical starting point, walk through a couple of simple customer examples, exactly what you're doing in the car and maybe one of those could be current and one of those could be sort of the vision of what you're powering exactly inside the car.

Sanjay Dhawan:

Sure. I'll give a couple of examples of current and then one example of the future. I will give you three, Jeff. You asked me two, I'll give you three.

The couple examples of current were last Sunday I was watching the U.S. Open finals and Mercedes was a main sponsor of that event. I received a number of phone calls from many of my friends and family who basically kind of were going through the demo that Mercedes was showing at the U.S. Open of their MBUX System and the key center of the demo was 'Hey, Mercedes,' right? That full interaction mechanism that they have launched a few months back is powered by product that Cerence sells to automotive OEMs. So, starting from the wake-up board, which basically wakes us the system so that the system is listening and responding to you, to the automatic speech recognition to the natural language interaction, to the speech enhancements and so on and so forth, and the stack that runs inside the car and also outside in the cloud is what we provide to automotive OEMs like Mercedes.

I received a similar phone call. Last week was the Frankfurt Auto Show and Porsche launched its first all-electric car. Again, the center of that interaction launch from Porsche was, 'Hello, Porsche.' Same, again, the whole kind of embedded and cloud stack is what Cerence basically provides to automotive OEMs.

That's the kind of traditional business. We're fairly unique because our approach is very hybrid and that's one of the reasons we have, you know, a major kind of market share in this space, and the reason why—and hybrid approach, by hybrid I mean part of our software runs inside the car and part of our software runs in the cloud—is because when you are driving there maybe are scenarios where you don't have full coverage of data and in that scenario also you want to make sure that the functionality of the product is there and the user can kind of get a good experience from our product.

Some of the new things that we are doing, we believe in multi-modality. What I mean by that is basically today we integrate almost 200 different sensors into our system, so we basically take inputs from these different sensors inside the car and we kind of create a very compelling user experience for our customers. We continue on that journey by including—enabling use cases like using voice biometrics to identify the driver and the passenger and basically improve the experience for the driver or the passenger, depending upon who is talking to the system. We're using gaze detection so that a smart mirror may be looking at our eyes and as you are driving you basically look on your right hand side and say, 'What is this building?' and the system basically knows your GPS coordinates, knows by looking at your eyes that you looked on your right-hand side, does the voice recognition and natural language detection and basically goes and get information off the building on the right-hand side and gives you that information, right?

Multi-modality, voice biometrics and many other kind of other interesting, exciting ways to improve the interaction.

Jeff Van Rhee:

That's great. That's helpful. I think then transitioning from there, it kind of gives us a sense of what you do and how you do it. Talk to me about barriers to entry. In the context of barriers to entry, most of the questions that I get are obviously you have, according to your slide deck, I think 80%, 85% market share in the in-car environment and now we're moving into this hybrid world. You've got dominance but clearly I think there's talk with Ford having integrated to Alexa in the Ford Sync. You've got Google making some noise with GM. Talk to me about how you sustain your dominance. Do you have evidence of that sustained dominance in your bookings, your new wins, your win rate, your backlog, things we don't necessarily see? The question is barriers to entry and specifically related to some of these more recognizable names trying to get into your world.

Sanjay Dhawan:

Sure. Let me kind of break the question. It's a fairly broad question, Jeff, so I'll just compartmentalize my answer a little bit.

Firstly, from a technology standpoint, there is a huge 20-plus years of history here of innovation that Nuance, Nuance Auto and now Cerence has as a starting point. We have almost 1,250 patents, core patents in the voice speech area. It is hard to do, trying to kind of get the natural language to work means training with lots and lots of data. We have 300 million cars on the road today with our technology so you can imagine how much data we get to train our systems. We are shipping 50 million cars a year, almost 2.5 million cars, new cars every quarter is shipping with Cerence technology.

The data that comes through these interactions is basically used to kind of train the system and make it better and so on and so forth. It's just a data game, right? We absolutely have a head start when it comes to doing that and doing that well.

One element of barrier to entry is technology, core technology that we have as a leader, given our Nuance heritage.

Secondly, in terms of moving forward, what is the trend that we see? I've spent a lot of my years with the automotive OEMs and so on and so forth, and ultimately, automotive OEMs want to own the experience and the data, the user data. Experience because it's their car and they want kind of deliver a certain experience, their brand experience to their customer. Secondly, they want to kind of also—they do understand that understanding what a user is trying to do inside the car is extremely valuable and they don't want to give up the control of that.

Our business model, Cerence's business model is very OEM friendly, so we allow the OEM to kind of white label the product under their brand, 'Hello, Mercedes,' 'Hello, Porsche.' Da-da-da-da-da, right? We also kind of give full access and monetization of the data to the OEM, whatsoever they want to do.

Clearly, others also want to get inside the car. You named Google, Alexa and so on, and we welcome that opportunity because the feedback that we are getting from the OEMs and in our own consumer discussions is that a consumer—if, Jeff, you think of yourself as a consumer, every day you use Apple devices and services. You use Google maps and search. You use Amazon Alexa for shopping and other experiences, and you don't want to be limited to—when you come in the car, you don't want to be limited to one (inaudible) ecosystem. You want to kind of bring your digital life from your home or your office into the car as well. What we are trying to do is basically in a OEM-friendly way create this architecture that we call cognitive arbitration. An OEM can have white label services which are OEM's own kind of branded services, but then it also expands the ecosystem into the Googles and the Alexas or the Siris, depending upon kind of what you want to do in the car.

Jeff Van Rhee:

Perfect. That's helpful. Talk to me about—a lot of questions sort of about process and what changes now that you've become independent of Nuance. Talk to me about sort of the low-hanging fruit in terms of the advantages of being an independent entity. Obviously the spin is coming October 1 and as you're off and running in your own direction, what does that do for you?

Sanjay Dhawan:

I think if you think about kind of the rationale of spin, I spend a lot of time with the Nuance CEO, with Mark Benjamin and the Board and so on and so forth, right, just to make sure all of us are aligned in terms of why the spin and so on and so forth, right? The rationale is very (inaudible) clear and very important.

As we look forward, auto is going through a major kind of transformation and that transformation is basically as the car gets more digital, the software architecture and the hardware architecture of the digital car is going to (inaudible). To basically participate in that, in a open and innovative way, if we were inside a larger company obviously the dedicated focus, no matter how hard you try is always going to—goes towards the larger groups, which in Nuance's case is healthcare and so on, right? By Cerence being independent, me and my team get to focus solely on the automotive roadmap, basically kind of participating with the OEMs in evolving this hardware/software architecture and obviously our goal is going to be to improve the average revenue per car that we derive and also look at kind of vertically and horizontally growing in that software stack that the OEMs will need to build this new digital and connected car.

Jeff Van Rhee:

That's helpful. In that same vein then, if you want to talk about I know in the investor deck that everybody should have, you've talked about the levers that you've got to play with. I think you just touched on one of them, but expand a little bit more. You've talked about deepening your penetration. Luxury cars, lots of voice and speech and seem to be evolving downmarket, but talk about what you need by penetration and how you achieve that, and in the same vein, where you stand with respect to ARPU. It looks like maybe if you do simple math, 50 million cars, you look at your revenue, you're doing about 5 bucks a car. I know that varies. How does that grow? What are the needle movers there an how do you drive that lever going forward? Penetration and ARPU questions there.

Sanjay Dhawan:

Penetration first. You rightly said, Jeff, that voice is more in the mid to high end of the cars and it's kind of going in the lower segments as well, so that's a simple kind of focus that I have with my sales team to kind of basically call upon OEMs car lines more adoption of our technology downstream in the car lines. The biggest penetration increase we expect to see is for our connected products. So, if you look traditionally speech was more as an embedded only kind of element inside the car, but as the car gets more connected we have the cloud portfolio with we call is connected product in our IR deck and you basically see a huge backlog there and also a kind of penetration of that which is growing exponentially, so we basically expect to see increase of revenue there.

There, today, although we sell as a perpetual license but we recognize that revenue over life of the connected service that we provide, but tomorrow we are also looking at regrouping our product to be a true kind of SaaS revenue model where we basically deliver the service in a subscription SaaS model, basically, right? So, with increased penetration.

I think the ARPU piece, you roughly got it right in terms of kind of what the average revenue per car today is, but as we come up with what I've said, vertically and horizontally kind of growing in the car, there are many new areas that we are looking at. I mentioned multi-modality and cognitive arbitration as one, but there are a few, one or two other examples I gave and maybe sometime in the future we'll go into kind of a bit of more detail on that with the analyst community.

One example I would give is I mentioned we have voice biometrics, right? Being in voice we are very good to kind of detect voice and understand voice and so on and so forth, and we have recently added a new product around emergency vehicle detection and we are almost there in terms of finding our first customer to kind of commercialize this product and so you'll hear more about it in the coming months.

What this product does is when you are in your car, many times this happens to all of us. We hear an emergency vehicle and we are looking left, right, up, down to basically see where the vehicle is coming from so that we can respond in a safe way to the emergency vehicle. Won't it be great that a intelligent system inside the car basically can do the detection for us and based on the sound direction and intensity and all that stuff tell us which way the emergency vehicle is approaching so that we can take an appropriate action as a driver.

That's another example of using voice technology to further increase our ARPU inside the car.

Jeff Van Rhee:

That's great. We've got maybe just one or two minutes more and I'm going to try to jam in two questions or categories here, if I can. Just briefly on the topic you were just on, you referenced shared and autonomous. Can you expand on that at all? What does that mean to Cerence? What is the opportunity in shared and autonomous?

Sanjay Dhawan:

Opportunity is huge. Shared, first. Autonomous, second. On shared, when you have a car being shared, using the Uber/Lyft scenario and so on and so forth, no longer can it be only the driver or a fixed driver is the interaction interface to the car. Now we have a product that we are working on in many different directions for multi-seat entertainment, multi-seat interactions so that different driver/passengers can interact with the car in different ways. That all requires deep voice speech technology that we do specialize in at Cerence.

On the autonomous side, Jeff, this one is even kind of a bigger opportunity because as the car gets more and more autonomous, there are many, many things that have to be solved. I'll give you one example.

When you and I are driving and we reach a stop sign and there is a pedestrian who wants to kind of cross the road, we typically look at the pedestrian, we do some eye signaling to the pedestrian and the pedestrian crosses because he or she has acknowledged that the driver knows of their presence and they can safely cross the road, right?

Fast forward, the car is autonomous. How does the car interact with passengers—occupants inside the car but also occupants outside the car. Voice, speech, lighting, many different kind of multi-modality mechanisms will be used to enhance that experience in a safe way as the car becomes more and more autonomous. We're looking at various different kind of product configurations for the AV segment and how do we work with OEMs in that area.

Jeff Van Rhee:

Okay, and I guess just a last one then. Back somewhat to the competitive landscape and sort of barriers to entry question. In your deck you give some visibility to backlog. You certainly give a lot of color on deferreds and we'll get to this in a second with Mark, about contract durations and structures. I guess the question is as you look at your current tone of business, current pace of business, is there anything you can share with us with respect to the competitive win rates? We don't see the revenue for several years but you see the win rates right now on 2022 models and beyond. Is there anything you're able to share with respect to the progression of win rates over the last couple of years? More currently? I'm sort of broadly asking what can you share in that area?

Sanjay Dhawan:

Mark, I will defer to you on this.

Mark Gallenberger:

Yes. In terms of our win rates, historically it's been extremely high and I think that's reflected in our market share right now. I think Sanjay alluded to 80% market share in the embedded or the in-car vehicles. Win rates right now are running about 90% and that's been consistent. Even with niche players trying to enter this market, even with some of the larger tech companies making attempts to get into this market, our win rate has still been very high.

Jeff Van Rhee:

Perfect. Perfect. Great, if we could then maybe just—with the time remaining I want to shift over to you, Mark. Maybe similar to Sanjay, if maybe you just want to take a minute or two to give us your background and the same question, why? What brought you here?

Mark Gallenberger:

Sure. Sure, yeah. My name is Mark Gallenberger. Just like Sanjay I was educated as an engineer as well, electrical engineering, so we both have technical backgrounds. For the last 18 years I've worked for a company called Xcerra Corporation, which is in the semiconductor supply chain. I came from a tech company but it was more on the semiconductor side of the business, so there is a natural adjacency with what Cerence does but more on the software side of the technology equation.

When I was with Xcerra I was the chief operating officer as well as the CFO of that business. That company is a public company. It recently got acquired last year by one of its competitors, and so when I was looking for my next opportunity, this one seemed to line up very nicely with my background and experience. I think it's an exciting space to be in. It's a high growth area. The voice enablement in the vehicle, I think it's in its infancy and so I think it's a great opportunity to join a growing company and a company that's growing profitably as well. So, it seemed like a very good fit with where I want to take my career and in terms of leveraging my past experiences.

Jeff Van Rhee:

That’s great. Maybe set the table for us. First, just a few basic pieces. Talk about the business model, particularly the revenue streams and I’m talking about services, connected license, and in that context talk about the contract structure and duration just to help people understand your contracting discipline and your revenue streams.

Mark Gallenberger:

Sure. Yes, there are three main revenue streams. One is the Licensing or Royalty revenue stream. The second one is the Connected Services or hosting services revenue stream. Then the third one is our Professional Services. To me, the Professional Services revenue stream really is the key enabler to the other two revenue streams, primarily the licensing fees. That’s where our engineers and technicians work very closely with our customers to make sure that we integrate our products and customize those products as needed so that they’re fully seamless and designed into our end customers’ products. That Professional Services business is really a key enabler to the other ones.

A little bit more color on Pro Services. The Pro Services I don’t view as the growth engine of the company, but that’s really just there to really help enable the growth of the other revenue streams.

The Licensing revenue piece, that is typically revenue that is recognized as car units ship in the future, so when the car company manufactures those vehicles and they are shipped, that’s when we would recognize revenue on the licensing fees.

We also have a component that’s in our License revenue stream which we call prepay contracts and those are not variable in terms of futures unit volume per shipment but it’s really fixed contracts. Since those contracts are fixed and non-cancellable, we take revenue as we book and sign those contracts. So, there’s two components of that License revenue stream.

That last piece is the Connected. The Connected is really the hosting services that we provide to our customers which enables them to access the cloud for critical information. Those service contracts are over a multi-year period. Some could be three years, four years, five years. We even have some that are the lifetime of the vehicle and so it varies by customer, but they are multi-year. They’re all multi-year agreements and that’s when we recognize revenue over the service duration period. We would post—once we sign a contract and begin delivering that service, we would post the deferred revenue balance on the balance sheet and then we would simply amortize that amount over the life of that service period.

In summary, that’s really the three main sort of revenue streams.

Jeff Van Rhee:

Maybe along that theme again, questions about just again understanding the model. In the forward deck you talk about a 330 midpoint in ’20 revenues and I you’ve said in the deck that 260 of that will come out of backlog, and I think you just addressed how that portion happens, coming out of backlog.

Talk to the other component, the 260 to 330 leaves you, what? Seventy, that comes from elsewhere. Obviously 260 out of 330 is great visibility. What about the part that isn’t completely visible out of backlog? How does that show up and flow into the model?

Mark Gallenberger:

That’s a great question. I think there’s the two pieces, the two main pieces for that would be what I had mentioned before, some of these prepaid contracts that we clearly have some visibility as to what we’re doing with certain customers but that's not in backlog today. As we continue to get designed into next generation vehicles, next generation platforms and model years, some of those agreements will be prepaid contracts and so that's going to be a good component of what gets us to our guidance of 330.

The other piece would be additional wins that we would expect to realize over the next 12 months in terms of new opportunities and as those professional services start to ramp up, we would have some book-ship opportunities in terms of the Pro Services.

Between those two pieces, those are not in backlog today but that's in the pipeline of all of the different sales opportunities that we're working on as we speak today. Because of our strong penetration, because of our strong customer list, we're so diverse. We've got multiple, multiple engagements around the world in terms of computing design in the next generation platforms. It's a healthy pipeline of opportunities and that's what enables us to have some book shift within the calendar year or the fiscal year.

Jeff Van Rhee:

Mark, on that same vein, are you able to talk about those revenue lines, License, Service, PS? Can you talk about the respective key things to call out, I guess? What's going to accelerate or decelerate Licenses? Which do you expect to grow fastest to slowest? Any color you want to provide about each of those lines and, to the extent you can, how you see them behaving going forward?

Mark Gallenberger:

Sure, sure. I'd be more than happy to talk about each one of those lines.

We are only going to give guidance at the top revenue level, so we won't be breaking it down into the individual three revenue lines and giving guidance as it relates to the projected rates there, but I think at a high level we can talk about how 59% of vehicles today have got in-care or the infotainment in the vehicle today. That we expect to grow to about 85%, so there's good penetration there. That's going to be directly related to our License revenue growth rates.

When you look at the connected car, that's still in its infancy and today worldwide vehicle shipment is only about 12% of those vehicles ship withy native connected car capabilities. We expect that to be a significant growth driver where that's going to grow to about 50% over the next four years.

If I looked at that revenue stream, I think that's going to be one of the stronger growth opportunities for not only Cerence to grow but also for the industry as a whole where the cars are going to get more and more connected.

If I kind of had to prioritize our growth rates I would say the Connected piece is going to be first, followed by Licensed, and as I mentioned before, the Professional Services I really don't expect any growth there because that's the piece that enables the other ones. That Service component I would expect to be generally flat, maybe slightly up.

Jeff Van Rhee:

Okay. Along those lines, on the Connected Car, just sort of order of magnitude sense of ARPU uplift on a connected car versus an Edge or in-car install, what's the progression here? How much more of an ARPU? I'm assuming that's uplift. How much uplift?

Mark Gallenberger:

Yes, I think there's going to be—we talk about the $5 per car. Once again, I don't know if I want to get too specific about Connected versus License, but I think as we see more features and functions and building out the stack, you're going to see that average revenue per vehicle continue to grow. I think the Connected portion also is going to grow nicely. If I had to kind of slice it down the middle, about 50/50, that's probably about where I'd see the split between License per vehicle as well as Connected per vehicle. As we add more features and functions, I would expect the revenue per vehicle to grow quite nicely in the future.

Jeff Van Rhee:

Yes, okay. Let's spend a few minutes then talking a little more about the model itself. Margins, you gave a guide in the Investor Deck there, quite a bit of color. I think on a non-GAAP operating margin you're talking 29% in '19 and the comparable number in '20 looks like 24.5%. To get it down from 29% to 24.5%, obviously on this spin there are a lot of moving parts for both you and the Parentco, but I think people want to understand what drives that decline in margin and then how do you think about margins in your intermediate and long-term target models? Just give us a sense of what's going on there with that dip and then some thoughts going forward.

Mark Gallenberger:

Sure. The dip is really attributed to the fact that Cerence is unplugging from Nuance and as a result there is going to be negative cost synergies. Becoming a standalone independent public company, there's a lot of cost involved with that and so we're estimating that incremental recurring cost to be about $17 million per year. If you kind of do the math on the $17 million on the 330, that gets you about 5 margin points and that's really what's driving the margin to come down from Fiscal Year '19 to '20.

If we weren't separating from Nuance, that margin for Fiscal Year '20 would be in the high 20s or 30% range.

Jeff Van Rhee:

Okay. Maybe take that and run with it a little bit. As you look at the business, obviously there's I think pretty aggressive R&D, at least Parentco, Nuance has talked about that the last couple of years on the development side, and maybe this is for both you and Sanjay, but I'm just curious at this point as you look at the model and your first glance, is it we've got the resources we needed. We reallocate within the business. Maybe a little from here goes over there, but it's not blatant that we need more spend this, SG&A or R&D or just any thoughts along those lines, if you're willing to share.

Mark Gallenberger:

Sure, sure. I think you're right on in terms of the R&D investment. Nuance has invested heavily in this division the last several years and we expect those investments to pay off quite nicely in the future in terms of higher revenue per vehicle and continuing our market share dominance and so on and so forth. I think once we get beyond FY20, through this transition year period, you're going to start to see those R&D investments normalize in which we'll still see R&D grow on a dollar basis, but as a percent of revenue I think we'll start to see that normalize and you'll start to see some very good leverage in the profit model once we get beyond our first transition year.

The other things we're going to be doing is focusing heavily on how do we deliver some of these services, whether it's Pro Services or Connected Services in a more efficient manner. As the Connected Service business grows, you're going to naturally see margin expansion there because this is some fixed cost components to that so you can get some scalability in that area.

In terms of the Pro Services, that's really people related but Sanjay and myself, we're going to be looking at that model to see if there's more efficient service delivery methods so that we can still deliver that high quality service to our customers but more efficiently in which we can recapture some of those margin points.

Sanjay Dhawan:

I second that, Jeff. Just to add to what Mark said, I think at a broad level I think we're well—the R&D and Sales and Marketing is well funded. I think inside there we're basically looking at some rejigging to kind of make sure that we do things more better and kind of create some more room for expansion in terms of margin and also kind of related spend in new areas and so on and so forth.

Jeff Van Rhee:

Perfect. Great. To keep on timeline here, I wonder if the two of you had any closing thoughts, anything we didn't touch on that you think is important to emphasize before I jump over to Dan Tempesta with a few closing questions we had.

Sanjay Dhawan:

No, I think, Mark, you want to go first? Then I'll just close out.

Mark Gallenberger:

Yes. I think like I said before, it's a very exciting company. That's really one of the main reasons why I joined this business because I do see a lot of potential in this business. I think given our market share leadership, our technology leadership, the business is very well positioned to stand alone as an independent company and to be successful and thrive in the future.

That's really all I had to say, but Sanjay, I'll turn that over to you now.

Sanjay Dhawan:

Thank you. And Jeff, from my standpoint, I've been in a part of the Silicon Valley innovation ecosystem the last 30 years. Nineteen eighty-nine was when I moved here from London and it's been my home. Over the last 23 years having led four different tech companies, one key trend that I look for is in our technology disruption because that kind of creates innovation opportunities and I hope all of us agree that that's happening in the car.

Amongst all these various different verticals in tech, automotive is probably the most exciting one right now and I'm just absolutely thrilled that Cerence is a pureplay auto tech company with amazing leadership in voice, which is a key part of the technology that makes the most sense in the car, but then, again, that's just the starting point, right?

As a pureplay auto tech company, we will be exploring many areas to grow and certainly look forward to all the support from the shareholders and analysts. Thank you so much.

Jeff Van Rhee:

Yes, that's perfect. Great. Thank you, guys.

Dan Tempesta, are you still there?

Dan Tempesta:

Hey, Jeff. How are you doing?

Jeff Van Rhee:

Yes, good. We've got wake you up. You don't get (inaudible) very often, so, hopefully, we've got to throw at least a few at you here.

A couple in particular—and really, we're going to keep this brief because I think there's just two kind of key questions that people want to understand. I know the debt, the process of spinning out and then essentially the Spinco raising debt and the transfer to Parent and the use of cash at the Parent are some of the common questions. Can you just take a second and walk through that debt process and sort of the set up process of Cerence and the use of cash? It would probably be helpful.

Dan Tempesta:

Sure. One of the things that we've been really consistent on from the beginning is that Nuance would at the time of the spin remain net leverage neutral, so that's our focus. At 6/30, the most recent quarter, we were around 2.6 times, 2.5 or 2.6 times, and post spin that is our intention as well. The team right now, both the Nuance and the Cerence team, are out raising some financing. We're trying to raise $425 million of a Term Loan B. That includes also a $75 million revolver. The plan is to leave $100 million of that cash on the books of Cerence, a really healthy balance. Twenty-five of that is really prefunding some of the spin activities that the Cerence team will assume is payables, so a natural cash balance, think of it as $85 million, really healthy, 25% of revenue, and greater than 1 times CFFO unlevered. I think we set this business up terrifically. Then, we'll take a distribution back and you should think of that as 425 minus 110, so call it $310 million coming back.

We've already announced to some of our high yield bondholders that when the transaction completes we will paydown $300 million of debt and when you do all the math you're left with that sort of net leverage neutral place that we all planned for, so that's really tracking very well.

Jeff Van Rhee:

Very helpful. Maybe you're the good guy to give us just a real brief recap of process from here to completed spin. I know Cerence, when issued, and a few steps along the way, but maybe just spend 30 seconds on the process here.

Dan Tempesta:

Sure. Earlier this week, on Monday, the team was in New York kicking off the financing. That process will continue over the next week or so as the financing (inaudible) continues. Next week, Sanjay and Mark and team, they'll be on the road. They have a couple of days. They're on the road for an equity roadshow, so they'll have a couple of days in California, San Francisco, then they spend a couple of days in New York. We're then entering the two-week when issued trading period, and that all leads up to October 1 go-live for the spin.

Jeff Van Rhee:

That's great. Dan, anything else? I know given my coverage of Nuance, it's been very, very active in terms of from the Nuance perspective questions. Anything else that you're hearing frequently that we didn't touch on that you think is important for either new Cerence holders or existing Nuance holders, that we didn't touch on?

Dan Tempesta:

I thought what Sanjay and Mark said was good. We were just on the road yesterday, Mark Benjamin and I, meeting in New York with some investors, and I'd say the team really covered the majority of the questions we were getting. I thought it was really well handled.

The one question I get on the Nuance side is what's the impact to the margins, any insight we can give there? What I would say is I'm not guiding 2020 on Nuance margins yet, but I'll give a little bit of color as you think about your models. For Nuance's fiscal year 2019, we guided 27% for operating margin and I have always said that's a little bit high because we had cost savings programs this year and they did really well, and those are ahead of our investment programs. Call it, I don't know, 50 or 100 basis points higher than we would have liked to have land just because the savings are ahead of the investments, but we're going to make those investments so keep that in mind. That's going to happen in 2020. The reason I bring that up is of course when we lose Auto, we're going to lose operating margin because it's such a profitable business,. Think of it as probably a loss of 50 to 100 basis points of operating margins. That's the math you can do in Fiscal Year '19.

Philosophically, we're really focused on operating margins. We have continued to say this. We're not interested in taking the operating margins down significantly, so even though we're going to lose that Auto just naturally and there are going to be some stranded costs, we're really putting cost programs in place to address those stranded costs plus the investment. So, I don't want to guide it but I want people to know that we remain very focused on preserving operating margins.

Jeff Van Rhee:

Great. All right. We'll keep things on schedule and I think we'll wrap it up there, guys. Everybody that's on, if you missed any—we'll publish this as well. There is a replay. Folks can come back and everyone, Cerence, Sanjay, Mark, Richard, thank you so much, and Tracy and Dan, thanks for jumping on short order as well. I think hopefully made good use of everybody's time.

Sanjay Dhawan:

Thanks so much.

Jeff Van Rhee:

With that, I'll wrap it up there and thanks everybody for dialing in. Have a great day.

Sanjay Dhawan:

All right. Thank you.

Operator:

This concludes today's conference call. You may now disconnect.