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NCR - Q2 2015 NCR Corp Earnings Call

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OVERVIEW:

Co. reported 2Q15 non-GAAP EPS of $0.66. Expects 3Q15 reported revenue to be $1.63-1.65b.

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CORPORATE PARTICIPANTS

Gavin Bell *NCR Corporation - VP-IR*

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

Bob Fishman *NCR Corporation - CFO and SVP*

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

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

Paul Langenbahn *NCR Corporation - SVP and President-Hospitality*

CONFERENCE CALL PARTICIPANTS

Paul Coster *JPMorgan - Analyst*

Ian Zaffino *Oppenheimer & Co. - Analyst*

Gil Luria *Wedbush Securities - Analyst*

Katy Huberty *Morgan Stanley - Analyst*

Dan Perlin *RBC Capital Markets - Analyst*

S.K. Prasad Borra *Goldman Sachs - Analyst*

Meghna Ladha *Susquehanna Financial Group/SIG - Analyst*

Matt Somerville *Olympic Global Advisors - Analyst*

PRESENTATION

Operator

Good day, ladies and gentlemen, welcome to the NCR Corporation second-quarter fiscal year 2015 earnings, call. Today's conference is being recorded. At this time I would like to turn the conference over to Mr. Bell, Vice President of Investor Relations. Please go ahead, sir.

Gavin Bell - *NCR Corporation - VP-IR*

Good afternoon and thank you for joining our second-quarter 2015 earnings call. Joining me on the call today and offering opening remarks are Bill Nuti, Chairman and Chief Executive Officer, and Bob Fishman, Chief Financial Officer.

Additionally, available on the call today for Q&A are Andy Hayman, Senior Vice President and President Financial Services; Michael Bayer, Senior Vice President and President Retail Solutions; and Paul Langenbahn, Senior Vice President and President of Hospitality.

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

On today's call we will be referring to presentation materials posted on our website. We will also be discussing certain non-GAAP financial information such as free cash flow and results excluding the impact of pension and other items. Reconciliation of these non-GAAP financial measures to their most directly comparable GAAP measures and other information concerning such measures are included in the presentation materials and in our earnings release. These are also available on the investors relations section of NCR's website. A replay of the call will be available later today on our website, NCR.com.

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

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

Thanks Gavin. Good afternoon, everyone, and thank you for joining us today. I am pleased with our second-quarter results which were in line with our expectations. We have reached the midpoint of 2015 and remain on track to achieve our full-year results despite the increased pressure on revenue and profitability from foreign currency headwinds from our initial 2015 guidance.

The NCR team has executed well this year and I am perfectly pleased with the progress we've made towards becoming a software-driven, hardware-enabled company.

This progress is evident in our results, culture and management system and the talent we've been able to attract. Turning to slide number 3, which shows our financial highlights for the quarter.

Q2 revenue was down 3% compared to last year due to the impact of FX. But it was up 4% on a constant currency basis. Recurring revenue now represents 42% of total revenue, and that is down 3% on the as reported basis compared to last year but up 3% on a constant currency basis.

Operational gross margin in Q2 was 29.1%, which was down 90 basis points, primarily due to an unfavorable mix of revenue. Q2 NPOI was $202 million, which is above our guidance range of $190 million to $200 million. NPOI was down 4% on an as reported basis but up 4% on a constant currency basis.

Non-GAAP EPS was $0.66 in Q2, which was down 3% as reported and up 6% on a constant currency basis. And lastly, our free cash flow execution and results continue to improve.

Free cash flow increased $92 million in Q2 compared to last year to $95 million. For the first six months of the year, free cash flow is $119 million compared to free cash outflow of $48 million in the first half of 2014.

As you know, increasing free cash flow and improving annual linearity are key areas of focus and I am pleased with our progress this year.

And now on slide number 4, we will provide some more detail around software-related revenue growth which was down 1% as reported but up 3% constant currency. Year-to-date software revenue was up 2% as reported and up 6% constant currency.

Within our software revenue streams, we saw continued momentum in cloud growth, up 9% constant currency year over year. Software-related revenue continues to grow faster than our other revenue streams.

While this has been by design, over the medium to long term consisting of mid- to high single-digit software-related revenue growth will continue to positively impact our topline, margins, and free cash flow.

On our last call we talked about the launch of NCR Kalpana, our cloud-based ATM software platform that transforms how financial institutions operate and makes running their business easier. Kalpana is one example of our commitment to helping our customers significantly lower their total cost of ownership through disruptive innovation.

Slide number 5 shows how our latest disruptive innovation in the retail market, NCR Retail ONE. Just announced in June to over 700 customers at our synergy conference, it is a powerful software platform designed to help retailers implement omnichannel and stay relevant in their industry. NCR Retail ONE is an intelligent, open commerce hub that integrates retail applications and back end data sources to deliver the next generation of productivity gains and consumer experience innovations to the retail market.

Retail ONE can be implemented via a public or private cloud and implementation, enterprise on premise software license, or a hybrid of both. We believe the open nature of the platform is particularly important, as it gives retailers tremendous choice and flexibility.

NCR Retail ONE can mix and match software applications from NCR, our partners, retail applications and even third parties, which means that solutions can be easily and seamlessly deployed. Recent research shows that 86% of the retail community plans to implement a unified commerce system in response to the connected consumer and the rapidly changing shopper experience.

However, of that 86%, nearly half are saying that they are struggling to integrate legacy systems across channels. Retail ONE enables gradual migration to solve that problem and empower retailers to differentiate their businesses and the shopping experiences it provides consumers without expensive transitioning from legacy infrastructure.

In addition to the platform integration of Retail ONE, we continue our partnership in the go to market application, development and security areas with Intel, Microsoft and Cisco, as well as other key partners.

Overall, we are excited about the launch of Retail ONE and the value it offers retailers of all sizes as they continue to bridge physical and digital channels and offer flexible payment options from physical to online to mobile.

Lastly, slide number 6 shows our key highlights for Q2. First, Q2 was in line with our expectations and we experienced improved stability and balance across our businesses. We are at the halfway point of the year and remain on track to achieve our goals for the full year.

Our financial services business continues to generate solid results. Our order growth was up again up in Q2 and backlog supports improved revenue growth in the second half of the year and into early 2016. Our branch transformation solutions and CXP software portfolio continue to drive significant demand and we remain confident in these trends.

In retail, we continue to be encouraged by improving industry dynamics. Those signs, including improved execution, helped us achieve higher-than-expected growth in Q2 after a very strong Q1.

Order growth was bolstered by a large self checkout win in Europe. The shift in customer spending priorities is gaining further traction and we are optimistic that momentum and retail solutions will be maintained in the second half of 2015.

We are optimistic about Retail ONE and the positive early response it has received in the market, including from industry partners. We are also excited about our ongoing leadership in self checkout.

As the latest RVR report states, NCR shipped more (inaudible) in 2014 than all other vendors combined. This was the fifth consecutive year we accomplished that goal.

We also increased our share of electronic point-of-sale technology, including and for the first time ever reaching the number one market share position in North America.

Hospitality had a good quarter that included solid operating margin expansion, due to higher software revenues, driven by cloud growth. Hospitality continues to improve the foundation of their business while marching forward on their strategic plans.

Software revenue growth across NCR booked another key highlight for the quarter, particularly our cloud revenue growth. We have also further advanced our efforts to build a better NCR. The transformation of our sales and services organizations are delivering results and our restructuring initiative remains on track.

We are also pleased to announce that the Securities and Exchange Commission, after a lengthy review, said it does not plan to recommend enforcement action, related to a previously disclosed investigation concerning certain aspects of our compliance with the Foreign Corrupt Practices Act.

Finally, free cash flow is tracking well ahead of last year and we are focused on continuing to drive free cash flow growth and linearity as we move through the rest of 2015.

In summary, I am pleased with the second quarter and by the improving execution across NCR. Before turning it over to Bob for the financials, I want to take a moment and let everyone know we will be hosting an analyst day at the New York Stock Exchange on September 15. It has been some time since we held an analyst day and we think the time is right to meet with all of you in person and continue having a dialogue about NCR and our strategic business.

I certainly hope that all of you can join us and hear from not just myself and Bob, but the rest of our executive team as well. Now I would like to turn the call over to Bob to review our performance by segment and our financials. Bob?

Bob Fishman - *NCR Corporation - CFO and SVP*

Thank you, Bill. I will start on slide 7, which shows our Q2 operational results on an as reported and constant currency basis which Bill previously discussed.

We experienced unfavorable foreign currency fluctuations during Q2, with impacts of approximately $110 million in revenue, $16 million in NPOI and $0.06 in EPS, all roughly in line with our previous expectations. Revenue was higher by 4%, NPOI was higher by 4%, and non-GAAP EPS was higher by 6%, all on a constant currency basis.

The next slide shows our Q2 GAAP results. The decrease in GAAP results is primarily related to the non-cash settlement of a pension plan in the UK, which I will cover in more detail on slide 15.

Additionally, the restructuring plan and FX also contributed to the decrease in GAAP results. The restructuring plan charge included in income from operations was $8 million in Q2 2015.

On slide 9, you will see our financial services Q2 results. On a constant currency basis, revenue was up 1% due to improvement in the Americas, Western Europe and Middle East Africa, offset by declines in Russia and China. Excluding Russia and China, revenue was up 4% on a constant currency basis. Operating margin was down 60 basis points at 14.6%, and down 40 basis points on a constant currency basis. The decline was due to a less favorable mix of revenue in North America and Europe, and the lower revenue in Russia and China.

From a solutions perspective, our branch transformation revenues were up 140% during the quarter, led by North America and Middle East Africa. We added a number of wins for our CX banking and payment software, driving enterprise software growth of 20% in the quarter on a constant currency basis. Additionally, our digital banking user growth continues to reach record levels due to increased sales capacity and net promoter scores.

Our new services offerings are gaining traction to support customer needs for higher availability, efficient infrastructure costs and reduced risks.

The next slide shows our retail solutions Q2 results. Revenue was flat as reported and up 7% on a constant currency basis due to increased spending by retailers in North America and Europe. Operating margin was 8.3% and decreased 100 basis points on a constant currency basis.

Retail operating income was lower than the prior year due to a less favorable mix of revenue in North America and was up significantly as compared to Q1 2015. Key developments for retail include the spending shift back towards omnichannel solutions which gain further traction in the quarter. We are expecting improvement in retail in the second half of 2015.

We experienced positive order momentum in Q2 after strong orders in Q1, including a major new self checkout win in Q2. We also continued to demonstrate our global leadership in self checkout and are pleased with becoming number 1 in point-of-sale in North America for the first time ever, according to RVR.

In addition, we are excited about the recent launch of our Retail ONE omni-commerce platform. Our connected payment software solution continues to drive strong cloud revenue growth, and we saw sequential growth in managed services revenue, driven by the successful onboarding of one of our top customers.

Turning to the next slide, hospitality revenue was up 4% on a constant currency basis, driven by improvement in the higher-margin revenue streams, offset by lower hardware revenue. Software-related revenue was up 11%, which includes cloud revenue up 23%. Additionally, cloud application sites increased 18%.

Operating margin performance was 15.7%, up 220 basis points due to this higher software related revenue, including cloud and professional services revenue. In Q2, we launched Orderman 7 to the US market. We saw growth in international software-related revenue which is up 12% year on year, and we continued to see progress in the North America SMB market with 8% revenue growth and 18% software-related revenue growth.

Additionally, we continued our focus on managed services by adding menu maintenance offerings for franchisees of quick service brands.

Next, looking at our emerging industries business on slide 12, revenue was up 2% year over year and up 11% on a constant currency basis, driven by an increase in telecom and technology constant currency revenue. Operating margin was 11.5%, up 910 basis points, driven by higher services margin.

On slide 13, you can see the solid growth in cloud revenue on an as-reported basis. On a constant currency basis, cloud was up 9% and software-related revenue grew 3%. Order revenue was down 2% as reported, up 6% on a constant currency basis, and other services, which includes our traditional break fix business, was down by 6% as reported, up 2% on a constant currency basis.

On slide 14, you can see free cash flow for the quarter. Free cash flow for Q2 2015 was $95 million compared to $3 million in the prior quarter. On a year-to-date basis, free cash flow was $119 million compared to a free cash outflow of $48 million in the prior year. The increases in free cash flow were mainly due to improvements in cash from operations, lower capital expenditures and lower discontinued operations.

As a result of our strong first half of the year, we are increasing our full-year free cash flow guidance range from $325 million to $375 million, to $350 million to $400 million in 2015.

Slide 15 is a summary of our recent UK London pension plan transaction. This transaction is something of a milestone, as it completes phase 3 of our multiyear pension de-risking strategy. Our de-risking strategy focused on plans which closed the largest enterprise risk to the Company and over the past few years we have been working to either shrink or terminate them.

We announced the start of this UK transaction several quarters ago, and in Q2, we successfully settled transaction by transferring the plan to an insurer. This was our largest international plan and transferring it reduces our global pension liability by about 19% and helps our cash flow by reducing our recurring international cash contributions. We estimate that we will have saved approximately $100 million in projected plan contributions that we otherwise would have made over the period from 2014 to 2017. This transfer also benefits and reduces risk to the over 5,000 plan participants that are either current or former employees.

As a result of the settlement, we incurred a non-cash GAAP charge of $427 million or $2.51 per diluted share in the quarter and recording an offsetting decrease to prepaid pension costs in the June 30 balance sheet.

Slide 16 is an update on the restructuring plan. We incurred a pretax charge of $24 million in the first half of 2015 and expect to incur an additional $15 million to $40 million in 2015. The cash impact was $30 million in the first half of 2015 and we expect to pay an additional $41 million to $56 million in 2015.

As far as savings generated, we achieved $18 million in 2014 and estimate approximately $70 million in 2015 and approximately $105 million in 2016. As previously communicated, we expect approximately 50% of the savings to benefit NPOI with the remainder reinvested in the business.

Slide 17 shows our net debt to EBITDA metric, where we closed Q2 with a leverage ratio of 3.1 times. This was benefited from our strong free cash flow generation in the quarter.

Slide 18 shows our full-year 2015 guidance. We are reaffirming our full-year revenue and non-GAAP guidance. We have updated our GAAP income from operations and GAAP-diluted EPS guidance to include the impact of the UK London Pension Plan noncash settlement charge.

We have increased our free cash flow guidance to $350 million to $400 million dollars. Slide 19 shows our 2015 full year revenue guidance by segment. We are reaffirming our revenue growth by segment.

On slide 20 you will find our Q3 2015 guidance. I expect as reported revenue will be in the range of $1.63 billion to $1.65 billion dollars. This includes a negative FX impact of roughly 6 points compared to the prior year.

Revenue is expected to be up 5% to 6% on a constant currency basis. I expect NPOI to be negatively impacted by roughly $17 million of FX. Based on the midpoint of the range, NPOI growth is expected to be up 5% on an as reported basis and up 14% on a constant currency basis.

Now I will open up the call for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Paul Coster, JPMorgan.

Paul Coster - *JPMorgan - Analyst*

Thanks. Can you give us some color regarding the ongoing strategic review and also reports in the press that you are in negotiations with private equity (inaudible). And I have a quick follow-up.

Bob Fishman - *NCR Corporation - CFO and SVP*

Sure, Paul. I will not comment on the latter except to say that the strategic (inaudible) review is -- remains underway. And we expect that process to conclude in the near future.

Paul Coster - *JPMorgan - Analyst*

And head of the analyst event, [do you think]?

Bob Fishman - *NCR Corporation - CFO and SVP*

Quite possible. Yes.

Paul Coster - *JPMorgan - Analyst*

And my other question, really, is just on orders. I didn't really sort of pick up the theme so much in retail and financial services. Can you just give us a little bit of color about orders? I know it's more difficult to get visibility from -- in the financial services sector these days.

But what can you tell us, Bill?

Bob Fishman - *NCR Corporation - CFO and SVP*

Yes, so let me give you a little bit of color. I wasn't quite pleased with orders in Q2 as we were in Q1. I'll let Andy and Michael also contribute. But the high point, Paul, are that on a currency neutral basis, financial is up, year over year, about 6%. And retail is up about 13%. So retail had a really strong Q2 again in orders.

But it was partially a good guide was really a big win we had in self checkout as well. But even without that, the numbers would have been quite good.

But Andy and/or Michael, I will go to you, Andy, first. Any color on orders for fall?

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

It's Andy first, with financial services. I would just add to what Bill said. We had a really good quarter in orders. And when you look at the underlying fundamentals, Russia and China have been fairly significant headwinds for us. And when you normalize for this, they were probably about a 600 basis point impact, so call it 13% order growth, right around there, for the rest of the world, FX neutral. So a really good quarter in terms of order and backlog growth for financial services.

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

And Michael, for retail?

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

Yes, as Bill already mentioned, we had a strong quarter in Q1 and we saw continued strengths globally on the order front and that was also already in Q1 my statement supporting the growth in the second half of the year. Due to our order versus recognition policy, we will see this additional rollout initiative in our revenues to materialize in the second half.

Even on an as reported like-for-like basis, we have grown you today high single-digits. And all of that just underlines performance back to natural spending of our original customers.

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

Paul, the only other two comments I would make are two important metrics we track. In financial, branch transformation in the quarters were up about 100% year over year on a big number. So that was quite a significant growth in branch and self checkout orders were up 46% year over year.

Paul Coster - *JPMorgan - Analyst*

Thank you very much.

Operator

Ian Zaffino, Oppenheimer.

Ian Zaffino - *Oppenheimer & Co. - Analyst*

Just going down a little bit more on the retail business, the big self checkout win, was that with a new customer or is that an existing customer that just re-upped? And if you could give us a little bit more color on that, that would be helpful.

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

Sure, I will let Michael add some more color. But the answer quickly is it was a new customer win. But Michael, some more color on that?

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

Yes, it was new and we will be able and allowed to disclose it after we finish the installation, which is supposed to finish early November. It was a replacement of the biggest customer of one of our competitors.

Ian Zaffino - *Oppenheimer & Co. - Analyst*

So you've replaced by another competitor's self checkout machine with your own self checkout machine/ or is it an assisted checkout machine replaced with your own self checkout?

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

No, it's a complete competitive replacement and expansion of their self checkout strategy. So we will not replace like for like. We will replace with different colors in terms of user -- usage of the self checkout card only in combined as well as a higher density of the self checkout in that particular customer.

Ian Zaffino - *Oppenheimer & Co. - Analyst*

Okay, thank you. And then just following up, Bill, on your comment about the bank branch transformation, new business and new wins. Was that business related to new locations opening up with your new machines? Or were they pulling out old machines and replacing them with your new machines?

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

Andy, why don't you comment on that?

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

Yes, think of it less as new branches, although there is certainly a percentage. But it's a small percentage of the order growth related to new branch openings. It's more additive to an ATM fleet or a replacement of a portion of an ATM fleet within existing branches. So that's the vast majority of the growth that Bill was mentioning in terms of the order growth for branch.

Ian Zaffino - *Oppenheimer & Co. - Analyst*

Okay, great. Thank you. Good quarter. Good to see the cash flow coming in. Thanks a lot, take care.

Operator

Gil Luria, Wedbush Securities.

Gil Luria - *Wedbush Securities - Analyst*

The software business decelerated in the quarter. Even the tip of the spear, the cloud, is only growing high single digits, the rest low single digits. What is it that slowed that business down? Are there any temporary factors that you think will reverse themselves going forward?

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

I am quite enthusiastic about software growth on the year. In fact, the current forecast for Q3 software growth is extremely healthy.

I think if you'll look back to Q2, I would just say it's a matter of being a bit lumpy. That business, still, I was quite pleased with the cloud growth of high single digits. I expect cloud to continue to be high to low double-digit growth for the foreseeable future. I would expect that for the full year, we will be in the high single digit growth rate for software-related revenue. So we feel good about that right now.

Gil Luria - *Wedbush Securities - Analyst*

In terms of China, can you give us a sense of where we are compared to the peak? What year did that business peak and what is the year going to be like in terms of China relative to that peak?

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

Andy, why don't you take that one?

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

Sure. In terms of China, if you go back in time and look at 2012, 2013, it was in the [170 million to 180 million] range in both of those years. I think the peak was 2013 at the mid-180s. And fast forward to today and it's a business that this year is going to be closer to 100 million or so, it has been a significant decline in China.

As we look ahead, there's quite a bit of activity going on. First of all, there has been significant government shifts in terms of what has to be purchased for local providers that has created a large number of local competitors, and a lot of activity is happening there that has affected some of the revenues that we're looking at right now in terms of our declines.

We do believe, both for China and Russia, that should normalize as we head into the first quarter of 2016. And then specifically in China, we have several activities underway that have been underway since late last year for going local, building a local brand with partners to not only stem the declines but also with a much more software-driven strategy, build a new normal for us in terms of growth rates. But that is where we currently are.

Gil Luria - *Wedbush Securities - Analyst*

Got it. And then, last question on pension, just wanted to go through the impact. It sounds like you are going to add [427] to the underfunded status. You talked about estimated cash savings. Were those already included in your guidance? And then the pension expense increase of 15% -- of $15 million, is that the income statement, the one that you back out of NPOI?

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

Yes, so the improvement in cash flow is already included in our estimate of pension contributions for the year. Then you had a question on the million of expense. Yes, that is P&L, so that is income statement. That is included in our pension expense guidance this year. That number is around $10 million this year for pension expense.

And one thing that is nice about this particular transaction, with it being the end of phase 3, we will be moving to a more traditional operating income metric next year. So, this idea of NPOI, where investors are trying to figure out what the piece stands for, think of us moving to a more traditional operating income and also focusing more on EBITDA next year.

And then you had another question, Gil, on the underfunded, is that right?

Gil Luria - *Wedbush Securities - Analyst*

Yes, the $427 million gets added to the $168 million that you added -- you ended the last year?

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

That is exactly right. So we finished last year at the $168 million. Add $427 million that means at the end of Q2 we are close to $600 million underfunded. That is what we spoke about two quarters ago, that we were headed in that direction. Think of that as being 2/3 the US plan and 1/3 Germany.

Gil Luria - *Wedbush Securities - Analyst*

So too early to congratulate (multiple speakers) can we congratulate you on the completion of phase 3? Are you done with a multiyear journey of cleaning up pension?

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

I will take that congratulations. We have been working long and hard. We started this process three to four years ago. Phase 3 does mark the combination of our work on pension. So I appreciate the congratulations.

Gil Luria - *Wedbush Securities - Analyst*

Thank you very much.

Operator

Katy Huberty, Morgan Stanley.

Katy Huberty - *Morgan Stanley - Analyst*

First, a clarification; I just wanted to go back and make sure I understand the timing of the big self checkout deal that you have brought up a couple of times on this call. So, the majority of the revenue would hit in the calendar fourth quarter of this year, is that correct?

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

(multiple speakers) Sorry.

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

It's fine, Michael.

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

Maturity will hit in Q3. We've taken some of the revenue in June, but not fundamental, and we will finish it in October, early November.

Katy Huberty - *Morgan Stanley - Analyst*

Okay. And when you talked about the recovery in retail, and you went through this year, were you thinking this deal would come through? Or is this incremental to the recovery that you talked about last quarter?

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

We, of course, worked at this win for quite some time. We started the detailed work of such a win takes nine to 12 months. So we started that in Q4, there is also a recovery in Russia. We quite frankly have had good performance in Russia from an order point of view, which will also turn into revenue second half, again on the self checkout, when we have one [pilot below] of the five leading retailers in Russia. We see more and more interest also in Latin America. So we are continuously with the strong self checkout portfolio, with a strong value proposition of our self checkout software as you will also see that our portfolios expanding to have self checkout units for not only in self checkout and convenience stores and still mentioned before that in combination with quite [un]significant wins for POS hardware rollouts. Those orders made the good performance and will positively influence our second half.

Katy Huberty - *Morgan Stanley - Analyst*

Okay, great. And then in financial services, we have talked in the past about the weakness in Brazil and China, so that is not necessarily new. There were some comments about weaker mix in North America.

Was there something that surprised you in the developed markets this quarter in addition to the emerging market weakness?

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

The way I think about that right now is larger banks in the second quarter made up a higher proportion of our revenues and the developed markets. That is the simple math on it. And we see that normalizing as we exit the year. So that's the phenomenon in the second quarter that occurred.

Katy Huberty - *Morgan Stanley - Analyst*

Okay, great. And then, maybe a question for Bill and Bob, if I just take a step back, you've driven this mixed shift towards software-related revenues over the last couple of years. And when we look at the gross margin line, ex currency it dropped by 100 basis points.

Could you just talk about some of the offsetting factors that are limiting growth gross margin expansion as you go through this mix shift in the business? Thank you and that's my last question.

Bob Fishman - *NCR Corporation - CFO and SVP*

No doubt that driving more software as a piece of total revenue is important in terms of driving gross margin rate expansion. We look at the margin by product, which includes the hardware piece of our business as well as services. The services margin is improving nicely and that reflects the recurring revenue stream and a lot of the work that we are doing in services, including higher value-managed services and each of the divisions can speak to that as well.

Within the product piece, that moves along with hardware and hardware margin rates can be influenced by bigger rollouts in a particular quarter that might have lower margins and that can often reflect the purchasing power of a particular customer. So I would say, hardware margin can move around.

I am actually, when I look ahead and look at what should be a record number of new product introductions, over the next year or so I'm confident that hardware margin will continue to improve. The good thing about new products is that you have the opportunity to take off out the new products to improve the gross margin rate. So that is really what we are seeing in terms of pressure on the Q2 margin rate.

Michael or Andy, did you want to talk a little bit about some of your managed service piece of the business and how service margins are improving?

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

Yes, I will jump in first, Michael, and you can follow. Just a couple things on margin. First of all, I do think as we normalized the mix that we talked about earlier in terms of a larger bank, smaller bank, financial institutions becoming a greater percentage. I think that will impact the margins positively as we look at the other quarters.

Specific to Bob's point about managed services, it's a business at NCR that historically had not invested in new service offers for quite some time. We came out with about eight new service offers, either brand-new ones or refined ones, and that's going to make up -- in terms of backlog of services in the back half of the year, it will make up about half of our growth. So we are looking for about 300 basis points of growth just purely from the new service offerings.

So if you think about cash management services as financial institutions are more concerned about rate hikes, that's a growing area of interest and wins that we are seeing on cash management and managed services, and also security services. We had a huge win in the Middle East on security services where we are doing a full and to end security management for a financial institution there. So we are seeing a lot of interest on the new offers around managed services.

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

Let me just add to what Andy said. We have started our journey to offer and drive more managed services offerings in retail roughly 12 months ago. We have since then some substantial wins and we have just finalized and are just in the final steps of finalizing the on boarding of one of our biggest customers in the managed service arena.

We see more and more demand and we are not even responding to that demand. We are proactively driving that demand, where we look into what some of our customers call front of the house, or we would call it in store managed services where we incorporate all technology of any third-party from few NCR in the shop. And we would service all of that and we would maintain all of that.

In some of the cases, that expands to help desk capabilities. That expands to back of the house and distribution centers. And the customers are more and more interested to leverage our services performance and services power that we can give them in 180 countries around the world being a major differentiator in the marketplace.

So that is continuous growth for retail. That is continuous broadening the scope and we are investing in that area, together with our services organization.

Katy Huberty - *Morgan Stanley - Analyst*

Thank you for all the detail.

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

I will give you just a few more comments on margin. To your point, the mix shift we've been able to drive has really given us a lift over the last several years. I expect margins in the back half of the year, call it 20 to 25 bps year over year with a strong Q3, and I do expect us to continue to be able to drive meaningful margin expansion, similar to prior years in 2016 and beyond.

The one factor this year as well that has impacted us has been FX. So on a standalone basis, going into 2016 assuming FX were to moderate, it could be quite a good year on the margin front for us.

Katy Huberty - *Morgan Stanley - Analyst*

Thank you.

Operator

Dan Perlin, RBC Capital Markets.

Dan Perlin - *RBC Capital Markets - Analyst*

I just wanted to go back to this large managed service client and retail. Have you recognize any meaningful revenue in the current quarter or is that still on the come in the back half?

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

So a couple of comments on this particular customer. This is a very large win for us we had in Q1. And there is no doubt that we are going to see a lift on a year-over-year basis in Q3, Q4 and Q1 of next year on this client.

Michael, any other thoughts on that besides those comments?

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

No, I think you handled it perfectly, Bill. I would just leave it that way for the time being.

Dan Perlin - *RBC Capital Markets - Analyst*

Okay. So it sounds like it is still one to come. Andy, I had a question for you about the North American mix, the shift toward large financial institutions rather than small. I can understand that it bounces around a little bit. My question is, what does that tell us or is there something indicative about the cross-selling opportunities that we saw in the hardware around DI, which is clearly -- tilts towards more mid- and small financial institutions? And I think was a big part of the incremental growth driver and part of the story long term.

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

Yes, it's a good question. First of all, [Namer] North America for us was up north of 10% on a really tough compare (technical difficulty) big second quarter last year, another big second quarter this year, so it's a really strong business for us right now.

Backlog is also growing significantly. And in terms of the mix between the larger versus the smaller financial institutions, again, a lot of that is related to what was going on a year ago. And as we look right now, and to the back half we see, based on the funnel, really good shift back toward what we call our norms, where the smaller bank and bigger bank is more balanced between the mix there.

Specific to Digital Insight and how we have integrated the product offerings and the sales force, we continue on that journey. The cross-sell last year blew away the business case. This year, again, it's blowing away the business case on a similar percentage. Think of it as 40% to 50% ahead on the cross-sell. So the message the customer continues to resonate as a growing stream.

So, we remain confident in the business that's got a lot of momentum.

Dan Perlin - *RBC Capital Markets - Analyst*

What can you tell us about the incremental profitability through the machines that you're selling today? I think in the past you have indicated that the software-embedded components of the machines you are selling are -- I think you said 40% more today than they were a year or two ago. Is that still -- does that still hold? Has it gotten better, has it gotten worse? (multiple speakers) changed materially internationally versus domestic? Thanks.

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

Right, yes, so probably what you are referring to would be the solutions that are sold within branch transformation portfolio, which last year for us products and services was $130 million. This year what we've said as we will add about another $100 million or so to that. So we are right on plan for that for this year, so we see a really strong quarter -- I'm sorry, a really strong year for branch transformation.

The margins within that, yes, you're looking at margins that would be quite a bit higher than our traditional margins. Think of it as -- call it another 20% higher. So if we are in that 20% to 30% on any given deal, in traditional products would be into the 40% to 50% range of branch transformation portfolio. So you are exactly right with your 40% comment. It's not on the low end there.

The last thing I would say on margins just in general is you are talking about on the machine side. But on the enterprise software side, which is the biggest part of our -- driving our growth, the enterprise software -- in other words, software that is sold not attached to any machine sale, that business is up north of 20% for us right now. The licenses in the quarter for that up over 30%.

So we are having a huge year on the enterprise software side and we don't see an end to that, that kind of growth as we look ahead.

Dan Perlin - *RBC Capital Markets - Analyst*

That's great.

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

And that will have a big impact, obviously, on margins as it continues to grow faster than the rest of the revenue streams.

Dan Perlin - *RBC Capital Markets - Analyst*

Okay. I just had two housekeeping questions for Bob. One is I'm just trying to understand the driver behind the fourth-quarter spike or jump up in your other expense and income. Even at the low end of the range, that would imply a pretty significant ramp for that number to get you to 215 on the low end.

And then the last is you are still sticking to it looks like 135 million shares for 2015. Are you -- is that an indication that you're hiring some people in the back half of the year? And if you are, what kind and where would they go?

Bob Fishman - *NCR Corporation - CFO and SVP*

On the other income and expense, we were certainly encouraged by the number in Q2. It was roughly $46 million compared to our guidance of $55 million. In Q3 we guided again to $55 million but the lesson we learned last year is not to be too aggressive with the FX rate. So I would say we've got some room for improvement there. We certainly look like we're headed towards the lower end of the OIE range for the full year. But we are just trying to be a bit cautious there, because volatility in FX can move that number.

Hopefully you are right and there is some upside there. I would not read too much into the 175 million of shares. I would say that could end up a little bit lower, but it really doesn't reflect increased hiring.

Dan Perlin - *RBC Capital Markets - Analyst*

Okay, thank you guys.

Operator

S.K. Prasad Borra, Goldman Sachs.

S.K. Prasad Borra - *Goldman Sachs - Analyst*

Thanks for taking my questions. Probably to start off, can you elaborate on what are the strategic alternatives or what are the options you have at your disposal?

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

On prior calls I have talked about the full range of strategic alternatives that we as the Board think we should look at, everything from return capital to shareholders in the forms of dividends or buybacks to divestitures of businesses that are non-core, to spin off alternatives of businesses that are also non-core to a full sale of the Company, to a host of other items.

So I would say that as a Board, annually, we do a really good job of looking at everything and all of those things therein. And we have been particularly diligent this year around all of them, and as I said earlier, we should be concluding that process shortly.

S.K. Prasad Borra - *Goldman Sachs - Analyst*

Okay. Probably just one question on pension; can you please update on what's the status of the net pension obligations? And is phase 3 the last big phase of addressing the pension issue? Or is there anything else after that?

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

No, that's really it. The phase 3 marks the end of our pension journey. So basically the guidance that we've given in terms of the pension contribution of $30 million to $35 million for this year includes all of the work that we've done.

S.K. Prasad Borra - *Goldman Sachs - Analyst*

And probably just last one, from a composition point of view, and as you are expanding your services portfolio across both financial services and retail, has your competitive landscape changed much and is it pretty in term? Do you have to compromise on the margins or do you think actually it's a better margin preferred and you can net to net expand margins?

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

A couple of things I would comment on and then maybe Andy and Michael have some additional views. But at the enterprise level, one of the accomplishments amongst several in the last year that we've had is we can now see in our funnel as a result of investments we've been making for a long period of time, a fairly strong growth of our services business going into 2016. Now the mix of that is also changing.

We have built and developed and now launched a set of new offers in the market that are more managed services-based and they are lower cost to deliver kinds of services that leverage our fixed cost infrastructure. So one of the things I'm quite enthusiastic about going forward right now is our services growth going into 2016, the mix shift that will begin to occur as a result of higher-margin offers and some of the successes we've had early on in our journey there.

Andy or Michael, any further comments there?

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

Yes, it's Andy. Let me just jump in real quick and then hand it to Michael. If you think about -- first of all, we are not interested in just any managed service. What we are interested in is managed services that leverage our assets, whether it be our infrastructure assets or our software assets.

And just to pick one example, which is around cash management, we can deliver cash management as a license. We can deliver cash management software as a SaaS description offering or we can deliver it as a managed service offering.

So, in a managed service offering, a customer is looking to build business processes that help them reduce their dependency on cash, optimize their cash in the network and reduce logistics costs associated with cash deployment. Our software does that really well. And then for banks or other financial institutions not able to put the right business process around that, then we can add an additional service around that, to when we are leveraging these assets the margins go from -- anywhere from 20% to 30% for traditional maintenance break/fix services, we can add 10 to 15 to 20 points onto that when we are leveraging our software assets. That is where we are seeing a lot of the new offer in the growth on managed services.

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

I think I talked already around managed services growth, but as Andy was mentioning, the cash management, that was also a new offering. We brought a much broader audience in our self checkout unit. As we have incorporated cash management software, our broader scheme and with much more analytics around it throughout the last 12 months to help our customers to reduce the cash in all of the self checkout's units they have and combine it with cash management throughout the store.

We also have expanded our offerings into predictive services and in the whole security and security analytics for our customers. So, driven all of that by a strong service coverage, as I mentioned before, is giving us the possibility to extend service offerings for our existing customers, or to go for new customers which might not necessarily have a big footprint of NCR. But given our services, offerings in the broadness of our third-party portfolio, which we can handle, we are a very competitive and interesting partner.

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

Yes, I'd like to bring in maybe Paul Langenbahn into this discussion, who runs hospitality for us. First of all, Paul has done a great job in his role and has really brought a level of stability back to hospitality, a level of high performance to that team. Both Bob and I could not be more pleased with the software-related revenue growth, his cloud growth and how well that business is now positioned for growth and margin expansion long term.

But Paul is also working on a plan around services expansion. Paul, maybe you can make a few comments there?

Paul Langenbahn - *NCR Corporation - SVP and President-Hospitality*

Sure Bill. I think it's part of the same story, it's where the intersection of the assets in the capabilities the Company has with market need and ways we can add value in the market. One example that is sort of an analog to the cash management model and financial service is around menu maintenance.

So we have software that controls all of the menu maintenance, which is the items in the recipes and the prices and so on and so forth across that network of point-of-sale systems. And you look at, for example, large heavily franchised quick serve restaurant brand, the franchisor in most cases cannot or will not set the pricing for the franchisees. And the franchisees often don't have a lot of infrastructure. They don't have big IT staff, they don't have a lot of administrative support often in their businesses and so -- and there are tens of thousands of sites that are already customers of NCRs in the space.

So one of the things we've been able to do is using our cloud-based menu management software is actually package up a managed service around that, where we are able to very efficiently do that work for thousands of quick serve restaurant franchise locations. So that's one example.

There's other examples where we are leveraging capabilities; for example, a companion product to one of our staff offerings is actually deploying managed firewall as a managed service to secure a small business or a franchise location network in front of their story to make their network more secure. And we have thousands of sites now that signed up for that service as well. So there's a few examples where we are really leveraging the assets of the Company to add value for our customers and those things tend to be not only very good for our customers, but very high-margin services for NCR.

S.K. Prasad Borra - *Goldman Sachs - Analyst*

Thank you.

Operator

Meghna Ladha, Susquehanna.

Meghna Ladha - *Susquehanna Financial Group/SIG - Analyst*

Thanks for taking my questions, most of them have been answered. But can you talk about the competitive environment as it relates to the financial services business? Which markets are you specifically gaining share and why?

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

As we look at share, we are watching obviously closely the competitive reports from who is publicly traded and then we have good checks in the field for others. It looks like right now we are gaining share in most markets. The exception would be when there's competition that -- where we are seeing some irrational pricing in certain markets that we feel like is one time in nature. We've seen it a little bit and parts of Europe. We've seen it in parts of Asia. We have already mentioned have already mentioned what's going on in China. So those would be the ones I would call out.

Meghna Ladha - *Susquehanna Financial Group/SIG - Analyst*

Thank you.

Operator

[Matt Somerville, Olympic Global Advisors].

Matt Somerville - *Olympic Global Advisors - Analyst*

I want to spend a minute talking about free cash flow. Can you guys remind me how you are being incented at going forward on free cash versus how you were incented in the past, and specifically, Bob, maybe what you're doing to improve linearity and how we should think about the sustainability of the linearity?

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

Hey, Matt. Welcome back. We are now about 40% of the bonus of all of the management team at NCR is currently linked to free cash flow targets. We had that bonus team in place as well last year for the first time and this year.

And Bob won't toot his own horn, so I will for him. He has been doing a lot of communication and training, hand-to-hand combat, if you will, with every employee around the importance of free cash flow, what role they play. Bob rolls out a video every quarter to every employee in terms of training with regard to free cash flow, the impact it can have.

And I also want to compliment my team. They are certainly, when you're compensated on free cash flow, it draws more attention to it perhaps. But all of them have engaged in working with us to drive a better free cash flow story, not just in aggregate but also linearity by quarter. Bob?

Bob Fishman - *NCR Corporation - CFO and SVP*

Yes, maybe I'll just say a few things. Luckily I don't star in the video every month; the employees would get tired of seeing me. But I will pick up on your linearity point.

We felt confident in increasing the free cash flow guidance for the year, really because we are trying to optimize every line within the free cash flow equation. So in terms of some of the legacy issues, if you look back in Q2 of last year, we were paying for 100% of the cleanup of the Fox River. In

Q3 of last year, we ended up getting a contribution from the partner who was also in the River. So now we are under a situation where we are getting paid on a timely basis on Fox River.

We have spoken about pension contribution. Those are down significantly year on year. We talked about driving more software and that higher gross margin really helps my free cash flow. The CapEx is down significantly, so we have a program in place where we look at the capital, we attach business cases to it. The capital needs to earn a hurdle rate over our weighted average cost of capital. And so we have been effective in terms of driving CapEx improvement at cash tax rates.

We are all over that in terms of driving the low cash tax rates. And then really a focus on working capital, optimizing inventory turns, as an example.

But linearity is key, and so when we talk about these videos on a monthly basis, it's not the finance team. It's really the business team, so operations trying to drive linearity across the business. And when we talk about linearity, it's not necessarily from Q4 to Q1. We are talking about months in the quarter. So we are trying to drive more orders and more revenue earlier in the quarter so my team has an opportunity to collect that cash, so a lot of work around linearity. There is more room for improvement in that space. But it does help working capital to have all of the employees focus on that.

Matt Somerville - *Olympic Global Advisors - Analyst*

And then just as my follow-up, you talked about kind of how we should think about margins in retail and the ATM business. Can you also maybe comment, second half of the year, how we should be thinking about emerging industries? I know it's a small piece of your business, but -- and then hospitality as well, relative to where you were at in the first half.

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

We've been very pleased with emerging industries. Again, 2/3 of that business is very much of a services business within the telecom and technology space. Again, at this time last year, we were on boarding a number of challenging customers and we worked our way through that. Think of emerging industries as having hit kind of a low double digit operating margin. There's no reason why they can't kind of continue at that clip in Q3 and Q4.

When I think about hospitality, Paul is close to a 16% operating margin and he should continue to improve in the back half as he drives more clout and more software-related revenue.

Matt Somerville - *Olympic Global Advisors - Analyst*

Great, thanks a lot, guys.

Operator

At this time there are no further questions. I will hand things back to Mr. Nuti for any additional or closing remarks.

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

Thank you all for joining us today and we look forward to seeing you at the upcoming analyst day in September. Good night.

Operator

Ladies and gentlemen, that does conclude today's conference. We would like to thank you all for your participation.