INTUIT INC (INTU) Earnings Report: Q3 2016 Conference Call Transcript

The following INTUIT INC conference call took place on May 24, 2016, 04:30 PM ET. This is a transcript of that earnings call:

Company Participants

- Matt Rhodes; Intuit; Investor Relations
- Brad Smith; Intuit; Chairman & CEO
- Neil Williams; Intuit; CFO

Other Participants

- Walter Pritchard; Citigroup; Analyst
- Keith Weiss; Morgan Stanley; Analyst
- Kash Rangan; BoA Merrill Lynch; Analyst
- Brent Thill; UBS; Analyst
- Ross MacMillan; RBC Capital Markets; Analyst
- Scott Schneeberger; Oppenheimer & Co.; Analyst
- Michael Nemeroff; Credit Suisse; Analyst
- Yun Kim; Brean Capital; Analyst
- Nandan Amladi; Deutsche Bank; Analyst
- David Togut; Evercore ISI; Analyst
- Patrick Coville; Rett Research; Analyst

MANAGEMENT DISCUSSION SECTION

Operator:

At this time, I would like to welcome everyone to Intuit's third quarter FY16 conference call.

(Operator Instructions)

With that, I'll now turn the call over to Matt Rhodes, Intuit's Vice President of Investor Relations. Mr. Rhodes?

Matt Rhodes (Investor Relations):

Thank you, Operator. Good afternoon, everyone. Welcome to Intuit's third quarter FY16 conference call. I'm here with Brad Smith, our Chairman and CEO; and Neil Williams, our CFO.

Before we start, I'd like to remind everyone that our remarks will Include forward-looking statements. There are a number of factors that could cause Intuit's results to differ materially from our expectations. You can learn more about these risks in the press release we issued earlier this afternoon, our Form 10-K for FY15, and our other SEC filings.

All of those documents are available on the Investor Relations page of Intuit's website, at Intuit.com. We assume no obligation to update any forward-looking statements.

Some of the numbers in this report are presented on a non-GAAP basis. We've reconciled the comparable

GAAP and non-GAAP numbers in today's press release. Unless otherwise noted, all growth rates refer to the current period versus the comparable prior-year period, and the business metrics and associated growth rates refer to worldwide business metrics.

Also, all reported results and guidance, except GAAP net income and EPS, exclude Demandforce, QuickBase, and Quicken, which have been sold and reclassified to discontinued operations.

A copy of our prepared remarks and supplemental financial information will be available on our website after this call ends.

With that, I'll turn the call over to Brad Smith.

Brad Smith (Chairman & CEO):

All right. Thank you, Matt. And thanks to all of you for joining us.

As you already know, we had an outstanding tax season. We're also pleased with our performance in Small Business. At the company level in our fiscal third quarter, we came in ahead of our guidance across the board. And as a result, we're raising our revenue, operating income and earnings per share guidance for the year.

Since tax is on everyone's mind, let's start there. We feel great about the product innovation that we delivered in TurboTax this year, as well as the results enabled by that innovation. As you know, there are four key drivers to our Consumer Tax business.

The first driver is the number of returns filed with the IRS. The latest IRS data indicates that total returns were up about 1.5%. That was a bit stronger than we expected, so it was a modest tailwind.

The second driver is the percentage of those returns filed using do-it-yourself software. This season, the category grew nearly 6% versus the assisted category, which was up only slightly. This suggests the do-it-yourself software category gained more than 1 point of share again this year, driving more than 3 points of revenue growth for TurboTax.

The third driver is TurboTax's share within the do-it-yourself software category. For the third consecutive year, we gained share within the category. In fact, this season we gained more than 3 points of share, bringing our total software category share to roughly 65%.

And the fourth driver is revenue per return. As you know, our goal is to grow customers faster than revenue, which yields a positive lifetime value pay-off as their tax situations grow more complex over time. Our strategy to gain share of the less complex returns continued to bear fruit, enabling unit growth of 12% overall, which was faster than our revenue growth of over 9%. With that said, our revenue growth for the segment far outpaced our original outlook of 5% to 7% at the beginning of the fiscal year.

Bottom line, it was a very successful tax season for TurboTax. So what drove the performance? The answer is simple, an awesome, innovative product experience. But what's behind the awesome experience is not so simple. It is driven by deep data science and rigorous execution from a very talented TurboTax team.

We began this multi-year journey three years ago to reimagine the tax prep experience in support of a grand vision of taxes are done. And this season, we began to really see it pay off. We remain committed to continuing to invest and build on our competitive advantage, driving share gains for the category and for TurboTax.

This season, our team more than tripled its pace of innovation, introducing over 20 new product improvements. We coupled this product innovation with a great demand generation campaign that really resonated: it doesn't take a genius to do your taxes. We made the complex simple, which, when you get down to it, is what Intuit does every day. Our seamless cloud-based experience drove increased mobile discovery and usage. Our mobile app downloads were up 85% versus last season and the number of completed returns through the mobile app and through mobile browsers doubled. This year, customers snapped 5 million photos of tax documents with mobile devices. That is up four times greater than it was last year. This represented 25% of all the documents imported into TurboTax, which saved time and reduced errors while delighting customers.

We also continue to reimagine the entire product experience, using data to help customers finish their taxes faster, with increased confidence. For example, we broke down the Affordable Care Act into simple questions and provided new confidence building features, like Explain Why and SmartLook. These innovations helped reduce the tax prep time by 40%, on average, for our customers. We also delivered an excellent customer care experience and continued to invest in security, working with the industry and the government to protect our customers and to reduce fraud.

On top of all of that product improvement, we continue to focus on serving an important segment that we feel is under served and over charged, the simple return segment. Absolute Zero gives these taxpayers the most affordable option, a great product that costs them nothing. But Absolute Zero is just one of the reasons that we won this year. In fact, TurboTax gained share versus software competitors who matched the Absolute Zero offer and we even gained share at the end of season at full price. All in all, TurboTax grew units double digits and expanded share. We also grew revenue more than 9% and we improved margins in an already very profitable business. This was simply a great season for TurboTax.

Now let me shift to the Pro Tax business, which we recently rebranded as the Pro Connect Group, given the strategic role this business plays in our ecosystem. The Pro Connect Group supports both of our strategic goals, to do the nation's taxes and to be the operating system behind small business success. In support of doing the nation's taxes, we're doing just that. We grew individual returns about 1% in this business this year, which is faster than the overall assisted category group.

New customers were a bit soft, so we did a nice job with retention, leading to modest customer and return growth. Looking ahead, we're focused on growing the Pro Tax business in ways that are less reliant on price. We're leaning into the cloud, with Intuit Tax Online, and we're innovating with new attached solutions, like refund transfer and e-signatures. We've got some work to do to drive faster adoption of these services, but we're optimistic about the future.

The new name reflects Pro Connect Group's expanded efforts to support small business success. The more we connect our accountant customers with our small business customers, the more successful they all are and the healthier our ecosystem becomes. For example, we know QuickBooks Online retention is 11 points better when a small business works with an accountant, so we're tapping into our accountant network to make these connections.

Nearly 600,000 QuickBooks Online subscribers are now linked to an accountant. That is up 70% versus last year. This all nets out to a strategically important, highly profitable business, albeit with a slower growth rate than TurboTax or the Small Business Group. Neil will talk more about our expectations for this business in a minute.

With that overview on the Tax side of the house, let's transition to Small Business. We continue to generate strong new user growth in our online ecosystem. Again this quarter, more than 80% of QuickBooks Online customers were new to the Intuit franchise and total QuickBooks paying customer growth remained healthy. Year-to-date across Desktop and Online, new customers are up 16%, which is an acceleration from last year.

QuickBooks Online continued to build momentum. We grew total QuickBooks Online subscribers 45% in the third quarter. This resulted in the addition of 140,000 QBO subscribers in the quarter, bringing us to 1,397,000 paid subs worldwide at the end of the April, which was ahead of our guidance. Roughly 75,000 of those QBO subscribers are using QuickBooks Self-Employed, which is up from 50,000 last quarter. Outside the US, QuickBooks Online grew roughly 60%, to 255,000 paying subscribers.

In total, we're executing well and we're on track to meet our subscriber targets for FY16 and FY17. Also, it's important to note that revenue per customer is coming in a bit stronger than we expected so far this year. As we said at Investor Day, we're expecting to land at 2 million to 2.2 million QBO subs at the end of FY17.

Now we're also improving customer retention, and we fully expect retention to continue to improve next year, as more of our QBO customers are acquired through or work with an accountant. Attach of payroll, payments, and third-party apps also improves retention and we're building solid traction there, as well. For example, we now have over 100,000 QuickBooks Online accountant customers who have at least three of their own clients on QBO. That's more than double what it was a year ago.

We now also have 2,500 third-party apps in our ecosystem. That's up from 1,100 a year ago. And approximately 15% of QuickBooks Online customers are connecting to at least one third-party app. That's up from 9% a year ago. Payroll and payments, as you know, are drivers of retention and they also help drive revenue per customer, and the attached rates for these products remain healthy, at 19% for Payroll and 8% for Payments.

So that's the story at the high level. Our teams have driven significant innovation across all of our offerings and it's resulted in strong financial results for the quarter and for the year.

With that, I'm going to turn it over to Neil to walk you through the financial details.

Neil Williams (CFO):

Thanks, Brad. Good afternoon, everyone.

For the third quarter of FY16, we delivered revenue of $2.3 billion, up 8%. This growth reflects a shift of approximately $30 million of Consumer Tax revenue from Q3 into Q2 relative to last season. We delivered non-GAAP operating income of $1.4 billion, up 11%, GAAP operating income of $1.3 billion, up 21%, non-GAAP earnings per share of $3.43, up 20%, and GAAP earnings per share of $3.94, which reflects an after tax gain of $0.67 per share on the divestiture of Quicken, QuickBase, and Demandforce.

Turning to the business segments, total Small Business segment revenue increased 12% for the quarter. Small Business Online ecosystem revenue grew approximately 24% for the quarter, as customer acquisition in our online ecosystem continues to drive growth. QuickBooks Online subscribers grew 45%, Online active Payments customers grew 6%, and Online Payments charge volume grew 18%. Online Payroll customers grew 17%.

Switching to the desktop side, total desktop ecosystem revenue increased 8%. QuickBooks desktop units were up 3% in the third quarter. And for the full year, we expect desktop units and revenue will be up slightly.

I know it's been difficult to correlate the growth rate and QBO subscriptions to our online ecosystem revenue growth rate. Here's some detail on Online revenue that should help with your modeling. In the third quarter, Online Payroll revenue grew 21% and Online Payments revenue grew 13%. About 40% of our Online Payroll customers are attached to QBO, while 60% are not.

We sell standalone Online Payroll through partners and accountants. This is a good, profitable business, but one that grows much slower than Payroll attached to QuickBooks Online. The revenue mix is closer to 50/50. We expect Payroll customers attached to QuickBooks Online to grow around 25% this year and revenue from those customers to grow nearly 40%.

Now let's look at Payments through the same lens. The customer and revenue mix for attached and non-attached solutions is about 50/50, but the story is a little different. We are not currently focused on standalone payments channels, like GoPayment and online processing that are not attached to QBO. The QBO attached business is growing very fast and the non-attached business is shrinking. We expect Payments customers and revenue attached to QuickBooks Online to grow more than 50% this year.

Consumer Tax revenue was up 7% versus the third quarter last year; and for the year, we expect Consumer Tax revenue growth of approximately 9%. As a reminder, third quarter consumer tax revenue reflects a shift from the third quarter to the second quarter, primarily driven by an extra weekend day in January this year.

One thing I'd like to call out as we start thinking about next season and next year's guidance, we're investing to improve the total TurboTax product experience, thus delivering the results you saw this season. This remains a high margin business at over 60%. We remain focused on growing customers, gaining share, and increasing profit dollars, rather than margin expansion.

Our Pro Connect Group Professional Tax revenue was $126 million in the third quarter. For the fourth quarter, we expect Pro Connect revenue to be approximately the same as in the fourth quarter of FY15. As Brad said, we're focused less on price on the Pro Tax side and investing in our accountant offerings to enhance growth in the QuickBooks Online ecosystem. We expect revenue to be roughly flat in FY17, with margins remaining above 60%.

We continue to take a disciplined approach to capital management, investing the cash we generate in opportunities that yield an expected return on investment greater than 15% over five years. We repurchased $465 million of shares in the third quarter and we have $435 million remaining on our authorization.

Our cash and investment balance was $1.6 billion at the end of the third quarter and our Board approved a $0.30 dividend per share for our fiscal fourth quarter, payable on July 18. This represents a 20% increase versus last year.

Year-to-date, we've returned nearly $2.5 billion in cash to our shareholders via share repurchases and dividends. We provided guidance for the fourth quarter in our press release. We also raised our full-year revenue, operating income, and EPS guidance, and now we expect revenue growth of 11% to 12% for the year. We reiterated our full year FY16 guidance for QuickBooks Online subscribers.

As we look forward to FY17, we are pleased that our trajectory is in line with the long-term customer and financial plans that we shared last year. Small Business and Consumer Tax remain quite healthy. We'll continue to invest in awesome products, security, and customer care. The investments we're making outside the US will pay off over a longer term horizon.

Taking all this into consideration, I still believe that $4.30 is the best estimate of where non-GAAP EPS will come in next year. We'll share more when we provide FY17 guidance in August.

With that, I'll turn it back to Brad to close.

Brad Smith (Chairman & CEO):

Thank you, Neil.

In a headline, we're having a great year. Customer growth is as strong as it's ever been in Small Business and TurboTax and our accountant facing teams are driving adoption and help across the ecosystem. We're further penetrating large addressable markets and we remain deeply committed to accelerating customer and revenue growth.

Now before I close, I'd like to share a few words about our dear friend, Bill Campbell. Personally and professionally, Bill's larger than life persona, his colorful language, his brilliance and his leadership stretched from coast to coast. Respected by all as the coach, his influence shaped men and women from football fields to corporate boardrooms, and to his table at the Old Pro Sports Bar in Palo Alto, California. He was indeed one of a kind. And while Bill can never be replaced, he will always be remembered.

With that, let's turn it over to you to hear what's on your mind. Operator?

QUESTIONS & ANSWERS

Operator:

(Operator Instructions)

Walter Pritchard of Citi.

Walter Pritchard (Analyst - Citigroup):

I know you get this question a lot on the Desktop versus online, but I'm wondering if you could maybe walk us through some of the factors that you saw in the April quarter that drove growth in Desktop and maybe online subs a little lower than we were expecting, although pretty much spot on. Just trying to understand if there's anything new going on there as we got through the last three months.

Brad Smith (Chairman & CEO):

Walter, it's Brad. Thank you.

First of all, I would tell you the important thing to think about is that Desktop and online are not a zero sum game. In fact, what we're doing is we're expanding the total addressable market.

And I know that I've had a couple of shareholders ask me questions about the fact sheet we used to report years ago that included the number of Desktop customers that run the last three year version. We don't report that anymore. And so there was a question of, hey, is that number actually decreasing faster than online subs are growing and are you losing customers? So I'll tell you what, we'll share some information at this moment that actually is stuff that we used to publish, just so everyone's got the same data.

If you take the total number of QuickBooks Desktop customers and look at the ones that are on the last three years' version, those are the active customers, and then you add that to the online subscribers and the Desktop subscribers, the total base is up 4%. That is the first time that base has grown in over a decade.

If you then take that number and say, how many actually paid us this year, they either bought a version of Desktop in the last 12 months or they got a subscription from us, that number is up 20%. And then if you look at total new users, whether they bought Desktop or online, that's up 16%. So no matter how you cut it, the headline is we're expanding TAM , we're growing our base, we're entering new markets, and we feel very good that both the Desktop and the online business are growing.

In terms of Desktop, the thing that we discovered is what we talked about on the last call. We have a group of customers that even with feature parity and even with pricing concessions do not want to move to the cloud right now, either because their accountant isn't yet on the cloud or the small business likes the product the way they have it and they don't want to make the move.

We want to make sure they remain active customers of Intuit and that they're buying Payroll and Payment services. So we want to keep them delighted. So we're making sure that the Desktop customers are happy, the cloud customers are happy, and that those who want to move over, we want to make it easy for them to do that.

So net-net, we have a very vibrant ecosystem right now. It's growing in total. And the online subs for us actually was right on our expectations.

I felt great about 45% growth. I feel good about the momentum we have in the countries outside the US. And most importantly, I love the fact that we're expanding TAM , both new countries, as well as self-employed, which gives us a lot of runway for the future. So that's how we felt about the QuickBooks business overall.

Walter Pritchard (Analyst - Citigroup):

Got it. Sounds like Matt shouldn't have taken that off the metric sheet.

On the international side, could you just update us on how you're thinking about customer acquisition costs versus lifetime revenue in some of the international countries? It seems like to us there's a varying degree of competition in some of the markets you've entered in the last year or 18 months.

Brad Smith (Chairman & CEO):

Yes, I can. As you might imagine, it's a country by country story. So in each country, we have a different set of strategic outcomes.

We fundamentally believe that certain markets right now, we have a real advantage and we have momentum and we're going to invest to win in that market. In other countries, we know that we're moving in and we're the second place player. And so we want to be a challenger in that market. And for every specific country, Neil and I have sat with the country managers and we're agreed upon an LTV to [CAC], and it's a multi-year target.

So we actually have, where should we be a year from now, two years from now, three years from now? In some cases, we push that number a little further out for strategic reasons. In other cases, we say we think we can get the profitability a little bit sooner. But it truly is a country by country formula.

And make no mistake, we see a lot of upside. And the number one focus we have is expanding TAM and accelerating customer growth, because we know lifetime value will come over time. We just want to make sure we're doing that prudently with the right cost to acquire.

Walter Pritchard (Analyst - Citigroup):

Okay. Thanks, Brad.

Operator:

Keith Weiss of Morgan Stanley .

Keith Weiss (Analyst - Morgan Stanley):

Thank you guys for taking the question, and very nice quarter. If I may, one question on Tax and one question digging in on the QuickBooks side of the equation.

On Tax, again, a very good year of market share gains. As we think of that rolling forward, any reason to believe in terms of perhaps stuff that you saw from your competitors, structural things within the marketplace, that these share gains shouldn't be sustainable on a going forward basis?

You are getting some pretty big numbers there. So perhaps it's just law of large numbers. But any reason then why we shouldn't be extracting that on a going forward basis on the Tax side?

Brad Smith (Chairman & CEO):

Okay. And Keith, did you want to put your second question out there, or do you want me to take them one at a time?

Keith Weiss (Analyst - Morgan Stanley):

Sure. I'll put the second question out there, as well.

On the QuickBooks Online side of the equation, if we just look at the numbers from face value, where you guys are expecting to get to at the end of FY16 and then look at where you're expecting to get to at the end of FY17, it does seem like you need to see an acceleration in quarterly net sub adds into next year. The question is, are we looking at that right? And if so, what causes that acceleration, that bigger number of quarterly sub adds into next year, or are there other factors in play, the improving renewal rates or the like?

Brad Smith (Chairman & CEO):

Got it. Thank you, Keith. First of all, thanks for the feedback on the quarter.

Let me talk to Tax first. The results you saw this year are the results of a multi-year investment we've been making in products and innovation which is not easily matched by competition. I mentioned a couple things in my opening talk track, that even though we had success with Absolute Zero, we also had success when competitors matched Absolute Zero and we were head-to-head and we took share. And we also had success after Absolute Zero was done and we were at full price.

What's happening right now is we are really making big advances towards taxes completely going away and having no friction for customers to get to their refund. And you heard me talk about, this year on average, customers spent 40% less time having to do their taxes. That is not stuff that competition can match.

Now at the same time, I'll tell you, we have a lot of respect for our competition. We don't underestimate them and we know every year is going to be competitive. But do I believe this team can continue to advance our product innovation and as a result continue to win more customers and take share? I do.

That's the expectation we have of ourselves and that's the expectation we want to deliver for our customers as a product, basically get them closer to taxes are done. Said another way, I don't buy the law of the large numbers, in our case. We're going to continue to work hard to get at that number.

The second is QBO and acceleration. You're right, for us to deliver the 2 million to the 2.2 million subs growth, you're going to continue to see an acceleration in terms of the net adds we bring in on a quarterly basis. We fully know that and we continue to reinforce our confidence in that. And you may ask why.

Well, remember, one of the things we talked about when we gave that forecast is we needed to have total subs growth on a 40% compounded annual growth rate. This quarter was 45%.

The second thing is while we've made some adjustments outside the US and Canada and India, we've got a clear path to how to get those countries repositioned in a good way. UK and Australia are on fire and we just brought on two new countries, Brazil and France. And so we believe with the expanding TAM and the fact that we're early innings in both Self-Employed and Global, as well as the fact that the US grew in the mid 30s, we see our way to the 2 to 2.2.

We're not batting an eye. And your math is correct. We think that is doable.

Keith Weiss (Analyst - Morgan Stanley):

Excellent. Thank you very much, guys.

Brad Smith (Chairman & CEO):

All right, Keith. Thank you.

Operator:

Our next question comes from Kash Rangan of Bank of America Merrill Lynch.

Kash Rangan (Analyst - BoA Merrill Lynch):

Hello, guys. Congratulations on the Tax numbers in the Consumer side. My question is more on the QBO side.

Granted that you guys have been putting up very good growth in QBO sub base, I would have thought that the attached rate of Payroll and Payments, which are quite healthy at 19%, 8%. But I would have thought that those businesses should be growing even faster. And it's a little bit surprising that QBO base business, although it's larger than Payroll and Payments, it's actually growing faster and adding more new dollars than the other two businesses.

Can you help us understand when could we see the inflection point where the attached rate starts to inflect pretty materially that you could realize your growth objectives, which I'm sure are pretty aggressive with respect to Payments and Payroll? It seems to me there's something limiting these attach rates from going potentially very high. I'm sure that you've thought through this as much as anybody else, but just wanted to get your perspective. Thank you.

Brad Smith (Chairman & CEO):

Yes, Kash, thank you. I'd say first of all at face value, the one thing we have to keep in mind is we have a growing base of self-employed customers in these QBO numbers. And so those self-employed customers, by definition, don't have employees, so they don't need Payroll. And many times, they're driving for Uber or Lyft or somebody else, and they don't need Payments.

And so if you actually look at it on an apples-to-apples basis, our attach rate remains very healthy compared to where it was a year ago. At the same time, we do see opportunities to continue to improve the attach rate. We are focused on first use, making sure we reduce the friction in the customer experience and continuing to get those services available outside the US in the non-US countries, which will allow us to bring that penetration and that attach rate up for the total base.

So you're correct, we do think that there's still opportunity there. We're working on it hard. But one of the things you have to look at right now in the absolute numbers, is keep in mind that last quarter, we had 50,000 QBO Self-Employed. This quarter we have 75,000.

And that number doesn't come with Payroll and Payments opportunities today. And so that basically makes the attach rates look the way they do.

The other thing I would say about the ability to improve the revenue, the ecosystem, in addition to attach, is obviously we've shared with you in the past, we have customers that come in that first year on a promotional pricing period. When they hit the 13th month, that average revenue per customer for that unit goes up about 50%. And we're going to have customers rolling off that promotional pricing period and that's going to help us bring revenue up.

The last piece I'll add, so in addition to attach rates and moving off of promotional pricing, is retention. A year ago, we would talk to you about retention in the low to mid 70%s. We now talk to you in QBO about retention in the high 70%s and starting to tickle the low 80%s. And every point of retention adds a net 15,000 subs. And so that number is also a lever that we continue to improve and we've improved it significantly over the last 12 months.

So those are the pieces, Kash -- I know there's a lot of math in there -- those are the pieces that lead us to the confidence we have in the actual Online ecosystem revenue. It is attach rate. It is retention. And it is rolling off the promotional pricing.

Kash Rangan (Analyst - BoA Merrill Lynch):

Got it. That's all very Adobe-esque and very positive.

Brad, if I could sneak in one, what would be your longer term objective for Payroll and Payment attached rates on your QBO ecosystem? That's it for me. Thank you.

Brad Smith (Chairman & CEO):

Kash, I appreciate the feedback and the compliment comparing us to our friends here in the Valley. We have a lot of respect for them.

This is one of those mindset things, it's hard in management to say, what is the limitation? So we actually look at the number of people that are paying employees and saying we should have 100% of them, if they're using QBO. And how many are accepting their credit card? And we should say, hey, we should have 100% of them.

We know right now about half of small businesses accept payments. So we think that number is a good aspirational goal. Somewhere between here and there is reality. But right now, I'd hate to limit our potential by putting a number out there that our employees think is, okay, the best we can be.

Payroll for us is typically, we say, about 40% to 50% of Desktop customers. Since right now, our QBO feature functionality is a little more service oriented, I'd say somewhere in the 30% to 40% is the near term. But I think over time, you're looking at half of the base using Payroll, as well.

Kash Rangan (Analyst - BoA Merrill Lynch):

Wonderful. Thanks so much, Brad.

Operator:

Our next question comes from Brent Thill of UBS.

Brent Thill (Analyst - UBS):

Thank you. Brad, just on QBO, you raised the full year guide, but you reiterated your goal. And I think there are a few investor questions about the deceleration of growth, especially outside the US, where the growth rate is still obviously very healthy but decelerating very quickly.

If you could just put that into context of your targets on QuickBooks Online, where you feel like you're hitting, are you hitting the stride that you'd like to hit? You mentioned some of the reorganization in the process in India and in Canada. How long will that take to stabilize to help that base grow again?

Brad Smith (Chairman & CEO):

Brent, I'd be happy to do that. I'll start with it was just a short time ago, in the fall at Investor Day, when we removed the original target of 2 million subs, which was the original outlook for 2017 and we raised it to 2 million to 2.2 million. And we said, hey, that's a new goal. And that was about nine months ago, not even nine months ago.

And then from there, of course, we've been accelerating and said, to do that, we have to deliver 40%-plus CAGR. And we've been above that number. And so we actually are achieving the outcomes that we set for ourselves internally.

Now along the way, we've had some learning. One was Canada. As you know, we found out that we were selling units through retail and then they weren't retaining at the levels we expected them to. And so we shut down that channel. I will tell you the Canada pivot is now behind us and the momentum is rebuilding in Canada, and we feel very good about the Canada outlook right now.

The other area was India. And India is where we didn't take the time to localize the product and get all the compliance features at the level that an accountant would have confidence to recommend it. As a result, they were recommending our product in conjunction with another product and it was becoming a companion app. We did not want that to be the brand. And so we have now stopped that.

We've actually been finalizing the product localization and we're now starting to go direct to small businesses while we get back out to accountants and let them know the new version. That one is not as far along as Canada, but we're already seeing the progress in India, as well.

The last two are the new countries, Brazil, which has now ported its acquisition we did a year ago called ZeroPaper, reporting over onto QBO and we're starting to accelerate there. And then France, we just did general release.

So when you put that together, US remains strong, Self-Employed is opening a new market, Canada is back on track, India has made its turn, Brazil and France are ramping up, and the UK and Australia remain gang busters. And so we feel good about our 2 million to 2.2 million.

I understand, there's a little bit of you have to have faith and confidence if you take a look at what we've delivered so far. But I hope that we can demonstrate through the first quarter, the second quarter, that we're going to be on track to deliver those numbers, because we certainly feel good about them or we wouldn't reiterate the guidance.

Brent Thill (Analyst - UBS):

Okay. And Neil, you got out to a really good start early on in Tax. Were you able to accelerate any investments this quarter that maybe you wanted to put in that you got more confident that you could put in, given the trajectory of the Tax business out of the gate?

Neil Williams (CFO):

You know, Brent, we've been testing product experiments all along in the Tax business. I can tell you, we invested everywhere we saw a favorable payback. And you see that with the unit growth we've had this year. We didn't leave any investment dollars on the shelf, you can rest assured with that.

And we think, as Brad said, this is a multi-year journey. And so there are more things that we want to do next season. And we made some investments this season. I think it will pay off next year, as well.

Brent Thill (Analyst - UBS):

Thank you.

Operator:

Our next question comes from Ross MacMillan of RBC Capital Markets.

Ross MacMillan (Analyst - RBC Capital Markets):

Thanks so much and apologies for the background noise. I'm at an airport. Brad, I had a couple of questions.

Congrats from me on the tax season, as well. Great effort. I actually had two questions on QBO.

The first is when we look at the core US subs ex-international and self-employed, the net adds have flattened a little bit here in the last couple of quarters. And I'm just curious, as we think forward, especially towards the 2 million to 2.2 million goal, would you expect that the, call it, core domestic sub adds would reaccelerate again? Or I'd love your thoughts around that.

And then the second question is, you had the QBO announcement and you talked about the QBOA and the importance of the accounting channel. Maybe you could restate the importance there. It sounds like it has implications for churn and other aspects here, so I'd love to get your quotes of color there. Thanks.

Brad Smith (Chairman & CEO):

Thank you, Ross, and no problem on the background noise. I know you're a busy man out there traveling and appreciate you dialing in.

Let me start with QBO for a minute, core US. I think one of the things that we're working hard to help everybody understand inside the Company and outside is last year when we introduced QuickBooks Self-Employed, we actually eliminated the low end SKU in QuickBooks Online, which was called QuickBooks Online Simple Start. And so we always used to count QuickBooks Online Simple Start as the core QuickBooks Online product lineup, because there is a low-end customer who quite frankly was over served by that product and we shut it down and replaced it with QuickBooks Self-Employed.

So I think it's a little bit of a misnomer to say pull out Self-Employed and just tell us how the rest of QuickBooks Online is growing. So that would be similar to saying, pull out TurboTax Deluxe and just look at the rest of product lineup. I think it is something we all have to get our head around is it is a part of the core product lineup, and honestly, it's expanding TAM . There's 30 million to 50 million people in that space that the original QuickBooks Simple Start didn't serve.

So I think that would be the first thing. And I just want to make sure that you know that's how we look at it.

Now when you back that out and say, how is the QuickBooks Online core US business growing? What I like about it is it's doing exactly what we wanted it to do. It's expanding TAM .

So the Desktop customers are still growing. QBO, 80% of the customers are new to the franchise. They've never used QuickBooks or accounting before. Self-Employed is going after a category that they could have never been served before with the old QuickBooks Online Simple Start.

And you put it all together and in the US, that number is, without Self-Employed, growing in the mid 30%s, which is a very healthy number. But if you add back in Self-Employed, since we used to have Simple Start in there, the number is even better. So that would be the way we look at it in terms of core. And I do think there's continued opportunity to keep that healthy above 30% and even potentially accelerate it as we get wiser about how to market the Self-Employed product.

So that's on the Self-Employed side. On the accountant side, you're absolutely right. This business is strategic.

We've known for years two realities about the accountants being involved in a small business choice. The first is the success rate of the small business goes up 89% if they work with an accountant. The second is over half of all Accounting, Payroll, and Payment decisions are made because the accountants influenced them and told them to buy it. So they are a tremendous decision-making advocate for our products.

The third piece is a piece that we talked about today in the opening point. If the accountant is working with a small business, the retention of QuickBooks Online goes up 1,100 basis points, 11 points. And 1 point of retention is incredible for us in our subs business.

So the importance of the accountants has never been more critical as we move to SaaS. And we also think they're going to be the catalyst to get a lot of these customers to adopt the cloud, which is why we're leaning in so heavily with QuickBooks Online for accountants.

So that's the summary on the accountants side, and I hope I also helped clear up a little bit about how we look at core QBO, especially as it relates to Simple Start -- or Self-Employed, I'm sorry. I got the old term in there, Matt.

Operator:

Scott Schneeberger of Oppenheimer.

Scott Schneeberger (Analyst - Oppenheimer & Co.):

Thank you. Brad, I have one multi-part for you on TurboTax and then one for Neil.

On TurboTax, you had mentioned on an earlier question after you turned off Absolute Zero, you still grew very nicely on a relative basis. Could you please elaborate on this year versus past years?

And then as the follow-on, could you elaborate on the ACA and the fraud dynamic this year and how you're looking forward to next year? Thanks. And then I'll come back later with Neil's.

Brad Smith (Chairman & CEO):

Yes, Scott, thanks for the question. In terms of elaborating on TurboTax, as you know, the full season we picked up a little over 3 points of share. As you look at it in pieces and parts, sort of early season, what happened in the core season while Absolute Zero was an offering and then what happened at the end of season when Absolute Zero stopped being offered by us, although one of our competitors continued to offer a version of it out there and we went back to full price, we took equal parts share throughout the season. So we didn't have any variation that said, hey, this was all the result of this.

And then you step back and say, well, what drove that? When you look at it this year, the team put out 3x -- three times more the product innovation than we did last year. Over 20 new products feature functionality and innovations were put into the product. And that, plus a really good campaign that I think resonated, where people really felt more self-empowered, was what actually drove our competitive advantage this year. And so that's really the TurboTax piece.

In terms of ACA and fraud, we've been pretty consistent on ACA. It's just the next piece of legislation that's been introduced by government that causes people to say uh-oh, this is complicated. And our job is to say no, you're capable of doing it, we'll make it simple.

And we worked really hard for three years to do that. And the Affordable Care Act has not been a headwind at all. In fact, it's been one of the highest converting aspects of our website.

In terms of fraud, we'll have a summit again in the summertime with the rest of the industry and the IRS Commissioner, but I think we all collectively feel good that we made big advances this year as an industry. And we think that those advances will continue as we look ahead to next year and we remain committed to getting bad actors out of the US tax system.

Scott Schneeberger (Analyst - Oppenheimer & Co.):

Great. Thanks so much for that, Brad.

And then Neil, you alluded in prepared remarks that $4.30 still looks like the most reasonable shakeout points for FY17 EPS. At Investor Day, you discussed some things that would drive you toward the low and the high end of the range. Could you somewhat address that and tell us how you're seeing each of those items progressing now that we've moved a couple quarters since the Investor Day? Thanks so much.

Neil Williams (CFO):

Sure, Scott. I think the thing that this season's confirmed for us is that when we have an opportunity to increase our share and grow our customer counts, it's a great way to grow our top line revenue and also our earnings per share. Just like we talked about back in August, I think as we see opportunities to grow the top line more through customer acquisition, it tends to move us up and we tend to see move on the top side.

We are looking to invest and make the product better every day, both in Small Business and in Consumer Tax. As you can imagine, this time of year we have a lot of ideas, a lot of suggestions for ways to take advantage of that expanded addressable market that Brad mentioned and to grow the product faster. We're running tests and we're running experiments now to determine which of those we think would have the biggest impact next year, both in Small Business and in Consumer Tax.

We consider the markets that we're in. We've talked about some adjustments we've made to some of our markets outside the US already.

Those are things that help us balance, Scott, between delivering what we consider is a very strong mid-teens improvement in EPS, at the same time while continuing to invest in the future to be sure that we have a good FY18 and FY19 after FY17. So that's the way we're looking to balance it off for the balance of this year, and say more about that when we give guidance in August at Investor Day.

Operator:

Michael Nemeroff of Credit Suisse.

Michael Nemeroff (Analyst - Credit Suisse):

Thank you for taking my questions. You gave a lot of detail specifically around the blended retention rate. I was curious if you could maybe break out the retention rates or give us a sense of the retention rates, the differences between the different subscribers and QBO, the US, the international, and specifically the SE, since it's grown so fast.

And then on the delta in the contribution between a QBO sub and the Desktop customer, I'm curious, how many years do you anticipate before there's parity between those two customers in the future?

Brad Smith (Chairman & CEO):

Okay, Michael, I'll take the first one and have Neil jump in and help on the second one.

We are pretty guilty of sharing lots of facts and factoids, and our fact sheet is pretty rich. One of the things we haven't shared at this point is breaking out the retention rates for the different SKUs in QuickBooks Online. We don't tend to do that for the other product lines either, so QuickBooks Online Self-Employed versus its bigger brothers and sisters in US and non-US.

I can tell you what we did talk about, which is we began the year in the low to mid 70%s and we're finishing up the fiscal year with retention in the high 70%s. That's pretty significant improvement in a 12-month period, and we see opportunity to continue to improve that as we go into next year.

But unfortunately, we aren't breaking out at the level that you would like to hear it today. And over time, if we think that becomes more meaningful and material, then we'll consider doing that. And Neil, the second question was QBO subs and Desktop.

Neil Williams (CFO):

On the average revenue per user, Michael, there's a pretty big gap right now. We talked about around $425 a year for the US subscriber versus something around $125 a year for a subscriber outside the US. And what we said was we clearly expect to see that revenue per user grow for each one of those segments. And as Brad mentioned in the script, that's certainly our experience so far this year.

But we don't see that gap actually closing. And we don't see a QBO subscriber outside the US getting to the same average revenue per user we see in the US for a considerable time period.

We don't really have the Payroll and Payments attach opportunities that you see in the US outside the US. And that's where a lot of the revenue comes from, as you well know. And so we think that disparity is going to exist for a while. Are you speaking of Online primarily or are you thinking of Desktop?

Michael Nemeroff (Analyst - Credit Suisse):

Both actually, but that answers the question. Thank you very much.

Operator:

Our next question comes from Yun Kim of Brean Capital.

Yun Kim (Analyst - Brean Capital):

Hello, Brad. On the QBO Payroll and Payment attach rates, can you just talk about what efforts are being made to improve the attach rates for existing QBOs rather than focusing only on the new QBOs? So if you take out the QBO Self-Employed, are the overall attach rates for QBO subs improving?

Brad Smith (Chairman & CEO):

Yes, so let me just start with the second part of the question first. If you back out the Self-Employed and the non-US QBO subs, I'm looking at Matt and Jerry, I know we had done some math on that and I believe the answer is yes, they are a little bit year-over-year. So thank you for that. We've got so many different pieces of math here.

The second piece was then what are we doing in addition to new? And the good news is when someone's coming in and making an accounting decision, the best time to get them signed up for Payroll and Payments is in that first 90-day window. But that doesn't mean we can't go back and continue to drive penetration into the base.

And in a SaaS product, you're able to do that with special offers. You're able to do that with special offers, you're able to do that with moment of truth pop-ups and things that will say, hey, you just added another employee, would you like to sign up for payroll services? And just as we're learning at TurboTax, we can use machine learning and data science to look for more creative ways to expose them to these kinds of offers.

And so I have to tell you, TurboTax has been leading the way in using data as a way to attach products and services, and we're now bringing that same level of rigor to the QuickBooks Online team. And we're trying to use that as a way to improve the attach rates for Payroll and Payments, as well.

We're early days, but we think there's a lot of opportunity there. And we feel the same way many of you on this call have, which is looks like a lot of upside there, are you going after it aggressively? And our answer is yes, we are. And we agree, we have a lot of opportunity to continue to improve.

Yun Kim (Analyst - Brean Capital):

Okay. And then just on the QuickBooks Desktop unit sales has been pretty resilient over the past several quarters. I think last quarter you talked about some pricing was driving some of that resiliency. When can we expect that unit sales to go back to double-digit decline versus right now it's been pretty strong?

Brad Smith (Chairman & CEO):

You know, so far, Yun Kim, I've been wrong on every Desktop forecast we've made. Because one of the things that we assumed was that that customer behavior was predictable based upon what we saw in other product lines, like TurboTax and Desktop, and it's not.

What we're seeing right now is there's a very delighted group of QuickBooks Desktop customers. And when we try creative things like raising the price on them, lowering the price on the cloud, getting feature parity, that didn't move them. All it did was cause them to delay purchasing the newest version of QuickBooks Desktop.

So then we went back and we tested some pricing promotions. It's not an everyday low price. We just advertise at the price that it used to be before we raised it. And sure enough, those customers went out and bought the newer version of QuickBooks Desktop.

So the good news is they're staying with us. They're not going anywhere. And they're not hurting QuickBooks Online subscribers.

So really what we're doing now is we're making sure that we keep those customers happy. We continue to expose them to attached services, like Payroll and Payments, and we continue to let them know that there's a cloud-based version that's great for them, should they ever decide to move. But our hope right now is that we keep them in the franchise regardless of which product they choose.

Yun Kim (Analyst - Brean Capital):

Okay. Great. Thank you so much.

Operator:

Our next question comes from Nandan Amladi of Deutsche Bank.

Nandan Amladi (Analyst - Deutsche Bank):

Thank you. I'm at the airport, as well, so pardon the background noise.

I was going to ask about the media partnership that you announced yesterday. Can you put that in the context of the co-advisor networks you have and what segments and geographies this media partnership is intended to do and what your expectations are for revenue contribution?

Brad Smith (Chairman & CEO):

Great, Nandan. Thank you for the question.

As we talked a few minutes ago, accountants are critical. We've had a program for years called Pro Advisor. In the last couple years, as we've leaned into the cloud, we've put a cloud-based set of services together for them that includes QuickBooks Online for Accountants and a lot of other value added services. I mentioned the fact that we have 600,000 of our customers now that are linked to an accountant, and that's up 70% from last year.

And this announcement that we announced yesterday of BDO is just another example of we're working with accounting firms of all sizes, not just the independent firms, also the ones that buy our ProSeries and Lacerte product to do taxes, and also larger firms like BDO. At this point in time, we're working together to come up with a set of goals that we think are realistic in the first year as we get their firms trained and get them prepared to be good consultants for QuickBooks Online. So we haven't announced any public goals.

I can tell you, we're very excited about the partnership. They're a world-class firm. It's very relevant to the customers that we serve, and we think it will be value added for their firms, as well.

Nandan Amladi (Analyst - Deutsche Bank):

Thank you.

Operator:

Our next question comes from David Togut of Evercore ISI.

David Togut (Analyst - Evercore ISI):

Thank you for taking my question. Brad, you talked about promotional pricing rolling off for QBO. Can you help us think about FY17 and FY18 pricing both for QBO and TurboTax? What should we expect on a year-over-year basis apples-to-apples unit price?

Brad Smith (Chairman & CEO):

David, want to be wary of sharing any of our pricing decisions too far in advance, because obviously we have competition that would love to know the answers to these questions. But that being said, we have a tailwind. And our tailwind is, as you know, we offer a promotional discount in the first 30 days or sometimes the first 90 days for someone to come in to QuickBooks Online. They'll begin to use it for free, then they'll get a discount of like 30%, then they work their way up to full price.

And imagine the large base of net adds we've been putting in that will anniversary off of that at the 13th month and then will basically become full price at a roughly $24, $25 a month. And we have a nice tail wind of that base that's going to be rolling off that promotional pricing. So what you should expect in FY17 and going into FY18 is continuing improvement in average revenue per customer.

This is where Neil's answer a few minutes ago comes in to play. We've got three cohorts of customers. We have QuickBooks Online US, QuickBooks Online non-US, and of course, the mix effect of QuickBooks Self-

Employed. All of those are actually getting stronger every 90 days in terms of average revenue per customer.

But depending upon which one of those grows the fastest, it could actually bring the blended mix down a little bit. But we would tell you we look at it on a marginal contribution basis for each of those cohorts, and all of them are getting better and will continue to get better in FY17 and FY18.

David Togut (Analyst - Evercore ISI):

Thank you. That's very helpful. Just a quick follow-up.

You had mentioned that you had essentially equivalent functionality at this point between QB Desktop and QBO. Is the functionality for manufacturing customers, which I think is about 33% of the QB Desktop base, particular advance job costing and advance inventory management? Do you have equivalent functionality for those customers now on QBO versus QB Desktop?

Brad Smith (Chairman & CEO):

Yes, David, thanks for the question. And I didn't mean to suggest we had 100% feature parity, because we don't. We're still in that 70%-plus percent range.

We just made some decisions last week to continue to invest in building out feature parity to get it up to Premier and eventually to QuickBooks enterprise level. That will be a multi-year journey.

But I will put it into context for you. No, we don't have those advanced inventory capabilities today. We have foundational inventory which is different than it was six months ago, and it's getting stronger every day. But it's not advanced yet. We don't have the job costing in there yet.

But I think it's important for us to think about of the 3.5 million Desktop customers we have today, 2.5 million do have feature parity. 2.5 million could move over tomorrow if that was the only decision they were waiting on. And as we know, we've moved about 100,000 over through the first three quarters of this year. That's up 22% last year, but that's not 2.5 million.

So we're going to continue to build up feature parity. We think that's important for the long term. We're going to continue to try to get the accountants to encourage the Desktop customer to look at the cloud. And we'll continue to do things like promotional pricing.

But I think at the end of the day, we've just got to get that small business comfortable that it's good to be in the cloud. And I think that's just going to be a matter of time.

David Togut (Analyst - Evercore ISI):

Understood. Thanks so much for the helpful detail.

Operator:

Our next question comes from Patrick Coville [Rett] Research.

Patrick Coville (Analyst - Rett Research):

Hello there. Thank you so much for taking my question.

Going to ask you about the profitability in the Small Business segment, really nice uptick there that was notable. And some color on whether that was driven by the Desktop business or whether there was some moving parts in Online that are worth highlighting to us?

Neil Williams (CFO):

This is Neil. I think the big thing you're seeing there is the impact of the ratable accounting change we made last year that has some impact on this year, as well. The overall business unit contributions in the segment, if you take that into account, have been in the low 40%s, high 30%s. And that's where it ought to be and where we expect it to be.

Patrick Coville (Analyst - Rett Research):

Got it. And then looking forward to next year, the way that I model it out to get to your $4.30 EPS estimate, I think you guys will need a quite aggressive continuation in profitability in the Small Business segment. Is that right? And if so, what are the levers that I can expect you guys to pull on to achieve that?

Neil Williams (CFO):

Think about, Patrick, a couple things. On the plus side, we definitely continue to see improvements in average revenue per user and growth in customers.

This is also the side, though, where we have opportunities to grow and expand to invest in the markets where we're already entering the space, but where as Brad said, we're not the number one player. And we may consider additional markets next year. So this is a great area where we have big opportunities to draw revenue and increase revenue in the short run, but also big investment opportunities that don't pay off in the short run, either.

So we're balancing those two things in our planning process for a multi-year profit plan to be able to generate good cash and good profitability in the short run. But make sure that we're investing for the long haul, too, so that growth is sustainable and accelerating beyond 2017.

Patrick Coville (Analyst - Rett Research):

Got it. Got it. Thank you so much and well done on a brilliant three months.

Operator:

Thank you. And gentlemen, I'm not showing any further questions. Would you like to close with any additional remarks?

Brad Smith (Chairman & CEO):

Yes, I would, Operator. I want to thank everybody for the questions today.

As we're entering the final stretch of our fiscal year, we feel like we're building some really strong momentum. Our strategy is working. The innovation we're putting into our products is not easily replicated and matched by our competitors. And we're still on the early innings of penetrating this large and growing total addressable market.

So we're excited and we're looking forward to talking to you again soon. And until then, everyone have a good day. Take care.

Operator:

Ladies and gentlemen, thank you for participating.