inContact, Inc.

Fourth Quarter 2015 Earnings Conference Call

February 16, 2016

C O R P O R A T E   P A R T I C I P A N T S

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P R E S E N T A T I O N

Operator:

Good day, everyone, and welcome to today's program. At this time, all participants are in listen-only mode. Later, you will have the opportunity to ask questions during the question-and-answer session. You may register to ask a question anytime by pressing star and one on your touchtone phone and you may withdraw yourself from the queue by pressing the pound key. Please note this call is being recorded.

It's now my pleasure to turn the conference over to the Chief Financial Officer, Mr. Greg Ayers. Please go ahead.

Gregory Ayers:

Thank you and good afternoon. This is Greg Ayers, CFO of inContact. Welcome to our Q4 and Full Year 2015 Conference Call. I will begin the call with some prepared remarks and I will then turn the call over to CEO, Paul Jarman, to review our fourth quarter and full year results. Finally, I will provide additional detail on our financial results for the quarter and year before opening it up for Q&A. For access to our news release and other information about inContact, please visit our website at www.incontact.com.

The purpose of today's call is to provide you with information regarding our fourth quarter and full year 2015 results. Some of our discussion and responses to your questions may contain forward-looking statements which are subject to risks, uncertainties, and assumptions. Should any of these risks or uncertainties materialize or should our assumptions prove to be incorrect, actual Company results could differ materially from these forward-looking statements. These risks, uncertainties, and assumptions, as well as other information on potential risk factors that could affect our financial results, are included in our filings with the SEC, including our most recent report on Form 10-Q, particularly under the heading 'Risk Factors'. During the call, we may offer incremental metrics to provide additional insight into our business or quarterly results. Please be advised, this detail may be one time and may or may not be provided in the future and now, I'll turn the call over to Paul Jarman. Paul?

Paul Jarman:

Thank you, Greg, and thank you, everyone, for joining our call this afternoon. Today I am pleased to report exceptional results for fourth quarter and for the full year 2015, in both top line and bottom line financial performance. We are achieving strong momentum in three key metrics: revenues, customer growth, and operating margin. I am pleased to report that at the end of 2015, annualized monthly recurring revenues increased 42% to $159.4 million. For the full year 2015, we set a new record with 523 total customer contracts. We are attracting new customers at a strong pace and we're seeing excellent expansion within existing accounts. All of this is because we're making it easier for customers to drive tangible results with the broadest and most tenured cloud offering in the market. In 2015 we supported over 6 billion interaction which underscores the proven scalability of inContact's multitenant cloud customer experience solution. Building upon our leadership position in the cloud, we recently completed two small but meaningful technology acquisitions. These assets will bring added capabilities in unstructured data analytics and workforce optimization, further extending the reach of our solutions in two of our fastest growing areas. We'll share more detail on these transactions in a few minutes.

Total software revenue in Q4 came in at an all time high of $40.5 million, up 34% year-over-year. For the full year 2015, we achieved record software revenues of $143.7 million, up an impressive 43% for the year. I am pleased with our leadership performance in 2015 and we have much to look forward to in the coming year. Today, we are increasing our revenue guidance for 2016 which Greg will discuss in more detail later in the call.

Now let's take a look at profitability. We achieved a major milestone in our Company history with positive non-GAAP operating income for Q4. Non-GAAP operating income for Q4 was $1.3 million compared to a $2.8 million non-GAAP operating loss in Q4 of 2014, an improvement of $4.1 million. We anticipate an operating profit on a non-GAAP basis for the full year in 2016.

Turning to overall sales momentum in Q4; our software bookings represented 35% year-over-year growth in estimated contract value. Moving forward, we look for sales momentum in terms of Annualized Monthly Revenues or ARR. As I mentioned above, as of yearend, ARR increased a robust 42% year-over-year. ARR is a superior metric because it gives a complete picture of our forward momentum and revenue growth based on our subscription model. We are taking market share away from other players in a very large $18.1 billion total available market. This is another indicator of our compelling leadership position.

Over the last two years, we have regularly reported on how the vitality and competitive advantage of our channel strategy is paying off in multiple ways. The breadth and depth of our channel which includes carriers, unified communications, referral partners, bars, and implementation partners, gives us unparalleled reach across both the SMB and enterprise segments of the market. These channel partners provide a significant barrier to competitors who have a very limited partner ecosystem. We now have the largest carriers selling our product and every one of them is bringing in new enterprise customers every quarter. Combined carriers brought us in 26 new customers, some of which were our largest in 2015. We also now have major cloud UC providers in our partner ecosystem. Through them we are tapping into the strong adoption and momentum in the cloud unified communications market. The combined solution of unified communications and the contact center in the cloud is another powerful wedge for longterm market leadership. Two of our newest channels had partners delivering over $1 million in Annual Contract Value or ACV in 2015. Our strong partnership with Salesforce is another way that we attract and keep clients by offering a complete customer interaction solution in the cloud. An example of this is one of our larger customers who have up to 8,000 agents using our system in conjunction with Salesforce. In 2015, that global customer completed over 32 million calls, including over 2 million 911 emergency calls.

In January, we held our annual sales kickoff and partner event with over 70 attendees, representing carriers, bars, UC, and referral partners, learning alongside our partner facing and direct sales teams. Those partners are getting in-depth training, market understanding, sales enablement, and go-to-market support to ensure our mutual success. In 2016, we are turbo charging our channel by sharing our deep expertise in cloud, contact center, customer experience, and how they can help organizations achieve their goal.

Customer experience is rapidly evolving for organizations of any size, a result of the proliferation of digital channels and social media, mobile technology, the need to reduce customer churn and increased loyalty of always on consumers. As a result, enterprises seek a customer experience strategy that successfully connects to consumers throughout the customer journey. Every contact or touch point on that customer journey is an opportunity to get the customer on-board, complete the sell, increase their loyalty, reduce churn and otherwise drive greater customer satisfaction. The contact center is truly the front line in this battle. We are succeeding in providing the best performing and widest range of tools to help make these contact centers achieve their business objectives.

While we are especially seeing this success with our enterprise customers, we now have over 85 customers that bill over half a million annually and over 20 customers who are billing over a million. Customer billings in excess of $1 million increased 92% over 2014. We also have over 115 Fortune-500 or Global-2000 customers. With our product and distribution advantages, we are adding enterprise customers at a faster rate than the market. Our revenues grow significantly with them as they roll out our complete solution to all their divisions and regions over time. The great news is that these customers are willing to share how inContact is making it easier to achieve their goals. At a recent industry event, our primary contact, Columbia Sportswear shared dramatic results since moving to the inContact cloud solution. In four years, their call volume increased tenfold to over 1.3 million per year. At the same time, they reduced total cost of ownership by 15%. Another customer achieved over $18 million in savings from using our solution in 2015.

Our recent announced contract with a large national digital healthcare company offers an excellent example of how our software enables improved business outcomes for our customers. Our solution will enable omnichannel connectivity between patients and thousands of specialized caregivers via both 24/7 on demand capabilities as well as scheduled sessions. These interactions will include both voice communications and two-way digital information displayed on mobile devices, all of which will be recorded and stored in compliance with HIPAA standards. Our solution also includes full integration with patients' electronic medical records and with specialized wearables, tailored to the needs of each disease program. The majority of these caregivers will work remotely from their own offices for care centers in this revolutionary protocol for disease management. On-premise software wasn't even a consideration in the RFP process for this account. We beat all comers in the SaaS space with a solution that is in this customer's words, 'profoundly human in its approach'. inContact was selected for many factors including streamlined omnichannel routing including voice, chat and e-mail, built-in scalability to support up to 5,000 caregivers within 12 to 18 months, competitive pricing and the complete cloud solution with workforce optimization and in-depth real-time reporting.

Let me now give you another example of a global networking technology company serving retail, manufacturing, and other industries. They are making the move from three disparate premise systems which were inflexible, complex, and difficult to administer with 600 agents located in six centers in North America, APAC, EMEA, and Latin America. They chose inContact to help them to achieve two primary goals: improve global customer service for B2B customers, and improve visibility and operational effectiveness across the enterprise. They chose inContact over competing cloud providers because we have the most unified solution; we have superior end-to-end reporting and flexibility in the cloud; we have a superior value adding ecosystem built on our APIs with over 200 available for developers; and we do all of this globally.

We have a unique position in the cloud market. We have the most complete and easiest and most reliable way to help companies achieve their customer experience goals. Continuous innovation is part of our DNA at inContact. We were recently honored with a 2016 Product of the Year award from Customer Magazine. Our groundbreaking new agent interface, inContact's My Agent Experience or MAX, was recognized as one of the most innovative technologies for customer experience in 2015. During the last month, we closed two technology acquisitions. We acquired intellectual property including five patents around advanced analytics technology from Attensity, Inc., a leading provider of text-based analytics. A group of Attensity engineers from their Salt Lake City office have joined our Team. We also acquired AC2, a New Jersey based company focused on workforce optimization technology which included another five patents to continue to augment our workforce optimization solutions. A small group of AC2 employees are joining our Workforce Optimization Group in Columbus, Ohio. In both cases, the companies were focused primarily on building new technologies to take to market. They have proven their solutions with mid-market and enterprise customers, and built the technology in a multitenant cloud environment. We expect these acquisitions to make a meaningful contribution to revenues in 2017 and beyond and we will be integrating this software into our product offerings and training our sales teams on these solutions throughout the year.

Our first acquisition brings us tremendous opportunity in analytics using natural language processing technology to analyze large amounts of unstructured data. That data explosion comes from a variety of channels including e-mail, text, chat, customer survey, blogs, communities, social media and other channels. The customer intelligence software from Attensity is built on expertise in extracting timely, relevant insights from millions of text-based conversations. The Attensity big data engine gives us significant capabilities in text-based analytics for all customer experience channels and is a significant untapped market for us with an estimated market size of over $1 billion. Unstructured data from e-mails, texts, survey results, trouble tickets, tweets, and other social media includes a wealth of actionable business intelligence. With our newly acquired software, companies can analyze this mountain of unstructured data for compliments or complaints, products or service issues, and respond proactively using the resources already available in the contact center. Using patented and natural language processing technology, we extract an accurate and meaningful reflection of the underlying sentiment of the comment or the subtle meaning that identifies trends and customer intent. This solution is built for big data and can help organizations predict consumer behavior. Nearly 40% of contact centers use text and instant messaging with this number set to increase to over 60% by 2017, representing one of the fastest growing segments in the customer experience area. Attensity has already shown success with Fortune-500 customers and we expect with this additional solution, we will be a leader in the text-based channels that are becoming a key part of our omnichannel solution.

The second technology acquisition is a perfect addition to our workforce optimization solution which continues to be a game changer in the cloud. The new technology is for workforce management tools that are covered by five US patents and will be a big differentiator for us. As companies seek greater efficiency and utilization of their agents through intelligent scheduling, automated workforce management tools can optimize agent performance and costs. These technologies will complement our current workforce management solution that we offer in the market today. The new W-10 (phon) technologies are used by mid-market and enterprise companies such as Delta Airlines.

Continuous innovation and technology vision separates the leaders from the rest. We have the widest and deepest multitenant solution in the market. inContact now holds 29 total patents across all of our software solutions. We lead our industry with our complete vision and ability to execute whereas competitors have offerings that are still less complete, reliable, or less proven. Our ability to simultaneously produce revenue growth and bottom line performance is evidenced in the 2015 results, and is foremost in our plans for 2016. The Company's incentive program is centered on these three key targets: total software revenues, annualized recurring revenues, and non-GAAP operating income. By aligning compensation to business results and guidance, we are highly committed to delivering results which we believe will translate into significant market appreciation.

In summary, inContact is delivering market-leading growth, continuous innovation in customer experience technology, a high-performing go-to-market sales organization and channel ecosystem, and increasing non-GAAP operating results.

I would now like to turn the time over to Greg for more Q4 and 2015 financial details and for the 2016 guidance.

Gregory Ayers:

Thank you, Paul. We achieved very strong results in the fourth quarter and now I'll provide more details about the financial performance. The financial results I will discuss are presented on both a GAAP and non-GAAP basis. However, all revenue figures are GAAP. At this point, I'd also like to remind everyone of the Safe Harbor statement made at the beginning of the call.

First let's look at the software segment which includes all revenue related to the delivery of our software application and associated professional services. For Q4 2015, I'm happy to report that software segment revenue increased 20—excuse me, $40.5 million, a 34% increase over last year's $30.3 million Annualized monthly recurring revenues at the end of 2015 totaled $159.4 million, a 42% increase over the $112.6 million level for ARR one year ago. Annualized monthly recurring revenue equals recurring software revenue for the last month of the quarter multiplied by 12. Recurring software revenue includes all subscription software revenues, maintenance revenues from customers that previously purchased Uptivity's workforce optimization software on a licensed basis, and the small portion of professional services revenues that we recognize ratably over a 50-month period. It excludes license sales of our premise-based WFO software and related professional services revenues and of course all revenues associated with our Network Connectivity segment. Because of our focus on subscription revenues, we believe the ARR metric is the best way to measure the success of the Company's revenue growth initiatives. It incorporates all components of revenue: existing accounts, new accounts, growth in the number of seats at all existing accounts, additional services implemented at existing accounts, and net attrition, into one metric. Both new business and growth at existing accounts were important contributors to the growth at ARR for the fourth quarter.

Bookings as measured by Annual Contract Value or ACV grew 35% over levels recorded in Q4 of last year. It's the last time we will report bookings on a quarterly basis as we encourage Investors to shift their focus to the more complete metric of ARR. We closed 144 new contracts in the quarter, including 93 new logos and 51 up-sells to existing accounts. Our software revenue retention rate which excludes up-sells, was approximately 93% in Q4.

Now I'd like to turn to software segment gross margins. On a non-GAAP basis which excludes stock-based compensation as well as the amortization of acquired intangibles, gross margin for the software segment reached 63.5%, up from 62.8% in Q4 of '14. For the full year, gross margins improved to 63% in 2015 versus 61.1% in 2014. Gross margins benefited during the period from revenue increases attributable to higher seed volume as well as leverage in customer service and network operation expenses. We believe this level of improvement in gross margin is sustainable going forward.

Our second segment is Network Connectivity which includes all communications services provided to our software customers as well as to legacy telco clients. Network Connectivity segment revenue for Q4 2015 was $21 million, a 10% increase over the $19.1 million in Q4 of last year. For the full year, Network Connectivity revenues also grew 10% to a total of $78.3 million. Gross margin for the Network connectivity segment was 39.6% in Q4, a substantial increase over the 36.5% gross margins in Q4 of 2014. Operating margin for this segment was a record 31.8% in Q4, a large increase over 24.6% in Q4 of 2014. Improvement in the gross margin is principally attributable to reduced unit costs paid to carriers, driven by volume increases. While we believe these lower per minute rates are sustainable, other considerations impacting the network connectivity gross margin yields gross margin guidance in the 36% to 37% range.

With the exception of accounts sold by certain carrier and cloud TDX partners, contact center prospects typically request that we provide their connectivity services. We believe our global, geographically redundant carrier class network, providing both time-division multiplexing and VoIP connectivity, results in superior call quality. Recently, we've quantified this qualitative advantage by publishing our MOS scores, a standard measure of call quality used throughout the telecom industry. In January, we began providing MOS scores for individual accounts on an overnight basis. This is an unprecedented level of disclosure for our industry and highlights the competitive advantage we enjoy as a result of our carrier-grade network.

Consolidated revenue for Q4 increased to $61.5 million, a 24% increase from last year's $49.4 million. On a non-GAAP basis, consolidated gross margin was 55.4%, up from 52.6% in Q4 of 2014. The improvement in consolidated gross margin was attributable to economies of scale in both the software and Network Connectivity segments. Total operating expenses equaled 56% of revenues in Q4, down from 61% of revenues last year. This is a drop of 500 basis points, reflecting the operating leverage in our business model. Sales and marketing expenditures equaled 27.4% of total revenues, an increase of $2.3 million over Q4 of 2014. R&D spending was equal to 13.5% of revenues, in line with recent quarters. In the fourth quarter, G&A spending fell to 15.5% of total revenues compared to 17.9% a year ago. We're seeing some of the benefits of our initiatives to increase efficiencies through automation and business process improvements. GAAP operating loss for Q4 was $2.1 million, a 61% improvement from the operating loss of $5.5 million in Q4 of 2014. On a non-GAAP basis, operating income for Q4 was $1.3 million compared to $2.8 million operating loss in Q4 of 2014, an improvement of $4.1 million.

Adjusted EBITDA, a non-GAAP measure, is an important metric of our operating results due to the significant amount of depreciation and amortization resulting from the acquisitions of software, customer basis and Network technology, as well as the amortization of capitalized software development costs and stock-based comp. Adjusted EBITDA was $5.8 million for Q4, substantially greater than the $1.2 million recorded in Q4 of 2014. On a sequential basis, Adjusted EBITDA increased by roughly $1.9 million. This was our 16th consecutive quarter with positive Adjusted EBITDA. We were pleased with the leverage shown by our business model this quarter, increasing Adjusted EBITDA by $4.6 million year-over-year on a $12.1 million increase in revenues.

At quarter end, we had over $29 million in cash and cash equivalents, $75.1 million in short-term investments, and access to additional $15 million under our line of credit.

Now turning to updated guidance for 2016; I would like to remind everyone of the Safe Harbor statement at the beginning of today's call. Also our guidance for 2016 is inclusive of the impact on both revenues and expenses of the two recently completed technology acquisitions. Based on the strong software revenue results we've achieved in Q4, we're raising our guidance for 2016. Twenty sixteen, we anticipate consolidated revenues to be between $257 million and $263 million. We expect total software revenues to be between $177 million and $183 million for the full year. This represents a 23% to 27% growth rate for software revenues. We expect to achieve this increased software guidance even as we accelerate our conversion of the Uptivity workforce optimization revenue from premise to SaaS.

We currently anticipate that perpetual license revenues will account for less than approximately 2% of total software revenues by Q4 of 2016. This decrease in perpetual license revenue will have no impact on our ARR metric in 2016. We expect to achieve operating income of $2 million to $2.5 million on a non-GAAP basis for the full year. We expect Adjusted EBITDA will be between $19.5 million and $21 million, which would represent a growth rate of 41% to 51%. For EPS, on a non-GAAP basis, we anticipate a net loss of $0.06 to $0.09 per share in 2016. In 2015, we demonstrated our ability to grow revenues at a rate comparable to the best companies in the SaaS sector even as we improved our margins considerably. We expect to sustain high revenue growth and improve profit and cash flow margins again in 2016.

Operator, we're now ready to take questions.

Operator:

At this time, if you would like to ask a question, please press star and one on your touchtone phone. You may withdraw your question by pressing the pound key. Once again, it's star and one on your touchtone phone.

We'll go first to John Difucci with Jefferies. Please go ahead.

John Difucci:

Thank you. Paul, I have a question on what you refer to or we refer to sometimes as true cloud adoption as contact center software and I'm not just talking about hosting, I'm talking about true cloud multitenant solution. Your results reflect strong momentum here. I guess, are you seeing incremental traction? Because it's our understanding that the penetration here is still pretty low but are you seeing incremental traction of customers willing to—or require—or requesting to sort of a switch from on-premise or even a hosted solution to a true cloud solution? I guess in the context of that, are you seeing any incremental macro pressure that some companies are starting to talk about right now?

Paul Jarman:

You bet, John. So let me answer them in order there. So, first of all, as it relates to incremental adoption in our space, there is a couple of factors that are helping us. The first is, is that the customer experience is just becoming a bigger topic at a company and that drives the look at additional technologies and looking at how to get multiple channels working together is driving additional interest. So then the mid market is saying, 'hey the cloud is a very easy way of doing this'. But what we're seeing which is helpful is, there is more and more of the enterprises willing to look at it and start to do it. Those two examples I gave in my talk were both around 600 seats and both of those said, we would prefer a cloud solution first. So our RFP is going there first before we consider anybody on the prem. So when you start to get lot of those 600,000 to 800,000 seats centers saying we're going to tilt our RFP just to the cloud. That's very different than a few years ago and it's very encouraging for us.

We've not really seen a lot of people come to us and say, wow, we need to change our strategies or we need to change how we're working with our customers because of any economic worries today. We've seen in other tougher economic times that often the customer experience area and the retention and the ability to make costs more effective through technology resonate in good and bad economies. So we've not seen that yet and that's all we've seen so far.

John Difucci:

That's really helpful, Paul. Thank you on both of those counts. I guess if I could, Greg, a follow up. As we anticipate run rate profitability going forward here or as it develops, where do you expect to get the most leverage out of the model? Should we expect this in the gross margin line and I know you've had some other things, some other projects that you've been working on to improve internal efficiencies such as a new billing system. I guess, how do all these things come together and where do we see, like as we model out the future, where we start to see the improvement?

Gregory Ayers:

Yes, John, I think that about three quarters of the improvement is going to come in the gross profit and about a quarter of the improvement is going to be in leverage on the G&A line. Obviously we'll evaluate the investments that we make against the anticipated payoffs. We are presented with great opportunities every quarter with regard to make investments but we obviously go through that rational evaluation, but mostly on the gross profit line.

John Difucci:

Okay, great. Nice job, guys. Thank you.

Operator:

We'll take our next question from Katherine Egbert with Piper Jaffray.

Katherine Egbert:

Hi. Good afternoon. To follow up a little bit, this quarter you saw record number of new contracts, record number of new logos, and solid expansions. Can you talk about may be elaborate a little bit more on what you just said about RFPs for the cloud, I mean are you seeing an increasing number of RFPs? Is your win rate going up? Any color you can provide, thanks

Paul Jarman:

Yes, so, Katherine, a couple of things on that. First of all, we're seeing more RFPs where there're just given the cloud providers where in the past it used to be it was all half prem, half cloud. So that is starting to become more common where given the cloud providers have nod to prem. Secondly, we are winning more contracts and we are growing and part of that is because we have a deeper, not only direct sales team but ecosystem around more routes to market. So as we see synergies with bars and UC companies and carriers and our own efforts with more cloud interest, the width of our distribution helps us capture that interest because a lot of that still has to be sold out there. I mean we just need more people talking about; A, the cloud; and B, inContact as they're doing it and so as we expand the number of people telling the story, that's the other helpful benefit we're seeing.

Katherine Egbert:

Thanks. That helps and then on the financial side, Greg, you're projecting an operating profit for the year. Can you tell us how maybe that plays out? How does that shape throughout the year? Obviously, this quarter in 2015 only Cupola (phon) was operating profitable. Could you just maybe say how that would play out and then also the impact of the acquisitions on operating expenditures in 2016? Thanks.

Gregory Ayers:

Sure. So, obviously as has been demonstrated by our performance in Q4 this year, we see significant leverage in Q4 given the seasonality. That taken along with the fact that there are sometimes seasonal expenses with regard to our user conference and other trade shows that we attend, would indicate that it's clearly—we're not—again, if we had felt comfortable making the—establishing the expectation or providing guidance that would be non-GAAP operating income for every quarter, we would have. So, goes to reason that it'll—it could be close to breakeven for a couple of quarters before again we return back to solid non-GAAP operating income in Q4.

Katherine Egbert:

Okay. That's really helpful. I'll jump back in the queue. Good job.

Operator:

We'll take the next question from Mike Latimore with Northland Capital. Please go ahead.

Mike Latimore:

Hi, great. Thanks a lot. Excellent quarter and year (inaudible). The—I think, Paul, you talked about further emphasizing the channel I believe this year. Can you talk a little bit about some of the efforts around that and then also any expectations in terms of sales headcount growth this year from a direct standpoint?

Paul Jarman:

Yes. So a couple of things on that. So number one is we have made some investments last year in not only adding to the channels but speeding up our ability to enable the channel. So the training, the processes and all the things that it takes to get someone up and selling and effective, we've added people to that process and so we're really two-fold in '16. One is we brought on some really good partners in '15 and our job over the first couple of quarters is really enabling them and accelerating their ability to tell our story and bring in additional revenue. At the same time, we have some people that specialize in bringing new partners in and adding to our current partner portfolio. We're very—we're unique in that we can really offer a partner anything from a referral agreement to a resale agreement to an OEM agreement and having significant experience in each of those areas has been helpful bringing partners to us and then it's just the hard work and kind of the day-to-day battle of helping them really be effective but we understand how to do it and we're doing a lot more of that. For example, I talked about having over 70 people at our kickoff which was used to be just for our direct sales team. So they got all the same instruction that our own direct sales people had at the conference.

Your second question is basically this. We really kept our percent of the sales cost, sales and marketing cost constant with our revenue growth. So total revenue we've been around 28%, 29% on average of revenue that we respend in to sales and marketing. We'll keep that constant and we're going to be allocating those dollars between direct sales and channel sales and channel enablement. So nothing really specific as to a percent increase, but just know that the increases are in line with our percent of revenue we're spending in sales and marketing.

Mike Latimore:

Fair enough and I know you went through an absolutely dollar book but was the absolute dollar booked in the fourth quarter higher than that in the third quarter?

Paul Jarman:

It was.

Mike Latimore:

Okay and then can you talk a little bit about just sales cycle and I know you're getting into more big deals but I guess can you talk maybe about the sales cycle and the traditional maybe smaller side of the market versus what you're seeing in the large side of the market, just any changes over the last year on sales cycle in those respective carriers?

Paul Jarman:

Yes, and for us the SMB market is between zero and a hundred seats and often times we'll see those sale cycles within 90 days. Sometimes the bigger ones of those will go to maybe four months but that's usually 90 to 120 days in those cycles. The enterprise cycles can be anywhere from four to eight months and just depending on what type of customer, what type of project, but what is better though is that we spend a lot less time than we used to convincing them to consider the cloud. Now it's really about, how we solve their problems, how we give them confidence in inContact and move through their internal processes, so it's not nearly the missionary sell it used to be. It's more just facilitation of a decision.

Mike Latimore:

Okay and then I guess last question is just on software gross margin. Greg, did you say that you expect the software gross margin to improve or stay the same this year? I wasn't quite clear on that?

Gregory Ayers:

Yes, Mike. So we're expecting to see leverage in the software segment and obviously that was going to help us achieve non-GAAP operating income for the full year and so most of the leverage is going to come in the gross margin line. Some of that is also going to be—the profitability is going to be contributed by leverage in G&A.

Mike Latimore:

Okay, great. Thanks a lot. Great, great, quarter.

Operator:

The next question comes from Brian Schwartz with Oppenheimer. Please go ahead.

Brian Schwartz:

Yes, hi. Thanks for taking my questions here this afternoon. I have a one question and then a follow-up for Greg. Paul, someone asked you a question about sales cycles on the different market segments and then there's been a lot of questions here about the demand environment after a real strong quarter that you guys put out. The question I wanted to ask you, maybe you could help us out a little bit, you know what are you seeing in terms of the pipeline momentum or the demand momentum if you kind of parse the mid market that you're going after? So if you kind of look at the SMB market, the less than 100-seat folks and then your enterprise, your 100 plus seats, and then that larger enterprise, those hundreds of types seat deals that are out there, is it possible to update us on kind of what you're seeing in terms of the opportunities ahead in those three segments of the mid market?

Paul Jarman:

Yes, you bet. So, Brian, what I said earlier in the call which—that was interesting was our million plus accounts grew by 92% year-over-year. So that gives you a feel for the growth rate in the largest accounts and what we're seeing in the market right now. We expect to see steady progress in all three. We have a good inside sales team for the mid-market. We have some great new partners focused on the mid-market. Our direct sales team I think is very good at that kind of 100 to 1,000 range, and then we have with the carriers and some other partners, some abilities to go in to get those bigger accounts and so we feel like we have distribution to all three, we're seeing interest in all three and we expect to see it set across those three this year. So, we've—pleasantly, we're surprised by the enterprise success and speed and we expect to see that continue but we're in no ways less excited in what we're seeing in the mid and the SMB.

Brian Schwartz:

Thanks, Paul, and then the follow-up question I had was just around the topic of the operating margin. You talked about that as a key metric for the business. If I look at the guidance here for 2016, looks really nice here. It looks anywhere from about 100 basis points to 300 basis points of operating margin expansion. The question I wanted to ask you is how should we think about your philosophy, the management philosophy, for the future operating margin expansion given now you're entering a position, it's a very high class problem in terms of having to decide what to do around the velocity of the profitable operating income that the business is investing. So anything that you could help us in terms of the medium-term and just how you think about the future pace of operating margin? Thanks.

Paul Jarman:

So I'd say this. We have—we've really stated three objectives. One is revenue growth, ARR growth, and bottom-line improvement. So we believe we're at a size and a scale where we should be able to show great growth and continue to show better bottom-line results. So when you look at that, you'll see emphasis adding contact about you know taking that journey from EBITDA to non-GAAP operating to non-GAAP net income and we're on that journey. We're going to do that. At the same time, you're going to see on occasion take advantage of unique opportunities. We felt with like these two acquisitions, that they are key parts of our market. They were the right companies at the right price and we'll spend about $1.5 million in '16 net getting those all through our systems and ready to market. So that takes a little bit of our operating leverage down but just a portion and really, it's still a very good number as you mentioned.

Brian Schwartz:

Good color. Thank you very much.

Operator:

The next question is from Eric Martinuzzi with Lake Street Capital.

Eric Martinuzzi:

Yes on the two acquisitions, I understand the guidance captures them but can you break that apart and is there a material contribution from either or both?

Paul Jarman:

Well, as I just mentioned to Brian, on a net basis there—about $1.5 million for us in expense for the year above their contribution. When you look at those two acquisitions, what we were looking for was really great technology that had good IP and had experts that continue progressing it and so we didn't buy them for a lot of revenue. They don't have a lot of revenue. But what they do have is very capable competent technology stacks that we are immediately integrating into our products and we believe that those will have significant differentiation for how we sell our current products and also new areas of revenue and new price points and cross-sell, up-sell into our base over time. So I would say that the bigger investment in general will be associated with the Attensity or the unstructured data and analytics but they both—you know they'll both be key activities for us over the next nine months.

Eric Martinuzzi:

Got it. Thanks.

Operator:

The next question is from Jeff Van Rhee with Craig-Hallum.

Jeff Van Rhee:

Great thanks. Paul, before you move on from the acquisitions, just in terms of integration challenges going forward, have you got live customers in the field with both of these vendors? Just give me a sense of what the technology roadmap looks like and where you are right now.

Paul Jarman:

You bet. So we have both. We have live customers with both acquisitions and frankly we have live customers that are both mid-market and Fortune-500 quality. So both of these have similar technology stacks as us, both of these have multitenant solutions, so that we don't have to re-go in and re-operate on the code to make it multitenant, and both of these have decent APIs that allow us a really descent integration in. We'll be taking the analytics product and obviously doing additional integration to capture some of the benefit into our text channels. But the nice thing is, is it's already multitenant. They spent the that last two years making it multitenant and it should be a reasonable effort for us to get the first stages done in the next 90 to 120 days and then follow-on stages over the next 6 to 12 months.

Jeff Van Rhee:

Understanding it's extremely early but if they're out there and they've got some customers, can you just give us a sense of what kind of ARPU, either they're delivering standalone or how do you think about ARPU uplift?

Paul Jarman:

So there's a couple types of uplift that we think we can see. We think it helps us in our organic win rates because we're now delivering insight and advanced scheduling on top of our algorithms, on top of what we already have. The second is that they do create more value in some of our products we have today and the third is, is they have standalone solutions that could be $20 to $30 as we sell on alongside of what we do. So think of the other price points we have in workforce optimization. It would look something similar to some of those

Jeff Van Rhee:

Okay and then along those lines, workforce optimization, Greg, you alluded to it but I just want to take it to the conclusion. As far as Uptivity and this conversion from the perpetual to the recurring, what kind of drag does that represent for '16 over '15 because of that conversion cycle?

Gregory Ayers:

So, Jeff, it's about our a 2% software growth headwind.

Jeff Van Rhee:

Two percent software growth. Okay, got it and then just a few cleanup items. The channel as a percent of either revenue or bookings, probably bookings would be the better this quarter?

Gregory Ayers:

Yes, it was a little higher than 50%.

Jeff Van Rhee:

How do you think about that? I mean does the pipeline suggests that sort of sustainable or is higher than we should think?

Paul Jarman:

Are you asking the percent, Jeff, or you asking what?

Jeff Van Rhee:

Yes, just the mix of probably what your pipeline looks like. So percent—if the channel is just over 50% of bookings this quarter in Q4, as you look at the pipe in Q1, is channel really surging as a percent or do we stay steady here? Just what you're seeing in the pipe with respect to mix of bookings.

Paul Jarman:

I think your channel's pushing ahead a little bit. So that kind of 50% to 60%, we're trying to keep it as above that range but as we add additional partners, we're seeing a little bit of additional weight there.

Jeff Van Rhee:

Okay and last quarter you commented on your telco partners and I think you had said there were 20% of bookings. Any chance you can update that this quarter? Did you see material improvement from that or similar?

Paul Jarman:

Yes, I think it's right in close proximity to where we were last quarter. So about the same percent.

Jeff Van Rhee:

Okay and then I guess, just last one, I'll let somebody else jump on. Greg, with respect to the numbers you gave the EBITDA, can you take that all the way out to free cash flow maybe fill in some of the gaps, how we should think about capitalized cap ex and maybe even a sense of what that yields on free cash flow?

Gregory Ayers:

Jeff, I can give you a couple of data points with regard to a capitalization of software in '16. So we're expecting it to be a little bit higher than it was this year, so around $12 million to $13 million. PP&E should be slightly less than what we spent in '15, somewhere around the $13 million level and so when looking obviously to generate cash from operating activities, but given the fact that we've done these two acquisitions, and then we'll still be capitalizing a significant portion of the software development costs, we're not at free cash flow yet.

Jeff Van Rhee:

Okay, great. Great quarter, guys. Thanks.

Operator:

Next we'll go to Mark Schappel with Benchmark.

Mark Schappel:

Hi. Good evening. Nice job on the quarter, guys. Greg, as a follow up to an earlier question, in your prepared remarks you mentioned that you plan to accelerate the conversion of upcoming revenues to subscription. So I was just wondering if you could just touch on a few of the initiatives you are working on to make this conversion happen any quicker.

Paul Jarman:

Yes, Mark, I'll address that one. So, really, Mark, what we're doing is we've—we've had for the last year and half, a cloud Uptivity privatized to the inContact product. When we sold the prem solutions in the past, we've sold them when it connects to the premise Avaya or premise Cisco or other prem pieces on the customer site. What we've enabled is the fact that we can now keep our solution in the cloud and still connect it to the premise Avaya, premise Cisco and that was the key point that allowed us to move the other part of that business to be different where we could now sell cloud-based workforce optimization to premise-based products that weren't ours.

Mark Schappel:

Okay. Great and then just a follow-up to an earlier question on the headcount growth, would you expect most of that to happen at the end of first half of the year, headcount growth?

Paul Jarman:

Headcount in general or…

Mark Schappel:

I'm sorry, sales headcount.

Paul Jarman:

Okay. It will be ratable through the year. We'll keep it—if you can just keep it close to that 29%, 28%, it will just be kind of ratable with that as a percent.

Mark Schappel:

Great, thank you.

Operator:

Next we'll take a follow-up from Katherine Egbert with Piper Jaffray.

Katherine Egbert:

Hi, thanks. Real quick, Greg, you mentioned—oh, I'm sorry, Paul you mentioned in your introductory remarks, international expansion. Can you elaborate? You haven't talked about that too much previously.

Paul Jarman:

Well, so there's two parts of international expansion, Katherine. There's the part where we are—our solutions are available in lots of different countries. So we have call center or contact center agents in over a hundred countries today that use our product. So the first thing we're attracting is a lot more multinationals, because—you know especially the strong US presence, we can connect their worldwide contact center and follow the sun into a single system. That's exciting to them. As I mentioned in my contacts there was one at APAC and Latin America and Europe and the US, and we can make that work seamlessly across the different areas. So, one of them is just frankly that the multinationals can be very effective with our solution. As it relates to our international expansion, our primary focus has been Europe, as we already have facilities there. We have partners there and we have some direct sales people there and some service teams there. So that's where we would focus mostly this year as it relates to actual selling into other parts of the world and gaining business. We have, as you look at some of the partners we have, like the RingCentrals and others, they have presence in a lot of these places and we'll piggyback from them into those markets.

Katherine Egbert:

Okay and then just real quickly, what about any kind of vertical specialty, particularly in say like federal?

Paul Jarman:

Great question. What we are doing is, is we've already had a lot of success in staying local. One of our larger accounts in the fourth quarter came from actual state government and as Brian asked earlier about our investments versus our net income strategy, we will be spending a little less than a million dollars this year in becoming certified for the Federal government so that we can be Federal M certified and sell it our whole new sectors. So that's another area where we expect to be relevant by '17 and be the first true multitenant cloud player to do that and we're doing some investment here in '16 to be ready for that and that's a very complicated and onerous process to get there but we are opening up markets like that and we've already got customers that want to join and use us. We're now going through the certifications which will take a good six to nine months to make that happen.

Katherine Egbert:

Okay, good. Thank you.

Operator:

It appears we have no further questions at this time. I will turn the program back over to our presenters for closing remarks.

Paul Jarman:

Well, we appreciate everybody's interest today. We are excited about not only what happened in fourth quarter—we thought it was a very solid quarter—but we are very excited about our opportunities in '16 as I mentioned both in leadership, in our top line revenues, and in our bottom line results. So thank you for your time today and have a great day.

Operator:

Ladies and gentlemen, this does conclude today's program. Thanks for your participation. You may now disconnect. Have a great day.