BLUCORA

Blucora, Inc. Second Quarter 2019 Earnings Conference Call

BILL MICHALEK, VICE PRESIDENT INVESTOR RELATIONS
Thank you and welcome, everyone, to Blucora's second quarter 2019 Earnings Conference Call. By now, you should have had the opportunity to review a copy of our earnings release and supplemental information. If you have not reviewed these documents, they are available on the investor relations section of our website at Blucora.com. I'm joined today by John Clendening, Chief Executive Officer and Davinder Athwal, our Chief Financial Officer.

Before we begin, let me remind everyone that today's discussion contains forward-looking statements based on the environment as we currently see it and speak only as of the current date. As such, they include risks and uncertainties, and actual results and events could differ materially from our current expectations. Please refer to our press release and our other SEC filings, including our Forms 10-K, 10-Q and other reports, for more information on the specific risk factors. We assume no obligation to update our forward-looking statements.

We will discuss both GAAP and non-GAAP financial measures today, and the earnings release and supplemental information available on blucora.com include the full GAAP and non-GAAP reconciliations.

With that, let me hand it over to John.

JOHN CLENDENING, PRESIDENT AND CHIEF EXECUTIVE OFFICER
Thanks Bill, and good morning everyone.

I'm pleased to report that Blucora was able to build on our strong start to the year and post solid second quarter results, exceeding the high-end of our target ranges on most metrics. We closed on our acquisition of 1st Global, which is an important milestone for us. And even after funding the acquisition, we ended the quarter at a 2.1x net leverage ratio, due to our strong cash generation. Overall, we continue to execute to plan and are very pleased with the results.

Wealth Management
Let's get in to some of the detail, starting first with wealth management. We had a couple pieces of big news in this segment during the quarter, including closing on our acquisition of 1st Global on May 6. To briefly review the rationale for the acquisition, first it adds significant scale to our wealth management business which drives substantial revenue and cost synergies. A meaningful amount of the revenue synergies is external and contracted and the bulk of the remaining cost synergies are fully under our control. Second, it is complementary to HD Vest and enhances our business with a strong position in large accounting firms, a large proportion of advisory assets and strong capabilities in key areas such onboarding, advisor development and in-house portfolio management. Third, we expect the transaction will be financially accretive to EPS and other key performance metrics, such as advisor productivity and return on client assets. And finally, it expands our established tax-optimized investing footprint by creating by far the largest and most capable tax-focused wealth manager, positioned to provide better service and capabilities to our advisors, and ultimately better outcomes for their clients.

The integration of the two companies is going well and tracking to plan, and so I'm pleased to affirm our previously shared financial benefit expectations. We continue to be impressed with the 1st Global advisor base and their passion for their clients. They share our fundamental belief that true wealth management must consider all aspects of a client's financial life. I've also been impressed with the quality of the broad employee base, which includes highly talented individuals that are making an impact, even beyond wealth management.

The other big piece of news in wealth management in the second quarter was that we found the right person, in Enrique Vasquez, to lead the combined business. I can't say how excited I am to have Enrique on board. He has incredible experience including with GE, Societe Generale, and 12 years as CEO of Cetera Financial Specialists. It's interesting that in one quarter we combined the #1 and #2 tax-focused wealth management firms and brought in the former CEO of the #3 firm. Enrique is a top-notch talent and person, and an invaluable addition to our overall leadership team.

I'll start with consolidated wealth management results for the quarter, then Davinder can get in to more of the detail. Consolidated wealth management consists of HD Vest plus 1st Global from the May 6 closing date through quarter end. On that basis, wealth management revenue was $127.8 million, and segment income was $17 million, both of which were above the high-end of our target ranges.

On a consolidated basis, net flows into Total Client Assets were about $300 million, and we ended the quarter with a combined $67.6 billion in Total Client Assets. Net inflows into advisory assets in the second quarter were about $310 million, and we ended the quarter with $26 billion in advisory assets. Advisory assets as a proportion of Total Client Assets ended the quarter at 38.8%.

A couple updates I'll add here for wealth management:

- First, recruiting was strong in Q2 across both businesses.
    - This includes about 30 new individual advisors, all of which are tax pros.
    - We also had a handful of established advisor transfers, two of which were larger in size, with a combined $100 million in client assets that will soon begin to move over. One of these advisors joins from an RIA. While RIA transfers are not an everyday occurrence, our strong compliance support and product offerings to enable advisors to scale and grow, is compelling.
    - In addition to individual advisors, we had 6 new accounting firms join during the quarter.
        - Two joined the platform as established practices and advisors, with about $30 million in Total Client Assets that will be moved over in Q3 and Q4.
        - Four more joined as new practices with an estimated $700 million in total client asset prospecting opportunity.
- And Second, in Tax Smart Innovation, we have told you about the tax-smart investing software platform to help advisors systematically capture tax-alpha for clients that we have been beta testing. We have now launched our first commercial version in June, with great response. Demand was very strong, and we are making it available now to approximately 250 HD Vest advisors, with a broader rollout to follow. It is a sophisticated tool and requires some training, so we're in the process now of getting this group trained and up and running. This training will be our focus throughout the fall, and we expect to see meaningful usage, which should allow us to track how advisors are using it and how it impacts their growth metrics and overall business. We're also working on a couple of additional modules, to add to the tax-loss harvesting module, that we hope to have in beta testing by the end of the year.

So overall in wealth management, strong progress in our results and positioning for the future.

Tax Preparation

Turning to tax preparation. TaxAct completed a very strong tax season and first half of the year, with first half revenue up 12.5% year-over-year, vs. our upwardly revised guidance of approximately 13%, and well-above our original expectation going in to tax season. First half segment margin came in at about 60%, which was above our previous expectation of 58%, largely due to lower than expected marketing spend and timing of tax year 2019 initiative spending.

We were pleased with our progress this season which included a number of highlights, including:

- Increasing market share in the professional market with TaxAct Pro;
- Maintaining a stable monetized filer base in consumer, even while taking pricing up more than 10%;

- Improving the customer experience with an enhanced mobile experience;
- Launching 10-minute taxes, a streamlined process to guide simple filers to complete in record time;
- Introducing refund marketplace, which while underutilized broadly, allowed our filers to place refund dollars on gift cards from national retailers on gift cards and receive bonus money of up to $599;
- Engaging with another almost 2 million filers in our BluPrint experience, which analyzes tax returns to uncover real savings opportunities for our customers. We believe we're the only online tax software company that offers this level of insight and guidance into the financial health of our customers and provides comprehensive solutions which can save our customers real money now and for years to come. This is phenomenal value creation opportunity for our customers. And this year we had new partners to connect them to should they want to take advantage of particular opportunities; and
- Lastly, and perhaps most importantly, we made significant improvements in our talent and capabilities across all aspects of the TaxAct business.

Now with tax-year 2018 behind us, we are working hard to refine our plans to build on the success of this year and further improve our competitive positioning for next season. We'll share more detail on that later in the year, but a few areas of focus are around:

- Significantly enhancing the user experience, making it much easier and more enjoyable, and removing friction points for filers at every level of complexity;
- Ensuring our sku line up is competitive and attractive;
- Providing more insight and value to our customers from start to e-file completion;
- Bringing more of the value and insights of BluPrint to more of our customers, including within the tax interview, to give them more value and more ways to improve their financial lives;
- Sharpening our marketing message in order to more powerfully appeal to our targeted core attitudinal segment, while concurrently appealing to filers across the complexity spectrum and at all price points, including free;
- Investing in modernizing the underlying and supporting technology, in order to support enhancements in the client experience.

So overall on tax preparation, we delivered very strong financial results and continued to make incremental progress on repositioning the business for the future. I mentioned this last quarter, but I believe the change in our product experience year-over-year will likely be the most significant in the company's history, and I'm looking forward to sharing more later.

Closing

In closing, we had a strong quarter with good execution across both businesses. We met or exceeded our targets on all metrics. Our Wealth management business saw record levels of advisory assets and total client assets, completed the acquisition of 1st Global and onboarded a great new leader. Our Tax Preparation business delivered a very strong tax season and first half and is making great progress in positioning for next season and beyond. Overall, we continue to improve our business positioning and capabilities, and I remain very optimistic about the opportunities we have ahead.

With that I'll turn the call over to Davinder.

<u>DAVINDER ATHWAL, CHIEF FINANCIAL OFFICER</u>

Thanks John. I'd like to provide some additional detail on second quarter performance, a balance sheet update, and an updated outlook for the remainder of the year.

I'll begin with consolidated results for the second quarter, which includes 1st Global from the May 6 closing date through quarter end.

- Total revenue was $193.7 million, which was above the high-end of our guidance range
- Adjusted EBITDA was $52.1 million, also above the high-end of our target range

- Non-GAAP net income came in at $41.4 million, or $0.83 per share
- And GAAP net income came in at $31 million, or $0.62 per share

Since we closed on the acquisition of 1st Global during the quarter we gave guidance for the historical business and 1st Global separately, so for comparison purposes, excluding 1st Global:

- Blucora revenue would have been $164.8 million, at the mid-point of our target range and up 4% year-over-year;
- Adjusted EBITDA would have been $49.9 million, above the high-end of our target range. On a year-over-year basis this would be down 5% due to timing of tax season revenue being more weighted to Q1 this year vs. last; and,
- Non-GAAP net income would have been $39.4 million, or $0.79 per diluted share, and GAAP net income would have been $29.6 million, or $0.59 per diluted share, again better than our target ranges, and down year-over-year due to the timing of tax season results vs. last year.

Looking at segment performance, John reviewed the consolidated **Wealth Management** numbers. I'll provide a bit more of the breakdown.

HD Vest revenue for the quarter was $98.8 million, up 7% year-over-year and above the high-end of our guidance range. The year-over-year growth was primarily due to a combination of fee-based advisory revenue, which was up 9% on higher advisory asset balances, as well as higher cash sweep, which more than doubled and reflects the change in clearing economics and interest rates year-over-year. Commission revenue was down modestly, at about 2% year-over-year, but continues to normalize, and transaction & fee revenue was up 6% year-over-year, primarily driven by advisor related ancillary revenue.

HD Vest segment income grew 14% year-over-year to $14.8 million, also above the high-end of our target range. The higher year-over-year growth rate can be attributed largely to the absence of clearing conversion related costs relative to the year-ago quarter, as well as some expense control; this was partially offset by the previously disclosed advisor bonus of about $700 thousand. As a reminder, we expect to see another $400 thousand in Q3 and then that goes away.

1st Global, for the period of May 6 acquisition closing date through the end of the quarter, added an incremental $29 million in revenue, and $2.2 million in segment income, which as John mentioned, were also above our target ranges, helped by a bit better-than-expected transaction revenue and net flows into advisory.

Moving to assets.

At HD Vest advisory assets were up 12% year-over-year to $14.5 billion. Total client assets increased 5% year-over-year and crossed the $47 billion mark. The levels for both advisory assets and total client assets represent new records for the company. At 1st Global, advisory assets were up 5% year-over-year to $11.7 billion, and Total Client Assets were flat year-over-year at $20 billion.

As it relates to the acquisition, as John mentioned, the integration is going well, and we remain on track to hit our synergy targets. Additionally, advisor and advisor asset retention has been very strong.

Moving on to **Tax Preparation,** TaxAct finished up a strong first half with revenue up about 12.5%, which while slightly shy of our most recent guidance, on slightly less robust refund transfer product funding, was well above our original target. Segment margin came in at 60% vs. our target of 58% on lower than expected marketing spend and timing of initiative spending. For the second quarter, revenue was $65.9 million, flat versus prior year, and segment income was $41.4 million, down 6% year-over-year.

As John mentioned, we are working hard to build on our successes and learnings from this tax season and create a significantly improved product and competitive position going in to next tax season, while laying the groundwork for long-term growth beyond. As part of this, we plan to accelerate our investment in technology, in particular the timing of our code refactoring work to complete over the next two years. Importantly, this refactoring work is at a stage where the focus is on improving the clients experience, in order to drive increases in conversion and retention. We look forward to sharing more of our strategy and 2020 expectations over the next couple of calls.

Finishing up on **second quarter performance**, unallocated corporate operating expenses were $6.2 million, lighter than we expected due to the timing of certain items between quarters.

Moving on to liquidity, we ended the quarter with cash and cash equivalents of $110 million and our net debt was $280 million, which reflects another strong cash flow quarter, the payout and termination of the HD Vest minority interest and the closing of the 1st Global acquisition which was funded with $125 million addition to our Term B loan and $55 million in cash. This brings our net leverage ratio to a comfortable 2.1x, as of the end of the quarter.

Finally, as it relates to the acquisition closing and integration, in the second quarter we recorded $4.7 million in transaction costs and another $4.5 million in integration costs. These costs are broken out on a separate line in our supplemental so you can track them, and they are added back for purposes of reporting Adjusted EBITDA. As a reminder, as we indicated at closing, we expect a total of $28 million in integration expense with roughly $10 million in 2019 and the balance in 2020. Our goal is to accelerate as much of the integration activities to 2019 as possible to maximize the long-term benefits. If we're successful in doing that, more of the cost will pull in to 2019 and the total synergies would likewise increase.

Third Quarter Outlook

With that, let's turn to our outlook. For the third quarter we expect:

- TaxAct revenue between $3.5 to $4.0 million and segment loss of $13.5 to $14.0 million.
- For our wealth management business, including 1st Global, we expect third quarter revenue of $139.0 to $145.5 million and segment income of $18.5 to $21.5 million.

On a consolidated basis for the third quarter, again including 1st Global, we expect total Blucora revenue between $142.5 to $149.5 million, Adjusted EBITDA of between a $4.0 million loss and breakeven, a non-GAAP net loss of $10.0 to 14.5 million, or $0.20 to 0.29 cents per share and a GAAP-net-loss attributable to Blucora of $30.5 to $35.5 million, or $0.62 to 0.72 cents per share. This outlook includes third quarter unallocated operating expenses of $8.0 to $8.5 million.

Full-Year Outlook

For the full-year, we expect:

- TaxAct revenue of between $210.0 to $211.0 million and segment income of $93.0 to $94.5 million, which includes the accelerated technology investment referenced earlier and previously.
- For our wealth management business, we expect full-year revenue, which includes 1st Global for the period of May 6 through year-end, of $500.0 to $513.0 million and segment income of $67.0 to $73.5 million.

This translates to consolidated full year outlook, again including 1st Global for the partial year, of revenue of between $710.0 and $724.0 million, Adjusted EBITDA of $130.5 to $139.5 million, non-GAAP net income of $92.5 to $102.5 million, or $1.84 to $2.04 per diluted share, and GAAP-net-income attributable to Blucora of $27.0 to $37.5 million, or $0.54 to $0.75 per diluted share, with $28.5 to $29.5 in corporate unallocated expense.

I'd like to call out that while we are raising our guidance for the full year, we have also incorporated the July 31 rate cut and also assumed an October rate cut in to our targets, which would affect cash sweep revenue in wealth management.

Our outlook also includes the following additional assumptions:

- A broad range for transactional revenue due to its variability;
- Market volatility, including the impact to net flows and cash sweep balances;
- An effective tax rate of -3% to -7% for GAAP-net-income, attributable to Blucora; and

- Our guidance for GAAP-net-income or loss attributable to Blucora excludes any impact to tax expense for discrete items and variable stock-based compensation granted to non-employee advisors.

This concludes our prepared remarks; we will now turn the call over to the operator for Q&A. Operator?