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Blucora, Inc. Fourth Quarter 2019 Earnings Conference Call

BILL MICHALEK, VICE PRESIDENT INVESTOR RELATIONS

Thank you and welcome, everyone, to Blucora's fourth 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 Chris Walters, Chief Executive Officer and Todd Mackay, our Chief Business Operations and Development 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 available on blucora.com includes the full GAAP and non-GAAP reconciliations.

With that, let me hand it over to Chris.

CHRIS WALTERS, PRESIDENT AND CHIEF EXECUTIVE OFFICER

Thanks Bill, and good morning everyone.

I'm excited to be speaking with all of you for the first time in my capacity as CEO of Blucora. I have had the pleasure of serving on Blucora's Board of Directors since 2014, and from that seat have played an active role in developing our current strategy, including driving our tax-centric vision and championing our acquisitions of HD Vest, 1st Global and HKFS. I've also had the benefit of great insight into the business, it's successes, growth opportunities, challenges and how Blucora has been able to position itself for the future. It's exactly for these reasons that I was so interested to expand my role with the company and take the CEO position. I believe Blucora has the potential to accelerate organic growth with a cash engine that can be a great enabler. I'm also genuinely excited about the purpose of the company, including maximizing value for consumers and enabling them to live better financial lives. In short, I couldn't be more pleased to transition to CEO and spearhead the next phase of our growth and work with all of you.

We have a lot to cover today, including fourth quarter results that were in-line or better than our target ranges on all metrics, record annual performance for both TaxAct and Avantax, and an update on tax season, so let's dive right in.

Wealth Management

Starting first with wealth management. Fourth quarter wealth management revenue was $145.2 million, and segment income was $19 million, both of which were at or above the mid-point of our target ranges.

On a consolidated basis, net flows into Total Client Assets were about $180 million, and we ended the quarter with $70.6 billion in Total Client Assets. Net inflows into advisory assets in the fourth quarter were about $200 million, and we ended the quarter with $27.6 billion in advisory assets. Advisory assets as a proportion of Total Client Assets ended the quarter at 39%.

A few updates I'll call out here for Wealth Management:

- During the quarter we completed the final business combination of our back-end processing and support functions in wealth management, following the 1st Global acquisition, which will allow us to operate even more efficiently.
- We enhanced our advisor service structure with regional teams, leveraging an area where 1st Global had great success, to provide segmented groups of advisors with enhanced service and operational support though small, dedicated teams.
- We also rolled out a robust action plan to enhance our operations and service metrics to improve the advisor experience. The team has been successfully executing on the deadlines to achieve results that will continue to integrate platforms and streamline functionality. The initiative has been well-received by advisors.
- We began cross-selling some of the more popular products between the legacy HD Vest and 1st Global advisor bases, including select home office advisory solutions and a retirement plan offering, with more products to come in Q1, all to the benefit of clients.
- Recruiting continues to be strong with more than 60 new advisors joining in Q4, including new tax pro advisors as well as established advisor transfers.
- We also added another high-value accounting firm in the quarter with approximately $10 million in cumulative accounting revenue and representing an estimated $1 billion prospecting opportunity in total client assets.
- As it relates to our proprietary Tax-Smart Investing software platform, or TSI, which is designed to help advisors systematically identify and capture tax alpha for clients across multiple accounts, we have a few very positive updates:
    - First, we ended the year with about 900 advisors on the platform, significantly exceeding our goal of 500. And we began the rollout to our legacy 1st Global advisor base, adding about 100 advisors there. Overall feedback from advisors and end-clients continues to be very good.
    - Second, we officially launched our second module, the Capital Gains Analyzer™ which captures and reports the annual capital gains estimates of mutual funds. This module allows our advisors to focus more on planning and client outcomes, as opposed to data gathering. We also launched version 2.0 of the Tax Loss Harvester, which can identify losses to offset those gains for clients, in a fraction of the time. The new version streamlines reporting and adds incremental lot-level detail and other data for deeper client conversations.
    - The last update on TSI is that we just launched this month a beta test of our third TSI module, the Social Security Planner. This module helps clients optimize the timing of social security based on their specific cash flow needs and timing, and relative benefits for each partner in a couple. Early feedback on this module is quite positive.

The other big news in the broader wealth management arena recently, was our announcement in early January of our intent to acquire HK Financial Services (HKFS). This pending transaction reinforces our strategy of delivering tax-advantaged wealth management solutions to advisors, CPA firms and end-clients.

The combination with HKFS is expected to add approximately $4.5 billion to Blucora's total client assets, bringing the total, based on year-end numbers, to more than $75 billion. By comparison, we ended 2018 with just over $42 billion, so that would represent almost 80% growth in total client assets in about one year. The complementary nature of the transaction is expected to expand Blucora's addressable market, add a growth and profit engine, and enhance and expand available growth opportunities, ultimately further strengthening the company's established leadership in tax-aware investing. Most importantly, it enables us to serve CPA firms the way they want to be served, either in our independent model with CPAs becoming wealth management advisors, or a turnkey RIA for CPAs firms who prefer to essentially outsource the wealth management work to a firm they trust, but while ensuring close coordination. As we enhance our offering to CPA firms and give them more optionality, it will increase the performance of recruiting efforts. As a reminder, HK Financial Services will be run as a third division of Blucora, with very little integration and no overlap, eliminating risk of disruption to the Avantax advisors.

We continue to expect the transaction to close around the end of the first quarter, subject to customary closing conditions.

FY 2019 Highlights

For the company as a whole, as we look back at the full year 2019, the team has really accomplished a great deal, including:

- Growing total revenue by 28%, including the addition of 1st Global starting from the May acquisition date
- Growing adjusted EBITDA by 15%,
- Growing non-GAAP earnings by 11% and crossing the $2 mark at $2.11 diluted net income per share,
- Generating more than $80 million in free cash flow,
- Improving wealth management revenue by 36%,
- Achieving record net flows including approximately $1 billion into advisory
- Acquiring 1st Global, which added significant scale, complementary capabilities and high recurring revenue
- Achieving $6.5 million in synergies related to 1st Global, which was more than double our original estimate at the time of acquisition
- Achieving our 22nd consecutive year of revenue growth at TaxAct, growing 12% and maintaining the stability in our monetized units,
- Implementing a share repurchase program, following a $100 million authorization
- And last but not least, bringing great new talent into the organization

In 2019 we generated strong financial results while investing for future growth, strengthening our platform and laying the groundwork to capture the significant opportunities we see ahead. While we have made good progress, I'm even more excited about where we'll go from here.

Tax Season Update and Outlook

So let's move to Tax Preparation and our update on the current season. As you may be aware total IRS filings are roughly flat year-over-year and DDIY filings up about 3.5% as of February 8. Competitive intensity continues to be high, with the volumetric leader spending aggressively on marketing, with a messaging focus around their Free offering and the storefront players focusing on both free and hybrid assisted offerings.

Against this backdrop, we came into this year with a goal of building on the success of last season and targeting to achieve more balanced growth across units and pricing. To do so, we made several significant improvements, particularly in our user experience which I am excited about and will discuss in more detail in a moment.

As you all know, every tax season is unique and this one is no different. So far this season, we are excited about a lot of the progress we are making but at the same time we do have opportunities to optimize in certain areas as we move through the season. So let's touch on the areas we are excited about as well as the areas we want to optimize a bit further.

In the last couple calls, we have discussed the need to improve our customer experience. And to do that we have and continue to invest both in updating our legacy code as well as reimagining the user experience. I am happy to share that we are starting to see the fruits of our labor, for example:

- Our conversion or complete rate is up 5 points vs this time last year – which is a good indicator that the off-season improvements we made in the product and the underlying engine, were the right ones and are having the desired result.
- Also, our retention, or returning customer rates are also running ahead of last year by 4 points.

As well as those bright spots, we have also faced challenges and this is still a very competitive market, especially around the free product where today we don't enjoy the advantage we have vs the volumetric leaders that we do with our higher end SKUs in terms of pricing. The price to acquire a free customer is up significantly. We continue to optimize in this space to find the right balance of cost and profitable growth. Along with pressure with the Free product, we were also a bit out of position to start the season from a marketing perspective, with our messaging initially not focused on what was resonating with early season filers, resulting in a top of the funnel that has been below expectations, albeit improving.

At this relatively early point of the season, as has been the case at this point in time in previous seasons, our performance lags the overall market, with starts down about 20% through February 16 and e-files down 11%. A couple things I would note here are 1) we delayed our ramp in marketing spend somewhat compared to last year, and 2) our business tends to make up ground in the second peak of tax season given our focus on paying filers, who disproportionately file later in the season.

We see opportunities to improve our approach and top of funnel performance in 2nd peak. This is an area where I have significant experience and am working closely with the team to ensure that we are in the best possible position for the remainder of the season.

All factors considered, we remain comfortable with our prior outlook for the first half of 2020, which included segment margin in the range of 56.7%-57.7% on revenue growth of 3%-5% vs. the comparable prior-year period, as adjusted for SimpleTax.

Enhanced Core Product Experience
Switching back to our product experience. During the off-season, the #1 focus of the team has been improving the client experience. The team spent countless hours scouring over every page and every word on the customer journey, making it much easier and more enjoyable while removing friction points for filers at every level of complexity. We believe this is reflected in a significantly improved customer experience this season, which we hope will continue to drive increases in *conversion* in-season, with less leakage in the customer funnel, as well as better *retention* in subsequent seasons.

We have also launched new or improved branded product features, which we believe will have strong appeal and differentiation. These include:

- **My Tax Plan**: this new feature creates a custom plan for TaxAct filers, to save more on taxes next year. Our technology personalizes each plan to the customer's unique tax situation, provides specific savings amounts, and includes a downloadable "checklist" of actions to save. We believe this feature will be a real and differentiated benefit to customers and help bring them back next year;

- **Pro Tips**: is a visually enticing way to reveal lesser-known tax advantages, customized for the individual filer, that help customers get a bigger refund this year and for years to come. This feature is expanded and greatly enhanced for this season;

- **We also brought back some more of our most popular features, like an enhanced personalized Deduction Maximizer,** which helps customers uncover additional deductions that in our experience are commonly overlooked, as well as our $100,000 accuracy guarantee.

We believe we're the only online tax software company that offers this level of personalized insight and guidance into the financial health of our customers. This delivers a significant value to our customers who can save real money now and for years to come.

One last update here is on our assisted offering, where tax gurus offer live tax help. As you may recall, we piloted this offering last year and are expanding our testing this season. Our goal is to exit this season with a fully vetted plan to launch a more fulsome offering, profitably and at scale next season should our testing prove a viable economic model.

Overall, we've made great strides in improving our product, positioning and capabilities in this business. Curtis has done a great job in his first full off-season at the helm and the product is significantly improved, and already showing results with higher conversion rates.

I see a great deal of opportunity for the business over the medium to long-term, and that's perhaps one of the things that has been most exciting to me in terms of my initial observations. The product improvements will drive higher retention rates going forward and when combined with improved marketing efforts we'll be in stronger position to grow units in coming years.

In conclusion, across the full business, we had a solid fourth quarter which capped a strong 2019 for Blucora, with record performance in a number of categories. The company has made good progress positioning itself for future growth. And our expectations for tax season remain in-line with our previous estimates. While I'm only in week number three of my tenure as CEO and am still learning and assessing, in my initial observations, I already see a number of ways we could optimize to spur higher organic growth rates.

With that let me turn it over to Todd.

TODD MACKAY, CHIEF BUSINESS OPERATIONS AND DEVELOPMENT OFFICER

Thanks Chris, and Good Morning everyone.

I'll provide some additional detail on our fourth quarter results, and add color on our current outlook for Q1 and tax season.

For the fourth-quarter we reported:

- Total revenue of $149.4 million, which was a bit above the mid-point of our guidance
- Adjusted EBITDA loss of $733 thousand, which exceeded the top-end of our target
- Non-GAAP net loss of $4.8 million, or $0.10 per share, both better than the top-end of the range
- And GAAP net income of $17.3 million, or $0.36 per share, which surpassed expectations, based on better operational results as well as a $49 million tax benefit resulting from the release of valuation allowances associated with our NOLs, and our ability to utilize them in future periods.

In terms of segment performance, and beginning with wealth management, revenue was $145.2 million, and segment income was $19.1 million, both of which were at or above the mid-point of our target ranges. Segment income included a $540 thousand legal settlement that was not contemplated in our guidance.

On a pro-forma basis for the 1st Global acquisition, wealth management revenue was up 2% y/y, driven by higher advisory and transaction revenue, which were up 4% and 13%, respectively, and more than offset a decline in mutual fund revenue share, sweep revenue and fees.

Net inflows into advisory assets in the fourth quarter were about $200 million, and we ended the quarter with $27.6 billion in advisory assets. Net flows into Total Client Assets were approximately $180 million, and we crossed the $70 billion threshold for the first time, ending the fourth quarter with $70.6 billion. Advisory assets as a proportion of Total Client Assets ended the quarter at 39.1%, also a new record.

Moving on to the Tax Prep segment, TaxAct revenue for the fourth quarter was $4.2 million, up 4% percent versus the prior year. Segment loss was $12.3 million, up by about $3.6 million versus the prior year, driven by the product development investment work that we discussed over the past couple of quarters.

Finishing up on fourth quarter performance, unallocated corporate operating expenses were $7.6 million, which is lighter than we expected as we were able to find efficiencies and defer some planned spend.

Moving on to liquidity, we ended the quarter with cash and cash equivalents of $80.8 million and our net debt was $318.9 million, resulting in a net leverage ratio of 2.3x at the end of December. During the quarter, we repurchased approximately 744,000 shares at an average price of approximately $21.05 per share, for a total of about $15.7 million in repurchases, and representing about 1.5% of our shares outstanding. We have about $72 million remaining under our current share repurchase authorization, which will allow us to continue to be opportunistic in the future as may be appropriate.

Finally, as it relates to acquisition and integration costs, in the fourth quarter we recorded $8 million, of which about 60% was related to the 1st Global integration and the remainder related to costs associated with the HKFS acquisition.

First quarter 2019 outlook
For the first quarter, we expect TaxAct revenues between $131.0 to $136.5 million or approximately 64 percent of the first half 2020 revenue and segment income of $77.0 to $80.5 million.

We expect Avantax first quarter revenue between $140.0 and $145.0 million and segment income of $16.5 to $18.5 million.

On a consolidated basis, we expect first quarter revenue between $271.0 and $281.5 million, adjusted EBITDA between $85.0 and $91.0 million, non-GAAP net income of $74.5 to $80.5 million or $1.52 to $1.64 per diluted share and GAAP income attributable to Blucora of $31.5 to $34.5 million or $0.64 to $0.70 per diluted share. This includes unallocated corporate operating expense of $8.0-$8.5 million.

As we have done in the past, we expect to provide a full year outlook during our first quarter call upon the completion of tax season. There are a couple of items I'll mention now that may be helpful as you look ahead or for modeling purposes.

- Regarding NOLs - In 2019, we utilized approximately $70 million in NOLs, leaving a gross or pre-tax balance of $392 million.
- Given that we have released a large portion of valuation allowances associated with our NOLs at once, rather than the quarterly offsets that we have shown historically, we will show a higher GAAP tax rate for 2020, estimated at approximately 30%.
- In terms of non-recurring items, we expect approximately $13 million of remaining integration costs relating to 1st Global, which should close out our integration expense related to that transaction, and keep us on our originally targeted budget.
- We also expect to close our acquisition of HK Financial Services by the end of Q1 or shortly thereafter, subject to satisfaction of customary closing conditions. We estimate that approximately $8 million, of the planned $10-$11 million of integration costs, to hit in 2020, as well as transaction costs.
- In Q1 we also expect to record about $6.5 million related to our senior management transitions.

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

CHRIS WALTERS, PRESIDENT AND CHIEF EXECUTIVE OFFICER

Thank you all for joining us today. In closing, I'd just like to say that I'm incredibly excited to have expanded my role with Blucora and have the opportunity to work more closely with our employees as we provide the best products, service and solutions to our customers and advisors, and enable better outcomes for end-clients. 2019 was a great year for Blucora and I'm looking forward to keeping you updated on our progress. Speak with you next quarter.