BLUCORA

Blucora, Inc. Third Quarter 2020
Earnings Conference Call

BILL MICHALEK, VICE PRESIDENT INVESTOR RELATIONS

Thank you and welcome, everyone, to Blucora's third quarter 2020 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 Marc Mehlman, 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 and 10-Q and other reports, for more information on the specific risk factors. We assume no obligation to update our forward-looking statements, except as required by law.

We will discuss both GAAP and non-GAAP financial measures today. Our earnings release, supplemental information and earnings presentation are available on blucora.com and include full reconciliations of each non-GAAP financial measure discussed to the nearest applicable GAAP measure.

With that, let me hand it over to Chris.

CHRIS WALTERS, PRESIDENT AND CHIEF EXECUTIVE OFFICER

Thanks Bill, and good morning everyone.

I'm pleased to report that our third quarter results showed incremental improvement and came in higher than expected on a number of metrics that Marc will cover shortly. In addition, we closed the acquisition of HKFS, adding a historically fast-growing high margin business to our company and we made progress in setting ourselves up for future growth. I continue to be impressed by our employees and their commitment to executing on the strategy we have put in place. I am also proud of our financial professionals who have worked tirelessly to position their clients for success, both from a tax and wealth management perspective, through an uncertain time. Having met with financial professionals regularly since joining, I can see the passion they have for their work, and it makes us want to work even harder to position them for success. More on that in a moment.

Tax Preparation

I'll start this morning with an overview of our TaxAct business. We are very focused on executing all that is required to best position us for tax year 2020 in this shortened off-season.

As discussed, we made significant progress last year on our product; however we were challenged by being out of position on marketing at the start of the season and not having an assisted offering available for all interested customers.

To prepare for a strong upcoming tax season, we are focused on several things:

- Ensuring that we have our entire marketing approach optimized, including our team structure and capabilities, media partners, messaging and technology.
- Continuing to enhance our core consumer product offering with an emphasis on the areas that proved to be most challenging for users last year, as well as our landing pages, which are the intersection point between product and marketing and are critical to start rate.
- Launching our hybrid-assisted offering to all users who may have interest. Our testing over the last couple of years gives us confidence that we will be able to execute this effectively.
- Improving our Tax Pro software in targeted ways, including coverage for more tax situations and an improved onboarding experience.

We have a solid plan to accomplish a great deal in shortened off season with a number of talented new additions to our team. All aspects of what we are trying to accomplish are tracking well to enable us to start next season with both marketing and product further optimized and working in concert. This combination is focused on enabling us to make progress in the early stages of executing our sustainable growth strategy for the business.

Wealth Management

I'll now move to Wealth Management. There has been a great deal of change in the business over the last two years. We transitioned to a new clearing platform and completed the acquisition of 1st Global and began to integrate the businesses. The change continued this quarter with the completion of the HKFS acquisition and the rolling out of new advisory pricing.

I'm pleased with the progress we are making; however, the amount of change has been significant for our financial professionals and their teams. We need to improve on multiple fronts in the coming year including improved service levels, a better technology experience for both financial professionals and their customers, completing the integration of all core systems and processes and increasing stability so that future changes are focused primarily on better experiences for our financial professionals and their customers.

It has been a busy quarter with us making progress on many fronts including:

- Adding a new product management team that will be the architect for improved financial professional and end customer technology experiences.
- Rolling out a regional service model that is focused on improving the service experience for our valued financial professionals.
- Consolidating and refining our advisory programs and pricing, consistent with Regulation BI, which we believe will drive an incremental shift to advisory services. We also expect to see a decrease in the distribution of paper statements.
- Upgrading our operational approach which has improved processing times.
- Adding 3 new large HKFS affiliated accounting practices and recruiting 60 new financial professionals to be affiliated with Avantax during the quarter.

We are confident in our differentiated, tax-focused wealth management strategy and that our market position is compelling for the right financial professionals and their customers. That said, we have work to do in the coming year to solidify the foundation for long-term organic growth.

We plan to focus on:

- Improving our service and operational performance;
- Aligning systems, processes and technology to improve efficiency and scalability;
- Maximizing financial professional performance by providing improved tools; and
- Completing the integrations of 1st Global and HKFS.

These efforts will take some time to show impact. Over the course of the coming year, we anticipate that our efforts will lead to decreasing risk of financial professional departures, and an increasing share of advisory assets. The combination of actions will put us in a stronger position from which we expect to deliver organic asset growth in future years.

Blucora

Let's now turn to Blucora as a whole.

It has been a challenging year, with the start of a global pandemic following closely after my start in the CEO role. External forces had large impacts on both sides of our business, including the extension of tax season and the equivalent of six, 25-basis-point interest rate cuts. I am proud that we have been able to keep our team safe while delivering for our customers and financial professionals in this challenging environment and making significant progress on repositioning the company to enable sustained growth in the coming years. Near-term financial results have been adversely impacted by events of this year; however we are fortunate to have two strong profitable businesses, with positive cash flow and ongoing demand during these challenging times.

A number of challenges became clearer after I stepped into the CEO role 9 months ago, including:

- The need for more sustainable growth strategies for the company or our businesses;
- A leadership structure that didn't provide the necessary clarity and ownership needed to drive performance;
- Skill gaps across a number of important areas;
- A lack of cultural alignment across the organization;
- An underinvestment in technology, resulting in challenges for our financial professionals, customers and employees; and
- Potentially high value synergies between the businesses had not been meaningfully tested.

We've addressed these challenges by taking the following actions:

- Shifted to sustainable growth strategies for each business and across Blucora, including establishing priorities for realizing value across the businesses. We've aligned the organization toward common goals and priorities down to every individual team member.
- Adjusted our leadership structure- most notably consolidating operations within the business units, and combining our software efforts under one leader in Curtis Campbell and our wealth management efforts under Todd Mackay. We also separated our CIO and CTO teams to bolster our technology efforts.
- Expanded the roles of a number of our talented team members and added many new members to our team with the required skills sets. We believe we now have the right team in place to deliver going forward.
- Rolled out a culture initiative to ensure one common sense of purpose. While we are early in the process, our employee engagement has shown <u>significant</u> improvement in terms of alignment on priorities, clarity of objectives and overall satisfaction.

- Increased our investment in our technology teams and in efforts at the Blucora and business unit level to more effectively meet the needs of financial professionals, customers and employees.
- Committed to testing the highest value potential synergies in the coming year which are:
  - Improving the tools needed to make our financial professionals more productive by leveraging the product and technology leadership and approaches from TaxAct. It will be about 12 months before we expect to see a material benefit flow from these efforts.
  - Converting TaxAct pro users into Avantax financial professionals, or into HKFS referral partners. We are in the early stages of engaging tax pros now to test and refine our approach before a planned roll out in the middle of next year.
  - Helping financial professionals acquire more customers. Most tax and financial professionals have limited time and marketing sophistication or scale. Our financial professionals can leverage the marketing capabilities within our TaxAct organization to help them drive new customer acquisition, resulting in higher asset flows. We expect to begin to define our service offerings in early 2021 and test the service offering in the 2nd half of the year.

I am more enthusiastic now than ever about the opportunity in front of Blucora. We believe our tax-focused software and wealth management company has a compelling position in large and growing markets. We have made significant progress in the midst of a very challenging environment to best position the company to deliver sustained organic growth in the coming years. We have an execution-focused team in place to deliver on the promise.

With that I'll turn it over to Marc to review our Q3 performance and full year 2020 and tax season outlooks.

MARC MEHLMAN, CHIEF FINANCIAL OFFICER

Thank you, Chris, and good morning everyone.

I'd like to provide some additional detail on our third quarter results, an updated outlook for the full-year 2020, as well as a preliminary outlook for the upcoming year in tax preparation.

Starting with third quarter results, our acquisition of HKFS closed on July 1 and, therefore, has been included in our results for the full quarter. On this basis, consolidated third-quarter results were as follows:

- Total revenue of $175.4 million, which was toward the upper end of our guidance range.
- A GAAP net loss of $26.2 million, or $0.55 per share, which includes acquisition and integration costs of $10.3 million primarily related to the closing of the HKFS acquisition. Our GAAP net loss and GAAP EPS were both below our target ranges due to a higher than forecasted tax expense. I'd like to offer more perspective on this. Our GAAP reported net income figure is greatly impacted by the variability in our tax rate, which can be volatile, especially on an intra-period basis, as profitability estimates are adjusted throughout the year. Small movements in pre-tax income cause larger swings in the tax rate due, in part, to changes in NOL utilization, which is one of the reasons why we also present non-GAAP financial measures, which we believe provides investors with a more complete understanding of our underlying operations when viewed as a supplement to GAAP results.
- Now, moving to that view, Adjusted EBITDA was $27.0 million, above the high-end of our target range.
- Non-GAAP net income was $15.1 million, or $0.31 per share, both also above the high-end of our target range.

Tax Preparation

Turning now to tax preparation. TaxAct revenue for the third quarter was $39.4 million, just above the high-end of our target range. This was driven by better overall performance in 3rd peak leading up to the October 15 deadline, including ancillary product sales that came in a bit better than our forecast. Segment operating income was $16.2 million, also above our target range, due to the flow through from revenue.

Wealth Management

Moving to wealth management. Third quarter wealth management revenue was $135.9 million, which was right about at the mid-point of our target range and included about $9.2 million of revenue related to HKFS.

Relative to last quarter, the total revenue number represents an improvement of 17%, driven by a 25% increase in advisory revenue. This growth was also driven by a number of additional factors, including:

- Market improvement;
- The addition of HKFS, including net inflows within that business; and
- A 12% increase in trailing revenue and 14% increase in transaction revenue.

Excluding the addition of HKFS, which contributed $9.2 million of revenue this quarter, revenue grew 9% relative to last quarter.

On a year-over-year basis, total wealth management revenue was down 7%. This was primarily driven by a 90% decrease in sweep revenue and a 27% decline in transaction-based commission revenue, the latter driven by the factors we mentioned last quarter. These factors include the extended tax season and limited ability to meet in person, making it difficult to drive business development activities, both with existing customers as well as attracting new ones. Excluding HKFS revenue of $9.2 million, revenue declined 13% year-over-year.

Wealth management segment operating income came in at $17.5 million, above the high-end of the target range, primarily due to prudent expense management.

Total client assets increased 13% year-over-year to $76.2 billion, which includes approximately $5 billion from the addition of HKFS. Fee-based advisory assets were up 23% year-over-year to $32.4 billion. This is a new record for advisory assets, even excluding HKFS, and advisory assets as a percentage of total client assets ended the quarter at 42.6%, up about 370 basis points from the same quarter last year, also hitting a high-water mark.

Net inflows into advisory assets were about $125 million, consisting of about $70 million in outflows at Avantax, boosted by net inflows at HKFS of about $200 million. We saw net outflows in total client assets of about $300 million, which represents an improvement from last quarter's result and consists of about a $500 million outflow at Avantax, partially offset by the $200 million inflow at HKFS.

Finally, in wealth management, HKFS contributed revenue of about $9.2 million, and contributed $3.1 million to wealth management segment operating income, which represents a 34% margin on a standalone basis. Total client assets at HKFS ended the quarter at about $5 billion, up from about $4.5 billion in Q2, with net inflows of about $200 million during the quarter. More than 90% of HKFS client assets are in an advisory billing structure. As of the end of the third quarter, HKFS served about 75 CPA firms, 4,400 RIA clients and over 13,000 retirement plan participants.

Finishing up on **third quarter performance,** unallocated corporate expenses came in at $6.7 million, slightly better than the midpoint of our range. During the quarter, we had about $5.4 million in transaction and integration costs related to HKFS, $1.8 million in integration costs related to the acquisition of 1st Global, and a $4.1 million impairment charge related to exiting the former 1st Global headquarters building.

Finally, the HKFS transaction included two potential earn-out payments to be paid based on ending asset balances in June 2021 and June 2022, which could potentially total up to $60 million, and which are contingent upon certain performance metrics. The earn-out potential stemmed from a renegotiation of the upfront price from $160 million down to $100 million. This contingent consideration is recorded on our balance sheet in other current liabilities and other long-term liabilities. The estimated fair value of this liability will be re-evaluated each quarter until the second earn out measurement date, and the change in the fair value will be reflected in operating income. This will be highlighted in the "change in fair value of acquisition-related contingent consideration" line on the P&L and excluded for purposes of calculating our non-GAAP net income. It is important to understand that this quarterly evaluation will add uncertainty in estimating our GAAP net income. For the third quarter, the fair value of the liability declined to $26.6 million, which resulted in a gain of $1 million.

It's important to note that the valuation methodology aligns with best practice and includes assumptions for a number of market-based discount factors. This results in a much lower earn-out valuation than what is estimated on an undiscounted basis. We hope that the HKFS business continues to perform favorably over the next two years, which would result in the payout of the earn out, as the achievement of the earn-out metrics would be bring very positive growth in this business. As we provide guidance over the next two years, we will do our best to incorporate our latest thinking into non-GAAP expectations resulting from what we expect to ultimately payout.

Liquidity
Turning to liquidity, at the start of the quarter, and in connection with the HKFS acquisition, we entered into a $175 million add-on term loan to our existing credit facility. We used approximately $100 million of the proceeds of the term loan increase to fund the purchase price of the HKFS acquisition, with the remainder of the proceeds, net of fees, currently remaining on the balance sheet. We ended the quarter with cash and cash equivalents of $151.2 million, and our net debt was $412 million. Our reported net leverage ratio at the end of the quarter was 4.5x, compared to 4.4x in the prior quarter.

As we look forward, from a capital allocation perspective, we will continue to be prudent. We have not engaged in any share repurchase activity and have no near-term plans to do so. With the HKFS acquisition completed, our ongoing priorities for cash deployment, aside from unique opportunities, will be to support organic growth and pay down debt. Our long-term net-leverage goal remains to be below 3x.

Full-Year Outlook
With that, let's turn to our updated full-year outlook for 2020.

For the full-year, we expect:

- TaxAct revenue of between $207.0 to 208.0 million and segment operating income of $47.5 to $48.5 million.

- For our wealth management business, we expect full-year revenue, which includes HKFS for the period of July 1 through year-end, of $535.5 to $540.5 million and segment operating income of $68.5 to $70.5 million.

This translates to consolidated full year outlook, again including HKFS for the partial year, of:

- Revenue of between $742.5 and $748.5 million,
- Adjusted EBITDA of $88.5 to $92.5 million,
- Non-GAAP net income of $46.0 to $51.0 million, or $0.95 to $1.05 per diluted share,
- GAAP net loss attributable to Blucora of between $339.0 to $333.0 million, or $7.05 to $6.94 per diluted share; and
- Corporate unallocated expenses to be between $26.5 and $27.5 million.

So, as you can see, third quarter results were ahead of our targets, and our full-year estimates at the midpoint have also increased. We plan to reinvest some of the improved results in accelerating opportunities for tax season readiness. The change in corporate level expenses relates, in part, to managing discretionary spend based on performance of the overall business. The new spend forecast now takes into consideration our upwardly revised revenue target as we held off on certain investments until we had more confidence in business performance. On a net basis, that results in our adjusted EBITDA target for the year improving by $1.0 million at the midpoint relative to our prior 2020 outlook, with non-GAAP EPS improving by $0.10 per share.

In these 2020 results, you have COVID-related impacts which are discrete, including the costs of the extended season at TaxAct, and some of those will be longer-lasting; such as the decline in sweep revenue that we experienced from the 2nd quarter on, and that will likely persist beyond 2021.

Preliminary Tax Season Outlook

Finally, at this time of year it has been customary to provide a preliminary outlook for the first half of the upcoming tax season. Given that this year's tax season was extended into the third quarter, we feel that it may be more helpful to provide a preliminary outlook for the entire year for TaxAct. A few things I'll note as it relates to this guidance:

1) Our product enhancements showed significant improvements in conversion, retention and customer satisfaction this past season. The decline in consumer units seen in prior seasons was significantly improved.
2) The marketing improvements implemented during this past season showed a significant improvement in second peak unique site visits; and we've continued to enhance our marketing team and plan for next season.
3) As discussed earlier, we plan to launch our commercial version of a hybrid-assisted product offering in January.

These factors, among others, give us confidence as we head into the upcoming season. However, we are also entering into a transition year as we move from price-based growth to unit and ARPU-based growth. This transition, as well as the fact that we are guiding over a longer timeframe, yields less certainty.

Incorporating these factors, and assuming normal start and end dates for a typical tax season, we are preliminarily targeting TaxAct revenue to grow in low single digits relative to full year 2020. In terms of segment operating income, consistent with our prior commentary, we expect a healthy rebound next year and expect a minimum of $20 million of additional segment operating income vs. 2020. This preliminary guidance does include maintaining a higher than historical level of marketing spend, although lower than last tax season. However, if we are not getting the desired returns on this marketing spend, we can certainly dial back in line with performance.

We believe this to be a high-confidence outlook as we drive our strategy of positive monetized unit growth, launch of our hybrid assisted model and anticipate a strong improvement in our marketing capability, all while driving improvements in product quality. When grouped together, these initiatives are exciting, and we believe will set the stage for long-term sustainable growth.

Now before I turn it over to the operator, I wanted to make known to you that Bill Michalek, who has been with Blucora since early 2017, has accepted a new role outside of the company. As such, this will be his last earnings call with us.

I'd like to sincerely thank Bill for his fine work and many, many contributions to Blucora. We will miss him and wish him well, and every success, in his new endeavor. Another member of our team, Dee Littrell, who has been working in Avantax, and has many years of IR experience with the former Cash America, will be stepping in on an interim basis while we search for a new full-time investor relations leader. His contact information is on our website.

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