Avantax®

Q2 2023 Earnings Conference Call

DEE LITTRELL, INVESTOR RELATIONS

Thank you and welcome everyone to the Avantax second quarter 2023 Earnings Conference Call. Yesterday afternoon, following market close, we issued our earnings release and posted the release and supplemental information on the investor relations section of our website at Avantax.com.

I am 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 that 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 SEC filings, including our most recent Form 10-K and Form 10-Q, for more information on some of these specific risks and uncertainties. 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 and supplemental financial information are available on the investor relations section of our website at Avantax.com and include full reconciliations of each non-GAAP financial measure discussed to the nearest applicable GAAP measure.

With that, let me hand the call over to Chris.

CHRIS WALTERS, CHIEF EXECUTIVE OFFICER

Thank you, Dee.

Good morning.

I am pleased to report that two quarters in, operating as a pure play wealth management business, we have maintained strong operational performance across key metrics.

We delivered our sixth straight quarter of positive net asset flows and are on pace toward another record year. We have also continued to see a stabilization in our Financial Professional count and growth in count of our most productive Financial Professionals. We continued to experience strong inflows of assets and minimal attrition, resulting in our production retention rate remaining above 99.5% in the second quarter.

We have also continued to make significant progress towards streamlining our operations to provide a more scalable and efficient organization.

- With regard to asset flows:
    - Our 6th straight quarter with positive net asset flows was driven by the growth and retention of our existing Financial Professionals through same store sales.
    - While Q2 same store sales were not quite as high as we saw in Q1 as expected, it is worth noting that we received over $200 million of new flows in just the first few days of Q3 putting us off to a great start for this quarter.
    - In addition to the positive organic flows, we also brought in additional net new assets by closing our first external acquisition into APP and expanding our national presence of our employee-based RIA which now has more than $7.6 billion of associated assets under management.
    - From a newly recruited assets perspective, we recruited approximately $141 million in new assets and have an extremely robust pipeline which Marc will get into in a moment.
    - We added 50 new Financial Professionals primarily from our recruiting efforts and also added 19 Financial Professionals to our Strategic Partners Program that helps unite tax and wealth

professionals to drive incremental growth to our existing and newly recruited Financial Professionals.

  - Overall, this quarter was a strong indicator of the strength of our tax-focused wealth management model. Existing and prospective clients are increasingly turning to Avantax Financial Professionals for a more comprehensive and tax-inclusive approach to their financial plans.

- Financial Professional Retention:

  - In Q2 we continued our trend of exceeding 99% production retention, which we believe continues to be best in class. This strong performance on production retention is driven by multiple parts of the business:

    - Our client services and operations team, which continued to achieve superior service and processing metrics.

    - Our elite business strategy team that partners closely with our largest Financial Professionals and their firms to help them maximize their performance.

    - Our growth consulting team, which provides data driven, critical insights and solutions to our Financial Professionals to support their growth.

    - Our product and technology teams that continue to prioritize the Financial Professional experience and build out digital experiences that are easier-to-use, more intuitive, and can provide unique value to our Financial Professionals and their end clients. We are excited about some of the future developments that will be coming toward the end of the year which will enable our Financial Professionals and CPA Affiliates to even more easily serve their tax clients with wealth management.

        - Our marketing team, which helps Financial Professionals market their firms through innovative support like our collaborative Marketing Mastermind program, small group marketing coaching, and our in-house agency model, SigniFI, that allows Financial Professionals to take marketing execution off their plates entirely.

    - In addition, our initiatives focused on growth strategies and practice management for our Financial Professionals and accounting firms, such as our Rise to Elite Coaching Program, which have proven successful as Financial Professionals participating in these programs are outperforming expectations. This peer-to-peer coaching program for our Financial Professionals has accelerated the growth of our graduates by more than their peers, which is a promising sign for the future.

    - Finally, our upcoming conference, Connect for Growth, will take place later this summer in Dallas and has shown strong Financial Professional interest. We have already surpassed last year's registration numbers and last year's attendees ramped up their growth rate by more than others.

- Now on to our Mix-Shift:

    - We completed the acquisition of Minnesota-based Summit Wealth Advocates, an independent RIA and advisory firm that manages over $300 million in client assets. This represents our first acquisition of a wealth management firm not affiliated with Avantax and we look forward to others in the future.

    - Our advisory assets under management continued setting a new high-water mark at just shy of 51% of total client assets.

    - This growth was partially enabled by strong same store sales of new advisory assets with net outflows from brokerage accounts.

- We have a strong recruiting pipeline heading into the remainder of the year and will continue to look for acquisition opportunities for firms that are a good fit for APP.

Now on to TaxAct Separation

Finally, I'm happy to report that the Transition Services Agreement - or TSA in relation to the TaxAct separation is on track to complete this quarter and that we have already continued to progress on our post sale efficiency initiatives, with savings expected to begin being reflected in our fourth quarter numbers.

Now, I'll turn it over to Marc and we will be happy to answer questions after the prepared remarks.

MARC MEHLMAN, CHIEF FINANCIAL OFFICER

Thank you, Chris, and good morning everyone. During the second quarter, we continued to build on the foundation the team has created for a strong 2023 and beyond. We continued the trend of breaking records for revenues and assets in advisory accounts as a percentage of total client assets. As Chris mentioned, we saw net positive asset flows for the sixth consecutive quarter and a continued strong production retention rate of 99.6%.

Before reviewing the second quarter results, I would like to point out that we have brought back Non-GAAP net income and Non-GAAP net income per diluted share into our company reporting and guidance. We believe that this will provide meaningful information to management, investors, and analysts regarding the Company's performance, while assisting investors with the public valuation of the business. As noted earlier, our earnings release and supplemental financial information include full reconciliations of those to the nearest applicable GAAP measure.

2023 has been a year of profound change for the business, as we separated the TaxAct business from our operations and reset many of the financial and operational elements of our business. This has been done amidst a continued noisy macro-backdrop of rising equity markets, client cash sorting and continued volatility in interest rate expectations. That said, with the ending of the TSA this quarter, our Term Loan A fully drawn, the Fed apparently nearing the end of its hiking campaign and many of the planned actions to reset the business now complete, we should have less noise and more predictability in our financial performance.

As it relates to those planned efficiency actions, in the third quarter we have acted on nearly $7 million of annual run-rate savings which when added to the actions taken earlier this year surpasses $10 million in annual run-rate cost efficiencies. We are committed to a continuous focus on managing our cost base in light of our pure play wealth focus and with the TSA almost behind us, we have the focus and ability to do so. We will have more to share at an Investor Day we plan to schedule later this year, where we will share our medium to long-term focus areas and expected financial outcomes.

Now, to discuss our second quarter financial results:

- Total revenue of $186.9 million was up approximately 15% from the second quarter of the previous year and up approximately 5% sequentially from the first quarter of 2023. The year over year increase of $24.3 million is due primarily to additional cash sweep revenue bolstered by strong production retention rate and net new asset flows.

- Adjusted EBITDA from continuing operations was $31.1 million versus $5.2 million for the same period last year.

- GAAP net income from continuing operations was $3.6 million, or $0.09 per diluted share. This compares to $0.8 million, or $0.02 per diluted share for the same period last year.

- Non-GAAP net income from continuing operations was $13.9 million, or $0.36 per diluted share. This compares to Non-GAAP net income of $1.7 million, or $0.03 per diluted share for the same period last year.

A few other details regarding our performance this quarter:

We ended the second quarter with total client assets of $83.8 billion. That is up approximately 4% sequentially from the first quarter of 2023, due to market improvements and net positive asset inflows. Fee-based advisory assets were also up sequentially by approximately 5% from the first quarter to $42.6 billion with advisory assets as a percentage of total client assets ending the quarter at a new record high of 50.9%. Net asset flows into advisory for the quarter were $762 million with total client assets having net inflows of $390 million for the quarter.

Newly recruited assets were approximately $141 million for the second quarter of 2023 versus $228 million for the first quarter of 2023. The decline is a timing issue as our recruitment pipeline remains strong. Through August 8, we have over $500 million in committed new store sales assets. We will continue to experience variability with our newly recruited assets on a quarter-to-quarter basis. This is partially due to the size of the recruits and onboarding of new client accounts.

Our pipeline remains stronger than we've seen historically, and based on historical norms, the number of offers we currently have out to recruits would result in achieving our full-year expectations of between 2% and 2.5% annual growth in recruited assets.

At the end of the second quarter, our cash sweep balances were approximately $2.8 billion. This is down from $3.1 billion, at the end of the first quarter and down slightly from the $2.9 billion we reported having as of April, largely in line with the rest of the industry.

As discussed last quarter, balances have started to stabilize as clients repositioned their mix of cash assets to higher yield products, such as treasuries and money market funds, during the first half of the year. During the second quarter, month-over-month declines in these assets for May and June were down approximately 2% and 1%, respectively. As of August 8, we had roughly $2.7 billion in cash sweep balances with the bulk of the difference from the end of the quarter due to the quarterly advisory fee charged in early July.

During our first quarter earnings call we discussed the possibility of putting into place hedges for our cash sweep income. We in fact entered into derivative contracts this past quarter that in essence allow us to float between 2.5% and 5.5%. These hedges went into effect for June and will expire on May 31, 2026. The cost of implementing this program was just over $14 million which we have elected to defer over the 36-month period, resulting in a monthly charge of approximately $0.4 million which first started hitting the P&L in June. To frame the financial impact of executing on these hedges, it is equivalent to earning about a quarter point less on our sweep balances for the down-side protection below 2.5%.

Liquidity

We ended the quarter with a strong balance sheet, with cash and cash equivalents of $109.8 million and total debt of $268.3 million outstanding on our term loan. At the end of Q2, our net leverage ratio was 1.6x. For the medium term we expect our net leverage ratio to be between 1.5x and 2.5x.

During the second quarter, under our established $200 million repurchase authorization, we continued to repurchase our common stock with the repurchase of approximately 2.2 million shares for an aggregate purchase price of approximately $51.2 million. As of June 30, 2023, we had approximately $124.0 million remaining under our repurchase authorization. Additionally, between July 1, 2023 and August 4, 2023 we repurchased approximately 0.4 million shares of our common stock for an aggregate purchase price of approximately $9.1 million. As of August 4, 2023, we had approximately $115.0 million remaining on our authorization.

Earlier this year I shared guidance for interest expense which assumed a more modest amount of stock repurchases. So far in 2023, through August 4th, we repurchased a total of approximately 11.9 million shares which is significantly greater than what we anticipated earlier this year. As a result we borrowed on the Term Loan A faster than expected resulting in a new interest expense forecast I'll share in a moment as part of our updated guidance. With the delayed draw Term Loan A now fully drawn, interest expense will be simpler to forecast.

Our capital allocation priorities continue to be a mix of returning capital to shareholders, investing in our business to fuel long-term growth and executing on our acquisition program of independent Financial Professionals. Our share repurchases moving forward will likely be less than the amount purchased in the second quarter as we adjust our purchasing as appropriate relative to other communicated capital allocation opportunities.

2023 Full-Year Outlook

With that, let's turn to our Full-Year 2023 outlook:

We are adjusting our previously issued guidance to account for our cash sweep balance hedging activities and a lower cash sweep balance with expected market improvement offsetting some of the downside from those two factors as well as some softness in transaction sales, for instance 1031 exchanges. We expect full-year revenue of between $753.0 million and $756.0 million and Adjusted EBITDA of between $124.5 million to $126.5 million. These figures assume 1% market growth per quarter from the end of Q2 2023. As it relates to Fed Funds rates, we are including the recent 25 bps increase, which occurred in late July 2023 and we are assuming no additional rate hikes or cuts for the remainder of 2023.

Factors that can drive revenue and profit outcomes include the performance of transaction-based commissions revenues, timing of asset flows throughout the year and changes in cash balances.

With respect to GAAP net income, we expect between $16.0 million and $18.0 million and GAAP earnings per diluted share of between $0.40 to $0.45 per share. We anticipate Non-GAAP net income to be between $49.0 million and $52.3 and Non-GAAP net income per diluted share to be between $1.22 and $1.30 per share.

As mentioned earlier, we expect one-time items relating to the cost of delivering cost savings, transition items related to the sale of TaxAct and other one-time matters incurred this year to be higher than previously anticipated, expecting the number to be closer to $20 million. As mentioned earlier, much of the originally anticipated change is behind us, with just several million dollars of below the line expenses expected to be incurred the balance of this year, much of it in the third quarter.

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

CHRIS WALTERS, CHIEF EXECUTIVE OFFICER

Thank you all for joining us today and for your interest in Avantax. Speak with you next quarter.