Avantax®

Q1 2023 Earnings Conference Call

DEE LITTRELL, INVESTOR RELATIONS

Thank you and welcome everyone to the Avantax first quarter 2023 Earnings Conference Call. On Monday afternoon, following market close, we posted our earnings 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 share our first quarter 2023 earnings results. After announcing our corporate name change to Avantax earlier this year, we're off to a great start in our first quarter reporting as a pure-play wealth management business with the continuation of our strong operational performance that we reported last night.

We delivered record setting net asset flows with strong inflows of assets and minimal attrition and continued positive momentum in newly recruited assets. Our production retention rates continue to exceed 99% based on the effective support that we provide to our Financial Professionals including growth consulting, marketing and service. Lastly, average production per advisor continues to see a steady increase and is now 15% higher than it was just two years ago.

Last quarter, we focused our remarks on the significant progress we made on focusing and streamlining operations and capital structure. Since then, we have made additional progress in both areas.

Beginning with Operations for the first quarter:

- With regard to Sales:
  - We drove positive net new asset flows for the 5th straight quarter, largely due to strong same-store sales flows and limited attrition.
  - Net new assets were at the highest levels in years for the organization.
  - Same store sales across both advisory and brokerage assets outperformed, building on strong quarter over quarter results.
  - From a new store sales perspective, we recruited 54 new Financial Professionals, including 9 new affiliates to Avantax Planning Partners across 5 new CPA firms. We also added 13 Financial Professionals to our Strategic Partners Program that helps pair up tax and wealth professionals to drive incremental value.
  - Overall, this quarter was a strong indicator of the strength of our tax-focused wealth management model. Coming off a year when both equity and bond markets were down considerably, more existing and prospective clients turned to Avantax Financial Professionals looking for a more comprehensive and tax-inclusive approach to their financial plans.
  - In addition, our initiatives focused on growth strategies and practice management for our Financial Professionals and accounting firms, such as our Connect for Growth Conference and our Rise to Elite Coaching Program, have proven successful as Financial Professionals participating in these programs are outperforming both their Avantax peers as well as industry benchmarks.

- Financial Professional Retention:
  - In Q1 we continued our trend of exceeding 99% production retention, which we believe continues to be best in class. This performance on retention was driven by multiple parts of the business:
    - Our client services and operations team, which continues to achieve superior service and processing metrics.
    - Our elite business strategy team that partners closely with our top performing Financial Professionals 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 for our Financial Professionals and their end clients.
    - As we move past tax season, our revamped chapter program – Growth Through Community – is launching to drive more connectivity, education, and accountability.

- Now Onto Our Mix-Shift:
    - Our assets under management now are more than 50% of our total client assets.
    - This shift was partially enabled by both strong same store sales of new Advisory assets, as well as attrition being concentrated toward commission-based assets.
    - Additionally, we have continued to look to acquire firms that are a good fit for Avantax Planning Partners, our employee-based RIA business. In the past we have focused our efforts on acquiring independent Financial Professionals affiliated with Avantax Wealth Management, but we are excited to note that we are now expanding our acquisitions to other wealth management firms not currently affiliated with Avantax Wealth Management and expect to close at least two external deals this year.

On Capital Structure:

- During Q1, we closed a modified Dutch Auction pursuant to which we purchased approximately 8.3 million shares, or approximately 17.4%, of our outstanding shares for a total amount of approximately $250 million. The tender was funded by cash on hand and a $170 million draw from our term-loan facility.
- Additionally, in March, we recommenced our stock buyback program, which Marc will detail in a few minutes.

TaxAct Separation

- Finally, I would like to share an update on the TaxAct separation. As part of the sale, we agreed to execute Transition Service Agreements - or TSAs - in several key operational areas to ensure a smooth transition.
- We expect to complete the services provided by the end of Q3. At that time, we expect to be positioned to deliver stable run-rate financial performance for the business beginning in Q4.

Now, I will 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. The team has continued to execute our business plan extremely well, and we are performing in-line with our internal expectations. The investments that we made over the past couple of years continue to drive record-breaking results. We are extremely proud of the efforts of our team over this time period and of our Financial Professionals who continue to guide their end-clients through volatile times. We believe that the business is well positioned to deliver sustained long-term annual growth.

We have delivered another well executed record-breaking quarter. Avantax broke records for revenues, total net new assets and assets in advisory accounts as a percentage of total client assets.

Now, to discuss our first quarter financial results:

- Total revenue of $178.0 million was up approximately 7% from the first quarter of the previous year and up 3% from the fourth quarter of 2022. Achieving this revenue figure continues to be a reflection of the favorable interest rate environment as well as asset mix-shifts we've seen in our portfolio. Transaction-based commission revenues were down slightly from the fourth quarter to $18.8 million, which is a reflection of the higher interest rate environment which has impacted alternative investments, like 1031 exchanges. Year-over-year transaction-based commission revenues decreased 9% during the first quarter.

- Adjusted EBITDA from continuing operations for the first quarter of 2023 was $28.1 million versus $5.7 million for same period last year.

- GAAP net income was $1.7 million, or $0.04 per diluted share. Included in our GAAP net income was the finalization of the working capital estimate for the TaxAct sale, resulting in income from discontinued operations of $1.9 million. A couple items of note that I would like to point out are $5.2 million in executive transition costs and $7.8 million in stock-based compensation costs. The stock-based compensation costs include an additional approximately $2 million in costs associated with actions we took earlier in the year to right-size our team.

A few other details regarding our performance this quarter:

Our pay-out rate increased in the first quarter to 75.2%, up from 74.2% during the fourth quarter of 2022. This was driven in part by a larger share of performance coming from our highest tier Financial Professionals and the continued mix of assets into advisory based accounts. We will continue to see fluctuations in our payout rate depending on the concentration of transaction-based revenues, the make-up of net flows and the mix of assets in the quarter.

We ended the first quarter with total client assets of $80.6 billion. That is up approximately 5% sequentially from the fourth quarter of 2022, due to market improvements and net positive asset inflows. Fee-based advisory assets were also up sequentially by approximately 6% from the fourth quarter to $40.6 billion with advisory assets as a percentage of total client assets ending the quarter at a new record high of 50.3%. Net asset flows into advisory for the quarter were $906 million with total client assets having net inflows of $932 million for the quarter. This compares to net asset inflows into advisory of $638 million and total client asset inflows of $495 million for the fourth quarter of 2022.

Newly recruited assets were approximately $228 million for the first quarter of 2023 versus $401 million for the fourth quarter of 2022. This decline is a timing issue as our recruitment pipeline remains strong and we would expect some lumpiness quarter to quarter based on the size of recruits.

I would like to turn your attention to cash balances and our sweep driven revenues. I'll point you to slide number 10 in our earnings presentation deck. This provides a 3-year lookback at our cash sweep balances as a percentage of total client assets, which tend to fluctuate between 3 and 4% of assets. Similar to our peers, we have noticed that our clients have been repositioning cash assets to higher yielding products, such as treasuries and money market funds. However, we don't see the assets leaving our platform, just repositioned. Because of this movement, client cash sweep balances have declined year-over-year to $3.1 billion at the end of March 2023. This is down 14% from the end of 2022, although we had a number of large deposits toward the end of the year that were subsequently invested in the first part of January. Balances started to stabilize in mid-March and have stayed relatively stable since then, with cash balances currently at $2.9 billion, as a result of Advisory billings that took place in April.

Assuming a stable cash balance for the remainder of the year, the most recent interest rate hike in May and our current sharing amounts, we anticipate a small negative impact to the sweep revenue we expected earlier this year, in the low to mid-single digit millions, offset in part by stronger equity markets.

Liquidity

Turning to the balance sheet, we ended the quarter with cash and cash equivalents of $145 million and total debt of $170 million outstanding on our term loan. In early March, we announced the results of the completion of our modified Dutch Auction tender offer. We were able to repurchase and retire approximately 8.3 million shares at $30 per share. The cost of the tender offer of approximately $250 million was satisfied with cash on hand and proceeds from our delayed draw term-loan facility. For reference, by the end of the second quarter, we expect to have borrowed the entire amount of the $270 million Term Loan A.

As mentioned in the fourth quarter, our Board of Directors authorized the Company to repurchase $200 million of our company's common stock. In addition to the purchase of approximately $250 million of shares in the tender offer, so far in the first three months of 2023, we have also purchased approximately 1.0 million shares of our common stock at a total purchase price of approximately $24.8 million. Also, between April 1, 2023 and May 5, 2023, we repurchased approximately 0.7 million shares at a total purchase price of approximately $17.0 million. This brings our total share repurchases through May 5th to approximately 1.7 million shares for approximately $41.8 million.

Our capital allocation priorities continue to be returning capital to shareholders, investing in our business to fuel long-term growth and executing on our acquisition program of independent Financial Professionals.

For the medium term we expect our net leverage ratio to be between 1.5x and 2.5x.

2023 Full-Year Outlook

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

We are reconfirming our previously issued guidance from February. We expect full-year revenue of between $750 million and $758 million and Adjusted EBITDA of between $124.5 million to $135.5 million. These figures assume 1% market growth per quarter from the end of Q1 2023. As it relates to Fed Funds rates, we are assuming no additional rate hikes or cuts subsequent to the May meeting decision.

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

Our guidance assumes that we will drive meaningful cost efficiencies in the business, that will be realized throughout the year, with a larger amount following the conclusion of the provision of transition services in connection with the TaxAct sale, which we believe will be substantially completed by the end of the third quarter 2023.

With respect to GAAP Net Income, we expect between $25.5 million and $40.1 million and GAAP earnings per share of between $0.63 to $0.96 per share. We are also anticipating coming in at the higher end, if not a bit higher, of the previously shared range for adjusted expense items relating to the cost of delivering cost savings and transition items related to the sale of TaxAct. As a reminder, that range was between $7.8 million and $14.5 million.

Lastly, we have received several questions as it relates to our cash sweep program and whether we plan to hedge the variable rate tied to the Fed Funds Rate. We have explored a number of options and intend to hedge a significant portion of our notional balance for between 3 and 5 years. We will provide additional details once we enter into a hedging agreement and, thereafter, will report quarterly on cash balances, hedged amounts, tenors and rates hedged.

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.