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Blucora, Inc. Conference Call on Acquisition of HK Financial Services

BILL MICHALEK, VICE PRESIDENT INVESTOR RELATIONS

Thank you and welcome, everyone, to Blucora's Conference Call. On the call today are John Clendening, Chief Executive Officer, Davinder Athwal, our Chief Financial Officer, and Todd Mackay, Chief Business Operations and Development Officer. Please note that we have posted a press release and supplementary presentation in the investor relations section of our website at Blucora.com.

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, 8-K 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. For a reconciliation of these measures, please refer to our website, where our press release, supplementary presentation and other SEC filings provide these reconciliations.

With that, let me hand it over to John.

JOHN CLENDENING, PRESIDENT AND CHIEF EXECUTIVE OFFICER

Thanks Bill, and thank you, everyone, for joining our call today. We're excited to discuss today's announcement of our intent to acquire HK Financial Services, which will add a highly complementary channel to our current business.

HK Financial Services is a tax-focused wealth management firm focused on the retail market. They operate in the captive, or employee-based, RIA space, which is the fastest-growing segment of wealth management, and one adjacent to our attractive independent advisor/IBD model, Avantax Wealth Management. HKFS partners with CPA firms to provide holistic tax-focused financial planning and advice across investments, retirement plan services and insurance. They are a fast-growing firm with $4.4 billion in total client assets, 75 accounting firm partners, 4,100 advisory end clients, 11,000 retirement plan participants, and a compound annual revenue growth rate over the past 5 years of about 9%.

HK Financial Services, and the CPA firms they partner with, believe that after-tax returns and financial planning that incorporates tax advantaged solutions are what matter most – and that investors deserve better than the offerings of mainstream wealth managers who make the assumption that taxes don't matter. They achieve this focus by partnering with CPA firms, through a referral arrangement to provide clients with well-coordinated wealth management solutions, with a revenue split back to the CPA firm which averages about 35%, or about 65% retention by HKFS. Now, this conviction around Tax-Smart Investing will sound familiar to you all, as it's also the underpinning our independent advisor business, Avantax Wealth Management. It's a differentiated approach and one we are further activating with investment in technology, to automate the capture of tax alpha, through our Tax-Smart Investing suite of software.

Importantly, there are some clear differences that make plain the complementary, rather than conflicting, nature of this business relative to Avantax Wealth Management. Here I'd point you to a few fundamentals:

- First, each has a distinct business model. Avantax Wealth Management is an *independent* model where the Advisor is an independent affiliate, rather than an employee, who has taken the view that they want to be out in front with their tax clients as they integrate and control wealth management solutions in to the client relationship. Most often it is the tax professional that becomes the wealth advisor with Avantax Wealth Management enabling the success of the Advisor as the holistic provider. Now, HK Financial Services, as a captive RIA, utilizes *employee* Advisors who work with CPAs firms who prefer to essentially outsource the wealth management work to a firm they trust, but while ensuring close coordination. So, the different models appeal to different types of tax professionals and CPA firms.

- Second, there is no chance of channel conflict. Channel conflict arises when two channels are competing to win the business of the same client. In our situation, this is not the case. Here, each of our Avantax Wealth Management Advisors, and the HK Financial Services employees and partner CPAs are focused on cross-serving their existing tax clients. In other words, the risk that each are competing for the same end-client is roughly nil.

Having added clarity on that point, now let's get back to more about HK Financial Services. Their revenue breakdown, includes:

- **Advisory**, which as you know from following Avantax, is attractive, recurring revenue. And HKFS services clients with an in-house, employee advisor team which enables a consistent experience for clients and attractive economics for HKFS. The advisory business represents 74% of revenue and has been growing at a compound growth rate of approximately 10% over the past 5 years.
- **Retirement Plan Services**, which includes providing end-to-end 401(k) services for the small business clients of the referring CPA firms, that includes asset management, plan administration and record keeping. This business represents 19% of HKFS revenue and has been growing at a 24% CAGR. This business is also recurring in nature, and a good portion of this is non-compensable to the referring CPA firms, and therefore very high margin.
- **Insurance** products, representing 5% of revenue.
- And finally**, a small amount of commission-based revenue**, which largely consists of mutual funds as well as annuities and alternative investments and represents about 2% of revenue.

Our diligence has shown us that HKFS is a great business in terms of growth, quality and profitability. Big picture, this acquisition is right in our wheelhouse and has important attributes that make it both strategically and financially attractive. On top of that they are a high quality and growth-oriented team committed to better serving clients and enabling better outcomes. I would point you to four main takeaways:

1. One - it **increases our total addressable market** of serving tax professionals with wealth management services and so strengthens Blucora's position as the premier player in tax-smart investing, regardless of channel or business model. This acquisition extends Blucora's presence into a large, and adjacent wealth management segment with favorable tailwinds – the captive RIA space, which, as I mentioned, is the fastest-growing segment in wealth management with attractive recurring revenue. We will now be well-positioned in both of the fastest-growing channels of wealth management, RIA and IBD, while doing so through the unique and differentiated channel of tax professionals.

   This means our enhanced offering enables us to serve more CPA firms and tax pros in more ways. When we approach a CPA firm, they will have two options. They can join us as in independent advisor at Avantax, our historical model, a great fit for firms that prefer to manage and largely own the end-to-end experience for their clients, with our help and utilizing our turnkey services. Or, they can now sign up for a different turnkey approach, our captive RIA solution, where the CPA refers the client to one of our in-house HKFS advisors who then does all the wealth management and financial planning work, with the CPA receiving a recurring revenue stream and helping coordinate work with the client.

   The simple implication is we ought to close more business by offering tax professionals and CPAs more options to better serve their tax client base while transforming the value of their practice. And, there is so much opportunity ahead of us. Our back-of-the-envelope math tells us that Avantax Wealth Management and HK Financial Services together would comprise only 2-4% of the ~90k addressable tax professional firms that today enjoy trusted relationships with their clients. These CPA firms have trusted relationships with clients who in turn have several trillion dollars in investable assets, so it's safe to say the opportunity to grow by bringing superior wealth management is truly remarkable.

2. Two – it is **fully complementary.** Given the fundamental differences in business models, and preferences of tax professionals as described earlier, 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.

3. Three – it **adds a strong growth and profit engine and platform** that will enhance our revenue growth rate, increase margins and be accretive to EBITDA, EPS and free cash flow. HKFS has been growing revenue at about a 9% clip, with an attractive high-recurring revenue model that approaches 100%, with 74% of revenue from advisory, 19% from retirement plan services, and 7% from insurance and brokerage. They boast high adjusted EBITDA margins of approximately 30% vs. the strong-for-the-sector 14%-15% segment margin for our Avantax business.

4. Four – we are excited by the **growth catalysts that the acquisition generates.** I mentioned how operating as a captive RIA, with employee advisors, HKFS complements our independent advisor network and enhances our margin profile, but without channel conflict or cannibalization. In addition, we are excited about a number of growth-enhancing opportunities. I will highlight just a few here.

   (A) Creation of an incremental revenue stream for Avantax Advisors. HKFS has built an end-to-end retirement plan service for small business clients. This is something that Avantax currently outsources, so it will be a new value-added offering for Avantax advisors. Over time, if Avantax advisors choose, they could also transition existing external plans to our new in-house offering. This is a win-win: advisors get a turnkey solution and specialist services for better sales in to client base and less work for the advisor, while getting the same revenue on the assets, and Blucora gets additional revenue share through the enhanced services of plan administration and record keeping.

   (B) HKFS will improve asset retention by providing an 'off ramp' opportunity for retiring or stalled Avantax Wealth Management advisors. Avantax wealth managers who wish to retire now have a terrific added option, knowing their clients will be well-served. In this case, the retiring or stalled advisor, who would otherwise leave the wealth management business entirely, can now transition the wealth management relationships to our HKFS advisor and thereby still offer their clients integrated tax and wealth management without managing the advisor piece themselves, and still enjoying the financial benefits.

   (C) In addition to organic growth, you all know as well as we do, that there are ample opportunities to drive accretive growth in captive RIA through acquisition of the right type of Advisors. It would be fair to expect that we will participate in this opportunity, in a way that makes sense to us, at the right time and pace, and in a manner that is attractive to our shareholders. I'm sure we'll have more on this in the time post-close.

   (D) Finally, this acquisition will enable even more clients to benefit from our Tax-Smart Investing software platform, generating incremental tax-alpha which is almost universally ignored at most other firms. Our conviction is this will spur higher organic growth.

The acquisition is structured as a stock purchase with a price of $160 million, which represents an attractive multiple of approximately 9.3x fully realized synergies on pro forma 2020 EBITDA. Overall, we estimate the transaction can generate $15mm - $16mm of run-rate EBITDA accretion by the end of 2020, with meaningful accretion to earnings per share.

As you might expect, we believe we have taken an appropriately conservative view of the key synergies related to this transaction and believe the short- and long-term benefits of the transaction are substantial. HKFS has an impressive business model, employee team and base of CPA firms and end-clients. Our entire leadership team is looking forward to their employees, advisors and partners and clients joining us as we continue to grow.

Finally, one leadership update before I turn it over to Davinder to discuss some additional detail about the transaction. In addition to the acquisition news this morning, we also announced that Davinder will be stepping down from his role and transitioning out of the business over the coming weeks. As I mentioned in the press release, Davinder has helped us make meaningful progress on our strategic growth plan over the past two years, including his role in the acquisition and integration of 1st Global, strengthening the balance sheet and building an incredibly strong finance and accounting team. With the acquisition of HKFS now upon us, Davinder and I took this as an opportunity to evaluate our respective future needs and growth plans and came to the mutual landing point that now would be the right time for Davinder to move on to his next opportunity. This will allow Blucora to bring a new perspective to the company as we enter our next phase of growth and execution, while allowing Davinder the opportunity to pursue opportunities that make the most sense for him, both professionally and personally. I am grateful for Davinder's many contributions as well as his commitment to remaining involved to ensure a smooth transition.

Also in the release this morning, we announced that Rick Simonson has been retained as a special advisor to the company. Rick is a well-regarded, long-tenured CFO with companies like Sabre and Nokia. He has significant technology expertise and experience scaling companies, which are among the key attributes we are looking for as we conduct a thorough search for our permanent CFO. His counsel to me and the team will be valued during the interim period.

Davinder and I have agreed that his last day in his current capacity will be January 31, and he will then move to an advisory role and be available to us as may be needed through 2020 while we search for his successor. We have retained an Executive Search firm, as of this morning, to help us on this critical search. Davinder, is there anything you would like to add?

<u>DAVINDER ATHWAL, CHIEF FINANCIAL OFFICER</u>
Thank you, John and good morning everyone.

Let me just add that I have truly enjoyed my time with the company and believe there is incredible growth potential in this business and a great team at the helm. But it is time for me to move on. I remain fully committed to the company for the remainder of my time here to ensure that we have a smooth transition. While this means there will be changes to my scope of responsibility, there will be no change in my effort and dedication to assist John and the executive leadership team meet our near-term objectives while I am here.

So, with that, let's dive in to my prepared remarks. First let me say that I share John's excitement about this transaction. This is a great opportunity for Blucora to accelerate growth and profitability by adding a fast-growing, high-recurring revenue business; one that is a complement to a current business, and one that is expected to be nicely accretive to both EPS and free cash flow, enhancing shareholder value.

To start with, I'll provide an overview of HKFS's business approach (and their revenue mix) and then we'll talk more about the specifics of the transaction.

From a revenue perspective, for the trailing twelve months ended September, they generated $31 million. In wealth management, which represents 74% of revenue, and about 68% of assets, they offer customized portfolio management with passive and active models, using separately managed accounts and alternative investments as appropriate.

In Retirement Plan Services, which represents 19% of revenue and about 22% of assets, HKFS provides end-to-end plan services across asset management, record keeping and administration for 401(k) plans. The small business segment of the 401(k) market represents about a $750 billion market in terms of assets. HKFS revenue in this segment has been growing at about a 24% growth rate with a gross margin above 80%. We believe what HKFS has been doing in this segment is very different from others in the RIA and IBD space making it compelling for a couple of reasons. First, in addition to the asset management for retirement plans, they also offer recordkeeping and administration. The recordkeeping and administration business is attractive recurring revenue and also very high margin. This is also something that Avantax advisors currently outsource as we have no offering right now, and for which Avantax receives no revenue. Second, HKFS has a turnkey process from presentation to plan design and investment selection, to in-house specialists that efficiently drive the enrollment of new plans – these are things that advisors are currently doing on their own and take countless hours. Now all they'll need to do is make an introduction. We expect this will be compelling for Avantax advisors for ease of use: they can now capitalize on HKFS plan specialists and back office support, allowing those that currently offer retirement plans to outsource the work to HKFS while still earning the same as they do today.

In Insurance, which represents 5% of HKFS revenue, the company works to provide an insurance planning program that works hand-in-hand with the client's wealth management objectives, rounds out a comprehensive wealth management offering, and helps to protect their assets as part of an overall plan.

Not broken out separately in this presentation, but HKFS has about $400 million in brokerage assets which are custodied at a third-party firm. These are largely for annuities and alternative investments.

We believe the short- and long-term benefits of the transaction are substantial. In terms of synergies, as John mentioned, we believe we have taken an appropriately conservative view of the key synergies related to this transaction. Just to give you a flavor of the types of synergies available, here are a few examples:

1) In 2019 across the Avantax platform we brought on about 700 retirement plans and outsourced the record keeping and administration for almost 100% of those, for which we received nothing. Our synergy target assumes that, going forward, a little more than a quarter of that new accounts amount will be served in house. In short, very doable.
2) In Brokerage – HKFS has $400 million in commission-based assets that are being custodied at a third-party firm, for which HK is paying a platform fee and receiving a 92% payout. About $250 million of this is true brokerage, and the remainder direct to fund or annuity. By shifting those assets to our platform, we immediately capture 100% payout and eliminate the fee. We view this as an "easy-to-capture" synergy.
3) In advisory, we have identified synergies which will make the business more efficient and profitable which includes adding incremental value proposition through the addition of TSI tools, that will create pricing headroom.
4) And lastly, the net effect of other items including IT consolidation, personnel expense and benefits will also result in a net cost synergy.

On top of the higher confidence synergies, there is another set about which we are optimistic, but is not relied upon in our targets. An example of this would be the significant opportunity from advisors that may want to transition existing retirement accounts to the HKFS solution. While we have assumed no transfers in our targets, even a single-digit percentage of asset conversion would be meaningful. Another example relates to our ability to bring on new advisors that are already in the Avantax pipeline, using the HKFS model, that would otherwise not convert. Another would be incremental revenue from Avantax advisors who are looking for an off ramp, for whatever reason, as well as the acquisition of current Avantax advisors who are contemplating retirement.

Given our long-standing focus on shareholder value creation, we have put an increased emphasis on the quality of our planning and execution of this transaction and resulting integration. We anticipate achieving about 35% of run-rate synergies by the end of 2020, and about 75% by the end of 2021.

The transaction was signed yesterday, with a purchase price of $160 million. As part of the transaction, Blucora expects to issue $165 million of add-on term loan fungible with existing debt. The transaction values HKFS at approximately 9.3x fully realized synergies on pro forma 2020 EBITDA. This would take our net leverage ratio to 3.1x, based on Pro Forma LTM 3Q'19 Adjusted EBITDA, and we would expect to see some debt pay down here in the first half of 2020, as is our typical pattern, bringing that multiple even lower. You have seen how our strong cash generation affords us the opportunity to consider acquisitions of this nature, or as John mentioned, future RIA add-ons if and when the time is right.

The resulting increase in profitability of the combined company will also increase the likelihood that we fully utilize our NOL balance over the next few years. We anticipate integration costs to be approximately $10-11 million, which is primarily composed of technology & system integration, onboarding costs for HKFS employees and clients; consulting, severance and other administrative matters. The impact to the P&L is estimated to be approximately $8 million in 2020, with the balance in 2021. Any rolling integration costs beyond 2021 have been included in our run-rate synergized EBITDA. Finally, we expect the transaction to close by the end of the first quarter of 2020, subject to regulatory approval and customary closing conditions.

We expect the transaction to generate $15mm - $16mm of run-rate EBITDA accretion by the end of 2020.

With that, I'll turn it over to the operator for any questions.

JOHN CLENDENING, PRESIDENT AND CHIEF EXECUTIVE OFFICER

Thanks everyone, we appreciated the chance to share this exciting news with you. And, we hope all of you have a wonderful 2020.