BLUCORA

Blucora, Inc. First Quarter 2020
Earnings Conference Call

BILL MICHALEK, VICE PRESIDENT INVESTOR RELATIONS

Thank you and welcome, everyone, to Blucora's first 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, Marc Mehlman, Chief Financial Officer and Todd Mackay, President of Wealth Management.

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, and the earnings release available on blucora.com includes 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. We hope that you and your families are safe and healthy during these unprecedented times.

I'd like to start today with an update on how we are positioned in light of COVID-19.

First, we took early action for the safety of our employees, and to ensure the effective operation of our business. For the past eight weeks, we have had almost the entirety of our workforce working from home -with the tools they need to be effective in supporting our customers and advisors across our businesses. For the 10 or so employees that are still visiting an office location on a daily basis, we are taking extra precautions and being incredibly mindful of their safety, in addition to providing extra pay. I'm very pleased that our employees are safe and that we have been able continue serve our clients effectively with our team working from home. I'm also pleased that we have been able to give back to the community through our partnership with Feeding America, and a donation equivalent to 5 million meals. Overall, through this situation, our productivity and service metrics have remained virtually unchanged, and that is a testament to our dedicated employees.

We are fortunate to have two strong businesses with ongoing demand through this type of environment. People still need to file their taxes, and - more than ever – people will need to plan for their financial needs, including their retirement. In Tax Preparation, this environment is likely to enhance the shift toward online filing. In Wealth Management, our advisors enjoy trusted relationships with their customers by providing both tax services as well as wealth management. Our advisors are largely focused on the long-term value creation they achieve for their customers, based on the unique financial needs of each client. Further, as an overall business, we have positive cash flow and ample liquidity to cover our current operational needs. Marc will touch more on this in a few moments.

While we are fortunate in many ways, we have certainly seen significant business impacts as a result of the COVID-19 outbreak. The primary impact in tax prep is due to the extension of the tax season to July 15th, pushing the deadline for potential customers to file their returns into the 3rd quarter. We therefore are required to continue our marketing efforts over an extended period and to maintain our customer support levels to ensure a good customer experience, increasing our costs while the number of filers remains the same.

In wealth management, the primary impact stems from the decline in interest rates, impacting our cash sweep income. As rates are now zero, we see no further downside on this front. Additionally, the decline in the market has an impact to advisory fees and trails that will become more apparent in the second quarter, albeit muted by the mix of equity vs. fixed income, as well as the payout rate of our independent business model.

Thesis/Looking ahead

Taking a step back, as I have now crossed the three -month mark in my tenure as CEO, I'd like to share a few additional thoughts on how we are positioned and the road ahead.

Last quarter I highlighted our 2019 performance and how we advanced the ball in terms of positioning for future growth. We generated solid results across a number of categories, made a strategic acquisition, reorganized into a more streamlined business, hired exceptional people across all levels of the business, and invested in the business to drive returns.

Since the February call, we have acted quickly to ensure that we have a full leadership team in place and the right operational structure to support and accelerate the execution of our priorities. At a high level, we consolidated operations within the business units, combined our software efforts under one leader, Curtis Campbell, and wealth management efforts under Todd Mackay. We supplemented our businesses with strong new leaders including a head of growth and marketing, in Raj Doshi, our new CFO Marc Mehlman, new head of HR, Jody Diaz and two very talented technology leaders, in Paul Lehman, our CIO and Dilip Nagaraja, CTO.

We have also recently had the opportunity to conduct a deeper dive into the businesses. There are a few key challenges and opportunities in each division that the management team is focused on, and I'll walk you through those before we get into our 1Q results.

Tax Preparation

For TaxAct, the offering has undergone a significant product upgrade, and we've right-sized pricing to offer a smaller discount to the competition, but it has come at the expense of a loss in the number of e-filers. This was expected, and with much of it behind us, the company needs to shift to growth. To do so requires a data-driven marketing approach, utilizing new and cost-effective strategies to drive customer acquisition.

Over the past few months we have done a lot of testing with many new partners as well as added some additional tools. We have been improving our team and structure; and we have learned a great deal which will help us in the future. The early results were extremely promising, though our efforts were hampered by the government's decision to delay tax filings.

The most impactful work will be over the next seven months, as we finish out this season and prepare for next. Our goal is to come in to next tax season with product and marketing both optimized and working in concert. This is a big undertaking, which I believe will be a powerful combination. As we attract new customers and delight them with our improved product experience which is saving them money and identifying ways to improve their financial situation, we also have an opportunity to drive customer engagement beyond tax season to improve retention.

We have made a giant leap in our product quality and we will continue to push it further, setting the stage for the significant improvements we witnessed in customer enjoyment year over year to continue. We plan to continue to make improvements in the experience, including differentiated features, to drive further gains in customer conversion.

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. We anticipate that the product improvements will drive higher retention rates going forward. New initiatives, such as assisted tax preparation, could drive higher unit economics. When combined with improved marketing efforts and additional engagement on the off-seasons, these improvements mean we'll be in stronger position to grow units – and revenue – in coming years.

Wealth Management

In wealth management, over the past two years, we have converted to a new clearing platform, rolled-out a new technology stack for advisors, and acquired and integrated a large competitor. This business looks very different than it did a few years ago, and it is uniquely well positioned going forward to address a very large opportunity. You have heard us say in previous earnings calls that we could potentially grow to 7-8 times our current size without our advisors having to introduce themselves to a single person they don't already do business with - and without us having to bring on a single new advisor.

We continue to believe this to be true, and it will be part of our organic growth efforts which we plan to make our top priority moving forward. We are actively engaged to: 1) improve our service and operational performance to delight our advisors, 2) align systems, processes and technology to improve efficiency and scalability, and 3) maximize advisor performance by providing tools including supporting efficient prospecting to increase client penetration and wallet share.

HKFS

It is also clear that one area we needed to address was providing an option to CPAs who want to add wealth management as a service offering to their clients, but who don't want to become a full-time advisor. To accomplish this, we announced the acquisition of HKFS. We anticipate that adding HKFS to our platform will significantly enhance our go to market strategy, accelerating organic growth through cross sell opportunities and new incremental revenue streams. HKFS has successfully worked with CPA firms on a partnership basis. With this acquisition, CPA's can essentially outsource the wealth management work to a firm they trust, while ensuring close coordination. We no longer have to walk away from this opportunity because we have another turnkey option to allow them to monetize and serve their client base. This grows their business, and ours.

You may have seen that we recently entered in to an amended acquisition agreement, which, among other things, lowered the purchase price and extended the closing window. The rationale for this transaction remains strong, if not even enhanced, in this environment:

- HKFS brings a clear strategic advantage to us, and the business has been growing at double-digit asset growth rates with adjusted EBITDA margins of about 30%.
- It gives us a new way to monetize the 700 retirement plans our advisors start each year for their clients. And this represents an incremental revenue stream for advisors.
- It gives us a new way to retain assets, providing an 'offramp' opportunity for retiring or plateaued advisors. This not only drives asset retention, but also improved margin transitioning from affiliate model to captive RIA.
- And in this type of environment, more people generally look to advisory. Further, in this environment advisors may choose to exit the business. Having HKFS will give us increased ability to capitalize on both of those trends.
- In short, we believe it will help drive significant, and profitable, growth over time.

This business has never had more potential; and the stage is now set to turn our attention to organic growth. We have a great deal of opportunity to accelerate growth, and have an execution-focused team in place to begin to capture it.

Cross-Business Synergies

In addition to the opportunities within each business, we plan to also explore a few opportunities across our businesses that haven't really been thoroughly tested to-date. One example I'd highlight is prospecting within our TaxAct Pro user base to convert to Avantax advisors. We currently have approximately 20,000 TaxAct Pro users and about 4,000 Avantax advisors. Even if only 5% converted, it would represent a 25% increase in our advisor base. Another example is in applying our TaxAct marketing resources to help our Avantax advisors grow their businesses. Most advisor practices have limited marketing scale or resources, so if we can leverage the significant marketing capabilities within our organization to help them drive new customer acquisition, it could make a material impact.

Flow Restatement

Finally, before we discuss Q1 results, I want to note that since joining as CEO, I and the rest of the team have been conducting exhaustive reviews of the businesses. It came to our attention that the flows data that we noted last quarter for Q4 contained a misclassification between line items that roll up to the ending balance. Specifically, certain client reinvestment amounts included in the net flows line should have been categorized as 'market impact and other' in order to be consistent with past practice. This resulted in the company mentioning on last quarter's call that fourth quarter net inflows into advisory assets were approximately $200 million, and net inflows into total client assets were approximately $180 million. The figures, for the fourth quarter, should have been net outflows of approximately $90 million for advisory assets and net outflows of $834 million for total client assets. This also resulted in us calling out record advisory flows of approximately $1 billion for the full year, when the actual number was approximately $712 million -which, while strong, was not a record.

Again, these items relate to the classification of flows relative to our past practice, but do not impact the total reported advisory assets or total client asset amounts reported. We apologize for this administrative error and have included a summary of this change in our 10-Q. We have also taken corrective measures to ensure that something like this does not happen again.

Outflows in Q4 were due to multiple factors including: normal attrition, asset re-allocation as well as anticipated outflows related to the acquisition of 1st Global. We are still tracking below our anticipated and modeled attrition, but did experience some of this in Q4 and we could see more over the next few quarters. We have initiatives underway to keep the outflows below anticipated levels.

Now, for a review of our Q1 results.

Wealth Management

Starting first with wealth management. First quarter wealth management revenue was $145.0 million - at the top of our guidance range, and segment income was $22.6 million, above the high-end of our target range. These results reflect healthy revenue performance combined with expense control measures that we implemented in light of recent events. In wealth management, the decline in the market did not impact our advisory fees in Q1 as they are billed in advance for each quarter, based on the prior quarter's ending balances. The change in interest rates, which happened in the last month of the quarter, also did not show up in Q1 results. As a result, in the first quarter, the business performed well despite the COVID-19 outbreak.

On a consolidated basis, net flows into Total Client Assets were about $125 million, and we ended the quarter with $61.0 billion in Total Client Assets. Net inflows into advisory assets in the first quarter were a very healthy $390 million, and we ended the quarter with $23.6 billion in advisory assets. Advisory assets as a proportion of Total Client Assets ended the quarter at 38.7%.

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

- First, I'm incredibly proud of the team and their ability to so quickly shift to a remote working environment. Not only did they transition almost seamlessly, but service metrics actually continued to improve materially throughout the quarter. While there has been an ongoing effort to optimize processes and procedures (including daily KPI tracking), we were pleasantly surprised to see the metrics continue to improve during the transition. Again, great work by the team.
- Recruiting also continued to be strong, with about 55 new advisors joining in Q1, including 42 new tax pro advisors as well as established advisor transfers. Two of the transferring advisors have assets in the $50-$100 million range that we expect to transfer over in the current quarter.
- We also added 6 new accounting firms in the quarter with approximately $10 million in cumulative accounting revenue, representing an estimated $1 billion prospecting opportunity in total client assets.
- As it relates to our proprietary Tax-Smart Investing software platform, or TSI, we continue to make progress now with about 1,100 advisors on the platform. Advisors using the Tax Loss Harvester tool have placed trades over the past quarter that equates to millions of dollars in potential tax savings for their clients.

Overall, good progress in wealth management.

Tax Season Update and Outlook

So let's move to Tax Preparation. Normally on this call we're summarizing all of the ins and outs of the tax season that would have ended on April 15th. As you know, in late March the IRS announced that the season has now been extended to July 15th. Thus, while the full season summary has been pushed out, let me give you an update on our progress since our last call.

In mid-February we indicated that we had started the season a bit out of position from a marketing perspective, but that our product improvements were really resonating - with retention and conversion rates up 4 and 5 percentage points, respectively. In the month or so after our call, our product metrics continued to improve. By March 20th our retention rate was up another point to 5 points vs. the prior year, and the conversion rate was up another 2 points, - to 7 points up y/y. These are phenomenal improvements in one year! On top of these metrics our customer Net Promoter Scores have been up by double-digits vs. last year; which is another indicator of customer satisfaction which we anticipate will benefit us in the upcoming years.

On the marketing side, we tested and implemented some new marketing activities. Since not everyone is familiar with our brand, it can require some time and multiple impressions per customer to be considered. However, as we got to mid-March, we started to see new users coming in. In fact, our new-user mix improved over the course of about a week and was coming in at almost double where we had peaked the prior year. This was all very exciting and gives us confidence that our marketing improvements are working. And on the TaxAct pro side, we were up year-over-year through March 20th and gaining market share.

The IRS announced a delay on March 21st, which first applied to payments and then the filing date. Post these announcements, filing volumes across all methods slowed materially. The DIY segment of the industry, which had been trending up 3.6% year-over-year prior to the announcement, was down 11.5% as of April 17, and total IRS e-files across all methods down 18% as of April 17.

For the quarter, tax prep revenue came in at $118.3 million, significantly below our prior guidance, due to a shift of volume out of the quarter following the extension of the tax season. Segment income came in at $37.8 million, reflecting the impacts to revenue, as well as increased investments - much of which has been around testing new and alternative approaches to acquire customers. Our consumer e-files for the quarter were down slightly, or in single-digits, versus the same period last year, with pro e-files approximately flat.

In addition to the positive trends we were seeing prior to the deadline change, I would call out a few other things:

- As it relates to our expanded test in assisted, we have continued to see good results. We had plenty of demand and in fact, we expanded our test further than we had originally intended, by about [20%]. Feedback from customers about the experience has been very positive. As a reminder, our goal this year is to exit the season with significant learnings, and to launch a broader assisted tax offering next season - should our testing prove a viable economic model.
- And in Pro, similar to the last couple of years, our market share trends throughout the season so far have continued to show modest gains.

As we look out over the next few months, we're in uncharted territory. This will be the first tax season in the history of our business to span over almost 7 months. The traditional filing patterns don't apply this year, and may be further impacted by what the virus does from here. We will use the remainder of the season to continue to test and optimize our marketing activity. We will look to not only see how we can impact this season, but also to make sure we come in to next season in an even better position with both product and marketing optimized from day one. With these learnings, an improved product, and higher conversion and NPS scores, which positively impacts our lifetime value, - I am optimistic about our potential for next year.

Conclusion
In summary, our business is in the fortunate position of having two strong, profitable businesses, each of which has ongoing demand in this environment. We believe we have adequate liquidity, cash flows and flexibility, to sustain us through difficult times.

In the long-term, as a company, we occupy an amazing position, given that we have the opportunity to support millions of Americans each year in the pursuit of their financial goals. We have enormous potential both in and across our businesses.

I now have the pleasure of turning the call over to our new CFO, Marc Mehlman, for the first time. I couldn't be more excited to have Marc join us, and I know he will be a great partner and make a positive impact on the business. Marc…

MARC MEHLMAN, CHIEF FINANCIAL OFFICER
Thanks Chris –

I'm really excited to be here at Blucora, and I look forward to working with all of you as we continue to execute on our priorities and grow the business. I joined Blucora because I'm passionate about our purpose. Having spent the last several years in a tax focused business, I understand first-hand the complexity but also the opportunity that comes from a changing tax landscape. Having a partner who helps you navigate the scenarios life can throw at you is invaluable, and as Chris mentioned earlier, the services we provide matters even more now in this time of uncertainty. In my first week I can already see the passion of our people and the value our tools can bring to our advisors on the Wealth management side and the direct users of our TaxAct solution. I am excited to bring discipline and focused investment to those areas of opportunity that allow for everyone to benefit. Lastly, I believe we are fortunate to have analysts that have covered our business or industry for a number of years and through a number of cycles. I look forward to getting to know you and leveraging your insights to ensure we're providing the right level of context so you can properly measure our business. Now, I'll just hit on a couple of topics today, then open it up to Q&A.

Similar to Chris, I'll also begin with a Coronavirus-related item. As you all know, the pandemic has had a significant negative impact on the global economy and caused a substantial disruption to securities markets. These factors negatively impacted key wealth management business drivers, interest rates and client asset levels to be specific. These macroeconomic factors, and the resulting decline in our share price when measured as of March 31, served as a triggering event that resulted in a review of the goodwill of our business units. Based on that review, and the implied value as of March 31, relative to our carrying value, we recorded an impairment of goodwill of approximately $271 million relating to our wealth management business. While additional impairment is possible should economic or business conditions worsens, we believe our impairment test as of 3/31 factored in conservative assumptions for our Wealth Management business.

While a non-cash item, it is nonetheless a large and non-recurring item, I wanted to start there and provide a bit of color. Now to move to the rest of the results for the first quarter:

- As Chris mentioned, wealth management revenue of $145.0 million was at the top of our guidance range. Excluding the impact of First Global, revenue for wealth management increased roughly $13M year over year.
- Tax preparation revenue, with the extension of the tax season and related volume being pushed to future quarters, came in significantly below our prior guidance range at $118.3 million.
- As a result, consolidated first quarter revenue also came in below our prior guidance range at $263.3 million
- The impairment resulted in us reporting a GAAP net income for the quarter, which came in at a negative $315.5 million or negative $6.60 per share.
- Adjusted EBITDA, which reflects corporate operating expenses coming in a bit better than expected, was $53.3 million
- And Non-GAAP net income was $43.6 million, or $0.90 per share

Liquidity
In terms of liquidity, the company generated about $39 million in free cash flow in the first quarter, and we also drew down a net $45 million from our revolver to ensure that we had ample reserves in an uncertain market. As a result, we ended the quarter with $168 million in cash and equivalents on our balance sheet. We also recently amended our credit agreement to give us a bit more flexibility going in to the balance of the year, enabling more flexibility to invest in new opportunities as we manage altered timing of our expected cash flows.

As Chris mentioned, we believe we have more than sufficient liquidity to cover our operational needs including non-recurring cash obligations in 2020 - such as our headquarters move and acquisition and integration costs. To retain ultimate flexibility, we are scenario-planning for different environments, and looking at when and where we would lower our cost structure, and when we would invest to accelerate future growth.

From a capital allocation perspective, we will be very prudent. The renegotiated terms for HKFS give us time to continue monitoring credit markets to fund that purchase. The short list of where to deploy cash would be to fund HKFS, plus organic growth opportunities. We would not expect any share repurchase activity in the near-term, and looking past 2020, we would expect debt pay down, in addition to organic growth opportunities, to be the primary focus areas.

Finally, in terms of outlook, given the delay in tax season and the uncertainty given the pandemic, we are electing at this time to withdraw our prior tax season guidance and not to provide additional guidance at this time. We believe this to be the prudent approach given the number of variables currently at play.

With that I'll turn it over to the operator for Q&A, operator?

CHRIS WALTERS, PRESIDENT AND CHIEF EXECUTIVE OFFICER

Thank you all for joining us today and for your interest in Blucora. I would like to thank all of our employees across the company for their hard work, dedication, flexibility and determination during this period. This year has already brought a number of changes and challenges and you have risen to the challenge of each one.

And finally, thank you also to our advisors, customers, and clients - you play a major role in our success and we couldn't be more pleased to be able to play a role in yours.