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Blucora, Inc. First Quarter 2019 Earnings Conference Call

BILL MICHALEK, VICE PRESIDENT INVESTOR RELATIONS

Thank you and welcome, everyone, to Blucora's first quarter 2019 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 John Clendening, Chief Executive Officer and Davinder Athwal, our 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, 10-Q 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, and the earnings release and supplemental information available on blucora.com include the full GAAP and non-GAAP reconciliations.

With that, let me hand it over to John.

JOHN CLENDENING, PRESIDENT AND CHIEF EXECUTIVE OFFICER

Thanks Bill, and good morning everyone.

I'm pleased to report that Blucora had a very strong start to the year, posting double-digit growth rates and exceeding the high-end of our guidance range on most metrics. Compared to last year's first quarter, Blucora revenue grew by 10%, adjusted EBITDA by 26% and non-GAAP EPS by 30%. We generated strong cash flow and reduced our net leverage ratio to less than one, at 0.8x prior to the acquisition closing, vs. 1.5x at the end of the fourth quarter.

Tax Preparation

So let's jump right in to segment performance, starting with tax preparation. For this discussion I will be talking about the full tax-season which is through Tax Day +1, or through April 16, as well as our full first half 2019 expectation for TaxAct. TaxAct delivered very strong financial results and continued to make progress on repositioning the business for the future.

We expect to grow first half TaxAct revenue by approximately 13% vs. the comparable period last year, which would put us above the high-end of our original and upwardly revised outlook ranges for revenue. Even with some incremental strategic investment in the business, we expect first half segment margin will come in at the 58% range, obviously very strong and at the high-end of our revised outlook range and above our original range.

Monetized units for the season were approximately flat year-over-year, marking the second consecutive year of stability in this metric, following prior declines and coincident with some increases in list prices. As a reminder, monetized units include software units for which we are paid for either or both of the software or ancillary service, as well as partnership units. Overall units, which includes free or unpaid units, declined year-over-year as expected.

So, let's get in to a bit of the detail. As you'll recall the season got off to a very slow start with the government shutdown and customer uncertainty around tax reform, and early results from the IRS showed total filings down 12% and DDIY down 9% as of February 1st. The DDIY market saw a nice recovery from there and ultimately ended the season up about 4.2% in unit volume.

This season we continued to focus on monetized units. As we would expect when aiming for higher value customers and de-emphasizing ‘free,’ our total DDIY e-files declined year-over-year while our average revenue per user increased. Through April 16 our total U.S. consumer E-files were 3.1 million representing total market share of about 5.5%, a reduction of 160 basis points from last season, again due to a drop-off in unpaid filers, while maintaining stable monetized filers and increasing list pricing by more than 10%.

Big picture, and those of you who have been dialing in for a few years know this because we’ve been consistent, we have been on a multi-year journey to close the gap in our discount to the volumetric leader, in order to create a more normalized discount while improving unit economics. While there is room for further price increases we have clearly made substantial progress on unit economics. In online consumer, our segment income per filer is roughly double the amount that it was in 2016, and thus we now feature a much healthier economic profile.

We have also stepped up our efforts on making the tax filing experience easier and more rewarding for our customers. To enhance the customer experience, we introduced an upgraded mobile experience as well as innovations like **Ten minute taxes** – a streamlined process to guide certain filers with simple returns to complete their returns in just ten minutes or less. Innovations like this are designed to enable our customers to do more in less time so they can get back to the things that matter most to them.

We also introduced refund marketplace which rewarded filers with a bonus amount on a gift card, when they allocated a portion of their refund to gift cards from an assortment of national retailers. This bonus made the tax filing process ‘better than free’ for many filers, with about 40% of all filers who took advantage of the marketplace walking away from TaxAct filing experience with more bonus money than they paid us to file. In total, TaxAct customers placed more than $6.5 million in refund dollars on nearly 40,000 cards, and earned hundreds of thousands of dollars in bonus money. This year the bonuses ranged up to $599, which is a nice bonus, just for choosing TaxAct.

In addition to the enhanced customer experience, we had some new and expanded partnerships this season. Partner volumes increased significantly year-over-year, albeit from a small base, driven by distribution partnerships. Our proprietary BluPrint analysis, which analyzes a tax return and uncovers real savings opportunities for our customers, was also back this year, although with a late start, and is helping customers and connecting them with other partner products where appropriate. Consistent with our mission to provide the most value to customers across their financial lives, many of these products are offered with monetary or other bonuses or at discounted rates. For example, these products could include a 50-basis point discount on loans or no interest for 15 months on credit cards. We look forward to continuing to engage with the now roughly 4 million cumulative customers that have indicated through BluPrint that they are interested in TaxAct helping them with their financial lives, even outside of tax season. We hope to build on this over time and shift how and when our TaxAct customers work with us.

We believe we’re the only online tax software company that offers this level of insight and guidance into the financial health of our customers and provides comprehensive solutions which can save our customers real money now and for years to come. This is phenomenal value creation opportunity for our customers.

TaxAct Pro, our product for professional tax preparers, had a successful season and outperformed the market. In a market that saw the overall IRS assisted market decline by about 0.7%, TaxAct pro grew e-files by 4 percent year over year, and increased market share.

So overall on tax preparation, we delivered very strong financial results and continued to make incremental progress on repositioning the business for the future. As you know, Curtis Campbell joined us late last year to lead our TaxAct business. While he joined late in the year and largely inherited a strategy for the season, he has made an enormous impact. Not only on our results this season, but also in making significant improvements in our capabilities across all aspects of the business, including leadership, marketing, product management and engineering. He has brought in great new talent in to the organization, has already spent an incredible amount of time with customers, and is establishing a clear vision and roadmap to significantly strengthen our strategic and competitive positioning in this business, with an eye toward organic growth on the strength of our now-attractive unit economics.

We are looking forward to our first tax season next year with Curtis at the helm for the full cycle. As we look ahead, there are some changes we would expect to see as a result of Curtis' leadership, as well as the fruits of the progress we have been able to make over the past few seasons. This is because we have never been more clear on the steps necessary to restore this business to strong organic growth, with a reduced dependence on list price increases. We will really lean in to the customer and their experience as we aim to unlock what is most valuable to them. We will accelerate our investment in technology, in particular the timing of our code refactoring work to complete over the next two years. We will continue to evolve our BluPrint solution to leverage the tremendous potential to uncover opportunities for customers. We will aim to continue to build on our partnership strategy. One other change you may see is an increasing return back to the 'free' market. Over the past few seasons we have pivoted our focus away from 'free.' Our goal was to pick the most attractive segments of the market, where we could be the most effective and drive the highest lifetime value customers, and for us, that started with monetized units and a focus on those customers willing to pay us in year one.

While we have been committed to creating attractive economics on the monetized side, and as noted we've made dramatic progress in this regard, this has naturally come at a cost to overall units, as well as monetized units, as it is hard to grow units at the same time as raising prices. Now that we have built a healthier business with better lifetime value and attractive economics on monetized units, we believe we can now afford to open back up to 'free.' Three years ago it would not have made sense, but our improved economic footing points us to look to grow quality monetized units as well as quality 'free' units. Overall, we're already very excited about our plans for next year. While we are just a short time out of this past tax season and there is a long way to go to next year, I wouldn't be surprised if the year-over-year change and improvement next year is the most significant in our history. More to come on that.

Wealth Management

Turning now to wealth management. HD Vest results were generally in-line or better than our target ranges. Revenue was about at the midpoint of our target range and down about 3% year-over-year to $89.5 million, driven by a reduction in trailer revenue resulting from the industry's mutual fund share class conversion from C shares to A shares, the reduction in transactional activity that we discussed last quarter resulting from the clearing conversion, and higher advisor payout, partially offset by higher sweep revenue. Segment income was above the high-end of our target range and down about 12% year-over-year to $11.5 million. The decline y/y was primarily driven by higher advisor payout and incremental expenses associated with the clearing conversion. The outperformance relative to expectations was driven by better expense control as well as certain anticipated clearing related costs being reimbursed or credited.

Fee-based Advisory Assets were up 10% year-over-year to $14 billion, setting a new record level for the company and crossing the 30% of total assets threshold for the first time. Total Client Assets increased 4% year-over-year to $46.2 billion. Net inflows into Advisory Assets in Q1 was about $270 million. Net inflows into total client assets was about $100 million.

A few updates I'll call out here for HD Vest:

- As it relates to the clearing conversion, our service level metrics are back in-line with our pre-conversion norms.
- While transactional volumes for the quarter remained soft as expected, as advisors continued to ramp to speed with the new technology implemented during the conversion, as well as worked through the complexity of the tax law changes with their tax clients, now that tax-season is behind us, we are seeing a significant rebound in

transaction activity and continue to expect to be back to a normalized range by the end of the second quarter. This is important since we tend to have lower average payout ratios on transactions due to advisor mix.

- Recruiting continues to be strong with about 40 new advisors joining in Q1, including new tax pro advisors as well as established advisor transfers. The largest transfer in Q1 was an advisor with about $180 million in assets, transferring from one of the top wire houses. About $10 million from that advisor transferred in Q1, and we expect the remainder will continue to transfer over the coming months.
- We also added 4 more high-value accounting firms in the quarter with approximately $13 million in cumulative accounting revenue and representing an estimated $1.3 billion prospecting opportunity in total client assets.
- And in Tax Smart Innovation, we have told you about the tax-smart investing software platform to help advisors systematically capture tax-alpha for clients that we have had in beta testing. The product has continued to evolve and improve and has exceeded my expectations of where we'd be at this point. I'm excited to say that it will launch officially next month, and be available to all HD Vest advisors. Investors unnecessarily give up 1-2 percentage points of performance each year to taxes, and this product identifies the top opportunities in an advisor's client base every day, and helps capture that opportunity. This is a big deal for investors: over say a 30-year period, it could mean as much as $800,000 in incremental assets at retirement for an average investor. We'll continue to provide updates here after we launch and work to drive broad advisor adoption. This is also a big deal for Blucora as we continue to unlock the differentiated value of the combination of tax and wealth management through proprietary technologies.

The other big news in our wealth management segment is that our acquisition of 1st Global has closed as of May 6th. To briefly summarize the four key points from the conference call we held in mid-March: First, 1st Global adds significant scale to our wealth management business which drives substantial revenue and cost synergies. A meaningful amount of the revenue synergies is external and contracted and the bulk of the remainder are fully under our control. Second, it is complementary and enhances our business with a strong position in large accounting firms, a large proportion of advisory assets and strong capabilities in key areas such onboarding, advisor development and in-house portfolio management. Third, we expect the transaction will be financially accretive to EPS and other key performance metrics, such as advisor productivity and return on client assets. And finally, it expands our established tax-optimized investing footprint by creating by far the largest and most capable tax-focused wealth manager, positioned to provide better service and capabilities to our advisors, and ultimately better outcomes for their clients. And, assets managed under an RIA framework now total approximately $24 billion. It's been terrific to meet with dozens of 1st Global advisors in the past few weeks and I'm excited they are now part of the Blucora family. All of the 1st Global advisors we've met with share in our fundamental belief that true wealth management must consider all aspects of a client's financial life and tax is a crucial piece of that. The days of the advisor disclosure that tells the client to "consult your tax advisor" are gone and a new age of wealth management which capitalizes on the combination of tax professionals, financial advisors and value creating technologies is here.

So, in closing, I'm very pleased with our strong consolidated first quarter results with double-digit revenue, Adjusted EBITDA and earnings growth, and significant cash flow. TaxAct posted great financial results led by a significantly strengthened team. Wealth management is showing growth in each of the three key drivers of value creation: organic growth, conversion to fee-based AUM and increased income from sweep. And continuing to position the business for continued future success with our attractive consolidating acquisition, which extends our lead in our market segment, and key innovations like our tax-smart investing platform.

Simply put, we continue to make great progress and best position the company for the future.

One final thought before I turn it over to Davinder. As many of you may have read in our recently filed proxy, one of our board members, Lance Dunn, has indicated his intent to retire from the Board after the upcoming annual meeting. Lance has made many significant contributions to Blucora over the years, not only as a member of our Board since 2012, but also as the co-founder and former CEO of TaxAct. I'd like to sincerely thank Lance for those contributions as well as his great support and guidance to me personally.

With that let me turn it over to Davinder.

DAVINDER ATHWAL, CHIEF FINANCIAL OFFICER

Thanks John –

As a follow-up to John's comments I'd like to provide some additional detail on first quarter performance, a balance sheet update and an outlook for each of the second quarter and full fiscal-year. Beginning with consolidated results for the first quarter, and year-on-year growth:

- Revenue was $225.8 million, or up 10%;
- Adjusted EBITDA was $83.7 million, up 26%;
- Non-GAAP net income was $77.2 million, or $1.56 per diluted share, representing an improvement of 33% and 30% respectively;
- GAAP net income was $62.2 million, or $1.25 per diluted share, representing an improvement of 37% and 34% respectively; and
- Lastly, operating free cash flow for the quarter was $69.0 million, up 22%.

Turning now to segment performance, and beginning with **Tax Preparation.** TaxAct first quarter revenue was $136.2 million which was in-line with our upwardly revised guidance range with segment income of $79.3 million, which was above the high-end of the target range, driven largely by a shift of marketing dollars between quarters. As John mentioned, we expect first half revenue growth to be approximately 13% vs last year. These results are driven by an approximate 37% increase in DDIY consumer average revenue per user. Segment margin for first half is expected to come in at 58%, which is at the high-end of our upwardly revised range.

Moving on to **Wealth Management:**

HD Vest first quarter revenue was $89.5 million at about the midpoint of our target range and segment income was $11.5 million, above the high-end of our guidance range, driven by lower than expected impact from post-clearing conversion items as well as better expense control.

As previewed last quarter, we did have some unusual items in the first quarter, including:

- Approximately $1 million in advisor bonus recognizing top advisors based on production and advisory assets. This will decline to about $700 thousand in Q2, $400 thousand in Q3 and go away thereafter.
- An increase of $300 thousand in legal reserves, that we do not expect to see again in Q2.
- A charge of $400 thousand for short-term contract support costs, however those costs were ultimately reimbursed or credited, so there was no net impact in the quarter.

We are pleased with total client asset net flows of about $100 million and our advisory net flows of $270 million.

Finishing up on **first quarter performance:**

Unallocated corporate expenses came in at $7.1 million, in-line with our expected range. Moving on to the balance sheet, we ended the quarter with cash and cash equivalents of $149.8 million and our net debt was $115.2 million, which reflects continued strong cash-flow. Our net leverage ratio ending the quarter was 0.8x, down from 2.1x a year ago. Also, in Q1 we implemented the new accounting standard for how we account for leases. While the new standard "grosses up" our balance sheet, it has no impact on how we report Segment Income, Adjusted EBITDA, or Free Cash Flow.

As John mentioned, subsequent to the end of the quarter we closed the acquisition of 1st Global, which we're very excited about. We believe it is a great opportunity for us to accelerate our growth and profitability with significant revenue and cost synergies; and it is expected to be accretive to both EPS and free cash flow, enhancing shareholder value. Since the acquisition closed on May 6, we'll include 1st Global's results from that date forward. A few metrics I'll share here:

As of the end of the first quarter, 1st Global had total client assets of $20.2 billion, of which $9.8 billion were advisory assets, and an advisor count of about 820. Combined with HD Vest Q1 ending metrics, that would result in a Q1-ending total client assets of $66 billion of which nearly $24 billion are in advisory assets, and advisor count of roughly 4,400.

As it relates to the transaction closing, on May 6 we paid $55 million in cash and borrowed $125 million as an add-on to out Term Loan B due 2024, at the existing interest rate of LIBOR plus 300 basis points. This brings our current debt level to about $390 million.

Priorities for our cash flow in 2019 will continue to be pay-down of our debt, investing in the growth of the business and supporting our growth initiatives. As we announced in March, we now have a $100 million share repurchase authorization that provides additional flexibility and an alternative for cash redeployment through opportunistic buybacks. Also, as a reminder, the non-controlling interest in HD Vest became redeemable last quarter and we will see an associated cash outlay of approximately $25 million in the second quarter, with no P&L impact. All told, we expect to end the second quarter at approximately 2.0x net leverage based on pro forma trailing twelve month EBITDA.

Second Quarter Outlook

Turning next to our outlook for the second quarter, for TaxAct, we have already provided our outlook for the first half of 2019. That outlook translates into a second quarter outlook for TaxAct of expected revenue between $67.5 to $68.0 million and segment income of $39.0 to $40.0 million.

Our outlook for Wealth Management in the second quarter, excluding 1st Global, we expect revenue of $95.5 to $98.5 million and segment income of $13.0 to $14.5 million. We expect 1st Global, for the partial quarter, to add $25.5 to $27.0 million in revenue and $1 to $1.5 million in segment income.

On a consolidated basis for the second quarter, excluding 1st Global, we expect total Blucora revenue of $163.0 to $166.5 million, Adjusted EBITDA of $44.0 to $47.0 million, non-GAAP net income of $35.5 to $38.5 million, or $0.71 to $0.77 per diluted share, and GAAP net income attributable to Blucora of $23.0 to $26.0 million, or $0.46 to $0.52 per diluted share. This assumes corporate unallocated expense of $7.5 to $8.0 million and excludes acquisition and integration costs.

Full-Year Outlook

For the full-year, we expect TaxAct revenue growth of 12.7 to 13.7 percent and segment margin of 43.6 to 44.6 percent. This margin rate reflects the accelerated technology investment John referenced, and is of course a sign of the confidence we have in the potential of this business.

For wealth management, excluding 1st Global, we expect revenue to grow approximately 3 to 6 percent with a segment margin of 14.7 to 15.8 percent. We expect 1st Global from the period of May 6 through year end to add between $108.5-$115.5 million in revenue and between $9-$11 million in segment income.

On a consolidated basis for the full year, excluding 1st Global, we expect revenue of $595.5 to $608.5 million, Adjusted EBITDA of $119.0 to $129.0 million, non-GAAP net income of $91.0 to $101.5 million, or $1.80 to $2.01 per diluted share, and GAAP net income attributable to Blucora of $41.0 to $51.5 million, or $0.81 to $1.02 per diluted share, with $28.5-$29.5 million in corporate unallocated expense.

Our outlook includes the following assumptions:

- A broad range for transactional revenue due to its variability;
- An effective tax rate of 6 to 8% for GAAP net income attributable to Blucora; and,
- Our guidance for GAAP net income or loss attributable to Blucora excludes any impact to tax expense for discrete items and variable stock-based compensation granted to non-employee advisors.

The outlook also excludes integration costs related to the 1st Global acquisition. We continue to anticipate total integration costs of approximately $28 million and estimate that roughly $10 million would fall in 2019, with the remaining $18 million coming in 2020. That said, the specific timing between periods may shift somewhat based on timing of conversion as well as our ability to accelerate certain items. These integration costs will be reflected in our reported GAAP results and be added back for non-GAAP figures.

Finally, we continue to expect the acquisition to generate $23mm - $24mm of run-rate EBITDA accretion by the end of 2019.

With that, I will turn the call over to the operator and we will take your questions.