Blucora, Inc.

Q1 2022 Earnings Conference Call

Dee Littrell, INVESTOR RELATIONS

Thank you and welcome, everyone, to Blucora's first quarter 2022 Earnings Conference Call. Earlier this morning, we posted the earnings release and supplemental information on the investor relations section of our website at Blucora.com. I'm 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 based on the environment as we currently see it 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 Blucora.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

Opening

Good morning, I'm pleased to share our first quarter 2022 results with you today.

During Investor Day in June of last year we shared a number of goals, that when achieved, would signal the positive execution of our strategy. I am happy to report that we have effectively executed on the most critical of these metrics and we feel better positioned than ever to deliver sustainable, profitable growth.

In tax software, we continued to accelerate our top-line growth momentum with an expectation of delivering double digit growth for TY 2021, which is ahead of our growth from the previous tax season. This growth is built on having delivered market share gains, ahead of schedule, increasing ARPU associated with well received customer bundles, and continued growth in conversion and retention rates. We also continue to maintain our value positioning and continue to enhance our marketing and partnerships efforts that will serve as the primary drivers of new customer acquisition in the future.

Relative to our expectations for Q1 and the year, external market dynamics have muted, this quarter, the long-term benefit of these important efforts. Our planning assumption for TY 2021 guidance was for DIY market growth of 3.5%, a reversion to historical growth levels and well below the 10% and 6% we saw in TY19 and TY20, respectively. Based on figures reported by the IRS upon the close of the season, the DIY market YTD declined by 3.7% when compared to the corresponding date from the prior year, a 7.2 point difference versus our 3.5% expectations. You will see this impact in our financial results this year, creating a revenue gap versus our earlier outlook that all flows through to the bottom line.

On the wealth side of Blucora, we succeeded in returning to net positive flows for Q1 and added more than $1 billion of net new advisory assets, a quarterly record in the history of our business. Our production retention rate approached 100%, on a nearly flat financial professional count. In addition to our growth from existing financial professionals, we continued to recruit record numbers of assets from new financial professionals into Avantax. More than $500 million in new assets transitioned to Avantax in the first quarter, which represents 56% of what we did in our record year of 2021. Our team is consistently delivering more value to our financial professionals and clients which is enabling this growth.

Similar to our tax business, Avantax's financial results were also impacted by market forces in Q1. Volatile, declining equity markets during the period temporarily offset the benefits of strong execution and, as you would expect, negatively impacted our financial results versus prior expectations. These headwinds, however, pale in comparison to the long-term benefits of the strong organic progress we are making, which, coupled with a favorable interest rate outlook, has the potential to double the run-rate profits for our wealth management business by the end of this year, in essence exiting 2022 with a run rate of $150M in segment income depending on market levels.

While we did not achieve the growth that we anticipated in our original Q1 outlook and have adjusted our full-year tax outlook because of the unexpected market headwinds I just described, I would note that, excluding the impact of those external factors, our Q1 results and updated 2022 guidance falls within the original outlooks we provided.

In summary, our strategy is working and we are performing well against it, including meeting or exceeding most of our critical underlying operating metrics across the businesses, which gives us confidence that we are progressing more rapidly than planned in executing our sustainable growth strategy.

Let's dive into our business performance, beginning with tax software.

Tax Software

Central to our plan to drive TaxAct to profitable, sustainable long-term growth, we committed to improve new customer acquisition, retention, unit growth, market share and ARPU. While the Q1 financial results and full year guidance we are providing now reflect an unexpected – and we believe temporary decline in the DIY tax market – we are pleased that we made meaningful improvements in all primary areas of focus.

- **First, customer acquisition**
    - We increased, for the season, the number of new customers added YoY by 19%. This was particularly strong given the decrease in total filers and associated substantial decline in new customers in the market this year.
    - Our customer acquisition approach really began even before the season started, with our award-winning advertising and bowl game sponsorships.
    - We used effective data and analytics to better target and personalize our customer outreach efforts, driving valuable customer engagement.
    - We partnered with several leading brands including Fidelity, American Express, Capital One and NerdWallet to grow customer acquisition driven by partnerships.
- **Second, customer retention**
    - Our paid federal retention rate for the season increased by 335 basis points driven by significant jumps in our year 2 and year 3 filers, with both groups exceeding plan. This increases the long-term value of new customers acquired. We were particularly pleased with what we saw in our year 2 filers, where returning users surpassed our plan expectations considerably.
    - This was driven by our continued improvements in our customer experience highlighted by Business Insider, which chose TaxAct as the Best Overall Tax Software this year.
    - We added important data partnerships, including W2 partners like TriNet and 1099 data partners like Charles Schwab that improved the experience for significant segments of our customers.
    - We offered compelling bundles that were well received by customers. One example of this is our All-Inclusive Bundle that includes – Federal and State preparation, Refund Transfer, E-File Concierge and Audit Defense.
    - We also delivered industry-leading customer care and tax expert guidance, at no cost to the vast majority of customers throughout the year, who were looking for the convenience and confidence of access to our agents and our tax Xperts. Both were important contributors to our conversion and retention success this season, with users of Xpert Assist converting at over 10pts higher than those that didn't use the offering. As it relates to customer care, we answered over 90% of the calls, far above our historical average, which led to higher conversion and higher customer satisfaction.

These efforts delivered significant gains, including:

- **Unit growth**
    - We increased units by 1% this season, when comparing to the corresponding end of season date for TY 20, driven by our acquisition and retention success.
    - We have seen an increase in filing extensions – both in the DIY and professional spaces – which we expect will provide a bit more revenue than usual for the business for the remainder of the year.
- **Increased market share**. I'm pleased to report that we successfully delivered on the commitment we made at Investor Day to **increase our consumer market share.** While navigating notable softness in the market overall, we increased our share by 19bp. We now have just under 5% of the tax software market, as of end of season.
- **Increased ARPU**. We grew ARPU 11% to just above $50, as we drove strategic mix shifts including significant interest in high value bundles that we tested last year and offered throughout the season this year. We continue to maintain our value Federal pricing as we drive ARPU gains through driving a greater adoption of ancillary offerings.

On the Tax Professional side of our business, we continued our trajectory of growing share with an increase of 13bp to 3.18% of the pro market. As a result, our expectations are to grow the professional business by more than 15% this year, relative to 4% last year.

Our SMB offering, which we believe will serve as a meaningful source of growth in the future, is expected to grow its revenue by more than 20%, to over $11M for the year which is embedded in our reported consumer figures.

Nevertheless, the dip in the DIY market was obviously a surprise for us, as it was for many of our peers and most of our partners. With the benefit of hindsight and initial data, we believe the key drivers were a reduction in the number of one-time filers, specifically those consumers receiving government funds (stimulus and unemployment), and a decrease in labor participation versus tax years 2019 and 2020. We view this as a temporary shift in what is likely to be a long-term continuation of DIY market growth.

While of course the market decline caused us to update our outlook, I'm pleased that we still expect to deliver both 9 to 11% revenue and segment income growth for the business thanks to the fundamental improvements we are achieving.

I am extremely proud of what our team has achieved in yet another unique tax season. We have a compelling value proposition, made significant progress in all areas of our business and are well positioned to continue the positive trajectory in future years with tailwinds from a rebound to more traditional market growth rates. Marc will share additional details in a few minutes.

Now, moving on to our wealth management business.

Wealth Management

In our wealth management segment, we committed to driving positive net asset flows and growing advisory assets by continuing to improve the overall financial professional experience and recruiting new financial professionals and firms. I'm happy to share that we successfully made progress in each of these areas in the first quarter, and in certain cases significantly exceeded our plan.

- We continued to improve the **financial professional experience** by investing in an improved account opening experience, end client portal, and an elevated service experience through our service consultant program. These efforts, along with others, have led to better FP retention and performance.
    - We have started to meaningfully stem the attrition of financial professionals, and we beat our net financial professional target for the quarter.
    - There was zero attrition from financial professionals with over $500 thousand in gross revenue for the trailing twelve months, and March was our lowest month of attrition in years.
    - We had a production retention rate of 99.6%, which is incredibly strong relative to our historic figures
- We also had exceptional **recruiting efforts**:
    - We brought 85 new financial professionals into Avantax during the quarter.
    - We set a company record in recruited assets for the quarter, exceeding $500 million.

As a result of these actions,

- We saw **great asset flows** in Q1 with progress that was ahead of our forecast:
    - We achieved positive net asset flows of more than $245 million, which is our best quarter since Q2 2019.
    - Our flows into advisory were over $1 billion, illustrating the continued positive mix-shift toward fee-based assets.
- Our employee-based RIA also continues to grow both organically and inorganically as we provide solutions for independent financial professionals to affiliate with us in our employee-based model and have a turn-key succession planning solution for themselves and their firms.
    - During Q1, we completed two acquisitions totaling more than $100 million in assets coming from our independent channel.
    - Currently, we have over $6 billion of assets in our acquisition pipeline
    - Our hybrid strategy allows not only for independent financial professionals to have multiple affiliation models and a certain and turnkey succession solution in house, but also will provide the ability to expand our margins and ROA within the business considerably over time.

I am thrilled with the continued progress from our team, despite the short-term impact to this quarter's financial results from a weaker and more volatile equity market, as Marc will get into in a moment.

I'm confident that the outlook for our wealth business is very bright, driven by the continued improvement in our operating performance and anticipated Fed rate hikes that would provide a meaningful boost to the business's profitability. If the Fed moves in line with the forward curve, we would generate an incremental $20 to $35 million in revenue this year, relative to 2021, the majority of which will flow to the bottom line. On an annualized basis, conservatively assuming 225 to 250bp Fed Funds Rate, cash sweep revenue would be between $73 and $82 million annually contributing to a segment operating income run rate of $150M, as I just mentioned.

Now, for the company overall.

Blucora

I continue to be encouraged by the Company's performance and progress, especially in the face of short-term, market-driven headwinds. Our fundamental operating metrics – and performance in each business are strong and continue to improve, regardless of the market headwinds. Looking ahead, I am even more optimistic about the continued execution of our sustainable growth strategy, especially coupled with multiple tailwinds, which should translate to compelling financial outcomes and returns for investors in the remainder of this year and in future years.

With that, I'll turn it over to Marc.

Marc Mehlman

Thank you, Chris, and good morning, everyone.

It's great to be with you all again. I'd like to provide some additional detail on our first quarter results as well as our outlook for the year ahead.

Starting with first quarter results, as Chris mentioned, this is an exciting time for the business. As you have hopefully observed, the team at Blucora is singularly focused and committed to driving long-term value for our shareholders. Not surprisingly, over time, markets will create headwinds that are outside of our control. However, that does not take away from our strategic focus on the long-term and on delivering sustainable growth. We intend to continue to invest in those areas that have proven to generate strong returns, including product, customer support, brand awareness and enhanced partnership capabilities.

As I laid out last quarter, our plan to create sustainable growth platforms, while shifting our business toward higher valuation models, is on track and, in our view, accelerating.

Beginning with first quarter financial results:

1. Total revenue was $307.6 million, an increase of 10% versus the first quarter of the prior year
2. GAAP net income was $34.6 million, or $0.70 per diluted share, versus $27.6 million, or $0.56 per diluted share, a year ago.
3. Adjusted EBITDA was $67.2 million versus a $64.6 million in the first quarter of 2021.
4. Non-GAAP net income was $52.6 million, or a $1.06 per diluted share.

Tax Software

Turning now to the Tax Software segment.

Tax Software segment revenue for the first quarter was $141.2 million, which represents 14% growth year-over-year. Segment operating income was $58 million, relative to $50.9 million in the first quarter of 2021. Marketing spend was greater than expected as we saw performance marketing opportunities to acquire customers at attractive cost per new start relative to in-season revenue expectations. In a declining market, with fewer new customers than in seasons past, the competitiveness for these customers was higher, and yet, we found opportunities to acquire customers at rates that would yield near break-even profitability in year 1. Further, we saw an opportunity to continue expanding our brand awareness, which we believe will deliver positive benefits in seasons to come.

Further, the first decline in the DIY market, which we believe to be a temporary adjustment from unnatural growth over the previous two-seasons, had a significant impact on our results relative to our earlier outlook, as a 7.2 point swing in the plan assumption (3.7% down versus 3.5% up), impacts top and bottom-line by $12 to $15 million for the year depending upon the impact of extension filings. Adjusting for this market driven impact, our growth would have been on track with the full-year revenue growth guidance we previously provided.

Wealth Management

Moving to the Wealth Management segment. We continued our strong momentum during the first quarter. Wealth Management segment revenue was $166.4 million, up 8% year-over-year. Transaction-based commission revenues were $20.6 million, a decrease of 15% sequentially, which is not uncommon during times of market volatility. Year-over-year transaction-based commission revenues decreased 8% for the first quarter.

Wealth Management segment operating income for the first quarter was $16.4 million, driven by unfavorable revenue performance as well as the impact of headcount investments made in the second half of 2021 in technology, growth consultants and support to enhance the experience of our financial professionals and their customers. We believe these long-term investments were critical to our delivery of net positive flows this quarter, strong advisory asset expansion and the new store sales we continue to generate.

The incremental headcount investments in the first quarter of this year were meaningfully lower than what we saw in 2021 as we are comfortable with the current positioning of the business, but we will have full year impacts in 2022 of the 2021 hires that are not offset by top-line performance, as a result of adverse market conditions. However, we expect these costs to be more than offset by the benefit of an expanding interest rate environment, as I will address momentarily.

Our pay-out rate increased slightly versus Q4, coming in at 75.4% versus 75.0% in the 4th quarter of 2021. This was driven by three factors: (1) greater retention and recruitment of higher producing financial professionals, (2) the timing of setting payout rates for independent financial professionals which occurred this period when equity markets were higher than the March quarter end and (3) intra-quarter volatility of the market that effects our employee-based RIA payout rate.

I will address full year outlook momentarily, but these impacts to payout rate will not impact our ability to deliver significant growth year-over-year in profitability despite difficult market conditions.

We ended the quarter with total client assets of $86.1 billion. Fee-based advisory assets were up 11% year-over-year to $40.9 billion, with advisory assets as a percentage of total client assets ending the quarter at a new high of 47.5%, 410 basis points higher than the end of Q1 2021.

We saw net inflows in advisory assets during the first quarter of $1.2 billion, a new record. Total client assets had net inflows of $245 million.

Corporate

At the Corporate level, unallocated corporate expenses during the quarter came in at $7.3 million.

Liquidity

Turning to the balance sheet, we ended the quarter with cash and cash equivalents of $144.2 million, and net debt of $416.7 million. Our Net Leverage Ratio at the end of the quarter was 3.0x. For the first quarter, we generated $47.3 million in cash from operating activities, and spent $30.5 on share repurchases. Through March 31st, as part of our share repurchase authorization, we purchased back 1.6M shares and an additional approximately 0.2M subsequent to the end of the quarter for a total outlay of $35M.

Our key priorities for cash remain investing in our business to fuel growth, both organically and via acquisitions of our independent financial professionals, and lastly returning cash to shareholders.

2022 Outlook

With that, let's turn to our 2022 outlook:

As most of the regulars on these calls know, Blucora has historically introduced full-year guidance on the first quarter call, in addition to short-term quarterly guidance each quarter.

Given increasing volatility in equity markets and ongoing changes over the past few years in how the tax season unfolds – both of which contribute volatility to our short-term results – we have decided this year to begin the transition to providing only annual guidance, with quarterly updates on our progress toward these figures. We believe this approach is more consistent with our strategic focus on building sustainable growth with continued profitability gains. As appropriate and where we have near-term visibility, we'll also provide color on quarterly seasonality.

As detailed in this morning's earnings release, in our tax software business, we expect revenue between $247.5 million and $251 million and segment operating income of $89 million to $91 million for full-year 2022. With the surprising Tax Year 21 season, and the marketing costs associated with targeting a smaller set of new potential customers, along with investments we have and plan to make that will enable us to continue accelerating revenue growth, our profit growth is likely to be in-line with our revenue growth this year versus a typical year where we see more attractive flow-through. These are purposeful decisions to drive top-line performance over a longer period of time, which we believe will drive more profitability than short-term decisions weighted toward single season dynamics.

For our wealth management business, we expect full-year revenue of $690 million to $720 million and segment operating income of $85 million to $100 million. Embedded within this guidance are assumptions on both market performance as well as fed funds rate expectations. The low-end of the range assumes the S&P500 maintains its current value as of Friday April 29th, at 4,132 and that the Fed hikes rates 25bp at each meeting for the balance of the year. The higher end of our guidance assumes 1% positive movement in the S&P500 per quarter from end of Q1 levels as well as the current forward curve of achieving 225bp interest rate by end of year which would equate to about $20M to $35M of revenue this year from cash sweep, depending upon when 50bp rate hikes occur.

Assuming that rates end the year at 225bp to 250bp, with no additional hikes in 2023, our cash sweep revenue would result in between $73M and $82M for 2023 alone, likely resulting, as Chris mentioned, in $150M or more in segment income for the wealth business, depending upon where market levels reside.

On a consolidated basis, we expect full-year revenue between $937.5 million and $971 million, adjusted EBITDA between $143.5 million and $162.0 million, GAAP net income of $22.5 million to $43.5 million or $0.46 to $0.89 per diluted share and non-GAAP income attributable to Blucora of $81.0 million to $100.0 million or $1.65 to $2.04 per diluted share. This outlook includes unallocated corporate operating expense of $30.5 million - $29.0 million.

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

Chris Walters

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