

INTELLIGENT SYSTEMS CORPORATION

Moderator: Strange, Leland

March 13, 2019

11:00 AM ET

OPERATOR: This is Conference # 8573248

Operator: Good morning. My name is Andrew, and I will be your conference operator today. At this time, I would like to welcome everyone to the 2018 Fiscal Year Earnings Release and Investor's Conference Call. All lines have been placed on mute to prevent any background noise. After the speaker's remarks, there will be a question-and-answer session. If you would like to ask a question during this time simply press star then the number one on your telephone keypad. If you would like to withdraw your question press the pound key, thank you.

Leland Strange, Chairman and CEO of Intelligent Systems Corporation, you may begin your conference.

Leland Strange: Good morning, everyone. Thanks for joining us today for our fourth quarter earnings call. I suspect or guess we'll have more people than normal, given the stock buying in the last few days. For those of you, who are on the call for the first time, be prepared for this to be a little different than what you may be used to.

I'm going to start today by just noting the usual protection provided to company and company executives with forward-looking statements within the meaning of the federal security laws. Simply put, everything I or the team says that's not a historical fact should be treated and read as

speculation. As speculating on what we think or believe as of this moment, we obviously believe it. We believe as have a good basis for what we think, but it may be proven incorrect in the future if it's not actually a historical fact.

We may expect, project, believe, plan, intend or use any number of other similar words in this call. So to be clear, everything and all I say that's not an actual historic or current fact should be deemed as forward-looking statement. And if we learn other facts later that could lead to different opinions and conclusions we may only and probably will not make further comments until required in filings. So with that behind us, I'm going to assume that you've read the press release or even perhaps the 10-K that we filed earlier this morning. With that underlying assumption, I'll only repeat a little of the information contained because you can read that for yourself. That may be a little unusual for those of you who listen to other conference call.

It's probably also unusual in that I may just follow some bullet points and generally be talking unscripted. I'm not sure that's really a word. Let's just say I tend to go off-script anyways, so call it unscripted or non-scripted. With me in the conference room and on the call is Matt White, the CFO of Intelligent Systems. I may call on him to assist or to help answer any of your questions after I conclude my remarks.

I could start my comments with the financial facts in the press release, but I would be ignoring the recent run up in our stock and rumors that are currently on the Street. So, let's hit those first. Understand that in almost all of our agreements and contracts we have NDA, nondisclosure agreements that prohibit us from disclosing the fact that we have an agreement without prior permission. Why do we agree to that? Well really, why not. We work and supply services to our customer, and our customer should be able to disclose whatever they wish to their customers without CoreCard interference. In some cases, our customers find it advantageous to disclose fully or partially that CoreCard is their vendor. In other cases, it's a well-kept secret. And in many cases our customer may say to us, do not publicly or in writing disclose but it's okay to use our name in talking to prospective customers.

So, unlike some of our competitors, we don't put our press releases or announce new contracts other than where pretty much required in our

filings or shareholder communications. We don't tout new contracts in order to boost the stock price, we just run the business. With that background, where does that leave us when rumors that may or may not be true are publicly floated? Of course, the best position is just to say, no comment. Someone has asked, "Well, if it's not true, why not just say it's not true, and everyone would then have the truth?" Well, I can tell you that I fell in that trap many, many years ago.

In the early Wild West, personal computer days, a magazine printed that our company had inked a large contract with Hewlett-Packard. I responded it was not true, and it was not. A week later in a newsletter at a trade show they retracted and stated the rumor had it that it was not HP but it was Epson. I said again publicly and categorically, not true. Then lo and behold, the following months that came out in the magazine and said it was with IBM. Well, that happened to be true, and I was caught where I could not plausibly deny it after denying the earlier speculation. Clearly I should've said no comment from the beginning. I learned then it was best to avoid that trap. I think it's clear from our required filings and public statements that we have several, and I want to emphasize that word, several, new, what I believe, important customers. If we could disclose the names of three or four of them I think you'd be impressed that this little firm in Norcross, Georgia with zero sales or marketing had been chosen to provide important services for these billions of dollars valuation firms.

Some of these are generating considerable current revenue now, and some are teed up for good future revenues. Some are licensing customers, and some are processing customers. Both often have some front-end loaded expenses, expenses for them and revenue for us. So, I'm telling you today that I'm going to neither confirm nor deny the rumors, nor will I publicly identify any large firms that are customers of CoreCard without their permission. I'll put equal weight on the rumors being false as being true. If you invest in our stock you should be aware of our position in this regard, and no amount of prodding is likely to give you any comfort or discomfort if you're relying on publications that purport to know. You really should just rely on our performance and not the names of customers.

So now, on to performance. Actually, before I forget, let me comment and state that the company bought back no stock under its previously

announced buyback program. So, as of this date, we have bought back none. I believe when we decided to do the buyback the stock was in the \$10-\$11 range, and we felt with our cash that would make sense. Of course there was not much volume, and as the stock started moving up (which by the way proved that our judgment was good) we chose not to interfere with the normal stock transactions.

Moving on, let's start with some financial facts of the press release. Our fourth quarter delivered an operating profit of a little over \$2 million, and I tend to concentrate on the operating profit line as it generally is what can be managed. And for the full-year, the operating profits came in at about \$6 million. Taxes were small for the year, as we used up all of our NOL, so we will be paying taxes in 2019. Our revenue for the quarter was a little over \$6 million, and for the full-year revenue was a little over \$20 million. Let me mentioned pass-through revenue. We have to include pass-through revenue in our reported revenue, and a portion of the revenue, and I'm going to point this out because there's very little margin on this revenue. The pass-through was about \$500,000 for the year. An example of pass-through revenue would be paying to produce a plastic card for a customer. Did I get that number right?

Matt White: That's the 2017 number, Leland. For 2018, it's \$1.3 million.

Leland Strange: Okay, sorry about that. So Matt then corrected me. The number for pass-through in 2018 was...

Matt White: \$1.3 million.

Leland Strange: \$1.3 million. Thanks, Matt. So again, that's why it's important to understand that part of that revenue. An example of that revenue would be paying to produce a plastic card for a customer. Some customers have us do the card fulfillment, and some do their own. If a vendor charges \$1.5 for a plastic card, we might just tagged on \$0.05 or \$0.10 as a handling charge rather than actually make margin. So, when you look at our margins we also have to think about how much as pass-through to see what the real operating margins are.

In the last conference call, I took the time to try to explain our business and revenue streams. I'm not going to repeat all of that today. I would

suggest if you are a new shareholder, you might want to go to our Web site to listen to the last call if you want to hear more descriptive information.

I will repeat, however, that our revenue generally comes from five sources. There's license fees, and there's very little current cost, so these are very high margin. Remember, we spent money over many years to be in a position to get a license fee, so that's a sunk cost. The license fee, varies with volume, meaning number of accounts.

Second source would be maintenance and support for licensees. This is recurring and is based on the amount of the license fee.

Third stream would be processing services. Generally, you're paid per account per month.

And fourth is professional services that's not technically recurring, but is certainly repeating, and it's a big chunk of our business, and we like that. We have highly qualified technical people that are very valuable for use by our customers.

And then fifth is managed services - sometimes we monitor or actually run other customer's operations. So those are your sources of revenue.

I am often asked why do big firms with loads of technical talent come to this little company located in Norcross, Georgia with no sales people? I usually somewhat facetiously remark, it's because they were smart enough to find us which makes them a good candidate to be a customer of ours.

And seriously, we like smart and knowledgeable customers who are capable of doing a lot more than that just kicking the tires. Let's say they will get under the hood and investigate again carefully what CoreCard is. What do find about the platform and software? I am going to give you a good example.

There are a lot of things that make the CoreCard platform more powerful than anything else on market. I say this while we also do some very mundane things with that platform that are easy for others. An example would be vanilla variety prepaid or payroll cards. Competitors at this

space would be Marqeta, Galileo, i2C; they are all private, and the big guys, FIS, CardServ, First Data, and TSYS. So those are just kind of plain what we call vanilla programs. Now, of course, those guys do other things too, but I just used that as an example.

So let me give you an example of a hard problem solution set that I am not certain anyone else can do. So pay attention because it gets complicated.

A customer goes online to Bass Pro Shop to buy a \$3000 pontoon boat. When they are checking out, an app asks if they would like to pay over time. They are given a choice of 12 months, 24 months, or 3 years. And that's based on the size of the purchase and with instant scoring of credit. The customer can click on details and see 12 months is an 8%, 24 months is 10%, and 36 months is 12%. Different customers also may get different offers. They get different interest and/or duration linked to loan based on a scoring algorithm. And they can see what the monthly payment will be for each plan. So in this case, the customer chooses 36 months and 12%.

Now that's simple enough. Most installment loan platform can do all of this up to this point. But let's go on, 20 days later he goes online again to Bass Pro Shops and buys a new motor for his pontoon boat. Prices are \$1,000. And he is given similar options for paying over time. But, Bass Pro Shops and the motor manufacturer will subsidize the interest on this purchase and offer no interest. The customer then chooses between 6- and 12-month plans. And he accepts a 12-month plan at no interest. Of course, if he fails to make timely payments, interest or fees will be assessed later.

And then the customer goes online the next months and buys fishing gear for \$500. The offer is six months at 6% interest. He now has three loans.

Most loan platforms can handle three or any number of separate and distinct loans. But it is really very customer-friendly to send out three statements expecting to make three separate payments? Of course, not. And ultimately everything gravitates to the most customer-friendly solution.

CoreCard combines these loans into one statement. There are still three loan plans because each is different. That sounds simple enough. But if

we give customer one payment amount, there are regulations called Reg Z that require you to inform the customer what the APR, that's the annual percentage rate is in a combined form. Here we have interest rates of 12%, 0%, and 6% with durations of 36 months, 12 months, and 6 months.

CoreCard presents one statement that aggregates required payment amounts and computes the APR for the combined loans. And guess what? When he sends in his check, he sends in the wrong amount and sends the check 10 days late. Uh oh, computer, what do I do? To which do we apply his payments and which loan will be delinquent because he underpaid? CoreCard has rules and algorithms that spread the payment over the proper buckets to stay in compliance with Fed regulations and loan agreements. The software determines where to apply interest, fees, and principal, and in what amounts to each loan plan. Remember, one of these loans was interest free.

That's complicated enough, but on the 59th day -- he has 60 days by the way to make any returns, on the 59th day, he returns the motor to Bass Pro Shops. And the check he sent in on day 60, by the way, is for the wrong amount, it gets returned and insufficient funds three days later.

This is where the "rubber meets the road" so to speak as far as handling a complex transaction while staying in compliance. A payment reversal has to look at the plans again just like the payment did and re-establish the proper "bill not paid" amounts and also generate appropriate fees again staying in compliance with regulations. I guess to get really excited let's do a return followed by a payment reversal for the customer that has over one hundred loans on their account. We do all of this in real time.

And, yes, we process for a unicorn that has an account just like I described with over a hundred loans on the account. Oh, did I say we could also add a standard revolving account to the loan account that incorporates minimum payments? So CoreCard generates all the documents necessary for the loan that's loan agreement, welcome letter, temporary shopping pass **et cetera**. And we have integrated collection software that keeps up with the required collections. We collect and often waive certain penalties that re-ages the loans and reports to the credit bureaus. And then you might want to securitize one part of one loan and sell it off. Or, move the loan from one bank to another and reissue the loan agreement, or the CFO wants to look across all loans of a certain

type and project in the future how much interest or fees are coming in for each month the next year.

All right, there are many complexities. I can continue to add to this example. And I believe very few, if any, other loan platform can do all of these things. This is just a sampling of the power of the CoreCard platform and we are confident that over time, more and more potential customers will recognize the competitive value.

Do most of the CoreCard customers use all the power of the platform to issue complex loans? No. the answer is no. Smart managements want to do even simple things on platforms that have the capability to do the most complex things as their own business evolves. That's why many of our customers have chosen CoreCard, bulletproof the future as fintech opportunities evolve.

I think I will go ahead and conclude our call after that example with simply a brief comment on the first quarter and 2019 year. As I have said and reasoned in the past calls, we are not giving specific guidance for good reason. But I will say that this first quarter -- the first quarter in 2019 will be better than last year's first quarter. And 2019 should be a very good year in comparison to 2018 which was also a good year. We will have probably have quarters that may not compare well as a result of how we recognize different revenue streams. So measure us by full years. I believe I said in mid-2018 that the company should be able to grow top and operating profit lines by at least an average of 25% per year over a four to five year period. I am still pretty comfortable with that statement.

I think with all of that, we'll open here for questions. Operator, see if anybody has questions.

Operator: At this time, I'd like to remind everyone in order to ask a question press star then the number one on your telephone keypad. We will pause for just a moment to compile the queue in a roster.

Your first question comes from the line of Namuan Khan. Your line is open. Namuan Khan, your line is open.

Leland Strange: Questions?

Operator: Your next question is from the line of Marclo Lyma, Marclo, your line is open.

Marclo Lyma: Yes, good morning, Leland. This is Marcello Lima. Thank you for your explanation of the business. That was very useful. I was wondering if you could explain to us just how automated are all these transactions that you described. So, is this all done by software or do you actually need bodies in the backend to allocate all these loan amounts and do all these -- run all these algorithms and make sure that the checks are applied properly, et cetera?

Leland Strange: Thank you, it's a good question. No, it's absolutely all embedded in the software. There's no human intervention in calculating any of that or figuring any of it out.

Marclo Lyma: Okay, and could you, I don't know if you'd like to talk about this, but if you could describe to us what does the technology stack look like for CoreCard? Is this sort of a software as a service product, does it run on premises, does it talk somewhere who's your comp provider, etcetera?

Leland Strange: Well, we license it, so other processors can use it on -- in wherever they want to install it. We also have it installed in our datacenters so that we can run it as a processor ourselves. So, the same software we use to processes for processing clients is also used by our licensees for them to be a processor for their clients.

Marclo Lyma: Understood. So, from what you're saying is they can download and install the product -- the software on premises or they can run from your datacenters. Are you running from your own datacenters or are you using AWS or Azure or another cloud provider?

Leland Strange: We use QTS actually. We use -- we have a big cage operation in Atlanta or Suwanee, and then we have disaster recovery in Richmond. This is not the kind of software you just download and put on a local computer. You're going to want to put it in a datacenter somewhere.

Marclo Lyma: Okay. And you talk about -- in past calls you've talked about licensing sales, sort of not taking business, people were knocking on your doors. And you said you didn't have the capacity to take on that business. What can you do to make this more scalable? Do you have to add more people; do you have an interest in doing that? What can you do to make this a more scalable process?

Leland Strange: Well, we're always adding people. At this point, we actually think it's pretty scalable, but nothing has -- I mean everything has limits to scalability. If you look at comparison between our 2017 and 2018, I would say we scaled pretty well in terms of revenue and profits. I think we'll scale pretty well in 2019. So, I'm not going to try to scale at 100% a year, I think that's probably irresponsible.

Be happy to scale at 25% a year, maybe higher. But we're in the fintech business. It's the kind of business you don't take chances by growing so fast that you make mistakes, because it takes forever to recover. Everything we do is very, very important to our customer, and everything has just got to be right. So, you don't run around loosely doing this, you do it very carefully. But we think we're scaling pretty well, at 25% or better percent a year.

Marclo Lyma: Do you think it would be possible, in the future, to breakout those five sources of revenues just so we can see, for example, what percentage of your \$18.7 million in service revenue last year was due to professional services, and how much each line items of those five sources of revenues contributed to the top line?

Leland Strange: I'd suggest you look at the 10-K because we breakout a fair amount of that in the 10-K.

Marclo Lyma: Okay. And what would you say are sort of your biggest constraints to growth, like if you could wave a magic wand and solve one or two key problems or constraints that are keeping you from growing even faster, what would that be?

Leland Strange: Well, if I had about 20 more people that had 15 years of experience of using CoreCard software, I could grow faster. And there is no magic wand that can make that happen. We have a lot of good, long-tenured

employees, who know this business backward and forward, and we focus on trying to continue to grow that base, but you don't get 10-year, 15-year of tenured folks overnight. So I think we are growing at as fast as we are growing in a reasonable way.

Marclo Lyma: Could you -- you listed a number of your traditional competitors, and you mentioned a number of these in the past as well, what are some competitors in the more exotic, I guess, more value-added services that you -- all the stuff that you described of making different payments, appliance, different loans etcetera? You said that this was pretty unique, but do you have competitors in that space as well, who would they be?

Leland Strange: We don't know of anyone that could do the example I gave you.

Marclo Lyma: Okay, thanks so much Leland.

Operator: Again if you would like to ask a question please press star one on your telephone keypad. There are no further questions at this time.

Leland Strange: Okay. Thank you for joining us today. I'll remind you again, read the 10-K that was filed this morning for more risk and information. And also our Web site will include a transcript of this call by sometime tomorrow. So, thank you everyone. We appreciate your time.

Operator: This concludes today's conference call, and you may now disconnect.