INTELLIGENT SYSTEMS CORPORATION

Moderator: Leland Strange
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OPERATOR: This is Conference # 3282539

Operator: Ladies and gentlemen, thank you for standing by, and welcome to the Intelligent Systems Corporation Earnings Release and Investors Conference Call.

At this time, all participants are in a listen-only mode. After the speakers' presentation, there will be a question and answer session. To ask a question during the session, you will need to press "star" "1" on your telephone. If you require any further assistance, please press "star" "0."

I would now like to hand the conference over to your speaker today, Leland Strange, Chairman and CEO. Thank you. Please go ahead.

Leland Strange: Good morning, everyone, and welcome to our call today. I have with me Matt White, who's our CFO. This is an interesting time, and I would guess most on this call are not in their offices. Matt and I are physically in the Intelligent Systems boardroom where we are typically for our calls. Our Intelligence Systems and Atlanta CoreCard offices are both located in an older converted distribution warehouse. It's a large single-story multi-tenant building located in the Atlanta suburban office and Industrial Park.

Intelligent Systems’ offices face one street and CoreCard offices have an entrance to the same building, but from a different street. We often joke that CoreCard is about a block away, and we get plenty of exercises going back and forth in the same building, although the most efficient path is to go outside one entrance and go in another one for CoreCard, which we do unless it's raining.

The INS office consists of less than 10 people and we’re spread out in our own cubicles, so some of us still come to the office each day. CoreCard employees, on the other hand, are generally not coming into their offices. Our employees are the strength of our company since our heavy investment in technology over many years will have little value without the dedication and longevity of these employees.

We implemented a quick and essentially issue-free transition plan several weeks ago for a 100 percent work-from-home structure even though we're considered an essential service and could work from our offices. I say 100 percent, but we do have our IT resources that have to work some on-site in our outsourced data centers. I want to recognize and acknowledge that I'm blessed to be working and surrounded with such a dedicated team who helped perform magnificently in these unprecedented and challenging times.

I hope this morning that all of you have taken the time to read the press release we put out. A copy of it is on our website, along with the other filings. I do want to remind everyone that during the call, including the Q&A, Matt and I will make certain forward-looking statements based on the business environment as we currently see it. If in doubt about what all that entails, please see the section of the safe harbor language regarding these statements in our press release and in our 10-Q. We undertake no obligation to update or revise these statements or the statements that we make today and emphasize are based on our speculation in an unknown time.

At this time, I'm going to turn it over to Matt, so he can talk about the financials, then I'll come back on and give some color. Matt, go ahead.

Matt White: Thanks, Leland, and good morning, everyone. As Leland noted in our press release, our first quarter performed in line with our expectations for the first two months of the quarter with momentum continuing from fiscal 2019.

Towards the last two weeks of March, we began to see the initial disruption of the pandemic.

With that said, revenue for the first quarter of 2020 was $7,893,000 compared to revenue for the first quarter of 2019 of $6,966,000, an increase of 13 percent. I'd like to remind everyone that the first quarter of 2019 benefited from the timing of a $950,000 professional services agreement with a European customer that did not recur in the first quarter of 2020. As we discussed on previous calls, similar to our license revenue, the timing of our professional services revenue can vary from quarter-to-quarter depending on when a project is delivered. This is why we often say that it's better to look at our results on an annual basis rather than quarterly.

The components of our revenue for the first quarter consisted of professional services revenue of $5,279,000, processing and maintenance revenue of $2,194,000, and third-party revenue of $420,000. As expected, we did not receive any license revenue in the first quarter of 2020.

And now turning to some additional highlights on our income statement for the first quarter of 2020. Income from operations was $2,379,000 for the first quarter of 2020 compared to income from operations of $2.605,000 for the same time last year, resulting in an operating margin of 30 percent compared to an operating margin of 37 percent for the same time last year and 39 percent for the fourth quarter of 2019. The sequential and year-over-year decline in operating income was primarily driven by lower license revenue in the first quarter of 2020. Additionally, we experienced higher general and administrative expenses compared to the first quarter of 2019, primarily related to legal costs associated with ongoing securities litigation.

Research and development expenses were lower from the same time last year, driven by lower accrued employee bonuses. Our marketing costs continued to remain low in the first quarter of 2020. Our first quarter 2020 tax rate was 28.5 percent compared to 24.1 percent in the 2019 period, due to the impact of a valuation allowance on tax benefits related to investment losses in 2020. Earnings per diluted share for the quarter was $0.12 compared to $0.23 for Q1 2019. Diluted EPS for Q1 2020 includes the negative impact of $0.11 per diluted share due to investment losses of approximately $1,050,000. And as mentioned above, we recorded a valuation allowance on the tax benefit of these write-downs.

While the impact of the COVID-19-related economic slowdown was limited for the first quarter of 2020, it's not currently possible to estimate the full potential impact on our business. However, there are 5 major areas where we could see disruption. First, we received license revenue when our customers achieve new active account tiers. In an environment of slower growth or declines in active accounts, we would anticipate lower license revenue.

Second, our maintenance revenue is also based on active account tiers. Therefore, lower license revenue would result in lower maintenance revenue. That being said, a decline in active accounts would not move customers into lower maintenance tiers.

Third, we typically receive processing revenue based on the number of active accounts our customers have on our system. If our customers fail to add new accounts or experienced declines in active accounts due to inactivity, we could experience lower growth in processing revenue or lower processing revenue.

Fourth, we would also anticipate delays or declines in professional services revenue as well as delays in new customer sign-ups and implementations if current customers or potential customers delay or cancel their plans.

And finally, we could experience higher cost and disruption to our operations in the event that virus prevents a large portion of our workforce from performing key duties. Our employees in India have been required to work remotely since mid-March. We have maintained key functions. However, the continuance of remote work will likely negatively impact productivity, which could impact operations and revenues.

And with that, I'll turn it back to Leland.

Leland Strange: OK. Thanks, Matt. We're just a few weeks into the pandemic, and its economic effects are yet to be determined. There's a wide range of possible outcomes. Did it impact us in the first quarter? It definitely affected us, but you cannot necessarily tell it from our good operating results. An example of the effect would be future license revenues. And I should say, timing of future license revenues.

As Matt said, and numbers show, the quarter comparison for a year ago had license revenue, and in this quarter, there was none. But we actually expected none, as we previously stated was possible, so you might have asked how did it affect the company? Well, remember, we recognize license revenue in what I call a stairstep fashion. You get nothing until you reach the next stair or the next tier. And after the pandemic started, our end customers who offer the cards, they closed stores, they backed off on advertising and added no new incentives. So naturally, new activations fell off dramatically.

While we expected no license revenue in the first quarter, we did expect to have a larger number of accounts teed up to recognize more license revenue in the third or fourth quarter. And we may still get it, but we're behind where we're expected to be. So this is an example of a potential future effect of the pandemic that's working under the reported numbers.

Everything we do revolves around how well our customers, our partners, our clients do. They have their own customers, and they depend on CoreCard to respond to their needs. I'm happy to report to shareholders that up to this point today, we really did not miss a beat as a result of working from home and taking care of our customers. That does not mean we just kept everything running on the processing front. We received a lot of professional service revenue by providing new features. Often, these features are coded, tested and put in a live environment, but are not released by the customer of our customer for months, sometimes 6 months or more. This work has continued and generally only slowed a little as of today. I cannot predict whether or not that will be the case tomorrow, but I believe any slowness will be minor and not major.

I cannot emphasize enough our focus and attention to helping our customers make money. Let me give you one example of how our team responds. When everything broke loose, one of our customers who was within 60 days of announcing a new credit product asked us to suspend the work, to put it on hold. We did. They subsequently laid off a good number of people. And then when the payroll protection program was announced, they asked us if we could customize their product to be able to offer these loans, and they wanted it quick. We worked around the clock, and within 4 or 5 days, they were able to take applications for the payroll protection product. This was important to the customer and, therefore, important to us. Our agile team and software framework allowed this fast performance.

Now I know some of you are looking to us to gather intelligence on some – on how some of our customers are doing? We're not going to speak specifically about any one customer. You see in our reported numbers that our own processing revenues have grown in this quarter in comparison with last year. Our customers are having the problems you would expect any credit card issuer to have. You can listen to conference call from Synchrony Financial, Global Payments, Capital One, and the messages are all the same. Transaction volume is down since travel is almost nonexistent.

If your business model is based on a number of transactions or amount of total transactions or credit issuance, you will have a significant shortfall in revenue. I sometimes hear from an investor or analyst, why don't you get paid by the transaction? Or why is your revenue model not built around sharing interchange? You'll note our revenue model is more skewed to number of active accounts. We'd rather give up the upside that the other models provide and hedge the downside that's provided by our model. You will see less downside in a recession and perhaps less upside in a boom with our model, and I emphasize the word perhaps. But this is the reason that our revenues are likely to remain fine despite the lower volume of transactions in this kind of market.

I would say, in summary, our customers are seeing lower purchasing volumes, lower demand for credit, lower request for customer line increases. And you might think that lower demand for credit and lower credit line increases is counterintuitive in a downturn. But actually during the beginning stages of something like this that comes on fast, the folks generally get more conservative. They just pause during a time of uncertainties.

So let's discuss the anticipated effect on our business in the future. As I said earlier, our U.S. team is working with the same efficiency as prior to the start of this pandemic. But the India office is a different story. India also went into a lockdown, and we really did have to scramble. Many of the newer and junior employees did not have laptops nor were they expected or prepared to work from home. A large percentage of the senior employees were able to quickly adjust and most had a reasonably good internet service from home. They jumped in and performed in ways that had never been anticipated.

Clearly, it makes me proud how management and employees adjusted almost overnight when the India lock in was decreed. But there is no question that our overall efficiency suffered as we were not able to provide suitable at-home work for many employees. We don't know today when the employees will be allowed to come back to the office, but we do know when that happens it will be staggered.

I think the very good thing during all of this is that we maintain first-class customer support, and we're able to continue providing the high-level professional services needed and designed by our customers. But I should add, the strain on operating resources is high and problems take longer and are harder to get resolved.

The effect on potential new customers is really unknown as of today. As you would expect, those conversations have slowed down, but have not stopped. We've actually signed a couple of new processing accounts in the last few weeks. These are small, but prior to the pandemic, we're expected to grow rapidly. I expect very slow growth at this point, but it is gratifying to see the continued progress with new processing customers.

Large customer engagements that would involve conversion from another processor require person-to-person conversation, and that means those have slowed, but they're still ongoing. The big question that you and, frankly, all of us are trying to determine is what does all of this mean for the balance of the year. It's a question that we honestly cannot answer at this time. There are just too many open-ended variables for us to make an informed assessment.

We've not completed professional services billing for April, so don't know the true affect for April. But our preliminary view for this quarter and the next few is that our revenues in most categories will remain fine. We're unlikely to get the growth we had anticipated and planned for, but we certainly don't see gloom and doom.

It's amazing how fast and how much the world can change in a matter of a few weeks. This pace of change often creates panic and scrambling of organizations to deal with uncertainty. Our team has often heard me say that the outcome of any negotiation is determined in the first inning before you even start negotiating.

Likewise, the choices you have made before coming face-to-face with this new type of business challenge for most management has already predetermined the outcome. Unlike some companies, we're not scrambling to cut advertising and marketing. We're not pulling back on outstanding offers for new employees. We're not panicking about where our cash is coming from in order to stay the course. We're not cutting spending that would impact future growth, but we do remain frugal and prudent.

The ultimate impact from this crisis is very difficult to quantify right now, with the duration and magnitude still largely unknown. We have positioned ourselves for the long haul and will stay the course as the pandemic runs its course. We're focused on resilience and long-term value creation in the choices we're making today to manage through the pandemic and its impact.

I'm sorry this call has so many generalities and so few specifics, but that's really all that we're able to know and provide at this time.

So operator, with that, I'll open the line for questions.

Operator: Certainly. To ask a question, please press "star" "1" on your telephone keypad.

Our first question actually comes from Leland Strange. Leland, please go ahead.

Leland Strange: Yes. I want to ask Matt to expand on a couple of things that folks have faxed into us in terms of questions. They are asking about the – primarily the deferred revenue and how that impacts cash and maybe a little more explanation on that? And then also about the lease obligations, the increase? Can you talk about both of those things for a minute? And we'll take other questions.

Matt White: Sure. On the deferred revenue, that relates to payments we received early in the quarter for – from customers in anticipation of future services. So some of our – some of the payments we received from customers are contractual. We often bill 50 percent upfront for our professional services agreements in anticipation of providing those future services. We often bill our maintenance in advance either quarterly or annually. And our customers have the ability to prepay some of their license revenue.

So we'll expect to see that deferred revenue translate into revenue over the next 12 months. I can't predict exactly when that will be recognized as revenue, but expect to see that, primarily in license revenue, but also maintenance and professional services.

And on the lease obligations, we entered into some new leases at the end of the first quarter, primarily in our data centers, leasing new space in our data centers as we continue to build out our processing environment.

Leland Strange: Someone also faxed in a question about R&D expenses, and how they were down in the quarter? I'll comment, and Matt, you can comment on that, too.

They're actually not. As we've said, our expenses in total are primarily for employees. And if an employee is billed out for professional service or for cost of sales, it goes in those categories. What's leftover in reality becomes R&D because they're all involved in improving the product.

Matt, can you add to that a little bit?

Matt White: Sure. Some of that relates to higher professional services revenue and the inclusion of those costs in cost of sales, for the time those employees are spending on professional service agreements. There were also lower bonus accruals in Q1 of 2020, which I think makes sense given this environment.

Leland Strange: So we're definitely not cutting back on any of those things. But operator, before you find your next question, let me just kind of throw something I was thinking about, when I talk about we're continuing to add employees.

Just yesterday, we interviewed another employee for the Atlanta office. But to tell you how things changed. He didn't want to come into the building. So the interview took place in the parking lot with everybody standing about 6 feet apart, answering questions.

I thought that was pretty hilarious. I wasn't part of that, but I sure wish I had a picture of it. That's a real change. But we're continuing to add employees.

Operator, with that, any other questions?

Operator: Our next question is from Mark Palmer of BTIG.

Mark Palmer: I guess the first question is the company's cash balance continued to grow in the quarter, going from, I guess, $26 million and change to over $30 million. What are your thoughts about the use of that cash? Or do you feel comfortable given the environment having that large of a cash balance?

Leland Strange: I always like to have as much cash as I can have, but I'll find a better use for it. No, we don't have a particular plan on what's going to happen with that. I'd like for it to grow. You can never have too much cash.

Mark Palmer: And then following up with – on Matt's comments with regard to the deferred revenue and how that could translate into license revenue as well as other revenue being recognized in future quarters. How should we think about that in terms of how that could be realized second quarter on?

And how – I know it's difficult to forecast how things are going to work with regard to licensing revenue. But is the key here just the number of cards that are activated in the next few quarters? And how that's going to translate into higher revenue tiers? Just trying to put our heads around how to think about the licensing revenue in particular.

Leland Strange: It's a little more complex than that. It does – it is primarily the number of active accounts that are being licensed. And when you talk about active accounts, there's the possibility that some accounts will go inactive while you activate another portion of new accounts. So there's – you start with your current account base, you deduct your inactive accounts, then you add the new ones to try to see what's the number of active accounts. And that's what license revenue is paid on.

So that number changes in the end of every month, we get that number. When it reaches a certain threshold and we've met the objectives required technically to get that revenue, that's when we account for it. And my best guess, it will move in over this year, although it could roll into next year. We don't know how long this thing is going to last. So that's why we have to be very careful here. We would normally have expected to book all of that this year, that under normal circumstances. This is not a normal time, and I don't know how to predict that.

I think what you can do, one thing you can read into it, is the confidence that somebody pays us, I will call it in advance, for additional license tiers, which would mean they certainly expected the accounts to grow.

Operator: Our next question comes from the line of Ishfaque Faruk of Sidoti & Company.

Ishfaque Faruk: A couple of questions from me. First of all, I was reading that some of your leading customers, Wirecard, there were issues with their auditors, and they're also revisiting some of their relationships with their partners. Do you think that might have somewhat of an effect in your business or not really?

Leland Strange: We don't see any effect on that or our business. So I think they pretty much got cleared from their audit. What's going to affect us from their business is, again, what affects everybody in this business. A lot of their business was travel, and we did get some revenue from them based on transactions. Obviously, travel transactions are gone to zero in Asia. So it will – so that will impact their view of spending money for professional services, and I could see that lightening up on their side until they see some daylight in travel recovery.

Ishfaque Faruk: And Leland, if I could follow up on that. Do you do most of their work with – for them in Asia? Or do you – can you give any geographic color?

Leland Strange: No, it would be mostly Asia Pacific. Again, they are licensing our software, and it's hosted in Germany. It's managed out of Singapore and Dubai. And most of the customers that use them for processing on our license software is in Asia Pacific.

Ishfaque Faruk: Got it. And Leland, in terms of your professional services, Leland or Matt, it was – professional services stayed pretty steady in this quarter. And as you – as we already know, a little bit into the second quarter, do you expect that to stay steady? Or do you expect some of that to taper off as employees work from home, but you said your employees are already pretty effectively working from home?

Leland Strange: Yes. Well, you kind of give me an idea to say something, but it's been hard for us to, I think, get people to buy into. When we've talked about professional services, it's almost recurring revenue. We say it's repeating revenue. And I always get my dander up when folks want to kind of just dismiss that is not important. It's actually very important to have that kind of recurring revenue in those kind of margins. So that's first.

Number two, I expect – remember, this expectation is based on a whole lot of unknowns that they're going to stay relatively similar. Now similar could be a little bit down, could be a little bit up, it could go either way, but I don't expect to see any big drop-off in professional services. That is very much a repeating-type business.

Matt, Any comment on that?

Matt White: No. I don't have anything to add necessarily. But it probably won't increase significantly, that is one thing I would say.

Ishfaque Faruk: Got it. And my last question. And Leland, you touched on it, and thanks for providing that you guys signed up a couple of new processing accounts in the last 2 weeks. Do you expect – you did mention that you expected a pick up in business. But do you expect some of these – a couple of these clients to pick up in the back half of this year? How are you viewing that internally?

Leland Strange: Why don't you tell me what the back half of this year is going to look like with the pandemic, and then I could project what we are going to do. I can't say that right now.

Operator: And I will now turn the call back over to management.

Leland Strange: OK. Well, we thank you for wanting to hear our update. As we usually say, if you have any other questions, feel free to call us. We're pretty happy with the way things are going right now. And again, just thank you. We look forward to talking to you in another 3 months. Thanks, everyone.

Operator: And this concludes today's conference call. You may now disconnect. Thank you for your participation.

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