

INTELLIGENT SYSTEMS CORPORATION

Moderator: Strange, Leland

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11:00 AM ET

OPERATOR: This is Conference # 6013159

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 one on your telephone. Please note that today's conference is being recorded. If you require any further assistance, please press star zero.

I would now like to hand the conference over to your speaker today, Leland Strange, President and CEO of Intelligent Systems Corporation. Thank you. Please go ahead.

Leland Strange: Hi, thanks. Good morning, everyone, and welcome to the Intelligent Systems Third Quarter Earnings Call. Thanks for joining us. Matt White, our CFO, picked the date for the call, and I'm not sure whether there was any relevance to the fact it was election day or not. I assume if you're live on the call today and not listening to a replay that you've already voted, either in person or absentee, as I did a couple of weeks ago.

I'll remind you that our comments will include forward-looking statements, but I can assure you that none of the forward-looking statements will try to predict the results of the presidential election tonight. Our forward-looking statements will consist of our best guess of what will be happening with our company. No polls were taken or required for our predictions or speculation. Just note that we do list the factors that might cause actual results to differ from our comments and speculation in our latest SEC filings that included the latest file this morning.

The last two calls, we discussed how the current pandemic economic disruption affects our business. And I also said that we -- I think all hope that measures and suggestions put in place would be bringing the impact down by this point, but it doesn't appear to have happened. With COVID, we're continuously concerned what might happen with our employees, our family, and it's very important to us to keep up with what's going on with our families. And so, I want you to know that we are taking the time and we are setting policies that impact our family. And our family is all of our CoreCard employees and their families.

In our Intelligent Systems and CoreCard Atlanta office, some of us are in every day per the normal routine and others are in the office on Tuesdays and Thursdays. We work from home on the other days. We have a mask optional policy in the offices. No mandate but encourage common sense, respect, and courtesy in interactions. Not having the former ability to encourage interactions does slow things down in the office though, in my opinion.

Turning to results for the third quarter. I assume you've all read the press release posted this morning. Results were a little better than expected, as I said, for the quarter due to the license revenue that I had initially expected to come in in the fourth quarter. It's always difficult for us to predict exactly when license revenue comes in since it's based on hitting tiers as opposed to scaling in. I expect the numbers to pretty much align with what we've been saying when you bring the whole second half of the year together and once the second half of the year has concluded.

I'll turn it over to Matt White, our CFO, now to go through the numbers and give us his thoughts. Matt?

Matt White:

Good morning, everyone. As Leland noted, we slightly outperformed our third quarter expectations, specifically with the license revenue. We think this demonstrates the strength of our business model and our strong financial position amid a challenging environment. Revenue for the third quarter of 2020 was \$10,304,000 compared to revenue for the third quarter of 2019 of \$9,522,000 an increase of 8%. The components of our revenue for the third quarter consisted of license revenue of \$1,600,000 professional services revenue of \$5,392,000 processing and maintenance revenue of \$2,950,000 and third-party revenue of \$362,000.

Similar to Q2, our processing revenue benefited from a new one-time program offering by a large customer, but not our largest, related to government stimulus efforts. We do not expect the revenue from this program to be as strong going forward, beginning in the fourth quarter. Additionally, we do not expect any additional revenues from our former customer Wirecard in 2020, and have only recognized to date, amounts that have been paid or are probable of being paid. We don't expect to be able to fully replace these impacts for the fourth quarter.

Turning to some additional highlights on our income statement for the third quarter of 2020. Income from operations was \$3,481,000 for the third quarter of 2020 compared to income from operations of \$4,200,000 for the same time last year, resulting in an operating margin of 34% compared to an operating margin of 44% for the same time last year. The year-over-year difference in operating margin was primarily driven by revenue mix in addition to previously announced infrastructure investments in our processing environment, which is part of our long-term growth strategy. The investments we've made will enable us to take on additional processing customers in 2021 and beyond, leading to sustainable growth.

Our third quarter 2020 tax rate was 18.9% compared to 26.3% in 2019, and this difference is primarily due to the timing of research and development credits. We expect an ongoing tax rate of between 22% and 24%. Earnings per diluted share for the quarter was \$0.31 compared to \$0.34 for Q3 2019.

And now I'd like to provide a quick update on our liquidity position. Our cash balance at September 30, 2020 was \$34,391,000 compared to \$26,415,000 at December 31, 2019, a significant increase in 2020. For the nine months ended September 30, 2020, cash provided by operations was \$15,184,000 compared to cash provided by operations of \$7,679,000 for the comparable prior year period. This provides us with significant reserves to both weather the current crisis and invest in our future. Our strong cash position allowed us to invest \$6.2 million in our processing infrastructure in 2020 and open the new recently-announced offices in Dubai and Chennai. We believe these new locations and people will allow us to enter new markets and further expand our offerings on the CoreCard platform.

The impact of the COVID-19-related economic slowdown continue to be muted for the third quarter of 2020. We have mitigated revenue declines through our ability to quickly modify our platform, enabling a large customer to continue participating in originating loans for the Paycheck Protection Program. While these programs are limited in duration, they highlight our nimble business model and our ability to quickly adapt to client needs.

Additionally, our employees in India have been required to work remotely since mid-March. However, we're encouraged that to date, we've been able to maintain key functions and business continuity in addition to delivering excellent service to our customers, as reflected in our strong professional services revenue for the quarter. Longer term, we believe the investments we've made this year will yield new customer opportunities and future revenue growth.

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

Leland Strange: Thanks, Matt. I think the third quarter is probably pretty well understood by investors, so I'm going to take the rest of the time to address three areas. First, the Wirecard business as well as the recent press release announcing the opening of the Dubai offices. Two, pandemic effects on our business. And then third, finally, the important ingredients we have in place for a continued steady long-term growth.

Before I do that, I'll remind you that you can fax questions to us, while this line is open to fax@intelsys.com. This is monitored and we may not respond to every question, but you can always check with us individually if you need more information, and if it is the kind that we can provide.

So as far as the Wirecard situation, we are opening a new office in Dubai, in the UAE. For a good number of years, we've operated what is known as APAC, the Asia Pacific region of the world, through our issuing licensee Wirecard. Wirecard had and still has offices and employees in Dubai,

Singapore, and Chennai, India, in addition to their headquarters in Germany. You're probably all well aware of the Wirecard collapse. Just a few years ago, they were our second largest revenue customer. Revenue from them this year is less than 4% for the first 9 months.

Their problems were almost exclusively in their acquiring businesses not in the issuing business, which is what we do. Since filing for bankruptcy, they've been selling out their acquiring -- well, actually they've been selling up all of their assets. We've been discussing taking over their issuing business in the APAC area for several months, but it's a complicated process with all of the banking and regulator licensing required in each country. While we wanted to get in the business, we didn't want to take on an ongoing obligation that was going to take a long time to end up being profitable for the company.

The Wirecard business also took a big hit as a result of the COVID pandemic, since many of their program's customers use the cards for multi-currency travel. As we all know, travel ground to a halt. Wirecard licensed software from CoreCard -- it provided a very flexible, multi-currency wallet as a prepaid currency and for virtual card transactions. It is a prepaid product. We have now opened our office in Dubai and have made offers to many current Wirecard employees to join us and to continue to offer the services to current Wirecard customers, and we've done this all with the help and assistance of Wirecard. We will be buying assets from Wirecard and using those assets as they are currently used by Wirecard.

The total purchase price is expected to be around \$1 million. We expect approximately 50 employees to join us initially, and we'll add others as the business evolves. Today, I have no idea how many current customers will immediately move to CoreCard. But we know that several -- I will say a few revenue customers have committed to the transition as we come up with our own processing environment there.

Since the announcement of Wirecard bankruptcy, many of their customers have made alternative arrangements. We are in dialogue with them, and we're ready to continue serving them with our new processing offering in the region. We're committed, and it's important to recognize that it would take an investment, both in time and currency, to develop this market. So, don't expect any immediate impact and don't expect me to report on the revenues from APAC on a month-to-month or quarter-to-quarter basis.

From an accounting perspective, it will be an ongoing expense that will not match revenues in the first year. So, think of it as we do, it's an investment. I would expect it to be, well, let's say, accretive in the normal sense of the word in the next 12 to 18 months, but in the meantime, it is going to impact our margins. But it's going to be I think a nice office and a nice center for us in the APAC region as we grow the business. Initially, we'll be emphasizing the prepaid product. But eventually, we expect to offer our full premium credit processing services in the region.

So, going back to the pandemic. It's I guess about the same as we reported three months ago and that impacts our employees, which then results in

productivity and efficiency penalties. And it impacts new customer acquisitions through slowing our conversations. The impact is not large and doesn't keep us from making progress, but it definitely impacts us.

I think the major impact on employees is in our India operations. We have just begun to bring back a few employees to our Bhopal office, while the Mumbai office employees continue to work from home. The newer employees, and we have a different definition than most when we talk about newer employees. Those are ones who did not come from the issuing business or have worked with us for less than three years. They are the ones that are coming back first along with some of our long-tenured team who can train them. Some of that training is just working side by side to get the experience our customers value from CoreCard.

You've heard me say probably more than once that we offer a premium product at a premium price. That means our customers get more in total from CoreCard than what they receive from other processors. So, they can pay us a little more and still come out ahead. As it is said in other industries, but very seldom in ours, quality is value and you get what you pay for. Our ability to offer innovative and the latest types of programs along with deep experience in settlements, regulatory issues, compliance, reporting and real-time accurate delivery of these are a result of the long tenured and experienced CoreCard team. That sets us apart.

Every potential customer does not recognize the value of the experienced relationship and accuracy CoreCard provides. So, we're not a good match for some. And frankly, we suggest they go to ITC, Galileo, Marqeta and a few others that offer prepaid programs if they are small programs. And we suggest they go to the former First Data and TSIS platforms if they have larger programs and don't need an agile environment. There are enough high-quality programs with experienced teams who understand the value of the CoreCard offerings that will allow CoreCard to grow much larger in the next few years just working with these quality companies.

As additional aside, you're probably aware that Kabbage was one of our early customers. Kabbage had visionary leaders in Rob Frohwein and Kathryn Petralia and would not sell it for what the market offers. They wanted to build uniqueness in many areas of their business, and CoreCard played an important role in being the system of record, keeping up with the complicated and ever-evolving futuristic program offerings. They successfully sold their company to American Express, and our contract has been assigned to AMEX. I guess that means we can now count AMEX as a customer. Seriously, this illustrates the kind of customer we want to partner with. I don't know what future business will look like with AMEX. And the fourth quarter will be very light compared to past quarters with Kabbage, but we look forward to continuing working with them.

I guess I've already digressed and begun talking about the future, and that's what happens when you don't use full scripts on these calls. So, let's just go on and look at the next few months. I'm continuously reminding investors that quarter-to-quarter comparisons don't tell our story as we manage year-to-year. A year ago, we said we expected 2020 to be just a

little better than 2019, I think I said, a little better or little worse, but about the same, as we're going to use the year to get ready for faster growth.

Obviously, we could not make the progress we wanted in hiring and training new employees with the pandemic overhang. And with the Wirecard bankruptcy, Kabbage stopping making loans after the payroll protection period and a lot less license revenue this year, and I guess adding lengthening times for discussions for new programs, we'll probably end up down for the year some compared to last year, but just a little as we almost filled all of those holes with other business.

Looking out to 2021 and assuming pandemic has stabilized or perhaps gets a little better, but I'm not expecting anything big, I expect 2021 to be a pretty good year for us with most of the pick-up coming in the second half. Am I just guessing? No. We're working on programs now that we can't discuss but believe will generate significant revenue in the fourth quarter next year. As a reminder, I previously said, I can only take on one big customer for next year, and we have that big customer for next year.

Maybe that's a good segue to again emphasize how long it takes to bring or convert programs from another processor. Contracts are usually 5 to 10 years. Large programs, they are in the 7 to 10 years. Smaller programs are in the 5 years. They usually call for renewal with a 6 to 12-month notice. Again, the larger programs longer term contracts call for 12 months. Shorter term call for 6 months.

If you're thinking about not renewing, you usually start a year out in serious discussions with others because you want to have your new plan in place at the time of notice. If you give notice, but fail to get off the program, there are significantly higher prices to be paid for processing by carrying over. So that means you want to be really clear when you give notice that you know what your plan is. That also means that you actually start to have discussions even a year before that notice period. So, I'm now having tentative discussions where prospects will not go live until three or so years from now. They'll make a decision to undertake serious discussions in a year, which will leave them two years; one for serious negotiations and one for notice period and conversion activities.

What about conversion activities? Well... you don't do them without significant benefits because they have significant risk. So, you don't want to change unless you're seeing significant benefits. I'll probably talk a little more about that and the process, perhaps in next call, but I think I just wanted to let you know we have good visibility on a year out from now, a cloudy review for two years out, but I can see pretty bright sunshine through both these lenses as far as large potential business.

Next year, I can only take one large customer. For the next year, we have the resources for more than one, maybe two or three. In every case, we are only going to accept business that we're certain we can deliver for the customer with exceptional service. We will choose customers

strategically in order to be able to do that and not take business where we think it's not good for both of us.

So that's sort of my view out for the rest of this year as well as 2021. I think I'll stop there. And operator, see if there are any questions.

Operator: At this time, I would like to remind everyone, in order to ask a question, please press start and then the number 1 on your telephone keypad. Your first question comes from Mark Palmer with BTIG. Please go ahead.

Mark Palmer: Yes. Good morning, and thanks for taking my question. If you could talk a little bit about what your thinking is with regard to the size of the addressable market associated with the company's international expansion, keeping in mind as you said that it's going to take some time before that effort begins to move the needle in terms of the company's operating performance, how should investors think about the size of that opportunity?

Leland Strange: I would like to just say large, but I know that's not what you're looking for. We don't really feel the need to quantify in dollars because of how large it is. There are two components of it. One is prepaid. Again, that's a large market. And the other is, credit. The current processor who is one of the largest in the area, uses VisionPLUS software. That software that we developed 30 years ago, that we converted -- when I say we, predecessor company Paysys, that we converted off of to the new CoreCard software. And so there has not been any innovative credit systems in that area for some time.

We believe there is room for that in some of the larger countries there, and we also believe that there'll be a lot of new things happening in places like Saudi Arabia, UAE, and other places as they in some ways, they're ahead of us for prepaid, in some ways they're behind us in terms of unique credit programs. So, Mark, I'm sorry, I'm not going to give you a number. If I were to throw out a number, I'd be saying it's \$1 billion or more. It's just a big number, but it will be slow. I expect more new things there than conversions in that area.

Let me make one other comment on that. Historically, the processors in that area have charged based on transactions as opposed to accounts. One thing we've done different is we have charged based on accounts. And we'll be kind of evolving our model also there because you're going to have to meet the needs of the current customers in that area to modify that. So, there's a lot of work to do. It's one of these things where I think people know we're fairly conservative. We're not willing to throw a lot of money buying a business out there.

I know we've talked. We've worked hard for some time. We wanted to wait and see how things settle down. We wanted to see what the prospects were. And we also wanted to limit what we spend knowing that it's going to take time to build the business. So, I think by doing it the way we did it, we were able to accomplish all of that and bring on some well-trained employees who have been running our system in the area. And we have

high hopes for it, but I don't see any big numbers for 18 months, two and three years out.

Mark Palmer: Okay. That's fair. And the company's cash balance continues to grow quarter-over-quarter, it did again in 3Q. If you could talk a little bit about your thinking about the potential for using a portion of that cash for M&A or would you like to just stand pat and continue to accumulate more cash?

Leland Strange: Well, we're not trying to accumulate cash, but we're certainly happy that we're making a nice profit and cash accumulates, which is something a lot of these other guys can't say, the fin techs in the business. But we'll use \$1 million of it here, but it could have been situation where we could have used \$5 million of it. So, we've got the cash to take advantage of opportunity and we're not trying to bank it. We certainly want to find a good use for it, but we're just not going to be led down the path of paying too much for things. Again, it's the long view, so I wish we could find something that we could we could put \$10 million to \$15 million at that would be accretive within the next year. But right now, I can't find those. I'm not going to count on the same kind of multiples everybody has forever. So that's part of the game too.

Mark Palmer: Understood. Thanks very much.

Leland Strange: Operator, do we have any more questions?

Operator: There are no further questions at this time.

Leland Strange: All right. We want to thank everyone for being able to call. I appreciate your interest in the company. And as we always say, if we can help you with any further discussions that we can do, that's appropriate, we're happy to do that. So thank you for being on the call and have a good rest of the day. Thank you, everyone.

Operator: Thank you. This concludes today's conference call. You may now disconnect.