Information Services (ISC Q3 2018 Earnings)

November 7, 2018

Corporate Speakers:

- Jonathan Hacksaw; Information Services Corporation; IR, Corporate Communications
- Jeff Stusek; Information Services Corporation; President, CEO
- Shawn Peters; Information Services Corporation; EVP, CFO

Participants:

- Stephanie Price; CIBC Capital Markets; Analyst
- Justin Keywood; GMP Securities L.P.; Analyst

PRESENTATION

Operator: Welcome to the ISC Q3 2018 Earnings Conference Call and Webcast.

(Operator Instructions)

I would now like to turn the conference over to your host, Mr. Jonathan Hackshaw.

Jonathan Hackshaw: Welcome to ISC's conference call for the third quarter ended September 30, 2018.

With me today are Jeff Stusek, President and CEO; and Shawn Peters, Executive Vice President and Chief Financial Officer. Jeff will provide opening comments followed by a review of our third quarter operation and financial results by Shawn Peters. We will keep our prepared remarks brief and follow with a question-and-answer session.

Before we begin, we would like to remind everyone that we will only be summarizing results today. ISC's unaudited, condensed, consolidated interim financial statements and management's discussion and analysis for the third quarter ended September 30, 2018, have been filed on SEDAR and are also available in the Investor section of our website under Financial Reports. We encourage you to review those reports in their entirety.

I would like to remind you that any statements made today that are not historical facts are considered to be forward-looking information within the meaning of applicable securities laws. These statements may involve a number of risks and uncertainties that are described in detail in the company's SEDAR filings, in particular, in ISC's Annual Information Form dated March 13, 2018, and ISC's unaudited, condensed, consolidated interim financial statements and notes and management's discussion and analysis for the third quarter ended September 30, 2018. Those risks and uncertainties may cause actual results to differ materially from those stated. Today's comments are made as of today's date and will not be updated except as required under applicable securities legislation.

Today's conference call is being broadcast live over the Internet and will be archived for replay shortly after the call in the Investor section of our website at www.company.isc.ca.

With that, I will now turn the call over to Jeff.

Jeff Stusek: Thank you, Jonathan. Welcome, everyone, and thank you, for joining us today. This is another strong quarter with year-over-year increases across-the-board in revenue, net income, EBITDA and EBITDA margin. The real estate market does, however, continue to demonstrate weakness, following successive interest rate increases along with changes to mortgage qualification rules in January of this year.

With further rate increases expected toward the end of the year, this is likely to impact our registry operation segment as it has done over the first nine months of the year. Nevertheless, our diversification strategy is delivering results as we build on organic growth opportunities while managing our core registry operations business, which remains a strong, free cash flow contributor.

Overall, ISC remains a healthy, well-funded business with the ability to deploy capital towards achieving our objectives while returning capital to shareholders through our dividend.

With that, I'd like now to ask Shawn to summarize our financial and operating performance for the quarter ended September 30, 2018.

Shawn Peters: Thank you, Jeff, and good morning, everyone. I'll provide you with some of the highlights of Q3 on a consolidated basis and then provide some further commentary about each of our reporting segments and their performance for the reporting period.

Revenue was $30.2 million for the three months ended September 30, 2018, an increase of $6.3 million or 26.5% from the third quarter of 2017. The increase was due to strong growth in our Services segment, including new revenue from our acquisition of AVS Systems Inc.

Net income for the three months ended September 30, 2018, was $7.8 million or $0.45 per basic and $0.44 per diluted share, an increase of $5.9 million from the third quarter of 2017, when net income was $1.9 million or $0.11 per basic and diluted share. This increase was due to increased earnings in our Services segment, a $2.8 million net adjustment to the fair value estimate of the contingent consideration associated with our AVS acquisition, and less income tax expense in the same period in 2017, which included the reduction of the carrying value of deferred tax assets and liabilities.

Consolidated EBITDA, or earnings before interest, taxes, depreciation and amortization expense, for the third quarter of 2018 was $11.6 million compared to $7.6 million in the same quarter last year, an increase of $4 million or 52.8%. The increase is due to additional earnings in our Services segment, a $2.8 million net adjustment to the fair value estimate of the contingent consideration associated with our AVS acquisition and organic growth.

The EBITDA margin for the third quarter of 2018 was 38.4% compared to 31.8% in the same quarter in 2017, up as a result of the $2.8 million net adjustment. Excluding stock-based compensation expense or income, stock option expense, transitional gains and losses on assets and acquisition and integration costs, adjusted EBITDA was $9.2 million for the quarter, compared to $8.7 million in the same quarter last year, with an adjusted EBITDA margin of 30.4% for the quarter compared to 36.4% in the third quarter of 2017.

EBITDA has increased due to increased earnings in our Services segment. And as expected, the margin compared to last year has decreased due to the high revenue and low margin profile of our collateral management product line following the acquisition of AVS.

For our registry operation segment, revenue was $17.9 million, a decline of $1.2 million or 6.5% compared to the third quarter in 2017. In the Saskatchewan Land Registry, revenue was $12.8 million for the quarter, a decline of 10.7% compared to the same period in 2017. This was due to lower transaction volumes and lower high-value property registration revenues compared to the previous periods.

Overall transaction volumes fell by 3.4% for the third quarter of 2018 compared to the same period last year. While the volume of regular land transfers increased by 12.8%, the volume of mortgage registrations declined by 10.8% with title search transaction volumes also declining by 3.9% compared to the same period in 2017.

We believe the new mortgage qualification guidelines, introduced in January 2018, along with the rise in interest rates, are impacting volumes. We expect they will continue to influence the property market in the near term, and therefore, negatively impact transaction volumes for the remainder of 2018 and into 2019.

Revenue for the Saskatchewan Personal Property Registry for the third quarter of 2018 was $2.7 million, a modest increase of 7.6% compared to the same period in 2017. This was due to higher maintenance revenue from increased renewals and amendments transactions, coupled with pricing changes made to search transactions in July 2018.

Revenue for the Saskatchewan Corporate Registry for the third quarter was $2.3 million, up $0.1 million compared to the same period in 2017. Revenue results for the third quarter are similar compared to the second quarter, generally reflecting the typical pattern of seasonality.

In summary, on a total basis, revenue for registry operations was largely impacted by general activity, particularly in the Saskatchewan Land Registry. EBITDA for our registry operations segment for the third quarter of 2018 was $8.7 million compared to $9 million for the same period last year. And for the nine months ended September 30, 2018, was $24.5 million compared to $26.3 million last year.

For our Services segment, revenue for the third quarter was $10.4 million, up $6.9 million compared to the same period last year. The increase in year-over-year revenue was the result of an increasing uptake of services for both legal and financial services customers for KYC, due diligence and collateral security registrations.

In addition to organic growth within the existing lines, the other driver of growth compared to the previous year was $6.5 million in new revenue from our AVS acquisition. As a result, EBITDA for our Services segment was $4 million for the three months ended September 30, 2018, an increase of $3.5 million compared to $0.5 million for the same period last year, and was $8.2 million compared to $1.7 million for the nine months ended September 30, 2018 and 2017, respectively.

Finally, with respect to Technology Solutions, which we began reporting as of January 1st of this year, revenue was $5.5 million for the three months ended September 30, 2018, flat compared to the same period in 2017. As a reminder, we generate revenue for this segment from external parties through the sale of software licenses and accompanying ongoing annual subscription fees related to the RegSys technology platform and the provision of technology solution definition and implementation services as well as monthly hosting, support and maintenance services.

Our Technology Solutions segment also records revenue from internal related parties, such as our registry operations segment. Revenue from external third-parties increased in the third quarter and year-to-date, due to an increase in design work on projects that were signed in the first half of 2018. This revenue will continue to grow as projects move from design into implementation.

Inter-segment services to registry operations are provided based on time incurred to support the registries and the cost to do so. Inter-segment revenue provided in the third quarter and year-to-date decreased due to a reduction in our costs to provide the services as a result of the savings associated with the termination of our DXC Technology Company contract in 2017, and increased efficiencies as a result of the implementation of RegSys. As a result of the timing and commencement of new business, EBITDA for our Technology Solutions segment decreased in the quarter.

Moving to expenses for the quarter, our consolidated expenses were $23.8 million, an increase of $5.6 million compared to $18.2 million for the third quarter of 2017. The increase was mainly due to an increase in the cost of goods sold due to the nature of our expanded collateral management business in our Services segment, which has a higher cost due to the nature of the business model. In our Information Technology Services costs, which were down $0.6 million for the quarter compared to the third quarter of 2017, we achieved the anticipated efficiencies and savings associated with the termination of our technology services contract with DXC.

Adjusted EBITDA was $9.2 million, a 30.4% margin for the three months ended September 30, 2018, up compared to $8.7 million, a 36.4% margin for the same period in

2017. For the nine months ended September 30, 2018, adjusted EBITDA was $25.6 million, a 29.1% margin compared to $24.4 million, a 34.9% margin for the same period last year. EBITDA and adjusted EBITDA have increased due to increased earnings in our Services segment, while as expected, the decreased margins compared to last year reflect the lower margin profile of our collateral management product line, following the acquisition of AVS.

Capital expenditures for the quarter were $0.7 million compared to $0.1 million for the same period in 2017. The increase in 2018 is due to system development work across our segments, and in particular to enhance our RegSys platform in our Technology Solutions segment.

With respect to debt, as of September 30, 2018, our total long-term debt was $20.4 million compared to $21.6 million at December 31, 2017. Subsequent to the end of the quarter, the company entered into an amended and restated credit agreement in connection with the secured credit facilities provided by our lender. Further details on this debt and our credit facilities can be found in our MD&A and financial statements.

From a cash flow perspective, we had $37.3 million in cash on hand at the end of the reporting period compared to $31.3 million as at December 31, 2017. As of September 30, 2018, our working capital was $14.1 million compared to $18.3 million at December 31, 2017. The decrease in working capital is the result of the AVS contingent consideration being recognized as a short-term liability in the third quarter of 2018 compared to a long-term liability at December 31, 2017, partially offset by an increase in cash and contract assets at September 30, 2018.

Free cash flow for the quarter was $7 million compared to $6.7 million for the same period last year. The increase in the quarter was due to improved results from operations before working capital changes. And the decrease year-to-date compared to the same period in 2017 was mainly due to additions in our intangible assets in 2018, as we continue to enhance our RegSys platform in our Technology Solutions segment.

Finally, we also announced yesterday that our Board of Directors approved our quarterly cash dividend of $0.20 per share. The dividend will be payable on or before January 15, 2019, to shareholders of record as of December 31, 2018.

With that, I'll now turn the call back over to Jeff for some concluding remarks.

Jeff Stusek: Thanks, Shawn. As I said in my introduction, this was a strong quarter. The diversification of our business is a key part of our strategy which is serving us well. We will continue to pursue opportunities for growth through appropriate acquisitions, while pursuing new business leads in all of our segments.

The adjustment of our annual guidance today is a reflection of current market conditions impacting our registry operations in Saskatchewan. Our Services segment is having a positive impact on our business overall, and as a result, we expect to see meaningful year-over-year annual growth rate.

With that, I will now turn the call back over to Jonathan.

Jonathan Hackshaw: We would like to begin the question-and-answer session now, please.

QUESTIONS AND ANSWERS

Operator: (Operator Instructions)

Stephanie Price, CIBC.

Stephanie Price: Can you give us a bit more color on the land registry transactions and the outlook for 2019 that you're seeing at the moment?

Shawn Peters: We continue to see headwinds in that I think most of the economic forecasts would have suggested that Saskatchewan would start to see some recovery at this point. And that was certainly our view as we came into 2018. We expected 2018 to be sort of flat, and then start to pick up probably towards the latter part of the year, but that's clearly not happening.

We're seeing increased inventory in the Saskatchewan real estate market, and that's putting a little bit of pressure on prices as well as volumes. And so at this point, that will take us some time to work itself out and we don't see that happening for the balance of 2018. And so we think it will continue to impact us in the fourth quarter.

Stephanie Price: And in terms of ERS, you mentioned the recent ERS contract wins are in the design phase, can you talk about that rollout? And when they moved to the implementation phase and how we should think about revenue in that line?

Shawn Peters: Most of them do continue right now in the design phase. We will start to see them move into implementation, some later in this fall and more into 2019. So we haven't given specific guidance for 2019, yet, but that's when we would expect to see that revenue start to come in.

Stephanie Price: And, in terms of the margins in that division, can you talk a bit about the longer-term margin potential? And how you're thinking about that Technology Services division?

Shawn Peters: That's a space that we're new in and just getting established in. We've had these successful contract wins, and we're working to execute them. We'll be working over that same period of time to increase the speed and efficiency of our delivery. This is also a competitive space as well, so early on, we expect the margins to be lower than our normal registry operations margins. But over time, we would hope to see them improve. But initially, they'll be in the low double-digit margins, is what we expect for 2019.

Operator: (Operator Instructions)

Justin Keywood, GMP Securities.

Justin Keywood: On the outlook section, there's mention of the AVS or there's an expectation of continued growth. I'm wondering if we could get a bit more precise there in what magnitude this could be going into Q4 next year?

Shawn Peters: Into Q4 next year or...?

Justin Keywood: Next quarter, and going into next year?

Shawn Peters: Yes, for Q4 this year, again, we expect to see continued growth in that space. What we're seeing is the continued onboarding of new customers, but also organic growth, even in the AVS business with our existing customers. We've talked about before that we continue to see good opportunity in this market, but we'll also start to see that growth slow down as we get past 2019, as the onboarding of customers -- there's a certain number of options that we see in our pipeline, so it won't be the dramatic growth that we've seen in AVS over the last number of years, but will still be strong growth all through 2019.

Justin Keywood: So, call it, the next 15 months, is this like a double-digit growth business? Or high single-digit?

Shawn Peters: I don't think we've given that guidance yet, Justin. But would be certainly happy to answer that as we get a little further into 2019.

Justin Keywood: And, going back to the ERS, there was some commentary on implementing some of the contract wins from earlier this year. I'm just wondering if we should expect to see some continued wins pick up, just because there's been a bit of pause there? And, if it's a decision to work on implementation versus going after new contracts? And, how that dynamic works?

Jeff Stusek: I'd say there's no pause. There's a lot of work that's on our plate to implement the wins that we've announced. But our sales team continues to look for opportunities. And it's not an intentional pause in order for us to catch up. A part of it's market-driven as the opportunities get cultivated and exercised. So, I can't tell you what to expect, but we're not intentionally pausing, if that's the question.

Justin Keywood: And as far as region of opportunities, is the US still looking good?

Jeff Stusek: As I've said at the number of the calls previously, we're happy with our Ohio and Missouri announcements/implementations. We think that's a beachhead that we want to continue to focus on. It will not be our sole focus, but I would say the United States remains a target for this great application and service that we're running in Ohio and Missouri. So, we're going to continue to focus on that. But there are other regions, certainly, globally that continue to interest us, as well.

Operator: I'm showing no further questions at this time. I'd like to turn the conference back to Mr. Hackshaw for any closing remarks.

Jonathan Hackshaw: With no further questions, I would like to, once again, thank everyone for joining us on today's call. And we look forward to speaking with you again at our next call. Have a good day.

Operator: Thank you. Ladies and gentlemen, this does conclude today's conference.