TECSYS INC.
First Quarter FY2018 Results
Financial Analyst Call
Thursday, September 7, 4:30pm

Operator

Good afternoon, everyone. Thank you for standing by. Welcome to the TECSYS First Quarter Fiscal 2018 Results Conference Call. At this time, all participants are in listen only mode. Following the presentation, we will conduct a question and answer session. Instructions will be provided at that time for you to queue up for questions. If anyone has difficulty hearing the conference, please press star zero for operator assistance at any time.

Please note that the complete first quarter report, including MD&A and financial statements, were filed on SEDAR this morning, September 7, 2017.

Some of the statements in this conference call, including the question-and-answer period, may include forward-looking statements that are based on management's beliefs and assumptions. Actual results may differ materially from such statements. I would like to remind everyone that this call is being recorded on Thursday, September 7, 2017, at 4:30 p.m. Eastern Time. I would now like to turn the conference over to Mr. Peter Brereton, Chief Executive Officer of TECSYS. Please go ahead, sir.

Peter Brereton

Thank you. Good afternoon, everyone. We appreciate you joining us for today's call. Joining me today is Brian Cosgrove, our Chief Financial Officer. I'll start by summarizing the key events for the quarter. Brian will then review our Q1 financial results, and I'll then close with a few comments on our outlook for the remainder of fiscal 2018, followed by a Q&A session.

Earlier today, we issued our unaudited 2018 first quarter financial results, and a copy of those results is available on our website at tecsys.com. While the first quarter of our fiscal year is typically a slower period, we are pleased to have delivered record bookings for our first quarter. Contract bookings for the first quarter of 2018 reached $9.9 million, a 64% increase over the $6 million achieved in Q1 of 2017. Included in the contract bookings in the quarter is an additional distribution center installation for one of our largest and longest-standing customers. Like many of our customers, they have standardized on our platform and are deploying it throughout their system. We expect continued implementations in their other distribution centers.

We also added another provincial Liquor Control Board as a customer, the fourth to choose our solution. The initial implementation is at one primary distribution center, with the potential to expand throughout their system.

The fact that our solution is chosen by liquor boards is a testament to the ability of our software to be adapted to meet various industry requirements. Liquor boards require a high degree of tracking and traceability in their distribution systems, and our software allows them to do that efficiently with minimum scanning and product handling.

On the health care side of our business, we had no new contract signings. While we believe the uncertainty around health care legislation has largely lifted, and we expect those hospital networks that have delayed signing to reengage once the summer is over, we do continue to have success at increasing our penetration in our base accounts. A large hospital network, that is also our partner and the first to implement our operating room solution, continues to roll this out throughout its system.

Also in the quarter, another U.S. hospital network customer went live with our cath lab solution at one of its cardiac hospitals. We are particularly pleased with our success here as this installation can serve as a model site and drive further deployments of the cath lab solution. Although bookings were strong, it did not translate into revenue growth. And so to some extent, Q1 was a typical summer quarter in terms of financial results, although it was certainly untypical in terms of business activity. Brian will now provide some detail on our financials for the quarter.

Brian Cosgrove

Thanks, Peter. Revenue in the first quarter grew by 2.6% to $16.5 million compared to $16.1 million in the first quarter of fiscal 2017. Approximately 72% of our revenue in the quarter was generated in the U.S. The stronger U.S. dollar, offset by our hedging program, resulted in currency having almost no impact on revenue in the quarter.

In the quarter, services revenue declined slightly to $6.1 million from $6.2 million in the first quarter of fiscal 2017. Most of our service revenues were implementation assistance, which includes consulting, training and some product adaptation. With our backlog currently at $41.7 million, we expect that services revenue will remain healthy for the near term and increase as we bring on new business. Both proprietary and third-party product revenue were consistent year-over-year at $1.2 million and $1.5 million respectively.

Cloud maintenance and subscription revenue increased by 7% to $7.1 million from $6.6 million in Q1 '17. This revenue stream is mostly recurring in nature and grew as a result of higher maintenance revenue from maintenance on new license sales, price increases and higher cloud revenue. Gross margin for the first quarter of fiscal 2018 was $7.8 million or 47% of revenue compared to $7.6 million or 47% in the first quarter of 2017. For the trailing 12 months ended July 31, 2017, gross margins were at $34.3 million or 50% compared to $35 million or 51% for the same period ended July 31, 2016.

Operating expenses for Q1 '18 were $7.7 million, up 4.4% over $7.3 million in the same quarter in the last year. As a percentage of revenue, operating expenses were 47% of revenue this past quarter compared to 46% in Q1 fiscal 2017, again reflecting the increased sales activity.

Looking at our operating expenses on a trailing 12-month basis demonstrates our success of controlling them and the benefits of scale we are achieving. Operating expenses for the 12 months ended July 31, 2017, declined $26.6 million or 39% of revenue compared to $30.4 million or 44% of revenue in the previous 12-month period. The decline in operating expenses is explained by the recognition of prior year federal nonrefundable R&D tax credits of $4.6 million in Q4 of 2017, which reduced gross R&D expenditures by a corresponding amount. Excluding that tax credit, operating expenses were at $31.2 million or 45% of revenue.

Sales and marketing expenses were flat year-over-year at $3.6 million as were net R&D expenses, $2.5 million for Q1 '18 compared to $2.4 million in the previous year. G&A expenses, however, increased 17.6% to $1.6 million from $1.3 million in Q1 '17. The increase in G&A expenses is largely due to higher salaries and benefits, incentives and recruiting costs in comparison to the same period last year.

Profits from operations declined in the quarter to $65,000 from $243,000 in Q1 '17. The reason for the decline was the increased operating cost in the quarter, particularly as we applied additional resources to ensure the successful launch of the Cath lab point-of-use solution mentioned earlier by Peter. The solution is currently being deployed, and we expect it to become a model for future installations.

EBITDA was $687,000 for the first quarter of fiscal 2018 compared to $814,000 in Q1 of 2017, with the decline the result of the increased operating expenses, lower profit from operations in the quarter. Looking at EBITDA on a trailing 12-month basis, the number was boosted by the recognition of prior year federal nonrefundable R&D tax credit of $4.6 million. For the 12 months ended July 31, 2017, EBITDA was $10.2 million. Excluding that tax credit, the EBITDA would have been $5.6 million, a 21% decline over $7.1 million in the previous trailing 12 months. We ended the quarter in a strong position, with cash and cash equivalents of $23.2 million compared to $13.5 million at the end of fiscal 2017. I will now hand the call back to Peter.

Peter Brereton

Thanks, Brian. While we are coming out of a traditionally quiet quarter, the sales activity in the quarter and our trailing 12 months' results demonstrate that our strategy is working and our solutions are gaining significant traction in the market.

You'll notice the trailing 12-month bookings were up 12% over the prior trailing 12 months, and that's in spite of the fact that the Affordable Care Act confusion in the U.S. has continued to slow the health care market. We expect the increased bookings in this quarter, along with our solid sales pipeline, will translate into revenue in future quarters, while the continued rollout of our point-of-use solutions for the OR and cath lab will increase our penetration of our base accounts. As the changes in U.S. health care legislation become less of a concern, we also expect to see signings of new IDN customers.

One development I'd like to mention before taking questions is our recent partnership with Ryder, a Fortune 500 fleet management and supply chain solutions company. Ryder will be combining our technology with their supply chain solutions to serve the health care market. Ryder is the third partner working with us to capture large hospital networks, and each one is taking a different entry point to the market. We are looking forward to the increased exposure we will have with this new partnership. With that, I will turn the call over for questions and back to the operator.

Operator

Thank you. Ladies and gentlemen, if you would like to register a question, please press the one followed by the four on your telephone. You will hear a three tone prompt to acknowledge your request. If your question has been answered and you would like to withdraw your registration, please press the one followed by the three. And finally, if you are using a speakerphone, please lift your handset before entering your request. One moment please for our first question.

And the first question comes from the line of Amr Ezzat with Echelon Partners.

Amr Ezzat

I've got a couple of questions on the bookings. You mentioned that it's strong partly due to the -- a couple of new accounts, but I'm wondering if that's a one-off quarter where you have like just one account strongly contributing to that. Your Q1's typically the lowest, I guess, booking quarter. So going forward, do we expect bookings to stay flattish to up from these levels? Or do we expect it to decline given the strength in Q1?

Peter Brereton

I mean, that's a good question, Amr. I mean, our -- we're in this very strange situation right now, really where the traditionally slower growing part of our business is actually leading the growth, which is the complex distribution side. And certainly, if we look at bookings in the first quarter, the strength -- the strong bookings were largely from the complex distribution side. At the same time, we've definitely got sort of this pent-up demand sitting there in the health care side. I mean, we -- it's not like we laid off the health care sales team for the last year.

They've been continuing to connect with accounts and set their groundwork for future agreements and opportunities and so on. And so as we look at our pipeline over Q2 and Q3 and to some extent, on into Q4, the health care pipeline looks very, very strong. So at this point, our expectation is that sort of Q1 bookings just give us a good start to the year, but that, in fact, we -- at this point, we expect to see continued strong bookings. At the same time, lacking a crystal ball, all I can go by really is the size of the pipeline and the sales activity and try to project from there.

Amr Ezzat

Understood. So potential, I guess, for Q2 and 3 to have like strong contribution from both verticals is what I understand.

Peter Brereton

At this point, it certainly looks like that, yes.

Amr Ezzat

Okay. That's good to hear. And then, I guess, on the cost side of the equation, on the OpEx, just wondering what pace we could expect for fiscal '18. Are you still able to keep it flattish on a dollar basis? Or do we start to see you guys reinvest?

Peter Brereton

That you're saying in R&D or just general OpEx?

Amr Ezzat

Everything, sales, marketing, R&D and G&A.

Peter Brereton

I mean, at this point, we still intend to keep it fairly flat. I would say, if bookings come in at a significant level this year, then I would anticipate that we would begin to grow our cost within sales beginning in the fourth quarter. I don't see us growing it much before then. So we'd run sort of most of the year with pretty well flat OpEx, and it would really be going into next year that you'd -- or Q4 going into next year, we may start turning it up a bit, depending on how the year turns out. I mean, some of the lumpiness and increases we've had in OpEx over the last quarter or so has to do with some of the change in management, recruiting fees and so on. Brian didn't want to blame himself for the increase in OpEx in Q1, but when you make some changes, you end up with some temporary bumps up in the OpEx.

Amr Ezzat

Understood. Just a housekeeping item. You've updated your service revenue guidance on your MD&A to $12.8 million to $13.3 million, and that's up from last quarter where you guys were anticipating $11.3 million to $11.8 million. And at the same time, I think you guys reclassified your definitions of what caused you to service revenue. I'm just wondering, is that -- what is the normalized number? Like are you indeed seeing strong growth in tandem with the backlog and booking growth? Or is this just like the reclassification that's causing your revenue guidance -- your service revenue guidance to increase? Or we could speak about that offline as well if you...

Peter Brereton

Yes, that -- I mean, I'm just looking at that now. Some of that would be reclassification for sure because you're -- a portion of what used to be proprietary product revenue and used to sit up in license fees we've now reclassified down to the cloud maintenance and subscription number so that we could show all of the recurring revenue in a single line.

Since we know recurring revenue is sort of a key measure of the business, we've grouped all recurring revenue elements into that line, which, by definition, pulled some of what used to show up in the license fee line down into the recurring revenue line. So that would be the biggest part of that difference. At the same time, the strong bookings quarter that we had in Q1 definitely increased our confidence in some of the go-forward services numbers.

Amr Ezzat

Understood. It's just because it's like a 10% like bump sequentially. Okay.

Peter Brereton

Yes.

Amr Ezzat

Okay. And maybe one last one for me. On the pharmacy solution, is that still expected to go live early in the calendar year? Any updates there?

Peter Brereton

That is right on track. We are in -- this is always the stage where a project gets really interesting and sort of we're right at the -- in the final throes of doing final planning with them for go-live. But at this point, yes, it's right on track to go live in that time frame, and I certainly think they're going to hit that date.

Operator

Our next question comes from the line of Nick Agostino with Laurentian Bank Securities.

Nick Agostino

I guess two questions on my part. First, can you guys give an update with regards to the OneSprint? I think on the last conference call, you said you were going to do a little bit of a re-tweaking of the product based on client feedback. And I'm just wondering where that re-tweaking sits, if you guys are ready to re-roll out the product.

Peter Brereton:

Yes, Nick, we're in the process of doing that now. We have gone through a sort of an initial pass on that. We're actually sort of kicking it back into R&D for some further work. And it's really over -- it will really be close to the end of the year by the time we really sort of go into a relaunch on it. At the same time, the first sort of true OneSprint project did go live actually about 1.5 months ago quite successfully. So we're sort of doing a bit of lessons learned now with that client to see what we can learn from that process. And one of the larger new accounts that we signed in the first quarter signed on the basis of following the OneSprint model to achieve a rapid rollout. So we're -- even though we're sort of going back to the drawing board to improve it for a second round, we're actually finally starting to get some traction on the -- on our first launch.

Nick Agostino

Okay. That's -- it's good news. And then the second question, just I think you maybe touched upon it last quarter as well, but just given the cash in the balance sheet, you did allude to there are certain M&A areas that you are looking at in terms of products and then maybe geographies. Can you just maybe provide a little bit of an update if you've made any progress with regards to singling out companies that you might be interested in, just where the whole M&A picture stands? And I'll leave my question there.

Peter Brereton

I mean, we continue to look for good opportunities, and we're -- there are different product areas we're pursuing as well as different potential geographic opportunities. But we have not, at this point, come across anything that we're ready to talk about.

Operator

Our next question comes from the line of Justin Keywood with GMP Securities.

Justin Keywood

Just on the health care business, are you able to break down the contribution of total revenue in the quarter?

Peter Brereton

Off the top of my head -- yes, Brian's got it right here.

Brian Cosgrove:

Yes, health care for the quarter was $16.5 million.

Peter Brereton

No, that's the total.

Brian Cosgrove

Sorry. The health care was $6.6 million, 40%.

Peter Brereton

Yes.

Justin Keywood

That's good. And also for bookings?

Peter Brereton

Bookings was lower. We'll get you that number. I think just off the top of my head, health care was about 33% because I know it's the -- it's interesting, for 3 consecutive years, bookings were -- in health care were substantially ahead of actual revenue by percentage. And unfortunately, ever since the political changes down in the U.S., health care bookings have trailed percentage-wise compared to actual revenue.

Justin Keywood

Okay. And then just you were mentioning that a higher growth resuming in the health care after the summer. I'm just wondering, is there anything specific expected to happen there? Or is it just related to better seasonality and maybe less concern of the health care reform happening anytime soon?

Peter Brereton

Yes, first of all, by the way, Justin, we did check. And yes, it's about 33% of the bookings in the first quarter were in effect. Okay. In terms, yes, it's really now like I think the big concern around the Affordable Care Act really largely faded out in the May, June time frame. So we've seen activity and effort pick up around getting these projects moving forward again. It's just, yes, now you're -- I mean, it's just been summertime, and nothing moves that fast in summer.

So the -- all the actual bookings that closed in the summer had to do with sort of activity, sales activity that had been sort of quite active in the spring months. So we're now saying, as we go into fall, typically, this is when health care picks up for us. And certainly, it looks like the concern around the Affordable Care Act has abated, and the focus has shifted on to other subjects.

Justin Keywood

Okay. That's good to hear. And then are you noticing any change in the competitive environment as far as on the health care side? Are there any new competitors entering the space?

Peter Brereton

Not that we're seeing. It's really so far the same activity, I mean -- or the same lay of the land. And we've got individual point solution players continuing to compete with us in individual areas. But in terms of an end-to-end supply chain solution, we don't see anyone else in there. The deals that have not signed have simply not signed. It's not like they've gone with somebody else. We do know there was -- like on the ERP side of things, there is -- which we -- where we don't really play in the hospital space at all, Workday is really the new player there, and that's definitely impacting some of the landscape.

I mean, hospitals have been largely running on the larger networks, have been largely running on Oracle or what used to be the Lawson platform, now owned by Infor, and Workday is now definitely making some inroads there. But that's not the area we play in anyway. So that's just -- at this point, that's just a new potential back office for us to connect to.

Justin Keywood

That's helpful context. And then just finally, I noticed the Canadian revenue saw some softness at least compared to last year. Is that just typical lumpiness? Or is there something particular there to account for it?

Peter Brereton

No, that's just -- I mean, that's just the project ebb and flow, right? Like quarterly, the revenue mix between Canada and the U.S. ebbs and flows, and that continued this quarter. If you actually look at our last sort of 5 years, you pretty much see the percentage of the business that is U.S. and international is getting higher every year. And that -- I mean, certainly, at this point, we see that continuing.

Justin Keywood

Okay. And just maybe if you could expand. As far as the European business, I think you mentioned some points on the past conference call. Is there anything to update there?

Peter Brereton

Nothing really significant. I mean, we do more and more business internationally, but a lot of it is through -- still through North American headquarter companies. And over the last couple of quarters, we've done implementations in Israel and a couple of implementations in Europe, but through North American companies that just sort of send us over there to deploy various distribution centers.

Our work with -- and we've got a large client in Switzerland we continue to do a lot of work with. We did a pilot project in Denmark in the spring, which went very well. We're now in continuing discussions with some of the health systems there. But I would say no real breakthroughs there at this point, but it does continue to slowly grow.

Operator

And ladies and gentlemen, as a brief reminder, in order to register for a question, please press the one followed by the four on your telephone keypad. Our next question comes from the line of Hubert Mak with Cormark Securities.

Hubert Mak

And you guys talk about a strong pipeline here. Can you somehow quantify for us like how that's grown maybe year-over-year, whether size, how about the number? Just can you kind of give us any color on that would be great?

Peter Brereton

Yes, it's -- I mean, we were just looking today at the pipeline over the next 6 months. I mean, our 6-month pipeline today is -- last I looked at it, it was up about 40% from the same time last year.

The thing is, these numbers get a bit deceiving because, in fact, about a year ago now, basically, health care stopped buying and the pipeline sort of had just continued slowly building.

So the outstanding pipeline numbers keeps looking more and more impressive as more goes into it without actually signing. So it's a little bit hard to have real confidence in the timing of that pipeline. But as we see it today, the pipeline over the next -- our Q2 and Q3, looks to be about up 40% from last year.

Hubert Mak

Okay. And then you're talking about -- you just alluded to like the pent-up demand in health care. Any idea how far along these deals are, like now that we're sort of delayed? Are these in like the -- just waiting for signatures? Or are these in the early outset? Can you just kind of give us an idea, like how far along some of these are?

Peter Brereton

Yes, we've got -- I mean, I can't be overly specific there, but we've got several agreements where we've been notified that we are the selected player, and we've got scheduled appointments with legal and -- to work through contracts and so on, with several of them with expectations that they would kick off projects sometime this fall, actually have feet on the ground, beginning implementations sometime in this fall. So we are near the end on a number of these. At the same time, as we've learned, until you have the actual signatures, it's sometimes hard to call.

Hubert Mak

Right. Okay. Understandable. And then in the context of the FX move here, how strongly it moved here in terms of Canadian versus U.S. And you guys put in arguably a 3% growth here. Like what's the thought around the sort of 12% annual growth target here? Like do you guys think you guys can hit this for this year in the context of the FX as well as what you guys put out in Q1?

Peter Brereton:

I mean, as you know, we don't particularly give revenue forecast. At the same time, we certainly are continuing to build the business and build our go-forward planning around the same sort of 8% to 12% growth plan. If you look at the last few years, we've -- I mean, last year, we did next to no growth. But if you look at the last 3 or 4 years or whatever on a more normalized basis, we're around 13%. And going forward, we certainly see a return to normalcy. I mean, we think the sort of the first year of the Trump administration was an aberration in the marketplace, and we're -- we certainly -- it certainly looks at this point like we're getting back to normal. And if we look at our first quarter bookings being up where they are, that's certainly a very good start to the year.

Hubert Mak

I mean, you -- can you remind me, you guys do hedge your revenue?

Brian Cosgrove

Yes, we do. We hedge a portion of it. And we hedge 50% of our estimated U.S. revenue 6 months out. So we have -- so part of the, I guess, the decreases in the U.S. dollar has been hedged for at least the next 6 months, so we'll see a partial impact of that in the short term.

Hubert Mak

Right. Okay. And then lastly, just looking a bit at the margins here, is this something that, I guess, it will continue to increase similar to last year, or you will look to, again, to sort of a double-digit range exiting Q4? Is that how I think about it in terms of like, I don't know, the seasonality, but just sort of the margin profile?

Peter Brereton

You're talking about EBITDA?

Hubert Mak

Correct.

Peter Brereton

Yes. I mean, we typically -- I mean, if you look at our last -- yes, and you go back and look at our last 5 years, I mean, Q1 is always a squeaker. And then the margins move up during the year. And typically, Q -- I mean, it varies year-by-year, but typically, Q2, 3 -- I mean, Q4 is typically the strongest. Q3 -- or Q2 and Q3 are typically more in the mid-range kind of thing. So you're right. I mean, typically, it moves up during the year, and Q4 is where it really shines. I mean, some of this is just the professional services side of things. February, March and April have no vacations in them at all.

I mean, there's no Christmas in there. There's no American Thanksgiving, there's no whatever. I mean, there's -- I mean, I guess there's Easter in there somewhere, but that's one day and everybody's back to work. Whereas the other quarters tend to get entire weeks or sometimes a couple of weeks get taken out by a vacation which drags down the numbers quite a bit.

Operator

And gentlemen, there are no further questions at this time. Please continue with your presentation or closing remarks.

Peter Brereton

Great. Thank you, everyone. Thank you for taking the time to join us today. And as always, if you have any additional questions, please don't hesitate to call Brian or myself. And we'll look forward to talking to you in -- at the beginning of December when we release our second quarter results. Thanks very much. Have a great evening. Bye for now.

Operator

Ladies and gentlemen, that does conclude the conference call for today. We thank you for your participation and ask that you please disconnect your line.

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