TECSYS INC.
Third Quarter FY2018 Results
Financial Analyst Call
Friday, March 2, 2018 @ 8:30am

Operator

Good morning, everyone. Thank you for standing by. Welcome to the TECSYS Third Quarter of Fiscal 2018 Results Conference Call. At this time, all participants are in a 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 a question. If anyone has difficulties hearing the conference, please press Star 0 for operator assistance at any time.

Please note that the complete third-quarter report including MD&A and financial statements were filed on SEDAR yesterday evening, March 1, 2018.

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 has been recorded on Friday, March 2, 2018 at 8:30 am, 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 and good morning. We appreciate you joining us for today's call. Joining me today is Brian Cosgrove, our Chief Financial Officer. I will start by summarizing the key events for the quarter. Brian will then review our Q3 financial results. And I'll close with a few comments on our outlook for the remainder of fiscal '18. We'll then have a Q&A session.

Yesterday evening, we issued our unaudited 2018 third-quarter financial results. In the third quarter of fiscal '18, we were successful in increasing our penetration into our base accounts on both the healthcare and complex distribution sides of the business. However, as we've said on previous occasions, the sales cycles for our solutions is long and will result in lumpy results.

The wins we did have in the quarter proved the effectiveness of our solutions. One was from a client that is a large healthcare system with 93 hospitals in its network. With this hospital network, we were already supplying them with a comprehensive distribution solution.

But last quarter, they contracted with us to supply an operating room point-of-use solution inside one of their hospitals. We think this is a good start.

Another client, a large university hospital system, continued to invest in our point-of-use pharmacy solution. And on the complex distribution side, one of our largest clients expanded their relationship with us with an additional contract.

There is significant potential to grow our presence in each of our base accounts. With our large complex distribution clients like Canon and the Caterpillar dealer network, for example, we've been able to achieve significant expansion throughout their distribution network.

There are similar opportunities on the healthcare side in terms of distribution centers, and as well now with the ability to work in hospital with our clients by providing point-of-use solutions like our OR, cath lab or pharmacy products.

In the quarter, we signed a contract with a new US healthcare network system comprising of 11 hospitals. They will be implementing our consolidated service center solutions to manage their internal supply chain. The lower signings of new healthcare accounts is reflected in our results with flat year-over-year revenue.

We are, however, continuing to see strong interest on the healthcare side and are now seeing these translate into stronger sales in Q4, as I will comment on later. Brian will now provide some details on our financials for the quarter.

Brian Cosgrove

Thanks, Peter. Revenue in the third quarter declined by less than 1% to $17.2 million compared to $17.4 million in the third quarter of fiscal '17. As Peter mentioned, this is a result of our long sales cycles and the delayed finding of new accounts.

In the quarter, about 59% of revenue was generated in the US. The lower exchange rate for the US dollar compared to an earlier - to a year earlier also impacted our results. On a constant currency basis, revenue would have been $17.8 million in Q3 '18; a 2% increase over Q3 '17.

Products represented 17% of total revenue in Q3 ‘18. Cloud maintenance and subscription represented 38%. And professional services represented 45%, compared to 18%, 38% and 44%, respectively, in Q3 ‘17.

In terms of our revenue segments, professional services revenue increased by 6% to $7.3 million from $6.9 million in Q3 ‘17. The increase was a result of higher customization services offset somewhat by lower implementation of service revenue. With our backlog currently at $42 million, we expect that services revenue will remain healthy for the near term and increase as we bring on new business.

Proprietary products revenue declined by $616,000 year-over-year in Q3 ‘18 to $930,000. This largely was a result of a decline in license revenue of $399,000 due to lower new contract signings. Third-party product revenue increased by 17% year-over-year to $1.9 million as a result of increased radio frequency and storage equipment sales.

Cloud maintenance and subscription revenue was flat year-over-year at $6.6 million in the quarter. This revenue stream is mostly recurring in nature. And while we achieved higher maintenance revenue, this revenue stream was affected by a currency headwind.

Gross margin for the third quarter of fiscal 2018 was $8.1 million or 47% of revenue compared to $8.9 million or 51% in the third quarter of 2017. Operating expenses for Q3 ‘18 were $7.3 million, 4% lower than $7.6 million in the same quarter last year.

As a percentage of revenue, operating expenses declined to 42% of revenue compared to 44% in Q3 fiscal 2017. The decline this past quarter was a result of lower sales in marketing and R&D expenses. The decrease reflects our ongoing strategy to control and lower operating costs.

On a trailing 12-month basis, excluding the recognition of $4.6 million of prior-year federal non-refundable R&D tax credits, operating expenses declined by 2% to $30.7 million compared to $31.4 million for the 12 months ended January 31, 2017.

Looking at expenses in detail, sales and marketing expenses decreased by 9% to $3.3 million from $3.7 million in Q3 ‘17, reflecting lower salaries and benefits, incentives and travel expenses. G&A expenses were increased by 9% to $1.6 million in the quarter compared to $1.5 million in Q3 ‘17. Higher G&A salaries and benefits and consulting expenses were the reason for the increase.

Net R&D expenses decreased to $2.4 million in Q3 ‘18 compared to $2.5 million in the same period last year. We achieved profits from operations of $845,000 in the third quarter of fiscal ‘18 compared to $1.3 million in the same quarter last year. The decrease is the result of lower sales; a decrease in margin due to the product mix and the impact of foreign exchange which negatively impacted profits by $400,000.

On a per share basis, we achieved basic and diluted earnings of 6 cents compared to 7 cents per quarter in Q3 ‘17. EBITDA declined by 32% in Q3 ‘18 to $1.3 million compared to $1.9 million in Q3 ‘17. The decrease is a reflection of the lower sales; a decrease in margin due to the product mix and the impact of foreign exchange. Adjusted for currency, the decline was 12%.

On a year-to-date basis, EBITDA was $4.2 million; a 13% increase over $3.7 million for the nine months ended January 31, 2017. Adjusted for currency, the increase was 24%. At the end of the quarter, cash and cash equivalents, as well as long-term investments in the form of redeemable GICs, totaled $20.7 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. To summarize despite flat revenue in the past quarter, we’re confident that fiscal ‘18 will be a solid year. We continue to have strong interest in our solutions on both the healthcare and complex distribution side and have a sustainable backlog. So far, the fourth quarter is off to a very strong start, with the signing of a new IDN and several base account projects.

Historically, our IDN customers would initially start by purchasing our solution to address a specific area and then expand over time. In this case, this new IDN customer recently signed; went ahead with an enterprise agreement for all of our modules except for pharmacy.

We are pleased with our continued discipline on operating expenses, which as Brian mentioned, contributed to a 13% increase in EBITDA on a year-to-date basis or 24% of adjusting for currency swing, against the backdrop of lower revenue growth. With that, I will turn the call over for questions and back to the operator.

Operator

Thank you. Ladies and gentlemen, to register a question over the phone, press 1-4 on your telephone keypad. Once again, to register a question over the phone, press 1-4 on your telephone keypad. And our first question comes from the line of Amr Ezzat of Echelon Partners. Please proceed with your question.

Amr Ezzat

Good morning, gents.

Peter Brereton

Good morning.

Amr Ezzat

Peter, on the growth sides, can you provide us with more colors on the dynamics there on a segmented basis? Is it still the same as the last couple of quarters whereby healthcare continues to suffer and complex distribution is growing, or where both verticals sort of flattish during the quarter? I'm just trying to get a sense of where we are in the healthcare segment.

Peter Brereton

Yes. I mean I would say healthcare has remained pretty much flat to even a slight decline, whereas complex distribution has continued to show some growth. I mean as we - you know, as I mentioned there towards the end of the call, I think for us that - you know, we are seeing the thought starting to happen. So, you know, I think that's about to reverse itself and get back to sort of healthcare being the leading growth side of the business.

You know, this - you know, we did add one new IDN in the third quarter. And now, we've added a very large contract with an IDN in the fourth quarter, you know, as I mentioned, because of the fact that they decided to sort of start with a much larger project than most of the IDNs typically start with. So, you know, we think that's about to shift gears again. But, you know, for Q3, your statement is accurate.

Amr Ezzat

Okay. Then, I guess just on the - what you mentioned about fiscal Q3, like last quarter, you mentioned, I guess, like some new contracts, like the IDN and several base accounts add-on. Did we see these numbers like flow into your sales in Q3? Or do we see some of that in Q4? I'm just wondering on the timing of that.

Peter Brereton

No. The ones that I mentioned where I say, you know, we signed a large new account, as well as several base add-ons, that is a reference to the beginning in Q4, like we definitely had some pretty major deal slippage out of Q3 into Q4.

Amr Ezzat

Oh okay.

Peter Brereton

But the deals that slipped out of Q3 into Q4, you know, I'm happy to say, did all sign in February, so - which isn't always the case. Sometimes, when you see deal slippage, it turns into a very long slippage. But in this case, it didn't.

Amr Ezzat

Understood. Then, on that new large IDN, congrats. But I maybe have missed out. Did you guys mention the size of the contract there?

Peter Brereton

No, we didn't. And we're not disclosing the size. But, you know, it is several times larger than our typical IDN contract, because of the fact that they decided to start with such a large engagement.

Amr Ezzat

Then, if I want to, perhaps, like compare its - relative to other IDNs or other distant clients, where does that sort of sit? Is it like a top three?

Peter Brereton

In terms of initial start, it would probably be - well, in fact, it would definitely be our largest-ever initial win, you know, and really because of the fact, as I say, that they've decided to, you know, start with so much at once.

Like many of our IDNs decide to start with the consolidated service center, and then later add delivery management to our - you know, maybe start with one hospital OR and then spread from there. In this case, they decided to just negotiate a comprehensive agreement to do all of their network point-of-use locations.

Amr Ezzat

Understood. That's great. On the OpEx side you're now running at $7.3 million. I know some of it is driven by R&D credits. But even when I'm looking at sales and marketing, the headcount there is lower than last year. Then, I'm just wondering, is that level sustainable? Or at what point do we start to see you guys layer on some investments?

Peter Brereton

Yes. You're going to start to see - I mean, you know, some of this is - needs to happen in sync here. I mean you are going to start to see some rising sales and marketing expense.

You know, we brought in the new Chief Marketing Officer, Laurie McGrath. She started at the beginning of January. She's doing a complete analysis of our marketing needs and will be looking to launch some more aggressive marketing programs in coming months.

And we also do need to add both sales, you know, sales rep headcount, as well as some leadership on the sales side. So you will see that, you know, start to ramp back up.

Our intention, however, is to continue to control it as a percentage of revenue and continue on our path towards moving that number down, you know, over the next several years as a percentage of revenue. But in real dollar terms, it's got to start to move up somewhat.

R&D as well; R&D will need to move up as we go into next fiscal year but, again, not substantially relative to the revenue side of things.

Amr Ezzat

Understood. You mentioned your pharmacy solution. It was meant to go live early in the calendar year. Any updates there?

Peter Brereton

At this point, they are intending to go live in May; so that has moved somewhat. There is a significant effort there in - really on the client side, in terms of really certifying the data.

They need sort of for their own pharmacy team to go through all their data and make sure all the, you know, various drug codes, and correlations, and substitutions, and so on are all accurate, before they flip the switch and go live. So, they're going through that phase now. And the intention, at this point, is to go live in May.

Amr Ezzat

Then maybe one last one for me, we've chatted on this before on - there's been a lot of talk on Amazon entering the hospital supply business. I'm just wondering what your thoughts are there, and how did it - or what its impact, you guys, at all?

Peter Brereton

Yes. I mean the hospital supply business has been dominated for, you know, literally decades by sort of, you know, the big four, you know, Cardinal, Amerisource, Owens & Minor and what's the other one? I'm forgetting one.

Amr Ezzat

McKesson.

Peter Brereton

McKesson, right? Yes. And Amazon is - you know, but those distributors operate, first of all, on actually quite slim margins. And many of them over the years have built up their own brands. And at the clinical level, there's pretty strong loyalty to some of those brands.

So, you know, I mean I have great respect for Amazon; an amazing company. In this case, they've got a - they definitely have a long hard fight on their hands. They're up against some very established players that have very strong loyalty in that market.

In terms of us, there's really no impact on us. I mean there's no - from our standpoint, we don't really care where hospitals buy their supplies or how they buy their supplies.

We just - you know, our focus is on helping them to know what to buy and when to buy it, and then managing it, and moving it all the way through the hospital supply chain right to a point of care and onto a patient bill. So that's our focus. And so, we don't see any impact on our business.

Operator

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

Nick Agostino

Yes. Good morning. I guess I have two questions, first on the IDN side. Can you maybe speak to - I think, if I recall correctly, in fiscal Q2, you had no wins. And now that we're in the second half of the fiscal year, we've seen two nice wins.

Can you maybe talk a little bit about how your conversations with the customers? Has the mood changed, just given what's happened in the US market?

And more specifically, you know, are these wins just basically a case of the sales cycle, as you said, is sometimes long and the wins were due, or you are seeing a shift in the mindset of your customers?

Peter Brereton

No. We feel like we're seeing a shift in the mindset of our customers. I mean the activity is up, our pipeline, I mean, even with this large new one we've just signed, sort of now officially out of pipeline and into the customer side of things. We still have a very sizable pipeline. And they're very active.

So, it seems as though the sort of the big fear over, you know, the end of Obamacare has subsided. And the focus is back on dealing with the sort of the shifting realities of US healthcare, which are all about getting costs under control and, you know, evidence-based medicine up to provide better results at lower cost.

So, I mean we think it's a good shift. We think the mindset is back where we need it to be. And we think these wins are just the sort of the early indicators of that shift.

Nick Agostino

Okay. And in terms of what you've said, the pipeline, can you maybe talk - just give a sense of how big the pipeline is right now, in terms of how many prospects you have? And I think, in the past, you were probably north of 20. Can you maybe - on a number of that nature, can you quantify which ones you see as being early stage versus late stage?

Peter Brereton

Sure. We're - that number would be down at this point. I mean we're seeing sort of - I mean, right now, we're really actively engaged with about a dozen new account healthcare players. At the same time, the sort of the opportunities that we are discussing with them are averaging sort of three to four times the typical opportunities we've seen in the past.

We are also putting more emphasis on our customer base, as with some of these new products we've rolled out in the last, you know, few years, open up tremendous opportunity in our customer base.

You know, one of the agreements we signed in the third quarter, you know, was a very nice contract, and yet it was for just one hospital out of a 92-hospital network. You know, so we're sort of looking at that and saying, "Okay. The base account side is now a very large opportunity. So we're putting more focus on that as well."

So, I would say total quantity of new accounts; less size; substantially larger. You know, in terms of phase, there is about probably four or five of them that right now that are right near the end of a sales cycle.

Nick Agostino

Okay. That's very helpful. And then, just switching gears, a similar conversation around complex distribution. I noticed there was, I think, no mention in the MD&A specifically.

Obviously, it was a big driver of growth momentum leading up to fiscal Q3. I think you said in the quarter, it was slightly up. Can you just maybe give us a little bit more color in terms of - when you say slightly up, how is that momentum looking relative to historical?

Peter Brereton

Momentum is looking decent. It definitely took a bit of a breather, I would say, in Q3 though, from the standpoint of, you know, there was no sort of sizable new account wins in complex distribution and so on; whereas, you know, to our surprise - I mean typically Q1 for complex distribution is very dry. And yet, you know, they knocked it over the park in Q1. So it definitely took a bit of a breather in Q3.

But it doesn't look like there's any real change in momentum there. I mean we're seeing some quite sizable opportunities. We're seeing a lot of activity around the eFulfillment and, you know, companies needing to modernize their supply chains to sort of deal with, for lack of a better word, the collapsing retail landscape.

I mean there's a lot of companies that are dependent for years on retail to get their goods to market. And now, sort of retail is not in great shape. And they're building new channels to market. So that's driving a lot of changes in the supply chain. So, you know, we're confident that that business is in pretty good shape. On our - in terms of year-to-date, they're up - you know, they're already up about 25% in terms of bookings over the full year last year. So we think that's looking decent.

Nick Agostino

Okay. And just last - just tagging onto that question, how has momentum looked as we start fiscal Q4, specifically on complex attribution?

Peter Brereton

Again, looking good. You know, the complex distribution sales cycle moves a lot faster than healthcare, of course. So, you know, sometimes you don't know until you're quite near the end of the sales cycle, whether you're in fact a winner or that dreaded, you know, second-place choice.

So, you know, it's a little harder to predict. Healthcare, we typically know sort of months ahead of time that we're the selected winner. And it just goes through a very long contract cycle.

But, you know, at this point, we're certainly expecting the complex distribution will end the year, you know, up substantially, probably 50% or something like that in terms of bookings over last year. So we think it's in good shape.

Operator

And once again, to register your question, press 1-4 on your telephone keypad. And our next question comes from the line of Justin Keywood of GMP Securities. Please proceed.

Justin Keywood

Thanks for taking my call. I was just looking to clarify. So the hospital that expanded within the quarter, that was the $1.3 million sale to one hospital, or am I reading that wrong?

Peter Brereton

No, that was - that particular sale was a - I think you might be mixing up the new win because we signed a new IDN in the third quarter. And we also signed a contract with an existing account, you know, to add a hospital, you know, to implement point-of-use in that hospital. Now, the contract wins, they were not that far apart though in size. I mean we're not disclosing the amounts. But they weren't that far apart.

Justin Keywood

Okay. And the - the hospital that expanded in the quarter though, they had 93 hospitals, is that correct?

Peter Brereton

That's right. That was the hospital network that's already using us as their sort of supply chain backbone to manage, you know, their centralized purchasing and distribution. And they decided to begin to bring us in on the point-of-use side. And they're starting with one hospital.

Justin Keywood

All right. So obviously, a strong opportunity to expand there.

Peter Brereton

We certainly hope so. We're pretty excited with that opportunity.

Justin Keywood

Okay. And then, on the proprietary sales in the quarter, I understand, you know, some lumpiness. But it seems to be kind of a multi-year low. I'm just wondering if there is anything else particularly that contributed to that.

Peter Brereton

Sure. It contributed to what?

Justin Keywood

The proprietary sales decline?

Peter Brereton

Yes, I mean that's just - I mean we literally just had - you know, we had several sizable proprietary sales slipped out of the quarter. So, you know, unfortunately, it's going to make for some real lumps and bumps in the numbers here. But the accounts that we thought we're going to close in Q3 and would have made for some nice smooth numbers, instead signed in the early weeks of Q4.

So, we ended up with a very low proprietary number because, you know, most of our proprietary sales are turned into revenue in the same quarter in which they're signed. So you see the impact, you know, almost immediately. And those numbers slipped out of January and into February. And that did it.

Justin Keywood

Okay. And then, just looking into Q4, should we maybe expect a, you know, similar level as in Q4 of last year then?

Peter Brereton

You know, I have to look at the comparables in detail. But I mean from - let me just look here. You know, I mean I don't want to give out advanced numbers, Justin. But let me just say that if that's where we ended in Q4 this year, I'd be quite disappointed, based on the February we've seen.

Justin Keywood

Okay. That's helpful. And then, just on the tax or R&D adjustments that happened in Q4 last year, there's obviously a large benefit. Any idea of - if we should see that in Q4 this year and what the magnitude might be?

Brian Cosgrove

No. That was a one-time adjustment of prior-year tax credits. So that was just a one-time adjustment. So, you won't see that this year.

Justin Keywood

But they're still deferred tax credits on the balance sheet to be used in future periods...

Brian Cosgrove

Yes, they're still to be used. They already existed. So, we had tax credits that were not yet on the balance sheet. And as our prospect of the ability to monetize them in the future, we booked them in our balance sheet, so they existed prior to that. But they just weren't on our balance sheet. And so, we did a one-time adjustment in Q4 '17. But that's for prior year. So, that's already reflected in the numbers. So, you won't see a big adjustment this year.

Justin Keywood

Okay. That's helpful. Thanks for taking my questions.

Peter Brereton

Okay. Thanks, Justin.

Operator

And there are no further questions at this time.

Peter Brereton

Okay. Well, thank you, everyone. Thank you for taking the time to join us. And as always, if you have additional questions, please don't hesitate to give Brian or I a call. And we will look forward to talking to you again when we report our Q4 and year-end results. Thank you.

Operator

Ladies and gentlemen, that concludes the conference call for today. We thank you for your participation and ask that you please disconnect your lines.

***** END *****