

TECSYS INC.
Fourth Quarter FY2018 Results
Financial Analyst Call
Friday, July 6, 2018 @ 8:30am

Operator

Good morning everyone. Thank you for standing by. Welcome to the TECSYS' Fourth Quarter Year End 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 questions.

Please note that the complete annual and fourth quarter report including MD&A and financial statements were filed on SEDAR after market close on July 5, 2018. All dollar amounts are expressed in Canadian currency, are prepared in accordance with international financial reporting standards.

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 Friday, July 6, 2018 at 8:30 AM Eastern Time.

I would now like to turn the conference over to Mr. Peter Brereton, Chief Executive Officer at TECSYS. Please go-ahead sir.

Peter Brereton

Thank you and good morning everyone. We appreciate you joining us for today's call. Yesterday, after market close, we issued our fiscal 2018 fourth quarter and year-end financial results and a copy of those results is available on SEDAR.

Joining me today is Berty Ho, our interim CFO. Berty has been TECSYS' CFO from 1998 until last year and has recently returned to the role on a temporary basis.

For today's call, I'll start by summarizing the key events of fiscal '18 and reviewing our financial results. Berty will walk us through the financials in more detail. I'll then close with a few comments on our outlook followed by a Q&A session.

Fiscal 2018 was very much a year in two parts. In the first half of the year, our results were bolstered by strong sales in the complex description business, offsetting slowness in our U.S. health care business. In the second half, our health care business began to return to its pre-U.S. election activity. In fact, looking at bookings, first half was two thirds complex distribution, one third health care and the second half was almost precisely the inverse. Overall, it was a solid year with record revenue and for the 10th consecutive year increased dividends to our shareholders.

Total contract value bookings for the year reached a record at \$48.1 million, a 13% increase compared to \$42.6 million booked in fiscal 2017. We added 12 new accounts over the course of the year. Nine of the contracts were in complex distribution. We concluded the addition of a fourth provincial liquor board as well as a Caterpillar dealer in line with our core strengths in the sector. One of these agreements was signed on a software-as-a-service model and another was signed through a channel partner.

Our contract bookings in the fourth quarter of fiscal 2018 really demonstrated how our momentum increased through the year. We achieved \$14.7 million in bookings in Q4, a 33% increase over the \$11.1 million of Q4 2017. This growth reflects the return of our health care business.

Uncertainty around health care legislation in the U.S. impacted momentum in our health care division in the first half of fiscal '18, resulting in no new contracts being received from hospital networks. Through this period, however, we continued to engage with hospitals and our pipeline of potential customers remained very strong. That pipeline began to convert into actual customers in the second half of the year and resulted in the signing of three IDNs, one in Q3 and two more in Q4.

With one of the IDNs, we signed a \$6.2 million contract, the largest we've ever signed with a health care system. This network is not the largest of our hospital customers, but the unique way they engaged us speaks to the leadership position we have established in the industry.

Other hospitals usually begin to work with us by putting our solution in one part of their facility and then build out from there. In this case, the customer did their research, visited point-of-use implementations at other hospitals and then contracted with us to put in place solutions at all of their network locations rather than doing a slow rollout.

It's important to add that along with this strong flow of new business, we maintained a book-to-bill ratio of 108% overall for fiscal 2018. For the fourth quarter of the year, it was a very healthy 115%.

Berty will now provide some details on our financials for the year and the quarter.

Berty Ho-Wo-Cheong

Thanks Peter. Total revenue in fiscal year 2018 was \$70.7 million, up 3% over \$68.4 million achieved in fiscal 2017. On a same currency exchange basis, revenue grew by about 5%.

In the fourth quarter of fiscal year 2018, total revenue was \$18.9 million, about 2% higher than Q4 2017 when we achieved \$18.4 million. On a same currency exchange basis revenue was up by 6%.

At the end of fiscal 2018, recurring revenue amounted to \$26.2 million or about 37% of revenue. Proprietary product revenue was \$6.9 million in fiscal 2018, 4% lower than the \$7.2 million in fiscal 2017. This is due to the decline in proprietary hardware deliveries in the year.

For the quarter, we saw a 16% increase in proprietary product revenue to \$3.1 million as a result of increased proprietary software license revenue. Third-party products revenue was \$6.8 million in fiscal year '18, even with fiscal year 2017.

For the quarter of fiscal - for the fourth quarter of fiscal 2018, we had an 11% decline of third-party product revenue to \$1.9 million from \$2.2 million in Q4 '17 as a result of lower third-party license and label revenue. We decided to exit the label business in August 2017. In fiscal year 2017, the label business contributed for about \$600,000.

Cloud, maintenance and subscription revenue was \$27 million for the year, 3% higher as a result of increased proprietary maintenance contract compared to fiscal 2017. For the quarter, cloud, maintenance and subscription revenue was \$6.9 million in Q4 2018, the same as the previous year.

Increased customization and implementation services revenue was reflected in a 9% increase in professional services revenue in fiscal 2018 to 20 points - \$27.8 million compared to \$25.6 million in fiscal 2017.

Gross margin for fiscal year 2018 was \$34.7 - sorry, \$34.9 million, a 2% increase compared to \$34.2 million in fiscal 2017.

The increase is a result of increased professional services and maintenance revenue where we achieved margin of 50%. The gross margin as a percentage of revenue was 49% in fiscal 2018 compared to 50% in fiscal 2017. Fourth quarter fiscal year 2018 gross margin was \$9.6 million or 51% of revenue compared to \$9.4 million or 51% of revenue in the previous year.

Total operating expenses for fiscal 2018 was \$30.6 million, 17% higher than \$26.2 million in fiscal 2017. However, when you add back the \$4.6 million of Canadian federal and nonrefundable R&D tax credit recognized in Q4 of 2017, operating expenses were actually down by 1%.

Looking at our operating expense segments, sales and marketing expenses were down 4% while G&A expenses were increased by 7% largely driven by higher salaries and benefits and increased recruitment cost. R&D expenses increased to \$9.8 million from \$5.3 million in fiscal 2017. This increase is a result of the \$4.6 million R&D tax credits mentioned above.

EBITDA in fiscal year 2018 was \$6.5 million, down from \$10.4 million in fiscal 2017. Adjusting for the impact of the R&D tax credit in fiscal 2017 mentioned above, EBITDA would be up 12%. In fact, if you adjust for the exceptional R&D tax credit as well as the currency headwinds, EBITDA rose 28% year-over-year.

Looking at EBITDA on a quarterly basis, we generated \$2.3 million in Q4 2018 compared to \$6.7 million in Q4 '17. After the adjustment of the R&D tax credit in fiscal 2017 mentioned above, EBITDA would be up 12%.

Net profit for fiscal year 2018 was \$3.9 million or \$0.30 per share compared to \$6 million or \$0.49 per share for fiscal year 2017. During the fourth quarter fiscal 2018 net profit was \$1.8 million or \$0.13 per share in Q4 2018 compared to \$4.8 million or \$0.39 per share for the same period in fiscal year 2017. Once again, to understand these numbers you need to adjust for the exceptional R&D tax credits.

We ended 2018 in a strong position with cash and cash equivalent as well as redeemable long-term investments of \$23.5 million, an increase from \$13.5 million at the end of our previous fiscal year. We believe this gives us a lot of flexibility in deploying capital.

As Peter mentioned, based on the continuous progress achieved in 2018 and our expectations of continued success, the board decided last November to increase our dividend by 11% to \$0.20 per share annualized, the 10th consecutive year in which we have increased dividend.

I will now turn the call over to Peter Brereton to provide some outlook comments.

Peter Brereton

Thank you. Thanks, Berty. In fiscal 2019, we are looking forward to the return of health care clients and delivering growth from both of our primary business sectors. The increased engagement of health care companies was evident in our recent user conference in June where attendance from hospital network customers increased by 50% compared to our previous user conference.

It seems that after approximately 18 months of uncertainty around U.S. health care legislation, the fears of radical change have subsided and hospital executives have begun to refocus on the need for cost savings and efficiencies in the face of relentless pressure from payers and the need to maintain margins in the face of increased operating costs.

In June, we hosted our annual user conference, Smart Vision 2018 in Orlando, Florida. At the conference, current users reported savings from implementing our solutions and benefits with rapid payback periods. And other noted that with our solution they were able to reduce their inventory by 30% and increase space availability by 25%. It is important to note, however, that the health care sales cycle is long, about 18 to 24 months and we don't expect this to change very much despite pent-up demand.

On the health care side, our pharmacy point-of-view solution is one that is creating a lot of interest among our customers from its potential to increase compliance while reducing costs. The first implementation is underway as we have mentioned before at a major university hospital and we expect it will go live in September.

Recently, TECSYS won a design competition from the Supply Chain Advancement Network in Health or SCAN Health whose mission is to address key problems, challenges and opportunities of high strategic importance for health systems in Canada and around the globe.

We are very pleased that SCAN Health selected TECSYS for the Alberta Health Services' perioperative services design competition. This represents additional validation of the TECSYS solution to improve the performance of perioperative practices. The judges assessed the competitive solutions - sorry, the judges that assessed the competitive solutions were composed of an international panel operating in the health care supply chain space.

We expect in-hospital solutions will be growing as a part of our business in the upcoming years. Innovation like this in health care as well as complex distribution will continue to be core to how we operate.

We were pleased to again be named this past May as a visionary by Gartner on their magic quadrant for warehouse management solutions, a position we've held since 2010.

I'm also pleased to announce the appointment of Mark J. Bentler as Chief Financial Officer. Mr. Bentler will succeed our interim CFO, Berty Ho-Wo-Cheong, Vice President of Mergers and Acquisitions and former CFO effective September 17, 2018. We are thrilled to welcome Mark to TECSYS. He brings a solid track record of leading in growing companies within the technology space along with an expertise in cross-functional leadership. We look forward to his contributions to our growth.

With that, we will open the call up to questions. Thank you.

Operator

Thank you. Ladies and gentlemen, if you'd like to register a question, please press the 1 followed by the 4 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 1 followed by the 3. If you are using a speakerphone, please lift your handset before entering your request. Once again to register a phone question, it is the 1 followed by the 4. One moment please for our first question.

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

Nick Agostino

Yes, good morning.

Berty Ho-Wo-Cheong

Good morning.

Nick Agostino

I guess a couple of things. First, if I can just clarify, Peter, did you say it was one IDN win in fiscal Q3 and then two IDN wins in fiscal Q4 and one of those wins was a \$6.4 million deal?

Peter Brereton

That's correct.

Nick Agostino

Okay. And sorry, that \$6.4 million was the one - was one of the ones that are in fiscal Q4? Just to be clear.

Peter Brereton

That's right, yes.

Nick Agostino

Okay, perfect. So just on the question side, you talk about health care returning to pre-U.S. elections activity levels. Can you maybe give us a state of what the growth rate looks like on the health care side as we speak? And then also where complex distribution sits equally from a growth rate perspective given your commentary at the beginning that health care was contributing to the second half growth whereas complex distribution say at the same time?

Peter Brereton

Sure. I mean, the - yes, a couple of comments there on the health care side. First of all, we feel that on the health care side we are in many ways for the first time in a position where we really have some very exciting possibilities for health care revenue growth within our existing customer base. And I mean our customer base of IDNs had always been a strong contributor to revenue.

But with the availability now of our full point-of-view solutions spanning cath lab and OR as well as the availability of pharmacy solution, this is, you know, the first fiscal year where we're really expecting that customer base to be a key part of the health care revenue growth. And there are some, you know, quite exciting opportunities in that base.

On the new account side, though the activity level is also quite high. So, you know, we'll have to see how this plays out. There are - some of these health care opportunities are now looking like they may go with a SaaS approach. And if they do, then of course you'll see - you know, you may see significant bookings, but with the revenue hitting over a more extended period of time. We're going to have to see how the year works out.

We offer these solutions both ways, upfront license fees with annual maintenance or on a subscription basis. But as the market sort of continues to drift more towards subscription, you know, that's, you know, potentially impacts revenue. We'll have to see how that plays out. But certainly, the pipeline looks very strong.

On the complex distribution side, it's always been lumpy, continues to be lumpy. You know, we were pleased with how the team did last year. They showed a - you know, that team is in essence three years old and they've now had three years of consistent year-over-year growth. I think in terms of total bookings last year, they grew their numbers by about 25% over prior year.

And, you know, certainly this year we're looking for similar levels of growth from that team. Because of the existing sort of large installed base of course, 25% growth in bookings does not result in 25% growth in revenue. It - you know, complex distribution has been running at about 10% revenue growth and we don't really expect much of a change there.

Nick Agostino

Okay, great. That was very helpful. And then just on the, I guess, channel partners. I know you've got some system integrators you're working with. I believe in the past you may have been looking at potential health care partners, possibly from a resell perspective. Is that still an avenue that you're pursuing and if so is there any update on that front?

Peter Brereton

There is no - I would say no exciting updates on that front. I mean we continue that process. You know, we're certainly continuing to work with RiseNow in a number of accounts out in the industry. We, you know, continue to work with Sisters of Mercy out in the industry. And - you know, so those efforts continue on the complex distribution side. As we mentioned in Q4, we actually signed a deal through one of our resellers that we've set up a little over a year ago. They've signed their first agreement and that implementation is commencing now.

So, you know, we're seeing a continual slow pickup in the whole sort of channel side of things. But there is no question that that, you know, continues to be sort of slow determining.

Nick Agostino

Okay, great, thank you.

Peter Brereton

Thanks.

Operator

Our next question comes from the line of Justin Keyword with GMP Securities. Please proceed with your question.

Justin Keyword

Good morning. Thanks for taking my call. On the 33% growth in bookings in the quarter, are you able to break it down what was the growth in health care versus complex distribution?

Berty Ho-Wo-Cheong

Sure. Actually, the growth rate was fairly similar and as Peter talked about earlier on, a strong growth in bookings in first half was primarily complex; second half, primarily health care. So overall, for the whole year on an average they worked out pretty much 13% each.

Justin Keyword

Okay. And there was also mentioned that FX hit the annual sales a bit. Do you have the constant currency growth for Q4?

Berty Ho-Wo-Cheong

Yes. The currency hit on revenue side in Q4 was about \$600,000.

Justin Keyword

Okay, thank you. And then I'm just wondering on the competitive landscape. If you're noticing any change there? Are there any new products coming out or some of the ERP vendors may be having more interest in the areas that you're targeting?

Peter Brereton

We haven't seen any change there. Of course, you know, in health care, specifically and say the last 18 months until quite recently has been quite slow. So that probably wouldn't have attracted a lot of interest anyway. But at this point, no, we have not seen any change. We continue to see sort of point solution competitors, but no broad-based competitor in the health care space.

Justin Keyword

Okay. And then just finally on the pharmacy solution, are you able to give any additional color on, you know, what that actually is? Is it like a hardware solution? Is it a software? And you mentioned that being sold to existing customers, but is it also a way to bring in new customers, maybe as a lead-in product?

Peter Brereton

I mean to your last question, certainly it is. I mean in fact if you look at the agreement - I mean we signed with University of Washington and that was a brand-new client that signed with us specifically to work with us to develop the pharmacy solution. So, there is a - you know, there is no question that the pharmacy solution is a potential way to enter new accounts.

In terms of description, it is not a hardware solution. In fact, in some ways that's what's unique about it, because in - the players that have been in pharmacy, hospital pharmacy for years have been very focused on the hardware piece of it. You know, pill counting machines and dispensing machines and, you know, robots and this kind of thing.

This - our solution is an end-to-end software solution for pharmacy. So, doing - going all the way from forecasting and demand planning to, you know, managing the inbound pharmacy, it places the orders with the vendors, receives the inbound drugs and then provides complete traceability and right down to the unit level for full compliance with DSCSA and other regulations. And then goes all the way to the in-hospital pharmacy and in fact receives the prescriptions from the doctors to actually dispense the individual doses.

So, it's an end-to-end platform for pharmacy. And the predominant payback that you look for with that is a dramatic reduction in expired product on the shelf. Product expiring on the shelf as well as to some extent in some class of drugs, you have a problem of theft. And - but both of those problems are exacerbated by the fact that most of these hospital networks really have no way of knowing what's on the shelf and how old it is.

You know, it literally is down to the pharmacist sort of looking at the shelf and deciding sort of based on what the level - you know, how old the bottles are on the shelf, what the level of liquid may be left in a bottle, et cetera and deciding when to order more. Because of that, you end up with a - the inability to know what's being stolen and the inability to manage products expiring on the shelf.

So those are the two areas that our focus is on, but our belief is that it - managing those more properly will save, you know, tens of millions of dollars for a typical hospital network.

Justin Keyword

Thank you. That's very helpful. And it's going to be ready for commercialization by September, did you mention?

Peter Brereton

We've actually already released the commercial product. There is a lot of data setup to be done to bring one of these pharmacy solutions live including setting up, you know, drug equivalents, codes and all kinds of stuff. So that work is underway right now. The - our first client on it, University of Washington is planning to go live with the solution in September.

Justin Keyword

Okay, all right, great. Thank you for taking my questions.

Peter Brereton

Great. Thanks Justin.

Operator

As a reminder once again ladies and gentlemen, to register a phone question it is the 1 followed by the 4 on your telephone. And our next question comes from the line of Blair Abernethy with Industrial Alliance Securities.

Blair Abernethy

Good morning gentlemen.

Berty Ho-Wo-Cheong

Good morning.

Peter Brereton

Good morning.

Blair Abernethy

Hi Peter, so just a little more characterization I guess on the health care pipeline if you could. So, if you look at your typical IDN deal, you know, you say 18 to 24 months selling cycle. Now you've been - arguably, they haven't had their checkbook out in the last 18 months that much. Where would you characterize the pipeline in terms of guys that are just entering the funnel versus halfway through that 18 to 24-month cycle versus how many are, you know, at the front edge of that?

Peter Brereton

It's a good question. We've been looking at that ourselves, because the challenge of course is you - you know, we had a number of them that were sort of let's say halfway through the cycle when all of a sudden, they hit the pause button because of, you know, the trauma going on in the U.S. health care space. And now they've sort of, you know, hit the resume button. So, you sort of go okay, so where are they in the sales cycle.

And, you know, our belief is that at this point we have, you know, a fairly substantial pipeline that is in sort of the last three to nine months of that cycle. You know, we'll see how that pans out. But certainly, it looks to us as though there is quite a number of opportunities that are nearing the end of that cycle.

We then have a number of other ones that are, you know, early in the cycle, that are just entering the cycle and we really just sort of started work within the last sort of three or four months.

The - I should provide a little bit of additional color on, you know, the sales pipeline comment or sorry, the sales cycle timeline comment. For our base accounts it is shorter, right? So, you know, that's really a new account comment because of the fact that our base accounts are becoming a more and more substantial portion of our bookings in the hospital space. That will be bringing down the - in fact, we're already seeing it, it is bringing down the average sales cycle just because, you know, on the bayside it tends to be more sort of six to nine months.

Blair Abernethy

Okay. Well, that's helpful. And if you look at your signed accounts now, what's - with the three - with the two this quarter, one last quarter, so with those three what's the total number of IDNs now? And of those - of that number, are they all referenceable for some - from some of the new guys that are coming into the pipe?

Peter Brereton

Yes, they are. I mean, they - our customer satisfaction rate in their - in the hospital community is very high. Now, I would add by the way that it has to be high. You know, this is a community where everybody knows everybody. So - you know, and it's not to say that during implementation they don't, you know, encounter moments of challenge and difficulty and issues to be worked out and that kind of thing. But overall, they're - that base is highly referenceable.

You know, from the standpoint of numbers of IDNs, it's a little bit depends on how you count it. We've got some IDNs that are merged with other IDNs. We've got some Canadian IDNs that are only using some of the point-of-use solutions and so on. So, if we look in total, it's still somewhere in the 30s. If you look at sort of major U.S.-based networks, it would be in the - I don't know what it would be, mid-20s right now or something like that.

Blair Abernethy

Okay, great. And then the last question I have is so given this - the taps coming back on in the health care vertical, what are you looking at in terms of your implementation team, you know, growth plans and so on and so forth this year?

Peter Brereton

I mean our challenge right now that we're trying to sort of get our heads around is how fast you grow the sales side of the house. You know, our sales folks right now particularly in health care are very busy. The opportunity seems to be growing, you know, pretty substantially and we're wrestling with sort of what do we do there.

I think in terms of our overall OpEx this year, you know, sales and to some extent marketing, so I'll call it sales and marketing in combination is the area where, you know, there will definitely be some upward pressure. If you look at the last year, we actually brought total sales and marketing spend down. But, you know, it's clearly time to grow that number again to capture some of what's going on in the space.

The other areas - I mean there will be a little bit of growth in spend in R&D. You know, G&A I think will remain pretty constant. So - and, you know, services continues to grow as necessary to meet demand. But I mean the services side, you know, is in essence our cost of goods sold. I mean that's something that we can just grow as the services revenue grows. So that's not so much of an issue.

Blair Abernethy

So, you don't - on the services side, you don't feel that you would - there is like any sort of capacity issues there?

Peter Brereton

No, I don't think so. We've got - you know, the leadership that's in place there now too is leadership that is very used to dealing with and driving sort of high growth in services. And we've really got a great on boarding system there for, you know, introducing new talent, bringing them in, having them work for - they work for a while in our customer care group, sort of in-house learning to support clients, learning to support - you know, solve issues with the products and so on. And then as they're needed out in the field, we can move them out into the field. But, you know, at that point they're already trained and ready to roll. So, it's a pretty effective on boarding process that we've developed there over the last couple of years.

Blair Abernethy

Okay, great. Thanks very much for the color Peter. And just one quick question on the tax, the tax rate obviously moving around a bit. But, you know what, are you - what are you thinking in terms of on a modeling, what should we be looking at modeling kind of going forward the next couple of years? The tax rate is sort of 20% to 25%, is that an appropriate level?

Berty Ho-Wo-Cheong

Yes. I mean, you know, the statutory rate for us is about 26%. So, you know, if we use somewhere around 25%, you know, on a go-forward normalized basis that will be a good rate.

Blair Abernethy

Okay, perfect. All right, thanks very much guys, yes.

Peter Brereton

At the same time Blair, I mean we're still a long way from having to pay any substantial cash taxes, right.

Blair Abernethy

Understood, yes. Okay, great. Thank you again.

Berty Ho-Wo-Cheong

You're welcome.

Peter Brereton

Okay, thank you.

Operator:

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

Peter Brereton

Okay. Well, thank you again everyone for taking the time to be with us. And as usual, if you have any additional questions, please don't hesitate to give Berty or I a call. And we look forward to talking to you in September to discuss our first quarter results. Have a great day. 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 lines.

***** END *****