INTELLIGENT SYSTEMS CORPORATION

Moderator: Leland Strange
May 9, 2018
11:00 a.m. ET

Operator: This is conference # 3987988.

Operator: Good morning. My name is (Kelly), and I will be your conference operator today.

At this time, I would like to welcome everyone to the earnings release and investor conference call. All lines have been placed on mute to prevent any background noise. After the prepared remarks there will be a question-and-answer session. If you would like to ask a question during this time simply press star then the number one on your telephone keypad. If you would like to withdraw your question press the pound key.

Thank you. I would now like to turn the conference over to Karen Reynolds, CFO. Please go ahead.

Karen Reynolds: Thank you, (Kelly). Good morning, and welcome to the Intelligent Systems' investor conference call. Joining me on this call is Leland Strange, our CEO.

Keeping with past investor calls, I anticipate this call lasting 20 to 30 minutes, during which time we plan to cover 2 areas. I will comment on the first quarter 2018 financial results, and then Leland will update you on the progress and the outlook for our CoreCard operation.

Similar to prior investor calls, we'll be brief in most of our explanation, but we are glad to add colors to any areas of particular interest you have. We will assume that you are on this call, you have the copy of the earnings release this morning. I am not going to repeat all the information in the press release. At the end of the call, we will have time for some questions and answers for either Leland or myself.

We have filed our Form 10-Q for the quarter ended March 31, 2018, earlier today. It should be available on our website at intelsys.com and at sec.gov at some points today.

I encourage you to read the notes of the financial statement, the MD&A in the risk section of the 10-Q for more complete understanding of our business and it's risks and (inaudible).

Although we plan to keep this call brief in nature, I do need to stay with the concepts known as forward-looking statements. I will remind you that this discussion today will contain forward-looking statements relating to Intelligent Systems and its operations.

Many of our statements and other information contained in this discussion are likely contain forward-looking statements, particularly when we use words such as anticipate, believe, plan, estimate, expect, likely and intend and other similar type of expressions.

If you are an investor or thinking about investing, you should note that such forward-looking statements are not guarantees of future performance and involve risks and uncertainties.

We will give you our best judgment of things as we see them. And as judgment might prove to be wrong, we're simply conveying our expectations based on what we know and believe at this time. And we are not making firm predictions about future.

OK. Now, onto the financial results. Our CoreCard operation is Intelligent Systems' core business. CoreCard is the primary focus of our management time and reason for allocation.

As you can see from the press release earlier today, our revenue grew 139 percent overall in the first quarter of 2018 compared to the same period in 2017. Revenue from services, which includes our software maintenance and support services, transaction processing services and professional services, grew 133 percent overall in the first quarter of 2018 compared to the same period in 2017.

We benefited from both an increase in our processing services customer base and a number of transactions processed and from the number and value professional services contract completed in the quarter. In addition, we recognized a onetime contractual minimum guarantee maintenance support revenue of approximately $250,000 in the quarter.

We did adopt a Financial Accounting Standards Board, which is commonly referred to FASB, pronouncement entitled, revenue from contractor customers, ASU 606 in the first quarter of 2018, using the full retrospective approach.

As a result of the implementation of ASU 606, certain revenue and the associated cost of revenue, as a reclassified from product revenue to service revenue. Product revenue is now primarily license fees only. Please refer to the note of our financial statement in the Form 10-Q for a further explanation of it.

License fee revenue for the first quarter of 2018 increased $95,000 over the comparable prior quarter, as we recognized the first software license implementation for a global license customer.

We continued to shift our focus, though, more towards the processing side of our scalability and processing services and licensing our product offering. The timing of revenue recognition, particularly on new contracts, may still fluctuate from quarter-to-quarter, depending upon the performance obligations we achieved.

Part of this revenue fluctuation may be based on items that are out of out control as well, such as the customers or third-party vendors' ability to remain on track with project implementation.

We are not large enough yet revenue wise to account for some of quarterly things in revenue we may experience. We expect to continue to see some revenue fluctuations that are processing services continues to grow will continue to level out (and evolve towards).

As you can also see from the press release, we reported income from operations of $821,000 in the first quarter of 2018 compared to a loss of $541,000 from the same quarter in 2017. The profitability increase is a direct result of the revenue I already discussed.

Total operating expenses increased 11 percent quarter-over-quarter, primarily due to R&D expenditures increasing 21 percent in 2018 over the same period in 2017. We started an expansion in our India operations during 2017, adding approximately 40 additional staffs during 2017. And we added approximately another 60 additional new hires in the first quarter of 2018.

As we discussed in our last investor call, we second office in India near Mumbai in the fourth quarter of 2017. It takes approximately two full years to train and new hire in our platform, architecture and our product offering.

All of our trained, experienced employees are currently fully deployed of revenue for project. We reported net income of $893,000 for the first quarter of 2018 compared to a loss of $580,000 in the first quarter of 2017. This increase is primarily attributable to the increase in operating income.

Our cash has decreased from $14 million at the end of 2017 to approximately $10 million at the end of March 2018. As we noted in our last Form 10-K piling, in the latter part of 2017, we have purchased an additional processing equipment for potential new customer of approximately $1.7 million.

This is an anticipation of a contract currently in negotiation with a potential new customer. We purchased an additional 2 million six processing equipment for the same potential customer during the first quarter of 2018.

We believe this relationship will have a positive outcome, and we currently remain in contract negotiation, but in the intent that it does not, potential customers agreed to seek ownership of and reimbursement for (inaudible).

During the first quarter, we also invested approximately 170,000 in capital equipment for our CoreCard processing center as well as equipment for new hires in India. And we used approximately $600,000 cash for operation support as well as our corporate and other public company expenses. The $600,000 of cash used is net of accumulated equipment purchases I just discussed.

The primary use of cash for the quarter is the increase, account receivables of approximately $1.7 million, which is directly related to the revenue increase for the quarter.

Payment was already remitted for approximately $1.6 million for this increase during the month of April. And for the most part, all of our customers are on trade receivables.

During the first quarter of 2018, we also advanced $235,000 on the convertible notes, an India best Fintech custody and we advanced $250,000 on a promissory note to a prior investee in a related industry in which we have a previous loan agreement with warrants attached.

We will continue to invest in other companies that we saw a good match for our CoreCard operation. These investments were primarily be in the Fintech industry or other related industries that complement the CoreCard business.

Although we were very pleased with the first quarter of 2018 results, we remain focused on the operation side of our business. Due to the timeline it may take for recent relationship to reach maturity levels, also coupled with additional R&D expenses we may chose to incur for new product initiatives or potential future growth, we cannot predict the full financial impact of the 2018 results.

However, we believe we will continue to grow revenue. I'm now going to turn this call over to Leland to discuss our operation side of the business further.

Leland Strange: OK, thanks, Karen. I'll try not to repeat some of the things you've said, and I'll add some comments about operations as well as my best guess on our outlook.

Yes, it was a good quarter. However, the first quarter positive bump in revenue and profits does create some new and unexpected challenges. We did previous expect some growth in the first quarter and for the year, but we definitely did have this level of potential activity in view late last year when we did our 2018 resource planning.

Your Intelligent Systems and CoreCard management are not just accelerating the bump. Everyone is pushing hard right now. We have a lot of work ahead of us to keep building on the base that we have spent many years developing in order to get to this point. I'll going to some detail later about the challenges, and how we're addressing them.

Understand our goal at CoreCard for the last 2 years has been to establish ourselves as a world-class processor for all types of funding, including loans, debit, prepaid, and any kind of advanced funds movement.

Funding maybe traditional revolving credit, using one of the networks such as Discover, MasterCard, Visa, JCP or whoever. It maybe a private label for bricks and mortar locations, or funding such as offered by many of the newer Internet providers.

The loans or credit could be one with revolving interest terms, could be an installment loan, a loan with only fees or loan that combines each of these things that I've mentioned with different methodologies. A particular strength of CoreCard is our ability to mix them, plus we offer additional complex payment application formulas for allowing payments to be dispersed across a variety of loans or programs.

Other funding processing could be prepaid, gift, expense management, fleet, but there are many other combinations or credit in prepaid in the world today. They're also complex rewards or incentive calculations that could be layered on top of the base funding programs. These could be total spend, limited by merchants or merchant categories or even SKU level in some cases.

Our focus for 2018 and future years is to concentrate on our processing activity for these type of products and minimize licensing activity. Licensed customers take a lot of resources, even though they pay per hour for the resources, which is certainly good revenue, but they often have us doing things that do not to enhance our ability to scale, since it is unique to their own corporate needs. It is not without some core values, however, since there's almost always some carryover to the base product.

So it is more than just an outsourcing of our resource, but to grow revenue, you have to continue bringing on board resources. I would say, off the top of my head, most work like this results in 50-50 unique work versus reusable work in a typical what we call PSA, or professional service agreement.

However, licensing does provide a good recurring revenue component, as maintenance so it's not a one and done licensing fee. To be a world-class processor, means we'll have to continue boosting our resources on the processing side of the business, while maintaining current commitments on the licensing side.

So what's the difference long-term between the licensing and processing businesses? Simply put, processing provides better opportunities to scale the business. We use the same software platform to process many customers and spend our R&D dollars continuing to improve that scalable platform on the processing side.

We don't have to have resources at the same level for new processing plans as we do to serve licensing plans under professional service agreement. But licensing certainly has other advantages in that it offers the possibility of large brought in license fees as well as also providing some professional services revenue.

But the professional service revenues for license are not necessarily guaranteed or recurring long-term, so we have to be careful when committing resources that might suddenly become redundant.

As I mentioned earlier, the maintenance per licensing customers is recurring and helps offset some R&D as the license customer get some of the benefit from our ongoing R&D for the processing platform.

I've used the word, world class, twice now. We're very good at CoreCard, but today, we're not, what I will call, a world-class processor. Honestly, I didn't expect to get to that point for several more years.

If you look at some of our competition, I consider TSYS, First Data, FiServe and FIS to be our primary competition in the credit space. They each have spent hundreds of millions over many, many years on mainframe software and they each help fine and mature software. But most of them have many different internal platforms that operate around the world as a result of the legacy buildup and their acquisitions of platform.

We have spent less than $50 million, although we did start from a good base using the PaySYS international cobol code, with permission, after we sold PaySYS to First Data, approximately 15 years ago. So we have one platform that could work anywhere in the world. This is a big deal for a company operating in many markets around the world.

So how are we getting to world-class earlier than planned? We're under a great deal of pressure to get there earlier than planned due to a potential licensing customer that is paying a part of the cost to have us move resources from other revenue-generated group, to getting our platform in a condition that they have specified.

It's a trade-off that we decided to make as the best use of resources. It hurts some of our previously planned activities, and requires us to absorb the cost to quickly ramp additional resources, but we do believe it's the right decision and the right direction.

You see the increase in revenue for the first quarter, and much of that is a result of potential license customers paying for our resources to help them get into the processing business themselves, and for advancing the capabilities of our platform.

You might find it ironical that I said earlier that we want to be a world-class processor and use less resources on licensing, and yet much of the new revenue for the quarter is coming from potential licensing customers.

I'll admit the irony. In fact, if voting resources to these license customers has actually slowed down work for (very) valuable currently contracted and potential processing customers. But we felt that it was the right thing to do at this time, and only time will tell if that was a great decision. And that's one of our challenges.

As I said in the press release this morning, our current team is 100-plus-percent utilized, and you obviously cannot maintain that over the long haul. We are adding resources, but it takes at least a couple of years to get good productivity from new resources in this very specialized and complex financial software environment. I think we've added almost 50 new resources since we opened our Mumbai office late last year, which brings our total employment to almost 400 employees.

So the first quarter was good, as a result of resources being at 100 percent plus utilized. And now the obvious questions are, first, is this sustainable? And two, how do you grow it? First, is it sustainable? That is the primary focus.

The top line revenue is definitely sustainable, if we actually get licenses executed with the potential licensing customers that we're working with. What are the odds? Pretty good, but not guaranteed.

In my opinion, as of today, if it does not work, it will because of contract terms and not because of technology or resources. We are in this business for long-term, and we'll sacrifice short-term revenue if necessary to protect the enterprise for the long term, as we build economies to compete with the big four processors.

So there's no guarantee we'll come to terms that we find acceptable, but we think we will, as we previously have come to agreements with other large public companies on what we believe to be our own reasonable terms.

We have a good pipeline of potential processing customers that will more than make up for a couple of potential or current license customer that we can lose due to our focus being on the more profitable processing side of the business. There could be a little blip if that happens, but the end result will be much more profitable revenue since we will be using our scalable platform.

The best of all worlds is that in the next 24 months we get the license customers up immediately and add the processing customers a little later then we would (without) the license customers. That will provide contingent, stable growth for the quarter we have just reported.

If we get the license customer, we will see an additional big positive blip in revenue and profits, either this year or early 2019. Exact timing is unpredictable as of today, given the state of negotiations.

If we only continue with processing customers, we'll see that growth over a monthly sustained basis rather than in a blip. Either way, we're very pleased with where we are now, and where we’re headed as far as the business is concerned.

I will still be cautious, because I am conservative by nature (inaudible) due to certain accounting treatment, it might not always translate quarter-to-quarter as we and you would like. In fact, I think we're (Warren Buffet) had some similar comments recently.

We don't comment on stock price because we have very little following at this point, but we do know what the underlying value is and believe we still have a lot of room for value recognition. Hopefully, as shareholders, you’ll be happy with the result.

With that, I think we'll open it up for questions.

Operator: Certainly. At this time I would like to remind everyone in order to ask a question please press star then the number one on your telephone keypad. Again that’s star then the number one on your telephone keypad.

Our first question comes from the line of Sam Rebotsky. Please go ahead.

Sam Rebotsky: So this is a very good quarter. And even though you don't talk about the stock price, it's nice that it has moved up. If we look at the comments in your 10-Q, relative to (liquidity) and capital resources, and you discussed increase incurred, the use of cash, prepayment of $2,580,000 for processing equipment software and related license for the year ending December 31 or for the current quarter in the $1,745,000 for December 2017.

Do you sell this? Or is this equipment that you're using? Because when I look in the balance sheets, I don't see equipment listed. So what is this processing equipment software, et cetera?

Karen Reynolds: The combined purchases is approximately $4.3 million, and it was purchased for a potential new customer that we're currently in negotiations with.

So it is listed as other current assets on the balance sheet, as we anticipate selling (the process) equipment due to the potential new customer. The customer has assured us if we don't move forward with the contract negotiation, that they will purchase the equipment (from us).

Sam Rebotsky: So this combined number of $4.3 million is included in other current assets of $5.46 million?

Karen Reynolds: Correct.

Sam Rebotsky: OK. OK. And the timeframe for a transaction is, Leland, if you sell the equipment, you'll make a profit. If you do not do something else, you will have a longer relationship with the customer, is that what you sort of said?

Leland Strange: No. No. We've just advanced on the equipment. There will be a profit on that receivable that there – or that other asset. We're just carrying it at this point as we go forward.

They've agreed to buy it, but we could end up changing that and they might be leased. We might take some of it back to use in our process environment. So it's very much in the – up in the air. I would say, it will be settled sometime this year.

Sam Rebotsky: OK, OK. And relative to the money that you've lent to the private company that you could have 14 percent of the stock, is there – how close is this transaction from occurring? Or is there anything imminent or it is a year, or two or three away, what type of investments is this?

Leland Strange: It’s – (way away) is unfortunately no. There's no visibility, and so you can have – there's no visibility to even say what will happen the next year or two. You never know. You never say never, you never know, but there's absolutely no probability in my mind that anything will happen this year, probably some next year.

Sam Rebotsky: OK, OK. And relative to the performance, the – I assume at this point the – it is not fruitful and you're not able to mention any of the names of any of these companies that either you bought the equipment, want to sell the equipment or the investments, I guess, as far as at this point, it's not – you’re not able to disclose that.

Leland Strange: There may never be a point where we can do it. Remember, our customers always require and understand why they’re required basically nondisclosure in their contract. They hold themselves out to the license customers, hold themselves out to be processors.

So – but they are using our software, so they just don't see any need why we should have to disclose it. And even many of our processing customers, they just soon not tell the world who is doing their processing because many of their customers think they’re doing it.

So we're – you could say it's a disadvantage. That’s just something we live with. We don't put out big press releases and talk about what great names that we have, although I can tell you we have some great names.

Sam Rebotsky: OK. And as far as the processing, you had – the 360 employees or almost 400, how much work can you do – can you process? The …

Leland Strange: I can't give you a number, but we're going to continue to grow people and grow the other side. But there's no way (I can sort of relate or translate this number for this much revenue processing at this point).

Sam Rebotsky: Well Leland you've certainly delivered. Your judgments have been good and hopefully, you continue to have – you deliver and have good judgments. Good luck. Thank you.

Leland Strange: Any further questions?

Operator: And there are no further questions at this time. I will now turn the call back over to Leland Strange for closing remarks.

Leland Strange: OK. We'll thank you for being on the call today. I think, in the future, we'll probably have these quarterly instead of twice a year. Things are moving a little faster, and I think it makes sense to update shareholders on a quarterly basis and be available for questions. Even though, apparently, we answered most of them in our presentation. But thank you. If you do have any questions you want to ask us directly, that we will be able to answer, please give us a call. Thanks.

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

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