TECSYS Inc. – TSX: TCS
First Quarter FY2017 Results
Financial Analysts Call
Thursday, September 8, 4:30pm

Operator: Ladies and gentlemen, thank you for standing by. Welcome to the Q1 FY2017 Results conference call. During the presentation, all participants will be in a listen-only mode.

Afterwards, we'll conduct a question and answer session. At that time, if you have a question, please press 1 followed by the 4 on your telephone. If at any time during the conference you need to reach an operator, please press Star zero.

As a reminder, this conference is being recorded, Thursday, September 8, 2016. I would now like to turn the conference over to Peter Brereton. Please go ahead, sir.

Peter Brereton: Thank you and good afternoon everyone. We appreciate you joining us for today's call. Earlier today, we issued our unaudited 2017 first quarter financial results, and a copy of those results is available on our Web site at tecsys.com.

Please note that the complete first quarter report including MD&A and financial statements were filed on (CEDAR) today, September 8, 2016. All dollar amounts are expressed in Canadian currency and prepared in accordance with the IFRS and our unaudited.

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.

Joining me today is Berty Ho, our chief financial officer. I'll start by summarizing the key events of the quarter and reviewing our Q1 financial results. I'll then close with a few comments and our outlook for the remainder of fiscal 2017 followed by a Q&A session.

In the three months ended July 31, 2016, Tecsys generated increased revenue and profit exiting the quarter well-positioned to meet our growth targets. This is despite the first quarter of our fiscal year tending to be our slowest on account of our typically long sales cycles and the fact that Q1 encompasses the months of May to July.

Revenue in the first quarter group 8% to $16.1 million compared to $14.9 million in the first quarter of fiscal 2016. About two-thirds of our revenue in the quarter was generated in the US, and as a result, the stronger US dollar had a positive impact on our revenue by about $950,000 offset by increased cost of about $150,000.

Contract bookings for the quarter were where we would expect to see them on a seasonal basis at $6 million for the quarter. Total contract bookings were about 10% lower than Q1 of 2016.

However, this is purely the result of the sales lumpiness that is so typical to our business. Included in the $6 million in total contract bookings for the quarter, our new contracts worth $1.7 million from two new customer signing on for complex distribution solutions.

The momentum we continue to see in our complex distribution division reflects the decision we made last year to reorganize our salesforce so that each of our divisions is served by its own dedicated team. These two new customers add to the five significant complex distribution wins we've had since putting that initiative in place.

Based on incoming inquiries, proposals in place and site visit requests, our healthcare pipeline remains very strong and we expect contract bookings from our base accounts and new customers to grow through fiscal 2017.

Looking at our revenue in more detail, you'll see that it is consistent with previous quarters with product sales representing about 28% of revenue and 68% coming from services.

Services revenue increased by 7% compared to the first quarter of 2015 to $11 million. Most of our service revenue is for implementation assistance which includes consulting, training and some product adaptation.

With our backlog currently at $42.1 million, we expect that services revenue will remain healthy for the near term and increase as we bring on new business.

Proprietary product revenue for the quarter increased by about 10% to $2.4 million as a result of higher sales of hardware technology. Third-party product revenue increased by about 5% to $2.2 million mainly attributable to higher sales of (unintelligible).

Gross margin for the first quarter of fiscal 2017 was $7.6 million dollars or 47% compared to $7.4 million or 50% in the first quarter of 2016. The difference is largely due to slightly lower gross margin on services revenue as a result of the increased headcount.

We have added staff in services to meet the demand from higher sales and expect the current headcount to be sufficient to support our continued growth into the future.

We are pleased with the overall trend in gross margins which are $35 million for the trailing 12 months ended July 31, 2016, or 51%, compared to $28.9 million, or 49% for the same period ended July 31, 2016.

In terms of operating expenses, this quarter demonstrated our success at controlling them and the benefits of scale we're starting to achieve. Our total operating expenses in Q1 of fiscal '17 were $7.4 million or 46% of revenue compared to $7.2 million or 48% of revenue in Q1 of 2016.

Sales and marketing expenses were flat year-over-year at $3.6 million and G&A expenses were down about 2% to $1.3 million while R&D - while net R&D expenses were up 8.2% or $185,000 for the quarter, this reflects the lower capitalization of deferred development costs compared to the first quarter of fiscal 2016.

Last year, we capitalized deferred development costs of $399,000 compared to none in the first quarter of fiscal 2017. Adjusting for this, Q1 2017 net R&D expenses would have been down $214,000 or 8% from the previous year.

As we mentioned in the past, we are committed to control the growth of our operating expenses. During the quarter, our headcount related to operating activities was relatively flat at 176 compared to Q4 2016 and down from 182 in Q1 of last year.

EBITDA was $114,000 for the first quarter of fiscal 2017 compared to $831,000 in Q1 of 2016. Both represent an EBITDA margin of about 5% and are consistent with previous first quarters.

Of course, last year's EBITDA's number was boosted by roughly $400,000 of capitalization of R&D, whereas, this year's number was not. In other events in the quarter, we had go-lives with eight clients ranging from hospital systems to heavy equipment dealers to (three PL) companies.

We ended the quarter in a strong position with cash and cash equivalents of $13-1/2 million compared to $9.7 million on April 30th at the end of our last fiscal year.

The significant increase is mainly as a result of cash collections on the accounts receivable generated from our record sales in the fourth quarter of fiscal 2016.

In summary, Q1 fiscal 2017 was in line with our expectations and typical for this time of year and previous quarters. However, we also think that it's important to look at our performance on a trailing 12 month basis which better reflects our sales cycle and project development timelines.

On that basis, we have achieved 16% growth in revenue from $59.2 million to $68.6 million when comparing the 12 months ended July 31, 2016 to the trailing 12 months ended a year earlier.

EBITDA over the same period had even stronger growth, $7.1 million or 10% of revenue up from $4.2 million or 7% of revenue. Looking forward, we expect continued progress to two 2017 based on our order bookings and solid sales pipeline.

We will continue to enhance an innovator product offering to both to add new customers and to increase our presence with existing customers. One example of this is OneSprint which we launched this quarter.

It is a plug-n-play warehouse management solution that can be launched at customized by the customer without the need for extensive consulting our application support.

We have had positive initial reaction to this in the market and expect to see related sales gain traction in the last two quarters of this year. On the healthcare side, our operating room solution is in the second stage of implementation at one of our largest hospital network customers.

This has generated a lot of interest and we expect will turn into orders once the solution is fully implemented later this year. With that, I will turn the call over for questions and back to the operator.

Operator: And ladies and gentlemen, if you'd like to register for question, please press 1 followed by the 4 on your telephone. You will hear a three toned prompt to knowledge or request.

If your question has already been answered and you'd like to withdraw your registration, please press 1 followed by the 3. If you're using a speakerphone, please list your handset before entering your request. One moment please for first our first question.

Once again, ladies and gentlemen, to register for a question, please press 1 followed by the 4 on your telephone. Our first question comes from the line of Hubert Mak, Cormark Securities. Please proceed with your question.

Hubert Mak: Guy guys, a couple questions here. The first is regarding the US services margins. I think last quarter, you know, you guys were I think talking that you were (be able to hold in the) 50% range and I think this quarter came in and

43%. Can you kind of talk about that and what's the reason for the sequential decline and where you think it's going to be for the year here?

Berty Ho: I think, Hubert, look, Q4 was - I think we all talked about it - was a bit of an unusual quarter in terms of revenue. I think the revenue for Q1 usually is a little bit, you know, kind of a bit of a seasonal touch to it.

And also, in Q1 you know, reflects the fact that we have added, you know, a number of people, you know, in terms of increasing our capacity, in terms of services.

Something, as they say, I think you one is a bit kind of on the low side but I think, you know, in the subsequent quarters, we certainly would expect to improve that margin.

Hubert Mak: You have any idea where - is it - or are were talking about the mid-40s or back to the 50s?

Berty Ho: I would say somewhere, yes, somewhere in the mid-40s would be where we're expected to be.

Hubert Mak: Okay, and then on the healthcare side, I didn't see any mention on health systems. So was there any new health system in the quarter and, I guess, if not, can you got of talk about the pipeline and given that these are typically a little bit longer sales cycle, how do you see that unfolding here this year in terms of signing up these healthcare - health systems?

Peter Brereton: Sure. You know, we did not add any new health systems in our first quarter. Our pipeline and then marketplace is very strong. It is - they are long sales cycle, though.

We're certainly quite confident that we'll add a number of additional interesting health systems to our base this year. We're up to about 30 systems so there's sort of - increasingly sort of the base account opportunity is beginning to become a very sizable opportunity relative to the new (income) opportunity.

Just because, you know, by the time you're up to 30 IDMs, and we're only, you know, somewhere around 10% or 15% penetrated into those IDMs in terms of the, you know, the products that are already running from us versus what they may potentially by over time.

So that basis becoming a larger and larger market opportunity. But on the new account side, as I say, none were added in the first quarter but it's, you know, it's just the typical issue with sort of sales, you know, the sales cycles, the long sales cycles meeting all the decision-makers in the office to be able to get the decisions done. And that's, you know, very difficult to do during the summer quarter.

Hubert Mak: And in terms of the signings, you know, I think previously you're just talking about sort of in around the six to eight health systems a year. Is that (just thinking) for this year as well or is there a change or?

Peter Brereton: No, that's still - we think it's still going to run in that kind of range. I mean, as I say, I think the, you know, what we've been finding interesting in the last year or so is the expansion in the total addressable market within the base. That has actually growing faster than we anticipated but the new name account side, we still anticipating somewhere in the six to eight new names.

Hubert Mak: Okay, and then just lastly a complex distribution here, you know, it sounds like you guys are rolling along here. Do you expect the growth rate to reaccelerate here income I guess, fiscal '17?

Peter Brereton: I mean, it takes a while because the basis a large there. I mean, we, you know, we've been in the market for decades, right, so the basis very large so it takes a fairly significant number of new accounts before you start really impacting the revenue line all that much.

But it certainly looks like it's going to start moving up. I mean, if you look at our last three years, let's say, the healthcare revenue has gone from about, sort of three years ago, $12 million to two years ago, you know, $23 million to last year, $33 million or something like that.

I mean, you know, the compounded annual growth rate that's pretty impressive. And that really has been the entire growth of the top line. If you look at what's happening on the top line, 100% of it has been coming out of healthcare.

You know, at this point, you know, given the success we're seeing, given the fact that some of the accounts we're winning in complex distribution also have a lot of follow on revenue.

I mean, we're, you know, one of the accounts we sign in the first quarter, this agreement is really just to do the first couple of their sites. But they've got another dozen sites or so that are not included in this agreement.

There's, you know, one of the ones we signed last year we're doing to projects with them in North America but they've got sites all around the world and want to use our product all around the world.

So, again, maybe a lot of follow on business there. So it's going to take a little while for the momentum that's building to start to affect the top line and we certainly believe it's going to move complex distribution back in the, you know, growth territory.

Hubert Mak: Okay, great. Thanks. I'll pass the line.

Peter Brereton: Thanks.

Operator: Our next question comes from the line of (Jim Luca Tucci) with (Cantor Fitzgerald). Please proceed with your question.

Jim Luca Tucci: Hi, guys. Thanks for taking my questions here. Just pursuing on the margin side, do you have a specific headcount number for the services side of the business, Peter?

Berty Ho: Yes, yes, we do. I mean, our services right now runs about 190 people, so.

Jim Luca Tucci: Okay, and I guess no imminent plans of expanding that salesforce?

Peter Brereton: The salesforce? No, the salesforce at this point is, I think, pretty steady number we're probably going to run with - I think throughout the rest of this fiscal year.

There's a - you know, we continually look at the customer base to make sure that we've got enough base account sales coverage. That's an area that we could consider further investment in.

But our thinking at this point, for the rest of this fiscal year, is to continue to invest in growing the services organization, you know, probably adding a few people per quarter, sort of four or five people per quarter kind of thing, but growing the services organization to meet demand.

But everything on the outback's side - finance (admin), R&D, sales, marketing, you know, pretty much holding the headcount flat. You know, as I mentioned in my update here a few minutes ago, we are actually down about - I don't know, what, four or five heads on the operating, you know, operating expense side of the ledger from a year ago.

Jim Luca Tucci: Great. And then, so I assume - and I see that in the quarter, you guys came in at 46% of sales on the op ex side. I guess it would be safe to assume that that would be a pro forma rate going forward.

Peter Brereton: Well, I mean, we're expecting to hold op ex more or less flat. It does vary somewhat, of course, based on, for instance, commissions. Sales commissions, of course, are part of operating expense. Management incentive is part of that.

So there's some variability in it, but we more or less are expecting to hold that flat for the next few quarters. You know, from a revenue standpoint, of course, typically, Q1 is our slowest quarter. So that holds true, then I would think operating expense, as a percentage of revenue, should drop through the year just as revenue rises. Yes.

Jim Luca Tucci: Excellent. Good, good. And then I don't see that in your MD&A that there was an annualized recurring revenue number. You have that on hand?

Berty Ho: Sure. It's 25.7.

Jim Luca Tucci: Excellent. And then just switching gears to the IDN side of the business, is there any plans or discussions of potentially signing a couple more throughout the balance of the fiscal calendar year? And I don't think I saw any sign in the first quarter, if you could confirm that for me.

Berty Ho: I think yes. I mean, clearly, I think it's Peter mentioned, in terms of the opportunities we're working up, you know, the - you know, as mentioned earlier on, we still expect to sign it anywhere between six to eight IDN on an annual basis.

Jim Luca Tucci: Okay, perfect. Okay, guys. Thanks. I'll pass the line here and I'll see what the end of the month in Arizona. Thank you.

Berty Ho: Okay. Oh, good.

Peter Brereton: Thanks. See you there.

Operator: Our next question comes from the line of (Nick Agostino), (Lorencion) Bank. Please proceed with your question.

Nick Agostino: Yes, good evening.

Man: Hi.

Nick Agostino: I guess I have two - hi - just two quick questions. First, going back to the services gross margin and just where the headcount sits, just asking, I guess, a slightly different question. If you look at where your headcount is today, what's up of revenue level from the services side could you support?

Berty Ho: I think, you know, we probably can support another, you know, 8% to 10%, you know, the assumption that, you know, we have - we increased our utilization rate.

Also remember there are number of new people we've hired. You know, compared to Q1, fiscal year 2016 to 2017, we have increased the headcount, you know, to the tune of 23.

So we have increased the capacity, so we should be able to add, I mean, I would say easier another 10% on a quarterly basis to the numbers that we've done in, you know, in Q1 fiscal year '17.

Nick Agostino: so just based on that, which is where was going with the question, just based on the fact that you've added these 12 - sorry 23 individuals over the last year, you figure you could probably do $12 million, give or take, quarterly run rate without any more bodies.

Berty Ho: Approximately, yes.

Nick Agostino: Okay, yes.

Peter Brereton: There's no - part of the thing, (Nick), there is actually some serious elasticity and the number for short period of time, right. Like, will sometimes have a quarter where you have a bunch of go-lives and a lot of your consultants are working, like, extra nights and weekends and so when to get the, you know, get the various accounts life.

So you end up seeing a real search sometimes in those quarters but those are not sustainable surges, right, because you just can't run - I mean, you can't run a consulting group, you know, with everyone doing, you know, nights and weekends constantly.

So sometimes in a quarter, it would surge above that. But I think the number that Berty is giving you hear is a sustainable run rate for that kind of number of heads.

Nick Agostino: Right. Yes, yes, just kind of get a sense of, we saw were Q1 came in, in, I guess in a quarter where you're hitting the lights out, you could probably have done $12 million just on that line number without adding more bodies, right?

Peter Brereton: Yes. Yes.

Nick Agostino: Okay, and then the other question, I know, and I think we've discussed this one in the past, you've had one new hospital come in as far as giving you guys assistance from a system integration perspective.

Peter Brereton: Yes.

Nick Agostino: Can you give us an update there where that hospital - you know, I think they've already done one project. They were working on a second at the last call, so an update there. Are you having discussions with other hospitals on similar contracts?

And then I believe you also had two small SIs there you were working with. I think on last call, they were in a training stage. Can you maybe just give us an update on where they are today?

Peter Brereton: Sure. I mean, in terms of the hospital network, yes, one of the projects is complete, very satisfactorily complete. The second project is now underway. We've had joint meetings and, you know, project launches and so on, you know, project launch meetings and that's underway.

They are - our discussion with them is ongoing in terms of much deeper involvement particularly as more and more projects involve, you know, working more directly with medical staff.

I think they can be a huge help to us when we're actually working with, you know, nurses and chief nursing officers and, you know, surgical teams and so on because they really understand the business process side of the equation.

So that is developing well. We're pleased with that. We have not yet launched discussions with other hospital networks to take a similar approach and probably won't until we have, you know, a few additional successes under our belts with this (version) and we really want to make this a great success before we start trying to replicate the model.

In terms of the small SIs, going well. I would say one of them is going better than the other although they're both going fairly well. And they're trained. They're, you know, up to speed and one of them has, you know, now been deployed on a project, well, couple of projects for a number of months.

The other one is starting to get more involved now in some projects. And one of the contracts that we signed in the first quarter for new accounts was actually directly influenced by one of those SIs.

So we're also starting to see some of that feedback cycle that we hoped to see where, you know, they benefited from being able to do some consulting work on some of our projects but they also, you know, have reach into the industry that we don't have an can work well for both companies and for the clients involved.

Nick Agostino: And then just one last question because you talked about, you know, you guys being a growth trajectory in line with what you were expecting, even despite were Q1 came in at the end of the day.

Last year, you know, you guys did EBITDA somewhere around, I believe, it was 10%, just north of 10%. And that includes a really strong Q4. Can you maybe just - what kind of EBITDA margins should we be looking at for 2017 once you normalize for what you guys did in 2016?

Peter Brereton: I mean, we're still on our overall track heading towards, you know, getting EBITDA margins up into the high teens. We don't give specific forecasts in terms of a given fiscal year but we feel like sort of everything is tracking well.

I mean, have a look at last year, you know, last year we made significant EBITDA gains over prior year, after a combination of some sort of very nice revenue growth and holding op ex flat, you know at least from Q1.

Op ex last year was actually up quite a bit over the year before. But during the year, we sort of hit the brakes on it and just started holding it flat and focusing on a much more strict approach to op ex while letting the revenue grow past it.

And we're continuing that approach this year. So, you know, we certainly have every expectation that we'll see, you know, significant additional gains in EBITDA by again, very simple formula - hold op ex flat and continue to grow the top line.

Nick Agostino: Okay, great. Thank you. That was it. Thank you.

Peter Brereton: Great.

Operator: Ladies and gentlemen, once again, to register for question, please press 1 followed by the 4 on your telephone. Our next question comes from the line of Gabriel Leung with Beacon Securities. Please proceed with your question.

Gabriel Leung: Good afternoon. Thanks for taking my questions. I've got two things I wanted to touch on. First, in terms of the professional services revenues in the quarter, you know, I know Q1 is a seasonally weaker one for you guys.

But if I look at the year-over-year growth number, I think came in at about negative 1% which is, you know, the first time we've seen it go negative in a long time. So I was wondering if there is anything to read there or their might just be a timing of project issue.

Berty Ho: I think it's just a timing, Gabe, frankly. I wouldn't - I certainly wouldn't read too much into it frankly.

Gabriel Leung: So if I look at - so - and the current fiscal Q2, do you have enough visibility from your clients will which are going live for implementing certain things to give you confidence that, you know, you're going to be back in that positive, you know, perhaps double-digit growth again and professional services in Q2?

Berty Ho: I think we have enough visibility to take us into a positive territory. And I should also mention I think we tend to stay away in terms of giving specific growth on specific lines in terms of percentage. We do for see positive growth, yes.

Gabriel Leung: Okay, and maybe the last thing, just on the healthcare business, you know, you mentioned earlier, you know, sort of, you know, mining the existing customer bases now become, you know, a very interesting growth driver for you guys, given they are about 30 IDNs now.

You know, what sort of metrics should we sort of track or that you can offer us that suggests that, you know, there are some very good follow-on orders from the IDNs they've already signed? Maybe talk about, you know, how many of that 30 - of those 30 IDNs that you're talking to are not talking about, you know, going second project?

Peter Brereton: You know, cutting give you a precise number on that, (Nick), off the top of my head but I can tell you, for instance, in our Q4, we signed, you know, roughly $3 million project with an existing account and IDN has been an account of ours for five, six years.

And, you know, they came back and bought - signed for significant point of use and OR project in the fourth quarter. That project will really only kickoff in sort of late this year. They have a lot of their own internal planning to do around the project and so little really kickoff and I think it's the November, December timeline.

But - and right now we also have - in fact, one of our accounts is already running the OR solution, is at a point where they're saying to us they really need to go to sort of a more organized monthly tour because they're just getting too many people coming through there for site visits.

A lot of them are existing accounts that are flying over there to see what they're doing in the OR and a lot of them are new accounts that are also flying over to see what they're doing in the OR.

But they're trying to organize it into sort of monthly you organized tours rather than just doing them one by one because they're saying it's starting to sort of be too disruptive for their business to have so many tours going on.

So, like, we're seeing a lot of activity around that and certainly this year, I would expect that the base account bookings in the healthcare arena would, you know, be roughly equal to the new account bookings.

Gabriel Leung: Perfect. I appreciate the feedback. Thank you.

Peter Brereton: Okay.

Operator: We have no further questions from the phone lines at this time.

Peter Brereton: Okay, well, thank you very much everyone for taking the time to be with us. And as always, if you have additional questions, please don't hesitate to give us - give any one of us a call. We'll be happy to help you out. Thanks very much. We look forward to talking to you at the end of our next quarter. Thanks. Bye for now.

Operator: Ladies and gentlemen, that does conclude today's conference call. We thank you for your participation and ask that you please disconnect your lines.

*****END*****