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TAX - Q2 2016 Liberty Tax Inc Earnings Call

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Lee Jagoda *CJS Securities - Analyst*

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PRESENTATION

Operator

Good morning. My name is Jackie and I will be your conference operator today. At this time, I would like to welcome everyone to the Liberty Tax, Incorporated second-quarter FY16 earnings conference call.

(Operator Instructions)

I would like to turn the call over to Vanessa Szajnoga to begin.

Vanessa Szajnoga - *Liberty Tax, Inc. - VP, General Counsel*

Thank you, Jackie. Good morning, everyone, and thank you for joining us. With me today are John Hewitt, our Founder, Chairman, and Chief Executive Officer; and Kathy Donovan, our Vice President and Chief Financial Officer.

The press release announcing our second-quarter earnings was distributed this morning. The earnings release may be accessed at the investor relations section of our website located at www.Libertytax.com. A replay of this call will be available shortly after the conclusion of the call. The information to access the replay was in the earnings press release.

I'd like to remind everyone that today's remarks may include forward-looking statements as defined under the Securities Exchange Act of 1934. Such statements are based on current information and management's expectations as of this date, and are not guarantees of future performance. Forward-looking statements involve certain risks, uncertainties, and assumptions that are difficult to predict. As a result, our actual outcomes and results could differ materially.

You can learn more about these risks in our annual report on Form 10-K for the fiscal year ended April 30, 2015 and our other SEC filings. Liberty Tax undertakes no obligation to publicly undertake these risk factors or forward-looking statements.

I would now like to turn the call over to John Hewitt. John.

John Hewitt - *Liberty Tax, Inc. - Founder, Chairman and CEO*

Thank you, Vanessa, and good morning, everyone. As I've often said, we grow our business in two ways: we increase our number of offices and increase our same-store sales.

Our target is to grow to over 11,000 locations in the United States. With about 2,000 franchisees today, that equates to less than six offices per franchisee. I believe this is a reasonable goal since our competitors have peaked at over seven offices per franchisee. So as you can see, most of our growth can be driven internally as our existing franchisees expand.

We do continue to bring in new franchisees, and at the end of November, the sales team completed 141 total US and Canada territory sales compared to 127 at the same point last year. Of these sales, 98 were sold to new franchises, compared to 94 at the same point last year.

During the first half of this year, we have done a number of things to increase our store count for 2016. While we continue to sign leases through early January, our office count today is over 200 greater than where we were at this time last year. This can be partially accredited to expanding our initiatives for A+ locations, mom-and-pop acquisitions, Company store clusters, and the SiempreTax+ brand. In addition, I have personally counseled our top franchisees with their specific growth plans.

Earlier this year, we announced our new A+ store initiative designed to identify prime locations throughout the country where we believe a store can be run at the highest level. Liberty would then lease and furnish the location before finding a franchisee to acquire it.

Another avenue for a prospective or existing Liberty franchisee to grow is through acquiring one of our Company stores. This includes our new cluster program, where we selected cities in which we open clusters of five to seven locations per market initially as Company stores. This program is currently active in 11 major metropolitan areas, including Dallas, Miami, and Seattle. This tax season, we are opening 50 new offices under the cluster program, and many have already been snapped up by our existing franchisees.

Our mom-and-pop acquisition program also increased again this year, providing the additional benefit of gaining new franchisees from conversions. The mom-and-pop acquisition team completed 40% more closed deals through the first half than in the same period last year. These deals are sometimes in the form of customer list purchases, so they do not always result in a new store, but we are happy to continue to expand our customer base. In addition, the number of pending contracts is up over last year, and we expect even more offices to come through the pipeline as we approach the tax season. The opportunity to acquire an existing customer base combined with the benefits of the Liberty brand and marketing strategies offer a great opportunity for a franchisee looking to expand, but who doesn't necessarily want to start from the ground floor.

Our Hispanic brand SiempreTax+ has had a very successful preseason. SiempreTax+ will grow from 57 locations last year to over 150 thus far. This can be attributed to the strong interest from both existing franchisees and new franchisees who see the opportunity of opening both a Liberty and a SiempreTax+.

As the Hispanic population is projected to continue strong growth in the foreseeable future, opening a SiempreTax+ office can present a lucrative option in many markets. We are striving to become a pillar in the Hispanic community throughout the country and remain engaged in numerous strategic partnerships to help advertise the SiempreTax+ brand.

Switching to existing store growth, we are optimistic about increasing our return counts per office next year. The tax industry as a whole should benefit from external trends. With the continued benefit of people living longer and the millions of jobs created in the past two years, we expect an increase of over 2 million additional filers in the 2016 tax season. We also believe that complications from Obamacare will push a higher percentage of people to use the assisted tax preparation over the next two years. Thus, the number of people paying a preparer will grow. And additionally, each year we benefit from the tenuring of our offices as they age. For example, second year offices increase from first year offices; third year offices increase from second, and so forth.

We launched a new guerilla marketing and interactive training this year that teaches franchisees how to use proven guerrilla marketing techniques to drive success in their market. Since the beginning of this fiscal year, we have hosted 46 trainings across 12 states and two countries and reached over 1,000 people in attendance. These marketing techniques will provide franchisees with the tools needed to help maximize their customer base potential.

Also, for the last couple years, we've been aggressive in moving our lower performing franchisees out and replacing them with better operators.

Another tool we are providing to the franchisees to drive return growth this year is a refund loan advance product. This refund loan advance option will be offered to our early season customers and will allow a filer to receive an advance loan prior to receiving their full refund.

There are a number of pre-qualifiers that will limit the number of people who qualify to 10% to 15% of our customer base. We believe this program could add mid-single digit growth to our return counts.

To the success of our sales season and the launch of our new growth initiatives, I am excited as ever heading into my 47th tax season. Long-term growth opportunities, such as SiempreTax+ brand and preseason investments into our existing offices have Liberty well positioned to once again outperform the industry.

Now I would like to turn the call over to our CFO, Kathy Donovan to take you through the details of our second-quarter results.

Kathy Donovan - *Liberty Tax, Inc. - VP and CFO*

Thank you, John, and good morning, everyone. As you just heard, the majority of our time this quarter was spent working to expand our store count, training our franchisees to maximize performance at their existing stores and continuing to invest in longer-term initiatives like SiempreTax+, which will drive growth both now and in the future. As such, my comments on the financial results for the quarter will be brief.

In the quarter, we generated revenue of \$7.9 million, in line with prior year, in which you are all aware is a seasonally light quarter. Through the first half, our franchise fee revenue reflects 109 new territory sales to either new or existing franchisees, compared to 107 as of October 31st last year.

As John has just said, this is the height of our selling season, and through November, we've now sold 141 new territories compared to 127 last year. On top of that, as of today, 11 existing Liberty franchisees have sold their SiempreTax+ rights to other parties who will now open a new SiempreTax+ store in that territory. Those sales will result in new store count but will not generate franchise fees for the Company.

In addition to that, we have established new relationships with several retail partners where our franchisees can operate seasonal locations. The decisions to open a seasonal location in a kiosk or mall can be made very close to the beginning of the season, and many of our franchisees are just making those decisions now.

On the expense side, reported operating expenses for the quarter declined by \$4 million. Excluding executive severance and legal settlement costs, which occurred last year, adjusted operating expenses for the quarter declined by \$0.8 million. Lower commissions, AD expense, and depreciation and amortization drove most of that decline.

Our year-to-date effective tax rate was 38.9%, and we expect a full-year rate of slightly over 38% once Congress renews the R&D tax credit for this year. For planning purposes, Congress has renewed that credit during our fiscal third quarter in each of the last two years. Due to the seasonal losses in the first half of the year, when that credit is renewed, we will need to record a higher tax rate to bring the year-to-date average in line.

Closing out the income statement, our seasonal net loss improved slightly to \$9.1 million, or \$0.71 per share.

Now to the balance sheet and cash flow. As expected, we increased the amount drawn on our revolver during the quarter. At the end of the second quarter, we had drawn \$57.3 million, versus \$16.6 million last quarter, and \$51.7 million a year ago. The increase of \$5.6 million versus prior year was primarily used to provide incremental financing for our franchisees to meet their off-season working capital needs and to provide capital for planned expansion. We expect to begin to pay back the revolver in February and to pay it back completely by the end of the year, as we receive funding from the IRS.

Finally, our Board has authorized us to issue our fourth consecutive quarterly dividend of \$0.16 per share, which will be paid on January 22, 2016 to shareholders of record on the close of business on January 15th. We believe this quarterly dividend shows our continued commitment to enhancing shareholder value and our confidence in future performance and long-term cash flow.

In conclusion, we feel good about our outlook for the upcoming tax season. The environment is favorable for paid tax preparers, we are on track to increase the number of locations operating during the season, and we have the right product offerings in place to attract new customers into our stores. We still have work to do, but we are looking forward to the season.

And with that, we would now be happy to take your questions. Jackie?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Lee Jagoda, CJS Securities.

Lee Jagoda - CJS Securities - Analyst

Could you better help us understand the conversion of territory signings to new stores and what percentage of the territories, generally sold, don't open a store in the first tax season? What was the number last year?

And then the last part of this is I assume you're selling two stores with the territory these days, so you have the ability or they have the ability to open up both a Liberty and a Siempre, is that right?

John Hewitt - Liberty Tax, Inc. - Founder, Chairman and CEO

That's a lot of questions, Lee. The last question is correct. Really they can open as many stores in a territory as they want. Most likely, most territories, they are only going to have one store.

But certainly if there is an Hispanic population more than roughly one-third of the population of a territory, then they are likely to have both a Liberty and a Siempre. They also could have two Liberty locations or two Siempre locations.

But again, most of the territories will have just one location, about 40% will have more than one location in the territory. As far as what percentage of new franchisees buy an existing location versus a new location, that number continues to move more and more towards existing, as we build out our office location. So, about two-thirds of the people that come in acquire a new territory versus an existing location.

Lee Jagoda - CJS Securities - Analyst

Okay, and then the last part of that was the -- if you buy a territory in a given tax season, how many of those people don't end up opening the store?

John Hewitt - Liberty Tax, Inc. - Founder, Chairman and CEO

Over 90% open at least one location. The exception is some people, and it is less than 25%, acquire multiple locations. When they acquire multiple locations, for example, if they acquire four territories, we would typically have them be required to open one the first year, one the second year, one the third year, and one the fourth year.



But that is not very often, and we are trying to stay away from the number of franchisees and giving you the number of territories that we are selling. And most of those, over 90% of them will open this year.

Lee Jagoda - *CJS Securities - Analyst*

Okay, and then just switching gears, I know you mentioned you signed some other retail partners. Would love some detail on that. What about the expectations for Walmart this tax season?

John Hewitt - *Liberty Tax, Inc. - Founder, Chairman and CEO*

Walmart is the same as last year, Walmart has increased rent and driven some of our franchisees out of their locations because of the very high rent. We have a couple of relationships, for example, that are expanding, Family Dollar, we are pleased to be in a number of Family Dollars.

Also there is an Hispanic money transfer organization, the largest Hispanic chain in the country called DoEx, and DoEx has approximately 500 locations. Their expertise is sending money to other countries for Hispanics. And we are excited about that partnership because, as I said, it's the largest chain of purely Hispanic customers in the country, until Siempre passes it one day.

Lee Jagoda - *CJS Securities - Analyst*

And I know the kiosks don't generally make too much money and don't have too much volume and people usually use it as more of an advertisement than anything else. But if I look at the Walmart combined with now the new relationships, would you expect the kiosks in total to decline, stay the same, or increase this tax season?

John Hewitt - *Liberty Tax, Inc. - Founder, Chairman and CEO*

Let me say this: we are focused on our store fronts; that is our bed and butter. And you are right, the kiosks tend to be flagships that we use to get brand and drive people eventually into our store fronts. We expect a number of kiosks to be about the same as last year.

Lee Jagoda - *CJS Securities - Analyst*

Okay. Very helpful. I will hop back in queue and let others ask some questions.

John Hewitt - *Liberty Tax, Inc. - Founder, Chairman and CEO*

Thank you, Lee.

Operator

Michael Millman, Millman Research.

John Hewitt - *Liberty Tax, Inc. - Founder, Chairman and CEO*

Welcome, Michael.

Michael Millman - *Millman Research - Analyst*

Thank you, John. A few questions, but we'll start with I think you called it assisted lending, or a refund advance loan? Could you talk about what that is and how that's going to work, and how it differs from something that seems similar in the past?

John Hewitt - *Liberty Tax, Inc. - Founder, Chairman and CEO*

Well, I will tell you what happened last year in the market, and Jackson Hewitt rolled this out. And their program, I believe, was that the customer could get a refund advance of \$500. And the customer had no fees, and the franchisee had to pay a fee of \$40.

Now, we believe that it had a significant increase in Jackson Hewitt volume. And totally, we think it was a 5% to 10% increase. And not coincidentally, Jackson Hewitt's best year in six years; after five years of significant decline, they had a small increase last year.

It's a program like that where the customer will get an amount up front, and the customer will have no fees. There will be a fee to our franchisees. What we've calculated is that with just a just a 3% to 4% increase in business, we can pay for the additional cost of those customers. Because of competitive reasons, we are not giving the exact details of our program.

Michael Millman - *Millman Research - Analyst*

So do you think that Block's weakness -- early-season weakness in volume was related to what Jackson Hewitt was doing? And maybe some others were doing that they were losing, basically losing the quick refund customers?

John Hewitt - *Liberty Tax, Inc. - Founder, Chairman and CEO*

Well H&R Block last year lost about 600,000 or 700,000 customers. Jackson Hewitt only gained not even 100,000 customers. I don't think that it was a major part of their problem; I think their problems are internal.

Michael Millman - *Millman Research - Analyst*

Okay, going on a little bit. The ACA moving to assisted, do you think that begins now or does it take a couple of years for really that to roll out? And what kind of numbers do you put on that?

John Hewitt - *Liberty Tax, Inc. - Founder, Chairman and CEO*

Yes. It is hard to judge at this point until we get some data from the government and the insurance company as to how many people are actually buying that insurance. The penalties have gone up dramatically, so that should drive the number of questions and the number of customers who are confused and have tax returns change.

However, the exemptions they had last year are still in place. So it is pretty easy to be exempted from a penalty; it is unclear how much it is going to help. We do believe that it is going to be a tailwind this tax season, but how much it's going to be is anyone's guess at this point.

Michael Millman - *Millman Research - Analyst*

Related in some sense is fraud. Do you see that helping assisted or basically reducing the online business?

John Hewitt - Liberty Tax, Inc. - Founder, Chairman and CEO

Well, the only way that it could help in terms of assisted would be that if the people who are committing fraud online file legitimate tax returns, then they could come back to assisted. Otherwise, I don't see it having any positive impact, any significant positive impact.

Michael Millman - Millman Research - Analyst

It's a negative impact on do-it-yourself then?

John Hewitt - Liberty Tax, Inc. - Founder, Chairman and CEO

Yes.

Michael Millman - Millman Research - Analyst

And what are you looking for in terms of pricing this year?

John Hewitt - Liberty Tax, Inc. - Founder, Chairman and CEO

The pricing -- typically, we are in the expectation of and we believe over the next three years that we are going to get about a 5% price increase a year. We believe that we are going to get some extra from ACA each year for the next few years.

It's just a question of what percentage our customers come in that take advantage of the ACA-related tax forms. So it could be anywhere in the neighborhood of 6% to 8%.

Michael Millman - Millman Research - Analyst

So the 5% is before ACA cost -- charges.

John Hewitt - Liberty Tax, Inc. - Founder, Chairman and CEO

That's correct.

Michael Millman - Millman Research - Analyst

And remind me, John, what was your price increase last year?

Kathy Donovan - Liberty Tax, Inc. - VP and CFO

About 3%.

Michael Millman - Millman Research - Analyst

Right. Thank you.



John Hewitt - Liberty Tax, Inc. - Founder, Chairman and CEO

Thank you, Michael.

Operator

Scott Schneeberger, Oppenheimer.

Unidentified Participant

Hi guys, it's actually Don filling in for Scott today. John, I have a couple of questions for you. First off, I know you and the franchisees put a lot of focus on and investment in training on ACA next year. Do you expect to reap any significant efficiencies from that in the upcoming tax season or would this year be more of another year of investments and training? How do you look at that?

John Hewitt - Liberty Tax, Inc. - Founder, Chairman and CEO

We certainly expect at least single-digit impact, minimally single-digit impact from an increase in customers from all of the efforts we put into developing licensed insurance agents in our offices to answer questions. We are the most aggressive in the industry in putting licensed insurance agents in our office.

Unidentified Participant

Okay, great. Perfect. Then also, the biggest operator in the DIY space is offering its absolute zero product again. I am curious on your take on how that could impact the tax industry over the next couple of tax seasons?

John Hewitt - Liberty Tax, Inc. - Founder, Chairman and CEO

Obviously, that is a great way to introduce your product to the market. We have a similar product ourselves. The difference between our DIY product and their absolute zero is we make ours available to everyone the entire season.

So I think so much of it that we do it all year for all customers, not just for 1040-A and 1040-EZ customers. And remember, our goal is unlike theirs. They don't have brick-and-mortar. Our goal is to drive as many of the DIY conversions into our offices.

Unidentified Participant

Okay. Got it. Last one for me. John, can you also remind us how you differentiate with your SiempreTax+ product, how that is differentiated from your competitors? And if you could also please clarify on the 11 franchisees that sold the rights, who are the buyers there? I'm sorry if I missed that earlier, but if you can clarify that as well, please.

John Hewitt - Liberty Tax, Inc. - Founder, Chairman and CEO

Sure, the owners of 11 territories who own Liberty rights were in Hispanic areas, primarily in South Florida. And we have a very aggressive area developer in South Florida who went to mostly to mom-and-pops who were Hispanic and said would you be interested in joining Liberty and acquiring a Siempre location in a territory?

And so they sold their rights to Hispanics who wanted to open a SiempreTax+ in their territory. The two biggest differentiators are to be a SiempreTax+ everything is in Spanish. You have to have all bilingual preparers. We are going after 100% of the Hispanic market.

The second part of that is what we've learned and our venture into the Hispanic market has not started two years ago with Siempre, but seven years ago, we started our Liberty Hispanic-certified offices. So we have over 700 Liberty-certified Hispanic offices, where you have to have bilingual preparers and offer other services, such as preparing an ITIN, which is a replacement for a Social Security number so that an undocumented worker can file a tax return and get a refund.

But we found in our Hispanic certified offices, as in our Siempre offices, those customers are demanding other services. In a Liberty office, they're not that interested in notary, for example or immigration questions, or sending money back to Mexico or Nicaragua or Colombia. Most of our Liberty customers are interested in a one-time visit.

Our Hispanic customers come in all year long. And so, instead of being a seasonal business, it's a year-long business. And so we are open 52 weeks a year and a good solid year-round business, as opposed to the Liberty offices, which tend to be just three-month business.

Unidentified Participant

Oh, okay. Thank you for taking all my questions. Have a good one.

John Hewitt - *Liberty Tax, Inc. - Founder, Chairman and CEO*

Thank you, Don.

Operator

Lee Jagoda, CJS Securities.

Lee Jagoda - *CJS Securities - Analyst*

John, I know you spoke earlier about -- at currently, the store count is 200 greater than last year, year over year. Does this include the 100 Company-owned stores you plan to open and you talked a little about last quarter?

John Hewitt - *Liberty Tax, Inc. - Founder, Chairman and CEO*

This includes all offices. And as I indicated earlier, and not in specifics, but many of the offices that we intend to open as Company offices as clusters have already been sold to franchisees.

Lee Jagoda - *CJS Securities - Analyst*

So how many incremental Company-owned stores are you currently sitting with now?

John Hewitt - *Liberty Tax, Inc. - Founder, Chairman and CEO*

I don't have that number in front of me. We are signing leases every day.

Kathy Donovan - *Liberty Tax, Inc. - VP and CFO*

Right.



John Hewitt - Liberty Tax, Inc. - Founder, Chairman and CEO

We have approved dozens more that we haven't opened yet. But it is approximately 50, Lee.

Lee Jagoda - CJS Securities - Analyst

Okay. And when were those staffed up during the quarter?

John Hewitt - Liberty Tax, Inc. - Founder, Chairman and CEO

They won't be staffed up until January.

Lee Jagoda - CJS Securities - Analyst

Okay. So you haven't incurred the staffing expense associated with those in these quarterly numbers? It is going to be more of a Q3, Q4 event?

John Hewitt - Liberty Tax, Inc. - Founder, Chairman and CEO

Exactly.

Lee Jagoda - CJS Securities - Analyst

Okay. And I think that's all for me. Thank you.

John Hewitt - Liberty Tax, Inc. - Founder, Chairman and CEO

Well, thank you. Thank you, everyone, and have a wonderful day.

Operator

Thank you. This concludes today's conference call. You may now disconnect.

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