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TAX - Q2 2017 Liberty Tax Inc Earnings Call

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## CORPORATE PARTICIPANTS

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

**John Hewitt** *Liberty Tax, Inc. - Chairman, CEO & President*

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

## CONFERENCE CALL PARTICIPANTS

**Lee Jagoda** *CJS Securities - Analyst*

**Michael Millman** *Millman Research Asset Management - Analyst*

## PRESENTATION

### Operator

Good morning. My name is Lashonda and I will be your conference operator today. At this time, I would like to welcome everybody to the Liberty Tax, Inc. second-quarter fiscal 2017 earnings call. (Operator Instructions). I will now turn today's call over to Vanessa Szajnoga to begin.

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

Thank you, Lashonda. 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](http://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, 2016 and our other SEC filings.

Liberty Tax undertakes no obligation to publicly update these risk factors or forward-looking statements.

This presentation also contains references to certain non-GAAP financial measures, which are metrics that we use internally to measure our operating performance. For a description of these non-GAAP financial measures, including the reasons management uses each and the reconciliations of these non-GAAP financial measures to the most directly comparable financial measures prepared in accordance with generally accepted accounting principles, please see the latest earnings release, which is also available under the Investor Relations section of our website. I would now like to turn the call over to John Hewitt. John.

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**John Hewitt** - *Liberty Tax, Inc. - Chairman, CEO & President*

Thank you, Vanessa and good morning, everyone. We are less than 24 days away from the start of our fiscal 2017 tax season. The industry has faced five years of headwinds. We are coming off the toughest season ever for Liberty Tax and the worst of this century for all of the branded competitors combined. We are focused on compliance, our Company's store profitability and our financial products group.

Historically, on this call, I've provided an update of our off-season sales efforts along with a description of the progress and improvements we've made to ensure that we have a successful upcoming tax season. This year, we have made changes to combat the industry-wide compliance issues, which impacted a handful of our franchisees last year. Last year was our most difficult year ever. I am afraid that this year was truly a reset year as



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we respond to the challenges we faced last tax season and worked to put in place measures to ensure we will be a stronger company built on a foundation of integrity.

Our compliance task force was very successful in analyzing, reviewing and evaluating the work of our compliance department and taking appropriate action to ensure that the standards of the Liberty brand are upheld and that those who do not uphold Liberty standards are exited from the Liberty system. The task force helped to create new processes and procedures to assist with the resolution of compliance concerns, whether at the customer preparer or franchisee level.

As a result of the work of our compliance department and the task force, we have taken back over 100 offices, which may sound like a lot, but is only about 2% of our system. We feel good that we have pruned down to a healthy vibrant franchise base.

We continue to work with Fred Goldberg, former IRS Commissioner and current partner at the law firm of Skadden, Arps, as well as Doug Gansler, former Maryland Attorney General and a partner at the law firm BuckleySandler. We also continue to work with other regulatory advisors throughout the US to advise on and further our compliance efforts.

Recently, in fact, we brought on Richard Ernst, former New York State Deputy Tax Commissioner, to consult with our team as our compliance counsel as we continue to enhance our compliance efforts. We have the strongest team in the industry. We recognize that our compliance efforts are part of the longer process in combating what is an industry-wide issue. We are committed to being proactive and look forward to continuing to work with industry groups in an effort to protect our brand and the integrity of tax preparation in general. We are focused on delivering top-notch tax preparation services at our locations while at the same time working to ensure that those we bring on to represent the Liberty brand are upholding our standards.

I am already focused on the next selling season and the available market opportunities remain great. The largest branded [taxpayer] operated more than 10,000 offices in the United States last tax season compared with the roughly 4,200 offices operated by Liberty. We clearly have room to grow. However, the last few years have been difficult, as I mentioned, for all the branded competitors. Increased regulation and enforcement has hurt the brands while mom-and-pops have gained share. Liberty has clearly outperformed the other branded competitors and we will continue to do so.

In terms of this year's sales efforts, the impact of last year's negative publicity was larger than we had expected. We sold fewer territories to new franchisees. Through November, the total number of territories sold to new franchises declined from 99 last year to 26 this year. While we are not satisfied with this decline in new territory sales, we are determined to attract and recruit franchisees who are uniquely qualified to uphold our standards and who are aligned to the goals of the Liberty brand.

I've stated previously that, with our roughly 2,000 franchisees, we believe we already have the total number of franchises needed to reach our goal of 11,000. That would equate to just 5.5 offices per franchise. Our two largest competitors peaked at over eight offices per franchise. Our focus going forward will be working with these existing franchisees to ensure they are successful, competent and ready to expand into new territories.

This off-season, however, many of our existing franchisees were not comfortable adding additional stores. We are now focused on working with these franchisees to ensure that they have a successful 2017 tax season and to put them in the position to expand when the season is over. In total, including both new and existing franchisees through November, we sold 50 new US and Canadian territories compared to 142 in the same period last year.

Turning to office count, it is still too early to know exactly how many stores will be opening in the coming tax season. We do expect office count to decline. We have actively pruned back certain franchise locations and as we previously announced, ended our seasonal relationship with Walmart. We will be operating more Company-owned locations this year as a result of the reacquisition of over 100 offices.

As we develop our Company store organization, we will drive more profit. Similar to our competitors, we are focused on growing healthy, larger, more profitable Company-owned stores. Our SiempreTax+ team is coming off a very strong year, which saw offices grow from 57 to 144 locations



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last tax season. The opportunity for Siempre is large as we are serving the fastest-growing population in the United States and will continue to be a catalyst for growth as we further enhance the brand and product offering within these stores.

We continue to invest in Siempre and believe that we now have a strong organization in place to move us forward. Store count may stabilize this year with our active pruning of some of the lower-performing offices. We believe this puts us in a better position to relaunch some of those prime locations with better operators next tax season. There's a lot of interest in Siempre and we expect strong growth for the foreseeable future.

We've also been preparing for the impact of the PATH Act, which was passed by Congress last year. Refunds for many early-season clients will be delayed until at least February 15 as a result of this legislation. We believe this will drive increased interest in our Refund Advance product, which will only be available from paid preparers. The PATH Act could drive marketshare for the entire paid preparer category and we believe that our product will be best in the industry. The tax refund is the largest single financial event of the year for many people and a two-week delay can cause financial hardship. We believe the Refund Advance will help bridge that period for many clients.

I would also like to talk briefly about the election. We believe the new administration will be very good for small business and therefore for us and our franchisees. We have more than 2,000 entrepreneurs who should benefit from reduced regulation and the easier playing field and the better playing field for small business will mean more people will file more complicated returns, which will drive them to a tax preparer.

The Affordable Care Act has not had the impact we originally anticipated. We will need to wait and see if the changes proposed during the election will be made and if so, what aspects of the Affordable Care Act will continue to be reflected and managed through the tax return.

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.

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### **Kathy Donovan** - Liberty Tax, Inc. - CFO

Okay, thank you, John. Good morning, everyone. For the second quarter of fiscal 2017, the Company delivered revenue of \$7.2 million, \$600,000 below last year in a quarter where revenues are seasonally low. As John described, we've sold fewer new territories this year, which drove lower franchise fee revenue. Through the first half, our revenue reflects 38 new territory sales to either new or existing franchisees compared to 109 as of October 31 last year. To give you an update through November, we have now sold 50 new territories compared to 142 last year.

We've also seen fewer sales between our franchisees. Through the first half, our franchisees have sold or transferred 113 territories compared to 173 last year. This drove lower transfer fees and commissions, which is reflected in other revenue on our income statement.

Tax preparation fees were up \$500,000 in the quarter and we expect that to continue. We will be operating more Company stores this year and the mix has changed. Last year, we ran a large number of first-year locations as part of our new cluster program while this year, as John said, we will be operating a slightly larger number of more mature, higher producing stores.

On the expense side, reporting operating expenses for the quarter were slightly above prior year. Excluding task force-related costs, non-GAAP operating expenses declined slightly. Cost-reduction efforts in several areas, including advertising, marketing, IT and travel, offset the increased compensation and other costs associated with the expanded number of Company stores. As you know, the incremental cost of running these stores through the off-season will be offset by higher tax preparation fees and margin during the season.

Closing out the income statement, we delivered a seasonal GAAP net loss of \$9.3 million or \$0.72 per share and on a non-GAAP net loss of \$9.2 million, also \$0.72 per share. Effective cost controls in several areas offset the lower franchise fees and the additional Company store costs.

Now to the balance sheet and cash flow. As expected, during the quarter, we drew from our revolver to fund off-season expenses. At the end of the second quarter, we had drawn \$66.6 million versus \$28 million last quarter and \$57.3 million a year ago. We use our revolver during the first three quarters of the year and then begin to pay it down once the IRS begins funding.



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Our first priority for the use of cash is investing in initiatives that drive either revenue growth or profit. We are also committed to returning cash to our shareholders. As such, we are pleased that our Board has authorized us to issue our eighth consecutive quarterly dividend of \$0.16 per share, which will be paid on January 23, 2017. We believe this quarterly dividend shows our continued commitment to enhancing shareholder value and our confidence in the performance and long-term cash flow.

In conclusion, we are managing our costs; we are improving the performance of our Company stores and we believe our franchisees are well-positioned to drive strong results this season. In addition, the Refund Advance product will be attractive to our customer base and will bring people into the stores. We are now focused on driving return count, profitability and cash flow for the season. And with that, we'd now be happy to take your questions. Lashonda.

### QUESTIONS AND ANSWERS

#### Operator

(Operator Instructions). Lee Jagoda, CJS Securities.

#### Lee Jagoda - CJS Securities - Analyst

So, for starters, can you lay out some of the details of your Refund Advance loan product for this tax season? Maybe talk about some of the ways it's similar and different versus what the competitors have laid out there?

#### John Hewitt - Liberty Tax, Inc. - Chairman, CEO & President

Lee, I will tell you a few things that are better about our product, but I don't want to tell everything because I don't want our competitors to copy us. So some of the things that are public that are clear is to get a card from our major competitors and most of the competitors, in fact, you need to take it on a card versus getting a check and we offer a card too and only about 6% of our customers choose to take a card. So most customers would rather have a check than a card and to get their product, you have to take it on a card. So that's one of the things.

We also have a higher limit on ours. We are going to have a \$1,300 limit and they have a bait-and-switch type of deal where you could apply for \$1,250 and only get a smaller amount where, with us, you either are going to get \$1,250 or nothing.

And finally, we have a higher percentage of refund -- a customer can get a higher percentage of their refund from us -- many of our customers -- than from them. There are a couple other advantages that I'm not going to mention on the call.

#### Lee Jagoda - CJS Securities - Analyst

Okay. In terms of Siempre, how should we think about the store expansions in terms of Siempre versus traditional Liberty? And if you can remind us how many Siempre locations were Company-owned stores last year versus your expectation for the upcoming season for Siempre.

#### John Hewitt - Liberty Tax, Inc. - Chairman, CEO & President

I don't have the number of Company-owned locations in front of me. It was about two dozen last year and we have a consolidation, both Siempre and with Liberty because of our compliance efforts and our pruning the system.



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**Lee Jagoda** - *CJS Securities - Analyst*

Okay. So we should expect more than two dozen Company-owned Siempres in this tax season. Is that fair?

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**John Hewitt** - *Liberty Tax, Inc. - Chairman, CEO & President*

Yes.

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**Lee Jagoda** - *CJS Securities - Analyst*

So then switching gears to pricing. Historically, we've always thought 4% to 6% annual increases in tax prep fees. Given there's a bunch of competitive pressure out there and I will use the quote free is the new norm, how do we see this trending in the current year?

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**John Hewitt** - *Liberty Tax, Inc. - Chairman, CEO & President*

I think that, especially with Block offering the 1040EZ for free, I think we expected a smaller increase anyway this year, so instead of a 3% to 5% increase, I would say maybe closer to a 2% to 3% increase.

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**Lee Jagoda** - *CJS Securities - Analyst*

Okay. That's it for me. I will hop back in queue. Thanks.

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**Operator**

Michael Millman, Millman Research Asset Management.

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**Michael Millman** - *Millman Research Asset Management - Analyst*

Just to follow up on that last question, it seemed to me what Block was suggesting on price was really closer to 1% and in total maybe flat to down.

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**John Hewitt** - *Liberty Tax, Inc. - Chairman, CEO & President*

Right. Well, I was talking about what our recommendation was and based on competitive -- if it is necessary for competitive reasons, we may be lower, but, at this point, I would say that it's 2% to 3%.

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**Michael Millman** - *Millman Research Asset Management - Analyst*

And in terms of also the RALs, do you think because Block has the name that they will be able to drive more customers than the others folk who offer RALs?

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**John Hewitt** - *Liberty Tax, Inc. - Chairman, CEO & President*

Are you talking about the name [reap] RAL, or Rapid Refund, are you talking about the name H&R Block?

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**Michael Millman** - Millman Research Asset Management - Analyst

I'm talking the name Block.

**John Hewitt** - Liberty Tax, Inc. - Chairman, CEO & President

Okay. No, I think Block has been decreasing for the last three years and their name is not as much of a driver today as it was 10 years ago and that's why they are doing less tax returns today than they were doing 10 or 15 years ago. So we expect to be the national industry leader again.

**Michael Millman** - Millman Research Asset Management - Analyst

In regard to the independents picking up share over the last couple years, a lot of us thought it had to do with pricing, more competitive pricing and maybe a more lax attitude towards compliance. Is that still the thought, or is there something else involved?

**John Hewitt** - Liberty Tax, Inc. - Chairman, CEO & President

Well, in terms of pricing, their pricing compared to our pricing has not changed dramatically over the last 25 years, so that was not a factor in the last couple years. The lax attitude towards compliance with the IRS regulations has really been the problem. Now, hopefully, that has diminished and all the people that are going to switch have switched over to the more lax and preparers that aren't following regulations, but that hasn't changed. We are hoping that, with our quarterly meetings with the IRS and industry, there is a consensus of virtually everyone with the possible exception of Intuit that the regulations for assisted preparers should be equal to the requirements of the online preparers and the same documentation should be necessary for both. So we are hoping that, by the following tax season, by 2018, everyone will be held to the same standard, which will be very beneficial for the national players.

**Michael Millman** - Millman Research Asset Management - Analyst

Turning a little bit to -- what are you seeing in terms of your tenured volume trends, particularly in some of the older --?

**John Hewitt** - Liberty Tax, Inc. - Chairman, CEO & President

We really don't talk too much about that because -- for competitive reasons, but certainly last year we had a decrease in returns and therefore, the tenuring was decreased from the previous year.

**Michael Millman** - Millman Research Asset Management - Analyst

And that was across all age categories?

**John Hewitt** - Liberty Tax, Inc. - Chairman, CEO & President

That was, yes.

**Michael Millman** - Millman Research Asset Management - Analyst

Okay. Thanks, John.



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**Operator**

And I will now turn today's call back over to John Hewitt for closing remarks.

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**John Hewitt** - Liberty Tax, Inc. - Chairman, CEO & President

I want to thank everyone for your interest and thank all of our franchisees and employees for their efforts. We understand that our success is due to -- we need to have happy successful employees and franchisees. Thank you and have a wonderful day.

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

Thank you.

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**Operator**

This concludes today's conference call. You may now disconnect your lines.

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