TECSYS INC.
Third Quarter FY2016 Results
Financial Analyst Call
Wednesday, March 2, 2016, 8:30am

Operator

Good morning ladies and gentlemen. Thank you for standing by. Welcome to the TECSYS Third Quarter Fiscal 2016 Results Conference Call. At this time all participants are in a listen-only mode. Following the presentation we will conduct a question and answer session. Instructions will be provided at that time for you to queue up for questions. If anyone has difficulties hearing the conference please press Star 0 for operator assistance at any time.

Please note that the complete third quarter report including MD&A and financial statements were filed on SEDAR March 1, 2016. All dollar amounts are expressed in Canadian currency and are prepared in accordance with International Financial Reporting Standards and are 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.

I would like to remind everyone that this call is being recorded on Wednesday, March 2, 2016 at 8:30 Eastern Time. I would now like to turn the conference over to Mr. Peter Brereton, Chief Executive Officer at TECSYS. Please go ahead sir.

Peter Brereton

Thank you and good morning everyone. We appreciate you joining us for today's call. Last night we issued our unaudited 2016 third quarter financial results. A copy of those results is available on our website at TECSYS.com. Joining me today is Berty Ho, our Chief Financial Officer.

I'll start by summarizing the key events for the quarter and reviewing our Q3 financial results. I'll then close with a few comments on our outlook for the remainder of the year followed by a Q&A session.

In the third quarter we continued to progress on the strategy we have discussed on previous calls. We signed two new healthcare providers including one IDN and one community hospital, expanded our relationship with existing complex distribution customers, and enhanced our Point of Use solutions. While this was not a high growth quarter from a top line revenue standpoint, we were in the final stages of a product build cycle for our next generation Point of Use product line. We have firm orders for this product line which should begin to ship in the near term.

Total contract bookings in the quarter were $9 million compared to $12 million in the third quarter of 2015. In Q3 of 2016 we added two new healthcare accounts with a total contract value of $1.9 million.

The IDN contract we signed during the quarter is with a large hospital network in the U.S. Midwest which comprises over 90 hospitals and more than 120 specialty health centers and clinics.

By far this is our biggest win to date. The network is twice the size of our next largest IDN customer. It's important to note that it took over 24 months to sign up this IDN. This is typical of the healthcare sales process. However, a win of this magnitude demonstrates that patience does pay off.

There are only a few hospital networks of this scale in the United States and we are pleased to have signed this account. We expect this will be a long term relationship that generates significant repeat business and substantial benefits for both organizations.

Also important is the visibility we gain in the industry by adding this IDN. As hospital networks increasingly are looking to transform their supply chains, the large players serve as role models for the entire industry. This contract is a further validation of the TECSYS solution and we're confident that it will help drive further sales.

The community hospital signed in the quarter which consists of a hospital and its outpatient clinic demonstrates the versatility and the broad application of our technology.

Looking to the remainder of 2016, we believe we could add two to three IDNs in Q4. While we may come short of our goal of closing eight IDNs this fiscal year we have closed some very large IDNs and some community hospitals which were not part of our initial plan.

In the quarter we also saw positive momentum with -- pardon me -- with our Point of Use solutions. In December we went live with the second implementation of our operating room solution. It was a three to four month process to launch and we expect to release our expanded OR solution in the spring.

For our complex distribution business we continued our progress with certain base accounts. Our Caterpillar dealer customers are investing in more licenses to cover more branches and several of our large customers expanded their relationship with us.

Now let's look at our financials for the quarter. Revenue in the quarter was $15.6 million, about a 4% increase from $15 million in Q3 of 2015. That increase was driven by gains in foreign exchange and services revenues mitigating the decline seen in our proprietary products and third party products.

Foreign exchange had a favorable impact of about $1.8 million in Q3 of 2016. About 70% of our revenue is generated in the U.S. and year over year the average U.S. seller exchange rate in the quarter increased to 1.32 from about 1.10 in the same quarter a year earlier. As a percentage of revenue our products accounted for 30% and services for 67%.

Breaking down revenue, we recorded $10-1/2 million in services revenue, up 25% or $2.1 million from Q3 of 2015. All of our services revenue streams improved particularly product adaptation services and support services compared to the same period last year. The increase in services revenue came mainly as a result of the higher order backlog at the beginning of the current quarter in addition of course to the strengthening of the U.S. dollar.

Proprietary product revenue defined as internally developed products including proprietary software and technology hardware was $2-1/2 million, down 24% from Q3 of 2015. This was due to lower hardware technology product sales and some products were sold based on a subscription model.

This trend toward subscription is likely to continue as we are seeing a tendency in healthcare to essentially rent rather than buy Point of Use solutions.

Third party products revenue decreased to $2.2 million or 22% lower than Q3 of 2015 due primarily to lower RF equipment sales. On an annualized basis recurring revenue was $25.3 million last quarter compared to $21.4 million in Q3 of 2015. While roughly 40% is due to foreign exchange gain we are pleased with the trend as a growing recurring revenue base can to some extent offset lumpiness in quarterly revenue.

Gross margin improved to 51% in the quarter compared to 47% in the previous year, a reflection of our increased productivity and efficiency in the services organization. Gross profit improved by $849,000 to $7.9 million compared to $7.1 million recorded last year. The improvement was driven by higher services margin of $1.8 million offset by lower product margin of $908,000.

Taking a look at total operating expenses for the third quarter, we saw an overall increase to $7.3 million, up $875,000 or 14% compared to $6.4 million for the same quarter last year. However sequentially total operating expenses were flat in spite of a reduction in R&D capitalization. As we said last quarter, we are through our major investment phase and our OPEX should grow at a lesser pace than our revenue.

Of the operating expenses sales and marketing costs were higher due to increased employee related expenses particularly as a result of reorganization of the sales force to focus on certain key verticals. We continue to believe this is the right strategy for driving long term growth which was supported by sales traction on both sides of the business again this quarter.

G&A expenses were well contained at 8.9% of total revenue for Q3 of 2016 compared to 9% during the previous quarter our previous year quarter. R&D expenses increased to $2.3 million last quarter, $457,000 higher than the same quarter last year.

This was partially due to a (unintelligible) of the R&D team as we invest in the next generation of solutions. These investments are in pursuit of new features and product functionality that will assist in continuing to drive sales growth.

The increase in R&D expense was also caused by the tapering off of R&D capitalization. We began to capitalize our R&D costs a number of years ago as we invested in rewriting our legacy product line. In Q3 of 2016 we capitalized only $140,000 of deferred development costs compared to $342,000 in Q3 of 2015. Over the next few quarters we expect capitalization of deferred development costs to decrease further.

For the third quarter of 2016 EBITDA grew 4% year over year to $1.3 million. EBITDA margin remained flat at 9% compared to Q3 of 2015. Profit from operations remained relatively flat at $.6 million compared to Q3 of 2015.

Considering the growth in our sales and marketing expenses as well as our R&D investments and reduced capitalizations or capitalization, we are pleased that we maintained our margins.

Now turning to cash and cash equivalents, we ended the quarter with $8.8 million in cash and cash equivalents compared to $10.8 million at the start of the fiscal year. The difference was mainly the result of cash used for repayment of long term debt, the payment of dividends, as well as investment in capital assets. Long term debt was reduced by $1.1 million during that nine month period.

In summary we showed strong growth in recurring revenue and signed one of the largest IDNs in the U.S. We continue to improve the productivity and efficiency of our service organization and reached a new record for our backlog. We remain optimistic about the growth prospects in the coming quarters and believe we will deliver strong operating leverage to enhance profitability for the next several years.

With that, I will turn it over to for Q&A. Thank you.

Operator [Q&A instructions]

Peter Brereton (post-Q&A)

Okay thank you everyone and thank you for taking the time to join us and as always if you have additional questions please feel free to call Berty or I and we'll look forward to talking to you at the end of Q4. Thanks, have a good day.