INTELLIGENT SYSTEMS CORPORATION

Moderator: Strange, Leland

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OPERATOR: This is Conference # 2061606

Operator: Good morning. My name is Adrian, and I will be your conference operator today. At this time, I would like to welcome everyone to the fourth quarter earnings release and investors conference call. All lines have been placed on mute to prevent any background noise. After the speaker's remarks, you will be allowed one question and if you would like to follow up, please press star one again to reenter the queue. If you would like to withdraw that question, press the pound key. Thank you. I would now like to turn the call over to CEO of Intelligent Systems Leland Strange. Please go ahead sir.

Leland Strange: Thank you. Welcome everyone on the call today. We appreciate you taking the time to join us. I have with me in the room Matt White Intelligent Systems and CoreCard CFO and Mark Raleigh the COO of CoreCard. We've recently officially set up an operating structure at CoreCard that mimics how it has actually been operating the last few years. Mark has a title of COO in an office of the president that has five members including myself as CEO. Management decisions are made among that group. So, I wanted to explain that even though we haven't updated the website that's really the way the management of our CoreCard subsidiary, which is the same as Intelligent Systems is now operating.

It appears it's been an interesting morning in the early hours of the market opening as investors traded over double our normal daily volume in less than two hours. I have to admit that I'm somewhat surprised as we thought our results are pretty good and the future likewise is looking good, but the market does what the market does. I’m going to remind you that whatever might be said in the course of the call that's not a historical fact, is a forward-looking statement within the meaning of federal securities laws. We'll be discussing events or developments that we believe at this particular time given the facts that we have today may occur in the future.

These forward looking statements are subject to a number of risks and uncertainties including those set forth in our SEC filings. Actual results may and probably will differ sometimes materially due to numerous risk factors. The company assumes no responsibility to provide updates to this information except in accordance with legal obligations. I think in a further comment on this statement I can tell you that a year ago, we did not believe that 2019 year would be as strong as it turned out to be. I could say the same thing about comments earlier about the 2018 year. We felt that each would be good in January of the year, but I had no information in January that would have backed up a forecast of what actually happened.

Our budget forecasts were not meant to be either conservative or to be a stretch. That was just our best guess. I think we recognized and commented on calls that license revenue is virtually impossible to predict on a quarterly basis, although we can come closer thinking of an annual amount. I've emphasized that we're closer since I've often stated we don't know how well our current or new customer will grow their portfolios. In many cases, they also lack good insight on that information. We want to be as transparent as possible because we know that shareholders and prospective shareholders want clarity.

We provide that as much as possible, but the dynamics of this business has its limitations that will only start smoothing out actual and projections once we're generating $100 plus million in revenue in my opinion. I mentioned these things at this point the content or in the context of forward looking statements. We give you an internal plan on our best guess based on what we know and believe at the time we make this statement. The last few years, we've been surprised to the upside and I'm hopeful that continues to be the case, but I'm sure we'll get surprises somewhat on the downside. I want to remind you about long term fundamentals in our industry because they are central to both our vision and our strategy.

I think it's an important reminder realizing that I first made an individual investment in the CoreCard predecessor company of $100,000 in 1986. Intelligent Systems first made an investment in the predecessor company in the late 90s. First Data acquired the predecessor company in the early 2000s for several hundred million in today's dollars. So, when I say very positive long-term fundamentals, I'm really talking about long term fundamentals.

Our strategy is designed to reward those who recognize the fundamentals as we do and support our strategy to build long term value. Often when you have companies make that statement it might be because they're losing money and need to justify the continued expense. I've been there and done that internally and externally with the CoreCard investment, but we're very profitable, we expect to remain so even as we continue to invest in the long term. Our decisions are deliberate driven by the goal of increasing long term shareholder value.

Ultimately, our goal is to position the company to be a world class processor for revolving credit that will come from having low cost infrastructure, an agile workforce and software platform that could do anything the future may need for payments and credit. We're going to let Matt talk about the fourth quarter at this point as well as the year and then we're going to randomly answer some questions. I'm going to give a shout out to Slingshot Capital. We had some folks from Singapore, I think six or seven folks from Singapore -- investors that have been with us for a couple of years -- come see us.

So, we appreciate their visit and no, we did not catch the virus even though I think maybe it's growing in Singapore. So, Matt, I think perhaps go ahead and talk about financials and then we ask questions about the financials.

Matt White: All right. Thanks Leland. Good morning everyone. As Leland noted, revenue and profitability results exceeded our expectations as our largest customers continue to add new features and product offerings. Revenue for the fourth quarter of 2019 was $10,303,000 compared to revenue for the fourth quarter of 2018 of $6,054,000, an increase of 70%. Revenue for the fiscal year 2019 was $34,303,000 compared to revenues of $20,100,000 for 2018, an increase of 71%. Excluding our largest customer, which represented 60% of our revenues for 2019, revenue grew 13% compared to 2018.

We expect to continue to see meaningful revenue growth outside of our largest customer. The components of our revenue for the fourth quarter consisted of license revenue of $2 million, professional services revenue of $5,998,000, processing and maintenance revenue of $1,879,000 and third party revenue of $426,000. Now, I'll talk through the components of our revenue. As we mentioned in previous statements, our license revenue will vary from quarter to quarter depending upon the number of active accounts our customers have. The fourth quarter license revenues were driven by active account increase related to our largest customer.

As a reminder, we receive license revenue primarily when our customers achieve new active account tiers. Once that new tier level is achieved, our customer receives a perpetual license up to that number of accounts and inactive accounts do not count towards a license tier. We charge annual maintenance to our license customers, which is reflected in our processing and maintenance revenue line. Maintenance revenue increases each time customers reach a new tier. As we’ve said before, the contract with our largest license customer includes a maximum tier level, which is because of the significant number of accounts, allows them to utilize the software for any number of active accounts once the maximum tier level is achieved.

We would still expect it to be several years if ever to hit the maximum tier level. This large customer currently uses the software for a single institution, additional license fees will apply if multiple institutions are added. Looking further into the revenue detail provided, professional services revenue comprises a significant portion of our overall revenue for the fourth quarter and year ended 2019. However, as we previously stated, we expect that to decrease as a percentage of total revenue over time as our customers utilize the new features we've developed to add active accounts to their system, which is ultimately reflected our license revenue and processing and maintenance revenue lines.

Additionally, we continuously create new functionality for our customers and as such we charge annual maintenance fees for professional services, which is also reflected in our processing and maintenance line. Our customers continue to seek out our industry leading services to create custom unique solutions and as such, we do not perform any professional services for third parties that are not license or processing customers. Generally, the types of professional services that we provide are high value add services delivered by highly trained personnel primarily in India.

These services include software development, system monitoring and testing and other similar services that require extensive training. As a result, we're able to realize a high margin on these services. Lastly for revenue, our third party revenue generally has a very low margin and constitutes services we provide on behalf of our customers, which we charge at slightly or above cost and we recognize this revenue gross for accounting purposes.

Turning to some additional highlights on our income statement, we achieved significantly higher income from operations of $3,979,000 for fourth quarter of 2019 compared to $2,268,000 for the fourth quarter 2018 resulting in an operating margin of 39% for the fourth quarter of 2019 compared to 37% for the fourth quarter of 2018 and 44% for the third quarter of 2019. I'll talk first about the year over year improvement that was primarily driven by the contribution of license revenue, which was higher in the fourth quarter 2019 than the fourth quarter of 2018.

Then for the margin decline in the fourth quarter compared to the third quarter, that was primarily driven by slightly lower license revenue, higher general and administrative expenses related to legal and personnel costs, and higher research and development expenses related to accrued employee bonuses. Now, our year to date 2019 tax rate was 18.8% compared to 0.1% in 2018 due to the utilization of net operating loss carry forwards in 2018. The 2019 tax rate benefited from tax deductions on stock option exercises, which depend on the timing of the stock option exercise and the difference between the grant date and exercise date fair value. Finally, earnings per diluted share for the quarter was 41 cents compared to 27 cents for Q4 2018. Full year 2019 diluted EPS was $1.22 compared to 70 cents for the full year 2018. With that, I'll turn it back to Leland.

Leland Strange: Okay. Thank you Matt. Obviously, we're pleased with the results. We're going to go to questions. I will tell you we have almost 40 questions submitted through our fax@intelsys.com, and we will not answer all those questions. We have to understand that on the call are people that read the transcript who are lawyers, competitors, employees, current customers, prospective customers as well as shareholders and prospective shareholders. So, some questions are simply inappropriate for us to answer based on competitive or other reasons.

I know that you'd like to have information about every little aspect of the company and how we operate, but we simply can't do that. One of the first questions that I will actually use as an example of that is the question asking how do we maintain in our India operations such low turnover? Frankly, I understand the question. It's not normal to have 10% of your employees be 10 year plus tenure in an office in India, but I'm not going to go into all the aspects of how that happens. We want to keep employees. We don't want everybody else to have the same information that we have. So, that's just one example.

So, I will start with the questions, and I'll ask Matt to chime in on some of them. First question we'll answer is: you mentioned you will be focusing on achieving great results with high visibility customers. Did you have new customer wins this quarter? The answer is, yes we had a new customer added during the quarter, but they are not going to be high visibility. There are very few high visibility customers that we will be adding. We hope to add two or three others, but frankly when you look at the high visibility ones we have, probably the highest visibility customer anybody could get. So, there's not anybody that's going to achieve those kind of numbers or be recognized in that way.

Most of the customers are small, doing business just in their own particular vertical, you would not even recognize some of them. So, we are going to focus as we've said this year particularly on really working hard with our high visibility customers to achieve great results. As they grow, we also grow. That's growth that's not required for any new customers, although we'll be adding new customers. Next question is: can you talk about how holiday sales impacted Q4? It's really probably nothing we could talk about because that has to do with our customers and what they do. I would suspect holiday sales or promotional campaigns definitely would boost our licensing revenue, but that kind of internal marking data that they have.

Third question is: last quarter you said that you didn't expect Q4 19 to be as strong as Q3 19, however, your results came in above Q3. Do you believe the strong beat to revenue took away from Q1 20 and how should we look at near term revenue trends. I'm going to let Matt jump in on that one.

Matt White: Sure, with the revenue coming in higher than expected that was primarily professional services, but we don't think that any of that moved revenue between periods, so we continue to have the same expectations for Q1 20 as we did before we saw the results for Q4 19.

Leland Strange: I think it'd be fair to say that we're expecting Q1 to not be quite as strong, but we don't think it did move it. We think we'll have a good Q1. Now, when I say that, I have to qualify based on license revenue. We've talked about this numerous times. We don't know when we'll get new license revenue sitting here today in the middle of February. My best guess is we may not get another license bump in this quarter, we're likely to get one in next quarter. I could be surprised on that, but we do think what I call repeating revenues, professional services and recurring will continue to be strong in Q1 of this quarter.

Another question: R&D increased by 20% from the previous quarter. How should investors think about this spending? Is the spending going towards developing new products or updating existing ones? Let me take the first part, and I'll ask Matt to do the second: is the spending going toward developing new products or updating existing one. I could tell you that it's not quite that clear cut. When you update the existing ones, you're also developing in many cases new products that are hooked to it. Our products all hang onto the same big platform. So, you are always updating your existing product to offer more and better features, and Matt maybe you could answer that R&D increased by 20%, how should investors think about this spending?

Matt White: Right. Some of that is accrued employee bonuses that I mentioned. So, as we continue to produce strong results, we'll want to continue to invest in our people so that those could continue into 2020.

Leland Strange: Okay. The next question: looking at the increased spending level SG&A this quarter, can you walk us through the components of that spending? Can we expect the same level of spending for fiscal year 2020? So, we'll talk about the increase in SG&A.

Matt White: Well, a lot of that is legal costs, hiring costs, personnel bonuses. We expect a similar cost structure in 2020. So, we expect similar levels of SG&A but probably not as significant at those we saw for Q4 2019 on a quarterly basis.

Leland Strange: Another question: in the release you noted that fiscal year 2020 will be a building period and you're investing in building a stable foundation for the business. Can you walk us through what sort of investments we can expect? What are the focus areas you believe to be the most imperative? Is INS hiring more developers and then always the question is a hiring sales staff. What do you hope to achieve during this building period? So, that's four or five questions, and I'll try to take those.

The investments that we expect are generally again in people -- we're increasing our staff, we have now over 500 folks in our India operations. I would hope that we can have close to 600 by the end of the year. It's always a challenge to get the right kind of people in the right situations, but we're growing that staff. Obviously, we're growing that staff because we believe that we will continue to grow our business and we'll have new customers that will need to help that sort of staff for implementation. In terms of other investment, there is some investment infrastructure, but it's not significant. We talk about investing a couple of million dollars and we have over $26. We're not talking about any significant needs of cash for investment. The question was is INS hiring more developers? I think I answered that. Yes, we're hiring developers and technical staff regularly.

Matt White: I don't know if you want to take couple of questions from the operator?

Leland Strange: Sure. Operator, if you have some questions, we'll take those.

Operator: Your first question comes from the line of Mark Palmer with BTIG.

Mark Palmer: Yes. Good morning. Hi. Nice quarter first of all and just wanted to dig in a little bit into the relationship between professional services revenue and license software revenue and processing revenue was obviously a very strong quarter in terms of professional services revenue. How should we think about how professional services revenue could translate into licensing revenue, and I guess more importantly processing revenue down the line?

Matt White: The professional services typically are performed for our licensed customers and so it's been adding new features, new product offerings, enhancing their system that we think will drive active account growth, which will lead to additional license revenue. As we mentioned to the extent the professional services are additional customization, there's add-on maintenance. So, we charge on a go-forward basis that will show up in the process and maintenance line. So, those are kind of the two future drivers of growth for professional services.

Leland Strange: I know Mark you separated the question in terms of processing revenue and professional services. Once again, we consider professional services to be pretty much repeating revenue. It's hard for an analyst to deal with that in the same way, but I think we've proven over two or three years now how professional revenues continues to grow and it's very much repeating from the same customers just as processing revenue would be repeating from the same customers. You got a follow up, did we not answer it well?

Operator: The next question comes from the line of Ishfaque Faruk with Sidoti & Co.

Ishaque Faruk: Hi. Good morning Matt and Leland. A couple of questions from me. First of all, great quarter, congrats on the fantastic quarter. In particular, your professional services was significantly higher than what I was expecting. Any particular one time items maybe like Q4 driven that you might call out on that?

Leland Strange: Well, you're obviously increasing your number of accounts very rapidly from a new rollout with a holiday season and it required more folks to be involved making sure things are going well and I can also say we're developing new features in that quarter that was live either this quarter or next quarter. So, now it's more or less business as usual I would say.

Ishaque Faruk: And if I may have a couple more follow ups. In terms of maintenance, maintenance was a little light. Is there anything to read into that perhaps, Leland or Matt?

Matt White: No, nothing to read into that. We expect that line to continue to grow. That'll be a significant growth driver in 2020.

Ishaque Faruk: Gotcha. Okay, and lastly you guys, Matt you mentioned growth of revenue, X your largest customer was around 13%, which is great. Are you guys being approached by more and more like smaller Fintech companies like the ones you already have like Kabbage and Deserve or is it more like large name brand banks that you guys know previously have been customers?

Leland Strange: Well, we talk to name brand banks, but those are not going to come on board any time soon if we get them at all. Obviously, they hopefully would -- that's a future year kind of thing and those are long, long conversations. So, generally you're talking about small Fintechs or you're talking about some existing medium sized clients that might want to switch. There have been some other processors that have had significant downtime and other issues, and then you have also some folks that are with other smaller processors now.

I'm not talking about the First Data’s, there are smaller processors who want to do revolving credit and the other folks really can't do that or do it well at this point. So, it's a variety of customers. We can't take on a bunch of little ones. That would be a distraction to us. We can take one or two, but we can't take on a bunch. So, we have to be somewhat strategic in our choices thinking in terms of timelines and when we think timelines, we think over several years how do they fit in while at the same time doing a great job for our existing customers. We do expect to continue to grow with new customers this year.

So, we will continue to have new business and you also have to think about some of our customers will offer totally new products. In a way, that's like a new customer. That's a total add-on to whatever they're doing for us now and we're certainly going to pay more attention to a current customer that wants to add a totally new different product. We treat it almost as a new customer, requires the same resources from a business analyst analyzing what they want, doing the implementation, it's all like a brand new customer. So, those will continue to increase.

That's one reason I don't think we are going to separate from what a totally new customer meaning a new brand name versus a new product. We just need to talk about how much we're growing outside of our main customer that ought to be the concern of the street in my opinion. Can you still grow the business outside of your one big customer?

Ishfaque Faruk: Yep, that answers my question. Thank you, guys. Congrats once again on the great results.

Leland Strange: Do you have any other questions operator? I've got others we can answer.

Operator: Again, if you would like to ask a question, press star then the number one. That is star one for questions.

Leland Strange: All right. Let me go ahead and actually what always comes up in a discussion and that's are you adding sales staff? The answer is no, not at this point. The answer may be different two quarters from now, but the answer is no at this point. We're talking to enough people that enough potential customers that we don't think we need to be out scouring for other names at this point. We're looking at our book for 2020. We feel pretty comfortable that will have decent growth.

Again, could be surprised on the upside, could be surprised on the downside, but based on what we see today, we feel we'll have pretty good growth. We want to do some things infrastructure wise before we really push hard for 2021, which will be the year we definitely will be pushing for processing revenue being 2021. All right. Any other questions?

Operator: Again, that is star one for questions.

Leland Strange: All right. I think I probably answered the main ones that we've been given. Sorry, if I didn't run your question either for some of the reasons that I mentioned earlier or just based on time. I want to tell you we definitely thank you for your interest in the company. As always, we say that if you have other questions that we can answer given the guidelines that we have, please give Matt or myself a call. We'll try to be available for any questions you might have. So, thank you everyone. We look forward to the next call in about three months.

Operator: This concludes today's fourth quarter earnings release and investor conference call. You may now disconnect.