CORPORATE PARTICIPANTS

James Leland Strange Intelligent Systems Corporation - Chairman, CEO & President

Matthew A. White Intelligent Systems Corporation - CFO & Corporate Secretary

CONFERENCE CALL PARTICIPANTS

Anja Marie Theresa Soderstrom Sidoti & Company, LLC - Senior Equity Research Analyst

Mark Anthony Palmer BTIG, LLC, Research Division - MD & Fintech Analyst

PRESENTATION

Matthew A. White - Intelligent Systems Corporation - CFO & Corporate Secretary

Good morning, everyone. With me on the call today is Leland Strange, Chairman and CEO of Intelligent Systems. He will add some additional comments and answer questions at the conclusion of my prepared remarks.

Before I start, I'd like to remind everyone that during the call, we will be making certain forward-looking statements to help you understand Intelligent Systems and its business environment. These statements involve a number of risk factors, uncertainties and other factors that could cause actual results to differ materially from our expectations. Factors that may affect future operations are included in our filings with the SEC, including our 2020 Form 10-K and subsequent filings.

As we noted in our press release, strong momentum from the first half of 2021 continued into the third quarter. Our professional services revenue remained solid. We saw continued growth in processing and maintenance revenue. And we recognized license revenue of $1.8 million in the third quarter of 2021, slightly ahead of expectations. Total revenue for the third quarter of 2021 was $12.9 million, a 26% increase compared to the third quarter of 2020. The components of our revenue for the third quarter consisted of professional services revenue of $6.9 million, processing and maintenance revenue of $3.5 million, third-party revenue of $0.8 million, and as I already highlighted, license revenue of $1.8 million.

We are pleased with our trajectory so far in 2021, and we now anticipate 30% to 35% revenue growth for the year. We expect continued growth in our processing and maintenance revenues from a combination of recently added customers who are now live and continued growth from existing customers and implementations that are currently in progress. We signed several new customer contracts this year, and we recently opened an office in Bogota, Colombia, where we expect to hire operations and development personnel to enable this new and continued growth. Hiring and training new personnel remains challenging, and our new office will provide additional opportunities to hire technical personnel to contribute to servicing existing customers and adding new customers. We do not initially expect to add customers in the region, but over time, this could be a new channel for growth.

Professional services revenue continued to be strong in the third quarter, and we anticipate similar professional services revenue in the fourth quarter likely in the range of $6.6 million to $6.8 million.

Turning to some additional highlights on our income statement for the third quarter of 2021. Income from operations was $3.3 million for the third quarter of 2021 compared to income from operations of $3.5 million for the same time last year. Our operating margin for the third quarter of 2021 was 26% compared to an operating margin of 34% from the same time last year. The year-over-year decline in our operating margin was primarily driven by previously announced infrastructure investments in our processing environment and our new office openings, both of which are a critical part of our long-term growth strategy.

Additionally, we are building a new platform that is resulting in higher research and development costs. We capitalized less than $100,000 in the third quarter and expect higher capitalized amounts in future quarters. Depreciation will start once the platform is live and in production. The investments we've made will enable us to take on additional processing customers in 2022 and future years.

Our Q3 2021 tax rate was 26.3% compared to 18.9% in Q3 2020. We expect our ongoing tax rate to be between 24% and 26%. Earnings per diluted share for the quarter was $0.29 compared to $0.31 for Q3 2020. We also repurchased $1.5 million of our shares in the third quarter, while maintaining significant cash reserves to continue to invest in our future.

Before I turn the call over to Leland, I would like to give a brief update on the effects of COVID-19 in India. We continue to experience a muted impact on our results in 2021. Employees are getting back into the office, and we are hiring and training as quickly as resources allow. We are seeing higher turnover due to increased demand for technical resources. And so as a result, we expect personnel costs to increase. That said, we remain incredibly optimistic about our long-term prospects and believe the investments we made last year and into this year will yield new customer wins and revenue growth in the future. As I mentioned previously, we expect top line growth of 30% to 35% for 2021 as compared to 2020, which is an increase of our previous guidance of 20% to 25% top line growth. And with that, I'll turn it over to Leland.

James Leland Strange - Intelligent Systems Corporation - Chairman, CEO & President

Okay. Thanks, Matt. A question we've already gotten in a few minutes ago has to do with our receivables. So I think I'm going to ask Matt to go ahead and answer that before I make some comments. I think we ended up with receivables a little higher than normal, and I think there's a question as to why. I know our receivables are different than a lot of folks and that we've got some really AAA top credit receivables. So maybe you can talk about the strength.

Matthew A. White - Intelligent Systems Corporation - CFO & Corporate Secretary

Yes. Some of that is just the timing of revenue recognition. We had license revenue that we recognized in the third quarter. So there's billings that are not yet due. There's other increases that relate to receivables that are now considered past due. However, as Leland mentioned, those are from highly rated large companies with significant ability to pay. So we don't have any concerns about the realizability of any of our receivables. And actually, there's some benefit to us in the short term in terms of being able to realize a little bit on those balances given the timing of when those are paid.

James Leland Strange - Intelligent Systems Corporation - Chairman, CEO & President

Yes. We're not going to get into the details of our contracts, but we do pick up a few basis points when we have higher receivables. So given the use of cash, I'm perfectly happy to let those things grow. But I don't expect they'll continue to grow, and there's no disputes and no questions about them, but that's the quick answer.

So Matt, I think you provided investors a pretty good picture of where we are and kind of what we expect in the near term. I want to say we have always and we continue to be cautious in providing projected data for reasons that we've explained many times, so let me just try to summarize again.

First, our ongoing professional services revenue is consistent and what I call repeating even though we cannot categorize it specifically as recurring. We surely don't have professional services contracts that have specific monthly or quarterly or annual revenue tied to them. Our contracts are simply to provide the services that are needed by our partners as they are needed. CoreCard can predict, based on partner conversations, what will be needed but predictions obviously have a variability factor, maybe as much as 10% in any quarter. But for annual periods, we've been able to
estimate what those needs will be and continue to believe this will steadily grow each year but of course, some quarter-to-quarter variability. Hence, perhaps not recurring, but predictably repeating.

I'll also repeat most of these services are delivered by high-level experienced FinTech employees that are not your typical or not BPO typical outsourcing. So hence, we have good margins. I know I've had to talk about this for the past 3 years, and I continue to want to think of it as recurring, but really it is repeating. In my book, it's very similar to recurring because we pretty much know we're going to keep getting them. As long as our customers stay in business, they're going to need us and we'll keep getting them.

The second thing that makes it hard to predict is the license revenue. Now usually, we can get it right in a particular year, but not always, and it's not in our control. Six months ago, for example, we expected to have a pretty significant bulk in the second half of the year, and I've stated that. Three months ago, we ended up getting some of that early. And now we believe we'll get some of it this quarter, but the larger amount will be pushed into next year. And it's not a certainty that we'd get it even this quarter, although I believe we will.

You'll recall that we recognize license revenue when either projects go live and/or when certain numbers of accounts go live. That means on December 31, we may be one account away from realizing $1 million or $2 million or $3 million in revenue. And on January 1st, it's realizable. Of course, if that happens, we don't invoice and we don't actually recognize it until the end of that month. But again, license revenue makes it pretty difficult to get precise, although we can give a broad view of what it will be, and we have a broad view of what we'll be getting in, I would say, even next year at this point in time.

The third thing is new business kickoff timings are really hard to precisely predict. We have a very good, well-known FinTech customer that expected to go live this summer. Then they changed their offering. You're going to push it to September. And now, due to some regulator questions about their innovative offerings and also some bank foot dragging, it’s pushed them into the next month. Now this has nothing to do with CoreCard. We can get a new program up and out in less than 90 days, maybe even 60, but it very seldom happens with the third parties.

So basically, those are the 3 reasons it's firmly why we don't like to provide quarterly guidance even though we would very much like to be able to. I think Matt has given a range for the year of 30% to 35%, and that wide 5% range really involves the fourth quarter, and that's a result of what I just summarized.

My thoughts on where we are as a business for the future. Several years ago, I said I expected us to grow at a 25% clip over the next 5 years. We continue to succeed in doing just that. I said that growing too fast will put our partner customers in jeopardy, and we'll not do that. I still subscribe to that, so that is the answer to those who want us to go at a 50% clip. Sure, we may grow a little faster as we're doing this year, but we're still saying that the 25% is a good target for us.

Let's see, Matt mentioned the new center we have opened in Bogota, Colombia. Today, I would say my personal biggest challenge is finding and keeping the talented team we need to grow. We're adding staff everywhere and continue to look for new ways to find sharp people that we could train to be valuable for fintech companies. People respect us for the quality of our help. And that, frankly, is the biggest challenge we have right now. We will not grow any faster than that 20% to 25% unless we get more help. It's possible we grow faster if we had enough but that's not going to happen in the next few months. I will say that the business is better for us even though we still have no sales staff. There are a sufficient number of companies looking to align with a FinTech processing company that prioritizes stability over top line type of growth. And that will allow us to become a very, very big player in this business.

We really don't need to tout the names of every new customer to get more customers. We don't need to give huge discounts or buy business because what we offer is a high-value program. We don't look for the easy payments business that pays pennies per transaction. And by the way, that's a decent business, but it's very competitive and ultimately does not have the stickiness that complex revolving credit provides. Nor does it provide the kind of profits our programs are able to generate for our customers. In fact, that type of transaction, think of a debit card or debit transaction or some of the stored value transactions. That's most often a cost to the company ordering the service rather than a way to make money. Most of our customers look to us to provide software that allows them to make money, not just offer a service as a convenience to their customers.

I think you need to keep in mind that our bread and butter, so to speak, is revolving credit products. Some of our larger customers have customer accounts with as many as a dozen different plans. And by the way, we call plans a specific set of terms. So on one account, you may have one plan that's 12 months no interest, another that's 24 months no interest. Another might be 12 months with 6% interest. Another might be revolving a 12% interest. Another could be four equal payments two weeks apart with no interest. And if that sounds like a buy now, pay later plan that you hear so much about, yes, that's what it is. And well, you get the idea. So if you've got one account with a dozen complex plans, that gets hard. All these plans have to take a payment or payments, and the software has to determine where to apply the payment dollars based on a predetermined algorithm. Of course, the customer is involved in that algorithm, and he's guided by maximizing the revenue while still maintaining compliance with all the regulations.

And finally, a statement has to be generated that's also compliant, that shows the actual APR, the annual percentage rate, for each plan on a single statement. No one of the newer entrants into the processing space can do that. I guess I better say to my knowledge or I'll hear from the lawyers when the call is over, but you feel free to do the due diligence on your end and ask your guys if they can do what I just described above or if they have any customers that do that. We think this is the future, that's our business. And while we do all the easier stuff that everyone else does, we really believe the complex stuff is where the future is.

Of course, we do constantly survey the competitive landscape to determine if we need to change course and make adjustments to our strategy. But our view today is to continue to invest to be able to do the hardest, most complex FinTech tasks that will be required in the future. That's why I'm pretty confident that our future continues to be bright, and we're happy to have our shareholders that want that steady long-term growth in value.

I guess with that, we'll open it up to see if we have any questions. There's not a whole lot of new things to talk about. We just keep running down the same track. Obviously doing a little better with revenue and profits and steady growth, but it is the same track.

So operator, if you are ready to open up for questions, we'll be happy to take a few.

QUESTIONS AND ANSWERS

Operator

The first question is from Mark Palmer with BTIG.

Mark Anthony Palmer - BTIG, LLC, Research Division - MD & Fintech Analyst

Yes. Nice quarter, certainly. I just wanted to delve into to the extent that you can, not the names of the new clients that you have been signing and going through implementation with, but what those end businesses are, what verticals you're focused in. You just made allusion to buy now, pay later. What other verticals are you seeing that are bubbling up with the type of needs regarding complex revolving credit that you can address?

James Leland Strange - Intelligent Systems Corporation - Chairman, CEO & President

Yes, it's a hard question. None of these are really large in the beginning. In fact, I can share that one of our others that we discussed were not large probably a quarter or two ago, and Matt, you'll have to help me, but we have a crypto client that's now, what, over 300,000? A lot of accounts.

Matthew A. White - Intelligent Systems Corporation - CFO & Corporate Secretary

A lot of accounts.

James Leland Strange - Intelligent Systems Corporation - Chairman, CEO & President

That we would have guessed would have 45,000 accounts now, and they're up in the hundreds of thousands. But we just don't name these type of guys. So there's a crypto. And then the one I mentioned I really don't want to describe. It's a really innovative program, and I suspect they're having to work with a regulator on whether it's too innovative and that also happens. So we're dealing primarily with right now I'm going to call them the new guys in FinTech. Crypto is all new. So several new crypto guys. We're dealing with some neo banks that want to offer some creative things. We've always and we continue to have conversations with some very large customers, but that's over the long term.

Matthew A. White - Intelligent Systems Corporation - CFO & Corporate Secretary

But those are primarily revolving credit programs. So really in that same vertical.

James Leland Strange - Intelligent Systems Corporation - Chairman, CEO & President

Yes, they're all revolving credit. Some of them are very creative, some are not. I mean crypto, it's just a currency. It's not particularly creative, but it does do it with crypto, which is the difference. Sorry, I can't be more detailed than that, but they're all over the place.

Mark Anthony Palmer - BTIG, LLC, Research Division - MD & Fintech Analyst

No, understood. If I could also delve into the constitution of the pipeline in another way. In other words, can you talk about the extent to which the new clients that you're pursuing would be for your own processing business versus additional licensed clients that would be coming on to the platform?

James Leland Strange - Intelligent Systems Corporation - Chairman, CEO & President

Sure. Any of the folks that start up small will always be for our own processing platform. So we have a group that's dedicated to that. The very large customers are likely to be licensing clients. That's more still out in the future when they could come on board. So we're doing both sides. I don't want to just miss the fact that our largest customer continues to also grow and bring on new clients. And that's part of our program for them to continue to bring on large clients, which they do. And even though it's licensing, it's the same to us, ultimately, and it's the same kind of growth.

I think I've said it before, I want to continue to grow our processing, but I also want to continue to grow our largest licensing client. And so I'll be happy if three years from now, they're still 60%, 70% of our revenue after we've grown maybe 50%, 100%. So we're growing in all areas.

Operator

Our next question is from Anja Soderstrom with Sidoti.

Anja Marie Theresa Soderstrom - Sidoti & Company, LLC - Senior Equity Research Analyst

I had a good overview already. But if you can just talk about the -- I'm just curious about the customer engagement, especially with the larger ones. How is that progressing? And is anything changing there?

James Leland Strange - Intelligent Systems Corporation - Chairman, CEO & President

Well, just by definition, large means slow, doesn't it? It's progressing, but it's just going to be slow. So I think you have to more rely on what we say in terms of the growth path that we're predicting as opposed to specific customers because it will be made up of a combination of things, and they're probably a blip. But I'm not going to have a new real large customer provide any big revenue next year, not a new one. I think we, again, we're going to grow very well, but there won't be one single new large customer to provide a blip of revenue.

Now, I qualify my words carefully. There could be a single large customer that we are doing a little bit for to get ready for the next year. I'm not sure it will happen next year. It could be the year after. But there will definitely not be a big new customer generating big new revenues next year. It will be continuing on the train track we're on now to generate that 25%, 30% growth.

Anja Marie Theresa Soderstrom - Sidoti & Company, LLC - Senior Equity Research Analyst

Okay. And then also, I'm just curious what attracted you to Colombia.

James Leland Strange - Intelligent Systems Corporation - Chairman, CEO & President

There are a lot of choices. And we knew we needed something in that time zone, that American time zone. So we just reviewed the potential choices and picked one. I mean we looked at Costa Rica, we looked at Panama, we looked at Colombia and just decided to, with the combination of factors, we thought Colombia would be best for us. And we're still looking for other locations, too, although further west, Philippines or whether it'd be something else in Latin America. We're just going to have to grow our staff a lot because we got a lot. I don't want to use the word pipeline. We have a lot of potential that we need more people for.

Anja Marie Theresa Soderstrom - Sidoti & Company, LLC - Senior Equity Research Analyst

Okay. And what are you doing to sort of attract and retain talent?

James Leland Strange - Intelligent Systems Corporation - Chairman, CEO & President

Well, number one is you pay more. As Matt indicated, India is a tremendous -- I'll give you a funny example. It's not funny, but it is. We had an employee that left us for a 50% pay raise. Now they have to give you 30 to 90 days notice before they leave in India. So while he was supposedly sure of his other employer in another town, has a 50% pay raise, he continued to negotiate and he had another company who gave him 50% on top of that 50%. So he just skipped the first one but he used it to leverage for the next one. It is brutal out there in terms of recruiting and holding talent.

Operator

Ladies and gentlemen, there are no further questions at this time. I would like to turn the call back to Leland Strange for any closing remarks.

James Leland Strange - Intelligent Systems Corporation - Chairman, CEO & President

Alright. Well, I just thank everybody for being on. And as usually we say, if you have any other questions later you'd like to talk to Matt and I about, we're certainly happy to make ourselves available. But we're very pleased with where we are, and we're very pleased with where we're headed. We hope everybody has a good holiday since we won't be talking to you for another quarter, so thank you very much.
