

## 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

### Operator

Greetings and welcome to Intelligent Systems Corporation Q2 2021 Earnings Conference Call. (Operator Instructions)

As a reminder, this conference is being recorded.

I would now like to turn the conference over to Matt White, Chief Financial Officer. Please proceed.

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

Thank you and 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 filings with the SEC, including our 2020 Form 10-K and subsequent filings.

As we noted in our press release, our strong momentum from the first quarter continued into the second quarter. We are especially pleased with our results given the difficult situation in India regarding COVID-19. Our professional services revenue remained strong. We saw quarter-over-quarter and year-over-year growth in processing and maintenance revenue. And as expected, we recognized license revenue of \$2.3 million in the second quarter of 2021.

Total revenue for the second quarter of 2021 was \$13.4 million, a 66% increase compared to the second quarter of 2020. The components of our revenue for the second quarter consisted of professional services revenue of \$6.1 million, processing and maintenance revenue of \$4.2 million, third-party revenue of \$0.8 million and, as I already highlighted, license revenue of \$2.3 million.

As noted in our press release, we continue to expect license revenue in the second half of 2021. However, we do anticipate some license revenue to move to early 2022. That said, we are pleased with our trajectory so far in 2021, and we continue to project 20% to 25% revenue growth for the year.

Included in our processing and maintenance revenues for Q2 2021 is approximately \$600,000 of revenues from the settlement of unrecorded accounts receivable with Wirecard. We executed an asset purchase agreement to buy hardware and customer intangible assets in the second quarter and settled all outstanding accounts receivable with our former customer. And as such, we do not expect any future revenue from this customer going forward.

As previously announced and discussed during our Q1 call, we went live with the Al Ansari Exchange, a former Wirecard customer in the Middle East region and began recognizing revenue from this customer in the second quarter. We are in discussions with other customers in the Middle East and other regions. However, it would likely be Q4 or early 2022 before we realize any revenues from these potential customers.

We expect continued growth in our processing and maintenance revenue from a combination of recently added customers who are now live, continued growth from existing customers and implementations that are currently in progress.

We have signed a number of contracts with new customers this year, and these new customers primarily fall into 3 different categories.

The first category consists of startups launching new programs. These companies are well funded with knowledgeable founders, but it will take time for them to build programs that will contribute meaningfully to revenue.

The second category consists of established companies moving into new markets, whether that's a U.K. company moving to the U.S. or a company with a base of prepaid or debit customers that want to move into credit. These companies have proven products or a significant customer base to market their new product to, so we expect them to contribute to revenue a little sooner than the startups I mentioned above. An example of this type of customer that we expect to go live soon is a crypto exchange offering rewards cards paid in cryptocurrencies, which -- this continues to demonstrate our ability to handle any account and currency.

The third general category are customers that are switching processors. These customers can contribute meaningfully to revenue as soon as the conversion is completed. On previous calls, we discussed the reluctance of potential customers to take on the potential risk of a conversion. And convincing them to make a change can be difficult, but we believe there are significant benefits to moving to CoreCard, especially for complex programs. We are currently working on a large conversion for a license customer, as previously discussed, and we expect to start a smaller conversion later this year.

Professional services revenue was strong in the second quarter, as expected, and we anticipate similar professional services revenue in the third quarter, likely in the range of \$5.6 million to \$5.8 million. However, we could be impacted by the COVID-19 pandemic in India.

Turning to some additional highlights on our income statement for the second quarter of 2021. Income from operations was \$3.9 million for the second quarter of 2021 compared to income from operations of \$2.7 million for the same time last year.

Our operating margin for the second quarter of 2021 was 29% compared to an operating margin of 34% for the same time last year. The year-over-year decline in 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, which is in the early development stage. Future stages will result in capital expenditures which we expect to start in Q3, and then we will recognize depreciation once the platform is live and in production. The investments we've made will enable us to take on additional processing customers in 2021 and future years.

Our tax rate for the second quarter was 26.3% compared to 19.3% in Q2 2020. We expect our ongoing tax rate to be between 24% and 26%.

Earnings per diluted share for the quarter was \$0.32 compared to \$0.24 for Q2 2020.

We also repurchased \$5 million of our shares in the second 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 we are seeing during COVID-19 primarily in India.

Overall, we continue to experience a muted impact on our results so far in 2021. The situation in India is trending in a positive direction but remains fluid. We offered in-office vaccines, allowing most of our employees to get vaccinated. Some are back in the office in certain locations, but most continue to work from home.

Our employees have gone above and beyond to be able to maintain key functions and business continuity in addition to delivering excellent service to our customers, as reflected in our strong professional services revenue.

Hiring and training remains difficult. However, we have increased our headcount in the second quarter, which has allowed us to continue adding new customers and maintain our guidance for the year. However, a potential increase in the severity of the pandemic in India could impact future operations and results, primarily regarding professional services revenue. That said, we remain incredibly optimistic about our long-term prospects and believe the investments we made last year and into this year will continue to yield new customer wins and revenue growth in the future.

As I mentioned previously, we expect top line growth of 20% to 25% for 2021 as compared to 2020, which is consistent with our previous guidance.

And with that, I'll turn it over to Leland.

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

Okay. Thank you, Matt. Just a brief perspective. Matt has big 4, Humana and Equifax experience. In fact, he came to Intelligent Systems from Equifax. He's involved in all aspects of the business, not just the financial side, and we certainly appreciate the perspective that he brings from his larger corporate company history. So thanks, Matt.

I'm primarily going to talk about some of our answers to some of the questions we've been given. I think Matt covered the business very well.

The big question that he and I are both getting now is generally concerning buy now pay later. It's really hot since I think Square purchased an Australian company for \$29 billion, and I think that company is actually losing money. In fact, I think that's probably one of our problems. We're making money, so we don't get the valuation of the companies that are all losing money, and you can't promise the future. But that's another just snide comment, I guess, I should say.

The fact is that buy now pay later is absolutely nothing new. Our predecessor company, PaySys International, did what's called buy now pay later for Neiman Marcus way back in the early 2000s.

Then, CoreCard offered the same thing for Fingerhut. If any of you are familiar with Fingerhut, they were a catalog retailer, which is simply an installment plan. It's actually a very simple installment plan that typically has no interest in it; no interest connected to it initially.

The merchant gives some discount to the software provider in order to get them to take on the receivable. And then if you pay it off in 2 weeks or 4 weeks or whatever the terms are, then there is no interest and there are no charges for most of them. Now some of them do have some charges. But if you fail to pay it off, you're going to be hit either with interest or with a late fee. It's really high. I guess one of the advantages of being around the business for a long time is I've seen a lot of trends come and go. We've focused at CoreCard on the long term and staying with the trend that's going to maximize profit.

So if I look at buy now pay later, I can tell you it's going to get a lot of attention from the regulators. While you try to get around the interest question and problem with fees, the regulators are coming along and saying, wait a minute, you're going have to calculate to see what the APR is or what the effective APR is, and then they're going to clamp down on the amount.

Then you've got the idea, is there a technology involved? And there is no technology involved in that. It's just very, very simple. I once taught computer programming at a master's program at a university, and that's the kind of thing I would assign to a student to do a program on. It's simple installments. CoreCard can do it.

So what's the advantage? And why do people pay so much for it? They're really paying because they're hooked to a bunch of merchants. It's not the technology, it's the fact that they've already got hooked into a lot of merchants, and therefore it'll drive a lot of top line volume.

We're kind of a behind-the-scenes player. We're not upfront. We're not out recruiting merchants. We simply provide the heavy back-office stuff. So we don't do that. I believe that you're going to see it go out of favor at some point or you're going to see the competitive situation to make it not profitable. Now I say not profitable. The question is, it's not profitable now, so will it ever get profitable? So tie that to regulation and tie it to what it actually does.

I'm not really concerned about how it impacts our business. I'm also not going to jump in and try to make that a focus of our business, although we could do that. Now hopefully, that covers our view of buy now pay later. It's not going to impact what we do, we believe.

Just as an aside to that, you probably know that as one of our largest customers, if you use their credit card, you can also buy things on installment. And that's a more complicated situation if in fact you get revolving credit, tie that to an installment plan. And then if you do charge interest, you will have to show a combined APR in order to satisfy the regulators. We're happy if it goes that way because I think you all know we constantly say we're best at complex interest, complex programs.

I think that covers my thoughts on buy now pay later. It's just not a factor for us in terms of where we are now.

The next thing I'll just talk about is in fact, Matt, let me ask you. Our sales and marketing number increased dramatically this quarter, I think, 40 percentage points.

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

We had a 48% increase.

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

Our sales and marketing increased 48%. Now it's still only about \$100,000 for the quarter, so I'm smiling as I say that.

I know there has always been concern and consternation about why don't we have a lot of salespeople and marketing people. Because, frankly, our largest competitor, and I'll get back to that in a second, you can find them everywhere with big boost in all of the shows and with salespeople running everywhere. So why do we not do it?

I think we're still in what I would consider an enviable position of resource allocation where we get to choose which potential customer offers us the most strategic opportunity. We still don't take all the business that comes in the door that might want to do business with us. We still are picky about the business we take, and we choose that not based on where we'll make the most profit but based on what offers us the best long-term strategic opportunity for the company.

I think you'll find in releases coming up over the next 6 months there'll be some good names that you'll hear. We can't talk about them yet until they want to do their own promotion, but these are strategic opportunities that we feel will build over time.

We are still talking to folks that could be very, very large customers out 2, 3, 4 years from now. They have the same concerns that you will have, I would have: now do you have enough resources to take care of should we come online?

We're working very hard after the pandemic impact in India to bring on more folks. We're doing some things differently there to try to bring them on and train them so we can take on the increase.

We have so far done what we've said every year, I guess. We continue to increase both top line and our earnings line, and that requires us to have more trained people. We expect to continue to do that over the next few years. We don't see any problem doing that. But we still don't have a big sales and marketing program and won't do that for a while.

I guess one of the questions that just came in talked about -- let me read it here a little better. It talked about India a little bit more and talked about the difficulty that people are having hiring in India. Some companies are giving away motorcycles or offering trips. They're doing all sorts of things. And it is absolutely true that technology is in very high demand -- technology professionals are in very high demand in India. It is absolutely a challenge.

Our people are heavily recruited by others because they know we have a really good training program, and we can teach people credit. So it's a battle. I won't say it's easy.

Anupam Pathak, who runs that operation, is absolutely terrific over there and runs a really good operation, but, man, it is challenging. I'm going to say I guess I'll leave it as challenging. It's not like we can't make progress because we are making progress. We have over 600 employees there now. I expect to have 700 employees there probably by the end of first quarter of next year.

We're also looking at establishing another operation in Latin America that would give us a little more. It's just simply another way to add resources and also give us diversification in location.

So I guess all in all, I would just say we're very pleased with where we're going. We're very pleased with where we've been. And you can see we're planning for the future to continue the same kind of growth.

Matt, is there anything I left out? Now I'll turn it back to you.

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

No, I don't think so. I think we can go to the phones and see if there's any questions there.

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## QUESTIONS AND ANSWERS

### Operator

At this time, we will conduct a question-and-answer session. (Operator Instructions) Our first question comes from Anja Soderstrom with Sidoti.

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

Congrats on a solid quarter despite the challenging environment for you. I'm glad to hear that India is [trading] positively for [you here]. Talk a little bit about that. How much better is it now than like 3 months ago?

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

That's kind of hard to compare. It certainly is getting better. As I mentioned in my prepared remarks, we've offered in-office vaccines to our employees, so most of our employees have been vaccinated. Some are coming back into the office. So we think that's good and, like I said, trending in the right direction. But it's something that is just so hard to predict that to say that it's – what percentage better it might be from Q1, it's something that's...

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

It's hard.

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

Now it's better.

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

It's better, but there's no way to measure it. It's clearly better now, and we're hopeful that it'll continue getting better despite the Delta variant that's out there. We're seeing – we think we're seeing progress. We've got more people coming to the office. I would say every week, there's a few more people coming in the office, so the trend line is good.

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

Okay. It's good to hear that. And then also, in terms of your license revenue that you expect in the second half, it's – you alluded to it before that you expected maybe some of that happening in the third quarter even. But now you're talking about some of it trickle into the next year. How should we think about that?

And also, this smaller transition you're talking about, is that going to help you then achieve the goal of the 20% to 25% growth for this year or...

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

Right. Well, so on the license revenue, as you mentioned, some of that will likely get pushed into 2022. Not a significant enough amount for us to change our guidance. We're making up some of that revenue shift in other places, probably mostly professional services but also in processing and maintenance.

So the license revenue, we expect to be heavily weighted towards Q4. It's always possible we could get an additional tier in Q3. But it's one of those things that if you've got a certain number of accounts on September 30 and it's not quite at the tier, we don't recognize the revenue. And if you're going to get that additional few thousand the next day. But the way the accounting works, we don't recognize it until the tier has been achieved. So that's why it'll be more heavily weighted towards Q4 and with the potential of some revenue in Q3.

As far as the other conversion, that will be a processing customer, so that won't impact license revenue at all. And that probably will be 2022 before we see the impact of that. So really unrelated to any of the guidance we've given for this year.

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

I think just to add to that, we'd love to be able to tell you more precisely. But as we've tried to explain over and over, that we have to be somewhat – I hate to use more conservative, but since we don't know that we'll get it, we think it would be irresponsible to try to project it too early.

We know we're going to get the numbers. We just don't know what quarter we're going to get them. So we do know. Again, we constantly have some update. We do know that we're going to be pushing some things into next year that we thought, I must say, 3 or 4 months ago that we would get this year. That's just business as usual.

That's why we're trying to be very careful in making – we only promise what we think we really know, and we tell you what we think. But we say it's a thinking game, not an absolute game.

The good part is, all the revenue that we projected 3 months ago, 4 months ago, 6 months ago, 12 months ago, we're going to get it, all the license and the processing revenue. It's just what quarter. We really can't be more precise because it's not in our hands in many of these decisions It's in the hands of other people to decide what and when they want to do it.

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**Operator**

Our next question comes from Mark Palmer with BTIG.

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

Yes. Very solid performance. As you're thinking about managing your capacity and adding to that capacity over time, as you discussed, how should we think about how that capacity is going to be allocated to license customers or your largest customer as your largest customer adds additional clients versus continuing to build your processing business? You've mentioned that there are, I guess, some big names that are coming down the pike in a few months that we'll be hearing about. Are those all processing clients? Or do some of those fall under the umbrella of your largest client or in the licensing bucket in that regard?

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

Yes. Thanks for the question, Mark. I think we've said in the past we're focusing on processing. So most of the new revenue will come from processing clients. Now we do think we'll continue to build with our largest client, but we're focusing on continuing to build the other side of the business. And you'll notice we've had really, really good growth on that side of the business. We expect that to continue.

So the resources that we are trying to get hired and trained are for primarily to grow the processing business and take on new clients there.

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**Operator**

Ladies and gentlemen, at this time, I would like to turn the call back over to management for closing comments.

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

Okay, Matt, did we miss anything? Or anything you'd like to add to it?

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

No. I think we covered everything. Thanks, everyone, for joining today. And as always, if you have other questions, please reach out to us.

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

Thank you.

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**Operator**

Thank you. This does conclude today's teleconference. You may disconnect your lines at this time and thank you for your participation and have a great day.