Q3 2018 Performant Financial Corp Earnings Call - Final

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Corporate Participants

* Lisa C. Im

Performant Financial Corporation - Chairman & CEO

* Richard Zubek

Performant Financial Corporation - IR Professional

Conference Call Participants

* Brian Dean Hogan

William Blair & Company L.L.C., Research Division - Associate

* Michael Matthew Tarkan

Compass Point Research & Trading, LLC, Research Division - MD, Director of Research & Senior Research Analyst

Presentation

OPERATOR: Greetings, and welcome to the Performant Financial Corporation Third Quarter 2018 Earnings Conference Call. (Operator Instructions) As a reminder this conference is being recorded.

I would now like to turn the conference over to your host, Richard Zubek, Vice President of Investor Relations. Thank you. You may begin.

RICHARD ZUBEK, IR PROFESSIONAL, PERFORMANT FINANCIAL CORPORATION: Thank you, operator. Good morning, everyone. By now you should have received a copy of the earnings release for the company's third quarter 2018 results. If you have not, a copy is available on the Investor Relations portion of our website. Today's call will be led by Lisa Im, Chief Executive Officer.

Before we begin, like to remind you that some of the comments made on today's call, including our financial guidance, are forward-looking statements. These statements are subject to risks and uncertainties, including those described in the company's filings with the SEC. Actual results may differ materially from those described during the call.

In addition, all forward-looking statements are made as of today, and the company does not undertake to update any forward-looking statements based on new circumstances or revised expectations.

Also all non-GAAP financial measures discussed during this call are reconciled to the most directly comparable GAAP measures in the table attached to our press release.

I would now like to turn the call over to Lisa Im. Lisa?

LISA C. IM, CHAIRMAN & CEO, PERFORMANT FINANCIAL CORPORATION: Thank you, Rich. Good

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third quarter in more detail form. We have also posted 2 additional items. One, an illustrative charge which helps clarify how our contracts start up, when they achieve maturity and the per unit economics; and two, we have republished CMS' CERT error rate for 2017, which can also be found on their website.

For Q3, we reported revenue of $27.6 million, which was down 7.1% versus prior year Q3. Adjusted EBITDA was a loss of $4.5 million, which was down $3.8 million versus the prior year. These results are also below our internal forecast for Q3 by approximately $4 million, in both revenue and adjusted EBITDA.

Both our revenue and adjusted EBITDA results in Q3 are timing shortfalls, directly related to delays in contract start-up. About $1.1 million of the shortfall is recovery revenue timing, which should correct in Q4.

$800,000 was due to a 6-week delay in obtaining necessary clearances for approximately 100 employees to begin work on a specific customer care contract. And more impactful about $2 million were the result of delays in beginning a couple of our larger health care contracts.

Before we cover Q3 results further, I'd like to provide some clarification on our relationships and how large contracts typically work in our business.

We have deep-seated relationships with our customers, 10-plus years working with CMS, over 30 years of total experience within the student lending industry and even the relationships within our new businesses that focus on commercial clients are approaching 5 years. As a result of this long-term success, many of our customers have expanded our business relationships with larger, longer term contracts.

Most of these large contracts require an investment in the start-up year, which means we will incur a loss during that first year. Those contracts begin to break even and then turn profitable in year 2. But it's not really until year 3 that they would reach maturity and steady state margins.

We are still in year 1 for many contracts across our recovery and health care businesses, so we will have a loss this year. Additionally, during Q3, we have delays in 3 of our major contracts due to external factors, two in health care and one in recovery.

What we mean by this is that for various reasons, our clients could not owe the business to us in the time frame we had anticipated, and we have to bear the brunt of expenses in variable headcount while falling behind in building our revenue into Q4. However, we are pleased that as of October, all of these contracts across our businesses have been implemented.

These delays aside, our business fundamentals are very solid. We anticipate our Q4 will show sequential growth over Q3 as our clients are some of the largest in their industry, and we expect that revenue growth in Q4 will continue to point to growth in 2019, which underlies our goal for 2021 of $200 million in revenue, with 20% margin.

For Q3 2018, our commercial health care revenues of $3.3 million were up 83% versus prior year and up 27% sequentially. As of October, we have completed the implementation process of the large commercial health care programs, which we expected in 2018.

While we knew this would be an investment year, in Q3, we experienced delays in timing of these contracts due to external factors which have now been resolved.

Two of these large contracts are for the third-party liability, or TPL services, which are similar to the Medicare secondary payer and the fee contract in work, where the clients are large commercial organizations.

We are very excited about these types of contracts, as one of our great strength is recovery, which really is the process whereby these dollars come back to our clients.

As we look to Q4 and into 2019, we see a business with very healthy growth and margins that are improving and starting to normalize, which we believe will continue into 2020 and beyond.

We also continued to build momentum in the MSPCRC contract, which is ramping well. For the Q3 period, our revenues were just under $3.2 million for this contract. Year-to-date, which is basically only Q2 and Q3, revenue is $7.2 million.

On the CMS recovery audit programs, we began work under our Region I and V contracts during Q2 of 2017. As you can see from the table that we provided, which is on our Investor website and on CMS' own research statistics data monitoring site under the CERT program, every rates for Medicare remained at fairly high level.

The Part A and Part B error rates are estimated to be 11.3% and 10.2%, respectively, which means $18.2 billion and $9.9 billion, respectively, were paid in error during 2017.

DME error rate is at 44.6%, pretty close to half of all payments are made in error, costing taxpayers $3.7 billion in 2017.

Despite these error rates, CMS has not yet scaled the claim volumes for the RAC program, which means our limit for document request to audit remains close to 0.5% per every 45 days.

Recovery, including Premiere, was slightly below our expectations, but this is largely due to timing of revenue, and we believe we will regain this revenue in Q4 and early 2019.

For example, work under one of our federal contracts was delayed by almost 6 months because special clearances for our employees were required. And while this process is going on, we had to keep employees engaged, but did not have the meaningful work that we estimated.

I am happy to report that we started that contract in earnest in October. As we look forward, key programs in both government and nongovernment markets provide opportunities for growth into 2019 and forward.

Moreover, our strategic relationship with ECMC should be a positive factor, as we think about the Federal Family Education Loan Program.

For the quarter, student lending business placements of $750 million or $274 million higher or plus 58% than Q2 of 2018 and $103 million higher or plus 16% than Q3 of 2017.

Student lending revenues in Q3 were $11.9 million, which was down $7.9 million or about 40% below the prior year. This is largely due to a $6.4 million decrease in revenues from Great Lakes. As a reminder, Great Lakes terminated their portfolio management agreement with us mid-2017 in search of a full servicing solution.

In our other revenue category, which is comprised of tax, IRS and customer care, revenues of $8.2 million were up 12% versus last year and up 6% sequentially. However, these results were a bit below our expectations due to external client delays in our customer care business, which cost us about 6 weeks of productivity during Q3.

That has been resolved in October, and all employees are feverishly working to provide our clients with our best service, and we expect to see strong double-digit growth into 2019.

We believe our IRS contract and other state tax recovery contracts will continue to grow into Q4 and beyond. These contracts are modeled to follow a similar year 1, 2 and 3 pattern, with year 1 being an investment year, followed by revenue growth in year 2 and double-digit margins when we achieve maturity in year 3.

Expenses of $34.8 million were $100,000 higher than Q2 and $800,000 or 2.4% higher than Q3 of 2017. The increase was due to higher health care expenses of $1.9 million versus prior year, as we invested in the start of several key contracts.

Our customer care business, as mentioned earlier, had higher expenses of $1.2 million versus prior year. Due to the delays previously described, we experienced a net loss situation in Q3.

Also, as a result of the Q3 external delays, which caused delays in our revenue and EBITDA, we are revising our full year revenue and adjusted EBITDA guidance for 2018.

Excluding the impact from the CMS RAC contract reserve release, we now anticipate revenues to be between $120 million and $130 million, and for adjusted EBITDA to be a loss between $7.5 million and $8.5 million.

Including the reserve release, which positively impact 2018 revenue and EBITDA by $28.4 million and $19.4 million, respectively, our outlook for revenue is in the range of $148 million to $168 million and for adjusted EBITDA is in the range of $10 million to $11 million.

For the remainder of 2018, or year 1 of several large contracts, we will continue to increase the investment to support contract and revenue growth. Although we are guiding to a net EBITDA loss this year, we want to reiterate the longer-term confidence we have in our business strategy. We renegotiated growth capital with our lender, who is also one of our largest clients, in anticipation of investments in these large contracts.

Our total access to growth capital under our credit agreement is in excess of $20 million. And with the covenant release for 6 quarters, we believe that we have room to fund the growth that can take us to a 2021 revenue target of $200 million.

We feel very good about our growth and the fundamentals of our business, and believe 2019 revenue will grow in every business line, especially in health care as we enter year 2 of several large contracts.

We see a growing strong diversified business as we look beyond 2018, a year in which we made significant investments to diversify and strengthen the Performant business in the mid to longer term. And we have confidence in achieving our 2021 target of $200 million in revenue, with 20% margins.

And with that, I'd like to open up the call for questions.

Questions and Answers

OPERATOR: (Operator Instructions) Our first question is from Michael Tarkan from Compass Point.

MICHAEL MATTHEW TARKAN, MD, DIRECTOR OF RESEARCH & SENIOR RESEARCH ANALYST, COMPASS POINT RESEARCH & TRADING, LLC, RESEARCH DIVISION: Lisa, you mentioned you're expecting growth in each business line in 2019. And I know maybe it's a little bit early to start thinking about how to frame that, but any kind of color as to what kind of growth on a consolidated level we could be looking for? And then how do we think about EBITDA in 2019? And then just your trajectory there as it relates to the targets? Is 2019 still going to be flattish? And then growth in 2020 and 2021?

LISA C. IM: Thanks for being on the call. As we look at -- as you know, we're providing guidance for 2019 on this call, but when we think about growth in the overall business, we do see growth in all of our businesses, particularly health care. Just as an example, if you think about the MSP contract, we really just started seeing some revenue come through, so we're going to see something like probably close to 3 quarters of more annualized revenue, in addition to what we saw this year. So we do expect that kind of growth, which I think is going to be a strong double-digit growth in health care. As you know, with recovery, we do -- we have some investments, but we see cycling of a couple of larger contracts, and we expect to see -- we see something in the lower but single to low double-digit kind of growth. And then our customer care business next year, we expect to grow kind of on trend, as it has in over the last couple of quarters. So we do see -- we certainly see revenue growth. But you should see from the investment charts that we posted, just to help folks to understand better what our contract investment look like in the year 2 of contract, there's still some contracts that are very large, and longer term has very, very large opportunity potential on the revenue side, but we're still going to invest a bit as we look at year 2. So we think again, for the earlier comment, we really don't say we're going to start seeing more normalized margins until we head into sort of 2020. And then we should start to see those margins on those contracts start to hit what we expect on a longer-term basis, and then I think fully as we enter 2021. Does that help without giving any specific guidance?

MICHAEL MATTHEW TARKAN: That's helpful. How do you balance? Just big picture, how do you balance the need for ramping these contracts? Will potential delays along the way, smaller revenues upfront. It just seems like there's a little bit of constraint to really do best whether it's because you're a public company, you were (inaudible) $20 million of growth capital. But just how do you think about all the investments needed to ramp these -- to get to their full potential in the process?

LISA C. IM: Yes. I think this year, some of these external delays that we were obviously having to weather through were not delays that we necessarily anticipated. And certainly, as we think about earlier in the year, working with our clients on their time line, they believe and we believe that the implementation of these clients would happen a lot faster. That said, as we -- we just don't live in a perfect world. And so some of the examples that we gave are clients having -- getting external approvals from their serviced industries, et cetera. And that's just took longer. So it was -- it's obviously a challenge because we have to work with our clients and their time line. I think our clients tried very hard to get the time lines closer to what we had anticipated. But at the end of sort of -- as we roll through Q3, it's much difficult to get this timely implemented. Anticipating that, we did increase our growth capital. As we look at sort of coming into the fourth quarter and sort of 2019, we don't think that the investment in 2019 will be nearly as -- not nearly as what we saw in this year, because these contracts are now fully implemented. So yes, we're going to start -- we're going to continue to increase our variable costs so that we can start to push higher and higher revenues as we get more business from these clients, as we start to work through all of the volumes that they're providing to us. But the investment, as we look forward in 2019, is not going to be what it was this year.

MICHAEL MATTHEW TARKAN: Okay. And then last one, just so I make sure I heard it correctly. So there were these delays not anticipated, but as of the end of October, there's no real delays out there and a lot of the initiatives have been rectified, so now we can start ramping the contracts?

LISA C. IM: Yes, that is correct. Everybody who is on a contract, when we think about variables, resources apply to contract, everybody is working. And as of October, all of those contracts have been fully implemented. So now it's just the ramp of working that comp business. And then of course, the ramp up of revenue as we push -- in health care, it might be claims that we push out or a recovery, folks that we contact. But they have been all implemented as of the end of October.

OPERATOR: Our next question is from Brian Hogan from William Blair.

BRIAN DEAN HOGAN, ASSOCIATE, WILLIAM BLAIR & COMPANY L.L.C., RESEARCH DIVISION: Quickly touch on the guidance to make sure I understand that the revenue delta that change lower $10 million on the low end. I guess, can you quantify what was maybe delayed on the revenue that was delayed that caused you to lower?

LISA C. IM: Yes. The delays in revenue that we anticipated are pretty close to, I would -- pretty close to about $9 million or so, plus or minus some million on either side. But it was a fair amount of revenue that we anticipated to start, obviously, much earlier in Q3. And we did not, of course, based on our comments, we were delayed in pushing that revenue through. So it's a fair amount.

BRIAN DEAN HOGAN: And so if those delays wouldn't have happened, you would have, I would say, captured guidance? Is that a fair assessment?

LISA C. IM: Yes, I think that's a fair assessment.

BRIAN DEAN HOGAN: All right. Moving on to like the -- obviously, you said in your prepared remarks, you have a 6 quarter covenant release -- or sorry 6 months or I don't know what -- maybe just clarify that 6 quarters?

LISA C. IM: Yes, it was 6 quarters. 6 quarters of covenant release in addition to additional capital. And as we think about our overall growth strategy, we knew that we would require some investments. And as you know, our lenders, one of our larger clients, with some equity interest in the company as well. So working with, what I would say, a supportive lender has been -- it's a privilege that not most companies have. So we feel very good about that, and we have full covenant release for 6 quarters, starting in Q4 of this year.

BRIAN DEAN HOGAN: Can you talk about Premiere and its contribution in the quarter and your expectations going forward and that's in the recovery line, the student loan recovery line? Is that true?

LISA C. IM: Yes, it is in the student recovery line. Just from a revenue contribution, we saw revenue -- part of the recovery revenue that was attributed to Premiere in Q3, it was only -- keep in mind, it was only 1 month. So it was only the month of September. So I want to say it was something close to $1.8 million, something like that. It was not a material -- it's not a huge contribution. And then from an earnings side, it was actually a negative number. So I think it's about a negative $800,000, something like that. And keep in mind that when we took on the Premiere business, we worked with the management team to put together cost savings in the organization and some ability to leverage our platforms since they do have a nice set of differentiated businesses, including commercial recovery in health care operations, being 1 month out the gate, we just -- we haven't been able to execute against everything. We knew that's not going in, and we're not -- we were going to get every (inaudible) in 30 days.

BRIAN DEAN HOGAN: Right, right. And then, I guess, you had provided maybe a preliminary outlook for contribution in 2019 being like $28 million to $32 million of revenue, and (inaudible) EBITDA contribution at the moment, but is that still fair?

LISA C. IM: Yes, so I think that's a fair assessment. And I think I'm recollecting back to when we announced the Premiere deal. I think we were estimating it to be close to breakeven next year. And of course, that may change as we work with that management team, which we're very happy with. But kind of going in, as you know, due diligence is imperfect, but we did the best we could and that's what we think. But again, as we work with our management team and as we put additional business, not only on to performance but on to premier, we will figure out as we walk the path whether there is continued opportunity to improve on the margin side sooner than what we anticipated.

BRIAN DEAN HOGAN: All right. And then the ramp-up of commercial health care. One, can you touch on your pipeline of potential new contracts? But then your existing contracts, as they ramp up over the course of 2019, what is a steady state revenue contribution?

LISA C. IM: Just based on the contracts that we have in hand, so we certainly have a nice pipeline of contracts. And we'll talk more about that when we provide 2019 guidance. We have a handful of really good contracts that we feel good about that are in the pipeline that are decent size. The ones that we implemented in 2018 were fairly large. And so these contracts, if you look at sort of where we are on health care recovery contracts, these contracts are steady state probably somewhere between $10 million and $20 million each, just depending on how quickly we can ramp up with our clients and how fast we can expand and grow with them. There's a need for the kind of services, I mentioned in my earlier comments that we do, because, for example, on a health care recovery contract, there are many companies that do -- that provide audit types of services for different health care payers. There are very few companies, and I would tell you I can't really think of one company that does a really great job of working with the payers and providing a really strong recovery service. We think that's a very distinct strength that we have, a differentiator, being able to work with payers and being able to help our clients, actually, bring in the money. And so we think there's big opportunity for those contracts. So the ones that we implemented this year, I would say, should range in the upwards of $20 million once we get them fully mature.

BRIAN DEAN HOGAN: You said each or is it collectively?

LISA C. IM: I think -- I would tell you, I think that could be each. If you think about the MSP contract, for example, and where we are, we're still ramping. We're not at where we think we're going to be. And that's a good example of a contract that is a health care recovery contract. And as we think about next year, I think, similarly, commercial health care, as you know, the whole world of payer in commercial health care is significantly large. And so when you think about the opportunity for us to add value to the clients with our core skill set, we think there's some pretty strong opportunities for some of these commercial payers. So I would say, at this point, Brian, it's early, right, because we were just starting year 1. So I don't have total visibility into sort of year 3, 4 and going forward, but I do believe those contracts are going to be material in size.

BRIAN DEAN HOGAN: All right, shifting to the IRS contract. I know the IRS has been slow in ramping that up and you get it mixed all there, i is dotted, t is crossed and all that. Can you talk about your performance on the IRS contract in relation to your expectations? And how it relates to the other part I think I saw some stats out there? And then, are you appropriately staffed there?

LISA C. IM: Yes, I mean, we're continuing to increase our resources dedicated to the IRS contract, which is a deliberative sort of slow start. One of the most important, I would say probably the most important, criteria for the IRS, for the program is the compliance piece. So including multiple audits and multiple, I would say, different -- same direction, but guidance is given by the IRS to ensure that we were -- that our quality was the best. I will tell you the published quality numbers, I don't think have individual companies broken out. But we make sure that we put 100% quality, and that was our focus. So as we move forward, we have a good process in place to ensure probably the best quality on service in that contract. And then making sure that all of our newer employees and our full staff is trained under that same guideline. So we think it's early, Brian, it's very early. But we think we prioritized what was appropriate. And for the IRS, and frankly for the critics of the program, everyone is looking at the program to try to make sure that the taxpayers are treated in the way that the IRS would like for them to be treated. And quality is going to be an exceptionally important part of the program as we go forward, particularly now with the oversight from the house.

BRIAN DEAN HOGAN: Shifting to the CMS RAC contract, it has a nice -- it looked like a nice step up in revenue quarter-over-quarter. I guess what I'm getting to is what is the potential there? And I appreciate your prepared remarks commentary about the potential in the CMS, just having, at least some of the reins. But what do you see the revenue steady state being in the current environment?

LISA C. IM: Well, in the current environment, we think it will probably be something below $10 million per year, but we're hoping the current environment changes as they get through this year. Part of our challenge, if you look at our performance versus, say, someone else who has just one audit region. We have Region V, which is the national DME home health contract, those expenditures are significantly smaller per claim. So if you think about what DME is comprised of, it's orthotic shoes, wheelchairs, crutches, those kinds of claims are very, very low dollar. And so when we have a cap of 0.5%, it takes a lot of work to create the claims and to create the work around it. We want to make sure we're being smart about the resources that we're putting behind those 2 contracts. But as we look at both contracts, we, obviously, are working with CMS to try to get those cap lifted, particularly for the DME portion, which -- in which we don't really work with providers, we work with suppliers. And so in the shorter term, under the current cap, we really don't see a huge opportunity maybe somewhere in the sort of $3 million to $5 million range. But we really believe, based on the error rates and what we believe CMS really ought to do for the benefit of the Medicaid Trust Fund, that they should lift the overall cap on the DME, on the Region V program, and then start to lift the one, that is the Region I regular audit program. So we're trying to work with them, Brian, to make sure that we provide not only the best service, but that taxpayers like you and me and everyone else on the call are seeing a good program that keeps integrity of Medicare trust, at least longer than what is currently being projected. So we think we can get back to that fund.

BRIAN DEAN HOGAN: I agree. A quick one on the placement volume -- student loan placement volumes. I think you would -- talk about your relationship with Great Lakes. I mean, I thought you're going to get more placements maybe from Great Lakes than to what you've been getting? And a nice step-up in placement volume overall this quarter. How much is that? Was it Premiere? And just kind of have that going forward.

LISA C. IM: Yes. As I mentioned earlier, it's -- we have a strategic relationship with ECMC, who is one of the largest guaranty agencies. Part of that is performance-driven, because, obviously, the better we perform on giving contract, the more placements we get. Some of that is, obviously, is Premiere. But our strategic relationship with ECMC is we believe is really going to be helpful. And they expect us to perform, and we expect to perform because we want to drive the best possible service back to our clients. But we do think that strategic relationship, Brian, is going to be very helpful. As we think about student loan business and how that grows in the sell program. I don't have the Premiere numbers broken out specifically, but we have, at the Performant level, also subgrowth in placement.

BRIAN DEAN HOGAN: Anything from Great Lakes?

LISA C. IM: We are not seeing any Great Lakes placements directly from Great Lakes, it's from Navient. And those placements are Navient runs a very specific contract. I think where outperformance is very strong on that contract. But they have 2 internal -- Navient has 2 internal collection companies that they feed, I think you have 4. So no matter how great our performance is, we're just -- we're going to see what the future brings. And then I'll just leave it at that.

BRIAN DEAN HOGAN: And then I guess the very last one is the ad saga continues. I guess they put out a new statement out there saying they we're exploring newest piece, following the court decision several weeks ago. I guess any updated thoughts on your end?

LISA C. IM: I don't have any updated thoughts on my end. I think it is definitely a saga, probably worthy of a TV show. But there are companies that continue to be in courts and bring (inaudible) into court, we are not one of those companies. We think Department of Education was probably trying to find a path that they can live with. We think there -- they inherited kind of a process and a contract or a process that they were trying to clean up. We have some empathy for what they're going through, having seen other government agencies try to climb out of these kind of things. So we're supportive of what they are trying to do. I don't think it's an easy answer. I don't think it's an easy solution. So at this point, I really don't have any speculation or thoughts around that process. I think we're going to have to watch and see what they do. And again, try to be supportive as we can.

OPERATOR: (Operator Instructions) And there are further questions, I'd like to turn the floor back over to Ms. Im for any closing comment.

LISA C. IM: Thank you. I'd like to thank you for being on the call with us today. I also, as always, want to thank our clients for their support and their trust in our service. And I will say, even though quarter 3 was lower than what we expected, we do feel very good about quarter 4, having implemented our contracts and really being able to provide that service to our clients. As we go from Q4 into 2019, we do expect to see revenue growth across all of our businesses. And as we look forward to what that momentum looks like after 2019, we do feel very confident that we will be driving toward our 2021 revenue target of $200 million. And at the time, we should see normalized margins of about 20% on these contracts. So I feel very good about that going forward. I want to thank our employees as well for bringing your best and bring your passion and your commitment to your performance. Thank you very much.

OPERATOR: This concludes today's teleconference. You may disconnect your lines at this time. Thank you for your participation.

Load-Date: November 12, 2018