H&R Block Q3 FY23

Financial Results Conference Call Transcript

May 9, 2023

[Introduction & Forward-Looking Statements]

Michaella Gallina, Vice President, Investor Relations: Thank you, Lateef. Good afternoon, everyone, and welcome to H&R Block's third quarter fiscal 2023 financial results conference call. Joining me today are Jeff Jones, our president and chief executive officer, and Tony Bowen, our chief financial officer.

Earlier today, we issued a press release and presentation, which can be downloaded or viewed live on our website at investors.hrblock.com. Our call is being broadcast and webcast live, and a replay of the webcast will be available for 90 days.

Before we begin, I'd like to remind listeners that comments made by management may include forward-looking statements within the meaning of federal securities laws. These statements involve material risks and uncertainties, and actual results could differ from those projected in any forward-looking statement due to numerous factors. For a description of these risks and uncertainties, please see H&R Block's Annual Report on Form 10-K and Quarterly Reports on Form 10-Q, as updated periodically with our other SEC filings.

Please note, some metrics we'll discuss today are presented on a non-GAAP basis. We've reconciled the comparable GAAP and non-GAAP figures in the appendix of our presentation.

Finally, the content of this call contains time-sensitive information accurate only as of today, May ninth, 2023. H&R Block undertakes no obligation to revise or otherwise update any statements to reflect events or circumstances after the date of this call.

With that, I will now turn it over to Jeff.

[Opening Remarks]

Jeff Jones, President, and Chief Executive Officer: Thank you, Michaella. Good afternoon everyone, and thanks for joining us. Today I will share highlights from the third quarter and discuss our tax season performance in context of the unusual market dynamics this year. Tony will share our financials in more detail later in the call. Then, we'll open it up for Q&A.

[Tax Season & Industry Dynamics]

As you'll recall, we and others expected this to be a normal tax filing year with the pandemic largely behind us, no new Federal programs, a large number of stimulus filers having left the industry, and strong employment. Generally, tax return volume was expected to grow about 1%, which is in line with its historical average.

But, after an initial peak, the industry volume in fact declined about 1% year over year, which was about 200 basis points below our expectations. While we are still analyzing results, we believe a number of factors contributed to this outcome, including:

- More stimulus filers rolled off than anticipated,
- a decrease in average refund size and an increase in balance due returns, which may have driven low-income filers to the sidelines,
- And the IRS filing delay in several states including California, which we estimate to be about 100 basis points of the impact.

As a result of industry volume declines, our own Assisted performance, and the impact of foreign exchange, we have updated our full year outlook. Tony will share more detail later in the call, but I'm pleased that we still expect to deliver EBITDA and EPS growth this year despite these headwinds. Let's dig deeper into our performance, starting with DIY.

[DIY]

As you recall, our goal was to return to share growth by increasing awareness that we offer a DIY product, improving quality, and making it easier to switch from TurboTax® by creating a customized experience in the product user flow. We also introduced new innovations like our industry first use of artificial intelligence that finds tax refunds that may have been missed on TurboTax® returns. This multifaceted strategy worked.

Through April 30, we grew DIY online clients by 2.5%, with many of them switching from TurboTax®. We also improved unaided awareness by 200 basis points, which is a significant move year over year. Our online net average charge was about flat. Our largest segment of new clients was Gen Z, between the ages of 18 to 25. Finally, our service quality scores were strong. These metrics are historically a good forward-looking indicator and confirm our progress and the prospects for our DIY business.

We also continue to see clients that begin in DIY choosing to upgrade by adding expert help, with one of our two products: Online Assist and Tax Pro Review. Online Assist offers on-demand access to an H&R Block tax expert. Clients can access this help before starting their return or while completing it, and AI is helping us get smarter about anticipating when the client may be struggling and needs this help. Tax Pro Review provides the benefit of having our tax experts check the entire return for accuracy, ensuring clients get their maximum refund, and then we file the return on their behalf. Tax Pro Review continues to grow double digits, which it has done nearly every year since we launched this capability more than a decade ago. Of course, both Online Assist and Tax Pro Review enable the client to access one of our tax experts without needing to visit an office.

[Assisted]

Now let's discuss our Assisted business.

Since I joined H&R Block, we have made numerous changes with the goal of improving relevance and driving growth among clients with greater lifetime value. For example, we introduced Upfront Transparent Pricing, eliminated FREE Assisted tax prep, and eliminated nationwide "50% off" promotions, to name a few. These efforts are paying off and this year we experienced client growth among each segment above 50 thousand dollars in income, with our fastest growing segment being clients over 100 thousand dollars in income.

However, this year the growth in higher value clients wasn't enough to offset the volume decline in the lower income segments. While we'll continue to learn more in the coming months, three key factors are clear:

- First, as I shared earlier, we were impacted by the overall industry decline, specifically as a result of very low-income filers - likely stimulus filers who had less than 5 thousand dollars in income - going back to the sidelines. This group likely made up a little more than 1/3 of our client loss this year. And as we look to the data, it appears they have returned to pre-pandemic levels, and we believe this headwind is now behind us.
- Second, we saw a decline in Earned Income Tax Credit filers. We simply did not do a good enough job attracting them with the right message at the right time, and I know that we can better focus marketing messages on relevant value propositions such as Refund Advance in the early part of the season. This group likely made up almost half of our client loss this season.
- And third, the IRS filing deadline extension in multiple states impacted the industry and our volumes. We estimate that the California delay likely made up about 15-20% of our volume declines.

All of these factors led to about a 3% decline in Assisted volumes. When the fiscal year ends, we'll conduct a full review and make decisions about changes and improvements for next year, but we believe we have a strong grasp on what drove the declines.

Assisted net average charge across Company and Franchise offices increased 4% year over year as we successfully offset the two-point headwind due to the rollback of the Child Tax and Earned Income Tax Credits. We feel great about our pricing approach as our client satisfaction scores improved, including notable moves in "price for value", "intent to return", and other service quality scores. Considering refund sizes declined and more clients were balance due, these are especially strong results.

Not only did we see the significant growth I already mentioned in Tax Pro Review, but we also saw continued improvement in virtual tool adoption which enable clients to exchange documents with their tax expert, check the status of their return, and approve and pay online. More than 30% of Assisted clients leveraged a virtual tool during their tax prep experience within our Company owned footprint.

Overall, the transformation of our Assisted tax preparation business has made more progress this year.

[Small Business Tax & Wave]

Turning to Small Business Assisted tax, volumes were down slightly with the broader industry, but we demonstrated pricing power that drove incremental revenue. NAC increased 5% alongside positive client satisfaction metrics, demonstrating our value proposition versus local CPAs. We are also focused on serving entity clients, which grew 6%, and company entity revenue increased by double digits. We recently launched an entity formation tool to allow small business customers to take advantage of benefits that may come from incorporating.

We are also pleased with the trends in our bookkeeping and payroll services in the early stages of its strategic focus. Our new dedicated internal sales team has meaningfully increased conversion rates and we feel good about the value we are creating for clients through year-round services. These are strong signals about how we are helping small businesses beyond tax.

At Wave, revenue growth was 10% in the quarter. Wave's new CEO has made a lot of progress in his strategic review of the business to accelerate revenue growth and drive long term profitability. We have already taken initial steps by restructuring the organization and we look forward to sharing additional detail in the coming months.

[Financial Products: Spruce]

In January, we introduced Spruce, our mobile banking platform, to our Assisted clients for the first time. Since launch, through April 30, we had 291 thousand signups and 288 million dollars in customer deposits.

When I view the performance of Spruce relative to the initial launch of today's leading challenger banks, we have outperformed in account sign ups. However, given our client base, we had higher expectations.

Some tax pros were successful in introducing Spruce to their clients which provides great insight about our value proposition and selling model. But on balance, our tax pro community focused on serving the tax needs of our clients.

That being said, Spruce clients *are* utilizing it to help them be better with money. This season tens of thousands of users deposited over 100 million dollars of refunds to their Spruce account up to 5 days early, which is a meaningful benefit especially at a time when every dollar matters. We are also seeing clients make their first purchase at a much faster rate than earlier customers. Recently, we launched a new feature enabling clients to easily set up direct deposit within the app with just a few clicks. Thousands of clients have engaged with this new tool, and of those, more than 80% have chosen to direct their *entire* paycheck.

All in all, Spruce demonstrated that it has value to clients, and we had important learnings which are already informing some shifts we'll make moving forward.

Before I turn it over to Tony to discuss our financials, let me just say that overall, while this was NOT the industry context we expected, and we didn't land where we wanted in Assisted, our DIY strategy was very successful, Tax Pro Review again grew double-digits, we attracted higher-value Assisted clients, small business continues to progress, and Spruce demonstrated signals of its potential. These important wins are a reflection of our Block Horizons strategy and are evidence of the progress we continue to make in transforming H&R Block.

Now, we are focused on finishing out the year and integrating these key learnings into plans for our next fiscal year.

Tony, I'll turn it over to you.

[Q3 FY23 Financials]

Tony Bowen, Chief Financial Officer: Thanks, Jeff. Good afternoon, everyone. Today I'll review results from the third quarter, provide additional color on our updated outlook, and discuss capital allocation.

In the third quarter, we delivered approximately $2.1 billion dollars of revenue, an increase of 1.5% or about $32 million dollars to the prior year. The increase was primarily driven by net average charge in the Assisted category, partially offset by lower software sales and a decline in online paid returns during the quarter compared to the prior year.

Total operating expenses were $1.2 billion dollars, an increase of 4.5%, primarily driven by higher field wages and the timing of advertising, partially offset by lower bad debt, legal fees, and consulting and outsourced services.

EBITDA was approximately $910 million dollars, a decrease of 1.3% or $11.7 million dollars to the prior year.

Interest expense was $22 million dollars, a decrease of 6%. As we have shared, this savings is the result of the 500-million-dollar notes we issued in June of 2021 at about half the rate of those we replaced, which were paid off early in May of 2022. While we have seen higher interest expense on our short-term borrowings, we expect a greater benefit from interest rates while we are in a positive cash position.

Pretax income was $855 million dollars compared to $862 million dollars in the prior year, and our effective tax rate was 24.5% compared to 21.7% last year.

We did not execute any share repurchase in the third quarter. Given our narrow trading windows, we have historically executed most of our share repurchases in the early part of the year. In the first half of 2023, we completed $350 million dollars of share buybacks, or another 5% of our shares outstanding.

Earnings per share from continuing operations increased from $4.06 to $4.14, while adjusted earnings per share from continuing operations increased from $4.11 to $4.20; note that the only adjustment we are currently making to adjusted earnings per share is amortization related to acquisitions.

On that note, franchise acquisitions are a core part of our Block Horizons strategy and our longer-term revenue growth target of 3-6%. We expect to acquire approximately 125 locations per year; though this year, we were able to complete 195. We will continue to be opportunistic and believe this is a great use of capital.

[FY23 Outlook]

Turning to our outlook, as Jeff mentioned, due to industry volumes as well as lighter than expected Assisted client volumes this season, and an expected foreign exchange impact of about $20 million dollars, we are updating our estimates. We now expect:

- Revenue to be in the range of 3.440 to 3.465 billion dollars,
- EBITDA to be in the range of 895 to 910 million dollars, and
- Adjusted earnings per share to be in the range of $3.65 to $3.80.
- We continue to expect our effective tax rate to be approximately 22%.

In a year with the industry declining and headwinds from the rollback of the Earned Income Tax Credit and the Child Tax Credit, including its impact on the Emerald Card, I’m encouraged that we still expect to grow EBITDA and deliver solid EPS growth.

[TSR]

Our longer-term total shareholder return algorithm remains unchanged. We believe we can deliver 3-6% long term revenue growth, EBITDA to grow at 1.5 times revenue, and double digit adjusted earnings per share growth annually through 2025.

As I've said, despite year-to-year nuances, the strength of our capital allocation story remains the same: we produce significant cash flow, pay a growing dividend, and buy back a meaningful amount of shares every year. We are committed to, and confident about, driving ongoing value for shareholders with these practices. With that, I will now turn things back over to Jeff for closing remarks.

[Closing Remarks]

Jeff Jones, President, and Chief Executive Officer: Thank you, Tony. While this isn't how we expected the season to play out, I am pleased that despite the many factors we have discussed, we still expect to grow EBITDA and EPS year over year.

We are focused on finishing the year strong, analyzing fiscal year results, and creating action plans for next year. I look forward to sharing more with you on our next call in August.

Now, operator, we will open the line for questions.

[Q&A]

Forward-Looking Statements

These materials contain forward-looking statements within the meaning of the securities laws. Forward-looking statements can be identified by the fact that they do not relate strictly to historical or current facts. They often include words or variation of words such as "expects," "anticipates," "intends," "plans," "believes," "commits," "seeks," "estimates," "projects," "forecasts," "targets," “calls for,” "would," "will," "should," "goal," "could," "may," or other similar expressions. Forward-looking statements provide management's current expectations or predictions of future conditions, events or results. All statements that address operating performance, events or developments that we expect or anticipate will occur in the future are forward-looking statements. They may include estimates of revenues, client trajectory, income, effective tax rate, earnings per share, cost savings, capital expenditures, dividends, share repurchases, liquidity, capital structure, market share, industry volumes, or other financial items, descriptions of management’s plans or objectives for future operations, products or services, or descriptions of assumptions underlying any of the above. They also include the expected impact of the coronavirus (COVID-19) pandemic, including, without limitation, the impact on economic and financial markets, the Company’s capital resources and financial condition, the expected use of proceeds under the Company’s revolving credit facility, future expenditures, potential regulatory actions, such as extensions of tax filing deadlines or other related relief, changes in consumer behaviors and modifications to the Company’s operations related thereto. All forward-looking statements speak only as of the date they are made and reflect the Company's good faith beliefs, assumptions and expectations, but they are not guarantees of future performance or events. Furthermore, the Company disclaims any obligation to publicly update or revise any forward-looking statement to reflect changes in underlying assumptions, factors, or expectations, new information, data or methods, future events or other changes, except as required by law. By their nature, forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially from those suggested by the forward-looking statements. Factors that might cause such differences include, but are not limited to a variety of economic, competitive, and regulatory factors, many of which are beyond the Company's control, that are described in our Annual Report on Form 10-K for the most recently completed fiscal year in the section entitled "Risk Factors" and additional factors we may describe from time to time in other filings with the Securities and Exchange Commission. You may get such filings for free at our website at http://investors.hrblock.com. In addition, factors that may cause the Company’s actual effective tax rate to differ from estimates include the Company’s actual results from operations compared to current estimates, future discrete items, changes in interpretations and assumptions the Company has made, future actions of the Company, and increases in applicable tax rates in jurisdictions where the Company operates. You should understand that it is not possible to predict or identify all such factors and, consequently, you should not consider any such list to be a complete set of all potential risks or uncertainties.

Non-GAAP Measures

We refer to certain Non-GAAP financial measures in these materials, including adjusted earnings per share, earnings before interest, taxes, depreciation, and amortization (EBITDA), free cash flow and free cash flow yield, which management believes provide additional meaningful information regarding the Company’s performance and financial strength. All non-GAAP financial measures in these materials are from continuing operations. Non-GAAP financial measures should not be considered as a substitute for, or superior to, measures of financial performance prepared in accordance with accounting principles generally accepted in the United States (GAAP). Because these measures are not measures of financial performance under GAAP and are susceptible to varying calculations, they may not be comparable to similarly titled measures for other companies. For a description of these non-GAAP financial measures, including the reasons management uses each measure, and reconciliations of these non-GAAP financial measures to the most directly comparable financial measures prepared in accordance with GAAP, please refer to the tables accompanying these materials and previously filed press releases posted on our investor relations website at https://investors.hrblock.com.

Market, Industry, and Operational Tax Data

The data included in these materials regarding the tax preparation services industry, including trends in the market and the Company's position and the position of its competitors within this industry, are based on the Company's estimates, which have been derived from management’s knowledge and experience in the industry, and information obtained from customers, trade and business organizations, internal research, publicly available information, industry publications and surveys and other contacts in the industry. The Company has also cited information compiled by industry publications, governmental agencies and publicly available sources. Although the Company believes these third-party sources to be reliable, it has not independently verified the data obtained from these sources and it cannot assure you of the accuracy or completeness of the data. Estimates of market size and relative positions in a market are difficult to develop and inherently uncertain and the Company cannot assure you that it is accurate. Accordingly, you should not place undue weight on the industry and market share data presented in these materials.

Unless otherwise noted, year-over-year comparisons of our operational tax metrics are calculated as July 1, 2022 to April 30, 2023 compared to the corresponding prior year period.