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TREE - Q1 2011 TreeCom Inc Earnings Conference Call

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PRESENTATION

Operator

Good day everyone and welcome to the Tree.com first quarter 2011 earnings conference call. Today's call is being recorded. On today's call is Chairman and CEO, Doug Lebda and Senior Vice President of Finance, Tamara Kotronis. At this time I would like to turn the call over to Mr. Lebda. Please go ahead.

Doug Lebda - *Tree.com, Inc. - Chairman, CEO and Director*

Thanks operator and thank you everyone for joining us today for Tree.com's Q1 2011 earnings conference call. First, a quick disclaimer.

During this call we may discuss Tree.com's plans, expectations, outlook, or forecast for future performance. These forward-looking statements typically are preceded by words such as, we expect, we believe, we anticipate, we are looking to, or other similar statements. These forward-looking statements are subject to risks and uncertainties and Tree.com's actual results could differ materially from the views expressed today. Some of the risks we face have been set forth in our earnings release and in greater detail in our periodic reports filed with the SEC. We will also discuss certain non-GAAP measures such as EBITDA and adjusted EBITDA. I refer you to today's press release for all comparable GAAP measures, definitions, and full reconciliations of adjusted EBITDA and EBITDA to net income.

Before beginning a discussion of our Q1 results, I would like to first put them in the context of the significant announcement we made today regarding the sale of certain assets of LendingTree Loans to Discover Financial Services. Late last year, anticipating a rising interest rate environment and corresponding expectations of falling loan origination volume and shrinking margins, our board of directors contemplated the strategic direction of the total company and as part of that, LTL. The board's conclusion was that to succeed as a lender, we needed to do two things.

One, be able to scale the business significantly larger. And two, diversify lead sources away from LendingTree long form volume only. So, in that context, our SurePoint transaction made perfect sense. As part of our strategic review, our board also thought that we should simultaneously have conversations with potential acquirers of the business, where LTL could be an even better fit.

We subsequently negotiated a deal with Discover that our board unanimously believes to be in the best interest of our shareholders. From our side, this will bring several benefits. One, bringing substantial cash to the Company. Two, free up even more cash that is tied up in warehouse covenants in LTL. Three, enable us to route volume back to our exchange lenders that in today's rate environment will monetize more profitably than the LTL. And four, enable us to focus on our core competency, growing the best lead generation business for both consumers and partners.

We believe Discover is an ideal transaction partner because of the synergies they have with the LTL platform. Their bank charter significantly simplifies the state licensing challenges and costs of a non-bank mortgage company. They have a lower cost of capital than Tree and they have a significant source of cross-sell capability from their other lines of business. In anticipation of this possible transaction we operated Q1 to maintain the asset value at LTL by completing the SurePoint acquisition and diversifying lead sources and continuing to invest in our product and technology so we can set the stage for growth in our lead gen businesses. So, with that, let me dig beneath the reported adjusted EBITDA loss of $15.4 million.

At LTL, SurePoint transition costs were $2.2 million, as we maintained capacity while state licenses were transitioned and the loan pipeline built back up. As we cut back on LendingTree marketing because of changes in the market, which I'll address in a minute, we also ramped up lead buys at LTL from other lead aggregators, which cost us another $1.5 million. And loan losses came in at a fast clip would cause us to book $3.3 million in loan loss expense for the quarter. Finally, given the declining loan origination pipeline, our fair value accounting charge was also $3.2 million.

We also had a number of significant short-term hits in marketing, which you can see in our marketing expense as a percentage of revenue, which increased from 37% in Q4 to 67% in Q1. With a significant amount of our volume going to LTL and their economics declining, many of our marketing deals went unprofitable in January. So, we had to pull back and adjust significantly.

Fortunately we learned our lesson in late 2009, when we had significant amounts of locked-in advertising. This time around, all of our ad buys have 30 to 60 day outs. So, as deals went underwater, we adjusted very quickly to cut spend. But those underwater deals still cost us about $3.5 million in Q1. We also had to significantly test new volume sources and even while we were cutting some spend, we were ramping others. That experimentation, as we tested, learned, and reallocated, cost us another approximately $3 million in the quarter.

Looking ahead from here, I am very optimistic about how things look in the marketing front. We have learned a lot weathering this storm and recent months have showed steady improvement in margins and advertising productivity. We also recently have hired a new CMO in Gabe Dalporto, who even though he's only been on board less than four weeks, has already had an impact building on all of the initiatives we have put in place over the last year.

In the exchanges, revenue was $14.1 million, compared to $12.2 million in Q4 and $19 million in Q1 2010. Adjusted EBITDA was a loss $9 million compared to $7 million loss in Q4. Here, too, there are a number of things to highlight. We're seeing significantly higher fees paid by lenders on our exchange with a 15% increase in the average fees lenders paid for our refinance leads. But we're unable to feel the full effect of this because a significant chunk of our LendingTree volume still goes to LTL. We expect to see this benefit as the Company transitions to a pure lead gen company.

I'm really pleased though that we continue to gain traction in our non-mortgage verticals. The a number of consumer requests transmitted to our network of non-mortgage service providers was 15% higher than last quarter and for the fifth consecutive quarter those transmitted requests make up more than half of the exchange's total. Given our focus on long-term growth and diversification and knowing a deal for LTL was possible, we maintained our investment posture with Tree.com, which cost us nearly $1 million in EBITDA for the quarter. We're really happy with our progress on this. Tree.com, which was previously launched in beta, is now live with content across 14 verticals and we have cracked 100,000 unique visitors already after only a month of exposing the site. We're now systematically adding more content, improving the user experience, and now adding monetization events across each vertical.

Even as we continue to invest in some areas, we also had to make a tough decision to shut our Realesate.com REALTORS business. As the real estate market continued to weaken, we couldn't maintain the investment and timeline we thought it would take to pull through on that business. Realestate.com is now fully transitioned to a site that monetizes via lead gen and advertising from realtors which, while smaller, is now profitable, scalable and we think more valuable and now a better strategic fit with a lead generation focused company.

In summary, Q1 was a transitional quarter. We transformed Realesate.com, stuck an attractive deal to sell the assets of LTL, adapted our marketing to the new environment, ramped up lead sales on the exchange, cut overhead costs, and grew our emerging businesses.

While I, for one, never like to lose money, I was pleased that we were able to improve our financial performance each month in the quarter and that trend has continued into Q2. We have now got this business significantly refocused and pointed completely in a new strategic direction and it's a direction that we believe will be more profitable, more scalable, more in line with our strengths, less risky, and more valuable to our shareholders. With that, let me turn the call over to Tamara to add more color to the financial results.

Tamara Kotronis - *Tree.com, Inc. - SVP of Financial Planning & Analysis and IR*

Thanks Doug and good morning to all on the line. While I will hit the highlights of our Q1 financial results, you can see most of that in the earnings press release. As such, I'm going to spend a good bit of my time talking about the LendingTree loans and Discover transaction and what that means for our Company.

Yesterday we signed a definitive agreement to sell certain assets of our mortgage origination subsidiary, LendingTree Loans, to Discover Bank, a subsidiary of Discover Financial Services. In exchange for the LendingTree Loans assets, Tree.com will receive a net purchase price of approximately $55.9 million. Post quote, Discover will leverage LTL's existing expertise for converting LendingTree leads and will be a significant partner for us on our mortgage network. Until then, we will generally operate LendingTree Loans in the ordinary course of business. LTL will continue receiving leads generated by the LendingTree brand, in addition to maintaining its lead diversification posture with third-party aggregator volume.

Upon close, Discover will receive the operating assets of the LTL mortgage business and Tree will retain the loans held for sale and pre-close liabilities. Retained liabilities include potential loan losses on past mortgages sold. At the end of Q1 we had reserved $19.5 million dollars for potential loan losses. As part of normal course of business, we will continue working with investors on potential loan buybacks as they arrive.

Until the closing, will also maintain our relationship with our warehouse lenders as a normal part of the mortgage operation. As a result of this pending transaction, starting in Q2, we will be presenting the LendingTree Loans results in discontinued operations and we will be recasting comparable periods to conform to that presentation.

Now to highlight some of the financial results in the quarter. On a GAAP basis, we reported a net loss of $39.5 million dollars or $3.63 per share. This compares to the fourth quarter 2010, where we reported net loss of $12.5 million dollars or $1.12 per share, and also to the first quarter 2010 where we posted a net loss of $6.1 million or $0.56 per share. The net loss in the first quarter 2011 was impacted by the strategic decision we made in March to discontinue operations of our Company owned brokerage business, Realestate.com REALTORS.

The Q1 net loss includes $13 million in expense from the impairment of goodwill and other intangible assets and $2 million in restructuring expense related to the shutdown. As a result of this decision, you can see in our earnings release tables and financial statements that we are presenting Realestate.com REALTORS bottom line results in Discontinued Operations.

Also in connection with exiting the Realestate.com REALTORS business, we have reevaluated our segment reporting based on the management of our continuing operations. In order to align our reporting with how we view our business, we have consolidated the corporate segment and the remaining real estate operations into the exchanges segment. We are now reporting results in two distinct segments, Lending Tree Loans and Exchanges. Comparable periods have been recast to conform to this new presentation.

Apart from charges resulting from the decision to shut down the Company-owned brokerage, Q1 net loss also was impacted by $4.5 million of expense related to the settlement of a previously pending legal matter.

Now, moving on to the Q1 results in our business segment, at LendingTree Loans, we posted an adjusted EBITDA loss of $6.5 million in the first quarter of 2011. The loss in Q1 was driven by lower revenue in the quarter, which was 48% lower than Q4 2010 and 25% lower than Q1 2010. And also by the factors Doug mentioned like transition costs of the SurePoint acquisition and investments in lead diversification.

As we mentioned in our last earnings call, interest rates at the end of Q4 had increased from a low near 4.2% to nearly 5% by year-end. Those higher mortgage rates continued into Q1 holding around 5%. In a higher interest rate environment, the incentive for customers to come into the market to refinance is much lower. The result of that is downward pressure on conversion rates and on revenue generated per loan. So, after enjoying several quarters of the positive effects of low interest rates, LTL closed 36% fewer loans in Q1 than Q4. At the same time the average revenue generated per loan decreased 20% from Q4 levels.

Despite the obvious revenue pressure in the first quarter of 2011, I want to highlight some positive notes at LTL. First, the acquisition of SurePoint Lending was finalized in mid-March, adding production capacity, a broader geographical footprint for talent acquisition, and a specialized expertise in converting lower quality leads. Second, LTL grew its lead volume by 53% over Q4 2010, due in large part to the team's efforts to diversify lead sources through third-party aggregators. And finally, operating expenses at LTL were about $0.5 million lower in Q1 than Q4 despite $1.1 million of additional operating expense related to the acquisition and integration of SurePoint.

The Exchanges segment which now includes overhead expense previously reported as Unallocated Corporate, posted an adjusted EBITDA loss of $9 million in Q1 compared to a $7 million loss in the fourth quarter of 2010. The increased losses over Q4 came inside of higher quarter-over-quarter revenue, and this was primarily the result of approximately $4 million in higher marketing costs, which offset the higher revenue.

Looking into the Exchanges metrics, we saw 19% more consumer requests being matched to our mortgage and non-mortgage service providers than in Q4. Furthermore, our LendingTree leads remain in high demand, especially in times of limited inventory. This is evidenced by a 14% increase in the average number of lenders being matched to our refinance consumers, and as Doug mentioned earlier, the higher prices that lenders are willing to pay. In our non-mortgage businesses these verticals which include education, insurance, auto and home services once again comprised more than 50% of the total matches in our Exchanges segment with over 160,000 matched consumer requests in the quarter.

As Doug described, earlier in the first quarter we took an intentional position of investing in marketing, product, and the Tree.com build-out. And we plan for this to continue into Q2. Without giving specific guidance, we believe that we will see revenue growth in both segments in Q2. But because of the continuation of our long-term investment strategy, we are likely to show another adjusted EBITDA loss, albeit lower than Q1.

Now, briefly turning to the balance sheet, we ended the quarter with approximately $63.5 million in cash, including $9.9 million of restricted cash. This is down approximately $16 million from the end of Q4. The change from last quarter principally reflects normal business operations in the quarter as we just highlighted. It also reflects the cash outflows related to the completion of the SurePoint acquisition, offset by the effects of the timing of fundings in sales in the mortgage portfolio.

We ended the quarter with 11 million common shares outstanding with another 943,000 options and 739,000 RSUs outstanding. We did not reinstate the 2010 share repurchase program in Q1, so we have approximately 4.3 million share repurchase authorization remaining. And with that, I'd like to turn it back over to the operator for Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Neil Doshi, Citi.

Neil Doshi - *Citigroup - Analyst*

Congrats on the deal, Doug. A couple questions around the transaction. First of all, did you guys go to other potential acquirers? And maybe a little bit of rationale behind selling the asset to Discover. And secondly, is there a breakup fee involved if, for whatever reason, Discover decides they don't want to purchase LTL? And then I have one more follow-on question.

Doug Lebda - *Tree.com, Inc. - Chairman, CEO and Director*

In terms of the process, and we are going to lay this all out clearly in the proxy, we did talk to some other potential acquirers. Very quickly we ended up -- I would say fairly quickly we ended up in an exclusive process with Discover. They had a very compelling offer and we thought it was a great home. So, we decided to enter into exclusivity with them and we proceeded down the deal path.

There is a breakup fee associated if the transaction does not close for a number of different reasons and again, we'll lay all of those out in the documents that we are going to file tomorrow.

Neil Doshi - *Citigroup - Analyst*

As we think about Q2, should we still consider you guys to continue to invest in the LTL business as if it was under a normal course of business? Or can we see some marketing leverage in some other lines?

Doug Lebda - *Tree.com, Inc. - Chairman, CEO and Director*

I think what we are going to do in Q2 is rationalize and right size the business for however Discover, for whatever size Discover needs it to be. So, we are going to look at the size of the Company, we are going to look at the marketing channels and we are going to start planning it for integration with Discover.

I think the biggest drag, if you will, on the expenses at LTL, is really loan loss reserves, which are coming at a fairly brisk pace. And as a result of this transaction, we'd clearly look, as we exit the mortgage business, we would look to negotiate settlements with our large investors on the LTL side.

Operator

Jeff Graf, Springhouse Capital.

Jeff Graf - *Springhouse Capital, L.P. - Analyst*

A few questions on the transaction. First, can you help me understand what the balance sheet is going to look like after the transaction closes? I assume that your warehouse facility will go with the business, or will transfer to Discover? I'm assuming your loans held for sale will go as well. And then, how much cash will you be sending along with LTL in the transaction?

Doug Lebda - *Tree.com, Inc. - Chairman, CEO and Director*

The loans held for sale would actually transfer the warehouse line. I believe Discover would set up their own warehouse line financing, if in fact they needed it. Clearly they would have investors, but that's really up to Discover.

Our warehouse line facility -- the way to think of it is essentially LendingTree is a pure lead gen business. Over time, the HLC business gets wound down. The assets and liabilities there get netted out and sent back to Tree.

In terms of cash, clearly we would have the cash we have today plus the $36 million that's paid at closing, plus 2 payments of $10 million each over the next 2 years against the liabilities of the loan losses that we will have to settle out. That reserve is roughly $20 million as of the end of Q1.

Jeff Graf - *Springhouse Capital, L.P. - Analyst*

Is there any tax liability or any other tax payment?

Doug Lebda - *Tree.com, Inc. - Chairman, CEO and Director*

We actually think this will -- because of some NOLs that we have at the Company, we actually think that this is going to effectively be tax-free to us.

Operator

(Operator Instructions) It appears we have no further questions. I'd like to turn the conference back over to our speakers for any additional or closing remarks.

Doug Lebda - *Tree.com, Inc. - Chairman, CEO and Director*

Thank you all very much. We appreciate the opportunity to engage with you. We think this is a very exciting transaction that sets the stage for a dramatic strategic shift at the Company. And we look forward to reporting back with you in just a few more months.

Operator

That does conclude today's presentation. Thank you for your participation.
