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TREE - Q1 2012 Tree.com, Inc. Earnings Conference Call

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PRESENTATION

Operator

Good day, everyone, and welcome to the Tree.com first-quarter 2012 earnings conference call. Today's call is being recorded. At this, I'd to turn the call over to Tamara Kotronis. Please go ahead.

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

Thanks, operator, and thank you to everyone for joining us today for Tree.com's Q1 2012 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. Many but not all of the risks we say are described in the periodic reports we filed with the SEC.

We will also discuss a number of non-GAAP measures. I refer you to today's press release for the comparable GAAP measures, definitions and full reconciliations of non-GAAP measures to GAAP. I will address the financials and then I will hand it over to Doug to provide more details on the quarter.

First, let me give a quick update on our LendingTree loans business, which is reflected in discontinued operations. We've been making steady progress toward completion of the pending asset sale to Discover and we're still on track to close midyear. In the meantime, we're certainly pleased to still have the mortgage business in this low interest rate environment, as LTL has been operating at levels we haven't seen in several years. In Q1, it funded the highest number of mortgage loans since mid-2007, generating over $50 million in revenue and net income of $16.4 million.

Looking at continuing operations comprising our core performance marketing business, revenue was $13.2 million in the first quarter, up 24% from last quarter and roughly flat to Q1 2011. Despite being flat year-over-year, we have demonstrated significant improvement in marketing efficiencies. In fact, selling and marketing expense as a percentage of revenue went from 112% in Q1 2011 to 80% in Q1 2012. That is a reduction in expense of nearly $5 million from Q1 a year ago.

Continuing operations posted a net loss in the quarter of $3.3 million, which is an improvement of $1.8 million over Q4 and a $12.8 million improvement over Q1 of 2011. The improvement quarter-over-quarter was driven by a $2.1 million income tax benefit in Q1, and the improvement year-over-year is largely driven by the combination of lower marketing expense, as I mentioned previously, and Q1 2011 included a $4.7 million nonrecurring legal settlement charge.

Adjusted EBITDA in continuing operations was a loss of $2.5 million in Q1, which is a $1.1 million decline from Q4 2011 but a $5.9 million improvement over Q1 2011. The quarter-over-quarter decline in adjusted EBITDA is due to an increase in marketing spend compared to Q4.

Interest rates flattened. As a result, we spent the more marketing dollars on consumer acquisition.

On a combined basis, revenue in Q1 2012 was $64.1 million, up 37% quarter-over-quarter and up 82% year-over-year. We posted net income of $13.1 million, or $1.15 per diluted share. This compares to net income of $1.2 million in Q4 2011 and a net loss of $39.5 million in Q1 2011, which included a $13 million asset impairment, a $4.7 million legal settlement mentioned earlier, and $2.3 million in restructuring.

The total Company adjusted EBITDA was $17.3 million in the quarter, which is a $12.5 million improvement over Q4 2011 and a $33.2 million improvement over Q1 2011 and marks the strongest quarter we have seen since the spin from IAC in 2008.

Looking to the balance sheet, we have ended the quarter with approximately $9 million cash and cash equivalents, plus $14.9 million in restricted cash. As has been the case throughout 2011, we did not repurchase any shares in Q4, so we still have approximately $4.3 million in share repurchase authorization remaining.

Today, we are reiterating our previous 2012 guidance of net income from continuing operations of $3 million to $4 million and adjusted exchanges EBITDA between $8 million and $12 million. In addition, last quarter, we had estimated our unrestricted cash balance after the sale of the HomeLoanCenter assets and subsequent wind down to be approximately $50 million. Today, given the results we just posted in Q1, we are increasing that estimate to at least $60 million.

With that, I would like to turn it over to Doug.

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

Thanks, Tamara. Thanks to all of you for joining us on the call today.

Q1 was a great quarter for Tree. I'm thrilled by the progress we have made on our transformation towards a pure play performance marketing company, success by recent initiatives, and the strength of our LendingTree brand. We stepped on the marketing gaps in Q1 and significantly scaled both lead volume and revenue. In fact, our mortgage revenue in continuing operations was up 33% over Q4. Adjusted mortgage revenue, a measure we introduced on last quarter's earnings call as the model revenue or business would have had without the effective LendingTree loans, was up a remarkable 41% over Q4.

In our nonmortgage business, revenue was up slightly, approximately 80% quarter-over-quarter. We expect to see continued revenue growth in 2012 as our education, home services, and auto verticals continue to prove out their initiatives.

Combining the mortgage and nonmortgage business, our total adjusted exchanges revenue was up 34% over Q4. Even better, with this revenue growth, we were still able to maintain strong margins. Adjusted variable marketing margin was $11.3 million in Q1, which is an increase of 18% quarter-over-quarter. As a percentage of total adjusted exchanges revenue, our VMM was very strong at 47%.

Compared to a year ago, total exchanges revenue was relatively flat but with significantly better margins. Those that have followed us for a while will recall that we stepped on the gas to drive volume and revenue in Q1 of 2011 but when we did, our margins were squeezed. This year, the marketing efficiencies we have worked so hard to achieve proved out marvelously. Adjusted VMM increased $7.4 million over Q1 2011 and as a percentage of revenue improved from 16% in the first quarter to 47% this quarter.

Adjusted exchanges EBITDA was $4.3 million in the quarter, up $1 million from Q4, and marks the fourth consecutive quarter of growth and the third consecutive quarter of positive adjusted exchanges bottom line.

Now let me give you some additional highlights from the quarter. In marketing, we're continuing to see significant improvements in efficiency. Key channels are ramping up to drive quality lead volume. Recently, in our display advertising channel, revenue per ad dollar improved 400% over last year while driving nearly 10 times the number of leads. It's worth noting that while this growth is off a low base, display was one of the channels we unwound for unprofitable spend last year and effectively turned off. We see the relaunch of this channel in Q1 with this kind of early success as a giant leap forward and expect display to become a meaningful contributor of profitable lead volume in the coming quarters.

On our mortgage exchange, we spent the last several months focusing on driving volume with marketing efficiency. The next step is to ensure we have a network of lenders ready and willing to take that volume and more. To illustrate our recent success, in Q1, the number of consumers matched with at least one lender was up 52% over Q4 and up 29% over Q1 of last year. In addition, our lender sales team is gaining traction and signed nearly 15 new lenders this quarter.

Turning to our nonmortgage business, in education, we have seven of the top largest public companies and for-profit secondary markets as clients. In addition, with over 100 articles published, our DegreeTree site has become a key resource for education seeking consumers. As a result, we are seeing an increase in organic traffic.

In auto, the work around improving the customer experience and expanding the scope of this business is all about getting growth. The new Car Elite program is now launched in a pilot program and we're looking to expand that partnership as well as launching others in the near future.

In the home services, we're seeing an increase in volume generated through online sources and are also targeting cross-sell volume from our flagship LendingTree site. Furthermore, the number of new service providers receiving leads continues to expand and we're now operating in 14 metros across the US and in over 100 home services categories.

Before we go to Q&A, I want to take this opportunity to thank everyone on the Tree team. We've all worked tirelessly, late nights, early mornings, weekends and holidays to get the job done. Our improved financial results are a direct reflection of these efforts. Revenue was up, bottom-line results are up, and cash is up. I'm proud of the work we're doing and I couldn't be more excited for our future.

With that, I'd like to turn the call back to the operator for Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Neil Doshi, Citi.

Neil Doshi - *Citigroup - Analyst*

Hey, Doug, congrats on the quarter. A few questions. One, could you provide any update on timing for the Discover transaction?

Secondly, given the strength that you saw in the quarter, any reason why you decided to maintain your guidance for the year and not bring it up?

Then lastly, if you can provide any update on the interest rate environment and how we should be thinking about marketing expenses going forward for that. Thanks.

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

Sure. All really good questions. On timing of Discover, we're still saying mid-year and contractually it will have to be before the very earliest part of July, so I think sometime in the next between now and the end of June is really the best guidance we can give. Quite frankly, given the profitability of the business, the longer it takes is better for us.

I'm not updating our guidance here. We are being conservative about the back half of the year, and we've talked about this before. Why I'm not really sure with the interest rate environment is going to be and then I will get into your next question -- but two, we have a significant amount of volume that we're going to have to clear with other lenders as Discover Home Loan Center goes getting exclusive leads to operating on what we call a compete model. Just to put that in perspective, basically every lead that goes to an LTL is only going to them where, if it goes to the network, it's got the opportunity to go to five lenders, so we're going to have a significant amount of sales. We are ramping that up now, but depending on how that volume clearance goes, we may need to actually reduce marketing spend as opposed to continue to drive that. So that is really the question. I think we're just being conservative at the moment until we see it in evidence. But I think we certainly feel that that guidance we gave before is obviously is much more -- we're much more certain about it than we have been in the past.

The interest-rate environment is very interesting. You see this in the tale of our two businesses, which is why I think the pro forma numbers matter so much, or the adjusted exchanges. Interest rates, if we saw an uptick in interest rates, we would be able to, I believe, increase -- pricing would naturally increase on the exchange and lender demand would increase. Given the success we've had in our marketing, I think that would be very helpful for the business and not at all hurtful.

Right now, we're kind of doing the proverbial selling ice cubes to Eskimos. Lenders are all flushed with leads. The larger lenders are doing a lot of HARP 2 volume, and there's a lot less capacity in the industry because it's just government regulations and people leaving it. So rising interest rates would be good for the exchanges business in the same way that low interest rates are good for the LendingTree Loans business.

So for the first time in a while, I am hoping that rates would move up a little bit. But I feel really good about where we are.

So in terms of marketing spend, the key thing to focus on I believe is variable margin dollars and where variable marketing margin that we disclose, and that is the business. Marketing spend for us is not expense. It's gas that drives the business and if we can spend it efficiently to drive up traffic, we're going to do that and really try to drive more margin to the bottom line.

Neil Doshi - *Citigroup - Analyst*

Great, thank you Doug.

Operator

Noah Steinberg, G2 Investment Partners.

Josh Goldberg - *G2 Investment Partners - Analyst*

Hey guys, Josh Goldberg here for Noah. Pretty strong results, congratulations.

Just a couple of questions. One is on the 50 new lenders that you added, based on our calculation, that is a very strong number. How many of those lenders do you think will be able to take over some of these LendingTree loans leads that you will have going forward?

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

So they all will so far there -- these are not among the largest lenders that we could go close on. So while we're happy to add 50 lenders, it shows that LendingTree has very strong lead quality. It shows that we can steal wallet share from our competitors, which we're very focused on, but they are generally smaller guys. We do have a number of large ones in the pipeline that we are very, very bullish about.

I feel very good about what our sales pipeline is looking like right now. That said, we still have some work to do but when I talk to lenders and they -- we say, hey, listen there's a lot more LendingTree leads, they are very happy to engage with us. The issue is they have diversified their lead sources, so to add us, they generally have to turn somebody else off or turn somebody else down, but they are doing that.

We're continuing very to have very good results from our predictable volume program that we talked about last quarter. That really changes the game, when we can tell a lender, hey, listen, post the DFS transaction, how many leads do you want? They say 10,000 a month, 5000 a month, whatever their number is. We can commit to that. That significantly helps our sales process because they can confidently plan their business around LendingTree with a nice, smooth order flow.

Josh Goldberg - *G2 Investment Partners - Analyst*

Okay, great. It says, based on your last quarter, you had $45.5 million of unrestricted cash and that number went to $59 million, an increase of $13.5 million in the quarter. Is that correct?

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

That is correct.

Josh Goldberg - *G2 Investment Partners - Analyst*

Was that majority I assume from the LendingTree loan side?

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

Yes, its cash flow tracks very closely to EBITDA. We had a net income total company of $13.1 million and that is tracking right to that difference effectively.

Josh Goldberg - *G2 Investment Partners - Analyst*

okay. If the deal closes midyear, there is a chance you can increase the cash by that same amount in the second quarter?

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

It would increase by whatever the profits are in the second quarter roughly would be a good -- we have not assumed the numbers we say at least $60 million. That is assuming -- that's kind of March balance sheet if there are additional profits at LTL or just in the business overall, clearly that, yes, cash should increase roughly. There are always some puts and takes on that, but that is absolutely accurate.

I would say this was a fantastic quarter at LTL, high margins, high volume, very efficient. It may not -- the trend may not be in perfect linear fashion in the next quarter.

Josh Goldberg - *G2 Investment Partners - Analyst*

And just from what I understand also, post-deal, Discover will pay you an additional $38 million?

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

That is correct.

Josh Goldberg - *G2 Investment Partners - Analyst*

Okay. So when you take the $60 million and you add the $38 million, I know it's going to happen over time, it's a substantial amount of cash that you will be having on your balance sheet post --

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

It is, but keep in mind, keep in mind we have $32 million of loan loss reserves on that business that we assume, when we say we're going to have at least $60 million post DFS, that we settle those at face value if that number could be a little bit higher or little bit lower than that. I think it is $33.5 million actually, not $32 million. So round numbers you pay for deals, transaction costs, et cetera, et cetera, and your purchase price roughly cleans up your balance sheet and gets rid of all of that risk, which is why your, at a high level, your unrestricted cash balance is roughly equal to the cash post-close.

Josh Goldberg - *G2 Investment Partners - Analyst*

Did the loan loss reserves go up in the first quarter?

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

Yes, it basically goes up every quarter as we increase -- as you just make adjustments for the fact you have originated more loans, it effectively moves roughly linearly with the amount of loans you close minus any settlements you have with your investors, and we didn't have any settlements.

Josh Goldberg - *G2 Investment Partners - Analyst*

Got you. Okay, great. Thank you very much.

Operator

(Operator Instructions). Nick Zamparelli, Zeke LP.

Nick Zamparelli - *Zeke Capital Advisors - Analyst*

Hey guys. Thanks for taking the question. Nice quarter.

With the improvement you are seeing in variable marketing margin percentage in your exchange business, I'm trying to think about how we should be modeling or thinking about long-term EBITDA margins for this business and how they might improve over time. If you could just kind of frame that for us?

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

Sure. The way -- I'll tell you what I think about it. You see that our fixed costs, below variable marketing margin our fixed costs in the exchanges business are pretty much fixed. It went up a little bit this quarter as we make some hires, but it's really not significant. I think we went up $0.5 million quarter over quarter. So, fixed costs are fixed. You drive up your variable marketing margin and it all falls to the bottom line. Given the strength of the LendingTree brand, we can market, now that marketing is working very well, we can market we believe more efficiently than our other lead gen competitors. We get significantly higher click through rates on the LendingTree brand, for example, than we get on the GetSmart brand as we can ramp up display where a number of our competitors are very successful. We can drive that volume up and as long as we can sell it and the price premium in the market, because of the high lead quality, it's really a matter of how much share you can grab from mortgage marketing.

I think of this as a media company. Mortgage companies need to spend money on advertising. They spend it on bank rate. They spend it on LendingTree. They spend it on our competitors. Some of them do their own direct advertising. It is really how much of that wallet can we go get as we add value to our advertisers.

Nick Zamparelli - *Zeke Capital Advisors - Analyst*

Okay. Great, thanks guys.

Operator

[Ron Legreaux], [DS Dana] Fund.

Ron Legreaux - *DS Dana Fund - Analyst*

Congratulations on the results. You mentioned in your presentation that display advertising was up 400%. What exactly is happening there with respect to display advertising?

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

So it's coming off of a very small base. Display advertising has become one of the most challenging areas of advertising online because of increases in technology and increases in just the ability of people to come in and buy advertising at highly variable prices through bidded exchanges. Because of that, you have to be highly variable in your advertising, so you literally have to constantly test thousands and thousands of combinations of creative messaging colors, et cetera, et cetera and you have to do it down to the placement level and you have to be very nimble to adjust in effectively real-time. We used to buy what I would call branded display advertising in sites like Yahoo and places like that where you had very long lead times. You kind of fix it in. That clearly did not work and the improvements we're seeing again off a very small base are driven 100% based on a new creative team and a new head of display advertising, and our marketing analytics team that are executing that and able to run all the variables that can make that channel work.

So the beauty of display, it is a huge channel to be able to go after, so you could really scale a business off of it if you are effective.

Search, while large, we can't go be -- you can't be higher than the number one placement on the key words that matter. So search caps out and then you've got to be able to go relatively -- it's tough to get continued growth out of search unless the search engines are growing. So you've got to go find other ways of getting it. Display will be a significant driver for the business if we can continue to improve there, and then ultimately off-line. We have a new head of our off-line advertising and we're going to go through an agency review process. We're running good creative in the market now but we want to get back to killer breakthrough creative TV which we think can drive the brand the way we used to drive it.

Ron Legreaux - *DS Dana Fund - Analyst*

Okay, thank you.

Operator

(Operator Instructions)

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

Hearing no more questions, I think we will close it out here. I want to thank everybody for their time and attention. Any further questions, you can always for free to reach out. We're going to stay focused on our business and we will get back -- is there another question?

Operator

Yes, Noah Steinberg.

Josh Goldberg - *G2 Investment Partners - Analyst*

Sorry about that. Can you just talk a little bit about the new advertising agency? We read somewhere that the amount of budget that you had seems like a very high number as well. Why you switched and everything like that?

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

Sure. Basically, we switched from a -- it's in the DR, Direct Response area. It's not sort of a branded agency yet. It is basically the group that does the buying for us. They buy very, very efficiently in what is called Direct Response media channel, so you are highly opportunistic. They're doing really great work for us. You can see it. Creative is very hard-hitting in driving consumers and what I referred to earlier, we will go, in addition to that, we will always continue to do that but we do want to come up with another breakthrough campaign and move back into so-called branded TV.

We're still going to maintain a very flexible -- maintain our flexibility and test our way back into that, but we do believe that we can significantly ramp spend again only if there is demand for that from the lenders.

But the beauty of TV advertising, if you think about all your advertising channels, this really goes to the core value of the LendingTree brand proposition. We -- the highest quality traffic you can drive to your advertisers, to our lenders, is off-line. If you think about it, that is where somebody has to see an ad, get up, go to a computer, type in www.LendingTree.com and take an action. And so therefore you're going to have very high intent to purchase and that is what we like.

The other nice thing is any TV -- any off-line advertising you do puts a halo that improves the results of your online advertising. It's called attribution modeling and that really helps as well too. The beauty of it is, with the LendingTree brand, none of our competitors can really do that, so that is a significant differentiator for us that really helps the whole business be much more profitable.

Josh Goldberg - *G2 Investment Partners - Analyst*

Okay, great.

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

Any more questions?

Operator

There are no further phone questions at this time.

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

Fantastic. Thank you all for your time. We appreciate your continued support and we will keep executing here and hopefully have some good news to report to you in another three months.

Operator

Again, that does conclude today's call. We do thank you for participating.
