Blackline Safety Corp.
First Quarter 2022 Results
Conference Call Transcript

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Speakers:

Scott Boston
Director, Finance

Cody Slater
Chief Executive Officer & Chair of the Board

Shane Grennan
Chief Financial Officer

Operator:
Welcome to the Blackline Safety First Quarter Results Conference Call.

As a reminder, all participants are in a listen-only mode and the conference is being recorded. After the presentation, there'll be an opportunity to ask questions. (Operator instructions 00:19).

I would now like to turn the conference over to Scott Boston, Director, Finance. Please go ahead.

Scott Boston:
Thank you, Cherise.

Good morning. Welcome, everyone. Thank you for joining us.

I'd like to remind everyone that this call is being recorded today, Wednesday, March 16, 2022.

With me today is Cody Slater, CEO and Chair of Blackline Safety Corp., as well as our CFO, Shane Grennan.

Before turning the call over to Cody, I would like to note that some of the information discussed in this call is based on information as of today and contains forward-looking statements that may involve risks and uncertainties. Actual results may differ materially from those set forth in such statements. For a discussion of these risks and uncertainties, you should review the forward-looking statements disclosure in the earnings news release as well as in the Company's SEDAR filings.

During the call, there will be a discussion of IFRS results, non-GAAP financial measures, non-GAAP ratios, and supplementary financial measures. A reconciliation between IFRS results and non-GAAP financial measures is available on the Company's earnings news release and MD&A, both of which can be found on our website, blacklinesafety.com, and on SEDAR.

All dollar amounts are reported in Canadian dollars, unless otherwise noted.

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With that, I will now hand the call over to Mr. Slater.

Cody Slater:
Thank you, Scott.

Good morning, everyone, and welcome to Blackline Safety's Q1 2022 Earnings Call. Today we will be discussing our first quarter results, which were issued before market opening this morning. To set the agenda for today's remarks, I will start by providing a broad Company overview. Shane will then discuss some of the highlights of our first quarter in greater detail, and I will conclude with the Company's outlook and some closing remarks before we take a few questions.

At a high level, the 47% top-line growth we delivered in the first quarter reflects the continued execution on our **Invest-to-Grow** strategy. This plan has involved strategically accelerating investments in sales and marketing and advancing our game-changing product roadmap to further capitalise on the expanding market for connected safety around the world.

The $15.7 million we generated in total revenue marked the twentieth consecutive quarter of year-over-year revenue growth. This milestone was driven by robust growth in our U.S. and Rest-of-World segments, with 80% and 93% total revenue growth, respectively. Sales in our Europe region were up 51% in Q1, and based on our current visibility and backlog, we expect the region's growth rates to accelerate in Fiscal 2022.

High-margin recurring software services increased 9% sequentially and 25% year over year to $7.4 million in the first quarter, again demonstrating the stickiness of our hardware-enabled Software as a Service business model. While hardware margins were challenged during the quarter due to a variety of factors that Shane will discuss, we think it's important to keep in mind that every dollar of G7 wearable hardware sales generates $4 in lifetime recurring service revenue.

The recurring service revenue has a substantially higher profit margin profile than the hardware does, such that approximately 92% of the lifetime gross profit is derived after the initial hardware sale; so, while we will continue to work on maximising hardware margins, the majority of our value creation clearly occurs after the initial sale and has been unaffected by these headwinds.

I'm incredibly proud of our team's continued success, mitigating with supply chain challenges and delivering for our customers where we continue to see extremely healthy demand for our products and services globally. We are adapting where we can to recapture our hardware margins, but ultimately we believe this is a short-term challenge that does not affect the long-term higher-margin profitability of our service agreements with our customers.

I will now turn the call over to our CFO, Shane Grennan, to discuss our first quarter results and financial position in more detail.

Shane Grennan:
Thank you, Cody, and good morning, all.

As Cody said, we achieved another quarter of strong year-over-year growth of 47%, yielding revenues of $15.7 million, including product revenues of $7.3 million, which represents a 91% increase from the same quarter last year. The increase was a reflection of our global sales team, which we built up over the last two years, with more than double the count of Regional Sales Managers in that time period.

I would note that Q1 is typically a seasonally slower quarter for us due to procurement cycles, and this seasonality is why we believe evaluating us on year-over-year growth is more appropriate than sequentially.

Service revenue grew to $8.3 million from $6.8 million, or 22%. Software services revenue remained the most significant portion of our service revenue at 89%. Rental revenue continues to grow rapidly, up 188% from the prior year to $0.2 million. We have invested in our rental fleet and operations centre in Houston, which will enable us to scale this up dramatically over the remainder of this fiscal year. Activity in this service line will remain seasonal, but will become a very steady growth driver for us.

On the hardware side, the G7 EXO sales were strong at 19% of our total hardware revenue for the quarter; however, this was down from 23% in the prior year quarter, which negatively impacted our hardware margins. Our **Invest-to-Grow** strategy continued to yield benefits, including our expanded sales team in the United States where revenue increased 80% to $6.9 million, including a large contract win with a major independent energy company during the quarter, which will contribute to strong service revenue growth when it is fully deployed in the third quarter.

Over the last two years we have focused heavily on our global network, which has translated to robust growth of 93% outside of North America and Europe to $1.2 million. I would like to emphasise this point even further by the fact that Rest-of-World revenue has grown from 4% to 8% of total revenue for this quarter when compared to two years ago. Note that we have closed on our previously announced agreement to secure a facility in Dubai, which we expect to contribute to further strength in Rest-of-World growth.

The expanded European sales team also delivered strong results. Even though Europe did not achieve the same growth rates as these other segments, total revenue grew 51% compared to the prior year quarter. Our European growth was negatively impacted by timing of some larger projects, but we expect this region’s growth rate to accelerate for the balance of the year.

Overall, service revenue during the quarter was $8.3 million, a 22% increase from the prior year. Software services revenue was up 25% year over year and up 9% sequentially, driven by new activations of devices and expansions of our existing customer base. Newly activated devices contributed to growth of $0.3 million in the quarter, while increases from our existing customer base added $0.5 million to the quarter.

This increase was offset by customers who renewed fewer active devices due to workforce reductions of $0.3 million and only $14,000 from customers who declined to renew this quarter. Our service margin percentage was largely unchanged at 68%, as increases in salaries, connectivity and data costs were mostly offset by the increase in service revenue.

Product gross margin for the quarter was adversely impacted by cost inflation from shortages of certain components and higher than normal freight charges, due to ongoing global supply chain challenges in the first quarter of 2022. As a result, product gross margin in the first quarter of 10% decreased from the prior year period of 17%, excluding the benefit of the Canada Emergency Wage Subsidy.

While some of our competitors experienced delays in delivering product to customers, our procurement team remained dynamic, and with our capital flexibility, we were able to absorb the increased costs and maintain our strong relationships with our customers. We take seriously the role that our devices and services play in keeping our customers' employees safe, and we will do whatever it takes to continue to meet their needs while these challenges persist.

That being said, we expect the proactive moves we are taking will mitigate inflation of our material costs and elevated freight charges. These efforts, along with increased product sales in future quarters, will contribute to higher gross margins in subsequent quarters. The overall combined gross margin percentage for products and services was 41%, which was lower than the same quarter last year, primarily driven by the higher proportion of product revenue overall.

Product research and development costs were up 59% to $5.3 million for the quarter. Excluding Wearable Technologies (WTL) and CEWS, the increase was 29%, driven largely by higher salaries and wage expense for additional team members. The team is continuing to work to ready G6 for market this coming summer, as well as developing concepts for the G5 which is planned for release in early Fiscal 2023.

On the sales and marketing expenses side, we saw an increase to $8.9 million. This equates to 107% year-over-year growth in our sales and marketing expenses compared to 173% in Q4 2021. Excluding the impact of CEWS and additional cost for wearable technologies, the increase was actually 90%. The increase is primarily due to increases in salaries of new hires and significantly higher travel and tradeshow costs as global travel restrictions eased and the Company fully returned to its flagship trade show. In addition, higher hardware sales drove increased sales and distributor commissions for the quarter.

General and administrative costs increased to $4.9 million. This reflects the continued trend of decreasing year-over-year growth in our G&A, which was 196% in Q3 2021, to 138% in Q4 2021, to 111% this quarter. Excluding the impact of CEWS and WTL, the increase was 82%. The increase was driven by the expansion of our operations team as we focus on improving our quality assurance, efficiency, and overall manufacturing capacity based on the demand in our pipeline expectations for G6.

We've also expanded the team responsible for system security to continue providing the highest levels of resiliency for both our customer-facing and internal systems. There were also higher costs associated with being listed on the TSX.

The Company continues to maintain a strong balance sheet with no debt and a solid working capital position of $52 million, including cash and short-term investments of $45 million. Additionally, the Company has access to a $15 million credit facility that is currently undrawn. Capital expenditures and lease payments for the quarter totalled $2 million, primarily due to sale of revenue generating gas sensor cartages, as well as additions to our Surface Mount Technology line and manufacturing equipment.

Inventory totaled $15.2 million at January 31, 2022, compared to $12.7 million at the end of our fourth quarter. The growth in inventory is a result of the build for G6, G7, and G7 EXO to meet increased anticipated orders in 2022, inflationary pressures on certain components, higher stocking requirements for the Company's subsidiaries in France and the U.K., as well as proactive management of material levels as a result of ongoing supply chain challenges.

Blackline provides the opportunity to our customers to purchase outright our devices, or to lease through our G7 lease program. With this customer decision affecting the timing of our cash inflows associated with that sale, we have expanded the number of customers opting for finance leases, with a total of $18.3 million in future contracted cashflows at January 31, 2022, an increase from $16.3 million at the prior year end and an increase from $7 million at January 31, 2021.

These finance leases positively impact our immediate product revenues and service revenues over time, but negatively impact the timing of associated cash inflows to Blackline. Generally, it takes one and a half to two years for a finance lease contract to catch up to a purchase agreement with service in terms of the cashflows.

Lastly, I would like to highlight that we continued to make progress on our environmental, social, and governance objectives. As discussed in our last call, we published our 2021 ESG report on February 17, highlighting a number of achievements, goals, and initiatives here at Blackline Safety. Perhaps most importantly, we have committed to achieving Net Zero as a Company by the end of Fiscal 2023. We recognise that we have a duty to continue to improve our impact on our environment, people, communities, investors, customers, and partners. We look forward to keeping you all apprised of our progress through future updates.

I will hand it back to Cody to discuss our outlook and to provide closing remarks.

Cody.

Cody Slater:
Thank you, Shane.

Looking ahead, we are launching the first of its kind G6 connected personal safety device for the zero-maintenance market in July, followed by the launch of the G5 in the light industry and construction markets in early Fiscal 2023. Both launches build on our success with the G7 and G7 EXO and will extend our competitive lead with the most comprehensive connected safety suite of technologies globally, including our Blackline Live portal for cloud-based real-time reporting.

Our software platform not only provides us with a competitive advantage but delivers tremendous value and insights for our customers who rely on our technology daily to ensure the wellbeing of their workers. Along that line, our team continually strives to innovate new ways to connect all elements of the Industrial worksite more broadly to further enhance workplace safety and operational efficiency.

Blackline's track record of innovation and growth was recently recognised by several noteworthy organisations and lists, including the Canadian Business New Innovators list, and the Deloitte Enterprise Fast 15. More importantly, though, our solution continues to see adoption by a growing list of high-quality customers, including securing a $4.3 million contract with a new major U.S. energy customer, and being named a preferred vendor by Shell plc in a three-year global framework agreement.

Our investment in sales and technology infrastructure over the past two years has established the foundation to not only take the G6 into the zero-maintenance market of over 2 million unconnected devices, but also expand beyond gas detection and begin to connect the broader industrial workplace. With the G5, we are looking into new areas beyond gas detection, where we currently have little to no penetration, opportunities that will significantly increase our total addressable market.

We believe we have reached a critical mass internally as a result of our successful invest-to-grow strategy. Our operations have scaled significantly, which gives us the strength and resources to capitalise on the growth opportunities in our current industrial markets as well as new types of workplaces as we transform them through connected worker technology.

As we look to the remainder of the year, we expect revenue growth to accelerate through continued market adoption of our products and services and the introduction of new products. At the same time, we also expect to see a moderation in expense growth, as the majority of the investment in scaling our operations is now complete, significantly improving operating leverage and demonstrating the attractiveness of our hardware-enabled SaaS model as we connect the world's industrial workforce.

Thank you to everyone for your attention today, and your continued support for Blackline Safety. I'll leave it there, and will turn the call over to the Operator, and open it up for questions.

Operator:
Thank you. We will now begin the question-and-answer session. (Operator instructions 17:20).

The first question comes from Amr Ezzat with Echelon Partners. Please go ahead.

Amr Ezzat:
Cody, Shane, good morning.

My first question is on the product gross margin front. You spoke to a few moving parts in your prepared remarks, and I'm trying to get a sense of what you guys deem as a one-off for the quarter for relative to maybe what's here at this table over the next few quarters.

Cody Slater:
Sure, Amr.

I think, you know, keeping in mind two things, a series of things impact our hardware margin. One is product mix, so a larger percentage of our EXO, which, this was a very light EXO quarter, will increase the margin just naturally. As well, the Q1's a very low product number, so there's a lot of—there's unabsorbed labour in there that just impacts that number. I think the real thing to look at as a differential rather than to Q4 is to Q1 the prior year where you're looking at a 17% to a 10%, you know, the majority of that's supply chain challenges.

I think it's fair to say we see those continuing for another quarter or two, but not much longer than that. It's a bit of a moving target with that, Amr, where you wind up with different products and materials at different points in time, and having to going on allocation, having to buy through secondary sources, so I would say we have seen the worst of it, is the view from our operations teams, but it's probably not over yet.

Amr Ezzat:
Okay, so if I sort of—the hit from supply chain, I guess, as you quantify it, is probably like 700 to 1,000 basis points, if I'm comparing it, like, to last year, and that differential will continue over the next couple of quarters. Is that a fair assessment?

Cody Slater:
Again, I'd say I think it's a fair assessment on a conservative standpoint, Amr. I think we'll see the Company do better than that from the realised margin base; but it's a reasonable assessment to take just because of the volatility in that space. We have components that you'll see that are—one being a power amplifier that goes into a number of our products. It's a $0.60 component that went on to allocation that you had brokers trying to sell for $60, we wound up acquiring for $6, but those are the kinds of things that sort of come in and out.

In the meantime, we've strengthened our inventory positions, which will mitigate that going forward though I'd say, and again as the product volumes increase, you'll see your greater leverage from just that absorption of labour. And as we get into quarters that are a bit more focussed on the EXO, like Q3 and Q4 will be stronger EXO quarters, you'll see a natural strengthening of the margin as well. Long way to say that I think that's a conservative number to use, that 700 basis points.

Amr Ezzat:

No, I appreciate the colour.

Let's stay on the EXO. I know fiscal Q1 can be tricky, as it's seasonally weak, but is there any read-through for us? Like, when we look at the EXO last year, I believe it was $1.7 million; this quarter it's looks like $1.4 million. Any read-throughs there, or just seasonality and it's extremely hard to come to a conclusion?

Cody Slater:
The EXO, if you look at it year on year we're still—Q4 was a very strong quarter for the EXO, in the range of two plus, $2.5 million dollars' worth of sales. That was really fuelled by a couple of very large orders in the U.K., so that's the lumpiness, I guess, I'd say is the nature of that market where you'll see some impacts form that. If you look at EXO growth year on year, though, Q1 a year ago we were about $800,000, $900,000, so you're seeing growth in the year-on-year numbers, a little drop from the Q4 because of that seasonality.

We'll see growth strengthen in the EXO market as we go forward into its more traditionally stronger fall quarters I would say, Q3 and Q4 for us; as well, we're adding certain feature sets to the EXO that allow it to expand into a bit broader market. It also will help to generate some strength in that space.

Amr Ezzat:
I think we've got different numbers for last year's EXO, which we could sort of discuss offline.

On the G6 launch, last quarter you spoke to supply chain being, like, the biggest risk, but you thought it was manageable. Just wondering how that has evolved since your last conference call. Then, on that same topic, on the inventory front, they continue to ramp, and you guys mentioned it's partly ahead of the G6 launch. But I'm just wondering, how does your inventory compare to what you guys had budgeted? Is it below budget? Over budget? On budget?

Cody Slater:
Sure, I'd say, I mean, to take your first question on the G6, material supply challenges are still its greatest risk to its July launch at this stage. The product itself is moving well, and by the product, I mean everything around the G6. G6 is not only the device. It is a totally new communication

protocol and system, back-end infrastructures; all that's coming together very well. We're pleased with the progress from all the product teams.

Our visibility today is similar to what it was before. We believe we're fine on the context of the supply chain. I will note things like when you start seeing segments of China being shut down, those are the risk—there's still risk that they're just entirely impossible to predict, I would say; but at this step point, we're confident with the launch time, confident with the product.

If you look at the inventory side, I'd say the inventories are heavier than we would have budgeted originally, and that's more to do with defensiveness around supply chain than it is to do with the G6. One of the points Shane made in his comments is, during these last couple of quarters, we've not—one thing I will say, on the supply chain, it's impacted our margins. That's absolutely true. It's certainly impacted even to a base where you don't see, like we actually have more people working and purchasing materials, all those kinds of things, than you would normally, just because it's so much more of a complex world to live in right now.

That's sort of behind the scenes, but we've not been in a position where that has caused us to not be able to deliver product to a customer, and that's something that our standard traditional gas detection competitors can't say, and a number of them have been in positions where they're just simply not able to deliver. That's been our key focus, and that is part of the reason why you see the growth in the inventory is just to ensure that those supply chain issues that we do see as potential challenges don't cause the problems that would allow us to—would force us to not be able to deliver to customers.

Amr Ezzat:

Okay, fantastic. That's good colour. I'll pass the line.

Cody Slater:
Thanks.

Operator:
The next question comes from Kris Thompson with PI Financial. Please go ahead

Kris Thompson:
Great, thanks. Morning, guys.

Just to confirm on the G6 customer trials, Cody, is that still slated to commence in April?

Cody Slater:
Yes, yes. We're still looking at an April timeline for initial customer trials. Everything on the development side of the G6 is still in tune with where we wanted it to be. We're doing our first manufacturing run of a few hundred devices. Soon we're going to be getting in front of more customers and getting some field experience there, so all that looks very positive right now.

Kris Thompson:
Okay, good stuff. Great to hear.

Just maybe for Shane, on the inflation front, there was a mention of higher salaries and MD&A for your SOC team members. Have you made all the salary changes by now, or should we expect additional margin pressure through the remainder of 2022?

Shane Grennan:
Yes, just on that point, Kris, I should clarify that is some increased headcount coming through in the SOC as opposed to salary inflations. Through the remainder of the fiscal year there will be an element for salary review that is taking place through that, but that would be a traditional number as opposed to anything out of the ordinary.

Kris Thompson:
Okay, great. Just last one for me, you mentioned headcount; can we get an idea of where you're at at the end of January, and what we should think about towards the end of this year? Because the OpEx, you know, I know you guys are scaling for the product launches and infrastructure builds globally, but just give as an idea of how that OpEx should look over the next few quarters, if you don't mind.

Shane Grennan:

Kris, we're sitting at 580 employees globally as of today. And that increased from where we were at the end of the fiscal year of 63 individuals across each of the departments and teams around the world.

Kris Thompson:
You said five, one, eight?

Shane Grennan:
Five, eight, zero.

Kris Thompson:
Five-eighty. And the end of the year, would you anticipate still being above 600?

Cody Slater:
Certainly above 600, but nowhere near the growth if you look at it like, you know, 60 people a quarter was our prior growth; it's not going to be anything close to that as we go forward here, Kris.

Kris Thompson:
Roger that. Thanks for taking my questions, guys. See you.

Shane Grennan:
Thank you.

Operator:
The next question comes from Bryan Fast with Raymond James. Please go ahead.

Bryan Fast:
Yes, thanks. Good morning.

I just want to dig into rental a bit more. Could you elaborate a bit more on the investment and what that entails? Then what will you be looking for out of that program in order to invest more?

Cody Slater:
Sure, Kris. It's a good question, Bryan, sorry.

It's a good question because we talk a little bit in some of the releases about the investment in hardware, so we've actually built up a hardware level of around 1,500 devices, mix of EXOs and G7s for the rental fleet, but there's also investment in—to date, there's also been investments in systems to build the rental systems, how we bill, how we manage, how we monitor, people, facilities. That's one of the core reasons for our Houston facility. We've brought on board the people who run that program, to build the program, and it's really starting to—that's over the last year, that's starting to show the real results and growth and that. I would say Q1, when you look at it, this is a market that will be seasonal, going forward.

Bryan, as something to keep in mind, Q1 will always be the slowest, Q2 and Q4 traditionally the strongest. This year, what you'll really see, though, is a ramp from Q1 to Q2 to Q3 to Q4, just because we're really just getting into the market. Our own internal forecasts, for Q1, as an example, we're about 30% below where we actually achieved in the quarter. If you look at it in the last year, we did $900,000, in Q4 on the rental side we're looking to be, as an annual number, we're looking at for it to be a contributor in and around the $3 million mark this year.

Bryan Fast:
Thanks, that's helpful. Then maybe could you talk about the shape of the sales pipeline and how that looks right now, and maybe what head markets you're seeing higher levels of activity?

Cody Slater:
Sure. If I look at the pipelines across the different groups, you're really—we're getting significantly enough now that it's worthwhile to look at it in those three categories we're sort of talking about: North America, Europe, and rest-of-world. The North American pipeline and the European—the North American pipeline in particular I would say is the strongest certainly we've ever seen it. It would support extremely strong growth targets going forward here, it's deeper than we've seen it before, and broader, and I think that's really simply because of the fact of the number of RSMs we have, the number of people we have in the field, those have expanded the opportunity to build up.

But it's also because North America's the first area we really—particularly in the U.S. is what I'm talking about, is the first area where we were really able to get back in front of customers with that expanded sales force and marketing team, I won't say post-COVID, but in the latter days of the COVID periods here. Europe sort of is the next market we were able to go down that path in.

Mainland Europe has seen a real strengthening in its pipeline particularly, now that we have the operation in France. We're seeing some real, just, higher ability to actually attract that larger scale customer and opportunity in those markets by having the feet on the ground.

Rest of the world, you've seen the growth there is pretty extreme, and to Shane's point, it's actually started to become a real contributor: 4% a year ago, 8% this last quarter. I think one of the biggest things for that market will really be, Bryan, the launch of the G6. That is a core – if I look at that, the UAE office and that whole Middle Eastern market spaces primarily, that's definitely a G6 market. Again, strong pipeline today, we'll continue to see strong growth there, but I think that will be really accelerated as we hit the G6 launch.

Bryan Fast:
Okay. That's very, very helpful. That's it for me. Thanks.

Cody Slater:
Thanks.

Shane Grennan:
Thanks, Bryan.

Operator:
The next question comes from David Kwan with TD Securities. Please go ahead.

David Kwan:
Hi, guys.

You mentioned briefly just about the impact of the spread of Omicron in China and some of the, I guess, temporary shutdowns that we're seeing in terms of manufacturing activity there. Like, have you seen much of an impact at this point? Do you expect much of an impact going forward?

Cody Slater:
The answer to the first potion of the question is we have not, actually, at this point in time, David, seen much of an impact from that. The problem that we expect is like, we go through—as soon as those things happen, our teams go through all of our supply components, what mark, what

customer, what manufacturer we're dealing with, and we have none of them are—none of our direct supply is impacted by anything we've seen to date. The unknown for us is indirect supply, where we buy a module, say, for one of our communications modules where they may be getting components from those areas that are shut down, and then we'll get a notification that their material is going on allocation.

That's where the risks are, I would say, again, mitigated by a strong inventory level, both in finished goods and in raw materials on those things we think are of highest risk.

David Kwan:
That's helpful. On the G6, you kind of talked about, you know, obviously sticking to the July launch; but in terms of the approvals, can you talk about where you are, kind of what's outstanding?

Cody Slater:
Products or approvals are still a gating point, but we don't anticipate that to be a problem at this point in time, David. We have everything lined up and going through. We're actually doing multiple approvals on the G6 to sort of minimise some of the risks there, so don't see that as being the gating point right now. Realistically, probably the biggest, still the biggest potential challenge to the timeline there are going to be supply chain.

David Kwan:
Okay. Then last question for me, just on the services revenue, just wanted to get your thoughts on how we should see the trajectory of that line in the coming quarters here, particularly I guess in light of the significant pickup in G7 revenue in recent quarters, obviously saw a very strong Q4, expect that probably a pretty decent uptick at least in heading into Q2.

Cody Slater:
Yes, I think that, like, the pickups from the Q4'll be in Q2 and Q3, the one, the biggest order we have there, is actually being deployed over a couple of quarters, but you will start seeing a better cadence from that service growth going into the later quarters of the year here.

David Kwan:
All right. That's it for me. Thanks, guys.

Cody Slater:

Thanks, David.

Operator:

The next question comes from John Shao with National Bank. Please go ahead.

John Shao:

Hi, good morning, guys.

I'm just curious about the conversation with your oil & gas client given the strong oil price lately, and do you see the potential of acceleration of product adoption in that market?

Cody Slater:

You know it's a good—an interesting question. I'd say it's really geographically centred. I think in—I'll give you an example. In Kazakhstan, actually, some of the larger broad opportunities we've been looking at have come back up to visibility and are being accelerated forward because of the oil price. Canada, not so much. Canada, a lot of our growth is usually driven by new investment in the oil and gas base, and that's not something we're really seeing. Strength in the U.S. market comes around. If you look at things like that, rental market is part of that growth, part of the strength in the oil and gas space, as well as the timing of the improvement in the oil and gas will be very positive for the G6 launch as well, too, because that's a broader market in oil and gas than the G7 is.

What I guess I'm saying there is, yes, we're seeing an impact, but maybe not as much as you've seen in the past when that kind of oil price would have driven big investment into new infrastructure and new facilities. That's the kind of thing we're not seeing.

John Shao:

Okay, thanks. For the G5, you mentioned it's a new market for the company, so who are we mainly competing with in that market?

Cody Slater:

The G5's really going to be new market. It not going to be—there's no direct competitor in the base. Think about things like port workers, large construction sites, railroad sites. You're talking about a product that's a little bit more—this is, again, it's based around the WTL acquisition (Wearable Technologies), so think about that safety vest with the capabilities for connectivity built into it. Bit more focussed on the productivity aspect, I'd say, here; it's a bit more of a software play than it is the hardware. The hardware's there simply really to get the data for these companies. There's a safety aspect as well too, but it will be—we're not directly competing with anything. But what we are, I would say it's not the—in that context, usually when you're talking about a brand-new market, there's a lot of difficulty within that base. But when you talk about those markets, and you talk about those concepts of efficiency and the operational side, it's something they're all looking for.

In one respect, we'll be competing against software offerings that attempt to help you manage a large operation like that in a more effective manner, but we'll be competing with it with a totally different approach.

John Shao:
Thanks.

Operator:
The next question comes from Raj Sharma with B. Riley. Please go ahead.

Raj Sharma:
Hi. Good morning, guys. Thank you for taking my questions.

I wanted to understand product gross margins. I know, Cody, that you just mentioned to an earlier participant on the call that we should look at gross margins this year about 700 basis points to 1,000 basis points lower year on year. With the significant increase in product this year that would have contributed to margin increases, that's entirely being impacted by supply chain issues, is that correct? And longer term, how do we—where do we see product gross margins settling? I understand that it's—that product gross margins can be very volatile.

Cody Slater:

Yes. I think really we see it—and it's a good point you make. When we talk about something like, say, a 700 basis point impact from supply chain challenges, just increased costs and what we're dealing with, that is an element I would look at as against what would have been margin improvement, based on volumes anyways. Like, that improvement is still going to be there. There's less unabsorbed labour, we are more effective if we're building more volume. Really, as you look towards the latter quarters of the year here, we would see the margins getting back into those 30% ranges in the latter part of this year, and the next part in the early part to mid- part of next year being partially based on new product introductions, like the G6 and some of the other things that are coming along the pipe, getting up into the higher 30s, mid-30s, shall we say.

It's not a—I mean, it's not a structural change in what we're talking about, but there is probably for the next couple of quarters still some impact to be taken until those volumes and new products sort of take over and put the story back in, regardless of what's happening on the supply chain.

Raj Sharma:
Right. Thank you, and you know, especially also because you're shifting the—in product, you're shifting part of it to rentals on equipment makes that even tougher to predict, and, you know, clearly the main contributor is the dollar, the dollar of products gets you the $4 of recurring, but does it—do you ask the question, whether it is so tough to predict the business and the gross margins, that is it better to kind of combine the two, the product and the service lines, and look at it as an overall business?

Cody Slater:
I think the issue when you look at that, like if you look at an order from the customer say, you know, like the one that came in yesterday for—actually, it's an interesting new market for us. It's refrigeration maintenance. They're looking at—I think the order's about $200,000 worth of hardware and $220,000 worth of service, but the service is a one-year contract. If you look at the lifetime value of that customer, we've never lost a customer over their sort of five-year scale, so if you say it's that—if you want to look at that sale and look at the overall margin as the lifetime value of this service and the hardware, and look at what the margin is, then that's a fair way to take an approach. If you look at it just as the individual contract, though, it's not—I think you're missing—it misses the point, because the individual contract is just for one year.

Yes, the individual contract, it's still weighted to service as far as margin, but hardware variance margin can impact it reasonably significantly; but if you stretch it over the lifetime value of that customer, you know, that hardware really makes a drop of 20%, and our hardware makes a difference in 5% in overall margin of the customer over its lifetime. So, it is something that I think is worth looking at, and something maybe we make service a little bit more, is like what is the lifetime value of a contract when we onboard a new customer and give a bit more visibility to that. Because that is the real story at the end of the day.

Raj Sharma:
All right. I mean is—I guess you were reminding us to keep the eye on the ball and sort of, you don't really care—you do care, but you don't really care where the product gross margins come in as long as you are able to sell the product, because the lifetime revenues from it are so substantial, and the lifetime gross margin dollars are so substantial. But the volatility does muddy it up.

Cody Slater:
It certainly does, and the volatility—I was just going to say, the volatility impacts cash flow and current EBITDA significantly, because right now, as we're getting out of this and we're starting to see the real growth return, it starts with hardware, so we have to lead with hardware and the hardware-enabled SaaS world, so we will see larger volumes of hardware, which will mean that that margin will impact that quarterly base. But, if you look a couple years out, when we'd be modelling that service is 70%, 75% of our revenue and hardware's 25%, then you could take a base of saying, yes, that you can balance the two. But it's really to get there, definitely there isn't a—nobody here would say we don't care about what our hardware margin is. We certainly do care, and in fact if we don't talk about things we're doing on the product right now where we are, as we migrate the G7 into its newer and newer versions going forward, we'll also be focussing on cost reduction in the product, other things like that. Certainly we focus on it, but we don't want to—the real value is ensuring we don't lose that long-term customer just because of a short-term focus on that hardware margin.

Raj Sharma:
Yes. I don't want to beat a dead horse, but just last, would you say that the impact that product gross margin would have been in 30% ex of supply chain impacts, and do these supply chain impacts stay for the rest of the year, or do you think they're pretty much getting resolved?

Cody Slater:

Probably have been, I mean, a little bit south of the 30%, just because the volumes weren't quite there, and I really—again, depends a little bit on product mix. But yes, you're not in—the product mix impacted it comparatively as well too, because we had lower EXOs, so the 700 basis points is sort of saying, if I looked at the product mix going forward for the next couple of quarters, we'd have been originally projecting a slightly north of 30% gross margin per product in Q2. Q3, we're probably projecting somewhat below because of that impact. But the volumes start to overcome that, and the mix of the EXO, heavier EXO portions in Q4, will also sort of help to mitigate that number.

Again, talking about those numbers on the supply chain side, I think this last quarter we've been dealing with supply chain challenges for a period of time. They really hit us this last quarter more than any other quarter. Just wound up with more things where you're dealing with brokers, higher rates, significantly or dramatically higher freight because you're flying things all over the place to get them in in time to keep that delivery to the customer on a timely base. I think we've seen the worst of it, but it is a variable that we just can't predict really.

Raj Sharma:

Got it. Thank you, for answering my questions. I'll take this offline. Thank you.

Cody Slater:

Thank you.

Operator:

This concludes the question-and-answer session. I would like to turn the conference back over to Cody Slater for any closing remarks.

Cody Slater:

I'd just like to thank everyone today for the questions and their participation, and we'd like to wish you all a good rest of the day. Thank you very much.

Operator:

This concludes today's conference call. You may disconnect your lines. Thank you for participating, and have a pleasant day.