Blackline Safety Corp.
Second Quarter Results
Conference Call Transcript

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Speakers: **Scott Boston**
Vice President of Finance

Cody Slater
Chief Executive Officer & Chairman of the Board

Shane Grennan
Chief Financial Officer

Operator:

Welcome to the Blackline Safety Second Quarter Results Conference Call.

As a reminder, all participants are in a listen-only mode and the conference is being recorded.

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

Scott Boston:

Thank you, Shah.

Welcome, everyone. Good morning and thank you for joining us.

I'd like to remind everyone again that this call is being recorded today, Tuesday, June 14, 2022.

With me today is Cody Slater, CEO and Chair of Blackline Safety Corp., as well as our Chief Financial Officer, 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 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 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'll now hand the call over to Mr. Slater.

Cody Slater:
Thank you, Scott.

Good morning, everyone, and welcome to Blackline Safety's Second Quarter 2022 Conference Call.

Today, we will be discussing our Fiscal results for the second quarter ended April 30, 2022, which were issued before the market opened this morning. To set the agenda for today's call, I will start by providing some high-level remarks. Shane will then discuss key financial highlights of the quarter in greater detail, and I'll conclude by providing our outlook and some closing comments before we take questions.

Our second quarter was another quarter of robust growth, with revenue up 43% year over year to $16.7 million. This represents the latest in an enviable record of 21 consecutive quarters of year-over-year revenue growth. This quarter's performance was driven by strong regional results as we continue to garner increased traction throughout our markets, with the U.S. market up 51%, our rest-of-the-world markets up 62% and, for the first time in two years, a return to growth in Canada, with the market here up 65%. However, growth in Europe of 9% was below our expectations. Note that the numbers exclude $0.8 million of high margin G7 EXO orders received at the end of the order that we expect to realize in Q3.

Product revenue in the quarter grew significantly and is up 72% year over year to $7.9 million as past investments in our sales and marketing network and capabilities continue to drive market penetration. I would note this growth in product revenue is being achieved while many larger competitors in our market are posting flat to negative hardware sales.

On the service side, revenue grew 24% year over year to $8.8 million, including software services growth of 26% year over year and 5% sequentially, as our hardware-enabled software-as-a-service business model continues to deliver long-term recurring revenue. As services' growth in the quarter was lower than expected, as some deployments from larger orders in the last two quarters are taking longer to implement, but we expect these deployments to be completed over the remainder of the fiscal year and further accelerate our service growth.

Our recurring service-based business continues to generate strong SaaS KPIs, with net dollar retention of 105%, and annual recurring revenue, or ARR, growth of 24% year on year to $30.8 million, up 4% sequentially from $29.6 million. Note that we adjusted our ARR definition to represent the annualized average of the prior three months rather than an exit rate, as we believe this provides a more accurate snapshot of our ARR, because it's less affected by the timing of customer renewals.

Our service margins have remained very healthy at nearly 70%, essentially unchanged from the prior year. The majority of lifetime gross profit for most of our products is derived from these higher-margin recurring revenues and not the initial hardware sale. For example, on the G7 wearable, our line of cloud-enabled wearable safety devices, every $1 of hardware sales generates $4 in lifetime recurring service revenue. This hardware-enabled SaaS model sees the recurring service revenue deliver approximately 90% of the lifetime gross profit after the initial hardware sale by providing a predictable stream of high margin service revenues.

Over the last 18 months, we implemented our invest-to-grow strategy to accelerate investments in sales and marketing, and advance our game-changing product roadmap. This has seen us expand our market footprint to six international offices with 220 distributors and 60 regional sales managers, add industry-leading products and services such as EXO and push-to-talk, driving dramatic quarterly revenue growth of 77% over that period. We are now in the midst of streamlining our expense profile as we've done much of the heavy lifting on G6 development and the global expansion of our sales capabilities. In fact, we expect operating expenses in Q4 of this year to be at or below Q2 levels.

We also see opportunities to increase margins, through investments in pricing, product design, and economies of scale in our manufacturing, to help address the margin compression caused by global supply chain challenges and associated costs of inflation. G7 was launched five years ago and has yet to see a pricing increase, so we expect broad market acceptance of this approach.

We are also shifting some of our R&D focus to reduce the cost of build, which we see as another margin expansion opportunity. We are planning a pricing increase in our services as well, which would be the first service pricing increase in five years. Effecting the service pricing increase will provide even higher margins here and further accelerate our service revenue growth. This will occur over time as legacy price contracts expire and are renewed at the higher rate and as we add new service revenues from new device sales. Collectively, we expect our operating expense management and margin improvement, along with continued top-line growth, to significantly improve overall financial performance.

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

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

As Cody mentioned, we achieved another quarter of strong year-over-year growth of 43%, yielding revenue of $16.7 million, including product revenue of $7.9 million, which represents a 72% increase from Q2 of last year. The increase was attributable to our expanded sales network and investment in our global sales team, as well as an improved ability to access customer sites where COVID restrictions limited some of these activities.

G7 EXO hardware sales remained strong, at 14% of our total hardware revenue for the quarter, which was unchanged from the prior-year quarter. Product gross margin for the quarter was adversely affected by cost inflation from shortages of certain components and higher-than-normal freight charges due to ongoing global supply chain challenges that have continued throughout the second quarter of 2022. As a result, product gross margin in the second quarter was 13%, an improvement from 10% in the first quarter, but down from the prior year of 25%.

Customers and distributers tell us we are executing better than our competition and avoiding delivery delays for our customers, even with our significant growth. As Cody mentioned, we are contemplating certain product pricing increases in the near future, as we believe our products have sufficient differentiation and value-add to warrant the healthy margin profile.

Overall, service revenue during the quarter was $8.8 million, a 24% increase from the prior-year quarter. Software services revenue was up 26% year over year and 5% sequentially, driven by new activations of devices and expansion of our existing customer base. Newly activated devices contributed to growth of $0.2 million in the quarter, while increases from our existing customer base added $0.6 million to the quarter. This increase was offset by customers who are using fewer active devices due to workforce reductions of $0.6 million and only $49,000 from customers who declined to renew this quarter.

Rental revenue continues to grow rapidly, up 384% from the prior year, to $0.5 million. We have continued to invest in our rental fleet and expect to continue to see strong growth in our rental business, although we note there is some seasonality in this service line.

Our service gross margin percentage was largely unchanged at 69%, versus 68% this year. The increase in service revenue was partially offset by increases in salaries, productivity, and data costs. The overall combined gross margin percentage for products and services was 42%, essentially in line with the prior quarter of 41%, but lower than the same quarter last year of 51%. I'd like to note that a primary driver of gross margin is the mix between products and services. While this is an important metric, success in our hardware-enabled SaaS model is frontend-loaded by our significant hardware growth, driving a lower overall gross margin in the short term. In the long term, we see the revenue mix shifting to a more balanced one, with services dominating the margin.

Our invest-to-grow strategy over the last 18 months has yielded benefits globally, with U.S. revenue growth of 51% for the prior year and 62% for the rest-of-world. Additionally, Canada returned to growth with a 65% increase from the prior year, largely as a result of increased demand in the energy markets.

In Europe, as Cody has mentioned, growth underperformed other regions and our own internal expectations. Europe grew 9% from the prior-year period, but we believe the potential for Europe is still strong, and we will look to improve on our operating results in the future to fully capitalize on the investments we have made.

Product research and development costs were up 57% from the prior-year quarter to $6.3 million. Salaries and wage expense, excluding Canada Emergency Wage Subsidy, or CEWS, increased

$1.7 million compared to the prior-year quarter, and we also incurred $0.4 million of incremental recruiting costs relative to the prior-year quarter as the team expanded.

Sales and marketing expenses increased 63% from the prior-year comparable quarter to $9 million. The increase was primarily due to increases in salaries of new hires, including our customer care and in-house marketing teams, as we invested in demand generation and distribution to fuel our commercial engine. The increase in salaries and wage expenses, excluding CEWS, for the sales and marketing team was $1.7 million during Fiscal Q2 2022, compared to the same period last year. Additionally, distributor sales commissions increased $0.7 million from the prior-year quarter due to higher product revenue.

General and administrative expenses increased 34% from the prior year to $6.2 million. The increase reflects the continued investment in our operations team to handle increased production volumes, including the ramp-up for G6, as well as continuing our focus on product quality, procurement, and manufacturing efficiency to address these key aspects of the next phase of our growth.

Capital expenditures for the quarter totalled $2.9 million, primarily for property and equipment additions for the expansion of our rental fleet, as well as additional SMT and manufacturing equipment. We also closed on the acquisition of Swift Labs in the quarter for total consideration of $3.2 million in cash and approximately 271,000 shares of Blackline common stock. Swift Labs is an Internet of Things design and engineering firm it worked with closely over the last three years, and we expect to greatly benefit from insourcing Lara Swift and her high-performing team.

Inventory totalled $17.5 million at quarter end, compared to $15.2 million at the end of the prior quarter and $12.7 million at the end of our prior fiscal year. Over the last two quarters, we invested almost $5 million in our inventory to mitigate supply chain challenges, with approximately $2 million of the increase being attributable to preparing for the launch of the G6.

Blackline provides the option 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 $23.1 million in future contracted cash flows at April 30, 2022, which is up from $7.9 million at the end of the prior-year quarter and up from $18.3 million at January 31, 2022. These finance leases positively impact our immediate product revenues and service retention 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 leased contract to catch up for a purchase agreement with service, in terms of the cash flows.

We continue to maintain a strong balance sheet with no debt and a solid working capital position of $31.8 million, including cash and short-term investments of $30 million. We believe our current working capital position and access to a $15 million line of credit, combined with continued revenue growth and our focus on management of operating expenses, gives us a solid runway to continue funding our business.

In closing, we are prudently managing our liquidity position and we expect larger, previous investments in our inventory and capital expenditures to be less material moving forward. Additionally, our operating expenses have been moderating as our business scales. This is evidenced by year-over-year expense growth, excluding CEWS, of 45% in the fiscal second quarter, 74% in the fiscal first quarter, and 105% in the fourth fiscal quarter of last year.

We expect this step function improvement in our expenses, looking ahead, as we anticipate our Q4 operating expenses to be at or below Q2 levels, which we believe, along with improvements in our working capital management, give us plenty of runway to continue on our trajectory.

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

Cody.

Cody Slater:
Thank you, Shane.

I want to spend a moment to address the appointment of Sean Stinson as our Chief Growth Officer in May. Sean has been with Blackline since 2013, and I have worked with him for many years, dating back to our days at BW Technologies. Sean is a proven leader and innovator. In his new role, he will be responsible for global revenue growth, channel management, and customer support functions worldwide, including Blackline Safety in Europe.

Our performance in Europe this fiscal year has not lived up to our expectations, yet we see tremendous potential for Blackline in the region. We have a strong team in Europe and have made significant investments in the area, so we do not believe our performance there is due to a lack of talent or market demand. In fact, we have seen strong growth in other areas, like the U.S. and rest-of-world, gives us confidence that Sean and the European team can get this region back on track and performing as we expect.

Sean has successfully scaled sales organizations in our other regions, and we expect his hands-on involvement will drive improved performance in Europe and broadly across all operating regions of the Company as we continue to see healthy demand for our products and services globally.

On the topic of the G6, we remain excited about the first-of-its-kind connected personal safety device for the $240 million annual zero-maintenance gas detection market. This is a market we believe is ripe for innovation, and we expect the launch to build on the success of the G7 and the G7 EXO to extend our competitive lead with the most comprehensive connected safety suite of technologies globally, including our Blackline Live for cloud-based real-time reporting.

Our software platform provides us with a competitive advantage by delivering tremendous value and insights for our customers who rely on our technology daily to ensure the wellbeing of their workers. We are now targeting the launch of G6 in October, and we look forward to showcasing the product this September 19 at the NSC Safety Congress & Expo in San Diego, which is North America's largest workplace safety event.

We pushed out the launch date relative to our commentary last quarter, as global supply chain issues have increased demands on our engineering teams that service products currently in the market. As certain components for our existing G7 and G7 EXO products are increasingly challenging to source, we directed engineering resources from the G6 to redesign and recertify these products with substitute components. Doing so has enabled us to continue to meet our customers' needs and deliver products to them in a timely manner. Demand and interest for the G6 remains strong as we approach commercial launch, so we continue to have confidence in the revenue-generating capabilities, despite the delay.

Additionally, we believe that these supply chain challenges validate our recent acquisition of Swift Labs, whose added engineering capabilities provide us with additional capacity to better address the engineering requirements driven by the ongoing supply chain challenges.

In conclusion, the last 18 months has seen us successfully execute our invest-to-grow strategy, driving robust growth and geographic expansion to meet the needs of a growing list of more than 1,000 customers in this multi-billion dollar market. We expect our next phase to be characterized by strong top-line growth while also streamlining our operating costs. As we have mentioned, we expect Q4 operating costs to be at or below that we reported in Q2, as the heavy lifting required for our market expansion and the G6 development are now behind us. I also mentioned earlier in our call the opportunities we see for pricing increases on both products and services, along with cost-saving design changes to our products, all of which will contribute to a strengthening of our gross margins.

As we look to the remainder of the year and into next year, we see the Company positioned to continue to deliver strong top-line growth, further accelerated by the upcoming launch of the G6. This, along with moderating operating expenses and improved margins, put us confidently on the path towards becoming the dominant player in the rapidly growing multi-billion dollar connected worker market.

Thank you, everyone, for your attention today and your continued support of 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.

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

Amr Ezzat:
Thanks. Cody, Shane, good morning, thanks for taking my questions.

My first one's on your product revenue. Obviously, it looks pretty impressive year on year; but, at least it seems to me, the growth seems a little softer from last quarter. I expected more growth. Is there anything hampering your product's growth specifically, be it supply chain, competitive pressures, or maybe industry softness in general? When I look at G7, for instance, what you guys segment out, the dollar value for the quarter is on a bit of a downtrend for the last three quarters, and I know it could be very lumpy, so any colour you can provide would be helpful.

Cody Slater:
Sure, Amr.

Really, I'd point to some of the comments we made around our European segment, that the rest of our core markets all grew in significant double digits, particularly on the product side. Europe was basically flat to a little negative on the product side. We don't really see that as market, but more just as operating aspects of how we're running the European space; that's where some of the changes are coming from. Also, Europe has also tended to be very lumpy for us, driven by lots of large orders. You can have—it's been harder to get the visibility there. As we focus on that market a little bit more, we see that becoming—having a bit more of a cadence to the growth there.

Again, when you look at the other segments, you can see they're not being impacted by product pressures from competitors. Some of the comments on some of the product we were unable to deliver where orders came in to do with timing and supply chains, those kinds of things. I would say there's nothing fundamental that says that that top-line growth in revenue won't return to Europe, and that we can maintain those kinds of growth numbers in the rest of the world.

Amr Ezzat:
Fantastic, that's good colour.

On the G6 delayed launch, I've got maybe a two-part question. Number one, maybe you could give us some colour as to how that impacts your growth objectives for the year. Then the second part is, do you expect to have adequate inventory on launch day, or should we be thinking about this launch as a soft launch?

Cody Slater:
Sure, Amr.

Obviously, the shift of the G6 shifts the potential revenue we're going to receive from that new product. Yes, we're out a little over a quarter from what we've projected before, but we still see continued strong growth in all the other product lines. We see continued strong growth in this second half of the year in our rental segment as well, as it's a more seasonal period for the rental, and the investments we've made there, we'll show some nice growth on that side. As well on the software side, we'll see an acceleration of some of that as we see some of those larger deployments we've mentioned actually get fully into the field. Very confident in the whole structure, as we're going forward, across all the product range.

The nice thing with the G6, and I would say in the context of the market, is this is, as you've mentioned many times before, a disposable product, so it's a two-year product that companies have to replace every two years. The market turns over fairly rapidly, so a delay like this isn't really impacting our access to the market. There will be customers who we'll miss, because they'll acquire again a replacement of their two-year devices, but this market's constantly churning. We see the acceleration after that point being quite strong.

As to your second part of the question really around supply chain and inventory, part of the reason for our inventory builds is to ensure that we do have proper inventory on hand at the time of the launch. Really, I'd look to this as being we're shipping in October and seeing significant impacts at our Q1, Q2 going forward. I'll just note that with the world of supply chain today, nothing is guaranteed on the context of deliverability of the product and access to materials, but we're proactively investing in that space to make sure that we're in a position to actually deliver on the demand.

Amr Ezzat:
Okay. Maybe one last one, and maybe I'm reading too much into it. On the services side, can you give us some colour on the fewer devices that were activated, these clients who didn't renew their plans at all? It seems like these numbers that you guys segment out are a little higher than the last few quarters; or am I reading too much into it? Maybe there's seasonality.

Shane Grennan:
Amr, Shane here.

Amr, I think the point there is when renewals, particularly in the oil and gas sector, came up as part of annual renewal, a number of our customers within that grouping were affected by M&A activity;

so on the whole, there was less devices for a select number of customers in the oil and gas space that came through.

Amr Ezzat:

Okay. Fantastic. Thanks, I'll pass the line.

Cody Slater:

Thanks, Amr.

Shane Grennan:

Thank you.

Operator:

The next question is from Doug Taylor with Canaccord Genuity. Please go ahead.

Doug Taylor:

Yes, thank you, good morning, Cody and Shane.

With your updated timetable here for the G6, can you just speak to or remind us of what exactly the remaining hurdles are prior to launch? Just so we can get a sense of—or the confidence and the goal that you have, and the new launch timetable? Thank you.

Cody Slater:

Sure, Doug.

It really is, as we sort of mentioned through some of the commentary, we've had to take a lot of engineering time off of the G6—that would be our hardware teams, our firmware teams, and some of our approval team, as we've had to look to replace components that we can't access to keep the supply chain moving on the G7 and the EXO. It's a bit of a general delay across a series of the engineering functions, so there's nothing that we're seeing in the remainder of the development cycle that's extremely high-risk as far as the development and launch of the product.

I think, again, I pointed out earlier, there is always—in today's world, there's always risk around supply chain, but we're actively working to mitigate it. That's why you would've seen, in the commentary, about $2 million so far invested in the inventory on the G6 side. We have functioning units, we have demos going out in the field in the not-too-distant future, and if you happen to be at the show in September, you'll see the product ready to go and ready to launch to market. We're quite comfortable, confident in the timelines. At this point, we tried to make sure—the real risk here, in timelines from supply chain, come in that context of the drive—the engineering time it takes to address issues to current manufactured products, which every manufacturer in the world is dealing with.

The addition of the Swift Labs team, really, that team has been in that world all their life. They develop and design these kinds of products and have given us the extra capacity that, I think, even if we see some additional problems on that supply chain side that we need to address on G7 or EXO, that we now have the engineering depth to be able to do that without further impacting the G6 launch.

Doug Taylor:
Okay, thank you.

Obviously, we're in a climate here where profitability has become more of a focus. I know you're signalling kind of peak expenses in the near term here. You said a couple times you think your current working capital, cash resources, and your credit line give you, I think, plenty of runway, I think was the term, to execute on your growth. Can I get you perhaps to speak a little bit more about how far you think your current balance sheet resources get you, and either qualitatively or quantitatively talk to what the thresholds or milestones you anticipate would coincide with sort of a cash flow breakeven metric? That'd be very helpful.

Cody Slater:
Well, just briefly, from our standpoint, between our cash and our excess to capital, we're in a position to see the Company come through to a breakeven level, based on, as you mention, that sort of moderating expense level going forward, and then the continued growth on the hardware and the services as we go forward also impacted, I'd point out, by some of the margin sides. One of the things we've really suffered from in the last while is the margin on the hardware, but we point to the long-term margins really in the service. We see, over the next couple of quarters, the opportunity from both price increases and shift in the product itself and some work on the supply chain side, that those margins will return. That helps in the same basis as well too.

The direct answer to your question is we feel we have the capital resources to take the Company to breakeven. That would be definitely sometime in the future here, driven as well by the G6 launch, but not something we've put a date to at this point in time.

Doug Taylor:
Okay. With what you're talking about with your expense profile, should we be expecting a further tick higher in Q3 to get through that launch, and then it come back down to Q4? Would you expect the expenses to further moderate thereafter, or to continue at that level?

Cody Slater:
I think it's probably fair, because as we're in the midst of doing these things, it's fair to say Q3 is a pickup from Q2, and then a bit of a step change down into Q4. Going forward from there, I really see them moderating as a percentage, Doug, so we continue to see top-line growth in both services and hardware, but seeing the percentage on all those aspects you're looking at being on a declining basis from that date forward.

Doug Taylor:
Okay, thanks for the colour. I'll pass the line.

Cody Slater:
Thanks very much.

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

Kris Thompson:
Great. Thanks, good morning, Cody and Shane.

Just on the safety operations centre, I see you're monitoring over 49,000 devices now; that's a big jump from 43,000 last quarter. Did a lot of those activations happen towards the end of the quarter, such that we'll see a nice little step function in the service revenue in Q3?

Cody Slater:

Yes, some of those were companies that have renewed for higher levels of services, actually, which is a nice thing to see. The biggest portion of that change wasn't driven by new customers; it was driven by old customers who've said they want to, when they've renewed their service, they renewed for a higher level of service. You'll see a bump, there's definitely a bump in there, but it's not an entire new customer. In most cases, it's that addition of the safety operations centre to a current customer base, which really is a positive thing. That's something we're starting to see now more of, where a lot of the contracts initially on something like the G7 were three-year contracts in the European space, and as those start to renew now, we're starting to see a bigger trend of customers renew for a higher level of service.

Kris Thompson:

Okay, that's good. Just a little bit more on that, Cody, the price increases. I guess they wouldn't have been reflected in those users, and when is that going to start, in Q3 or Q4? Can you give us an idea of the magnitude? Is it inflation? I mean, today's inflation, or yesterday's inflation?

Cody Slater:

Sure. The increases are not in place at this point in time. We'll be looking at putting those in between product and services over the next 90 days. They'll be definitely higher. The increases, depending on the particular aspects we're looking at, in most cases will be higher than inflation. If you look at inflation over the full period of the launch of the G7, maybe you see certain numbers a little bit closer to that kind of range. I don't want to give specific exact numbers from our select competitive standpoint, Kris, but also just, it varies by product. We've looked at this very detailed, by individual product, by individual service; but overall, something that will help us recover a reasonable percentage of that hardware margin.

On the services side, thinking about an overall 10% increase in service pricing, that's probably a reasonable number to be looking at, 10% to 15%, depends on the service. But again, that'll come with new contracts, but will also come with renewals of old contracts, so a large percentage each quarter of our overall service pool renews, so you'll start to see that blend in over the following four quarters of the year, to the point when all of our customers are on that higher level service plan.

Kris Thompson:

Okay, helpful. Just one on the OpEx, you did mention, again, Q4 is going to be at or below Q2. Just help us understand that. I think Swift Labs closed only for one month in Q2, and then you've got the NSC Safety Congress in Q4. I imagine there's going to be a big, one-time variable expense related to that conference. Is that Q4 run rate, with or without that Congress expense, just give us some comfort that you can reign in that OpEx? Thank you.

Shane Grennan:
Yes, I mean, Q4 definitely has some additional expenses, particularly in the one large conference space. The intent here and what we're guiding towards is saying that our overall operating expense in Q4 will be at or below that of Q2. You're right, there is some addition from Swift Labs into all of that, but there's other areas where we're going to be seeing some reductions in costs and reductions in spend. There's a lot of stuff happening in that build-up and development that we see moderating and pulling back a little bit as we go into that Q4 number.

Kris Thompson:
Okay, got it. I've got lots more, but I'll talk to you guys offline later. Thanks again.

Cody Slater:
Thanks.

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

Bryan Fast:
Yes, good morning.

Could you just talk about the growth in Canada? I mean, would a large portion of that increase in revenue come from energy markets, or are you seeing a bit more diversification there?

Cody Slater:
Primarily driven by the energy. It's a market unlike, say, when we talk about the U.S. or Europe or the rest of the world, well, we haven't invested significantly in putting more feet on the ground, expanding our distribution significantly, so what we are seeing is the market we're currently, in Canada, our core market is the energy industry, and it's just seeing that come back to life at the end of the day.

A lot of it's expansion in current customer base. We've talked a lot on the service side about loss in current customers, reduction in staff loads, and as Shane mentioned on some of the service stuff last quarter, we saw an impact from a number of the different mergers and acquisitions in that space. But we're now starting to see something we haven't seen for two years, which is the core of our customers start to purchase new products and expand the fleet they have, and expand the percentage of their personnel that we're protecting directly. It's nice positive indication of a return to growth in this market space.

Bryan Fast:
Okay, thanks, that's helpful.

Then just on the launch of the G6, are there certain regions or, I guess, end markets that you'll be targeting more heavily in the initial launch?

Cody Slater:
Certainly, we'll be targeting North America more heavily in the initial launch, and some of the large, refinery, chemical plants, sort of large-scale users of these kinds of products, will be the initial target, and then sort of broadening out from there. The product has another area where, given the investment we've made, we'll be putting some real focus on, is the Middle East. It's a massive market for that kind of a product in the Middle East. In the zero-maintenance world, that's one of the biggest areas and spaces, so having actual feet on the ground and having that scenario where there's a series of different regulatory challenges to get through, too, with the connected product, which we're through on that space, in that area. That'll be another focus for us for the launch of the G6.

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

Cody Slater:
Thanks.

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

David Kwan:

Hi, guys.

Looking back at what happened in Europe, it sounds like it was, I guess, mostly execution-driven, versus because of the macro environment. Did any deals slip, or were any of them lost?

Cody Slater:

Certainly, some deals slipped. I think, just that it is that sort of better visibility. Slipped indicates that something happened to push it out, or was it just simply forecasted in the wrong quarter, at the end of the day, is a different basis. We see there's nothing fundamentally wrong with the markets, there. We have the right product, we have excellent customer retention there, we have excellent penetration into a wide variety of industries. I think really, you could put a lot of it down to, we've been very dependent just on single large projects in a quarter to actually drive the total top-line growth. That makes it difficult to have some consistency, so we're looking at having more of a depth of pipeline going forward in the European space that we can generate that more regular level of growth.

David Kwan:

Okay, thanks, Cody.

Maybe just looking at how we look at that region kind of going forward, obviously we've seen a slowdown in the growth, particularly this quarter. But could we see the European revenues rebound, starting in Q3 to maybe what we saw, at least in Q1 of this year? Maybe beyond that, in terms of looking at a year-over-year growth number, kind of seeing something that we saw, like in the U.S. this quarter, or what we saw in Europe in Q1 in terms of growth, that kind of 50%-type growth level? Because obviously, you're facing tougher year-over-year comps ahead. You kind of had revenues more than doubling in the middle of last year, which I think would be pretty tough to hit in the near term at the very least.

But how should we think about kind of that growth in the coming quarters and years out of Europe?

Cody Slater:

Still, I'd say, a little lumpy for Q3. Q4, as we sort of implement some of the changes, we're looking up, but definitely better growth than we saw in the last quarter, but returning to that nice, strong, double digit, in that 50%-plus range for next fiscal year.

David Kwan:

Okay, that's helpful. Two more questions. I think there was a prior comment just talking about customers achieving longer-term finance leases this quarter. Are you seeing a change in buying patterns versus what we've seen historically where the vast majority of customers would buy upfront? Are there certain types of customers that are preferring these longer-term finance leases?

Cody Slater:

I do think we've seen—I mean, we certainly have been seeing more in the last period of time. I think it's an indication, a bit of a larger breadth into some of the different industries and spaces. The oil and gas space tends to like those longer-term leases. It's more of a North American product than it is a European product. Our European customers tend to do more—they purchase more around our traditional model. The North American customers, there's a tendency to see more of that shift to the leasing model.

The leasing model, the value that it generates, actually better margins over its life. The real core difference in there is that we don't tend to discount leases, whereas with a large hardware and service set, there'll be a discount on the hardware, a discount on the service. In the lease structure there isn't, so it's a nicer piece of business, it's a four-year retention, so very positive from that customer standpoint, but it does have a negative impact on cash flow.

David Kwan:

Thanks.

The last question, how should we be thinking about gross margins in the coming quarters here? Obviously, we've seen the headwinds and the supply chain issues, but then we're going to be seeing some price increases, and then also the eventual launch of the G6.

Cody Slater:

Yes. I think what I'd be looking at would be to say that we're still going to be—everything that we're talking about really isn't going to impact Q3 to any much of a degree. It's really, you'll start to see a recovery in Q4 of our margins, and then going forward from there, through the year, returning us back into those 30% ranges.

David Kwan:

All right. Thanks, guys.

Cody Slater:

Thanks, David.

Shane Grennan:

Thanks, David.

Operator:

The next question is from Raj Sharma with B. Riley. Please go ahead.

Raj Sharma:

Hi, thank you, good morning, Cody and Shane. Thank you for taking my question. A lot of my questions have been answered.

I wanted to understand the reasons for the decline in Europe, and if you were to sort of bifurcate for the macro reasons or pandemic-related reasons, and are you seeing a slowdown in any specific industries?

Cody Slater:

No, I think, as I said before, I think it's more that Europe has been very much based over the last—its growth, we've been very successful in our growth in Europe, but it has been driven by large projects. If you miss a large project, your growth is not as great; if you miss two of them, or they get pushed out, then you're in a situation where you're not seeing the level of growth that we want to see in those market spaces. I think the focus is with the RSM network we have and with the distribution channels we have, to broaden the pipeline across more small and mid-sized projects versus just the focus on the large, what we call whales, to enable us to wind us with a deeper pipeline and better visibility of where the growth can come from.

Raj Sharma:

Got it. Then on the price increases, how confident are you that you wouldn't face resistance? I mean, I know you mentioned that service could be 10% to 15%, but on the product, can you kind of comment on if there'd be resistance or if you have the pricing power?

Cody Slater:
I would say first, if you look at the pricing on our devices, the biggest point I'd make is that, again, think about the core of our devices, the G7 and the accessories, we have not had a price increase on it for over five years, whereas in the competitive world, the distributors are used to seeing price increase after price increase. We're very confident that there is no real—that there would be no issue from the market standpoint on the context of the hardware. It will still be—it's not significant enough to make an impact to the kinds of customers that are looking at adopting our types of products. I don't really see that being anything.

Right now, if you look at our product base, even in large orders, we're not discounting our price points to win orders. We know we're leaving money on the table in a lot of these space positions. Our approach for the last few years, in the introduction of all this, was to say, let's get as much market share as possible, let's get as quickly into the market. Really, all these markets, we're not where we want to be long term, but we're established in the market, we have established distribution, customer base. Now is the time when you could actually easily see a reasonably sized change in some of the pricing structure, without it actually impacting any of the base. It is important to note that every one of our competitors has raised price over the last couple of years here, at least once, typically, if not more.

Raj Sharma:
Okay.

Cody Slater:
So our G7 price point against five years ago is no longer the same as the market is today.

Raj Sharma:
Got it, that's very helpful. Then just lastly on the G6, I know the launch has been delayed. When we sort of model it out, and in terms of the inventory build-out prior to launch, what kind of contribution are you expecting from G6, and what kind of product margins? Or is it too early to sort of try to put a number on that?

Cody Slater:

I'd say, I don't really—well, I'd want to be careful about putting an actual hard number on what the sales numbers for G6 are going to be. We don't do that going forward. Again, I would point to the fact the market size is significant. The biggest difference for the G6 and the G7 is that turnover, the market. G7 competes in the multi-gas, five gas market space, where you're seeing a product be replaced every five years, four to five years. Companies can stretch that. You can keep maintaining the products and try to keep using it longer, so when there are things like COVID happens, etc., companies can stretch that out, push it further.

The G6, by nature, the devices actually self-working after a period of time, so that cycle is more visible as to where that market is, how quickly it churns. This is a product we expect to see good solid traction right away in. Margins will be overall similar to what our current margins are in our product base.

Raj Sharma:

Got it, that's very helpful. Thank you, I'll take more questions offline. Thanks.

Cody Slater:

Thanks, Raj.

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:

Thank you, Operator.

I would just like to thank everyone today for their 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.