Blackline Safety Corp.
First Quarter 2023 Results
Conference Call Transcript

Date: **March 16th, 2023**

Time: **9:00 AM MST/ 11:00 AM EST**

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

Cody Slater
Chief Executive Officer and Chair of the Board

Shane Grennan
Chief Financial Officer

Operator:
Welcome to the Blackline Safety Corp. First Quarter 2023 Results Conference Call.

As a reminder, all participants are in 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:
Welcome, and thank you for joining us.

I'd like to remind everyone that this call is being recorded today, Thursday, March 16, 2023.

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 involve risks and uncertainties. Actual results may differ materially from those set forth in such statements. For a discussion of these risks and uncertainties, please review the forward-looking statements disclosure in the earnings news release, as well as in the Company's SEDAR filings.

During this call, there will be a discussion of IFRS results, non-GAAP financial measures, non-GAAP ratios, and supplementary financial measures. 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 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.

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Cody Slater:

Thank you, Scott.

Good morning, everyone, and welcome to Blackline Safety's first quarter 2023 conference call.

Today, we will be discussing our fiscal results for the first quarter ended January 31, 2023, which were issued before market opening 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.

After a strong end to our Fiscal 2022 year, we continued our momentum into Q1 of Fiscal 2023, with total revenue of $21 million, representing our 24th consecutive quarter of year-over-year revenue growth, and operating expenses of $18.2 million, which declined over $2 million sequentially. This top line growth, combined with our execution on achieving meaningful cost reductions in our operations, has continued to lay the groundwork for our path towards positive Adjusted EBITDA generation for the Company as we exit the fiscal year. As a result, we were able to post our strongest overall gross margins since the second quarter of 2021, coming in at 49%, which benefited from continued momentum in our higher-margin services segment.

Our total revenue grew 34% year-over-year and generated gains during the quarter across all of our geographical regions.

Canada represented our largest year-over-year growth, increasing 69% during the quarter, which is a testament for our dedicated sales team in the region being able to take advantage of a strong energy sector, as well as several other markets across a variety of industries.

The U.S. region returned to growth this quarter after a slight decline in Q4, improving 36% from the year-ago comparable period. The U.S. region represented 45% of our total revenue in the quarter and has benefited from a robust pipeline and our established sales network in the region.

Our rest of the world market saw a 16% improvement year-over-year as the result of an increased presence in the region and strategic targeting of customers in specific industries, including fire emergency and hazardous materials response, energy, water treatment, and food processing. I

would also note that for our Rest of the World market in the quarter, the Company completed its largest-ever order in the Middle East region with a $1 million lifetime value for one of the world's largest energy and petrochemical companies, marking another blue-chip customer for Blackline that values our world-class connected safety solutions.

Lastly, in our European market, we saw an uptick year-over-year in revenue of 10%, which we expect to continue to improve in the coming quarters given our efforts to increase our presence in the region. We continue to view our European region as a key market for our future revenue growth.

Shifting to our business segments, product revenue of $9.4 million increased 29% compared to the prior-year quarter. This increase was driven by our expanded sales network and investments in our global sales team in the prior year, along with continued strong demand generation. Product margins came in at 21%, improving significantly from 10% in the prior-year quarter, declining sequentially, driven by lower volume, a significantly lower percentage of sales generated through our leasing program, and foreign exchange impact. Looking forward, we continue to see tailwinds for our margins through the remainder of the fiscal year. Specifically, we anticipate the recent price increases, coupled with product design improvements and a normalized adoption of our leasing program, will drive considerable margin improvement by the end of Fiscal 2023.

On the service side, we experienced continued momentum and strong growth, with a 39% increase to $11.6 million. This exceeded the 33% growth we recorded last quarter, which marked the strongest service growth we had achieved over the past two years at the time. In addition, we generated 34% year-over-year growth in ARR to $39.6 million and recorded net dollar retention of 113%, increasing year-over-year from 103%. The service revenue increase was driven by our software services, which increased 31% to $10.6 million, as we continue to activate new devices and experience net growth with our existing customer base.

On the rental side, we continued to see impressive growth, resulting in 305% expansion compared to the prior year's quarter to $1 million. We share our strong rental results as a leading indicator of future sales, which bodes well for the back half of Fiscal 2023. Our rental team continues to meet heightened demand for our connected solutions in the industrial construction, turnaround, and maintenance markets.

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Service margins expanded sequentially and year-over-year, coming in at 73%, the highest service margins achieved by the Company to date.

Looking ahead, we continue to anticipate that the 15% pricing increase, similar to the hardware business, coupled with greater adoption of our higher-value service offerings across our installed base, positions us well to continue to expand our service margins toward the end of Fiscal 2023.

Lastly, I'd like to highlight our continuous cost reduction efforts and the progress we've made over the past three quarters as we continue our path towards profitability.

We recorded total operating expenses for Q1 of $18.2 million, representing a sequential decline of over $2 million. The Company's success in reducing costs has been the result of better leveraging past investments in sales and marketing teams and rationalizing research and development costs as we move past the launch of the G6. This step change improvement in operating costs, along with our continued top line growth and leveraging our expanded presence in key geographic markets, puts us in a strong position to deliver on our goal of achieving Adjusted EBITDA profitability as we exit the fiscal year.

I will now turn the call over to our CFO Shane Grennan to discuss our fiscal 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 year-over-year revenue growth of 34%, generating revenue in the amount of $21 million. This includes $9.4 million in product revenue, which increased 29% year-over-year. The increase in the current year reflects the Company's expanded sales network and investments in our global sales team in the prior year, with continued strong demand generation and sales development activities.

Product gross margin percentage in the first quarter increased to 21% from 10% in the prior-year period. As Cody mentioned, but it's worth restating, product margin performance in Q1 declined sequentially. However, we expect our product margins to grow as we start to see the effects of our recent pricing increases, product design improvements, and increased adoption of our higher-

margin leasing program. We received negligible benefit from the 15% pricing increase implemented in Fiscal 2022 thus far. Combined, this will all contribute to meaningful product margin expansion in the second half of Fiscal 2023.

Overall, service revenue during the quarter increased 39% to $11.6 million, which is the strongest quarterly service growth achieved over the last 10 quarters. Software services were a major contributor to the growth, up 31% year-over-year, which also drove annual recurring revenue, up 34% to $39.7 million. Newly activated devices contributed to year-over-year growth of $1.5 million in the quarter, and net service increases within our existing customer base contributed $1.2 million of the growth. Our rental business also continues to generate robust growth, with revenue increasing 305% from the prior year to $1 million, marking our second consecutive quarter with nearly $1 million in revenue.

Our service gross margin percentage remained strong at 73%, which was 5% above the previous year. Our service revenue continued to grow, absorbing more fixed cost of sales. Similar to product gross margin, we expect a steady margin increase through Fiscal 2023 as we add new customers and renew existing customers under the new pricing model.

Our total gross margin percentage came in at 49%, yielding $10.1 million of gross margin and representing our highest gross margin percentage since the second quarter of 2021. The growth in total gross margin is largely due to a higher composition of service revenues, comprising 55% of total revenue, and our enhanced pricing strategy.

In terms of our geographic growth mix, we are pleased with our performance, as each one of our key geographic markets improved from the year-ago comparable period.

Our Canadian market represented our largest growth region, improving 69% from last year's Q1, as our sales team continues to take advantage of a strong energy sector among several other markets across a wide variety of industries.

The U.S. market was our second-largest growth market, returning back to growth of 36% from the year-ago comparable period as we leveraged our established sales network in the region.

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Additionally, our rest of world and European markets were able to see a year-over-year increase of 16% and 10%, respectively, as we continued to deliver results from our prior investments in an expanded sales presence for both regions and capitalize on growing demand for our products.

Shifting now to operating expenses, our total operating expenses for the quarter was $18.2 million, which was a nearly 6% decrease when compared to our expenses of $19.3 million in the prior-year quarter. Total expenses as a percentage of revenue was 86% in the quarter compared to 123% in the prior-year period.

Product research and development costs increased 6% from the prior-year quarter to $5.6 million, a decrease as a percentage of revenue to 27% from 34% in the prior-year period.

Salaries and wage expense increased $1 million year-over-year due to an increase in headcount, including the team members that joined Blackline from our acquisition of Swift Labs. This increase to salaries was offset by a decrease in contractors' consulting costs of $0.9 million, as the Company significantly reduced its use of external resources following the completion of the development of G6.

Sales and marketing expenses decreased 12% from the prior-year quarter to $7.8 million, which represented 37% of revenue compared to 57% in the prior year, as we executed on multiple cost reductions, including advertising expenses, which decreased $0.4 million, and recruiting costs, which decreased by $0.1 million.

General and administrative expenses increased 11% from the prior-year quarter to $5.5 million, which represented 26% of revenue compared to 31% in the prior year. Salaries expense increased $0.4 million, as the Company expanded our administrative functions, which allows us to support the scaling of the global business. Consulting and software maintenance and subscription expenses collectively decreased $0.2 million year-over-year as we continued our efforts in reducing costs for the Company.

To reiterate Cody's earlier commentary, our ability to make meaningful cost reductions as we head towards positive Adjusted EBITDA cannot be understated. Q1 operating expenses were more than $2 million lower sequentially, and the team continues to scrutinize our operating cost base as we look to better leverage our past investments and reinforce Blackline's position as a global leader in

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connected safety solutions. The largest contributors towards this reduction included $1.2 million sequential decrease in sales and marketing costs, and lower general and administrative expenses sequentially decreasing $0.2 million. The Company also benefited from a foreign exchange gain of $0.7 million in the quarter.

Moving on to capital expenditures, our capital expenditures for the quarter totalled $0.9 million, primarily for property and equipment additions of revenue-generating sensor cartridges for customers.

Inventory totalled $18.9 million at quarter-end compared to $18.7 million at the end of the fourth quarter and $15.2 million compared to the same period in the prior fiscal year. Recall that we had built up our inventory during Fiscal '22 for G6, G7, and G7 EXO due to global supply chain challenges, but have maintained inventory levels in the current quarter to meet anticipated orders. With past supply chain constraints improving, the change in our delivery schedule away from next day fulfillment, and the launch of the G6, we expect our inventory needs to moderate, allowing us to harvest some cash from our inventory in the coming quarters.

Our G7 leasing program had a total value of $35.5 million in future contracted cash flows at January 31, 2023, up from $18.3 million at the end of the prior-year period, and largely in line compared to $36 million at October 31, 2022.

As discussed on last quarter's conference call, we have evaluated several potential financial structures that would allow us to access the value embedded in our lease portfolio to enhance our liquidity position. We continue to work towards finalizing the financial structure, and plan to update the market upon the execution of such an agreement. As a reminder, since these are contractual payments with a broad and diverse customer base, many of which are investment-grade quality, we believe our lease portfolio presents an attractive option to increase our liquidity and lower our overall cost of capital. Securing such an option would provide immediately available, non-dilutive liquidity with the possibility for growth in line with the lease portfolio.

We exited the quarter with bank indebtedness of $8 million compared to $8.5 million at the end of our previous fiscal year. The decrease in the amount drawn is due to repayments made based on cash flows received via customer lease payments during the quarter. We ended Q1 2023 with $7

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million of availability on our senior secured credit facility, in addition to a working capital position of $37.9 million, including cash and short-term investments of $23.5 million.

We continue to believe these financial resources, coupled with continued revenue growth and the cost reductions we have achieved, put us in a solid position to fund the Company through our transition to generating sustained positive Adjusted EBITDA.

We would like to confirm that the Company has no cash or investments with Silicon Valley Bank at the end of our fiscal quarter. We continue to monitor the situation with regard to Silicon Valley Bank for potential impact on our customer or supplier base, but our initial consideration is that there should be no direct impact on Blackline. We continue to hold our investments and cash with only highly-rated financial institutions.

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

Cody Slater:
Thank you, Shane.

The last topics I would like to cover are brief updates on key promotions and leadership changes made within the last month; our Company progressed towards ESG goals and the latest on our most recent product innovation, the G6.

I'd like to highlight the recent promotions and changes to our Executive Leadership team.

Sean Stinson was promoted to President and Chief Growth Officer; Christine Gillies was promoted to Chief Product and Marketing Officer; VP of People Services Meaghan Whitney was promoted to Chief People Officer; and Co-Founder Brendon Cook was promoted to Chief Information Officer. These changes leverage the strength of people who built our industry, understand our customers, and are driven by our mission to become the world leader in connected safety solutions.

In reference to ESG, we have continued to make strides over the last fiscal year, highlighted by our improvements in our overall diversity, equity, and inclusion, as well as employee engagement. We also received ISO 14001 certification for our French subsidiary, an international certification requiring rigid standards for an effective environmental management system.

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Regarding the G6, we remain confident in its ability to disrupt and capture share in the $220 million annual zero-gas detection market, which has not seen significant innovation from products like the G6 in recent history. We see a strong market fit for the product, and continue to expect its impact on revenue to be delivered in the back half of this fiscal year. We look forward to providing more updates on G6 and its market penetration as we gain more exposure to customers throughout the year.

Our latest results demonstrate the strength of our hardware-enabled SaaS business model. With our annual recurring revenue base up 34% to $39.6 million, our net dollar retention reaching 113%, and our highest-ever service margin, we are well-positioned to deliver on our goal of exiting 2023 with positive Adjusted EBITDA. Our strategic plan, led by continued top line growth, healthy margin expansion, and focused cost management, will drive sustainable profitability for the Company. In fact, looking beyond the current fiscal year, we see our business model as one which can generate impressive EBITDA margins going forward.

It is important to note that our revenue growth is not only reflective of the financial strength of the Company, but also of our rapidly-growing market share as we protect more and more of the globally-industrial workforce, driven by our mission to ensure every worker has the confidence to get the job done and return home safe.

Thank you to everyone who tuned in for our call today and your continued support for Blackline Safety. I'd like to thank our shareholders for their continued belief in our Company, and I would like to thank all of our employees for their dedication and hard work.

With that being said, I'll turn the call over to the Operator and open it up for questions.

Operator:
The first question comes from Martin Toner from ATB Capital Markets. Please go ahead.

Martin Toner:
Just wondering if the 73% service margins that you guys had this quarter, is that the base going forward, or are there some reasons why that might—it's possible that it could dip from here before going higher as you guys expect?

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Cody Slater:

I think it's reasonable to look at that as a base now, Martin. Unlike our products side, service isn't really impacted by product—by mix or those kinds of things, so you've seen that trend over the last period of time, so look at that as a new base going forward, with opportunity to increase throughout the rest of the year.

Martin Toner:

Awesome. Thank you.

I'm happy you guys gave the NRR number. Can you talk a little bit about that 113% number and where you expect it to go from here?

Cody Slater:

Sure. We were just talking about this yesterday. Our targets internally were 115%. We're now going to—we're now going to start to relook to that and look to move that up over time to get more into the 120% range.

Martin Toner:

Fantastic.

Could you talk a little bit about how Q2's going? Are there any other big customers that have come in? How is the G6 launch going relative to your expectations as of today?

Cody Slater:

Yes, we're just partway in, obviously, through our Q2 here, and we continue to see strong pipeline, strong growth throughout the business in the areas we're looking for it at.

With the G6, I'd say, as we've said before, it's really a latter half product for us as far as volumes. It's early days, but the—what we're seeing in the market from the acceptance of the product and the interest in the product is exactly what we wanted to see, Martin, but it's going to be a little while longer before it starts to show up on the top line in a significant manner.

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Martin Toner:

Perfect. Thanks. That's it for me. Thank you very much.

Cody Slater:

Thank you.

Operator:

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

David Kwan:

Hey, guys.

On net dollar retention, I see the big bump there. How much of that was related to the price increase that you just implemented versus customers adding new services?

Shane Grennan:

Good morning, David.

I would say it's minimal from the pricing increase perspective. It really is the growth within the existing customer base for additional service offerings of the Company.

David Kwan:

That's helpful. Thanks, Shane, and I was curious, just given the prevailing macroenvironment here, are you seeing large deals getting broken up into smaller deals, so perhaps, we may see, I guess, fewer press releases on large deal wins maybe in the coming months and quarters unlike what we've seen in the past?

Cody Slater:

I think maybe a way to phrase it, David, is we're seeing more—the maturity of the Company is showing up in more of the mid-sized order base now than—so we're not as reliant on the large individual orders to make the kinds of growth targets that we're doing. Those large ones are still there, but they'll always be a bit lumpy in a base, most—and again, it is a bit industry-specific. Certain of the industries we deal with, it's site-by-site where those orders come in, so you're right, a large—what would look like a very large new customer winds up being a series of mid-sized

orders, and then there's some of those larger markets where they are periodic in when they happen. That would be things like the large utilities; the water, wastewaters, etc. It'll still be continuing to buy in single individual orders, so always a bit of a mix, but I think the nice thing from my standpoint is that we're seeing more and more of that mid-sized order flow coming through.

David Kwan:
Yes, that's helpful, Cody. The reason why I ask is, typically, when we've seen you guys announce a lot of large deals, we could see, obviously, a good quarter likely coming up here, but this quarter, I think your second-highest on record, but we really didn't see much in terms of large deals get announced, so it seemed like the cadence is more of these, like you said, mid-sized deals to help backfill, I don't know, the—I don't know, I'll call it the void of large deals, but just wondering if you're seeing more of those singles and doubles versus those homerun type deals in the pipeline?

Cody Slater:
Yes, I think that's fair to say, and again, I'd say it speaks to the maturity of the pipeline. We're now seeing deal flow coming through a far larger percentage of our RSMs in different markets in the pipeline so that you've—and again, that's based on more of that mid-sized level of order that just is what's really—what really drove this last quarter, for sure.

David Kwan:
That's helpful.

Last question, somewhat related note, but have you seen any changes in terms of customer buying behaviour? Are sales cycles lengthening because more approvals are being needed, or maybe more interest in, say, leases over up front purchases?

Cody Slater:
Really, almost the opposite in some respects, David. Well, maybe a better way to phrase this, in general, we haven't really seen much of a change, I would say, but we have seen that we're starting to see more orders that have a shorter time span between introduction to customer and placement of order, and that just is based on the maturity of the product in something like the G7 and the recognition of the Company now in the market where you're starting to see for the first time sizable orders where they're not going through trial phases, but just going straight to the

purchase phase, so—but the general drivers of the industries themself, similar kinds of base around the purchase timelines.

The leases, you'll have noted, for us, was a very light quarter on lease, and nothing particularly driving that. We expect to see that return to something more normal this Q2. That's really a customer decision in the sales channel at this point in time, so—but in general, to your point, nothing macro in the industry. There is a trend for us to see quicker adoption just because of the maturity of the product now and the Company.

David Kwan:
I appreciate it. Thanks, guys.

Cody Slater:
Thanks, David.

Operator:
The next question comes from Amr Ezzat from Echelon Partners. Please go ahead.

Cody Slater:
Good morning.

Amr Ezzat:
Thank you. Good morning. Congrats on the quarter.

If we could just pick off the leases, you guys were speaking about putting together a structure to finance the lease portfolio. Understand nothing to announce yet, but just wondering if you can give us a sense of timeline there?

Shane Grennan:
Good morning, Amr.

Yes, as noted, we're progressing with the—on that item. We would hope to have an announcement, I would say, within the next short order here on that, but we continue to progress that.

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Amr Ezzat:

Okay, short order being like this fiscal year? Is that fair?

Shane Grennan:

That's very fair. I'd say on much shorter timeline, and I—you get it previously early, 2023 in the calendar year, and that's still the case, Amr.

Amr Ezzat:

Fantastic.

Then, Cody, you just noted that it was a lighter quarter on leases, like sort of flat quarter-on-quarter. It's the first time we see it flat in a while. Is that a function of seasonality, or you mentioned there was one client there that impacted that balance?

Cody Slater:

Just a couple of quick points, so as a percentage of overall hardware revenue, like you say—as you say, the lease portfolio was flat, but as a percentage of new sales, last quarter, we were at—30% of the sales were generated through the leasing program. This last quarter, it was only 7%. Sometimes that's a bit of a mix. That's actually the lowest quarter we've had in a number of years. At this phase, we really allow the customer to decide which model they want to follow. Tends to be certain industries like oil and gas follow the lease model. It was just a quarter where that wasn't really—didn't really take place. Even most of our oil and gas customers went the purchase model.

Given the comments around the securitization, one of the issues from the lease standpoint for us is that, of course, we're financing that capital, so it's not something we promote very aggressively. Given financing around that portfolio, we'd be more aggressive about promoting that as a purchase option, because it's a higher-margin option for the Company; four-year retention, and we think it's also very nice for the customers involved, but at this stage, it's really totally up to the customer as to which way they're going to go on that lease, and this last quarter, that was just a very light number.

Amr Ezzat:

Fantastic. Appreciate the colour.

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On the G6 ramp, early days, and you guys spoke to it being like second half of the year weighted. Just looking to see if your goals, targets, all these numbers you gave us on number of units in dollars, evolved since the last conference call.

Cody Slater:
The numbers and targets are pretty similar from our mind, but the timelines have probably slipped out a little bit there, Amr, by a couple of months, something along that line. It's really going to be dependent on a lot of the larger potential customers as to how quickly they adopt, how long they want to do trials for, but still similar kinds of numbers, but I would look at it and say we're maybe a couple of months behind where we might have thought we'd have been at the beginning of—or at Q4 of last year.

Amr Ezzat:
Okay, then I think guys were saying like 45,000 to 50,000 units would be slippage. Where would that put you?

Cody Slater:
We were talking 40,000 to 45,000. Again, add a couple of months and we're still talking the same kind of a number, Amr, what—so a little hard to tell when all these things are going to fall, but more likely will be in the 25,000 to 30,000 in this fiscal year, but really straight on the track we wanted to be on with the G6 by the time we're running into the new year here.

Amr Ezzat:
Understood.

Then maybe one last one. Pretty impressive on the SG&A, like $18.2 million. Just thinking about the balance of the year. As sales ramp, where does that number sort of go? Can you guys keep it in the $18 million range, or we should expect that to go up?

Shane Grennan:
Yes, I'd say the variable in there is the—on the commission side of things, on the product commission side of things, Amr, but in general, that is the target for the remainder of the year.

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Amr Ezzat:

Fantastic. I'll pass the line. Congrats, again.

Shane Grennan:

Thank you.

Operator:

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

Bryan Fast:

Yes. Good morning, guys.

Just on Europe, we've seen it return to positive growth over the last few quarters just following the leadership changes mid last year. Do you feel like there's more heavy lifting to do there, or are you satisfied with where you're at now and just more fine tuning?

Cody Slater:

Good question. Is there such a thing as medium lifting? No, I do think the majority of work really has been done there, as getting the teams aligned, getting the systems in place that we have in North America, and that's where you're starting to see those results. Now it's just really managing that growth going forward. I would expect to see Europe to show progressive growth quarter-on-quarter as we go forward. As far as its year-on-year numbers, we're seeing a stronger—better pipeline management is one of the real key things, strong pipeline, and we've got a really good team there. I think they're going to be a key performer for us for this next year.

Bryan Fast:

Thanks, and then we saw strength in Canada from the energy side of things. Could you just highlight some of the other areas within the region where you're seeing strength?

Cody Slater:

Yes, some utility. We're starting to see—well, in North America, we're starting to see more business in light industrial, some of the other—trying to say the right term there—we're seeing some in power generation. We're seeing some in fire and safety. Fire and hazmat's a really growing—nicely growing market for us right now. That's actually something where we're focused

worldwide on, I'd say, so we're seeing adoption in North America, Canada, and into Europe as well too, so—and in the U.S., it's actually been—there'll be some interesting new customers being onboarded in some more of the heavy industrial side over the next couple of quarters that you'll see as well too.

Bryan Fast:
Okay. Thanks. That's helpful. I'll turn it over.

Operator:
The next question comes from Jason Zandberg from PI Financial. Please go ahead.

Jason Zandberg:
Hi, guys. Great quarter. Looks like you're tracking well for that EBITDA goal by the end of the year, so congrats on that.

What I wanted to ask is, you mentioned strong revenue in the energy sector, and this comes at a time when energy prices, commodity prices have come off quite a bit year-over-year, and we've seen it fall since the end of the quarter as well. Just wanted to know with the buying—the buying patterns of those energy customers are changing? Are they more leasing rather than buying? Do you feel that there's any correlation between energy prices and the activity—the solutions that you're providing for these customers? Just any colour would be great.

Cody Slater:
Well, I think the—a couple of—unpacking a couple of the questions there, the—one of the things we're seeing in the energy industry is actually adoption by some of the more—some of the larger players across multiple of their locations, so those aren't really driven by the current price point on energy. They're just driven by their rollout of our products across their facilities and functions. That's something we're getting. More and more of that growth is being driven by that. Generally speaking, the energy companies are more lease-focused. It's a program they tend to adopt probably at a greater rate than anybody. Just this last quarter, the energy—some of the energy orders we had decided to go down to purchase model instead of a lease model.

Jason Zandberg:

Okay, great. Good colour, and then maybe just wanted to look at your rental revenue. I know it's a small segment of your revenue right now, but growing quite nicely. Just wanted to know if you could provide any information such as asset utilization and whether you're planning on adding to that asset base over the next number of quarters?

Cody Slater:
Asset utilization's been in the 80% range on our rental group. They did really an excellent Q1. This is a bit of a cyclical business. We've mentioned that before, and Q1 tends to be one of the lowest ones; less turnarounds, particularly in certain of the industry base, but so—but even in that—but the numbers we posted in Q1, we were around that 80% utilization, and you'll see that moving up a little bit in the next couple of quarters, and we will be investing some additional hardware into the rental pools and some additional people over the next—really in Q3 and Q4 as we look to see that expand even further.

Jason Zandberg:
Okay, great, and again, congrats on the quarter.

Cody Slater:
Thanks very much.

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

John Shao:
Hey, guys. Thanks for taking my questions, so maybe, Cody, could you comment on the market dynamics a little bit, as we believe some of your competitors are also pushing their products with a connectivity feature?

Cody Slater:
It's true, John. In reality, we have a couple of our customers—competitors, excuse me, that have some connected product base. None that have a suite of products—a suite of features—connectivity features such as we do, so we don't really view them as directly competing. They certainly promote and market that. I would say that's a—we look at that as a positive, because more—the more people are talking about connected, looking at the value, and from a customer

standpoint, you really want to be looking at—if that's the direction you want to go in, you want to be looking at which is the company that really is the leader in that space, and by far and away, that would be Blackline compared to our traditional gas detection companies. We have lots of good competitors, but not—none that have even become close to catching up with where we on that—on the world of what we think the future of this whole market is.

John Shao:
Okay. Thanks for the colour.

Could you also give us some updates on your current product roadmap? You have the G6 and G7, so what is your next priority, or you think that the focus will be on G6 given you're still trying to digest this opportunity right now?

Cody Slater:
Well, currently, the focus really is on G6. You'll see a lot of new features start rolling out across the products roadmap from a service standpoint; additional value adds we believe will help our customer base and are also marketable. As far as true new products, the way you want to look at that is in NPI, the G6 is the focus for us for the next year here.

John Shao:
Okay, and my last question is how should we think about your production capacity at this moment? Do you think it's robust enough to cover the demand of the G6 scale?

Cody Slater:
Yes, the short answer's yes. We've got an excellent team around our operations there. We've expanded our surface mount capabilities significantly here and expanded a lot of the automation aspect around some of the manufacturability of the product as well too, to enable us to hit those volumes as we go forward.

John Shao:
Thank you. I'll pass the line.

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

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Raj Sharma:
Hi. Thank you for taking my questions.

If we could talk a little bit about—I know you mentioned this on—in your prepared notes, the product gross margins, they were lighter this quarter, and the commentary was that they were going to increase through the year. Can you just touch upon how soon you see them improving through the year, and is there going to be a bigger second half improvement or is it going to be a steady improvement, and will that entirely depend upon the product volumes?

Shane Grennan:
Hi, Raj.

I think, as Cody mentioned earlier, the first quarter was a proportionately much lower lease component of that—the finance lease component of that as opposed to the traditional bundles, product and service offering that we have. We would see that returning to more normalized proportions of the product revenue through the remainder of the year, and certainly, that will aid a bump back up in the product margin side of things, so I think to answer your question today, we would expect with the return to a more proportionate lease element of our product revenues and the associated margin with that as well.

Raj Sharma:
Got it, so it is entirely related to the lease percentage, and as far as the earlier supply chain costs that were a part of gross margins, those don't play a role anymore. Is that correct?

Cody Slater:
If you look at the number in Q1, there was obviously a number of factors that drove that, but if you take lease and FX, those two were really the key ones to see the differential between the margin from Q4 to the margin from Q1, so still, we're dealing with all the different—other different challenges, but I think normalize that quarter, you'd have been more in the range of what Q4 was, and then going forward, we'll see—we see growth coming from there.

Raj Sharma:

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Got it, and then could you please talk about the inventory? Is there build up required and sort of working capital needs for the rest of the year given you have—you likely have G6 ramping up?

Cody Slater:
No, we actually expect to see the inventory start to come down through the rest of the fiscal year.

Raj Sharma:
Right, so even despite the G6 ramp, that is the case, right, and the working capital needs?

Cody Slater:
Yes, that's correct.

Raj Sharma:
Right, okay, and then the G6, I just had a more—a bigger picture question. What would be a great year in product revenues for G6 for a fiscal year? What would you characterize as a great year?

Cody Slater:
I think, for us, we want to be looking at where we and the first full year after launch, which would be next year, 2024—certainly, we'll be targeting to be north of 10% of the marketplace there, and—but what I'd look to suggest with the G6 is look at what the velocity we come out of this year and go into next year at, because that will start to really define how well we're going to do in taking that market share over the next couple of years.

Raj Sharma:
Got it, and then just lastly, the Mideast—the large Mideast order, that was—have you talked about that and what sort of industry, and where do you see more inroads into that particular customer/industry?

Cody Slater:
Yes, oil and gas, the Middle East, one of the very largest players there, and this really—we do view this as the initial order as we build a stronger and stronger relationship with that company, and I think that—again, like a lot of these markets, getting in with one of the leaders then makes it a little easier to start moving down through the rest of that pipeline, so we really look to see, over the next year or two, a very significant increase in our penetration in that Middle Eastern market.

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Raj Sharma:

Great. Great. Thank you for answering my questions, and congratulations on the continued cost containment and keeping operating expenses down as you had promised you would, so thank you. I'll take it offline.

Cody Slater:

Thanks very much. Appreciate that.

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.

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