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Q1 2023 Creative Realities Inc Earnings Call

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CORPORATE PARTICIPANTS

Will Logan *Creative Realities, Inc. - Chief Financial Officer*
Rick Mills *Creative Realities, Inc. - Chief Executive Officer*

CONFERENCE CALL PARTICIPANTS

Brian Kinstlinger *Alliance Global Partnersl - Analyst*
Howard Halpern *Taglich Brothers - Analyst*

PRESENTATION

Operator

Good morning. At this time, I would like to welcome everyone to the Creative Realities, Inc. First Quarter 2023 Earnings Conference Call. This call will be recorded and a copy will be available on the company's website at cri.com following the completion of the call.

The company has prepared remarks summarizing the interim results, along with additional industry and company updates. Joining me on the call today are Rick Mills, CEO, and Will Logan, CFO.

Thank you very much. Mr. Logan, you may begin.

Will Logan ***Creative Realities, Inc. - Chief Financial Officer***

Thanks, Livia. Good morning. This is Will Logan, Chief Financial Officer of Creative Realities, Inc. Welcome to our financial results and earnings call for the three months ended March 31st, 2023.

I would like to take this opportunity to remind you that our remarks today will include forward-looking statements. The words anticipated, will, believes, expects, intends, plans, estimates, projects, should, may, propose, and similar expressions of the negative versions of such words or expressions as they relate to us or our management are intended to identify forward-looking statements.

Actual results may differ materially from those contemplated by these forward-looking statements. Factors that could cause these results to differ materially are set forth in our quarterly financial statements on Form 10-Q to be filed with the SEC later today, May 15th, 2023, and in our annual report on Form 10-K filed with the SEC on March 30th, 2023.

Any forward-looking statements that we make on this call are based on assumptions as of today and we undertake no obligation to update these statements as a result of new information or future events.

During this call, we will present both GAAP and non-GAAP financial measures. A reconciliation of GAAP to non-GAAP measures is included in our public filings and in our earnings release that was released earlier this morning.

It is now my pleasure to introduce Rick Mills, CEO of Creative Realities, Inc.

Rick Mills ***Creative Realities, Inc. - Chief Executive Officer***

Thanks, Will.

Good morning, everybody. Thanks for joining the call.

What a great quarter! Our Q1 2023 revenue of $9.9 million includes a record first quarter gross profit of $5.1 million and a record first quarter adjusted EBITDA of $960,000. This is on the heels of our recent fiscal 2022 earnings call where we announced record revenue last year of $43.3 million and record adjusted EBITDA of $3.8 million for last year.

We believe our first quarter results continue to demonstrate the ongoing growth in our revenue as this is the fifth consecutive quarter for which our revenue has approximated or exceeded $10 million, benefiting from increasing our record recurring revenue.

Notably, we had previously communicated that annual recurring revenue is approaching a level where it covers our operating expenses, something we call the golden rule.

Past this point, we project significant improvements in our adjusted EBITDA margin as every new dollar flows through to the bottom-line at higher and more favorable margins.

We see this in our first quarter results, where revenue mix is driving gross profit and working in conjunction with scale, driving adjusted EBITDA. In fact, though revenue for the first quarter was actually lower than the same period in 2022 by $800,000, our gross profit and adjusted EBITDA increased by over $1 million and $300,000 million, respectively, due primarily to the increase of $1.3 million in services revenue. It is important to understand these effects as we scale and drive SaaS-based annual recurring revenue.

On our last call, we issued full year 2023 guidance of $60 million in revenue with 2023 exit annualized run rates of $17 million in ARR and 15% adjusted EBITDA margin. We also communicated a backlog of approximately $110 million.

I'd like to reaffirm this guidance. We expect to see our business ramp-up even further as we get deeper into executing on existing and new client contracts and deployments throughout 2023 and beyond.

As you may recall, we had a number of other noteworthy announcements on our last call. In addition to announcing annual records for revenue and earnings, we also provided updates on significant new client contracts, which included winning an RFP for a national fast casual restaurant chain and securing an agreement to be an exclusive deployment partner for a new digital ad-supported network.

We have announced an additional agreement with Starlite Media to supply and deploy up to 5,000 displays in conjunction with the expansion of that network at an initial deployment commitment valued at $2 million to CRI and approximately $50 million of additional backlog at full deployment.

We also announced enhanced client engagements with Freshens, Road Runner Sports, and others. We are still working through an announcement with the national fast casual restaurant chain and hope to be in a position to issue that in the near future. It will be worth the wait.

As you can see, we have terrific momentum in the business and are seeing productivity from our business strategy. Very simply, we continue to win in the market, with a corresponding reduction in the timeline to new customer acquisition, and believe the company is uniquely situated to exploit the tremendous growth opportunities in our industry.

I will turn it back over to Will for a few notes on our business activities.

Will Logan ***Creative Realities, Inc. - Chief Financial Officer***

Thanks Rick.

As we've stated previously, I want to reiterate that the next few years look to be transformational for Creative Realities from a profit standpoint. As a management team, we're excited about the inflection point the company has reached with respect to its operating leverage and remain optimistic about the results that we anticipate producing throughout the remainder of calendar year 2023 as we capitalize on expanding revenue, and particularly our ARR, to drive adjusted EBITDA, free cash flow, and bottom-line results.

As we discussed on our call on March 30th, we expect and continue to expect that the first half of 2023 will fare similarly to the second half of 2022 from a P&L perspective, with anticipation of a material increase in both our revenue and profitability run rates beginning in the third quarter of 2023 and beyond, including throughout 2024 to a new level of normal for this business.

The combination of continued expansion from existing customer engagements and contracts won incrementally in the current year has set the stage for the company's quarterly revenue to double from third quarter 2023 and into the foreseeable future.

Our first quarter results, including revenue of approximately $10 million are in line with our expectations as we exited 2022 and keep us on track to achieve our previously stated growth targets for the full year of 2023 for both revenue and adjusted EBITDA.

As we scale revenue and particularly ARR, we're positioned to drive value creation that is transformational to the profitability of our business. Management is committed to continuing to exploit this position for the benefit of its shareholders and stakeholders.

A few highlights with respect to the period as of and for the three months ended March 31st, 2023. The company's cash on hand as of March 31st, 2023, increased to $3.9 million from $1.6 million as of December 31st, 2022, as a result of collections on accounts receivable and annual billings associated with our 2023 SaaS-based contracts. As of today's date, the company has $3.3 million cash on hand.

With respect to our debt, the company continues to service all of its debt facilities, including two instruments which are currently amortizing, the Reflect seller note and the 2022 term note.

With respect to the currently amortizing instruments, the company has repaid approximately $1.5 million in principal on the Reflect seller note since February 2022 and approximately $1 million principal on the 2022 term note since February of this year.

We've highlighted our reverse stock split on March 30th call. Effective March 27th, the company effectuated 1:3 reverse stock split to regain compliance with the NASDAQ minimum bid rule. We believe access to the NASDAQ capital markets is necessary to bridge the gap and the continued disparity between the observed trading price for the company's shares and our intrinsic value. The financial statements for the three months ended March 31st, 2023, reflect adjustments to equity to effectuate the split. Post reverse split, the company now has 7.4 million common shares outstanding, inclusive of any insider holdings.

With respect to offer to acquire shares of CRI, subsequent to the quarter end date, but prior to our interim reporting date, the company received an updated offer from Pegasus Capital Advisors to acquire all outstanding shares of the company's common stock. The proposal was for a purchase price of $2.85 per share in cash. The Special Committee of the company's Board of Directors is working diligently to evaluate this offer, but has not concluded that process at this time. We will update all shareholders at the appropriate time.

Rick, with that, would you please provide any updates on customer acquisition activities or our previously announced customer acquisitions?

Rick Mills ***Creative Realities, Inc. - Chief Executive Officer***

Sure, Will, thanks.

Okay. Regarding new business development activity. Again, I use the phrase CRI continues to win in the marketplace. We have been actively engaged in a number of discussions with many nationally recognized venues, brands, or chains.

During 2023, the company has continued to receive invitations to RFPs with total deployment values in excess of $10 million. Since the beginning of 2022, CRI has a win rate in excess of 80% on a dollar value basis of all RFPs in which we participate. We look forward to winning more this year.

Some updates on other previous announcements that we made. We remain in advanced discussions on two additional engagements via a partner relationship to deploy and support digital out-of-home networks in key verticals. These opportunities are similar in scale and economics with the recently announced Starlite Media contract.

Should the company ultimately secure these opportunities, it would result in hardware installation, day two service and SaaS revenues for up to a combined 2,000 locations and would add up to $32 million in our backlog with an anticipated delivery over a 24 to 36-month period.

Our drive-thru solution, we continue to secure commitments for our drive-thru products. In recent weeks, we've entered into discussions with two potential new drive-thru customers with plans for 300 locations each. The momentum for this product is real and we expect to deploy up to 1,000 drive-thru locations over the next 18 months, driving both hardware and installation and incremental software subscription license revenue.

To be clear, we are winning customers and closing deals in record time. Prior to COVID, our new customer acquisition time line often exceeded 18 months. For those customers we secured in the current year, the longest conversion cycle has been six months from introduction to execution of an MSA and initial deployment. This acceleration in customer close rates and adoption of our products and services is a key driver in our optimism and expectations for this business.

So, finally, let's talk about backlog. We have previously announced a backlog of approximately $110 million. Having delivered our first quarter results, our backlog remains at this historic level and we expect our backlog to grow in advance of our next earnings call. Despite continued revenue production, these results are primarily driven by previously existing customers as we have yet to begin deployment at scale for any of the recently announced key customer wins.

As a reminder, our calculation of backlog is comprised of the anticipated rollout of projects as indicated by our current customers under contract and includes all revenues that would be received by the company by deploying the products and services necessary to service these projects and includes projected revenues that are not currently subject to binding purchase orders or commitments.

Will, any further comments you'd like to add to our first quarter results?

Will Logan ***Creative Realities, Inc. - Chief Financial Officer***

Yes. Thanks Rick. Historically, we have provided an overview on this call of our financial results for the year. Those results were published this morning in our earnings release report, which included the condensed consolidated balance sheet as of March 31st, 2023, along with the condensed consolidated statement of operations and statement of cash flows for the three months ended the same date as well as a detailed reconciliation of net income to EBITDA and adjusted EBITDA.

Regarding the results for the three months ended March 31st, 2023, we note that the MD&A section of our interim report on Form 10-Q, which will be published later today, provides that reviewed financial information.

In the interest of time and in light of the insights and comments provided earlier in this call, as opposed to reacting those numbers on this call, we will move to Q&A portion of the call.

QUESTIONS AND ANSWERS

Operator

Thank you. (Operator Instructions)

Now, first question coming from the line of Brian Kinstlinger with Alliance Global Partners. Your line is open.

Brian Kinstlinger ***Alliance Global Partnersl - Analyst***

Hi, good morning guys. Thanks for taking my question. I joined a few minutes late, so sorry if I rehash certain aspects. But you've had tons of success early success with our drive-thru product, I know you just talked about it as well. Are you seeing more brands you drive-thru fast casual coming to you? Are you increasing your outreach? Just take us through the market dynamics now as you're becoming a meaningful player in this space.

Rick Mills ***Creative Realities, Inc. - Chief Executive Officer***

I would tell you -- Brian, this is Rick. Thanks for joining the call. Thanks for the question. Number one, I would tell you that it's a combination of both. We have significantly increased our outreach, okay? We added some sales assets over the last 18 -- 12, 18 months, if not a little sooner than that. So, we are really in touch with a lot of the fast-growing QSR drive-thrus. That's number one.

Number two, there's intense pressure on their side, "Whoever is a brand that has a drive-thru. How can I increase my drive-thru throughput and accuracy? If I can just improve my throughput by three seconds or five seconds per order through the drive-thru, it's a tremendous amount to profitability to the bottom-line." So, that industry, in particular, is under pressure to become as efficient as impossible through the drive-thru and that almost always includes digital conversion. Hopefully, that helps.

Brian Kinstlinger ***Alliance Global Partnersl - Analyst***

Great. And then maybe talk about the challenges in the economy right now. How they plan to deploy? Do they want to limit their capital investment early on? Just talk about the factors that weigh into them accepting product and beginning these projects?

Rick Mills ***Creative Realities, Inc. - Chief Executive Officer***

Well, certainly, everybody is concerned about the cash outlay. However, in most cases, the ROI on investments in digital is certainly less than 12 months, particularly if you do the inside of a store a drive-thru might extend to 14, 15 months ROI, but that's about it. So, the ROI is very quick and realizable.

Second piece, we have also offered and have the ability to offer drive-thru operators, if you will, an OpEx model where they, instead of writing a CapEx check up front, they can pay for it out of their OpEx ROI dollars via -- think of it as a pseudo-leasing program type approach. We have a financial partner that backstops that. So, we have those two approaches.

Will Logan ***Creative Realities, Inc. - Chief Financial Officer***

Yes and we would say, Brian, that QSR and retail are going through incredible transformations in their own right, right? Regardless of our business and we happen to be -- that's a tailwind for our business in this regard because those business models are requiring transformation, adoption of digital technologies, and improvements in their own operations to stay relevant in the current business environment.

Brian Kinstlinger ***Alliance Global Partnersl - Analyst***

Great. And then I asked this in the last few quarters, I think every time, but you've got this big backlog. Talk about your -- talk about the supply chain, your ability to -- if a customer decided to increase the pace of wanting shipments. Just talk about how that works with your business given, a, the balance sheet. B, whatever is happening in the supply chain world.

Rick Mills ***Creative Realities, Inc. - Chief Executive Officer***

I'll take the first part of that, Will. Supply chain, no longer an issue in terms of what we're dealing with. There's a couple of minor pieces and parts. That tends to affect our one-off custom store business where we're doing one flagship, okay? When it gets to the production rollout of many -- standard rollout across many locations, we just simply do not have supply issues or we've navigated them well in advance.

Number two -- second thing I would tell you, we spent the first quarter, and also in the second quarter, we've been adding in some key folks -- just additional personnel. So, thus we see a slight growth because we expect in Q3, as we stated, our revenue is going to double in one quarter.

So, we've been poking along now at $10 million a quarter for the last five quarters. We're going to do the same $10 million-or-so in Q2. But in the third quarter, we do expect a step-up -- a significant increase in revenue and gross margin associated with it. So, we expect to go to about $20 million a quarter on a go-forward basis, starting with Q3.

Will Logan ***Creative Realities, Inc. - Chief Financial Officer***

Yes, Brian, I would add on the supply chain side. There's a little bit of network equipment that's been hanging out there. We only have one deployment in the pipeline today that really leverages that, and it doesn't begin deploying until early third quarter and we have line of sight and visibility and access to product ahead of that time. So, to reiterate, no real issues on supply chain.

With respect to the kind of working capital question as we expand and grow, on these larger deployments in particular, we're leveraging material deposit on the hardware upfront in advance, somewhere typically anywhere between 10% and 50%, the hardware deployment often on a rolling basis.

So, we're mitigating some of that gap, if you will, between accounts receivable and accounts payable. Although most of our accounts payable at this time has moved into a 60-day tranche, so we're relatively aligned between accounts receivable and accounts payable.

Brian Kinstlinger ***Alliance Global Partnersl - Analyst***

Great. Two more questions. The first one, I've got to ask you, but you're no longer -- your growth clearly is independent anymore, what we thought maybe a long time ago it was. Talk about where the bowling contract is. Do we have signed contracts? Are you moving forward? Just remind us on where that stands.

Rick Mills ***Creative Realities, Inc. - Chief Executive Officer***

Great question. Yes, 100% contracts are executed done. Product has been ordered. And so we expect to begin significant deployments starting in the month of July. It may squeeze some into June. Most likely, it's going to hit hard in July. And so we expect that alone is as much as $1.5 million a month in additional revenue, starting in Q3.

Will Logan ***Creative Realities, Inc. - Chief Financial Officer***

Yes. Big transaction partners had a kickoff call -- had a big kickoff meeting late last month or earlier this month. Everything's queued up, lined up. We're talking to friendly sites and already getting those deployed to get the kinks out of the system so that we can scale efficiently and quickly.

Brian Kinstlinger ***Alliance Global Partnersl - Analyst***

Congrats. That's a long time coming for you guys. Last question I have is it sounds like your EBITDA margin clearly will be much higher than 15% in the second half of the year to get to 15% for the full year. Talk about what's the cash conversion from EBITDA to cash flow, please?

Will Logan ***Creative Realities, Inc. - Chief Financial Officer***

On a timeline basis or dollar value?

Brian Kinstlinger ***Alliance Global Partnersl - Analyst***

Yes, I mean if you generate $3 million EBITDA, will that lead to $1 million of free cash flow, $2 million? Is it breakeven on a cash basis? Just talk about that, if you will.

Will Logan ***Creative Realities, Inc. - Chief Financial Officer***

So, over -- even over the last year, Brian, we've been relatively -- from an operation standpoint, we've been effectively cash flow neutral. As we've talked about in prior calls, we've had some incremental or enhanced investment into a platform conversion, particularly in our showroom/automotive platform. So, the last year and a half on an R&D basis and CapEx basis, we look we look a little more rich or a little more expensive than we have and where we expect to be going forward.

We've got those projects wrapping up September/October this year and would expect the CapEx - particularly on the software side - to go back into a more normalized range, somewhere in the ballpark of $1.5 million a year.

So, as we enter the fourth quarter, and certainly throughout 2024, we would expect a material -- 70% of that EBITDA to start converting into cash. We've been a little hamstrung on that actual conversion during this investment period.

Brian Kinstlinger ***Alliance Global Partnersl - Analyst***

Okay. Thanks guys.

Rick Mills ***Creative Realities, Inc. - Chief Executive Officer***

Thanks Brian as always.

Operator

And our next question coming from the line of Howard Halpern with Taglich Brothers. Your line is open.

Howard Halpern ***Taglich Brothers - Analyst***

Congratulations guys. Great quarter. A lot of the questions were asked and answered, but I do have a couple. In terms of -- in the second half compared to the first half, what do you envision, especially with the deployment of projects, the sales mix between hardware and services in the second half compared to the first half?

Will Logan ***Creative Realities, Inc. - Chief Financial Officer***

Yes, I think we've talked about, Howard, in this period of hyper growth or super growth that we're going through this year, next year that will look similarly in aggregate to what we did in 2022, which is kind of a 50/50 split, hardware and services.

Certainly, as we scale beyond that and continue to grow the ARR and services base, we would expect at scale as we approach $100 million topline business that will settle in at about one-third hardware and two-thirds services, but would tell you that that's more of a 50/50 split on a full year basis this year and next year.

Howard Halpern ***Taglich Brothers - Analyst***

Okay. And then one clarification. On your adjusted EBITDA margin, you anticipate getting to that 15%, 15.9% by the fourth quarter, not for the full year of this -- of the current year? Or the 15%--

Will Logan ***Creative Realities, Inc. - Chief Financial Officer***

Yes, our exit run rate should exceed 15%. We're expecting that third quarter and fourth quarter to Brian's point earlier, we'll certainly exceed that clip to bring our full year to that number. And I would expect that to be a go-forward basis for 2024 with updated forward projections as we get into the second half.

Howard Halpern ***Taglich Brothers - Analyst***

Okay. And then one last one that I think I asked about last time, too. Deployment of advertisement. Now, that you're getting to scale, are customers coming to you to deploy the advertising on the screens? And what type of margin are we looking for as you are able to ramp this up over the next couple of years, the advertising portion?

Rick Mills ***Creative Realities, Inc. - Chief Executive Officer***

So, the answer is, yes, we are in discussions with customers all the time now about helping them "monetize" their network. Sub customers want counsel and advice, others want us to be the lead partner and go and secure the ad commitments. So, it's a mixture of both.

Will Logan ***Creative Realities, Inc. - Chief Financial Officer***

And Howard, I would add, as we split that monetization out, there's kind of two revenue plays for the business, right? The first is incremental sale force subscription revenue the ad-based platform in order to deliver those ads, that's going to look, smell, and feel a whole lot like the ARR that exists today, something like an 80% margin basis.

The actual incremental upsell opportunity if we are the ad sales agent, looks probably more like 40% gross margin in the current environment, but we expect that, that would expand to 50 over time as we get some scale and a little bit more control over the networks.

Howard Halpern ***Taglich Brothers - Analyst***

Okay. Okay guys. Keep up the great work.

Rick Mills ***Creative Realities, Inc. - Chief Executive Officer***

Appreciate the call Howard.

Will Logan ***Creative Realities, Inc. - Chief Financial Officer***

Thanks Howard.

Operator

Thank you. And that completes the questions from the line today. Mr. Logan, are there any additional inquiries from Investor Relations inbox that you would like to address?

Will Logan ***Creative Realities, Inc. - Chief Financial Officer***

Nothing else in the IRM box today.

So, with that, please let me conclude the call by thanking all of our shareholders, clients, partners, and employees for their continuing efforts, commitment and support as we work together to transform Creative Realities into the leading brand in digital signage solutions. This concludes the Creative Realities' 2023 first quarter earnings call.

Operator

Ladies and gentlemen, that does conclude our conference for today.

Thank you for your participation. You may now disconnect.