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Haivision Systems, Inc. (HAI.CA)

Q3 2021 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day and thank you for standing by. Welcome to the Haivision Third Quarter 2021 Earnings Release. At this time, all participants are in a listen-only mode. After the speakers' presentation, there will be a question-and-answer session. [Operator Instructions] As a reminder, this conference call is being recorded.

I would now like to turn the call over to Mirko Wicha, Chairman, President of Haivision Systems Incorporated. Please go ahead, sir.

Miroslav Wicha

Chairman, President & Chief Executive Officer, Haivision Systems, Inc.

Thank you, Charlie, and good afternoon, everyone. Thank you for joining us today. I am definitely excited to be back for our fiscal 2021 third quarter and the first nine months of our year results, which ended July 31st of this year.

Now both our Q3 and our nine-month performance, I will say, exceeded our expectations by delivering a record revenue of CAD 20.7 million and CAD 65.5 million in revenue, respectively. Again, using our functional currency, which is the US dollar, which we actually sell in, our nine months revenue actually grew more than 15% over the same period of last year. So all in all, a tremendous performance for the year thus far.

Now in addition, we delivered an unbelievable CAD 10.4 million of adjusted EBITDA during the nine-month period, which is an increase of 31% from the same period in 2020, again, an impressive operational and financial performance. Now I should remind everyone that last year, we had an outstanding operational result, so delivering a 31% growth over 2020 is definitely an amazing result. And then we'll go over all the numbers in more details shortly.

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Now as I mentioned previously, we have seen some of our programmatic government business move between quarters a lot more fluidly than in previous years. We have also enjoyed a surprisingly strong first half of the year when some programmatic business moved up into Q1, if you recall. And now we actually saw some programs move to Q4/Q1 from our Q3.

Now the good news is that despite this programmatic business shifting between quarters, we still managed to deliver a record Q3 quarter. Now I will also remind folks – well, I mean not remind, but I should mention that our Q3 performance in 2020, which actually was before we were public, was actually very exceptional because that year we grew 22.4% over Q3 of 2019. So understand the Q3-to-Q3 performance is another growth over a dramatic growth to last year.

So therefore, to exceed the 2020 performance, despite some programmatic business moving up was awesome. So this really speaks to the strength of our business and the thirst for our products. And I will just add that we do expect once again our Q4, which is what we're in now, to be the largest quarter of the year as usual.

Now we also added many important logos or new accounts during last quarter, which should prove to bring solid long-term revenue contribution well into the future. I'll share just a partial list of some of these noteworthy names and which actually include, again, the US State Department as part of our four-year rollout. During Q3, they've added another 10 US embassies globally. That's just – it's a great rollout of a programmatic business that is actually rolling out to every US embassy in the world.

Another great win, competitive win against the US – in the US Army European Technical Center in Wiesbaden. Another competitive great win for global IPTV deployment was the Missile Defense Agency. Another great account, Rheinmetall in Canada, which is a current client, but we want a new platform opportunity. So very exciting there.

Disney World broadcast operations in Florida, buying many MX4 encoders and decoders. Spotify, a bunch of Makitos. NBC News added several new locations to their network. And ESPN actually added over 50 additional Makitos to their existing installations. We also added Bell TV, which is the Canadian equivalent of Comcast, very, very proud to have them on board. We've got Melbourne Olympic Park, Eurovision Asia, Sony Picture Singapore, MBC, which is the second largest terrestrial broadcaster in Korea, and Deloitte India. So these are just some of the great names and logos that was added in Q3.

Now what I'd like to do is actually share some comments on a few strategic accounts over the last quarter, which I think are very interesting. Interesting comment from Jeff Tyler, who is a Digital Media Experience Manager at Microsoft. He quotes, "Haivision Hub allows us to simply and easily get many live streams from the sessions at our event venues to our production center without the hassle of programming each individual workflow manually. This saves us a tremendous amount of time and virtually eliminates errors."

Another great quote from Franck Choquard, Head of Content & Platform at Eurovision Sport at EBU. "The beauty of the Haivision Hub cloud solution integrated within the unique broadcast services delivered throughout our network is that it offers our EBU broadcasters flexibility to do more interviews and create more custom feeds to meet increasing demand for tailored content without staff having to travel to a sports venue." Pretty cool stuff on the Hub.

And finally, from Mitch Rosenthal, Director of Production Operations, Original Content at Twitch. "As a user across multiple companies, including Riot and Twitch, Haivision and the SRT technology have unleashed the

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possibilities of remote production. With SRT, Haivision has driven change within the industry that dramatically reduces our costs and stimulates our technical creativity in addressing the challenges of eSports."

Let's actually discuss some of the strategic partnerships because that's really exciting. With regards to our market-leading video streaming initiative, the SRT Alliance and the SRT open source project, during our third quarter, we actually surpassed the 500 member mark supporting SRT. We have recently announced that NTT Electronics, SK Telecom, Amazon Web Services and Lumen, who was formerly Century Link, have formally endorsed this important open source initiative. And just last week, Google Cloud announced their support of SRT. I can say now that every major cloud platform, and I'm talking Google, AWS, Microsoft, Tencent and Alibaba, support the SRT open source initiative.

Now our leadership with SRT has also resulted in significant corporate technical marketing and selling partnerships that directly impact our business. Now earlier this year, we formed a resell arrangement with Avid Technology, right, the leader in video editing and media management for news and sports. We have also formed a co-marketing relationship with a Belgian company, EVS, the world leader in replay systems used in sports production. And last week, we announced a partnership with Grass Valley, one of the largest broadcast technology providers.

Each of these relationships combine Haivision's low latency edge and cloud video solutions with the partner solutions to address today's challenges of remote production and remote workforces. And I truly believe that nurturing strong partnerships are key to our long-term success.

And a couple of great quotes from these partners I'd like to share with you as well. From Nicolas Bourdon, Chief Marketing Officer at EVS. He says, "In order to create replays and highlights quickly, replay operators rely on instant visual responses from the LSM-VIA replay user interface. When the replay operator cannot be on site, the Haivision solution completes the EVS replay environment by providing the best interaction possible for remote operators, even over widely available and cost-effective public Internet connections." Very powerful statement.

And from Sydney Lovely, Chief Technology Officer, Grass Valley, says, "While the industry is very enthusiastic about the benefits cloud production can provide, our audiences expect us to maintain high-quality image standards. And that starts with putting the best quality images into the production system. The powerful combination of Haivision technology and Grass Valley AMPP will provide broadcasters with the high performance and flexibility they need to deliver unmatched viewing quality to their audiences."

And I'd kind of like to add a few more quotes, if you don't mind, from several strategic SRT Alliance members, and these are important. From Anil Jain, Managing Director of Media & Entertainment Industry Solutions at Google Cloud, "Because Google Cloud is committed to helping media organizations around the world transform their audience experiences, we are delivering on that commitment by innovating alongside partners like Haivision and the SRT Alliance and helping drive the adoption of new technologies, such as the SRT protocol supporting our continuously expanding portfolio solutions for the media and entertainment industry."

Another great quote from Dan Garrett, Solutions Marketing Manager for AWS, says, "One of the challenges with live video workflows is connecting a diverse ecosystem of solutions. And SRT has shown that it's an important transport protocol and it provides secure and reliable transport of live video to and from the AWS Cloud. With SRT protocol input and output and AWS Elemental MediaConnect, along with input in AWS Elemental live appliances and software, AWS customers have more options when it comes to building scalable, reliable and secure live video workflows."

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Another one from Rob Nance, Senior Director of CDN and Vyvx Engineering from Lumen Technologies, "Whether over managed fiber or the public Internet, Lumen has worked for three decades to make video transport as efficient as possible. On the 30th anniversary of Vyvx, we're thrilled to contribute to the important work of the SRT Alliance and to support the open source protocols that can help our customers transport media over diverse and less reliable networks."

And I'll just finish finally from a good friend, Scott Brown, CTO of Encompass Digital Media. "Encompass was a very early supporter of SRT Alliance. By level-setting the playing field for performance video transport over the Internet, Haivision has enabled the ecosystem of companies in the IP video distribution space to focus on enhancements and new capabilities of their services and applications, accelerating adoption of cloud workflows and expanding the total addressable market for cloud services." So pretty amazing response from not just customers, clients, but from partners all throughout the industry.

Now let me just say a little bit on the overall market update. Our US and international broadcast business has continued to be robust throughout the year and has been growing very nicely the past three years. In fact, we continue to invest in the sector as remote production and remote, I'd like to say, everything is here to stay. This is a very, very exciting area for Haivision and one that we have made a huge impact in the previous two years alone.

Now having said that, we are, however, seeing some softness in the US ISR and defense market, specifically now given that the Afghanistan pullout has happened, the fact that the US market is somewhat saturated with ISR technology and, of course, us being the largest incumbent in that space. So the good news is that our international ISR in defense continues to grow and has been growing the past four years.

Now in addition, the CineMassive acquisition that we announced recently was aimed specifically to bolster our position in the defense market and expands our defense growth globally. So we're very excited for 2022 and beyond and what the CineMassive acquisition will do for Haivision.

Now the enterprise market in the US has slowed down again, and this is due to the fourth wave of COVID coming on strong in the US and Europe. Three to four months ago, as I mentioned, we're all encouraged that companies were coming back to the office and projects were being restarted and at the second half of the calendar year 2021 where the business is normal. Unfortunately, it has now taken a new twist, right, where most companies are reassessing their return back to the office policies and are now talking about returning in the spring of 2022. This has once again impacted our enterprise sector, which will be lower than expected for the year. But the good news is that it will return. Nothing has been lost or nothing has been canceled, just unfortunately delayed.

Now lastly, we are very bullish on the enterprise market with the CineMassive products. We are seeing a very strong demand for companies needing visual intelligence, data gathering tools, given the global cybersecurity threats and the security direction and requirements being mandated by the US government. And if I haven't said it earlier, the CineMassive acquisition will have a very positive impact to both our defense and enterprise verticals in the US and internationally. And everyone's excited about these opportunities, and we expect to continue our growth into 2022 and beyond.

Now our international business has been growing significantly in the past three years, and 2021 is no exception. Our investment in sales and technical staff in the international regions is continuing to bear fruit. Our overall international revenue, get this, has grown over 50% in the nine months of 2021 over 2020. Now if you remember, our international revenue grew 39% for the entire year of 2020 over 2019, which was already impressive.

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Our international business today represents 23.3% of our overall revenue in the first nine months of this year. Now that's an increase from 16.9% during the same period of last year. So clearly, our strategy of global expansion is working, shows the need for Haivision technology worldwide and adding the CineMassive portfolio into the hands of our international team, I call this, pure icing on the cake.

A quick little board update. Now during Q3, we also added another strategic board member, Major General Lee Levy II. General Lee is a highly respected and decorated US Air Force veteran. Now adding generally together with Sid Horn in Q2 and with Julie Tremblay in Q1, our board transformation to provide more independence and industry expertise is now completed. Our board comprises now of seven people. I'm especially looking forward to working with General Lee to help expand our presence within the government and defense sector worldwide.

Now very quick on the CineMassive acquisition update, and Dan is going to talk more about this. We are only a month into our acquisition of CineMassive and are working hard to integrate the company. Now our sales teams are already working together and doing account mapping and sale strategies are being worked on daily. There is a high degree of excitement in the potential of our combined company. We see huge opportunities, as I mentioned, in defense but also in public safety, state and local government, emergency response and, as I mentioned, the enterprise market. Our forecast and sales pipeline are growing significantly since the announcement of the acquisition.

We also plan to add more resources to the international market in the next few quarters as we already see a huge demand for the CineMassive products outside of the US. And as mentioned, Dan will give you more details about the mechanics and integration of CineMassive thus far.

A little bit on the Haivision Hub. To remind everyone, the Haivision Hub is again the simplest way to route broadcast video through the cloud, right? Haivision Hub saves time and eliminates errors, right, with the complete end-to-end live IP video routing, which really combines the edge device control. It also centralize management of any live contribution, workflow, simplifying connectivity and making ideal for breaking news, sporting, corporate and cultural events from anywhere to anywhere regionally or globally, right?

The good news is we have already 25 clients using Haivision Hub as part of their streaming workflow. And as we integrate our EMS, our element management system functionality later this year as part of the overall hub infrastructure, we expect to see the adoption of the platform only increase. Our early hub trials have proven very, very successful and we plan to be rolling this out globally with our worldwide sales force this quarter and next quarter. This is all part of our longer-term SaaS-based revenue focus.

A little update on Haivision Connect. The Haivision Connect development is also progressing very well with great excitement coming from our existing House of Worship faith clients, testing the Connect live and simulated live release version. We now have over 50 of our current clients using and testing the platform with very, very strong rave reviews. They love the ease of use and powerful analytics and social media integration features. We have even released this version to new clients and have actually added eight new logos and clients during Q3 using just the live Connect platform. So we are prioritizing and continuing to move all of our current faith clients to the new Connect platform, expecting to complete the transition from most of them by the end of calendar 2021.

Now from an M&A perspective, as promised, during the IPO, we did announce a – we've said we announced that we're doing a meaningful and impactful acquisition during the first six months. We've done that. We're excited about the CineMassive addition and what it will bring to the future. Other M&A discussions are progressing very well and we'll keep you posted on the progress if things get closer to realization. Now we do expect the return of travel will make it easier to expedite some of our M&A discussions in the next few months, especially now that the

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summer is over and people are starting to get back to work. We are already seeing business travel picking up in the US.

Finally, I once again just want to thank all of our investors, shareholders worldwide and all the people online today for their continued support of Haivision, and we look forward to speaking with many of you soon.

So I will now pass the microphone to Dan, our CFO.

Dan Rabinowitz

Chief Financial Officer & Executive Vice President-Operations, Haivision Systems, Inc.

Thank you, Mirko. So let's get into the numbers here. As Mirko mentioned, revenue for this third quarter of fiscal 2021 was CAD 20.7 million, representing an increase of CAD 300,000 from the same period in the prior year. The company generated record revenue of CAD 65.5 million for the nine months, exceeding the prior year by CAD 4.5 million or about 7.5%. However, even though we report our results in Canadian dollars, our functional currency is technically the US dollar. On a functional currency basis, revenue for the nine months represented an increase of over 15% when compared to the prior year, exceeding the overall growth of the global video streaming infrastructure market.

Our book of recurring revenue from maintenance and support contracts, our managed service offerings and from our other staff-based products is still robust. Recurring revenue for the quarter was CAD 5.8 million, which was a quarterly record, and represented 28% of this quarter's total revenue. On a year-to-date basis, recurring revenue represents about 26% of total revenue.

For this quarter, gross margins were 75.1%, down from recent history. Interestingly, the decline is less about direct product costs or the worldwide component shortage. Rather, we have invested incrementally in our production facilities to accommodate further growth by adding additional personnel and expanding the size of the production facility. We have, however, incurred additional air freight in costs to expedite shipments that further de-risks our supply chain. And as part of our Haivision Hub product release, we have been investing in subscription trials for customers interested in the platform. On a year-to-date basis, gross margins are 76.8%, consistent to the same period in the prior year.

Now the global shortage in electronic components continues to be a challenge. We continue to invest in higher levels of Haivision-owned components inventory to de-risk our supply chain and we have requested our contract manufacturer to extend the componentry inventory on our behalf, requiring some additional deposits. Thus, it has had an impact on our balance sheet. In the meantime, we continue to monitor the supply of electronic componentry and believe we have very limited exposure to any global component shortages for the foreseeable future.

As presented, total expenses for the third quarter were CAD 11.7 million, a decrease of CAD 900,000 when compared to the same period in the prior year. But if we normalize for share-based compensation, a noncash expense we did not incur in the prior year, total expenses were only CAD 10.8 million, a decrease of CAD 1.7 million when compared to the same period in the prior year.

However, much of that decrease can be explained by the Small Business Administration's recent forgiveness of the CAD 1.8 million paycheck protection program loan, widely referred to as the PPP loan in the United States. So if we're looking at each functional area, we invested in incremental head count in research and development but those incremental investments were offset by decreases in compensation expense related to the PPP loan

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forgiveness. And we have migrated away from the expensive cost of third-party consultants and moved to internal native cloud development.

On the other hand, general and administrative expenses for the quarter were higher than in the prior-year period but was the result of the incremental costs of professional fees and insurance as a public company. Much of those incremental costs were offset by the impact of the weaker Canadian dollar on US dollar-denominated assets and liabilities.

Operations and support expenses operated at consistent levels with the prior year, but they also benefited from the impact of the PPP loan forgiveness. And as I kind of mentioned, share-based payments as the result of noncash compensation expenses for grants of stock options, restricted share units and deferred share units, we did not have these kind of expenses in the prior year.

Total expenses for the nine months ended July 31 were CAD 55.1 million. However, that included CAD 16 million in noncash share-based payments that was not part of our cost structure in fiscal 2020. As we touched on in prior calls, the CAD 16 million share-based payment can be divided into two components. CAD 14.1 million was the result of a onetime nonrecurring noncash expense resulting from the exercise of options related to our legacy employee stock option plan. It was a combination of a 14-year program and truly was extraordinary and below the line expense. CAD 1.9 million relates to compensation expense for grants of stock options, restricted share units and deferred share units issued at the time of the public offering or since then. Again, there were no such expenses recognized in fiscal year 2020.

If we were to normalize for the share-based compensation, total expenses for the six months ended July 31 were CAD 39.1 million compared to CAD 40.1 million in the prior-year period, a modest decrease of CAD 1 million. But remember, the PPP loan forgiveness reduced expenses by CAD 1.8 million in fiscal 2021. So now if we normalize for both the share-based compensation and the benefit of the PPP loan, total expenses for the nine-month period as a percent of revenue fell to 59.7% compared to 65.7% for the same period last year.

The real story is about adjusted EBITDA, though. Adjusted EBITDA for the quarter was CAD 3.4 million, a modest decrease of CAD 200,000 compared to the same period in the prior year. This quarter now represents our 29th consecutive quarter of positive adjusted EBITDA. More interestingly, on a year-to-date basis, adjusted EBITDA was CAD 10.6 million, an increase of CAD 2.5 million or 31% when compared to the same period in the prior year. On a year-to-date basis, our adjusted EBITDA margin was 16.1% compared to only 13.2% for the same period in the prior year. And again, as a reminder, our adjusted EBITDA margin for all of fiscal 2020 was only 11.9%. Thus, we are well on our way to delivering on operational efficiencies as discussed on earlier calls.

Just to finish up with the P&L. Net income for the quarter was CAD 1.9 million compared to net income of CAD 2.1 million for the same period in the prior year. But as described earlier, share-based payments, the PPP loan forgiveness and the weaker Canadian dollar impacted financial results for the – net income for the current period. Our net loss also for the nine months was CAD 8.9 million compared to net income of CAD 4.3 million, but that share-based payment of CAD 60 million and the additional costs of being a public insurer was offset only slightly by the impact of the PPP loan forgiveness.

So now looking at the balance sheet. We ended the quarter with CAD 51.6 million in cash. That's an increase of CAD 4 million from the prior quarter-end. Total assets at quarter-end were CAD 94 million, and total liabilities at the quarter-end were CAD 28.5 million. In terms of financial liabilities, we had CAD 1.9 million outstanding related to the term facility outstanding with Silicon Valley Bank. Remember, the PPP loan of CAD 1.8 million related to the paycheck protection program was forgiven, so it reduced our debt load by more than 50%.

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Although not technically part of our third quarter performance, obviously, the big news is the recent closure of the CineMassive transaction effective August 2. The transaction consumed CAD 12.6 million in cash and the issuance of 2,145,000 shares. As Miro kind of mentioned, we're happy to say there was significant momentum in CineMassive's business after last year's down year impacted by COVID, and we believe CineMassive will be a key driver to our overall growth.

One of the key strategic benefits of the CineMassive transaction is that they possess a facility security clearance. As part of the transaction, we entered into a commitment letter with the Defense Counterintelligence and Security Agency, commonly referred to as DCSA, to finalize a special security agreement. Our plans to integrate CineMassive are well underway but are pending completion of that special security agreement. CineMassive's year-end is December 31. However, in the nine months ending July 31, revenues were, in US dollar terms, $17 million. And we have visibility to an at least another $4 million in our fourth quarter, Haivision's fourth quarter.

CineMassive too is facing certain constraints related to the worldwide component shortage, and we are in the process of de-risking their supply chain as well. With our support, we are encouraging them to invest in inventory based on forecasts rather than purchase orders received. Thus, there is some upside to fourth quarter expectations, if supply chains cooperate. Historically, CineMassive's big months are in November and December, so its impact on Haivision's first quarter should be even more significant.

Gross margins for CineMassive business have historically been between 55% and 60%, but we're closer to 60% in the nine months just ended. We believe there are opportunities for margin enhancements in the near term and midterm although not necessarily to the levels Haivision has enjoyed as of late.

CineMassive also has recurring revenue that represents approximately 13% of total revenue. At current revenue rates, CineMassive has been generating adjusted EBITDA margins in the low teens, but there appears to be ample opportunities to derive additional synergies.

Now since it's our intention that Haivision will sell CineMassive products and CineMassive will sell Haivision products and, in many cases, there may be joint opportunities, it may be unlikely to report revenues separately going forward. We had a similar experience with our Video Furnace, KulaByte and CoolSign acquisitions, where you could not specify which company was really responsible for generating the revenue.

Note, one result of the acquisition will be an increase in the right of use assets and lease liabilities related to the new real estate leases that accompanies the transaction. We are in the process of having a third party to evaluate the impact to our leases.

Other good news is that in late August, we entered into a three-year credit agreement providing for a new CAD 35 million revolving line of credit facility with Bank of Montreal. The revolving facility is for general working capital, general corporate requirements and financing for acquisitions. The financing also provides us access to an additional CAD 25 million on an uncommitted basis through an accordion provision under the same terms.

Interest is on a floating basis referenced to the Canadian prime rate, the US prime rate, the SEDAR rate or the bank acceptance rate. Now as part of the credit agreement, the term facility that was outstanding with Silicon Valley Bank was paid in full. At this moment, we are 100% debt free.

Before providing some guidance to fiscal 2021 performance, a quick note about currencies. Our current guidance does not consider the potential impact of foreign exchange gains or losses as we do not try to estimate future

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movements in foreign exchange rates. Given a bit of the weakness we are seeing on the enterprise side, the chunky nature of the programmatic business and the opportunities being presented by CineMassive, we expect revenue to be in excess of CAD 95 million for this fiscal year.

With that said, we are now ready to take questions.

QUESTION AND ANSWER SECTION

Operator: Thank you, sir. [Operator Instructions] Your first question comes from the line of Robert Young with Canaccord Genuity. Your line is now open.

Robert Young
Analyst, Canaccord Genuity Corp.

Q

Hi. Good evening. First question for me would be about the annual guidance you're just talking about. You were CAD 93 million to CAD 94 million before, and I think you said CineMassive is a CAD 4 million incremental impact. So on an apples-to-apples basis, if the guidance is CAD 95 million, you're seeing the full year a little bit impacted relative to before. And so this pushout in the program business into Q4, you're expecting a little more, I guess, broader impact, just a little bit of a headwind on the business in Q4 to continue, I guess.

Dan Rabinowitz
Chief Financial Officer & Executive Vice President-Operations, Haivision Systems, Inc.

A

I think that's a fair way to look at the equation. As Mirko kind of alluded to, the fourth quarter will be our largest quarter as it typically is. But there is a little bit of a headwind, particularly on the enterprise side, that we're trying to overcome. But CineMassive will certainly assist in overcoming much of that.

Robert Young
Analyst, Canaccord Genuity Corp.

Q

Is there a way to quantify that program revenue pushout from Q3 to Q4? Is it like several million dollars or would be small – is there any help you can provide there?

Miroslav Wicha
Chairman, President & Chief Executive Officer, Haivision Systems, Inc.

A

Rob, I guess...

Dan Rabinowitz
Chief Financial Officer & Executive Vice President-Operations, Haivision Systems, Inc.

A

Mirko?

Miroslav Wicha
Chairman, President & Chief Executive Officer, Haivision Systems, Inc.

A

There's actually been several programs that have been moved out a couple of quarters, not just one, and there's some funding decisions that have occurred within the US government, specifically. So there – it's not just one program. So there's several programs which is definitely going to impact some of our Q4, to a lesser extent Q1, but which should absolutely be covered off within the CineMassive numbers coming in.

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And don't forget also, Robert, I will remind everybody that we had a highly unusual large Q1 and so much Q2 where a lot of business actually did get pushed up. So we're seeing a little bit of that as well. So I think we're probably a little bullish back in January, February, March timeframe But what happened now is with the budgeting reassigned and also with the fourth wave, we're actually seeing a little more softness in the enterprise market, specifically.

Robert Young
Analyst, Canaccord Genuity Corp.

Q

Okay. Okay, that's fair. And then on the gross margins, the impact of CineMassive, you said it's a little bit lower gross margin profile and then my impression would be that some of these government programs might be higher margin. But is there any – to help with modeling, is there any way to quantify where you think gross margins will fall? I guess CineMassive, there's a full quarter impact in Q4. So we have – how do we think about that?

Dan Rabinowitz
Chief Financial Officer & Executive Vice President-Operations, Haivision Systems, Inc.

A

Well, I think that's exactly right. So if we have visibility of $4 million for CineMassive and on a year-to-date basis, they've been working at the high end of that 55% to 60% range, I think you should be able to model what the aggregate will be.

Robert Young
Analyst, Canaccord Genuity Corp.

Q

Okay. Fair enough. And I guess that's my two questions. I'll jump back in the queue.

Operator: [Operator Instructions] Your next question comes from the line of Kevin Krishnaratne with Desjardins. Your line is now open.

Kevin Krishnaratne
Analyst, Desjardins Securities, Inc.

Q

Hey there. Good afternoon or evening, gentlemen. Congrats on a busy quarter. The question for you, maybe a bigger picture on capital allocation. You ended, as you mentioned, the balance sheet with CAD 35 million, sort of CAD 50 million or so in change after the acquisition. Along with the credit facility, I think you'll have around CAD 65 million, CAD 70 million of available capital.

Just a couple of points that you talked about, some capital that you'd be investing into CineMassive in terms of hiring, sales and marketing stock internationally. Also, talked about some of the investment into the contract manufacturer. So wondering if you can just kind of elaborate a bit further on expectations there, anything around CapEx and then closing off with CineMassive, which at the amount that you've paid for that asset was sort of in the sweet spot. You had previously talked about CAD 10 million to CAD 20 million. Just wondering what your thoughts are on next targets in terms of sizing.

Dan Rabinowitz
Chief Financial Officer & Executive Vice President-Operations, Haivision Systems, Inc.

A

A lot of different questions in that one question. Let me see if I can sort of unpack that a bit. When I say investments, primarily, we're looking to de-risk our supply chain. And Haivision has had a good history in forecasting our business, buying to forecast and yet keeping our inventory levels relatively low. In the quarter that

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just ended, we had inventories of about CAD 5 million and that's for a business that we're talking about north of CAD 90 million this year. So it's – we're very efficient from an inventory standpoint as it relates to forecasting.

Now what we're seeing with the shortage of the supply chain constraints is that things are taking longer to get delivered. There are ways for us to mitigate that. Like I mentioned to you, we air shipped some products to us to make sure that we can make deliveries. But it also means that we have to be forecasting a little bit further and we are also de-risking by making investments in certain componentry ourselves so that we're in control of it rather than relying on the contract manufacturers.

Now take that same kind of experience and then extrapolate it to CineMassive. CineMassive, a privately held company, they obviously built a very fine business. But they weren't as quarterly focused as we are, and so they could make different decisions about supply chain, the length of supply chain and the length of fulfillment of orders that come in. So we've been working with them in making the purchases of those kind of products that might in their mind be more speculative, in our mind is consistent with where the forecast might be. So we're making those incremental investments in inventory again to be able to provide – to match the top line.

Now with respect to the contract manufacturers, yes, we've asked them to now keep six months of componentry in place and that represents a little bit of an investment on their part. They've asked us to put deposits in place. None of these things in my mind, given the size of our business, the scale of our business, are that meaningful. It's just sort of an observation that I want to make sure that the investment community understands that we are doing things to de-risk supply chain.

Now going forward, a lot of people ask questions about what is the size of the next acquisition. Well, if I had a crystal ball that could tell you exactly what the next acquisition that we'll close will be, then I could kind of give you an answer to that. But we're looking at all sorts of acquisitions in all sorts of different spaces at all different sizes and all different impacts to our organization. So when we went out with the IPO, clearly, we're viewing our next goal as having an impactful acquisition.

CineMassive in our mind is an impactful acquisition in terms of size, in terms of revenue, in terms of impact on EBITDA. I don't know whether the next one is going to be bigger or smaller than CineMassive, but we certainly have the capacity to do much larger transactions, particularly with the line of credits that we've put in place with Bank of America. And it's certainly given us the flexibility to jump on things more quickly than we could have in the past.

Kevin Krishnaratne
Analyst, Desjardins Securities, Inc.

Q

Got you. That's helpful. Thanks for the answer for that first question. Second one, I'll just home in on CineMassive. It looks like a great acquisition. You did give us some metrics there, 13% of recurring revenue. Wondering if you can give us any other sort of metrics, maybe the level the programmatic spend, mix of hardware and software. And then you've talked about Haivision proper before CineMassive as having sort of 50% hardware and then the other 50% in software and services. You like to move the mix skewing more towards maybe 30% hardware. That was all before CineMassive. I'm just wondering broad strokes if you could talk about how you think about mix evolving near term now that you've got CineMassive and what it brings in terms of its profile into the fold.

Dan Rabinowitz
Chief Financial Officer & Executive Vice President-Operations, Haivision Systems, Inc.

A

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A bit of a difficult question, and we're sort of like wrestling with that internally. We have been talking about hardware and we've been talking about software and we've been doing that because that's what the investment community has been hungry for, what percentage of it is hardware, what percentage of it is software. But if you really are looking under the covers and seeing what's going on here, even our software properties – what we consider to be software properties, they're installed on Dell servers as an accommodation to our customers that they need not buy third-party service or worry whether our software can run on those servers and what have you, right?

Our hardware has more man years of firmware and software in them than many other products that are out there, right. And so yes, we've classified products as hardware or software. But in reality, there's a blend, right? You cannot have this hardware without the software. You can't have the software without the hardware. And the others – now if you compare that, if you take that with CineMassive, they're in a similar construct. They have proprietary software that they put on hardware, and we have yet to go through the exercise of sort of saying, well, what are we going to do? We're going to classify it this way or that way. So I can't really give you much guidance as to what percentage of the business is classic hardware versus software versus services at this juncture. We're still getting our feet underneath us in that regard.

Kevin Krishnaratne
Analyst, Desjardins Securities, Inc.

Q

Okay. No, that's fair. I appreciate the color there, Dan. Thanks very much. I'll pass the line.

Operator: [Operating Instructions] Your next question comes from the line of Robert Young with Canaccord Genuity. Your line is now open.

Robert Young
Analyst, Canaccord Genuity Corp.

Q

I'll ask a couple more. The first one I'd ask is what do you think a normalized quarterly run rate on CineMassive would be in 2022, if you're willing to sort of look that far out? I know it's probably a little bit hard, given some of the headwinds in ISR and things, but I was wondering if you might take a stab at that to help us with 2022 outlook.

Dan Rabinowitz
Chief Financial Officer & Executive Vice President-Operations, Haivision Systems, Inc.

A

It's a little bit difficult for us to be able to give you sort of quarterly-to-quarterly kind of comparisons right now. My understanding of the business is that their November and their December are big months. Now they are on a calendar year. We are trying to work, making sure that our years are aligned so that we can forecast more accurately. So my suspicion is that we're going to see a little bit more of a weighting in our first quarter related to CineMassive and then less so much in the second, third, fourth quarter of CineMassive. But I'm not sure I can give you much more than that right now.

Robert Young
Analyst, Canaccord Genuity Corp.

Q

Okay. And then, Mirko, you talked a little bit about – or actually I'm not sure if it was Mirko but somebody commented about some demand for subscription products. But it sounded like it was a little bit different than, say, Hub or Connect. And so I was wondering if you could talk about that.

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Miroslav Wicha
Chairman, President & Chief Executive Officer, Haivision Systems, Inc.
A

Look, I'm not sure what we were referring to them because subscription product...

Robert Young
Analyst, Canaccord Genuity Corp.
Q

Subscription trial interest that you'd see.

Miroslav Wicha
Chairman, President & Chief Executive Officer, Haivision Systems, Inc.
A

Oh, well related to the Hub...

Dan Rabinowitz
Chief Financial Officer & Executive Vice President-Operations, Haivision Systems, Inc.
A

Oh, no, no, no. Okay, that – what I was – I was trying to give an explanation as to why we saw a modest deterioration in gross margins, right, 75.1% historically. Or I shouldn't say historically, but in recent history, we've had very, very robust gross margins. We are investing in trial, meaning we're allowing our customers to try Haivision Hub before buying. And so we're paying for the cost to transport. We're paying for the cost of computing while they're trying the product. It just impacted our cost structure for the quarter.

Robert Young
Analyst, Canaccord Genuity Corp.
Q

Okay. That makes sense. And then just on the Connect because I know – I guess that's either, in general, available or about to. You said you're up to 50 testing. Is there any opportunity outside of the worship space that you see right now? Or is the focus right now in the short term just getting all of your current customers rolled over and staying in that end market?

Miroslav Wicha
Chairman, President & Chief Executive Officer, Haivision Systems, Inc.
A

No, that is absolutely our focus at the moment. The number one priority is to transform all of our faith clients as soon as possible. So that is our number one focus. Once that's completed, so that will be later in 2022, we absolutely see the opportunity to move that into the general enterprise market. But at least for the foreseeable future, it's very heavily focused on the faith market.

Robert Young
Analyst, Canaccord Genuity Corp.
Q

Okay. And then on Hub, you said 25 customers. Could you maybe put that into context with what you think maybe the short-term market might be over the next couple of years? Like how do you think that Hub will roll out just based on the level of demand and interest that you see? And then I'll leave the line.

Miroslav Wicha
Chairman, President & Chief Executive Officer, Haivision Systems, Inc.
A

Well, that's a very, very difficult question because it is something very new for us. It is a different area, and it's just literally come out of the oven. So we're still, I think, in the very, very early stages, honestly. And to see already an adoption with some pretty large clients is very, very encouraging, but I think we're still at the beginning of the stage of this. I think this is more of a later 2022, 2023 type of a ramp-up. But until we complete the overall

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development strategy of Hub, because it's not just a routing connectivity tool, it's actually going to be our encompassing umbrella for management of all of our devices as well as routing our devices, which will be happening later in the next fiscal year, it's kind of hard to tell you honestly what the pickup could be in the short term, right? This is really a longer-term play for us to connect all of our....

Dan Rabinowitz
Chief Financial Officer & Executive Vice President-Operations, Haivision Systems, Inc.
A

I would say that at this juncture, we're exercising the product with real customers, making sure that we have all of the bits and bytes getting through correctly. And so we're not uncomfortable with the level of skill that we're at right now. And in fact, we think it's kind of prudent.

Robert Young
Analyst, Canaccord Genuity Corp.
Q

Okay. And now the cloud revenue in the quarter was a little ahead of where I expected, it was actually up quarter-to-quarter. I didn't expect that. And so I guess there's some cloud revenue that's a little stronger than I expected. Is there anything that you can describe? Is this connected to Hub? Or is it connected to Haivision Connect? What might have driven that?

Miroslav Wicha
Chairman, President & Chief Executive Officer, Haivision Systems, Inc.
A

Well, that's purely two factors. One is our faith market is actually growing and it's strengthening. It's actually – the renewal rate is very good. In fact, it's the highest it's been in three years. So that has shown a very nice growth, including our maintenance and support revenue has been growing steadily for the last four years. So those two combined have actually shown that record recurring revenue.

Dan Rabinowitz
Chief Financial Officer & Executive Vice President-Operations, Haivision Systems, Inc.
A

Folks, I know that Mirko has got to get off the phone. He's got a commitment in 40 minutes he's got to get to or else bad things happen. But I'll stay on the line as long as you need.

Robert Young
Analyst, Canaccord Genuity Corp.
Q

Yeah. Well, I'll pass the line now.

Operator: And your next question comes from the line of Kevin Krishnaratne with Desjardins. Your line is now open.

Kevin Krishnaratne
Analyst, Desjardins Securities, Inc.
Q

Hey there, Dan. Sorry. Just one quick clarification for me. We talked a lot about the softness in the quarter due to the pullback in ISR and then the programmatic and enterprise. A lot of that was just in the context of the US. But in international, that had been an area of some pretty decent numbers. You had CAD 6 million in Q1 and CAD 5.5 million in Q2 and it kind of dipped down. I know it still grew year-over-year. But are you seeing the same dynamics play out there? I'm just curious because it is a smaller base you're working off of there and also much less mature, I believe, from the government's point of view internationally versus the US. So just wondering thoughts there on how we think about that line over the next couple of quarters in international

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Dan Rabinowitz

Chief Financial Officer & Executive Vice President-Operations, Haivision Systems, Inc.

A

I am – I don't think we're seeing weakness to the same extent in international. In fact, we're still seeing growth in the international market. It's buoyant. We've made significant investments in that area. Beyond that, I'm not sure I can give you much more direction. But it's not – we're not seeing softness per se.

Kevin Krishnaratne

Analyst, Desjardins Securities, Inc.

Q

Okay. Okay, great. Thanks a lot.

Operator: And we have no further question. At this time, I will now turn the call back to our speakers for closing remarks.

Dan Rabinowitz

Chief Financial Officer & Executive Vice President-Operations, Haivision Systems, Inc.

So I'm assuming Mirko took advantage of the exit. He needed to get out of here. But I want to thank everyone for joining us on this call. Really do appreciate the support that everyone has been giving Haivision. It's been an interesting ride as of late and what we think we're going to see big things going forward. So thank you, all.

Operator: And this concludes today's conference call. Thank you for participating. You may now disconnect.

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