S&P Global
Market Intelligence

# Haivision Systems Inc.

TSX:HAI

*Earnings Call*

*Wednesday, June 12, 2024 10:15 PM GMT*


| | |
|---|---|
| CALL PARTICIPANTS | 2 |
| PRESENTATION | 3 |
| QUESTION AND ANSWER | 8 |

# Call Participants

## EXECUTIVES

**Dan Rabinowitz**
*CFO, Secretary & EVP of Operations*

**Miroslav Wicha**
*Chairman, President & CEO*

## ANALYSTS

**Daniel Rosenberg**
*Paradigm Capital Inc., Research Division*

**Nick Corcoran**
*Acumen Capital Finance Partners Limited, Research Division*

**Robert Young**
*Canaccord Genuity Corp., Research Division*

**Venkata Prasad Velagapudi**
*Research Capital Corporation, Research Division*

Copyright © 2024 S&P Global Market Intelligence, a division of S&P Global Inc. All Rights reserved.

# Presentation

**Operator**

Thank you for standing by. My name is Krista, and I will be your conference operator today. At this time, I would like to welcome everyone to the Haivision Second Quarter 2024 Earnings Conference Call. [Operator Instructions] I will now turn the conference over to Mirko Wicha, Chairman and Chief Executive Officer. You may begin.

**Miroslav Wicha**
*Chairman, President & CEO*

Thank you, Krista, and good afternoon, everyone. Thank you, everyone on the call for joining us today to discuss our second quarter and 6 months results for our fiscal year 2024, which ended on April 30.

Now as demonstrated by the results we announced earlier today, our business fundamentals just keep getting stronger. We have been telling you that we will significantly increase our operational efficiency and adjusted EBITDA throughout the past 18 months and our Q2 performance continues in that direction with some noteworthy highlights.

I'd like to begin with exciting news regarding our [ control room ] business transformation to a higher-margin "manufacturer" model from the old bespoke full integrator model. Now this transition has exceeded our expectations and is progressing much quicker than previously planned. Now we have always said that this transformation will be at the expense of top line. However, what is left is our proprietary high-margin business, which is good business. This is something we've been planning for and working towards all year.

And the great news is that we can see positive results already within the first 6 months of 2024. We expected this to be an 18- to 24-month transition, but it now looks like we'll accomplish the business transition within this fiscal year, which is great news. Our partners and resellers globally are very happy to see us embracing the partner model to scale this business and getting away from being an integrator and basically seen as a competitor, supplying these complete custom installations, including selling the third-party screen, keyboards, networking equipment and even furniture.

Now this time next year, the net positive revenue gain will be more apparent together with solid and consistent high gross margins. We expect to be training and preparing many of our strategic partners worldwide on the new Command 360 fully scalable platform by the end of this year in preparation for a full-blown rollout in fiscal 2025 a full year ahead of schedule. Now let me briefly discuss some of the numbers. Our Q2 gross margins were significantly higher than last year's Q2, going from 68.9% to 71.7%. We've been saying all along that we would deliver increased gross margins. And once again, we continue to deliver what we said we would.

We also delivered an adjusted EBITDA of $5.1 million, which represents a whopping 92% improvement from our previous Q2 and the impressive 14.8% operating margin was also the third quarter in a row. We've seen the mid-teens level of operational performance, again, exactly as we promised we would deliver. It's also noteworthy to mention that our Q2 performance now gives us a 12-month trailing adjusted EBITDA of $20.3 million, another impressive metric we promised to deliver back in 2023. I can safely say that we are well on our path on delivering on our promise of a 2-year adjusted EBITDA nearly tripling the EBITDA performance from the $8 million derived in fiscal 2022, I mean, I'd say not many tech companies can say that these days.

Now we have also delivered yet another positive net income quarter with a noteworthy 162% increase over the last year's Q2, again, demonstrating what we have been saying all along that we will show much higher increase in our profitability, and we expect this trend to continue throughout '24 and '25. Let me also add that our balance sheet has never looked so strong. As we have been saying over and over, we are moving quickly towards achieving our goal of delivering 20% EBITDA performance.

And with our Q2 performance, it should give you even more comfort that this is going to happen. Let me quickly touch on some of the latest U.S. federal government budget delays and the continuing resolutions

Copyright © 2024 S&P Global Market Intelligence, a division of S&P Global Inc. All Rights reserved.

that marred the first half of the year for all federal government suppliers, not just Haivision. The constant political bickering and congressional delays in approving the budget has stalled or delayed projects within the military and federal government institutions throughout the U.S.

Now we have seen many government suppliers feeling this pain throughout the industry. Now the good news for Haivision is that we didn't lose any deals and no deals that we're working on were canceled, although several projects have been pushed to the right and have been delayed due to the inability for Congress to approve a timely budget. Unfortunately, I don't think we can expect to see any federal employees working over time to catch up on the backlog. Thus, we should see the projects eventually coming back within the next few quarters.

And the good news is that the money is starting to flow again, but it will take a while to catch up to the normal levels expected at this time of the year. We do, however, anticipate the year-end buying cycle to be strong for the government's September year-end, which is especially typical during the election year. We continue to see strong demand for our global security operational centers within the global financial banking industry, cybersecurity, police centers, federal installations, public safety, and, in fact, all defense sectors and the need for our customers to have real-time, mission-critical and secure access to all their video sources and assets for real-time analysis or situational awareness is even more critical.

Our investments in additional salespeople and focused business development worldwide with strategic partners will set us up for solid growth in '25 and beyond. Dan will go through all the financials in detail, but let me reiterate our annual guidance we gave back in January, delivering an adjusted EBITDA in the mid-teens is well on target, while delivering higher margins and growth in operational performance is also well on target.

And considering our planned transformation on the control room business is way ahead of schedule. Some of the delays in federal spending, our top line will be lower than anticipated but all of our profitability metrics are well on track. And this has been our main focus and the most important metrics for this fiscal year. Better-than-expected transformation in our control room business will set us up for a much healthier and profitable business moving forward. All in all, a great performance.

And finally, we believe that Haivision has a very bright future ahead as we have now delivered not just promised but delivered a trailing 12-month adjusted EBITDA of $20.3 million as I said that cannot be taken away from us. It is no longer a promise. It is our actual performance. We are committed to maximizing long-term value for all of our shareholders. We are confident in our ability to execute on our strategic plan and deliver continued growth and even higher operational performance. I hope that the investment community will finally realize that we are significantly undervalued in terms of both revenue and now even on our EBITDA multiples. So Dan, please feel free to continue with the detailed financials.

**Dan Rabinowitz**
*CFO, Secretary & EVP of Operations*

Thank you. Now that Mirko has already stolen most of my thunder, I'm going to try to make the numbers a bit interesting. Revenue for the second quarter of fiscal 2024 was $34.2 million. That's a modest decrease of $900,000 or 2.7% from the prior year. But as we've discussed on previous calls, we fully exited the managed services business focused on House of Worship customers in April of 2023. The second quarter 2023 revenues included $1.2 million in cloud solutions revenue versus only $100,000 in the second quarter of fiscal 2024. That is a $1.1 million decrease year-over-year.

Normalizing for the decision to exit the House of Worship, we did experience growth, albeit modest growth, but there is more to this revenue story. As Mirko alluded to, we have been transitioning our control room business away from that of a system integrator where we provide bespoke solutions that include such low-margin, third-party components like screens and in some cases, even furniture to that of a manufacturer of proprietary hardware and software systems. This transition will enable us to scale the business much more quickly, particularly in international markets.

It will also enable existing and new channel partners to offer those same, third-party components to end users and derive the benefit from the incremental margins that may result. In other words, it's an

Copyright © 2024 S&P Global Market Intelligence, a division of S&P Global Inc. All Rights reserved.

added incentive for those channel partners to want to work with Haivision in this control room space. This transition, particularly in the public safety and enterprise verticals is happening at a much faster rate than originally anticipated. We will likely see increasing gross margins in that space as it's difficult for us to charge a premium for these off-the-shelf third-party components.

However, this transition will be at the expense of top line revenue, albeit at the expense of less, profitable top line revenue. Additionally, we introduced a long-term rental program, which was initially focused in the transmitter market. This initiative enables our customers to recognize an ongoing operating expense rather than a capital expense. It also enables them to future proof their purchases as they would have access to the newest technologies when available. The fact of the matter is that our competitors offer such a program in the transmitter space and those sales would not be otherwise available to us, if we didn't offer a program that is very competitive, those with our competitors.

However, for Haivision, there are additional benefits. First of all, it enables us to increase our recurring revenue posture, which is a key focus for us and it enables us to drive higher gross margins over the life of these agreements. We are happy to say that we've already experienced significant success having converted a high profile of customer away from our competitors. Revenue for the 6 months ended April 30 was $68.7 million, a very modest $400,000 decrease from the prior year comparative period.

Again, this year-over-year comparison is impacted by the decision to exit the House of Worship vertical in April 2023. Year-to-date, we had Cloud Solutions revenues of only $300,000 compared to $3.2 million in the prior year comparable period. That is a $2.8 million decrease year-over-year. And normalizing for the decision to exit the House of Worship vertical, we actually experienced a growth of about 4%.

And let's not forget that year-to-date results are also being impacted by our transition away from that of a system integrator in the control room space and our long-term rental program. Recurring revenue, which we define as cloud solutions and maintenance and support was $6.5 million in the second quarter and about $12.9 million on a year-to-date basis, representing approximately 19% of total revenue. As has been the case for the last 4 quarters, recurring revenue as a percentage of revenue is down from prior year comparative periods.

However, we anticipated the decline once we exited the House of Worship vertical with our managed service offering. For this quarter, gross margins were 71.7%, a significant improvement from the 68.9% realized the prior year, and we are seeing similar improvements on a year-to-date basis. Gross margins on a year-to-date basis were 72.3% compared to 67.8% in the prior year comparative period. That is a 450 basis point improvement.

Now I want to mention that gross margins for the last 4 quarters have been fairly consistent, averaging around 72.5%. At the risk of sounding like a broken record, the improvements can be attributed to 4 factors: First, our decision to exit the House of Worship vertical, which had high, relative fixed cost and the margins for bandwidth and storage were being squeezed. Secondly, we have digested the majority of high-priced difficult to procure components that we purchased to secure top line revenue. So we're seeing our margins on our proprietary products reverting to historical averages.

We completed our migration of ERP systems at both MCS and AbbVie West, so our supply chain folks have more visibility to these day-to-day operations. And as more of our business transitions away from bespoke implementations or migrates to longer-term rentals, margins may continue to improve just a bit. With that said, there is still some degree of seasonality with respect to the timing of revenues by vertical market. Thus, we may continue to see some variability in gross margins based on the mix of solutions sold in any given quarter.

To give you a sense of how the seasonality in our business may impact margins, our fourth quarter is commensurate with the U.S. government's year-end. Our revenues are typically disproportionately weighted to our performance hardware products like the Makita, which have robust gross margins. We will continue -- we will likely continue to see our fourth quarter margins being slightly better than that of other quarters. Total expenses for the second quarter were $22.7 million. That's a decrease of $2.4 million when compared to the same period in the prior year.

Copyright © 2024 S&P Global Market Intelligence, a division of S&P Global Inc. All Rights reserved.

As we've said before, our cost structure is heavily weighted towards compensation and related expenses. We ended the quarter with 365 employees compared to 380 employees a year ago. Approximately half of the year-over-year decrease can be attributed to compensation-related expenses, particularly in the research and development and sales and marketing areas, the focus of recent restructuring efforts. The remaining year-over-year differences can be attributed to occupancy expenses as we continue to rationalize our space decisions, decreases in amortization and depreciation expense, decreases in professional services and technology and communications as our back office continues to become more efficient and the more efficient use of digital marketing.

On a year-to-date basis, total expenses were $45.5 million, a decrease of $33.2 million when compared to the prior year comparative period. The reason for the year-to-year decreases are similar. Compensation-related expenses decreased by $2.2 million, while the remaining decreases could be found in amortization and depreciation, technology and telecommunications, marketing and professional services. The real news this quarter is that the result of higher gross margins and lower expenses is an adjusted EBITDA for the quarter of $5.1 million. That's a $2.4 million improvement or a 92% improvement from the same prior year period.

Further to the point, the adjusted EBITDA margin for this quarter was 14.8%, a notable improvement when compared to the 7.5% adjusted EBITDA for the prior year period. On other side, this is the third consecutive quarter with adjusted EBITDA in excess of $5 million. For the 6 months ended April 30, our adjusted EBITDA was $10.2 million. That's a $5.5 million or 116% improvement from the same prior year period.

And the adjusted EBITDA margin on a year-to-date basis is 14.9%, even more impressive improvement compared to the 6.9% in the same prior year period. As Mirko mentioned, our trailing 12-month adjusted EBITDA is $20.3 million, and our adjusted EBITDA margin is securely in the mid-teens as we promised to deliver over a year ago. It should become self-evident that there is now a level of consistency in gross margins and adjusted EBITDA that should be well received by the investment community, and it should become self-evident that we are building a very valuable business that may not yet be reflected in today's stock price.

Operating profit for the quarter was $1.8 million that's a $2.8 million improvement over the same prior year period or a 302% improvement. And when you look at it on a year-to-date basis, our operating profit was $4.1 million. That's a $6.1 million improvement over the same prior year period and that's also over a 300% improvement. Net income for the quarter was $900,000. That's a $2.4 million improvement compared to the $1.5 million loss that we incurred last year.

And on a year-to-date basis, that's -- our net income was $2.2 million and that's a $5.1 million improvement when compared to the net loss of $2.9 million in the prior year. But there is a very interesting trend that I want to point to. If you take a look at our full year net loss in 2021, it was $8.8 million. In 2022, our net loss was $6.2 million. In 2023, our net loss was $1.3 million. Here we are halfway through fiscal 2024, and our net income is a positive $2.2 million.

With respect to the balance sheet, we ended the quarter with cash balances of about $11.2 million. That does represent a decrease of $1.9 million from the prior quarter end. However, we ended the quarter with $1.7 million outstanding on the line of credit, which is also a decrease of $1.9 million from the prior quarter end. The timing of revenue within any given quarter has an impact on our level of accounts receivable and the resulting cash generation in a given quarter.

To give you -- to illustrate the point here, in our first quarter of fiscal 2024, approximately 65% of our revenue was derived in the first 2 months of the quarter. Calendar year end spending accelerated the timing of revenue in that first quarter of 2024. Obviously, the earlier in the quarter we invoiced the higher the chances to collect those receivables within the same quarter. However, in our second quarter of this fiscal year, less than 50% of our revenue came in the first 2 months of the quarter. That's more typical of our intra-quarter seasonality. The good news is that cash collections have been good, and we should see the benefit by the time we report our next quarterly results.

Copyright © 2024 S&P Global Market Intelligence, a division of S&P Global Inc. All Rights reserved.

Total assets at April 30 were $140.3 million. That is a decrease of $3.8 million from October 31, our fiscal year end. The decrease in assets during the 6-month period includes a $3.8 million reduction in intangible assets, the result of ongoing amortization expenses, a $2.5 million reduction in inventories as we continue to squeeze out efficiencies in our supply chain, the $1.5 million reduction in trade and other receivables and a $900,000 reduction in the right-of-use assets, the result of ongoing rent obligations.

Now these decreases were offset by the $2.9 million increase in cash and the $1.6 million increase in investment tax credit receivables. The story about liabilities is also compelling. Total liabilities at April 30 were $45.2 million, a decrease of $4.8 million from October 31. This decrease in liabilities includes a $3 million decrease in trade payables and other accruals, a $3 million decrease in the line of credit extended and a $1.4 million decrease in lease liabilities and term loans, again, the result of ongoing rent obligations and term loan repayments.

Now these decreases were offset by an increase of deferred revenue by $2.5 million, another indicator of the efficacy of our maintenance and support programs. So decreasing liabilities and increasing deferred revenue is a pretty solid story. In terms of expectations for fiscal 2024, we are revising our revenue guidance for the full year. Our revenue guidance for the full year now factors in the much quicker-than-anticipated transition away from the integrator model, which included those lower-margin, third-party components in the control room space, the delayed approval of U.S. federal budget and the resulting lethargy in government purchasing and our exit from the House of Worship vertical in April 2023 and, to a lesser degree, our long-term rental program, which exchanges longer-term recurring revenue at the expense of short-term product sales.

Thus, we are now projecting revenues for this fiscal year to be between $140 million and $142 million. We still anticipate adjusted EBITDA margins in the mid-teens as has been our guidance the entire year and we still anticipate seeing one quarter of this fiscal year knocking on the door of our long-term adjusted EBITDA margin goal of 20%. That concludes my prepared remarks. I'm going to pass the microphone back to you, Mirko, and then we'll open the floor to questions.

**Miroslav Wicha**
*Chairman, President & CEO*
Okay. Thanks, Dan. Well, I guess we could open up to questions, Krista. .

Copyright © 2024 S&P Global Market Intelligence, a division of S&P Global Inc. All Rights reserved.

# Question and Answer

**Operator**

[Operator Instructions] Your first question comes from Nick Corcoran

**Nick Corcoran**
*Acumen Capital Finance Partners Limited, Research Division*

My first question is just to do with U.S. federal spending. I'm wondering what we should see in terms of the trend through the third and fourth quarter and with revenue?

**Miroslav Wicha**
*Chairman, President & CEO*

Well, good question. I mean, I think Q4 is [ prepped ] up to be a pretty solid quarter because it is a government year-end, at the moment is we're just monitoring Q3 to see how quickly the money is trickling in. So we do see some softness in Q3. So it will be very similar to like our Q2, but it is picking up. So that's the good news. The question is how quickly can some of these people, actually, get back to work and get back to some of these projects.

So I'm still feeling a little soft in Q3 from the government perspective, much better in Q4. But we feel that the guidance that Dan just gave should be bang on, and we feel pretty confident.

**Nick Corcoran**
*Acumen Capital Finance Partners Limited, Research Division*

That's helpful. And maybe if we can just think about the organic growth by end market between government, enterprise and defense. What are you seeing there?

**Miroslav Wicha**
*Chairman, President & CEO*

Sorry, between government and defense or nongovernment?

**Nick Corcoran**
*Acumen Capital Finance Partners Limited, Research Division*

Government, enterprise and defense and just broadcast as well, sorry.

**Miroslav Wicha**
*Chairman, President & CEO*

So, Dan, do you want to take that one?

**Dan Rabinowitz**
*CFO, Secretary & EVP of Operations*

Nick, well, it's getting increasingly difficult for us to be sort of looking at this vertical given the amount of cross-selling that we're doing right now. And as we kind of alluded to in the past, it's almost like we have a portfolio of vertical focus, again, broadcast, enterprise and defense. .

And sometimes we see strength in certain verticals, and sometimes we see some weakness in certain verticals. In the first 2 quarters, obviously, we were seeing some weakness in the government defense spending, largely related to the budget and the deferral of a firm budget there. And we started seeing a pickup in the broadcast business, some of which is related to the Olympics this summer. I'd say that we're going to start seeing the government space -- defense and government space picking up in the third and the fourth quarter, probably more so in the fourth quarter than in the third quarter, although we are seeing sales increase in the third quarter. And I'd say the other 2 businesses are relatively stable at this point.

**Miroslav Wicha**

Copyright © 2024 S&P Global Market Intelligence, a division of S&P Global Inc. All Rights reserved.

*Chairman, President & CEO*

Yes. I mean I would just add to that, that we've been seeing good, solid business. I mean it is an Olympic year, right? We're doing a lot -- some good broadcast business throughout the last quarter, but also coming into this quarter. So that's actually been very, very healthy as is typical in a large sporting event here. .

**Nick Corcoran**
*Acumen Capital Finance Partners Limited, Research Division*

That's helpful. And maybe 1 more question from me just on the M&A pipeline. Are you still actively pursuing the M&A pipeline and could we potentially see a deal done in the next kind of 12 to 18 months?

**Miroslav Wicha**
*Chairman, President & CEO*

Well, I mean we're definitely continuing talking to people. And so we have not stepped up the gas on that except -- but being realistic, I mean there's nothing really, I would say, in the oven that that's hot that would even remotely close in a short period of time. So even if we started to have serious discussions, I don't even see them in closing this fiscal year. But I think within the next 12 to 18 months, I think it's very reasonable to think that we will be targeting an M&A event.

**Dan Rabinowitz**
*CFO, Secretary & EVP of Operations*

If I could just sort of -- if I could add tiny bit of color on that, right, I mean, obviously, we constantly are talking to people here. But our focus for 2024, obviously, was to demonstrate the profitability of the business, the efficacy of the business and what have you. And one of our hopes is that the profitability of the business will be reflected in a buoyant stock price and that may give us yet another arrow in the quiver to use in our M&A endeavors, right? It's not going to stop us from doing the right thing for our business, the stock price, but it would be another tool that would be beneficial as we're talking to people.

**Operator**

Your next question comes from Robert Young.

**Robert Young**
*Canaccord Genuity Corp., Research Division*

I was hoping to get a little more detail around this transition from the integrator model more towards higher-margin solution provider. Is there any way to maybe put a finer point around the margin impact from that, like the overall company margins?

**Dan Rabinowitz**
*CFO, Secretary & EVP of Operations*

We've been toying with that quite a bit. I've been trying to sketch that out for some period of time. I'm not sure I have a tremendous amount of visibility as to how it's going to impact the overall organization. I do think that we may see an increase in our gross margin as a result of that initiative. Is it going to add a point that would be -- I would think that's way over optimistic, maybe a half a point but it will be a better business for us. It will be -- it will enable us to deliver more timely, and It will enable us to deliver more quickly and it will enable us to expand more aggressively.

**Robert Young**
*Canaccord Genuity Corp., Research Division*

Okay. That's great to hear. I think last quarter, you suggested something about a U.S. focus on the development of a partner network around this initiative. I'm just curious is -- did I hear that right? Is this something a U.S. focus? Is there an international opportunity with partners maybe to expand the control room market business?

Copyright © 2024 S&P Global Market Intelligence, a division of S&P Global Inc. All Rights reserved.

**Miroslav Wicha**
*Chairman, President & CEO*

So absolutely. Great question. I mean I think early on, we talked about specifically in international, but it actually is global, which includes the U.S. So in fact, we are spending a lot of time on some very large U.S. partnerships as we transform this model. And then once we get well advanced to that, we're going to basically carbon copy that and move it into international.

So we are talking to a lot of international partners, but the first phase right now is to work with some of our big, big potential partners in the U.S. where that's where the majority of the business is. And remember, this has been a difficult challenge and amazingly enough, it's going so much better than we anticipated because we were perceived or CineMassive was perceived before we bought them and even after we bought them as a competitor to all of these guys, right? I mean as a full integrator, that's what these partners do. So we've been working hard to talk to these partners and explain to them that's not what we want to do, we don't want to be in integration business. That's your business, and we want to work with you guys.

So it's going to take a little bit more time to get their buy-in, but we're actually seeing some pretty amazing progress. And that is the only way you can sell internationally. I mean it all has to be through partners. So the good news is, we're ahead of the program. But it's still going to require training rolling out. But starting at the end of this fiscal year, we're going to be on a full-blown rollout. At the same time, what we really haven't talked about is our development in our platform is really tackling the beauty of rolling out a partner-friendly application software, hardware platform.

We'll be able to scale much quicker than we ever could have imagined as an integrator. So it's setting us up really nicely for 2025. But it starts with the U.S., right? I mean, you've got to get the U.S. right. That is the biggest market, and then we take it over internationally.

**Robert Young**
*Canaccord Genuity Corp., Research Division*

Okay. One more question on this thread would be around the partner development. I guess some of the comments suggest to me that you already have partners working with you on this given the channel confusion you're talking about that you've cleared up. But is there an effort to expand the partner network? Or is there an onboarding process? You noted training? Like is there anything maybe around the timing of that? Or any details you can share?

**Miroslav Wicha**
*Chairman, President & CEO*

Not too many details. I mean, the fact that we are adding more partners for sure. It's not like we want as many partners as possible. I mean we're managing it by market, by segment, by territories, but we are working with all of the largest integrators. The training is going to obviously take some good time. I mean, for the next 2 quarters, we're really focusing on building that trust, getting the people trained. So that's going to take about 2 quarters. And then we're going to be rolling that out to the international market.

**Robert Young**
*Canaccord Genuity Corp., Research Division*

Okay. Last question for me is just, maybe, clarify the rental component. I think you suggested it was to do the [ transmitter ] market. Is that limited to the [ U.S. ] business.

**Miroslav Wicha**
*Chairman, President & CEO*

Yes.

**Venkata Prasad Velagapudi**
*Research Capital Corporation, Research Division*

Copyright © 2024 S&P Global Market Intelligence, a division of S&P Global Inc. All Rights reserved.

And I think you also suggested there was -- it was a strong benefit in a high event year, I assume, that means the Summer Olympics. But is the Summer Olympics, like a big driver of rental opportunity for you on the AVIWEST products but the product just is general. Maybe you could just expand on that to better understand it, and then I'll pass the line.

**Miroslav Wicha**
*Chairman, President & CEO*

Sure. No, that's a good question. Yes, absolutely. We have seen any major world events like the World Cup, like the Euro Cup that's going on, like the Olympics, absolutely has a major rental component to it. And that's one of the reasons why we've been working on not just short-term rentals, but we've been talking a lot of the broadcasters for long-term rentals, which is also part of the business. So yes, we've seen a nice pickup of that.

In fact, we've converted one major account that we can't talk about, from a major competitor over a 2-year long-term rental was a big deal. So it's progressing very well. So the rental business is going up, it's something we have been investing in, and it's part of the business going forward. As Dan alluded to, it is sacrificing short-term revenue for longer-term, better revenue and the higher margin revenue going forward, just like a SaaS model, right? It's the same thing.

So that's progressing very well. But again, it's not significant, it's not huge. But we have also been selling a lot of our products, not just rentals because of the Olympics, and we're actually having a pretty significant technology demonstration at the Olympics. So again, we can't even talk about that because we're not allowed. The Olympics are very, very strict. But I think after they're finished, you'll be able to read up and see some of the really cool stuff that we're pushing the envelope of low latency wireless 5G technology from the transmitter side, very, very cool projects.

Sorry, Dan. Go ahead

**Dan Rabinowitz**
*CFO, Secretary & EVP of Operations*

I was just going to add, we've always been in the short-term rental program, particularly in Europe, and that business is expanding and that business does increase when there's big events like the Olympics and whatever the case might be. But we were specifically talking about a long-term rental program where companies might rent our equipment for years on end, 1, 2 or 3 years. That is a different business model and that is the model that we initiated in the second quarter here.

**Robert Young**
*Canaccord Genuity Corp., Research Division*

Okay. Great. And then just last little question is just around the inventory, down quarter-to-quarter, you've been doing some good work managing that over the last several quarters. Is there more to come down? Or should we expect that to start moving up, given the comments around Q3 and Q4, the government business and then I'll pass the line.

**Dan Rabinowitz**
*CFO, Secretary & EVP of Operations*

Well, no, I think that the reason why the inventory went from our historical low levels to where -- to the $22 million, $23 million level at some point in time here is because we were buying inventory that we thought we might be able to solve, particularly in the MCS space, in the Haivision MCS space. Our business has always been reliant on our ability to forecast the business and so we procure to forecast. And usually, we are able to sell that business -- sell that product very quickly within the same quarter that we procure it. So we're not -- I don't expect inventories to be going up.

I don't see inventories going up because of the third quarter or the fourth quarter increase in revenues per se. I'd say that if the business goes up by $10 million, we're going to have a working capital need related to AR and inventory. But we're not talking about those kind of things in the next couple of quarters. .

Copyright © 2024 S&P Global Market Intelligence, a division of S&P Global Inc. All Rights reserved.

**Operator**

Your next question comes from Daniel Rosenberg.

**Daniel Rosenberg**
*Paradigm Capital Inc., Research Division*

Mirko and Dan. My first one comes around the sales mix. I'm just wondering how this channel partner strategy currently stands up in terms of direct sales versus sales coming through channel partners? And what does that look like into the future as you scale with channel partners?

**Miroslav Wicha**
*Chairman, President & CEO*

Well, it's -- again, we're talking about the control rooms, right? So it's that specific market that has been going from an integrator, more of a direct sales to partners. The other markets, we do -- sorry, we deal with partners on an ongoing basis. So it's not a new concept for us. Remember, we fulfill through partners and integrators both in defense, in ISR and enterprises as well as broadcast, right? But the control room market is a significant piece that was -- I would say, what more like 80%, 90% of the defense business was direct integrator business, probably about 60% of the enterprise was direct business, right?

So we're transforming the defense and the government enterprise business to as much as possible a partner model. And I think we're probably going to go down less than 5% or 10% in the defense because some of the defense clients still require a little bit of an end-to-end solution for the manufacturer, but that's a longer-term goal. So I don't know if you want to take -- give more clarity, Dan, on the numbers or percentages, but it's really hard to dissect because this is -- the control room market that we're specifically talking about, right, which is not insignificant.

**Dan Rabinowitz**
*CFO, Secretary & EVP of Operations*

I would say -- I would put it this way. We have always been a channel-friendly company. The preponderance of our revenues are coming through the channels one way or another. Now in the control room space, it's a little bit more complicated because we still have channel partners there. But the complexity of the install had -- results in delays in delivery, it results in complexities that we have to overcome. And we want to take out that complexity give to the experts, the system integrators that do this for a living and let us focus on the proprietary technology that feeds these control rooms, it will enable us to expand our breadth much more quickly than we can do today.

**Daniel Rosenberg**
*Paradigm Capital Inc., Research Division*

Okay. Understood. And this transition, I mean, I imagine this is a multiyear process to get there. Or I mean you said it's going faster than anticipated, but what does that look like?

**Miroslav Wicha**
*Chairman, President & CEO*

We're definitely way ahead of the cycle, right? I mean we're expecting this to be at least a 2-year process. I would say this time next year, we're going to be very little doing direct integration business, if any at all. So I think this is a -- we're moving very, very quickly. It's more like a 12 month, let's say, maybe 18 months from when we started. So I would say next year, 2025, you're going to see by far a majority of all of our controller business going through partners.

**Daniel Rosenberg**
*Paradigm Capital Inc., Research Division*

Okay. And I'm wondering, as this occurs, is there any impact to kind of the maintenance and support revenue that you traditionally booked? Or is that a separate piece?

**Dan Rabinowitz**

Copyright © 2024 S&P Global Market Intelligence, a division of S&P Global Inc. All Rights reserved.

*CFO, Secretary & EVP of Operations*

It's a separate piece. I mean it's difficult to charge maintenance and support on third-party screens as an example, when those screen manufacturers have their own warranties. So it will be -- it will not -- as a percentage of revenue, it will be more robust and it will be more sound. It will be more consistent with our existing businesses, perhaps we'll lose a little maintenance and support because we're not driving the maintenance and support on those third-party components, but we couldn't really do very much in those areas anyways. .

**Daniel Rosenberg**
*Paradigm Capital Inc., Research Division*

Okay. And then lastly for me. So driving towards this long-term 20% goal, approaching it in the coming quarters. So the drivers there, is it -- it's a combination of scale and this transition that you speak of? Or are there other levers that you're working with to get there?

**Dan Rabinowitz**
*CFO, Secretary & EVP of Operations*

I would say, it's a scale question at this point here. We've built an efficient operation. We probably have squeezed as much from our OpEx as we can at this juncture. We've become exceedingly efficient. There may be some small opportunities on the gross margin line, but it's going to be confusing to sort of look at that gross margin line, given the seasonality we may see in the business and suggest that the incremental gross margin is solely related to this transition to a manufacturing model of sorts.

So I'm still looking at a 72.5% gross margin, it's a long-term margin, very consistent to what our average has been over the last 3 or 4 quarters that I think the rest of it is really related to scale at this point.

**Operator**

Your final question today comes from Venkata Velagapudi,

**Venkata Prasad Velagapudi**
*Research Capital Corporation, Research Division*

Dan and Mirko, I have a question on your gross margin in Q2 then. So it's easy to understand the increase in gross margin on a year-on-year basis. But how do we interpret a slight dip in gross margin in Q2. Is it something related to revenue mix? Or is there something else to look at?

**Dan Rabinowitz**
*CFO, Secretary & EVP of Operations*

Well, you do have sort of an eagle eye on that. There is a small factor that did affect gross margins in the second quarter and that is we did increase our reserves for obsolescence and we did increase our scrap and that actually represented almost a 1% difference between second quarter of this year and second quarter of last year. .

And you may see that as part of the variation from the first quarter and the second quarter. But again, our business is complex, and we have lots of different products and lots of different margins. And it is hard for anyone to be able to look at that gross margin [indiscernible], specifically, it's related to mix or specifically related in this case of scrap.

But I will tell you that second quarter did have a higher expense related to scrap or reserves than in prior quarters. That is going to disappear in the third quarter. So we'll probably revert back to that 72.5% number that we've been talking about earlier.

**Venkata Prasad Velagapudi**
*Research Capital Corporation, Research Division*

Okay. And I have another question about your SG&A. As per your guidance, you guys have successfully managed to decline this line item consistently, roughly $0.5 million per quarter over the last 4 quarters.

Copyright © 2024 S&P Global Market Intelligence, a division of S&P Global Inc. All Rights reserved.

So should we -- how do we interpret this going forward? Should we expect something in the same lines for the next 2 quarters? Or will it be much less significant?

**Dan Rabinowitz**
*CFO, Secretary & EVP of Operations*

I kind of missed -- you said $0.5 million. What were you referring to was $0.5 million.

**Venkata Prasad Velagapudi**
*Research Capital Corporation, Research Division*

In July -- in the quarter ending July last year, SG&A was $16.4 million, then $16 million then $15.5 million. And in this quarter, it's $15 million, So roughly, you have managed to reduce this line item by $0.5 million per quarter.

**Dan Rabinowitz**
*CFO, Secretary & EVP of Operations*

Yes. No, I think that -- I don't think there's a trend there that you should be looking at. I've been looking at OpEx on a general level here. And if you were to exclude the amortization and depreciation and some of the other things that are more accounting calculations than sort of the actual OpEx, our OpEx was flat in the second quarter to our first quarter. And so we believe that we arrived at stability in terms of OpEx. The only variability that we might see in the OpEx is related to marketing initiatives and margin is related to those large trade shows that we have in the second quarter and then again in the fourth quarter. But beyond that, it's relatively fixed in the short term.

**Venkata Prasad Velagapudi**
*Research Capital Corporation, Research Division*

Okay. And when you say the long-term gross margin, you are looking at 72.5%. Are you looking at this year? Or is it something we should consider as a long-term target?

**Dan Rabinowitz**
*CFO, Secretary & EVP of Operations*

I think it's more of a long-term standing. I'm not prepared to suggest that it's going to deviate much from where we are these days. Mix will change things. We may see an increase in our fourth quarter. But I'm a little bit more conservative as to whether this transition is going to result in that uplift immediately.

**Operator**

I will now turn it back over to Mirko for closing remarks.

**Miroslav Wicha**
*Chairman, President & CEO*

Thank you, Krysta. I just want to thank all of our shareholders and all the analysts on the line today for their continued support of Haivision and look forward to speaking with all of you in mid-September when we'll discuss the Q3 '24 results. And Just a heads up, I'll be taking that call from Europe. We're going to do an early morning before the market opens in September. So we'll have to deviate from the usual after the market close. I look forward to talking to all of you then. Thanks.

**Operator**
This concludes today's conference call. Thank you for your participation, and you may now disconnect.

Copyright © 2024 S&P Global Market Intelligence, a division of S&P Global Inc. All Rights reserved.

Copyright © 2024 by S&P Global Market Intelligence, a division of S&P Global Inc. All rights reserved.

These materials have been prepared solely for information purposes based upon information generally available to the public and from sources believed to be reliable. No content (including index data, ratings, credit-related analyses and data, research, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of S&P Global Market Intelligence or its affiliates (collectively, S&P Global). The Content shall not be used for any unlawful or unauthorized purposes. S&P Global and any third-party providers, (collectively S&P Global Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Global Parties are not responsible for any errors or omissions, regardless of the cause, for the results obtained from the use of the Content. THE CONTENT IS PROVIDED ON "AS IS" BASIS. S&P GLOBAL PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Global Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs or losses caused by negligence) in connection with any use of the Content even if advised of the possibility of such damages. S&P Global Market Intelligence's opinions, quotes and credit-related and other analyses are statements of opinion as of the date they are expressed and not statements of fact or recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security. S&P Global Market Intelligence may provide index data. Direct investment in an index is not possible. Exposure to an asset class represented by an index is available through investable instruments based on that index. S&P Global Market Intelligence assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P Global Market Intelligence does not act as a fiduciary or an investment advisor except where registered as such. S&P Global keeps certain activities of its divisions separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain divisions of S&P Global may have information that is not available to other S&P Global divisions. S&P Global has established policies and procedures to maintain the confidentiality of certain nonpublic information received in connection with each analytical process.

S&P Global may receive compensation for its ratings and certain analyses, normally from issuers or underwriters of securities or from obligors. S&P Global reserves the right to disseminate its opinions and analyses. S&P Global's public ratings and analyses are made available on its Web sites, www.standardandpoors.com (free of charge), and www.ratingsdirect.com and www.globalcreditportal.com (subscription), and may be distributed through other means, including via S&P Global publications and third-party redistributors. Additional information about our ratings fees is available at www.standardandpoors.com/usratingsfees.
© 2024 S&P Global Market Intelligence.