Katapult Holdings, Inc.

FQ4 2022 Earnings Call Transcript

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Call Participants

EXECUTIVES

Bill Wright
Vice President of Investor Relations

Derek Medlin
Chief Operating Officer

Nancy A. Walsh
Chief Financial Officer

Orlando J. Zayas
CEO, President & Director

ANALYSTS

Anthony Chinonye Chukumba
Loop Capital Markets LLC, Research Division

Joshua Michael Siegler
Cantor Fitzgerald & Co., Research Division

Presentation

Operator

Good day, and thank you for standing by. Welcome to the Katapult Fourth Quarter 2022 Earnings Call. [Operator Instructions] Please be advised that today's conference is being recorded.

I would now like to hand the conference over to your speaker today, Bill Wright, Head of Investor Relations. Please go ahead.

Bill Wright
Vice President of Investor Relations

Thank you, operator, and good morning. Welcome to Katapult's Fourth Quarter and Full Year 2022 Conference Call. With me today are Orlando Zayas, Chief Executive Officer; Nancy Walsh, our recently appointed Chief Financial Officer; and Derek Medlin, our Chief Operating Officer. We issued our earnings release and corresponding investor presentation this morning, and we will be referencing these during the call. Both can be found on the Investor Relations section of our website. We will be available for Q&A following today's prepared remarks.

Before we begin, I would like to remind everyone that this call will contain forward-looking statements regarding our financial performance, our business outlook and related assumptions that are subject to significant risks and uncertainties, including the future operating and financial performance of Katapult. These forward-looking statements should be considered in conjunction with cautionary statements contained in our earnings release and our Form 10-K for the year ended December 31, 2022, as well as the subsequent periodic and current reports we file with the SEC. These statements reflect management's current beliefs, assumptions and expectations and are subject to a number of factors that may cause actual results to differ materially from those statements. The information contained in this call is accurate only as of the date discussed. Except as required by law, we undertake no obligation to publicly update or revise any of these statements whether as a result of any new information, future events or otherwise.

During today's discussion of our financial performance, we will provide certain financial information that constitute non-GAAP financial measures under SEC rules. These non-GAAP financial measures should not be considered replacements for and should be read together with our GAAP results. A reconciliation of non-GAAP financial measures to the most directly comparable GAAP financial measures are included with today's earnings release and are available on the Investor Relations section of our website. This call is being recorded, and a webcast will be available for replay on the Investor Relations section of our website.

I will now turn the call over to Orlando.

Orlando J. Zayas
CEO, President & Director

Thank you, Bill. Good morning, everyone, and thank you for joining us. On today's call, we will review our fourth quarter 2022 financial results. We'll also provide an update on our mission to provide underserved nonprime consumers the flexibility they deserve to access the durable goods they need. I would first like to thank our team members for their dedication and hard work during this past year driving our growth strategies forward and providing an enhanced experience for our customers.

I would also like to introduce our new CFO, Nancy Walsh, who joined the company last December. Nancy is a highly accomplished senior finance executive with a global and domestic leadership experience in entrepreneurial publicly traded growth companies. More recently, she was Executive Vice President and Chief Financial Officer of LL Flooring, a multichannel specialty retailer of hardwood flooring and hardwood flooring accessories. In that role, she led teams and functions at a broad-based strategic level while driving detailed tactical execution. Nancy's financial and public company expertise at prominent retail brands like Timberland, Coach and Pier 1 is the perfect fit, and I'm thrilled she is here.

We are passionate about helping our customers. Since becoming a public company, we have built a solid foundation with strong core capabilities. In 2022, we focused on expanding our key leadership team and embarked on a series of strategic investments to launch new products. This is highlighted by a new feature on our mobile app, Katapult Pay, that is showing promising results thus far. As we look forward, we plan to drive top line growth and improve profitability.

The early signs of success as a result of our strategic plan for growth were reflected in Q4 2022 results. We delivered a 1.5% increase in gross originations year-over-year despite a challenging macro backdrop for our consumers and retailers. Gross originations improved as we progressed through the fourth quarter and December grew mid-teens year-over-year. Supporting this growth was deeper penetration of our Wayfair sales volume to the highest level since a year ago and the integration of 21 new direct merchants, and finally, the launch of 7 merchants through our mobile app featuring Katapult Pay, including Wayfair and Home Depot, bringing us a total of 18 new merchants for the year.

During the quarter, we continued to identify cost savings opportunities that are expected to result in significant cash operating expense reductions and sequential improvements in adjusted EBITDA in 2023 after onetime Q1 expenses related to severance. Our customer satisfaction remains strong with a Net Promoter Score of 56 at year-end. We achieved this success while keeping a close eye on all our core KPIs and maintaining prudent portfolio risk management.

Taking into context these Q4 2022 results, our operating priorities are centered around driving top line growth and executing a path to profitability. The levers for achieving these priorities include expanding customer usage of our mobile app, adding more merchants to our Katapult Pay feature, continuing to expand our direct merchant integrations and improving our operating leverage by diligently managing expenses, something Nancy will touch upon in a moment.

The success of our mobile app did not occur overnight. It's been driven by a series of strategic investments since early 2022 to develop functionality, create an engaging platform and expand access to a variety of quality merchants that will continue to enhance our relationship with our customers. The results speak for themselves, whether measuring monthly active users or gross originations through our mobile app. Importantly, all these accomplishments have occurred without additional direct-to-consumer marketing expense.

The driver of our mobile success has been our new feature, Katapult Pay. To refresh everyone's memory, Katapult Pay is our onetime-use virtual card technology that makes lease purchasing simple and intuitive for our customers. On our mobile app featuring Katapult Pay, our customers can complete a lease transaction, checking out with a onetime-use virtual card to facilitate the payment of a wide variety of merchants on our app. The Katapult Pay feature on our app offers merchants an accelerated option for adding Katapult's lease-to-own solution with minimal tech lift and lower cost while giving Katapult more control over the end-to-end customer experience and improve conversion rates. Customer adoption is exceeding our expectations. Despite no direct-to-consumer marketing expense in Q4 and only targeting existing Katapult customers, as of December 2022, we generated more than $8 million in gross originations in just under 4 months since launching Katapult Pay with Best Buy leading the way.

We believe this technology is industry disruptive, fueled by our proprietary AI algorithms. As you know, only durable goods can qualify for lease-to-own solutions. The power of our Katapult Pay feature on our app is the ability to precisely detect whether a customer is leasing a refrigerator or a video game in their Best Buy shopping card. At Home Depot, for example, there are many products that are not leasable. Our AI helps navigate the millions of products available to get the leasable items our customers need.

Looking ahead, we plan to continue adding new merchants to the Katapult Pay feature on our mobile app. In addition, we believe by providing valuable customer insights, we can accelerate new opportunities for adopting Katapult's lease-to-own solution in our mobile app while we expect to drive higher gross origination volume in the future. Stay tuned.

And now I will turn the call over to Nancy to share our financial details and our outlook. Nancy?

Nancy A. Walsh
Chief Financial Officer

Thank you, Orlando, and good morning, everyone. 2022's results reflected the ongoing challenging environment for both our consumers and retailers as the combination of rising inflation pressures and reduced consumer spending impacted our business. In response, we quickly adjusted and focused on managing our lease portfolio performance while still executing key investments and initiatives that we expect will drive growth in the future. We began to see the results of these growth investments in Q4 of 2022 as gross originations increased by 1.5% year-over-year. Gross originations improved as we progressed through the quarter, and December grew by mid-teens year-over-year. This increase reflects the technology investments made in our mobile app and Katapult Pay.

Total revenue for the quarter was $48.8 million. The year-over-year decrease is primarily driven by lower lease margins and $9 million related to the adoption of ASC 842. Please see Slide 11 for more information on ASC 842 and the impact on our results. Overall operating expenses decreased $6 million year-over-year. Excluding the impact of eliminating bad debt expense due to the adoption of ASC 842 effective January 1, 2022, operating expenses increased $3.5 million, primarily related to our 2022 investment initiatives. Adjusted EBITDA was negative $5 million, a decrease of $3.6 million year-over-year due primarily to lower revenue trends and higher expenses to support our strategic investments for growth in the quarter. Impairment charges as a percentage of gross originations in the fourth quarter of 2022 were 8.8%, a sequential improvement from 10.1% in the third quarter of 2022, which reflects prudent risk management in the face of rising inflation. We will continue to monitor the macro environment and will adjust underwriting accordingly.

Earlier this week, we reached an agreement with our lender to amend our revolving line of credit and term loan facility to extend the maturity date to June 4, 2025. This agreement also optimizes utilization ratios and creates a more efficient capital structure that will result in overall interest expense savings. We're delighted by the continued support from our existing long-term lending partner to provide us financial flexibility to drive top line growth and improve profitability. The major terms of this amendment include the following: for the revolving line of credit, reduced the revolving line of credit commitment to $75 million, increased the spread above the benchmark rate to 8.5% from 7.5%; for the term loan, paid down $25 million of outstanding principal, the spread above the benchmark rate remains at 8%, issued warrants to purchase up to 2 million shares of common stock at an exercise price of $0.01 per share.

Subject to the occurrence of certain events under the warrant agreement on December 5, 2023, warrants may be issued to purchase up to an additional 2 million shares of common stock at an exercise price of $0.01 per share, exercisable 3 months after issuing. In addition, the benchmark rate was converted from LIBOR to SOFR plus the applicable credit adjustment spread. The complete amendment was filed with our Form 10-K this morning. Except as set forth in the amendment, all other terms and conditions and financial covenants of the credit agreement remain in place.

The company continues to navigate uncertainty in the macro environment related to inflation, consumer spending and a challenging labor market. As a result, the company is not providing financial guidance at this time. The company is however providing 2023 commentary as follows: the company expects consumer spending headwinds to persist in 2023; historically lease-to-own solutions benefit from periods of shrinking prime credit availability, creating a countercyclical hedge against the challenging macro environment; the company expects to see year-over-year gross originations growth continue into 2023; the company also expects sequential improvement in the second half of 2023 compared to the first half of 2023 as the company sees the full benefit of new merchants through direct integrations as well as on our mobile app featuring Katapult Pay.

Entering 2023, the company believes the credit quality of our portfolio should continue to improve based on the advancement and ongoing development of our risk modeling, quality of our new merchants onboarded as well as the engagement and quality of the consumers attracted to our mobile app featuring Katapult Pay. The company expects the impact of expense reductions initiated in the fourth quarter of 2022 to reduce our total operating expenses by more than 10% for the full year 2023. Excluding underwriting and servicing costs which are variable and noncash stock-based compensation expense, we expect fixed cash operating expenses to decrease by more than 20% for the full year 2023.

The expense reduction efforts encompass all areas of spending and was effective as of January 1. In the first quarter of 2023, we completed an additional company-wide headcount reduction to align our organization to our 2023 plan. As a result, first quarter 2023 will be a transition quarter as onetime severance expense offsets the overall expense reductions. For the full year 2023, the company expects to achieve year-over-year improvement in adjusted EBITDA as a result of gross origination improvement and reduced operating expenses. Through early March, gross originations have increased year-over-year, continuing the positive trend from Q4 and in line with our expectations, driven by merchants with direct integration and the company's 2022 strategic investments in technology such as the mobile app featuring Katapult Pay.

I will now turn it back to Orlando for final comments.

Orlando J. Zayas
CEO, President & Director

Thank you, Nancy, and thank you all for attending. I want to reiterate; we are intently focused on executing our growth strategies to drive gross originations and improve profitability in 2023 and position us for success over the long term. We have built an experienced team of executives, a suite of innovative technology that I'm confident will help us weather the current macro uncertainty. We remain passionate about creating relationships with more customers and deepening our engagement by introducing new consumer access points, like our mobile app featuring Katapult Pay, to drive top line growth and improve profitability.

I'm excited about our team, our technology and our results today. I look forward to updating you on our mission to provide underserved nonprime consumers the flexibility they deserve to access durable goods they need on our next call. Thank you.

Question and Answer

Operator

[Operator Instructions] The first question comes from John Siegler with Cantor.

Joshua Michael Siegler
Cantor Fitzgerald & Co., Research Division

I think it would be great if we could start with some additional color on Katapult Pay. Specifically, I was curious if you could walk us through your marketing strategy there, how has it evolved over time and how do you expect to continue marketing the app in 2023. And further, do you expect Katapult Pay to meaningfully contribute in 2023?

Derek Medlin
Chief Operating Officer

John, this is Derek. I'll take that question, and thank you for it. So Katapult Pay thus far has been something that we've rolled out cautiously and with the objective of really trying to understand our customer, their behavior and how to make this customer experience smooth, transparent and easy for them to complete transactions. And it's been exceeding our expectations. Our focus thus far has been with existing consumers from Katapult, so really enlarging that lifetime value of a Katapult customer and then creating more engagement and value for our merchants, for those who are in the Katapult ecosystem. So we expect to continue that strategy going forward for the immediate future, which is to focus on existing approved customers and those who are looking to do business with us. And we think that this is a great solution because it gives customers more awareness of how they can be successful with Katapult, where they can use it at more retailers and how to complete transactions successfully and get the goods and durable goods that they're looking for.

On a go-forward basis, we'll constantly be testing new opportunities for us to grow and expand that community. And some of that will be through our new lightweight capabilities for new merchants to integrate with us using Katapult Pay versus a direct shopping card integration. So more to come on that in the future, but we do believe that this will be a major growth driver for us going forward.

Joshua Michael Siegler
Cantor Fitzgerald & Co., Research Division

Okay. Understood. That's helpful. And then for 2023, as you're thinking about the year, do you expect to start seeing some of that tighter underwriting by the prime lenders and more consumers to start moving down the credit waterfall?

Orlando J. Zayas
CEO, President & Director

John, it's Orlando. I'll take that question. Yes, we've already started seeing -- we track it pretty carefully since we're in the waterfall, and we are starting to see a rise of the prime customers especially in the first quarter. We don't think it's going to be a meaningful impact. It's not like when COVID happened and like literally it was in week where we saw improved -- the prime lenders tighten up. So we have seen evidence of it. We're seeing a better flow of customers, and we think that will continue.

Operator

Our next question comes from Anthony Chukumba with Loop Capital.

Anthony Chinonye Chukumba
Loop Capital Markets LLC, Research Division

Just one question on Katapult Pay. Just remind me, does the retailer have to opt into that? Can you -- you specifically mention Best Buy and Home Depot. So I'm just wondering, like is there some sort of like a partnership with them. How exactly does that work?

Derek Medlin
Chief Operating Officer

Anthony, this is Derek. Thanks again for your question and thanks for joining us this morning. So the answer is it varies. We have retailers that we have direct partnerships with. We have affiliate relationships with others. And so it's a different type of situation with each retailer. And what's really novel about this is how our technology works to integrate well with their websites, allowing the customer through over their mobile device to be able to shop just like they would on their website, have the guidance flow that will help them make sure they understand what [steerable] goods are eligible, check out and have all the information they need to be successful with their lease. And so we've made it where it's really easy for us to partner and really easy for customers to shop.

Anthony Chinonye Chukumba
Loop Capital Markets LLC, Research Division

Got it. That's helpful. And then I know it's still relatively early, but have you seen any significant differences in, I guess, KPIs between Katapult Pay customers and other lease sources just in terms of average ticket or merchandise write-off rates or anything like that? I mean, any significant differences to call out?

Derek Medlin
Chief Operating Officer

Yes, that's a great question. Thank you, Anthony. So what we're seeing right now is actually remarkably similar behavior in terms of average cart sizes and average performance, Everything is in line with our expectations, in fact, exceeding our expectations. I think the most exciting part is the frequency of a consumer who now, having the ability to go to our marketplace on the website, understand that we have this large network of retailers that they can shop at. And so we are seeing an increased frequency and shortened time between transactions, which, from our standpoint, is great from a lifetime value and an engagement standpoint. And consumers are performing extremely well. So it's early days, but we're really pleased with the results.

Anthony Chinonye Chukumba
Loop Capital Markets LLC, Research Division

Got it. And not to bogart the Q&A session, but I just had one final question. So you mentioned deeper penetration with Wayfair. So would that imply that your -- I guess, the -- your -- I don't cover Wayfair so I'm not super close to it, but I know that their sales are declining. Would that imply that your gross originations with Wayfair declined at a slower rate than their U.S. sales did. How should we think about that?

Orlando J. Zayas
CEO, President & Director

Hi, it's Orlando. Yes, that's directionally the right way to look at it. Obviously, we look at there in North America or the U.S. sales and compare how we do to that. And so that's how we look at that penetration rate. And so while we can't affect their sales in the same magnitude as they may with other marketing and things that they do, but we like to see obviously that penetration improve. And we did. We saw a nice improvement in the last quarter and we continue to. So it's all about working with their customers, getting them back in to buy more, making sure we market to them effectively, letting them know that they have the offer and it's proven to be successful.

Operator

I show no further questions at this time. This concludes today's conference call. Thank you for participating. You may now disconnect.