Katapult Holdings, Inc.

FQ3 2022 Earnings Call Transcript

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Call Participants

EXECUTIVES

Bill Wright
Vice President of Investor Relations

Derek Medlin
Chief Operating Officer

Karissa Cupito
Senior Advisor

Orlando J. Zayas
CEO, President & Director

ANALYSTS

Anthony Chinonye Chukumba
Loop Capital Markets LLC, Research Division

Harold Lee Goetsch
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Keeler Patton
Cantor Fitzgerald & Co., Research Division

Vincent Albert Caintic
Stephens Inc., Research Division

Presentation

Operator

Ladies and gentlemen, thank you for standing by and welcome to the Katapult Q3 2022 Earnings Call. I would now like to turn the call over to Bill Wright, Head of Investor Relations. Please go ahead.

Bill Wright
Vice President of Investor Relations

Thank you, and good morning. Welcome to the Katapult Third Quarter 2022 Earnings Results Conference Call. With me today are Orlando Zayas, Chief Executive Officer; Karissa Cupito, Chief Financial Officer; and Derek Medlin, 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 all be available for Q&A following today's prepared remarks.

Before we begin, I would like to remind everyone this call will contain forward-looking statements regarding future events and our financial performance, including statements regarding our market opportunity, the impact of our growth initiatives on future financial performance, the timing and growth origination and scale potential of our exclusive partnership with Sears, adoption and success of our mobile application and virtual credit card solution, Katapult Pay, and anticipated occurrence, timing and impact of impairment levels and prime lending tightening.

These should be considered in conjunction with cautionary statements contained in our earnings release and the company's most recent periodic SEC report, including our Form 10-Q for the quarter ended June 30, 2022, and 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. 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 constitutes non-GAAP financial measures under SEC rules. These include measures such as adjusted gross profit, adjusted EBITDA and adjusted net loss. These non-GAAP financial measures should not be considered replacements for and should be read together with our GAAP results. Reconciliations to GAAP measures and certain additional information are also included in today's earnings release, which is 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

Thanks, Bill. Good morning, everyone, and thank you for joining us.

On today's call, we'll review the results of the third quarter of 2022 and provide an update on significant progress we are making on our strategic growth initiatives.

Turning to Slide 4. You can see that our team continues to work diligently to create value and to capture additional share in the large virtual lease-to-own addressable market. We have only scratched the surface of the total e-commerce durable goods market opportunity for underserved customers, which we estimate to be about $40 billion to $50 billion.

While we are not immune to the ongoing macroeconomic pressures, we are confident in our ability to weather these challenges over the longer term and remain focused on progressing our strategic plan in order to create value for our shareholders.

During the quarter, we executed several aspects of our strategic growth plan. We successfully launched our mobile app and Katapult Pay, our virtual credit card solution. We also completed our planned strategic hires for the third quarter of 2022, and our new team members are quickly getting up to speed and making contributions, including the optimization of our sales process. This is already bearing fruit. As I am pleased to announce our exclusive partnership with Transform SR Holdings Management LLC, which operates multiple stores and online formats, including Sears Home Town, Sears Home Appliance Showrooms, Sears Home and Life and Sears full-line stores as well as Sears.com.

Being selected as Sears' exclusive lease purchase solution from a competitive bid process is very exciting and allows us to expand in both e-commerce and omnichannel space with a national retailer. We look forward to integrating with Sears' online e-commerce site and their 140 storefronts in the coming months, and we believe we will see meaningful gross originations from the partnership starting in 2023 and beyond.

Additionally, we are pleased that our Net Promoter Score continues to be high and that 46% of gross originations during the quarter were from repeat customers. We are proud to continue providing underserved consumers with a way to access goods that they need in their daily lives, especially during these challenging times.

Turning to Slide 5. You will see we continue to execute on our strategic growth plan that we first detailed on our fourth quarter 2021 earnings call. We have, in fact, achieved almost all of the goals that we set for ourselves at the beginning of the year, including filling key leadership positions, optimizing our sales process, introducing new marketing and brand initiatives, and launching new products. We expect these initiatives to pay dividends going forward.

Our work to add new merchants is always ongoing. We believe we are gaining momentum as retailers come to understand the value of partnering with Katapult.

Slide 6 provides additional details about our new product, Katapult Pay, which is powered by our newly launched mobile app. We envision that our mobile app will become the main way that our customers interact with our brand going forward. The beta version of this app launched during the third quarter, and since then, we achieved 30% customer adoption, largely through e-mail campaigns and word of mouth.

The mobile app allows customers to get preapproved, self-service release, make lease payments and, most importantly, utilize our proprietary Katapult Pay product. Katapult Pay is our onetime use virtual card technology that makes lease purchasing simpler than ever for our customers. Through our mobile app, customers can complete these transactions with select existing merchants and affiliate merchants and check out with a virtual credit card that can be entered like a regular credit card at checkout.

We currently have 20 merchants enabled with Katapult Pay, including Best Buy, Mattress Firm, Traeger Grills and HP. To date, since our soft launch beginning in September, we have already originated over 2,000 leases and over $2 million in gross originations with Katapult Pay. The success of the soft launch is very encouraging, and we plan to continue to grow this new origination channel in Q4 and into 2023 as we add more Katapult Pay merchants each quarter as well as leverage strong analytic capabilities to improve our app engagement and conversion plus begin to build out our affiliate revenue network.

Moving to Slide 7. We continue to steadily add to the number of retail partners each quarter. Most notably, we launched 2 enterprise clients, 1StopBedrooms and SimpleTire, both of which are competitive wins during the quarter. We also entered into agreement with iBUYPOWER, a leading e-commerce merchant for high-performance custom gaming PCs.

As our exclusive new partnership with Sears, we are currently working to complete both an online integration and support their e-commerce business, as well as full custom integration in the existing in-store point-of-sale system for rollout to their 140-plus stores across the U.S. Additionally, under the partnership, shoppers who apply but do not qualify for credit through the Sears prime financing provider, both in-store and online, will automatically be considered for eligibility to receive a Katapult lease purchase preapproval offer. We are very excited to partner with Sears and give non-prime consumers access to leading retailer and a pioneer of customer-focused brands like Craftsman, Kenmore and DieHard.

Together, we intend to seamlessly connect the digital and physical shopping experiences to serve more customers and Shop Your Way members. Katapult's ability to understand the needs of Sears and its affiliates, while being nimble enough to customize and support fast integration, played an important role in the decision of both sides to partner together. We believe that Sears has the potential to become 1 of our top merchant partners in 2023.

I would now like to turn it over to Karissa, our CFO, who will provide more details on our financial performance. Karissa?

Karissa Cupito
Senior Advisor

Thank you, Orlando. As detailed on Slide 8, third quarter results reflected the ongoing challenging macro environment for both retailers and consumers, which again resulted in decreased origination and weighed on our key revenue drivers.

Gross originations for the third quarter of 2022 were down $16.9 million. Total revenue for the third quarter of 2022 was $50.3 million. Of the $21.4 million decline in revenue, $5.4 million relates to the adoption of ASC 842, which was effective January 1, 2022, and is discussed on the next slide.

Gross profit was down $6.5 million year-over-year due to a decline in origination volume, lower lease margins and from the adoption of ASC 842. Adjusted gross profit was down $0.3 million and our net loss for the second quarter was $8.2 million and adjusted EBITDA decreased $2.4 million.

Turning to Slide 10. Overall operating expenses were down $4.4 million year-over-year or 21%. The total operating expense decline of $4.4 million includes the elimination of bad debt expense due to the adoption of ASC 842, offset by increases in professional and consulting fees and compensation costs related to an increase in head count in connection with our strategic investments for growth. With the launch of several of our significant initiatives completed, we anticipate lower operating expenses for the full year 2023 as our growth initiatives reach completion and as we look to continue lowering operating expenses across the organization in light of the challenging macroeconomic environment.

Turning to Slide 11. Impairment charges related to the property held for lease as a percentage of gross originations was 10.1% in Q3 of 2022, which reflects the return to prepandemic levels due to continuing economic pressures being felt by our consumers. The significant increase in inflation we have seen this year, coupled with an absence of stimulus funds, has negatively impacted our customers. And in response, we have continued to tighten our underwriting model throughout 2022, and based off of current vintage data, we anticipate our impairment charges as a percentage of gross originations to decline for Q4.

It is worth noting that as credit tightens across the credit spectrum, including prime lenders, we anticipate that new higher-income customers will seek out our offerings, widening the top of our application funnel. While we have not yet seen meaningful tightening from the prime lenders above us, we anticipate such tightening actions to eventually occur.

I will now turn the call back over to Orlando to wrap up with some key takeaways.

Orlando J. Zayas
CEO, President & Director

Thanks, Karissa. In conclusion, despite turbulent macroeconomic conditions, we believe our progress against our strategic growth investments thus far is paying dividends, with the addition of larger retail partners across diverse channels. We continue to conservatively manage our underwriting strategy, deepen relationships with existing customers, add new retail partners and launch new product capabilities.
As we look ahead, we remain confident that our company is well positioned to add market share in a large virtual lease-to-own addressable market. Thank you all. We will now take your questions.

Question and Answer

Operator

[Operator Instructions] Your first question comes from the line of Josh Siegler from Cantor Fitzgerald.

Keeler Patton
Cantor Fitzgerald & Co., Research Division

This is Keeler on for Josh. So you mentioned that you have not yet seen a tightening in underwriting from prime financing providers even though impairment charges seem like they're back at pre-COVID levels. Could you add a little color there around what you're seeing around consumer health and maybe when we could see a tightening from the prime guys?

Karissa Cupito
Senior Advisor

Yes, this is Karissa. In terms of the prime tightening, we have not seen a significant trend yet in terms of prime tightening. There's a lot of macroeconomic data that's coming out that's leading us to believe it will come in the near term, but we have not seen it and it's not reflected in our numbers, especially in Q3.

From the impairment perspective, we have been underwriting obviously throughout the entire year and with the latest vintages, we are seeing positive trends in terms of delinquencies, and that's why we believe the impairment as a percentage of property held for lease will be declining in Q4.

Keeler Patton
Cantor Fitzgerald & Co., Research Division

Got you. And then also wanted to touch on the Sears partnership, which is really great to see. Could you help us maybe size the opportunity a little bit there? What level of penetration do you think you can reach with the Sears partnership?

Orlando J. Zayas
CEO, President & Director

Thanks for the question. This is Orlando. I have a lot of experience with Sears. It was a client of mine before. Obviously, a lot has changed in the last few years. But their customer is very lease forward driven, especially their Home Town stores, which we're really excited about, because their Home Town stores are in small towns where the owner is a franchisee possibly, and they really focus on trying to help that customer and bring the customer that we like.

So we think that the penetration rate will be really strong, probably one of our strongest, because of the type of customer that they draw as well as the market that they have and the reputation they have with their customers, who continue to go back to them time and time again. So we're actually really excited about this opportunity because it really does fit perfectly with our mission and helping these customers get high-quality merchandise at a strong retailer.

So I don't know exactly what the numbers will be, but based on my previous experience, they're really strong, and we're really excited about it.

Operator

Your next question comes from the line of Vincent Caintic from Stephens.

Vincent Albert Caintic
Stephens Inc., Research Division

So following up on Sears, so that's very exciting to hear that. I was wondering if you could talk through how -- in order for this to be illustrative, how that sales cycle went the exclusivity that's pretty nice to have and essentially also the competition because I'm sure others maybe were competing against that, so how you, Katapult, was able to win that and what were the differentiators?

Orlando J. Zayas
CEO, President & Director

Yes. Thanks, Vincent. Nice to hear from you. It was a long process, let's just say. I think we first talked to them in early part of the year. Their current provider was basically shutting down and gave them 2 weeks' notice. So they had to move quickly. Unfortunately, it's still a big company and they didn't move as fast as we wanted them to because I was ready to start leasing in April. And I think where the differentiator was because they did -- and this is what took some time. They did shop to see what's the best alternative out there. And what they really liked is our tech.

And they realized that having no checking account, having the integration points, and we really had numerous calls with their tech side and our tech side to talk about how easy we can make the integration, especially on their Sears.com and Shop Your Way programs. And then on the in-store, again, they had to look at integrating into the POS system, and we've done that before. And so I think we eased the decision for them because we knew what we were talking about, and we knew we could do it really quickly and easily.

Vincent Albert Caintic
Stephens Inc., Research Division

Okay. Perfect. And so are they fully turned on already? Or is there still an integration process to go?

Orlando J. Zayas
CEO, President & Director

Yes. It's still an integration process because there's literally 3 integration points. There's the POS system, which is, as you can imagine, a relatively old POS system. There's the Shop Your Way, which is their loyalty program, and their Sears.com. So there's literally 3 integrations going on right now.

Vincent Albert Caintic
Stephens Inc., Research Division

Okay. Great. And then maybe expanding a bit or kind of pulling back a bit, but the discussions that you're having with your merchants now and perhaps ahead of the holiday season, how are they maybe positioning and how you can help. And then for the pipeline that you have, have things changed and maybe more engagement or more urgency that you're seeing from your merchants and potential merchants?

Derek Medlin
Chief Operating Officer

this is Derek Medlin. Thanks for the question. And what I'd love to say or what I'd like to share is that the pipeline is really strong and active. And even being in Q4, we believe that we -- with the revamped branding that we've done, the new CRO addition, Reid Bork, and a lot of the new product enhancements and integration capabilities that we've been working on are really resonating, especially during a time when many retailers are looking to expand consumer base and grow sales. And so we're really optimistic about the traction that we've had over the last few quarters but also going into next year, that's going to continue going forward.

Orlando J. Zayas
CEO, President & Director

Yes. Vincent, if I can add. I've been out talking to a number of retailers, both current retailers that we have as well as potential new retailers in the last few months. And it's interesting because I've been hearing the same story from most of them is they had the shipping issues back in '21. They overordered because they were trying to make up for it. Now they've got a lot of inventory, and they've got a lot of inventory to move.

So I'm pretty excited about the engagements that we've gotten so far, because they've got to move inventory. And when a retailer needs to -- sitting on a ton of inventory, they want to move it, they're looking for alternatives, and they know that we can move fast.

Operator

Your final question comes from the line of Hal Goetsch from Loop Capital.

Hal Goetsch
Loop Capital Markets LLC, Research Division

I got a quick question on the new virtual product. Can you tell us a little bit about the vendors involved and maybe some early indications on average order size and maybe early loss rates with this new product?

Derek Medlin
Chief Operating Officer

This is Derek. Thanks for the question. We're really excited about what we're seeing from the mobile app and the Katapult Pay product that we've launched. This is something that we've been working on for some time. Really with the aim to respond to what we're hearing, both from retailers and from consumers, about how can we make the customer experience better, how can we open up the opportunity for repeat transactions and recurring and higher engagement as well as giving for the Katapult community, a larger set of retailers to respond to.

So just it's early days, I'll say that just in general. We really only had this out in the marketplace for about 70 days. And the early numbers that we're seeing are really exciting. Just in terms of average order value, our consumers are behaving just like they have been in other form factors and in the digital experience. We were already mobile-enabled and mobile forward thinking, but with the mobile app and this new capability, we're seeing very similar sort of customer behavior.

But what's really exciting is to see the level of engagement, the higher and the faster repeat rate as well as the encouraging signs as they're finding new buying opportunities from new SKU categories, so someone who may have came in, found a mattress with us and is now very easily able to find a purchasing option at a Best Buy or at a Tractor Supply or at something similar to that.

So we're really excited about what this means for us, and we've been able to leverage our AI-driven systems and platforms, and its virtual card technology to create a new and easy purchasing path for consumers. And we are excited for what that means for 2023 and beyond.

Orlando J. Zayas
CEO, President & Director

Yes. And Harold, if I can add 1 thing, Derek forgot to add or forgot to mention is that we really haven't told anybody yet. This is the first public announcement about it, and it's just customers that have been using our app to make payments and things discovered it, and we were surprised at the engagement. And so now that it's -- we're kind of through the beta test. We've been in market 75 days. It's mostly our repeat customers. So we're going to walk carefully into other customers that we don't know, but we're excited about just the customers that we know being able to access a host of different products that we might not have been able to offer them before.

Hal Goetsch
Loop Capital Markets LLC, Research Division

Is it done over like a traditional network rails with a virtual card issued by a vendor like Marqeta or something? Is it a Visa-branded card with some stored amount set to a certain SIC code for the kind of product that is leasable? Tell us a little bit about those details, those kinds of things.

Derek Medlin
Chief Operating Officer

Great question. So it is similar. So what we're really trying to solve for were 2 things was that, one, we wanted to make it really easy for a consumer to shop in our marketplace to be able to access great merchants and great quality items. And what we were finding is that our conversion rate could improve if we could lead a customer through that processes and give them all the tools to understand that, how the lease would work and how to have a transparent flow without having to leave our site and go somewhere else.

And so that was 1 of the things that we were able to solve for by having a virtual card. But yes, what it enabled us to do is to display the properties of the lease, the terms of the lease, all of the pricing options clearly to the consumer. They can understand that, shop and check out. And the final step to checkout is to use a Visa or Mastercard branded card and complete that transaction seamlessly in the checkout just like they would with any other payment transaction.

We've got excellent both AI controls as well as traditional controls like you're mentioning to limit and reduce the fraud exposure there. And so just make it a seamless experience for the consumer. And so we still believe that a directly integrated account is a great one. That's the best consumer experience because it's extremely smooth and frictionless. This follows very closely after that and allows the customer to have a highly engaged and a repeat transaction very quickly.

Orlando J. Zayas
CEO, President & Director

And I think Derek is being a little humble in talking about our technology. Because if you think about the retailers that we have, there are a lot of things at Best Buy that you can't lease if we follow regulations, which we do. And that was part of the build was making sure that it's items that people can lease and that we can obviously avoid fraud and make the transaction seamlessly. I remember Derek called me and he said, "Wow, I just went through the process." He goes, it's really smooth, and it is.

And so we're pretty excited about it. And obviously, our customers are using it now without even telling him. So we believe that we've got a great opportunity here.

Operator

Your final question comes from the line of Anthony Chukumba from Loop Capital Markets.

Anthony Chinonye Chukumba
Loop Capital Markets LLC, Research Division

Just a few quick ones. I guess my first one, you mentioned with the mobile app, you said there's 30% customer adoption. Like can you just sort of give some context on that. I didn't understand exactly what you meant by 30% customer adoption. Like 30% of what essentially?

Derek Medlin
Chief Operating Officer

So Anthony, we -- thanks for the question. This is Derek again. So since we launched the mobile app this summer, we just made it available in that, in the stores, in the mobile marketplaces and stores. And you just started adding the tag to a couple of our communications, but no big massive campaign. And what we saw very quickly were a couple of data points are really interesting. So about 30% of our active customer base has already downloaded the application and is using it monthly. So that number is larger, if you would go beyond just an initial download, but this is active use.

And we've seen that continue to grow month over month. And then 1 of the other data points that's really interesting is that we're looking at how they're interacting with the app. And what we've seen is a significant shift in payment behavior away from just a traditional call in or log in to the customer portal to pay, but they're paying through the app. And we just believe that, our customer base, we knew that they were mobile first. We knew the types of devices and how they are engaging with us. And the mobile app has just enhanced that and we're seeing regular and recurring engagement and interaction with our brand and with our sites. And all that was basically no marketing effort to date, so we're excited about what that means in the future in terms of our way to stay even more connected to our customer base.

Anthony Chinonye Chukumba
Loop Capital Markets LLC, Research Division

Got it. Okay. No, that's helpful. Second thing, in terms of Sears, I think Orlando mentioned that they were franchise stores. So I guess, my question then becomes like, does each franchise store have to add your lease-to-own solution like is it going to be rolled out across all stores or just each store gets to -- each franchisee gets to decide whether they want to integrate it or not?

Orlando J. Zayas
CEO, President & Director

No. It is fully rolled out. When we get the integration complete, all the stores will have access to it. Now it's going to be up to us to visit the stores and get them familiar, encourage them to use it. But in my experience, these stores are highly engaged. And we got on a phone call recently with the head of the Hometown Stores. She was incredibly excited about it, because they had a program before. They were good users. And so I think adoption is going to be easy, but no, we don't have to have each store sign up.

Anthony Chinonye Chukumba
Loop Capital Markets LLC, Research Division

Got it. Okay. And then just one last question. Any color on your Wayfair business? Obviously, they're having their challenges.

Orlando J. Zayas
CEO, President & Director

They're still a great partner. We -- I was just up in Boston a couple of weeks ago. They love our partnership. Yes, they're having their challenges, apps are down. Obviously, we've tightened up as everybody else has, and they want more business. So we've had some good discussions and good plans, set up some plans around how we're going to market the program to their customers, how are we going to underwrite the customers better. We're really focused heavily on the partnership. Obviously, we want to continue it, but they're extremely happy with our partnership.

So we have to go along with them, ups and downs, but I know they're working really hard to drive volume. They just had a Way Day a couple of weeks ago. They're looking forward to the holiday season, and we're trying to help drive that business as well.

Operator

Thank you, ladies and gentlemen. This does conclude today's call. Thank you for your participation. You may now disconnect.