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AudioEye, Inc.

Third Quarter 2023 Earnings Conference Call

November 2, 2023

CORPORATE PARTICIPANTS

David Moradi, *Chief Executive Officer*

Kelly Georgevich, *Chief Financial Officer*

CONFERENCE CALL PARTICIPANTS

George Sutton, *Craig-Hallum Capital Group*

Zach Cummins, *B. Riley Securities*

Scott Buck, *H.C. Wainwright*

PRESENTATION

Operator

Good afternoon, and welcome to AudioEye's Third Quarter 2023 Earnings Conference Call.

Joining us for today's call are AudioEye's CEO, Mr. David Moradi, and CFO, Ms. Kelly Georgevich.

Following their remarks, we will open the call for questions from the Company's publishing analysts.

I would like to remind everyone that this call will be recorded and made available for replay via a link available in the Investor Relations section of the Company's website at www.audioeye.com.

Before I turn the call over to AudioEye's Chief Executive Officer, the Company would like to remind all participants that statements made by AudioEye Management during the course of this conference call that are not historical facts are considered to be forward-looking statements. The Private Securities Litigation Reform Act of 1995 provides a Safe Harbor for such forward-looking statements. The words believe, expect, anticipate, estimate, confident, will, and other similar statements of expectation, identify forward-looking statements. These statements are predictions, projections, or other statements about future events and are based on current expectations and assumptions that are subject to risks and uncertainties. Actual results could materially differ because of factors discussed in today's press release, in the comments made during this conference call, and in the Risk Factor section of the Company's annual report on Form 10-K, its quarterly reports on Form 10-Q and its other reports and filings with the Securities and Exchange Commission. Participants on this call are cautioned not to place undue reliance on these forward-looking statements which reflect Management's beliefs only as of the date hereof. AudioEye does not undertake any duty to update or correct any forward-looking statements.

Further Management's remarks today will include certain non-GAAP financial measures, a reconciliation of the most directly comparable GAAP financial measures to these non-GAAP financial measures is available in the Company's earnings release posted in the Investor Relations section of its website at www.audioeye.com.

Now, I'd like to turn the call over to AudioEye's Chief Executive Officer, Mr. David Moradi. Sir, please proceed.

David Moradi

Thank you, Operator. Welcome, everyone, and thank you for joining us.

We've been hard at work and are pleased to deliver several exciting announcements. First, record annual recurring revenue or ARR of $30.5 million. An increase of approximately $800,000 sequentially representing the largest sequential growth in six quarters. Second, revenue of $7.84 million representing the 31st sequential quarter of record revenue. Record reported non-GAAP profitability of $300,000 in the third quarter ahead of expectations of $100,000. Lastly, we remain on track, deliver positive free cash flow in the fourth quarter. Kelly will discuss the financial performance in more detail shortly.

During the quarter, we released the Industries First Digital Accessibility Index report. The results confirmed that traditional consulting approaches to solving web accessibility have failed and that most of the internet remains inaccessible to those with disabilities. As part of this study, AudioEye conducted an automated scan of over two million pages across 40,000 websites from companies with over $100 million in annual revenue.

More than three billion site specific elements for testing, including images, links, and headers. Following the scan, accessibility experts, including members of the disability community, audited the top sites in each industry revealing which issues are most disruptive to users. Of the three billion website elements tested, the findings concluded every page had at least one accessibility error and the average page had 37 items that failed one of the success criteria of WCAG.

Our study found that the most frequent barriers were related to image accessibility, descriptive links, and keyboard accessibility, which significantly impact people with a disability in the world trying to utilize the internet. The barriers found were significant preventing people with disabilities from accomplishing critical tasks that many of us regularly depend on, such as online shopping, banking, news access, and job related activities. AudioEye has the best product in the market to solve digital accessibility at scale, utilizing a unique combination of AI coupled with a scalable approach to leverage human assisted technology to catch errors that technology alone cannot detect.

Recently, we also shared findings from an analysis of over 900 legal claims from over 100 lawsuits and demand letters. The data is compelling. Customers using AudioEye managed plan are 67% less likely to receive a lawsuit with a valid WCAG issue compared to competitors offering the highest rates of protection against legal claims in the industry. In addition, while digital accessibility lawsuits increased year-over-year, lawsuits against AudioEye customers are decreasing. In the first half of 2023, lawsuits against AudioEye customers decreased by over 33% compared to the first half of '22, despite an increase in industry-wide lawsuit.

Moving on to guidance. We are guiding revenue between $7.9 million and $8 million for the fourth quarter of 2023. Fourth quarter we'll see the final sequential impacts of one-time revenue from the BOIA integration. We expect to generate a sequential increase in non-GAAP profitability in the fourth quarter and remain on track to deliver free cash flow in the quarter.

I'll now turn the call over to AudioEye CFO, Kelly.

Kelly Georgevich

Thank you, David.

Q3 2023 marks the 31st straight quarter of record revenue with $7.84 million, which represents 2% growth over the comparable period of prior year. Annual recurring revenue or ARR at the end of the third quarter of 2023 was $30.5 million, an $800,000 increase from ARR at the end of the second quarter of 2023 and represents an ARR annualized growth rate of 10.8%. We're pleased to see ARR grow at its highest rate in a year and a half.

Our two revenue channels are continuing to deliver solid performance. The partner and marketplace channel includes all revenue from our SMB focused marketplace products and revenue from a variety of partners who deploy these same products for their SMB customers. In the third quarter of 2023, this revenue channel grew 14% year-over-year and represented approximately 59% of revenue and 61% of ARR. Q3 2023 was the highest growth in ARR for the partner and marketplace channel since Q4 of 2020 with growth coming from a variety of sources within this channel. We expect this momentum to continue in the next quarter.

Our enterprise revenue channel, which typically consists of our larger customers and organizations, made up 41% of revenue and 39% of ARR in the third quarter of 2023. As mentioned previously, this channel faced additional headwinds in the first half of 2023 with one large customer contract renegotiation having an impact on total enterprise revenue, which we expect to normalize in the first half of 2024.

We have seen early success in the integration of COIA and selling existing customers in expanded suite of services, so as expected, the conversion of one-time AudioEye revenue to reoccurring services did have an approximately $200,000 impact to Q3, 2023 revenue. Our Q4 revenue guidance incorporates a lesser impact to complete this process.

The total customer count increased notably in Q3 2023 to approximately 107,000 customers from approximately 81,000 customers on September 30, 2022, and 104,000 customers on June 30, 2023. Increasing the customer count was a result of customer additions and our partnering marketplace channel.

Gross profit for the third quarter was $6.1 million or about 77% of revenue compared to $5.8 million and 75% of revenue in Q3 of last year. We continue to gain efficiency in the delivering of our products and services, which has resulted in lower cost of revenue while revenues increase.

While revenues were relatively consistent with the comparable period of prior year with 2% growth, operating expenses decreased approximately 8% or $600,000 to $7.4 million. This decrease was a result of continued efficiencies in sales and marketing and G&A offset by continued investments in R&D. Our total
R&D spend in Q3 of 2023 was approximately $2.4 million with approximately $500,000 reflected as software development costs and an investing section of the cash flow statement. The total R&D spend is about 31% of our revenue this quarter versus 33% essentially. We have invested notably in R&D over the last 12 months, improving our software and adding new product. We expect R&D investment as a percent of revenue to continue coming down over the next few quarters.

Net loss in the third quarter of 2023 was $1.1 million or $0.11 per share compared to $2.3 million or $0.20 per share in the same year ago period. Total net loss decreased 41% or $900,000 from the comparable period of prior year, thanks to an increase in gross profit as well as strategic and efficient spending in all departments.

On a non-GAAP basis, our Q3 net profit was $300,000 or $0.02 per share compared to a net profit of $100,000 or $0.01 per share in the same year ago period. The primary adjustments for GAAP earnings and EPS for Q3 2023 were non-cash share based compensation, depreciation and amortization and other non-reoccurring items.

Cash decreased by $1 million in a quarter, which was the result of cash outlay for tax payments from employee share based grants of approximately $100,000, non-GAAP obligation expenses of approximately $100,000, software capitalization of $500,000, and $300,000 of net cash used from other operating activities. As David mentioned, we expect to generate free cash flow and (inaudible) cash in the fourth quarter.

With that, we open up the call for questions. Operator, please give instructions.

Operator

Thank you. (Operator Instructions)

Our first question will come from George Sutton with Craig-Hallum. Please proceed.

George Sutton

Thank you. David, I wondered if you could work for a second with us on the DOJ proposed rule. The comment period ended last month, meaning we should get a final rule in the relative near term. I assume like us, you were actively reading the comments and have a bit of perspective, so I'm just curious what your perspective would be relative to the final rule. Then separate from that, how are you thinking of positioning the business to benefit from that ultimate rule?

David Moradi

Yes, as you said it's a good question. There's a 60 day comment period. We're really excited about this for Title 2. Hopefully we hear something soon and we're ramping up looking at this for the government sector as well in terms of what we're going to do on sales and marketing initiatives, but we think we're going to have some time. Demand probably picks up on this after the rule comes out in one to two years.

George Sutton

Separate from that, you've talked about building out your sales team over the last couple of quarters. Can you just give us an update on the go to market plans and how that feeds into your expectations for 2024?

David Moradi

You're talking about the enterprise sales team, right?

George Sutton

Correct.

David Moradi

Yes. We expect this process to ramp up over the next few months. We just hired these folks back in July, August, so they take about six months to ramp, but we're seeing really good progress so far, and pipeline's also building, so it gives us a lot of confidence. We're going to see good growth into 2024.

George Sutton

I understand you're not giving guidance yet on '24, but good growth in 2024, any perspective on what that might look like?

David Moradi

More than ‘23.

George Sutton

Okay. Thank you.

David Moradi

From ‘23 to ‘22.

Operator

Our next question comes from Zach Cummins with B. Riley, FBR. Please proceed.

Zach Cummins

Hi, David. Hi, Kelly. Thanks for taking my questions and congrats on the sequential increase in the ARR and strong profitability in this quarter.

David, just starting off, can you talk a little bit more about the current environment just speaking more so to the selling environment on both the partner and marketplace side, and obviously enterprise will take a little more time to ramp up in accordance with your sales team, but just curious on your perspective of the overall environment and what's driving your competence and continued ARR growth?

David Moradi

Yes, the macro environment's a bit tough out there. You're seeing some tightness on enterprise budget. People are looking to cut costs, but we are seeing good pipeline growth because of our products and positioning. But there are definitely budget and cost pressures. I'm sure you're seeing that as well out there in enterprise task.

Zach Cummins

Got it. In terms of the timeline to positive free cash flow, good to see that reaffirmed here in Q4. I'm just curious how you're thinking about the necessary capital to continue to execute upon growth plans moving forward. Say demand really starts to pick up or you execute on the enterprise side, just how are you thinking about available or necessary capital you need to run the business?

Kelly Georgevich

Yes, I can take that Zach. We do continue to believe that we have sufficient cash on hand to fund ongoing operations. We do expect revenue with the momentum on the partnership side and expansion on the enterprise side to grow and a lot of that to drop to the bottom line. We feel good about our cash position and where we stand, especially with the generation expected in Q4 and beyond.

Zach Cummins

Understood. Final question for me is, you are now going to have multiple quarters in a row of improving profitability. What's the approach to investing in growth versus continuing to expand margins here in the foreseeable future?

David Moradi

Yes, it's a good question. We look at things holistically on the business, decide if we should invest more into sales and marketing with LTV to cap ratios or more into R&D, but we think that's coming down, or we buy back stock with cash generation, that's a possibility.

Zach Cummins

Got it. Well, thanks for taking my questions and best of luck when in Q4.

David Moradi

Thanks so much.

Operator

Our next question comes from Scott Buck with H.C. Wainwright. Please proceed.

Scott Buck

Hi, good afternoon guys. Thanks for taking my questions. Just a couple from me. The first one on gross margin. So, nice year-over-year expansion, but it looks like we've stalled out here the past couple of quarters. Are we at the ceiling here for gross margin, or do you think you have a little bit more room to push higher?

Kelly Georgevich

We are happy to see gross margin grow year-over-year. I think we have proven we can find efficiencies in cost revenue. We did that over the last year. As we continue to grow revenue, we expect to continue to see efficiencies and we do think there's the ability to continue to grow gross margins going forward.

Scott Buck

Great. I appreciate that, Kelly. Second one from me. You talked about R&D expense coming down a bit over the next few quarters. Is that due to cash constraints, or is that more intentional just in terms of what you need to move the business forward?

David Moradi

Yes, we've invested a lot in R&D over the past year really improving software and new products are out there, so we expect R&D is in a good place and investment should come down as a percentage of revenue over the next few quarters, more in line with industry metrics, which would be around 25% in SaaS.

Scott Buck

I'm sorry, you said you were at 31% in the quarter, is that correct?

David Moradi

Correct.

Scott Buck

All right. I appreciate that, David. That's it for me guys. Thanks a lot.

David Moradi

Thank you.

Operator

At this time, this concludes our question-and-answer session. I'd now like to turn the call back over to Mr. Moradi for his closing remarks.

David Moradi

Thank you for joining us today. As always, I want to thank our employees, partners, and investors for their continued support. We look forward to updating you on our next call.

Operator

Thank you for joining us today for AudioEye's third quarter 2023 earnings conference call. As always, we would like to thank our employees and stakeholders for your continued hard work and dedication. You may now disconnect.