Fluent, Inc.
First Quarter 2021 Earnings Conference Call

Operator

Good afternoon, and welcome to the Fluent, Inc. First Quarter Earnings Conference Call.

I would like now to turn the conference over to Ryan McCarthy. Please go ahead.

Ryan McCarthy

Good afternoon, and welcome. Thank you for joining us to discuss our First Quarter 2021 Earnings Results.

Joining me on today's call are Fluent's CEO, Ryan Schulke, and CFO, Alex Mandel. Our call will begin with comments from Ryan Schulke and Alex Mandel, followed by a question-and-answer session.

I would like to remind you that this call is being webcast live and recorded. A replay of the event will be available following the call on our website. To access the webcast, please visit our Investor Relations page on our website, www.fluentco.com.

Before we begin, I would like to advise listeners that certain information discussed by Management during this conference call will contain forward-looking statements covered under the Safe Harbor provisions of the Private Securities Litigation Reform Act of 1995. Any forward-looking statements made during this call speak only as of the date hereof. Actual results could differ materially from those stated or implied by our forward-looking statements due to risks and uncertainties associated with the Company's business.

These statements may be identified by words such as expects, plans, projects, could, will, may, anticipates, believes, should, intends, estimates, and other words of similar meaning. The Company undertakes no obligation to update the information provided on this call. For a discussion of the risks and uncertainties associated with Fluent's business, we encourage you to review the Company's filings with the Securities and Exchange Commission, including the Company's most recent annual report on Form 10-K, and quarterly reports on Form 10-Q.

During the call, we will also present certain non-GAAP financial information relating to media margin, Adjusted EBITDA, and adjusted net income. Management evaluates the financial performance of our business on a variety of indicators, including media margin, Adjusted EBITDA, and adjusted net income. The definitions of these metrics and reconciliations to the most directly comparable GAAP financial measure are provided in the earnings press release issued earlier today.

With that, I'm pleased to introduce Fluent's CEO, Ryan Schulke

Ryan Schulke

Thanks, Ryan, and good afternoon. Thanks to everyone for joining us today.

As I shared with you on our last call in mid-March, Fluent operates in a dynamic and rapidly evolving marketplace, and we see a clear long-term strategic opportunity in further responding to the demand for higher quality digital experiences for consumers and more effective and sustainable solutions for marketers.

In turn, we're motivated and energized as we thoughtfully accelerate the strategic transition of our business with quality as a foundational principle. Through this process, we're committed to enhancing our media properties and consumer experience against an industry backdrop that is experiencing rapid change in many ways, including through a regulatory lens. We see the end game as delivering a fundamentally higher quality experience for consumers, which will enhance Fluent's brand equity with our clients, and build enterprise value for our stakeholders.

I previously contextualized this transition relative to our three strategic growth pillars. The significant progress we've made on-boarding and scaling larger and more sophisticated clients on our performance marketplace and increasing the monetization on our platform has motivated us to further redefine our media footprint in the form of our Traffic Quality Initiative. We see higher quality as the road to sustainable long-term growth and believe it will position us as an industry leader, even though in the near term we're knowingly foregoing some revenue opportunities.

In our earnings release today, our numbers for Q1 reflect revenue being down 11% year-over-year, media margin up 4% year-over-year, and Adjusted EBITDA representing 7% of revenue. All of these metrics are consistent with the ranges we indicated on our last call.

To further elaborate on our Traffic Quality Initiative, we're shifting from a higher volume approach to a quality-based approach, which we believe will accomplish several important objectives. These objectives start with improving consumer satisfaction with Fluent's promotional programs, thereby improving conversion rates and ROI for our advertiser clients, thereby driving increased pricing for Fluent's products, and ultimately enabling us to reinvest that incremental monetization into further improvements in our media sourcing. This represents the spinning of our flywheel.

Putting some time context around this initiative, in the latter part of 2020, and in Q1 of this year, we cut back more significantly on traffic sources that did not meet our quality requirements, which sits at the crux of the reduction of our revenue in Q1. While we actively monitor traffic on an ongoing basis, we believe the steepest of cuts needed at this time are behind us. That said, given the traffic adjustments to date and the time needed to develop partnerships with those who are as committed to quality as we are, while concurrently on-boarding and optimizing new supply, we do anticipate revenue in Q2 to be down year-over-year. While it's still early to call, we're currently anticipating revenue in Q2 trending similar to what we called for Q1, down 11% to 13% year-over-year. I shared on our last call that we anticipate the strategic transition will take a couple of quarters to reestablish prior trending levels, and we continue to maintain that outlook.

The natural cadence of these traffic initiatives, which are a known phenomenon in our industry, is to now net rebuild to our supply base through both expanding existing partnerships and activating new partnerships, channels, and strategies.

To drive our rebuild on this partnership front, we're leaning in with existing and new media partners who are aligned with our focus on quality and share our vision for building sustainable and profitable businesses together. We're working to forge deeper, more strategic sourcing relationships, where we can innovate, develop bespoke campaign and invest our time and energy in redefining our media footprint with confidence there will be an exciting return profile on our efforts.

On the media front, we're seeing compelling opportunities in areas we've long played in, as well as new channels and strategies that this initiative has prompted us to vet. Although it's early innings, we see green shoots in our rebuild base.

To demonstrate how important the strategic imperative is for Fluent, I'm personally leading our quality initiative along with two key cofounding executives, Matthew Koncz, President of our Performance Media Group, and Sean Cullen, our Executive Vice President of Product. We've been energized by our experience to date, as we can clearly see that redefining our media supply will open up significant strategic product opportunities that can further expand and deepen our addressable consumer audiences, and overall market opportunity.

Regarding our second growth pillar, our platform, I mentioned on the last call that monetization has increased significantly in 2020, approximately doubling from Q1 to Q4, and we saw that as a sustainable win. Monetization remained strong in Q1 of 2021 and continues to remain strong in Q2. This implies that as we build back our traffic supply, even smaller volume wins can have a more meaningful financial benefit than they would have a year ago.

Another aspect of our platform I've spoken to is the expansion of our CRM efforts, through which we have extended our relationship with consumers beyond their initial experience on our media properties and enhance their lifetime value. A key initiative on this front has been our investment in the Winopoly business, which is uniquely situated to provide telephony activations for Fluent's clients through a live agent capability. We're seeing that business perform ahead of plan, and grow strategic partnerships with clients in high value verticals, including senior care, financial services, and home services.

Regarding our third pillar, our performance marketplace, we continue to see world-class brands leaning in with strong demand that will exceeds our available supply. This strength further supports our efforts to redefine our media footprint. Fluent provides an innovative, high-value solution that addresses a massive market opportunity. The quality of our client base and demand from them validates this seven days a week.

I'd like to restate that we're enthusiastic about our strategic course, and it remains our core tenet behind the current transition we're working through. Fundamentally, we're confident that the higher quality model we are forging is the right path to achieving substantial and sustainable growth, while generating a revenue and earnings profile that will be more highly valued by the market.

Our experience through this transition thus far confirms our confidence in the mission. Fluent remains diligent in enhancing our brand equity, improving our own standards for the benefit of our clients and consumers, as well as our shareholders.

With that, I'll turn things to Alex for the detailed financial review.

Alexander Mandel

Thanks, Ryan, and good afternoon.

As Ryan spoke to, our team, led personally by Fluent's founding executives, has been leaning in to drive the strategic transition of our business through our Traffic Quality Initiative. In that context, the outlook we've previously shared for Q1 reflected a known and purposeful investment into redefining our media footprint. In the quarter, the Company generated $70.2 million of revenue, down 11% year-over-year, which is on the favorable end of the outlook we have provided.

We've mentioned the improvement in monetization on our platform during 2020 and the continuation of that benefit in 2021. Our media margin in Q1 of $24.9 million representing 35% of revenue, was up 4% year-over-year, ahead of the outlook we had provided. In addition to strong monetization, media margin was supported by continued progress on our programmatic data offering, and our CRM strategies, which target increased lifetime value of consumer relationships.

We noted that in the second half of 2020, as we tested various enhancements to the design of our rewards programs, we incurred higher costs of fulfilling rewards earned by consumers. Fulfillment cost is not reflected in media margin but is captured in our GAAP cost of revenue. Fulfillment costs moderated in Q1, although the increased media efficiency, which benefited our media margin, was outweighed by the incremental fulfillment cost, such that our cost of revenue as a percent of revenue increased to 72.7% in Q1, as compared to 71.7% in last year's Q1. Q2 fulfillment expense is likely to represent a further sequential reduction, which would benefit cost of revenue and Adjusted EBITDA.

Our operating expenses on a GAAP basis for Q1, comprising sales and marketing, product development and G&A, grew in aggregate by $1.5 million or 9% year-over-year to $19.3 million. However, G&A includes $1.7 million of non-cash accrued compensation for put/call expense relating to the Winopoly acquisition, which was fully incremental on a year-over-year basis to G&A costs. Excluding this item, overall operating expenses were relatively flat year-over-year.

Last week, Fluent executed a Settlement Agreement with the New York Attorney General, putting finality around this matter, which has been disclosed in our SEC filings beginning with the 2019 10-K. Fluent will satisfy payment of the $3.7 million settlement amount this month, which had previously been fully accrued for as of December 31, and therefore has no current or future P&L impact.

Adjusted EBITDA of $4.7 million in the quarter represented nearly 7% of revenue, relatively consistent with the outlook previously provided.

We closed on our new $65 million credit facility on March 31, so it is reflected on our balance sheet, but not meaningful to our P&L in the quarter. The facility consists of a $50 million term loan drawn at close, with a $15 million unfunded revolver. This new financing reduces our current effective interest rate by 500 basis points, and we therefore anticipate a significant reduction in interest expense in Q2 and going forward. The facility also provides meaningful financial flexibility for Fluent, and extends the maturity of our debt to 2026.

In connection with the transaction, we recorded a loss on early extinguishment of debt of $3 million on our P&L of which $2.2 million is a non-cash write-off of capitalized discount and financing costs from our prior term loan.

In Q1, we continued to be a non-cash federal taxpayer due to the availability of NOLs.

We reported GAAP net loss of $6.3 million in the quarter, and adjusted net income, a non-GAAP measure, of $351,000. Our non-GAAP metrics are reconciled in today's earnings release in our 10-Q and 10-K filings.

Turning to the balance sheet. We ended the quarter with $34.1 million of cash and restricted cash. Working capital, defined as current assets minus current liabilities, ended the quarter at $45.8 million, up $13.1 million year-over-year and $9.9 million sequentially.

Total gross debt at March 31 of $51.25 million included the $50 million funded term loan and remaining $1.25 million note payable in connection with the 2019 AdParlor Acquisition, which will be funded on July 1.

As we continue on our journey to strategically enhance the value of our customer acquisition solutions for our clients, and build value for our stakeholders, we appreciate your support. The strategic course we are charting has, as its core premise, the belief at a higher quality model will enable substantial and sustainable growth. While near term financial results will reflect this transition and investment, we are motivated by the opportunity to enhance Fluent's value proposition and brand equity and generate a revenue and earnings profile that will be more highly valued by the market.

We're glad to field questions at this time.

Operator

Our first question will come from Michael Graham of Canaccord. Please go ahead.

Michael Graham

Yes, thanks so much. Appreciate you guys taking the question and I think it's impressive and a good reflection that you're able to grow your media margin even when revenue is coming down from the Traffic Quality Initiative. I had just a couple of questions to maybe dive a little deeper into that initiative. One is, can you just maybe put any color around—I know you said you think that the peak of the traffic cuts is behind you. Can you put any color around how much longer you think you need to work through the initiatives? I also just wonder if you might be able to characterize a little bit for us how much traffic has come down from peak levels, and where you think that process bottoms out?

Ryan Schulke

Yes, nice to connect with you, Michael, and appreciate the question on the Traffic Quality Initiative. Really, as we've been talking about it, and per the last earning call, we did say we'd probably take a couple of quarters to get back to a prior trend level. We are anticipating a stronger back half as we really start to strategically partner with both existing partners that are adhering to our traffic quality and compliance standards, as well as new partners that we're on-boarding. There is a bit of an investment period in the sense of going out and establishing new relationships and testing into new types of channels and strategies. But we're seeing nice progress on that front and something that we do anticipate will take more shape—greater shape in the back half of the year.

With respect to overall traffic volume, there's a couple of different ways to look at it. One of the things we highlight is that, from Q1 of 2020 to Q4, we almost doubled the yield per visitor that we make, users that we drive to our properties. If you think about the 11% figure in terms of revenue, traffic actually went down quite a bit more than even that 11% number, but we're making a lot of it back due to higher quality experiences and advertisers beginning to pay up for that. It does take some time for advertisers to recognize some of the quality that they're seeing and to pay up for it. But those are active conversations we're having, and we are seeing a material amount of movement with respect to clients "bidding up" for our performance inventory.

Michael Graham

Thanks for that, Ryan. Just to clarify, I know you, even with revenue down 11%, you had nicely positive EBITDA in the quarter. Are you anticipating that condition persisting here as we go through the remaining quarters of the initiative?

Ryan Schulke

I would say that we're willing to sacrifice some media margin dollars to really get strategic footing in the right places that are going to sustain over time and have a lot of scale behind it. We will take a bit more of an aggressive attitude toward securing inventory and doing what we have to do, even at the expense of media margin, if that is to come, though we will maintain a fairly disciplined approach to overall operating expenses below that media margin line to ensure that there's continuity with respect to the amount of revenue flowing through to EBITDA.

Michael Graham

Okay, great. Thanks so much. Appreciate it, Ryan.

Ryan Schulke

Thank you.

Operator

The next question comes from Jim Goss of Barrington Research Associates. Please go ahead.

Jim Goss

Thanks. Ryan, could you talk a little about what has been cut to this point, and are other areas still on the block, and maybe what the new business mix looks like in the aftermath of the Traffic Quality Initiative?

Ryan Schulke

Yes, nice to hear from you, Jim. I would say that it falls into two buckets. One being publishers, supply side partners we were working with that, either the type of content we were being featured within, or the way they would run ad creative or their lack of controls around ad creative, was a big part of the conversation, so partners just not willing to adhere to certain guidelines that we outlaid.

Then second, maybe more importantly, any concerns that we had around consumer data, consumer privacy and things like that, partners who were not adhering to what—where we really believe the market is going with respect to consumer privacy and data policies in general. Those were the sharpest cuts, I would say. There is nothing I'm aware of that we haven't cut, and we're eager to be forging a path forward with the partners that are still with us, as well as the new ones we've been on-boarding quite actively over the last few months.

Jim Goss

It didn't involve the verticals you're serving, the media or home services, as you mentioned, or those sort of things, but rather involved which avenues you're using to promote the services you're choosing to promote?

Ryan Schulke

Right. It represented publishers, even specific channels and ways to go out, get our ads in front of the general public to drive traffic to our property. There's not a specific vertical to point to that would have been impacted more than another, for instance, at our core.

Jim Goss

Okay, can you talk about whether there are any global implications as you've been able—begun to move into certain of the European markets in particular? Is it more domestic than that area?

Ryan Schulke

We're doing a solid job in English speaking, that certainly is something that we've focused on, and will be a continued focus for scale, the English speaking markets. The EU is something that we haven't talked about in quite a bit though we are re-examining how we may approach especially the Western European market and potentially things beyond that such as APAC. I don't have anything to announce at this point. However, we are continuing to perform very strong in new English speaking markets. We do need to rejigger some thinking around how to better enter the Western European markets.

Jim Goss

Okay. Maybe lastly, I think you made a comment about the better half—second half looking a little bit better, so are you thinking the entire initiative will only take a couple of quarters to run its course, which was the optimistic, I think, of what you said several months ago?

Ryan Schulke

Yes, we do believe that we have good momentum, especially as we get toward Q3, Q4, we believe that a lot of this is behind us. The Company has been designed and the culture is extremely agile. Our client demand is extremely strong right now. As we lean into these higher quality suppliers and channels and different strategies on the product end that we're deploying to go out and engage consumers, these conversations are happening more rapidly with our partners around quality, the ability to pay at higher rates for some of these new traffic sources that we're onboarding, and we anticipate that we'll be able to scale. Nothing has changed materially in terms of our product outputs and our clients demand for our products is really—was, if you think about it, a couple of steps backwards to be able to make many, many steps forward over the long-term, and that's really what we're—how we're thinking about this, and we believe that the back half will be stronger than the first half.

Jim Goss

All right. Thanks very much. Appreciate it.

Ryan Schulke

Thanks, Jim.

Operator

The next question comes from Bill Dezellem of Tieton Capital Management. Please go ahead.

Bill Dezellem

Thank you. I'd like to start with the contact center exceeding your expectations. Would you please discuss that and if it in any way ties in with the Traffic Quality Initiative?

Ryan Schulke

Yes, Bill, good to hear from you, and we certainly are excited about that transaction, Winopoly, in terms of where things have gone. Fluent had historically been excellent at web-based execution. If you think about the business in terms of how a consumer looks at the products and services that we're promoting on behalf of our advertising clients, really, we're really strong, as we've always said, in media and entertainment, so streaming services, gaming, things like that; also a lot of direct-to-consumer commerce and subscription commerce where it is a lower cost consideration for the consumer and therefore we're driving those trials that are converting into paid trials. Our advertising clients can see it, in near real-time, and therefore, there's a ton of demand there.

Pre-having the live agent capability, in some of the more complex verticals, things like financial services, home services, other types of professional services like legal or senior care products, we really weren't able to take consumers as far down that funnel without the live agent capability. These are more complex decisions. Consumers are looking for more information, so that capability enabled us to start partnering and going further down the funnel with major players in these verticals, and work with them to even an end sale or some sort of appointment set, whereas before we had the live agent capability, we'd probably be working with them at some sort of qualified lead that we would drive or something like that, which results in more cap based budgets.

Also, with the CRM hooked in and now we're able to see a consumer and which consumers are actually traveling that journey, they're qualified, they're motivated to purchase, whether it's a home security system or whatever the product or service may be that we're offering to them, we actually have real time data flowing into us. We know which consumers are actually converting on these types of higher value offers and products and services, so it's really been a boost from our standpoint in terms of the commercial outputs.

Bill Dezellem

That's helpful. What do you think is driving that Winopoly business exceeding your expectations?

Ryan Schulke

I think it's been a combination of being able to just go further down the funnel and see down the funnel. Whereas, at a prior stage, really, once we would drive a click out of one of our media properties to our customer, the best we were seeing was that a lead was being generated. We didn't actually know who was converting on these offers. If you look at the core of our business where we're driving uncapped demand, as I described, in streaming services, subscription commerce and things like that, we're getting all of that in real time. It's really, a lot of it's about being able to ingest the data and make the optimizations needed, the CRM hooked in, and we do have really strong operators on top of that business that we brought in through that JV. All of those things coming together are really playing strongly for us.

Bill Dezellem

Thanks, Ryan. That's really helpful. Then I too will jump to the Traffic Quality Initiative. As I think about this, we really should be looking at it on a week to week, sequential week basis, it sounds like, and assuming that that characterization is accurate, have volumes bottomed now?

Ryan Schulke

Yes, you can never say anything with 100% certainty, but from our point of view, we've worked through the Traffic Quality Initiative. Anything that we were looking to move away from, we've really completed that. We're looking at rebuilding better, as they would say. I can't make an official call; however, I can say we have gone through things on our side and feel good about the types of traffic we are sourcing and the future partnerships where we're establishing at the moment.

Bill Dezellem

That's helpful. I know it's a little bit hard to pinpoint a specific time, but I'm going to ask it anyhow, what week or weeks was the bottom reached when you cleared out all of the traffic you wanted to move away from?

Ryan Schulke

Yes, I'd say this type of initiative does have a life of its own, and it's, as you mentioned, very real time, but I would say as late as the last week or two, we were, upon review, satisfied with where we were at. Not to say something couldn't pop up, but we've been fairly robust, I believe, in terms of how we've gone about this. Will we get some potential false positives where we think a new source is doing great but there's some things that we need to address from a consumer satisfaction standpoint, consumer experience? Potentially, but we really do believe we're working on a lot of the right things right now and beginning to establish some momentum behind it.

Bill Dezellem

That's really helpful. Given that you've given the—provided the same guidance, the 11% to 13% decline in revenues, that implies that you went through the first quarter in a bit of a week to week downtrend, but you're going to be coming out of the second quarter in that week to week uptrend, and so we're looking now at the light at the end of the tunnel.

Ryan Schulke

Correct, yes, that's an accurate summation.

Bill Dezellem

Great. Thank you. If you'll allow me, I'm going to ask one more question on this. Are there examples of other companies who have done similar Traffic Quality Initiatives, and if there are, would you talk about their longer-term outcome and what that ultimately meant for their business?

Ryan Schulke

Yes, and I've played less directly with some of the companies that have gone through these types of initiatives, but it is something that happens in our space. I know that Alex, being the former CFO of LendingTree, is aware of a couple of his former competitors who went through initiatives like these, and I'd love for him to maybe share a little bit more detail here.

Alexander Mandel

Sure. Hi, Bill, and good to speak with you again. There are companies in our space who have gone through these types of initiatives, you're correct. Some historical examples, going back to 2012, would include companies like BankRate as they worked through lead quality initiatives in respect of a specific client vertical, which related to insurance. QuinStreet also had a similar experience and also addressed that with education leads. Then another company, EverQuote, improved its traffic quality in 2018. We have seen other companies go through this and that supports Ryan's earlier statement in his recorded remarks about this being a known phenomenon within our industry, and those companies have gone on to have successful upticks from those various initiatives. They take a different amount of time, different set of circumstances, but in each case those were companies that were able to turn the corner, tick up and make meaningful gains, both operationally and in their stock prices in the 12 months following those initiatives.

Bill Dezellem

Great. Thank you, both. Congratulations on the refinancing.

Alexander Mandel

Thank you.

Ryan Schulke

Thanks, Bill.

Operator

This concludes our question-and-answer session. The conference has also concluded. Thank you for attending today's presentation and you may now disconnect.