Snap One Holdings Corp.(Q3 2022 Earnings)

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Corporate Speakers:

- Eric Steele; Snap One Holdings Corp.; Senior VP of Finance & VP of IR
- John Heyman; Snap One Holdings Corp.; CEO & Director
- Michael Carlet; Snap One Holdings Corp.; CFO

Participants:

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- Chirag Patel; Jefferies; Analyst]
- Ketan Mamtora; BMO Capital Markets; Equity Research, Building Products Analyst
- Keith Hughes; Truist Securities, Inc.; Research Division, MD
- Erik Woodring; Morgan Stanley; Research Division, Research Associate
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PRESENTATION

Operator^ Good afternoon. Welcome to Snap One Holdings Corporation's Fiscal Third Quarter 2022 Earnings Conference Call. (Operator Instructions) I would now like to turn the call over to Snap One's Senior Vice President of Finance, Eric Steele. Sir, please proceed.

Eric Steele^ Great. Thank you. Good afternoon, and welcome to Snap One's fiscal third quarter 2022 earnings conference call. As a reminder, this call is being recorded. Joining us today from Snap One are John Heyman, CEO; and Mike Carlet, CFO.

Before we begin, we would like to remind everyone that our prepared remarks contain forward-looking statements, and management may make additional forward-looking statements in response to your questions, including, but not limited to, statements of expectations, future events or future financial performance. These statements do not guarantee future performance, and therefore, undue reliance should not be placed upon them. Although we believe these expectations are reasonable, we undertake no obligation to revise any statements to reflect changes that occur after this call. Actual events or results could differ materially.

These statements are based on current expectations of the company's management and involve inherent risks and uncertainties, including those identified in the Risk Factors

section of our annual report on Form 10-K for the annual period ended December 31, 2021, filed with the SEC.

All non-GAAP financial measures referenced in today's call are reconciled in our earnings press release to the most directly comparable GAAP measure. This call also contains time-sensitive information that is accurate only as of the time and date of this broadcast, November 9, 2022.

Finally, I would like to remind everyone that this conference call is being webcast and a recording will be made available for replay on our Investor Relations website at investors.snapone.com. In addition to the webcast, we have posted a supplemental earnings presentation accompanying these results, which can also be found on our Investor Relations website. I will now turn the call over to our CEO, John Heyman. John?

John Heyman^ Thanks, Eric. Welcome, everyone, and thanks for joining us this afternoon. Obviously, everyone wants to hear our perspective on results, and we'll get to that quickly. However, to begin today's discussion, I'll give you some company background, review our recent performance and then turn the call over to Mike Carlet, our CFO, to discuss financial results for the quarter in more depth as well as to provide our outlook for the remainder of the year. After that, I'll share some closing remarks before opening the call for questions. Let's get started.

To begin, at Snap One, we provide a smart living platform that empowers professional integrators to deliver joy, connectivity and security to discerning end customers on a global scale. As a leading distributor to these integrators, we work with our growing network of approximately 20,000 professional do-it-for-me integrators to distribute our proprietary and third-party products through our e-commerce portal and local branches.

We further support our integrator partners with our proprietary software platforms and workflow solutions to allow them to successfully serve their residential and commercial customers across the project life cycle.

This is the essence of our Only Here strategy. Here at Snap One, we're positioning our integrators and our company to capitalize on the tremendous and durable growth opportunity in front of us. We believe it is inarguable that homes and businesses will become smarter over the next decade and require professional help to integrate and support the technology, and that is the #1 driver of our long-term growth. No company is better positioned for this future than Snap One.

Turning now to the business update. We acknowledge that our Q3 results were below our expectations. I just want to call out some highlights before we get into it further. #1, we grew approximately 8% in a tough climate despite supply chain issues, a softer economy, foreign currency headwinds and delays in local branch openings.

We have successfully managed through the inflationary cost environment as evidenced by sequential contribution margin rate increases, which we expect to sustain in 2023. And

finally, we wowed at the recent CEDIA Expo, the Smart Living Industries flagship trade show with new product launches that position us well for the future.

During the year, our team has successfully navigated the ongoing impacts of the global pandemic, supply chain and logistics challenges and an economic backdrop complicated by inflation, the war in Ukraine and rising interest rates. While some of these challenges have started to subside, the overall market environment has clearly grown more uncertain.

While we cannot ignore the impact of these elements on near-term performance, we remain steadfast in our view of our long-term prospects. We continue to believe growth in smart living adoption, the central role of the integrator of providing holistic solutions and our competitive differentiation positions Snap One for long-term success. We will continue to execute against our growth strategy, which remains unchanged.

So why have we hit a bit of a speed bump? Here is what we are seeing in the current environment. We began to observe a moderated pace of daily sales in the second half of the quarter. We anticipated a normal acceleration at the end of the quarter, but did not see that, and October trends have continued to be a bit softer than previously forecast.

Two, as we dug into the underlying demand trends and analyzed feedback from our integration partners, the reality is they remain busy. Their activity levels and near-term pipeline visibility remain healthy. However, certain integrators, who hold inventory, are starting to work through elevated levels of that inventory purchased in response to their own supply chain challenges.

Three, it's also important to remember that through our partners, we serve discerning end buyers, who are more insulated from economic slowdowns and inflationary cost pressures on a relative basis. While this enhances the resiliency of our end markets, high-end customers are still becoming more cautious. We are starting to observe some changes in their buying behavior, such as project de-scoping, project delays and product trade downs to manage the overall cost of an installation.

Of course, as you would all expect, we continue to monitor the broader macro uncertainty. As we look ahead to 2023 and beyond, we remain highly convicted in the secular trend of smart living adoption, which will propel our long-term growth. We're also encouraged by a strengthening contribution margin rate due to the benefit of pricing adjustments and input costs beginning to normalize. Together, this gives us confidence that we have a durable business that is poised for sustainable long-term growth.

Let me take a few minutes to reflect on the past quarter. As mentioned earlier, net sales were lower than our expectations in September and for the quarter, and this slowing of growth flowed through to our profitability. The pace of this slowdown was faster than what we have experienced previously and is partially attributable to the inventory destocking and project tightening dynamics I spoke to earlier. Demand has stabilized at

current levels, but given the macro uncertainty, we are taking a cautious tone to our near-term forecast.

Despite the end of the quarter slowdown, we believe our position in the industry remains very strong. In Q3, we delivered on many operational commitments as we continue to enhance the smart living experience by improving both hardware and software for our integrators and end consumers.

At the recent CEDIA Expo, we announced the upcoming launch of several of those innovative products, which we expect will drive a positive impact on 2023 results, including the following: First, we announced the upcoming 2023 launch of Halo, a new family of Control4 remotes with an elegant industrial design, a refined user interface and packed with new features that will enhance the end customers' automation experience. Halo represents a meaningful upgrade opportunity for our installed base.

We are also now in market with the new Araknis wireless access point, which enables enhanced connection speeds with WiFi 6 technology benefiting both end consumers and our partners. This product will provide improved network efficiency for customers and due to built-in OvrC monitoring and management will be simple for our integrators to set up and maintain. Everyone wants faster networking.

To bolster our lighting portfolio, we announced the upcoming launch of vibrant linear lighting, which integrates color, temperature and brightness and to personalize automated scenes for a fully immersive lighting experience. Lighting is a big growth category for us.

Finally, building on our suite of outdoor entertainment products, we announced the launch of Episode Radiance, a modular, all in a single wire, outdoor audio and lighting system. Radiance is a unique product that will drive new opportunities for our integrators to delight their customers. We changed outdoor audio years ago and with Radiance, we are changing it again.

In addition to these exciting announcements, we launched the WattBox Power product internationally and strategically started to merchandise our access networks access points on the Snap One portal, so that they can be more easily purchased by integrators.

Moving to our strategic initiatives. We had a few key accomplishments in the third quarter. First, as part of our ongoing strategy to grow in security and commercial, we expanded our product offerings across both markets. In security, we announced the upcoming launch of the new Luma X20 IP surveillance solution, which is an NDAA compliant product that delivers AI-powered security features, providing end customers with greater peace of mind while simplifying installation and long-term maintenance.

For commercial, we launched the Carbon Series, ceiling mounts, which are designed for commercial applications like menu boards and digital signage.

Second, as referenced in last quarter's call, we acquired Clare Controls, a provider of home automation and security products previously distributed by Snap One. Clare's hybrid automation and security solution addresses the attractive middle market opportunity between lightly featured conventional security systems and luxury level whole home control systems.

Third, we continued our strategic omnichannel presence expansion by opening a new domestic local branch in St. Louis, Missouri in July. This branch brings the company's domestic footprint to 33 locations with 2 more in Canada as of quarter end. We look forward to further branch openings in the coming quarters to better serve our integrators in additional markets.

Following the close of the quarter, we also completed the acquisition of Parasol, a powerful 24/7 remote support service based on OvrC, creating new opportunities for our integrator partners to focus on running their business while increasing profitability, productivity and service levels to their customers. The acquisition builds on our strategic investment in Parasol announced last year and increases our capabilities to provide an RMR service to the industry in addition to our 4Sight product line and other efforts.

I'll now comment briefly on our outlook before turning the call over to Mike. As we prepare for the rest of 2022 and 2023, we are focused on continuing to manage the business to deliver strong profits and drive operating leverage.

Considering the challenges referenced earlier, we are reducing both our net sales and adjusted EBITDA guidance for 2022, which Mike will discuss in further detail. As we think about 2023, we expect the operating environment to remain challenging. In response, we are constructing an operating plan that reflects the continued execution of our growth strategy.

We remain focused on controllable strategies consistent with our long-term growth algorithm that will enable us to outperform, including the following: one, increasing our share of wallet with existing integrators through the adoption of our ecosystems; two, continuing to innovate and launch the exciting products I referred to earlier; three, opening new local branches; four, adding new partners across our business, including in security and commercial markets.

And finally, we will moderate our expenses to drive efficiency and optimize productivity, which will generally -- which will generate enhanced profitability. And of course, we'll endeavor to enhance our balance sheet while doing all this.

We believe our resilient integrator partners, our diversified business model and consistently strong execution positions us to prosper in dynamic macro environments. We are observing an interesting dynamic in our supply chain. Over the past couple of years, we have incurred tens of millions of dollars in additional costs from supply chain inefficiencies.

We are now seeing a return to normal in freight, logistics and componentry expenses that we believe will be a material tailwind to our proprietary product margins in 2023. With that, I will turn the call over to Mike Carlet, our CFO, to discuss the quarter's results in more detail as well as our 2022 outlook. Mike?

Michael Carlet^ Thanks, John. Turning now to our financial results for the fiscal third quarter ended September 30, 2022. To begin, net sales in the fiscal third quarter increased 7.9% to $281.2 million, up from $260.7 million in the comparable year-ago period.

The growth in net sales during the quarter reflects organic growth, including the continued ramp of local branches opened in the past year and the cumulative impact of proprietary product price adjustments taken in the past year. Growth was also driven by the incremental sales benefit of Staub, which was acquired in late January this year.

Sales growth was moderated on a year-over-year basis, due in part to a greater-than-anticipated sales pull forward in late Q2 in response to our June 2022 price adjustment, creating a direct demand cost larger than expected in Q3. Additionally, our pace of local branch openings, a key driver of growth, has been delayed this year, further moderating our growth. However, we do anticipate several additional local branch openings in Q4.

While the quarterly growth rate is down sequentially on a 3-year pro forma CAGR basis, the growth is in line with our consistently communicated long-term target of low double-digit growth.

Contribution margin, a non-GAAP measurement of operating performance, increased 4% to $113.8 million or 40.5% of net sales in the fiscal third quarter. That's changed from $109.5 million or 42% of net sales in the comparable year-ago period.

We did see a second consecutive sequential quarter over increase in contribution margin as a percentage of net sales, which I'll discuss in a moment. As expected, the year-over-year decrease in contribution margin as a percentage of net sales was primarily related to our local branch expansion and growth strategy, which drove a change in product mix as our local branch footprint skews towards third-party product sales.

In the fiscal third quarter, third-party product sales represented 30.1% of total net sales compared to 29.2% in the comparable year ago period. As a reminder, third-party product typically has a lower contribution margin as a percentage of net sales relative to our proprietary products. The strategic expansion of our local branch footprint and curated third-party product portfolio remains an important part of our value proposition over the longer term as we aspire to be a one-step shop for our integrator partners.

As referenced above, on a sequential quarter-over-quarter basis, we are pleased to drive an increase in contribution margin as a percentage of net sales from 37.9% in Q1 to 39.2% in Q2 to 40.5% in Q3.

The approximate 130 basis point increase in contribution margin rate from Q2 was primarily driven by the full quarter benefit of the June price increase. The margin improvement was further aided by improved supply chain dynamics, including a reduction in the use of airfreight and sequentially declining inbound freight costs, partly offset by product mix.

Selling, general and administrative expenses in our fiscal third quarter decreased 14.9% to $89.4 million or 31.8% of net sales from $105 million or 40.3% of net sales in the comparable year-ago period. This decrease in SG&A expenses during the quarter was primarily due to lapping onetime expenses associated with our IPO that occurred in Q3 last year.

After adjusting for add-back items, selling, general and administrative expenses increased 5.8% to $81.9 million or 29.1% of net sales from $77.5 million or 29.7% of net sales. The increase in adjusted SG&A expense is related to increased costs associated with coming and operating as a public company, ongoing investments to support strategic growth, wage completion and the acquired cost of Staub and Clare, which we did not own for the full period of the prior fiscal year third quarter.

Our net loss totaled $1 million in the third quarter compared to a net loss of $21.5 million in the comparable year-ago period.

Adjusted EBITDA, a non-GAAP measurement of operating performance, decreased 0.8% to $31.9 million or 11.3% of net sales in the third quarter of '22 compared to $32.1 million or 12.3% of net sales in the comparable year-ago period. The adjusted EBITDA decline in the quarter was primarily attributable to operating expense growth described above outpacing growth of our contribution margin. Adjusted net income and non-GAAP measurement of operating performance decreased 11% to $14.9 million or 5.3% of net sales from $16.7 million or 6.4% of net sales in the comparable year-ago period.

And free cash flow, a non-GAAP measurement of operating performance, totaled negative $25.4 million in the 9 months ended September 30, 2022, compared to negative $18.1 million in the comparable year-ago period. The decrease in free cash flow was primarily attributable to a modest year-over increase in net cash used in operating activities and purchases of property and equipment. Net cash used in operating activities for the 9 months ended September 30, 2022, was negative $15.4 million. The use of cash has been primarily driven by investments to protect us against the supply chain, resulting in the use of net working capital, including increases in inventory.

We've seen sequential improvement in our change in working capital, including moderated inventory growth of $22 million in the quarter, which we expect to continue to moderate.

At the end of the fiscal third quarter 2022, we had approximately $74.7 million of liquidity, including cash and cash equivalents of $35.5 million and undrawn revolver capacity of $39.2 million. After the quarter, we secured an incremental $55 million term

loan to provide additional liquidity for general corporate purposes. We used most of the proceeds of that loan to pay down our existing revolving credit facility with the remaining cash added to the balance sheet.

Pro forma for the incremental term loan, total liquidity is approximately $125 million. We do not anticipate needing to tap into this incremental liquidity, but we want to be very conservative given the macro environment, and we'd like to be able to be opportunistic as situations arise to deploy capital towards organic growth drivers or strategic acquisitions that generate high rates of return.

Now before I turn the call back over to John, I'll take us a few minutes to provide an update on our financial outlook for the remainder of the year. As a reminder, Snap One provides annual guidance for net sales as well as adjusted EBITDA, as we believe those metrics to be key indicators for the overall performance of our business.

Our fiscal 2022 guidance includes our year-to-date performance, pricing adjustments; acquisition of Clare, we expect to have a modest dilutive impact on consolidated results in the short term; ongoing FX headwinds, and our anticipation of continued market uncertainty, with these inputs in mind, we are adjusting our annual net sales and adjusted EBITDA guidance ranges.

We now expect net sales in the fiscal year ending December 30, 2022, to range between $1.10 billion and $1.115 billion, which represent an increase of 9% to 11% compared to the prior fiscal year on an as-reported basis and 11% to 13% after adjusting fiscal 2021 to remove the impact of the 53rd week.

We believe the contributing factors for our 2022 net sales growth on a 52-week adjusted basis are as follows: 8% to 10% of our growth drives some organic growth, which includes volume, local branch openings, historical price adjustments and is net of FX headwinds and supply chain challenges that we've mentioned. 3% of our growth is derived from the impact of recently completed M&A, including Access Networks and Staub Electronics. On an as-reported basis, the lapping of the 53rd week in 2021 represents a 2% net sales growth headwind for the year.

In light of the softening demand environment, we're also revising our adjusted EBITDA guidance range to $109 million to $113 million, roughly in line with prior year on an as-reported basis. While John has already commented on the demand outlook, we remain confident in our gross margin trajectory and are continuing to take proactive steps to manage our expense structure to drive profitability.

Now one final update before I pass the call back over to John. As a reminder, Snap One's Board of Directors approved the stock repurchase program that authorized potential repurchases of up to $25 million of our common stock from the date of approval, which was May 12 through the end of 2023. As of September 30, 2022, we had repurchased approximately 222,000 shares of our common stock at an aggregate value of approximately $2.4 million.

Consistent with our capital allocation policy, we will continue to prioritize in this order: balance sheet strength, organic growth investments, accretive M&A and then opportunistic share repurchases. That completes my summary. I'll now turn the call back over to John for any additional commentary. John?

John Heyman^ Thanks, Mike. Just a few closing thoughts before we hit Q&A. First, even in this environment, we remain bullish around our growth aspirations and the longer-term operating model. For '23, we have confidence in our proprietary product launches, our growth in adjacent markets, such as commercial and security, local branch opening strategy and the benefit of 2022 pricing adjustments carrying over to 2023. We also anticipate continuing our favorable contribution rate -- margin rate trajectory as costs related to the supply chain alleviate.

Second, our focus remains on our Only Here strategy. This includes new product launches, software investments and platform investments, all in service of supporting our integrators to capitalize on the employment opportunity in front of us and them. Even in a moderated investment environment, we continue to strive to be the one partner that our integrators trust to support and grow their business.

And third, as I said earlier, we believe that all homes and businesses will become smarter over the next decade, driving demand for the types of experiences we offer today and those that we can only imagine in the future. The slowdown we have recently seen is temporary, and we will continue to strengthen our company during this period.

We've invested in scale and platforms that will drive better solutions for the end customer, more capacity for the integrator and growth for Snap One in a way that increases operating margin over time. Our actions in the first 3 quarters of the year have set us up to succeed in the current environment, while also preparing us for longer-term sustainable growth. And with that, Operator, please open the call for Q&A.

QUESTIONS AND ANSWERS

Operator^ (Operator Instructions) Our first question comes from the line of Chris Snyder from UBS.

Christopher Snyder^ I was hoping for some more color on the integrator inventory digestion. Is there anything you could provide to kind of quantify the headwind realized in the back half of '22? And then also, at what point do you think the destocking headwind will be in the rearview and the company can kind of continue to grow in line with the activity that you're seeing at the integrator level.

John Heyman^ Thanks, Chris. Look, historically, our partners have not carried much inventory. And what we've become aware of is that many have been responding to the supply chain challenges that are out there by reversing kind of that practice that they've had.

We have triangulated the numbers through surveys, analysis of our own data in terms of, for instance, when we see systems being turned on by OvrC, et cetera. And we would estimate that our partners are currently sitting on, what we would say is about $40 million to $60 million of inventory that we would call kind of sold in versus sold through inventory in the channel relative to prior year practices.

We, through that analysis, have seen that, that was primarily built in the second half of '21 and the first half of this year. That likely drove a couple of percentage points higher revenues during that time. Over the past few months, what we've noted with our partners, again, through surveys, is that a minority of partners continue to build inventory and most have started to unwind that inventory.

I would point, by the way, just to the new cycle and interest rates, et cetera, that we all started seeing in August and September. So we actually don't believe this practice has gone away from the channel, like we see the supply chain alleviating, but in some spots, they don't. There are other suppliers that are still having supply chain issues, and that's not lost on our integration partners. But we are seeing it start to unwind. And so we believe that they'll start to burn down kind of that inventory over the next 3 to 6 months, and I would include the period we're in, in that.

I will say this was something that because it's been a nonstandard practice by the channel, it's something that really started to -- we became aware of at CEDIA as we started to talk to our partners, service companies that provide services to our partners. And that's where it is. So a couple of points of growth last half of last year, first half of this year, starting to see it unwind. And I think based on activity, et cetera, it's going to last through next quarter probably into the second quarter a bit.

Christopher Snyder^ And generally, kind of the communication market, but what we've seen a lot with just the end market slowdown combined with improving kind of supply chains have seen a lot of destocking. So I guess I just want to confirm, though, the -- so the integrators may be sitting on an extra $40 million to $60 million. Did that get worked down at all in Q3? Or is there not really an impact in Q3? And then the idea is over the next 2 or 3 quarters, that will unwind at maybe like somewhere like maybe $20 million kind of revenue headwind per quarter over the next year, right?

John Heyman^ I think it definitely started to unwind in Q3. It's hard for me to put an actual number on it. I don't think it's more than $10 million, and I would consider it to be a $10 million to $20 million kind of headwind for us over the fourth, first and second quarter. And hopefully, it will just work its way out by the end of the first quarter.

Operator^ The company requests that each participant limit their comments to one question and one follow-up. Our next question comes from the line of Stephen Volkmann from Jefferies.

Chirag Patel^ It's actually Chirag Patel on for Steve this evening. Just wanted to kind of hit on Chris' comment on the inventory side with the integrator and move it to your own inventory. How much do you feel is -- what's kind of a real carry number that you really need at this point? How much are you going to be looking to draw that down in over what period of time? And then I think my next question will be regarding just pricing in general, but we'll start here.

Michael Carlet^ Sure. Thanks, Chirag. It's Mike. Obviously, as sales have seen a little bit of slowdown. And given our little bit longer supply chain, inventory has built up a little bit more than we expected even in this quarter.

We were on top of it. So our supply chain team right now, we feel comfortable that by the middle of the next year, assuming our run rate of sales stays at the current levels and as we forecast, then we would expect inventory to come down about $20 million to $25 million between now and the middle of next year as we manage through it. Obviously, as we have to think about the demand curve and whether that grows or shrinks, we'll have to react to that. But if we're to forecasting right, then we feel pretty good about taking that $25 million out of the system over the next 6 to 9 months.

John Heyman^ And on the pricing point, I think if you're -- I think we've definitely seen costs moderate in the supply chain -- and I think as we think about next year, we see targeted versus larger price increases as we sit here today with the current cost perspectives we have in the business. Should we see costs increase, then we'll, of course, respond from a pricing standpoint?

Chirag Patel^ I guess the other part that I was kind of looking for is just the idea of given the increases that have been happening over the last couple of quarters here within your own portfolio, what's a fair way to think about the carryover impact for next year? Is there -- is it a low single-digit kind of an idea? Or is it a little bit higher than that even?

Michael Carlet^ Yes. The pricing impact next year on what we've already done is about 3%. So just a carryover. So if we did no incremental pricing action next year to carry timing, as you go through it different in different quarters, but for the full year, it would be a 3% lift on current year sales.

Operator^ Our next question comes from the line of Ketan Mamtora from BMO Capital Markets.

Ketan Mamtora^ John, is it possible to provide just a little more color around kind of trends through the third quarter and into October. I know you mentioned in your prepared remarks that in the back half of Q3, you saw the impact. Curious if you can provide any sort of additional color around how that trended through the quarter? And how does October look? Is it kind of in line with September, a little bit better or a little worse?

John Heyman^ Sure. Thanks for the question. I would say that the biggest trend that we saw during the quarter was generally speaking, our business is pretty linear throughout

the quarter. And that's always been the trend. And the reason for that has always been -- our partners don't carry inventory. So it's very much a sell-through business. The exception to that is the last month of the quarter, when we have certain rewards and rebate programs that they're all stretching to try to meet.

And so -- and those generally happen at various levels. We had expected that to be once again significant in September. And so, I would say in August, we -- in the first part of the quarter, what we had -- don't forget, we had a 9% price increase in the second half. So we knew there were some buy ahead of inventory for that.

So we saw a little bit of a lag in Q3. That was expected. Then sales, I feel started to recover, and we expected a strong finish in September just like we have in every quarter. And that's what we didn't see. And it's the first quarter, we haven't seen that in my almost 8-year tenure with the company.

And -- we happen to be at CEDIA the last week of the quarter, and that's where we were able to start having discussions with either service providers to the industry or our partners directly. And as we started to inquire it was pretty clear that there was inventory being unwound. Now I think that's part of it. I think the second part of it is, again, I'm going to come back to the news cycle. Like if you've been -- first of all, the supply chain is alleviating with many vendors, not all, but with many, including us.

Second, if you're a small business person and you're reading all the news and you're sitting on a bunch of inventory, you're going to start to think about liquidating that faster, especially when you think the supply chain is catching up to your business. And so September was just not what we expected. In October, we don't typically talk about the quarter we're in on these calls. But what I'll say is, as we look at the guidance Mike's given, we're very comfortable with that based on kind of the sales that we're seeing in October and early November.

Ketan Mamtora^ And as my follow-up, how do you think about sort of the pace of investments in branch openings as we move through this sort of dynamic and uncertain environment?

John Heyman^ I think about it prudently. I think we'll -- it's a great question. It's one we're asking ourselves as we put together our budget for next year, especially, as we have a very strong outlook over the next 3 to 5 years. We're going to probably be a bit more targeted with our investments next year, which means we'll moderate them in other areas. And we are continuing to assess the various revenue scenarios for next year.

We believe we can grow through a slower environment based on all the things I talked about, the products, opening local sites, share of wallet strategies, new partner acquisition, the growth we see, the outsized growth we see in the commercial and security markets, which continue to grow at a much faster pace than our, what I'll call core residential technology market.

And so -- we are very optimistic, frankly, about our growth in those areas. And then the question we always ask ourselves is what's happening in the market. And so as we assess that, we assess where we're going to be willing to invest with the notion that we're going to increase profitability while doing so. So that's one piece.

The second piece of that is core to that strategy is the opening of local branches. We're working on some internal technology early in the year. And so we've got plans to open a bunch of local branches in the fourth quarter of this year, which should have been opened earlier this year, but permitting and supply chain affected local branch openings as well this year, which affected revenues this year.

And what I would say about next year is we'll get these sites opened in the fourth quarter. We've got some technology work internally that we're working on. We'll keep an eye on revenues and then we target opening more sites in the second half of next year.

Operator^ Our next question comes from the line of Keith Hughes from Truist.

Keith Hughes^ Given kind of the outlook we've discussed here, particularly in the short term, does it shift your thinking on the use of free cash flow more towards debt reduction? Or are we still going to go with the same pace we've seen for some time?

Michael Carlet^ Hey Keith, it's Mike. It doesn't substantially shift our view. Obviously, we're paying attention to the macro environment that's out there. And I would say that the reason we went out and obtained that additional term debt to pay down the revolver was to provide flexibility.

We want to do things. It probably does raise the bar quite frankly, from an ROI standpoint as we look at investment opportunities, whether those are organic or (inaudible) and what we want to make sure we can underwrite and during this time frame.

We've got a lot of certainty if we're going to deploy that capital. But I don't think it changes our view because I think we still feel really comfortable of our long-term growth plan, and we feel comfortable with our cash flow generation. So obviously, if things start changing on that, we feel less certain about that, we'll think about reprioritizing. But for right now, I think we're really comfortable where we're at from a liquidity standpoint. We'll be prudent on how we play, but doesn't change our prioritization of how we think about it.

Operator^ Our next question comes from the line of Erik Woodring from Morgan Stanley.

Erik Woodring^ I have two as well. Maybe just a follow up on the first question, John. Obviously, you mentioned a number of kind of emerging headwinds, slowing average daily sales growth, elevated customer inventories, some pull forward in 2Q and a delayed branch opening. I thought the color that you provided on channel inventories was -- customer inventories was very helpful.

Can you maybe help us understand -- it seems like that is the biggest headwind right now. If we put that to the side, maybe just help us kind of maybe qualitatively better understand which of the other factors are kind of having the most significant impact on the business today in 4Q? And then I have a follow-up after that.

John Heyman^ Thanks, Eric. I know you guys, and I would love to have it just be one thing. I think it's more of a combination of a few smaller things. On the controllable side, what I would just say is the supply chain just does is it -- doesn't only affect how much inventory we carry because of course, we're carrying enough inventory. It also affects when we launch products. So I would say some of the product launches that we showed at CEDIA, we would have hoped to have launched more quickly.

So that's #1. #2, I think that the integrators are busy, but -- and I said it in my opening comments, but there are some things we don't control as much. We can't control when a local entity, a local government entity gives us a permit to open a local store. So that causes delays when those times lengthen. The second piece, though, is the market. And I don't want to leave this call with everyone thinking that we're saying that the market is as strong as it's been over the past couple of years.

And what I would just say to that is, I read kind of -- I have lots of friends, colleagues in business. I know lots of builders. And I think there's a conservatism that's going on with buying today that is resulting in the descoping of projects that might mean 2 speakers in a room instead of 4. It might mean 4 speakers, but they're cheaper speakers.

And we're -- I think we're seeing that in lots of places. And the businesses and builders I talked to are seeing that in their customer base. And so I think there's just a little bit of that going on right now. And a little bit of that, a few percent kind of creates some softness. And so I think it's a combination of all those things that lead us to having a more cautious outlook around the rest of the year and as we plan for our budgets into next year so we think about our expense structure.

Erik Woodring^ And then maybe a follow-up. I think you guys have made it very clear and proving yourself in the market that your proprietary product is very highly regarded. Obviously, winning a number of different awards. You continue to launch product at a fairly rapid pace.

But then in the quarter, we did see more of the slowdown in your proprietary product rather than the third-party product. Can you just maybe help us parse that out? Why would we be seeing more of a slowdown in 1P product versus 3P? I understand there's probably some branch openings that impact, but just love to understand kind of the puts and takes there between those two.

John Heyman^ Thanks, Eric. I think when you look underneath it, if you did it on a couple of same-store sales basis, you would see growth rates that are almost equivalent between both product lines. What happens because historically, most of our proprietary

product was distributed nationwide throughout the U.S. for our e-commerce platforms, we had coverage all over. And those e-commerce platforms, historically, did not carry our third-party products. So when we go and open our local branch network, it adds that third-party product availability to our integrated partners in that market. And so we know that's going to happen.

As we add more local branches, the impact on third-party products is greater than our proprietary because what we see is we're already in market with our proprietary product. If you're in -- what was our most recent store -- so if you're in St. Louis, prior to our store openings, you could buy Control4 products, you can buy, OvrC products you can buy our Strong mount, you can buy our Episode speakers through our e-commerce platforms, but you couldn't buy local indoor TVs from us, you couldn't buy some other third-party products that we only carry at local store.

We open up that local store in St. Louis. Some folks will shift their 1P purchasing from our e-commerce platform to our local store. We do get some lift from opening our local store in our proprietary products, but it's much greater on the third-party products because now both those products are available in the market that weren't there previously.

That's the dynamic that we're dealing with it is expected. We know about it. We model it. We're going to continue to happen. TV is by far the biggest one that impact as we go forward. So that's the dynamic but on the same-store sales underneath it, the growth rate between 1P and 3P are all one (inaudible).

Operator^ Our next question comes from the line of Ryan Merkel from William Blair.

Ryan Merkel^ I wanted to ask about new residential construction. You didn't list that as a reason for the slowdown that you're seeing. And I'm curious, are you seeing any softness there? And what is your outlook for that business as we think about the next couple of quarters?

John Heyman^ Well, I think we -- thanks, Ryan. I think our general perspective on that is -- I spoke to what I thought was an overall caution from us in terms of kind of the market just a bit ago. In terms of construction itself, like our integrators continue to be super busy. And the penetration of our solutions in the housing market is very low.

So I think it certainly creates an -- I think a softer economy and higher interest rates certainly creates a bit of an overhang on the market, but there's tons of opportunity to -- for our integrators to go find other business. And so when builders are building homes, it's very easy for the integrator to find work. And when builders slow down building homes, it may take a tiny bit of time for the integrator to pivot, but they'll pivot.

They'll go find commercial work, they'll go find work in their installed base, and they will go find work in kind of what we would call the more the renovation market. And if our products were much more widely penetrated in the market, I'd be more concerned

about near-term construction trends, but I think it just creates what I'll call a light layer of softness as I look at it today.

Operator^ Our next call comes from the line of Paul Chung from JPMorgan.

Paul Chung^ So just on the gross margin bridge, it looks like you saw some benefits from lower air freight expense this quarter. Do you kind of expect a similar amount of gross margin uplift as we kind of move throughout the next coming quarters? Or is the benefit even higher as we think about airfreight dissipating? And then on the gross margin, to end the year and into next year, how do we think about the pricing benefits that you've implemented, the lower freight and product mix? Talk about the puts and takes on gross margins as we kind of think about '23 and the shape of performance for the year.

Michael Carlet^ Hey, Paul. So we don't guide specifically on our contribution margin or gross margin. But I'll give you some color around the numbers from the bridge and how we think about it. As we think about Q4 year-over-year to Q3, it should be similar performance would be our expectation that the trends that we're seeing aren't going to really change. We're getting the benefit of that pricing.

We expect it to continue. And so if you think out about that bridge for Q4, it will probably look pretty similar as it looks in Q3. And as we think about next year, as John mentioned during our call, the descriptor portion of the call, we do continue to see some of those cost pressures and supply chain moderate. So whether that's the cost of push in freight, whether that is some of that purchase price variance PPV that we've had to pay to ensure the supply chain, those things are definitely moderating.

And we do see over the next year, our margin rate returning back to where historically had been back in '21 and '20 as we as we continue to see that moderation in the price impacts that we've had. Clearly, we'll still continue to have a little bit of mix moving against us, as we talked about earlier. But we think all of that will put us back again, pretty similar to where our margin rates have been historically.

Paul Chung^ And then just a follow-up on the large amount of new products you kind of released during CEDIA, where are you seeing relative strength across the portfolio of products? It seems like the Radiance product was attracting a lot of attention. Just any comments on your product portfolio? And I know you have some near-term headwinds there, but maybe longer term, how these new products are expected to perform.

John Heyman^ I think we're super optimistic. I think integrators can't wait to get their hands on them. I think Halo is going to differentiate our entire control system offering. Frankly, the remote itself has been an area where we feel like we've been a bit behind where we needed to be.

So I think integrators can't wait to get their hands on them, and that will be early next year. We had hoped it would be this year. The lighting product, lighting is -- continues to

be a big growth area for the industry and for our customers and Radiance. You saw the reaction to Radiance. So we think in terms of audio and in terms of lighting, very exciting.

The outdoor products, typically, their big time is in the spring as the weather gets a bit warmer. So those are all really important releases for us. In some case, they'll generate new revenues and in some cases, build to generate just more attachment of other systems. And then the WiFi access points are out now and being very well received. And we've got more behind that. We've got more behind that.

Operator^ Our next question comes from the line of Brian Ruttenbur from Imperial Capital.

Brian Ruttenbur^ A quick question. I think I picked up on you saying that you may be pursuing more commercial business. Is that correct moving forward?

John Heyman^ Well, we have -- we do, Brian, well over a couple of hundred million dollars in the commercial and security markets, and those have been the fastest-growing markets for the company kind of generally speaking, kind of double the growth that we see in our more conventional residential technology market.

Brian Ruttenbur^ Can you talk about how you plan to do that pivot? I'm hearing a lot of companies out there making those kind of comments about wanting to go in from a retail, maybe market or consumer-driven market into the commercial security, what would you have to do in order to get bigger market share in that area?

John Heyman^ Our biggest -- well, I think we have to do 2 things that we've done very successfully. And first, I think it's a very adjacent market for us, #1. And the reason I say that is our integrators, just for everybody's information, generally speaking, about 1/3 of our core customers' business comes from commercial work anyway.

And so we already have products that are fit for commercial use. We've extended that with go-to-market activities to go recruit integrators who identify themselves as commercial integrators as opposed to residential. We've been quite successful with that strategy. We have been launching new products.

We did a release a little less than a year ago around our Control4 platform. It's not fully fit for all commercial settings, but it's fit for some. And I think we now have about 1,000 implementations of that. We have also noted that our commercial customers, about half of them are using OvrCs. And so we are continuing to look at how do we continue to develop our go-to-market with business development resources, continue to attract more channel partners and continue to feed those channel partners with new products.

Those could come from us or those could come from a third party. We just signed a relationship that we announced with Digital Watchdog on the surveillance space. And so we're doing it just like we kind of built our company, 20 years ago, by acquiring

customers and listening to them and building more products for them. We are fortunate that we've got a product team that is developing a much better understanding of that market.

And we have a distribution capability that other commercial product companies find attractive. So those are the things we're building. Then the question for us is, of course, in this environment how fast to build it? And how fast to invest there? How to faster invest in the security market? And of course, how fast to continue to drive wallet share in our market? And those are the things we're balancing in this year's budget cycle. And those are the things that make us all really excited about the next 3 to 5 years.

Brian Ruttenbur^ And then just one final question. Are there any planned reductions in staff in the near term? I think your revenue in the fourth quarter, according to guidance is down 6% to 8%. Is there any plan and changes to the staffing levels?

John Heyman^ Yes, based on our view of where the performance of the business is, there is no planned reductions in our workforce. We do have what I would call a hiring freeze for all but the most essential positions. And we feel like we've made significant investments that are ongoing that are sufficient to continue to grow our business.

Michael Carlet^ Hey, Brian, one thing just real quick bolt on top of that. When you talked about our Q4 guidance, we have the 53rd week last year. So if you adjust to that, our real guide for Q4 is down a couple of points -- up a couple of points on a comparable basis. So just to make sure everybody hears that.

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

John Heyman^ All right, everyone. We really appreciate your time today. I want to especially thank our team members who continue to work their butts off delivering on behalf of our partners and our shareholders. I want to thank our partners for all the great work they're doing out there. And of course, our investors for their continued support, and we will continue to keep you guys informed. But I appreciate it, and wish everybody a great Thanksgiving.

Operator^ Thank you for joining us today for Snap One's fiscal third quarter 2022 earnings conference call. You may now disconnect.