Jim Suva - Cricut, Inc. - SVP Finance

Thank you, operator, and good afternoon, everyone. Thank you for joining us on Cricut's third quarter 2023 earnings call. Please note that today's call is being webcast and recorded on the Investor Relations section of the company's website. A replay of the webcast will also be available following today's call. For your reference, accompanying slides used on today's call, along with a supplemental data sheet, have been posted to the investor relations section of the company's website, investor.cricut.com.

Joining me on the call today are Ashish Arora, Chief Executive Officer, and Kimball Shill, Chief Financial Officer. Today's prepared remarks have been recorded after which Ashish and Kimball will host live Q&A.

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, including statements regarding our strategies, business, expenses, and results of operations, in response to your questions. These statements do not guarantee future performance, and therefore, undue reliance should not be placed upon them. 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 Cricut's most-recently filed Form 10-Q. Actual events or results could differ materially. This call also contains time-sensitive information that is accurate only as of the date of this broadcast, November 7, 2023. Cricut assumes no obligation to update any forward-looking projection that may be made in today's release or call.

I will now turn the call over to Ashish.

Ashish Arora - Cricut, Inc. - CEO

Thank you, Jim

Q3 was strong from a profitability perspective, with operating income up 36% year over year despite a 1% sales decline. As we mentioned before, in 2023, we are focused on profitability and remain disciplined in our investments to generate value over time. We view our business through a long-term lens, and these investments will help us return to meaningful sales growth in the future. We continue to see retailers taking a conservative view with open-to-buy dollars and consumers being careful with discretionary spend, especially on higher-ticket items. As the category leader, we are focused on the things that we can control. We continue to innovate and grow interest in the category, which will ultimately drive customer acquisition. We are excited about the future of our platform and the opportunities ahead.

Before going into updates on our key priorities, I want to highlight some exciting new product launches in Q3 that demonstrate our commitment to innovation.

First - Joy Xtra: We launched Cricut Joy Xtra in Q3. It was available for purchase starting on September 7th. Targeted primarily at new creative users and broadening our market with a printer-friendly compatible format, Cricut Joy Xtra is designed to help makers create the most popular projects, especially full-color stickers, as well as custom cards, t-shirts, and much more, yet is compact enough to fit into any space.

Second - Cricut Venture: On the last earnings call, I mentioned we launched Cricut Venture, which became available for purchase on July 25. Cricut Venture is the largest and fastest connected cutting machine on the Cricut Platform and represents the fourth, all-new architecture of connected machines in our history.

The feedback from our users and independent reviewers on both machines has been very positive.

Now on to an update on our priorities. Recall that we have four priorities: New user acquisition, User engagement, Subscriptions, and Accessories & Materials. I will briefly review these items and provide some detailed commentary on our new platform innovations.

New User Acquisition - We ended the quarter with 8.6 million total users, approximately in line with our expectations. We continue our focus on new user acquisition to grow our member base engaging on our platform, which ultimately drives our monetization flywheel. We have previously shared that our funnel is healthy and we see an opportunity in holiday to pull consumers through the funnel who have been pausing in their purchase decisions. We are encouraged by recent Amazon Prime Day results that appear to confirm our research that consumers "looking for a deal" will act for the right value. As discussed last quarter, we are continuing our plan for deeper, shorter-lived promotions during holiday to convert more of these consumers.

As we enter Q4, we continue to focus on driving awareness for Cricut and our category by driving excitement by getting people talking about and making with Cricut, with friends and family and across social media. We know that Cricut is a key part of holiday season for makers across the globe. We plan to position Cricut as the key buy or gift of the season, from supporting sales promotions to executing holiday marketing campaigns that bridge awareness to revenue.

Turning to the International side of our business, we are excited to see a return to sequential and year-over-year revenue growth, up 36% YOY, with international representing 21.5% of total company revenue in the quarter compared to 15.6% in Q3 2022.

We ended the quarter with 3.64 million engaged users, compared to 3.56 million a year ago. As a reminder, we count an engaged user as one who cuts a project at least once a quarter.

Engagement embodies the core of our platform where we help users discover, make and share their projects. Our goal is to expand the breadth of makeable content and help users discover content that inspires them. We then want to make it easy for them to design and make their project and ultimately share on the platform for others to be inspired.

Although we are still in the early days of executing on our engagement strategy, we see several positive signs resulting from our efforts to drive engagement throughout our members' journeys on our platform.

Let me share a few examples of what we are working on.

A key onboarding metric we look at is the number of days new members cut within their first 30 days after registering their machines. This metric is a strong leading indicator of the long-term engagement of a member on our platform. Over the past year, we have mentioned initiatives such as Cricut Learn classes, assisted learning plans and other improvements in our out-of-box experience. In Q3, we saw an increase in this key on-boarding metric compared to a year ago, as well as the share of members who engage in our educational content.

Content plays a key role on our platform. We have been focused on delivering depth and breadth of images. We have now crossed 600k images available to our Cricut Access members. The growth of our library over the past year has been possible thanks to the great success of our Contributing Artists Program. We are also making strides in the discoverability of our content, so members can increasingly find content that is relevant to them. In Q3, we launched personalized content on the Design Space homepage, where each member gets recommendations based on their past activities on our platform. Before, all users in each country saw exactly the same content. We are pleased with the click-through-rates of members with this new, personalized content. We will continue to invest in personalization, along with growing our Cricut library of images.

A unique differentiator of our platform is Projects. With projects, our members can discover full project ideas that they can customize or just make them as-is. Unlike inspiration found on other platforms, Projects in Design Space are not just a visual inspiration that needs to be recreated from a blank canvas, but actual, makeable content. In Q3, we also made improvements to our project search algorithm to provide better visibility to members of Community Projects, which are projects made and shared on our platform by other members, not created by Cricut. As a result, we saw a significant increase in the number of members deciding to make their project based on a Community Project.

By way of context, we see our library of Community projects as a key area of growth for our platform. Community projects will increasingly be a fresh source of inspiration and makeable content for our subscribers as network effects accelerate the amount of makeable content, which in turn inspires others to discover, make and share projects. While providing more visibility to the diverse creations from our community, we are also making improvements to facilitate and stimulate project sharing. As we are successful in unlocking this opportunity, community projects will become a massive opportunity for growth and will create a competitive moat that will be hard for others to replicate.

As we broaden our library of images and projects, it is important that our users are able to find the content they are looking for. I have already talked about the personalization technologies we are investing in. In addition, we are also focused on improving search. We launched Semantic Search in early Q3 and are actively testing and optimizing it. Machine learning powers Semantic Search. We are already seeing significant search conversion gains for multi-word queries and are actively training the machine-learning model on Cricut- and cutting-machine-specific terms to further improve the results.

The common thread across all of our engagement efforts is to help users discover content that inspires them, and matches their skill level and time availability, so they can find fulfillment in making and sharing their creations.

Paid subscribers were in-line with our expectations and increased 261,000 year-over-year but decreased 23,000 sequentially in Q3, ending with approximately 2.7 million paid subscribers. Recall, we communicated our expectation that paid subscribers could be flat to down in the second half of the year. While we have a positive outlook on subscriptions, lower new user adds compared to prior years puts pressure on our subscriber growth rate and attach rates throughout the second half of the year. As of today, I am pleased to say that in the month of October and thus far in November our paid subscriber count has been positive.

To be clear, positive paid subscriber growth is our plan. We have a rich roadmap to continually increase the value proposition for subscribers, including an ever-growing suite of premium design tools, along with the content strategies described previously. Our goal is to make it incredibly compelling to sign up as a subscriber to leverage our software and services. As our engagement efforts bear fruit, we expect to see a boost to subscriptions.

Accessories and Materials sales declined 12% YOY.

As we've highlighted before, we are on a two-year journey to transform this business. Consistent with prior comments, we will continue our promotional cadence in this category to remain price competitive for consumers. We see that when we are in the price range of our competitors, we get our fair share.

We have a strong focus on optimizing our products for lower costs, so we can compete better in the market with improved margins, while still creating a differentiated offering that works seamlessly with our machines and platform. For example, along with the launch of Cricut Joy Xtra, we released several innovative new materials, like printable waterproof sticker sheets, iron-on, and vinyl, that leverage standard inkjet printers and then work seamlessly with our print-then-cut technology to produce full-color projects in a single cut layer.

We are intensely focused on the overall customer experience, and we are motivated to work with those retailers that help us create a great experience both on the shelf and for actual usage of our ecosystem. I have never felt so encouraged and excited about the Cricut platform. We are in the early days of this transformation, while remaining profitable. We are driven to continue to innovate while exhibiting both long-term focus and current discipline. As we look ahead into Q4 and beyond I am excited about the future innovations of our platform and products that will continue beyond what I detailed previously to help users Discover, Make and Share. With that I will turn it over to Kimball.

Kimball Shill - Cricut, Inc. - CFO

Thank you Ashish, and welcome everyone. In the third quarter, we delivered revenue of $174.9 million, a 1% decline compared to prior year. We generated $17.2 million in net income, a 38% YOY increase and our 19th consecutive quarter of positive net income, as we continued to invest in our key priorities.

Breaking revenue down further, revenue from connected machines was $49.5 million, down 6% over Q3 2022. We continued to experience the effects of softness in consumer discretionary spending and retailer caution in inventory commitments.

Revenue from Accessories & Materials for the quarter was $49.1 million, down 12% over Q3 2022 and was primarily driven by a decrease in Project Materials. As Ashish referenced, we have more work to do here.

Subscriptions revenue for the quarter was $76.3 million, an 11% increase over Q3 2022, reflecting targeted investments in Cricut Access and the expansive improvements made over the last several quarters.

In terms of geographic breakdown, international revenue was $37.6 million up 36%, compared to $27.6 million in Q3 2022. As a percentage of total revenue, international was 21.5%, compared to 15.6% of total revenue in Q3 2022.

Turning to users and engagement. I am pleased to share we ended the quarter with over 8.6 million total users, or 16% growth over Q3 2022. We ended the quarter with over 3.6 million engaged users, which was a 2% increase from Q3 last year, and essentially flat sequentially.

We ended the quarter with approximately 2.7 million paid subscribers, up 11% from Q3 2022, but down 23,000 sequentially. Our subscription attach rate declined to 31% in Q3 2023 and from 33% last year. As discussed in earlier calls, there is some natural subscriber attrition; so, subscriber growth will be muted until we increase the pace of machine sales and new user acquisition.

Moving to gross margin. Total gross margins in the third quarter was 46.8%, an improvement compared to the 46.2% in Q3 2022, and reflects a higher amount of subscription revenue as a percentage of total revenue.

Breaking gross margin down further, gross margin from connected machines was 15.9%, compared to 6.1% in Q3 of last year. The increase in margin was primarily due to less promotional activity as a percentage of revenue and a favorable product mix compared to Q3 2022, as our end-of-life Maker machine continues to represent a smaller percentage of machine sales.

Subscriptions gross margin for the quarter was 89.3%, compared to Q3 2022 of 90.6%.

Third Quarter gross margin for Accessories & Materials was 12.1%, this compares to 29.2% in Q3 2022. The decline in margin was driven primarily by inventory impairments. Without the impairments, gross margin would have been approximately 30%. Our full-year expectations for A&M margins remain unchanged.

Looking into Q4 for both Connected Machines and Accessories & Materials, margin pressures from capitalized warehousing and operations expenses will accelerate as we reduce inventory levels. Also, Q4 is typically our lowest gross margin quarter. Machine sales are seasonally higher with the holidays, which will naturally pressure margins, since machines carry lower gross margins than other products and will represent a higher percentage of revenue in that quarter.

Total operating expense for the quarter was $58.2 million and included $11.7 million in stock-based compensation. Total operating expense was down nearly 10% from $64.4 million in Q3 2022. The $6.2 million decrease in total operating expense included a $4.5 million reduction in bad debt allowance.

Operating income for the quarter was $23.7 million, or 13.5% of revenue, compared to $17.4 million, or 9.8% of revenue in Q3 last year.

Our tax rate of 32.5% was higher than normal, compared to 29.5% in Q3 last year, due to an increase in stock-based compensation difference due to the decrease in stock price upon vesting versus the stock price at the grant date.

We delivered our 19th consecutive quarter of positive net income. Net income was $17.2 million, or $0.08 per diluted share, compared to $12.4 million, or $0.06 per diluted share in Q3 2022.

Turning now to balance sheet and cash flow. We continue to generate healthy cash flow on an annual basis, which funds inventory needs and investments for long-term growth. Year-to-date, we have generated $196.0 million in cash from operations, compared to $630 thousand a year ago, ending with a cash and cash equivalents balance of $173.6 million. We remain debt free. Recall, we are generating higher levels of cash as we work to bring inventory more in line with pre-pandemic norms. Accordingly, inventory decreased by $180.2 million from a year ago to $303.6 million at the end of quarter.

In Q2, we announced a $234.6 million special shareholder dividend, of which $232.2 million was distributed in July, with the remainder to be paid upon vesting of restricted shares.

During the quarter, we used $347 thousand of cash to repurchase 39 thousand shares of our stock. We have $26.9 million remaining in the repurchase program as of the end of Q3. After the end of the quarter and through October 31 we used $6.9 million of cash to repurchase 821 thousand shares of our stock which results in $20 million remaining in the repurchase program as of November 1.

Much of our outlook remains consistent with what I communicated in our prior earnings call, but I do want to highlight a few additional items. During Q3, and specifically in July, we paid the special dividend, which will result in a lower cash balance and lower interest income in the second half of the year. We expect to continue generating healthy cash flow from operations and to end the year with substantial cash and no debt.

Consistent with our commentary last quarter, we continue to see softening in consumer spend in our category and retailers taking a conservative approach to inventory commitments. Retailers did not restock to historical normal levels in Q3. As a result, we are taking a prudent and prioritized approach in our planning as we look ahead. Leveraging our consumer analytics, we plan to execute deeper Q4 promotions for machines, combined with comprehensive marketing plans, to address consumer concerns about affordability and consumer reluctance to spend. We remain cautious because it is difficult to predict how consumers and retailers will respond to these initiatives.

Typical revenue seasonality is 60% in the second half. Given the current macro environment, we expect second half revenue to be softer as a percentage of full year revenues and expect a lower sequential growth rate in Q4 compared to historical norms. In terms of new user growth, we still expect to add fewer new users in 2023 than we did last year.

We have a positive outlook on subscriptions and expect to end Q4 with more paid subscribers than we had in Q3. As we look to 2024, however, new user growth rates may put pressure on our subscriber growth and attach rates, which could result in a similar seasonal subscriber pattern as we observed in 2023.

Gross margins will continue to be pressured for multiple reasons. First, the mix of revenue in Q4 is more weighted toward machines, which carry lower gross margins. Second, on physical products, higher fixed costs as a percentage of revenue in warehousing and capitalized operations expense will be more pronounced in Q4 as inventory levels decrease. Third, Accessories & Materials will also have a promotional cadence to remain price competitive. As a result, we expect full year Accessories & Materials margins will be similar to Q4 2022's gross margin. We expect operating margins to be similar to 2022 full-year margins.

We remain focused on managing our profitability, while investing in areas with the highest impact. Should macro conditions worsen, we will continue to make adjustments as needed, just as we demonstrated in 2022. We expect to continue generating healthy cash flow from operations and remain committed to our long-term operating margin targets of 15% to 19%. Our proven model has demonstrated that when we operate at scale and drive top line growth, these margins are achievable.

With that, I'll turn the call over to the operator for questions.