Bakkt Holdings, Inc.
CEO and CFO Highlight Closing of Apex Acquisition, Expense Management Progress, and New Partners

On August 16, WTR held a fireside chat with Bakkt CEO Gavin Michael and CFO Karen Alexander. The conversation can be accessed on demand.

CEO Michael highlighted the results of Bakkt’s recent 2Q23 earnings, including: (1) the closing of the Apex Crypto acquisition; (2) new strategic alliances with Plaid and Fireblocks; (3) moves into international markets (Latin America, with the UK, the EU, Hong Kong, and Australia expected to follow; (4) improved profit margins; and (5) improved operating cash flow usage.

CFO Alexander discussed the expense management progress, highlighting that SG&A was down 23% Y/Y and compensation was down 21%. The new guidance is for 2H23 free cash utilization to be down 70-80% from the 1H23 and end the year with approximately $80 million in cash. The take rate for crypto transactions in the quarter of 38 bps is in line with the historical 30-40 bps Apex was achieving before the acquisition. All together, the company is still targeting to be adjusted EBITDA break-even by the end of 2024.

The Plaid relationship is a bilateral referral agreement. Bakkt will be a Plaid crypto trading solution provider for its clients who are interested in providing crypto solutions to end-customers. Plaid has an extensive network of more than 8,000 fintechs that utilize their platform today.

For Fireblocks, Bakkt will provide disaster recovery services to Fireblocks’ Off-Exchange customers and will also join Fireblocks’ qualified custodian network. The Fireblocks network has thousands of institutions using it daily.

Regarding the pipeline, management indicated that it is seeing good traction in miners, family offices, registered investment advisers, and corporate treasury functions for custody functions. Michael sees the recent Bitcoin ETF activity in the market as a sign of more opportunities for Bakkt. On the trading side, neobanks and fintechs are strong and the Plaid relationship is expected to accelerate opportunities.

View all our fireside chats and reports on Bakkt on our website.
ABOUT THE EXECUTIVES

Gavin Michael has served as Bakkt’s Chief Executive Officer and a director since the Closing. Dr. Michael has served as the company’s President since December 2021. Dr. Michael served in the same role at Bakkt Opco Holdings, LLC (f/k/a/ Bakkt Holdings, LLC (“Opco”)) from January 2021 until the Closing.

Prior to joining Opco, from November 2016 until April 2021, Dr. Michael was the Head of Technology for Citi’s Global Consumer Bank, responsible for the long-term strategic direction, planning and management of Citi’s global technology organization, execution of its cloud architecture, data and service strategies, and driving digitization efforts to accelerate speed to market.

Before joining Citi, from April 2013 until November 2016, Dr. Michael was Head of Digital for Consumer & Community Banking at Chase, where he was responsible for all aspects of the digital business, including the Chase Mobile App and Chase Online. Dr. Michael was also previously the Chief Technology Innovation Officer at Accenture, the IT director for Lloyds Banking Group’s retail banking business, and Head of Strategy and Architecture at National Australia Bank. He has also held senior technology roles at IBM and served as a Director of Avanade, Inc.

Dr. Michael earned a Ph.D. in Computer Science from Australian National University and a bachelor’s degree from the University of Western Australia.

Karen Alexander has served as the Chief Financial Officer since August 2022. Ms. Alexander was previously the Interim Chief Financial Officer of Bakkt since May 2022. Ms. Alexander joined Bakkt in June 2021 as the Chief Accounting Officer. Prior to joining Bakkt, Ms. Alexander worked at GE Capital from October 2004 to April 2021 in finance and accounting roles of increasing responsibility, most recently serving as Global Technical Controller from January 2017 to April 2021. Ms. Alexander began her career as an external auditor with Arthur Andersen LLP and Ernst & Young LLP. She holds a bachelor’s degree in accounting from Miami University (Ohio).
EXECUTIVE DISCUSSION

John Roy: Welcome to today’s fireside chat with Bakkt. I’m John Roy, your host. I work for Water Tower Research, and I cover Technology. I’m joined by CEO Gavin Michael and CFO Karen Alexander. I should mention that Bakkt’s safe harbor statement is on its website.

With that, I’m so glad to speak with you both again. How are you doing?

Karen Alexander: We’re doing well.

Gavin Michael: We’re very well, John. Great to be back. Thank you very much.

John Roy: Thanks for joining us again. Could you give us some of the key strategic highlights that came out of the earnings call for the second quarter?

Gavin Michael: Let me take that one. At the beginning of the year, we laid a set of key strategic highlights and focus areas for the company. I think as we’ve gone through 2Q, you can see that we’re making strong progress, again, executing on those key priorities. We’ve expanded our platform through the acquisition of Apex Crypto. We’re activating and broadening the client network and we’re being prudent with our capital allocation. We’re seeing strong traction with new custody and crypto trading clients.

We’re building new strategic alliances with some very prominent players as our capabilities and best-in-class infrastructure just continue to resonate strongly in the market. I’m excited that we’re expanding into international markets alongside our clients, with Latin America expected to launch in the fourth quarter and other markets like the UK, the European Union, Hong Kong, and Australia to follow. We’re focused on delivering solid results for our existing loyalty clients as we work together to grow their transaction volume.

I think the last point is that we continue to manage our expenses. We’re seeing improved gross profit margins and as part of our 2Q update, we updated our full-year operating cash flow outlook to improve approximately 20% from where we started at the beginning of the year. When you look at the company’s performance through the second quarter, you can see that progress. But importantly, you can see our focus as well. We laid out a set of priorities at the beginning of the year, we continue to deliver against those priorities, and we’re excited by the progress that we’ve made through this last quarter.

John Roy: That sounds good. Speaking of performance, can you give us an overview of the financial performance of the quarter? What were some of the positives and can you improve from here?

Karen Alexander: I’m happy to take that one. Obviously, one of the things I was most excited about was to be able to report Apex Crypto in our results for the first time. We closed that transaction on April 1. If you look at that performance and think back to what happened in the second quarter, it was a tough quarter for the market. The market in general was down on crypto trading volume of about 40%, but we outperformed the market, so we were down 25%. Obviously, it’s never great to be down, but we look at where we were relative to market performance, and I think that showed the durability and some of the things that are unique about the customers that we acquired through the acquisition, and the fact that they tend to be more resilient even through some of the trading costs.

When you also look at the results, one of the things that we were also happy to report is the progress that we’re making with operating expenses. As Gavin alluded to, you’re starting to see the real benefit from the discipline that we’ve put into place and that we’ve been talking about for the past couple of quarters. SG&A was down 23% Y/Y. Comp and benefits were down 21%. We’re obviously focused on activating the partnerships that we’ve signed and signing new ones. When I think about, call it room for improvement or things that we know the market expects from us, I think continuing to see those activations and starting to really show our investors the proof points of the opportunities that we have on the custody side are the things that we’re going to continue to focus on and deliver.

John Roy: You revised guidance. Can you walk us through that? Where does that leave us on the cash position at the end of the year? Do you need to raise?

Karen Alexander: I’ll walk you through it in pieces. On the revenue side, think about it by business. For the loyalty business, we expect to come in relatively consistent with 2022. The one thing to recall in the 2022 performance is that it was a very strong transaction revenue year coming off of a post-COVID rebound. The fact that the loyalty business continues to operate at that level is where we see that net revenue expected to come in at the end of the year, let’s call it, roughly $55 million.

The range that we provided for revenue really comes into the crypto side of our business. At the low end of the range, we’re really looking at the market trading dynamics that we saw in the first half of 2023, and assuming that those remain pretty steady throughout the remainder of the year, we are factoring in international expansion, as you heard us talk about last week, and as Gavin mentioned, with ibex and some of the opportunities that we have internationally, we expect to start seeing that in 4Q. The range between the low end and the high end, really the delta there, is how quickly we can ramp up internationally. We see international as a great momentum maker into 2024, and it’s just going to be a matter of timing for the second half of the year in terms of what you’ll see there.
On the cash flow side, as Gavin mentioned, I was really happy to report that we are taking down our free cash flow utilization outlook; down by $10 - $15 million, which is the 20% reduction referenced. When you really look at those numbers, you’re going to see second half free cash utilization down a good 70% to 80% compared with where we were in the first half of 2023. Then if you compare that with our cash position, at that rate, we’ll end the year with approximately $80 million of cash on our balance sheet.

You think about where we are from a capital position perspective, you’re going to continue to see the benefits from the cost cutting that we did earlier in the year. Even on comp and benefits, we’re going to have another $7 million reduction in 2024, which is the full-year effect of the decisions that we took earlier this year. You’re seeing us continue to improve margins. We’re absolutely still working toward being adjusted EBITDA break-even by the end of 2024.

**John Roy:** Taking a look at the crypto transactions, I mean the take rate there. Can you walk us through that and then what should we think about that rate going forward?

**Karen Alexander:** Obviously, when you look at our statement of operations, we’ve got some big numbers on there because as I mentioned last week on the call, we actually report crypto service revenue on a gross basis. That’s an accounting phenomenon because from an accounting perspective, we act as a principal in the services that we provide. If we think about the economics of crypto trading, you’ve got gross crypto revenues, which is basically the gross proceeds from the purchases and sales of crypto back and forth into cash and coin.

We typically have a spread on those of about 100 basis points. Then, when you look below the revenue line, you’ll see a gross crypto cost line that is really primarily the cost of providing the crypto basically net of the spread. Then it also includes some, for instance, blockchain fees and the like, but it’s mostly the difference; that 100 basis points between the rate that we charge to the customer and the cost of fulfilling that trade. The line that you’ll see after that on the statement of operations is what we call execution, clearing and brokerage fees, which is a very long way of saying this is the rev share that we give to our partners. As we’ve talked about a lot, we are a B2B2C model, so we’re partnering with partners like Webull. They are basically serving as our introducing broker, so we’re giving them a share of that spread.

When you do the math on all of that, you could either get in dollar terms or in basis point terms, the take rate, what drops down to the bottom line to us in terms of the contribution of those trading activities. For the second quarter, it was about $1.3 million, which translates to about 38 bps. That amount, if you look historically at how Apex results looked over time, it’s always been somewhere in that 30- to 40-bp range. It could change because every partner is different in terms of how we do the rev share, for instance. We have partners where we have a tiered structure, which we think works well for both of us because the more their customers trade, as they go into higher tiers, the more rev share that they could take from us.

You could see a change over time depending on what the partner wants to do in terms of the spread that they charge, and then what we do with rev share. But we have a pretty good track record of being in, let’s call, the mid-to upper 30-bp range.

**John Roy:** That gives a clear picture of where you think things are headed. Let’s talk about custody. A couple of investors have been asking me, why wasn’t Bakkt more in the Bitcoin ETFs and could we talk about the custody situation?

**Gavin Michael:** We’ve been fortunate that clients are proactively reaching out to us because there’s interest in this secure, trusted institutional-grade custody platform that we’ve built. Honestly, the influx of client interest has been even more pronounced as we’ve seen the disruptive events in the crypto markets, which are really highlighting the difficulty in storing digital assets and, importantly, the need for multi-custodian access. While we’re signing up new custody clients and we’re focused on using this momentum, when we look at initiatives like the ETF products that are happening, we see that as just opening up the market for us. I would say that many of the relationships that you’ve seen in those environments are ones that have been in market for a while. But the focus on this multi-custodial access and diversifying the custody relationship and us continuing to build on our custody solution with the ability to do private key backup is really giving us enormous opportunity in a wide range of client opportunities, including those that you mentioned.

**John Roy:** Is custody a commodity? It doesn’t really sound like it. Could you give us an idea what the revenue potential and costs look like.

**Karen Alexander:** I can definitely speak to that. If you think about custody, just the core of what it is, it is a service and it’s really a backbone product where we earn fees as a percentage of assets under custody. Sometimes there’s some minimums in there that give us a floor, but it’s a pretty straightforward AUC model. But to Gavin’s point, and one of the things that we mentioned last week is we talk about our custody solutions as a solutions portal. It’s not just taking and holding the assets, but we’re really looking to expand those services. We’ve already been talking about the Off-Exchange solutions that we’re providing disaster recovery, the future roadmap that we have to start supporting more assets and things like institutional staking and open loop.

What that does over time is that really diversifies the revenue profile because you’re going to have a mix of revenue that’s based on assets under custody. You’re going to have some that are based on a platform or fixed
fee structure. I think disaster recovery is one of those examples. When you compare that with what we’ve built so far, we’ve built a lot of this infrastructure already and we’ve got a team, a development team that we feel like is right-sized now, not only to complete the near-term roadmap, but also to add these features over time. We don’t see our costs going up. On a variable basis like the incremental variable cost for bringing on, for instance, a new custody customer is minimal.

You’re really going to see leverage as we add those custody customers too. Basically, they could be serviced primarily out of our fixed cost base. We feel like we’ve got the right tech team to continue to build out those capabilities without having to add incremental variable costs. I think you’re going to really see, again, the leverage coming out of that part of the product and what we’ve built as it grows.

**John Roy:** Great. Let’s transition to the new collaboration with Plaid and Fireblocks. Could you walk us through the details on what those are and what that’s really going to bring to Bakkt, and maybe some color on revenue potential?

**Gavin Michael:** These are great new strategic relationships for us. It’s providing us with access to a strong pipeline of prospective clients, who are already inside the Plaid and Fireblocks networks today. With Plaid, it’s a bilateral referral agreement. We will be a Plaid crypto trading solution provider for their clients who are interested in providing crypto solutions to their end customers. They have an extensive network of more than 8,000 fintechs that utilize their platform today. The agreement provides us with a strong pipeline of prospects for our crypto solutions and it’s bilateral in that, while Plaid is referring customers to us for crypto, we’ll also take advantage of their infrastructure to be able to refer clients of ours. We’re looking for access to Plaid’s extensive set of services and we would then refer them onto Plaid. We like this in that it is a bilateral agreement.

With Fireblocks, it’s a multifaceted agreement. We’re going to provide disaster recovery services to Fireblocks’ Off-Exchange customers who will also join Fireblocks qualified custodian network. The way to think about it is with our relationship, every Off-Exchange customer will require a disaster recovery package, so again tremendous opportunity for us in safeguarding these assets.

The Fireblocks network has thousands of institutions using it daily. It provides us, again, access to a strong pipeline of prospective clients. These partnerships are really designed to expand our client base, expand our volumes, and bring to us a set of targeted opportunities, where there’s interest in the assets and capabilities that we offer, whether that be our trading platform or our secure custody platform.

**John Roy:** Sounds like some good collaborations coming forward here. Obviously, Apex Crypto just closed and it did do a lot of things, good things for you guys this quarter. Could you give us a view into what you think are the biggest revenue opportunities going forward.

**Gavin Michael:** What Apex Crypto gave us was the capability of an advanced trading platform that coupled well with our secure custody environment together with our fiat on-ramps. What we announced last week is this continued expansion of our crypto trading clients, and mostly in the fintech industry. This is a direct result of the acquisition of Apex Crypto. We signed on new clients and we’re engaged in a set of late-stage negotiations with an additional number of prospects.

We’re also making solid progress on the international expansion. We’re actively working with the client base to execute a go-to-market strategy in markets with regulatory clarity. Again, our entry into those markets is through clients that already have an existing presence there, partners of ours who are seeing the regulatory clarity as providing them with an environment, where there’s a changing consumer sentiment that they want; positive sentiment, that they want to take advantage of. When we look at growth and look at the opportunities to continue to drive growth in the fintech and neobank space, we’ve demonstrated the ability to continue to capture more share. We’re excited by the potential of that both here in the US, but also growing internationally and they’re a direct result of the Apex acquisition.

**John Roy:** Can you give us your view into the pipeline, and where you are seeing traction in signing new clients?

**Gavin Michael:** We’re seeing traction in this new client activity. When we think about custody, for example, custody is really working well with prospects including mining, family offices, registered investment advisers, and corporate treasury functions as well. The qualified sales opportunities for custody are up 10 times in the first half of 2023 compared with the second half of 2022, so great momentum in establishing a pipeline of strong custody relationships. As Karen mentioned, it’s a great anchor product. It gives us a strong base from which we can build other services. We’re excited by the way the pipeline is shaping up for custody.

In trading, we obviously continue to see that growth in the US, again, in that neobank, fintech space. Great traction and with the added pipeline coming in from Plaid, we’re excited by what’s happening here in the US.

But, as I said earlier, the international growth is very strong and we like the markets, where we see that increased regulatory clarity and we like the fact that a number of our existing partners are looking to expand their operations into those markets and are using crypto as part of that expansion proposition. Again, when we look at the pipeline, we’re really happy and excited with the growth that we’re seeing in custody, excited by what we’ve signed with Fireblocks as a way to give us greater access and greater depth. But the diversity of opportunity across mining and family offices, the RIAs and the corporate treasury functions is really giving us a solid base together with then the trading platform growing both here in the US and then using that as an expansion proposition into those international markets.
John Roy: I think we need to leave it here, because we’re running out of time today. Gavin, Karen, thank you so much for joining me today in today’s fireside chat. Investors, if you’d like to learn more about Bakkt, please visit its website or you could look at our WTR research. Thanks everyone for joining us today.


Gavin Michael: Thanks, John.

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ABOUT THE ANALYST

John Roy  
Managing Director

Prior to Water Tower Research, John worked as a lead analyst at UBS, covering IT Hardware, Communications Equipment, and IT Services. During his 20 years covering technology stocks on the sell-side, he was also a lead analyst covering IT Hardware and Nanotechnology at Merrill Lynch; and Alternative Energy, Advanced Materials and Nanotechnology at W.R. Hambrecht, and at Janney Montgomery Scott. Before his sell-side equity research career, John was a lead software architect at J.P. Morgan, an AI sales engineer at Neuron Data, and a systems engineer and AI researcher at Hughes Aircraft.

John holds a Ph.D. in Computer Science from the University of California, Irvine, a MSEE degree from the University of Southern California, and a BSEE degree from the University of California, San Diego where he was a Regents Scholar.
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