CORPORATE PARTICIPANTS

Stephen Cooper, Co-Founder, President, Chief Executive Officer & Director
John Morrison, Chief Financial Officer

CONFERENCE CALL PARTICIPANTS

Ruben Roy, The Benchmark Company
Scott Searle, ROTH Capital
Joe Gomes, Noble Capital

PRESENTATION

Operator:

Good afternoon, and thank you for joining us today to discuss One Stop Systems’ financial results for the third quarter ended September 30, 2019.

With us today are the Company's President and Chief Executive Officer, Steve Cooper; and its Chief Financial Officer, John Morrison. Following their remarks, we will open the call to your questions.

Before we conclude today's call, I will provide some important cautions regarding the forward-looking statements made by Management during the call. I would also like to remind everyone that today's call will be recorded and will be made available for replay via the instructions in today's press release in the Investors section of the Company's website.

Now I would like to turn the call over to OSS' President and CEO, Steve Cooper. Please go ahead, sir.

Stephen Cooper:

Thank you, Jessica, and good afternoon, everyone. Q3 was another strong quarter with strong record revenue and strong earnings growth. As recently reminded by a long term shareholder and advisor, the growing revenue and developing state of the art technology is good, but the earnings growth is what is really important. He also commented that they call it an earnings call for a reason, so with that, let me talk about earnings growth.

We have in place a corporate earnings growth strategy which includes three key elements: grow revenue, improve profit margin, and contain expenses. I am pleased to report that we are making progress in each of these areas. Revenue is at record level and strong growth is expected to continue. Our margins are increasing and we are managing our expenses such that they are declining as a percentage of revenue.
That resulted that the Company’s earnings are increasing nicely. There are quarterly fluctuations and nonrecurring accounting items that sometimes obscure these underlying trends but if you look at the nine-month results, particularly for adjusted EPS or Adjusted EBITDA, it is very clear that we are making strong progress with earnings growth. Our earnings growth strategy is a key focus throughout the Company and we are committed to see these trends continue throughout this year and into 2020.

In addition to earnings growth, we have several highlights to report. One of the highlights for the quarter was the excellent performance from our Bressner business unit, which we acquired in October 2018. Bressner revenue set a new quarterly record and their profitability exceeded our expectation. Sales of our traditional OSS products sold through the Bressner in Europe have increased significantly illustrating the strategic benefit of having a strong European sales presence.

Another highlight of the quarter was closing new long-term contract and moving into volume production for key customer design-in. This included signing a $36 million long term agreement to provide MIL-SPEC flash arrays and beginning production that gives our $60 million agreement for video display systems. We expect these long term programs will provide a substantial revenue and profitability stream for many years to come.

At this point, I'd like to turn the call over to our CFO, John Morrison, who will take us through the financial results for the quarter. Afterward, I'll return to discuss our outlook for the remainder of the year. John?

John Morrison:

Thank you, Steve, and good afternoon, everyone. Thank you for joining us today. Earlier today, we issued a press release with our results for the third quarter ended September 30, 2019. The earnings release is available on the Investors Relations section of our website at onestopsystems.com.

Starting with our statement of operations. Our revenue in the third quarter increased 55% from $9.6 million to a record $14.9 million. This increase in revenue was primarily driven by revenue from acquisition. CDI, acquired in August 2018, contributed $626,000, and Bressner, acquired in October 2018, contributed $5.2 million. Revenue on an organic basis decreased 2% from $9.6 million to $9.4 million. The decrease was primarily attributable to reduced shipments, approximately $1.4 million of our military arrays compared to our unusually high level of shipments in Q3 of 2018. Quarterly shipment fluctuations from this military program are not unusual; however, the program continues to grow on an annual basis. Revenue from the first nine months of 2019 increased 76% to $39.9 million with organic growth of $2.2 million or an increase of 9%.

Our gross profit in the third quarter increased 59% to $5 million with gross margins improving from 32.9% to 33.7%. For the first nine months of 2019, our gross profit increased 83% to $12.9 million, with gross margins improving from 31% to 32.2%.

In the third quarter of 2019, our operating expenses increased 31% from $3.5 million to $4.6 million. The increase was primarily due to increased expenses associated with the acquisition or additions of CDI and Bressner. As Steve pointed out earlier, our expenses are growing at a rate less than our revenue growth and thus are becoming a lower percentage of our revenue.

Net income on a GAAP basis was $545,000 or $0.03 per basic and diluted share in Q3 compared to the net income of $1.3 million or $0.09 per diluted share in the year ago period. The year ago period included a unique tax benefit of $1.4 million. Excluding this tax benefit, GAAP EPS improved by $0.04 per share. Given the significance of our non-cash charges and one time acquisition expenses that are included in the GAAP financial statement, we believe non-GAAP earnings per share and Adjusted EBITDA metrics can be helpful in evaluating our overall financial performance.
Non-GAAP net income is $901,000 or $0.05 per diluted share in Q3 as compared to $1.6 million or $0.11 per diluted share in the year-ago period. Again, excluding that unique tax benefit which occurred in the prior year, non-GAAP EPS improved by $0.04 per share. Adjusted EBITDA was $947,000 in Q3 as compared to $614,000 in the same year-ago period.

Now, moving to our balance sheet. Our cash and cash equivalents were $4.2 million as of September 30, 2019 as compared to $4.9 million at June 30, 2019. During the quarter, there were several activities that affected our cash position. First of all, we received net proceed of approximately $2.6 million from an equity offering. Cash flow from operations was negative $1.3 million due to a customer overpayment refund of $2.5 million. The Company also invested $705,000 for new capital equipment and paid down debt by $1.2 million. The net of these activities was a decrease in cash on hand of approximately $700,000. We believe our cash on hand and available funds provide the Company with sufficient liquidity to meet our cash requirements for the current operations.

Now, I'd like to turn the call back to Steve. Steve?

Stephen Cooper:

Thank you, John. Looking forward, we are encouraged by our sales prospect. So far this year, we won a total of 16 new design-ins across all three of our business units, each with multiyear values exceeding $1 million. Our sales pipeline also looks strong and currently includes 15 major design-in opportunities. Winning new designs is key toward diversifying and expanding our customer base and will help drive our growth in 2020 and beyond. The reason we are seeing these great opportunities is our technological leadership in areas that are essential for the AI on the edge mega trend. The needs for these applications are high amounts of IO inputs from sensors and cameras, high capacity, high speed storage and massive computational power.

Our PCI Express Gen 4 IO expansion products fulfill the high IO need and our ion accelerate flash arrays fulfill the storage need, and our AI and applied compute accelerators fulfill the computational need. When we combine these great technologies with our expertise and custom rugged environment, design and test, you have the OSS winning formula.

Our technological leadership strengthening results, major contracts, and design-ins means we are on track towards a record 2019 and a strong momentum going into 2020. We reiterate our guidance for revenue of $15.5 million to $17.5 million in Q4 and given our strong Q3, this narrows our annual expectations to $55 million to $58 million for the full year, representing overall annual growth of 49% to 57% with organic growth of 8% to 10%. The actual timing of shipments from quarter to quarter may fluctuate depending upon changes in customer delivery schedules and other external factors.

We'd now like to open the call to your questions. Operator?

Operator:

Thank you. If you would like to ask a question at this time, please press star, followed by the number one on your telephone keypad. If you're calling from a speakerphone, please make sure your mute function is off to ensure your signal can reach our equipment. Again, star, one to ask a question and I will pause for just a moment.

We'll go first to Ruben Roy with the Benchmark Company.

Ruben Roy:
Thanks for taking my questions, and Steve and John, congrats on another nice quarter and good outlook for the end of the year here.

I just wanted to start with the design win commentary, it looks like you added another five wins during the quarter and first of all, as you layer these design wins in, do you have some clarity at this point on how you are expecting them to roll into revenues? It looks like you got some revenue from Oracle this quarter, maybe give us a little bit of an idea how these might play out as you look forward over the next 12 to 18 months? Then also I was wondering on the mix at this point, you have got these 16 design wins, how do they look from a military versus commercial perspective? Thanks.

Stephen Cooper:

Yes, we had a great year in terms of winning design wins, not only we had more prospects than we traditionally had, but our win rate has also been higher than normal. In terms of timing of how the design wins move into revenue, it varies from each one, but typically there is, we win the design, which is usually when we start designing the custom products for them, so we declare it a win once we get a substantial financial commitment from the customer, meaning they placed a major PO to do the design. The designs typically take six months to nine months for commercial projects and about a year to year and a half if it is a military project because of the extra testing required for military programs, so each design win, you can model it, we do model it for next year, so the design wins that we won earlier in this year are just now starting to go into production and will start (inaudible) from the beginning of the year, but the design wins, for example, the ones we won just this past quarter will probably generate more significant revenues in Q3, Q4 of next year.

Ruben Roy:

That's really helpful.

Stephen Cooper:

Second question, which was the mix of military versus commercial. Most of the design wins we won thus far this year, probably three quarters of them have been in the commercial space. However, a couple of ones that are in the military space are quite a bit larger, so in terms of financial results, if you weigh them based on their revenue potential, I would say it is about 40% military, 60% commercial, is the ratio we are seeing right now.

Ruben Roy:

Got it, okay. Thanks for that, Steve, it is helpful. A quick followup would be, as these two start to roll ahead and it seems like, as you said, you are hitting a win rate that is well above your targeted 30%, how is that, again, from a longer term perspective, play into your calculus on expenses? You have been bringing those down nicely, it looks like you are going to end the year may be 35% of revenue or so, but do you have a target for expenses as you continue to win these design wins?

Stephen Cooper:

Yes, the design wins, of course, almost always require engineering to complete, so since winning more design wins means we need more engineers, which increase our expenses, but to the extent that revenue is coming on more rapidly than the design wins are ramping up, as you note, the percent of total revenue is coming down, as we are getting higher and higher efficiency. We do expect that to continue
next year, I believe next year’s model, John, help me on this, for expenses and percent of revenue, might be…?

John Morrison:

We are looking probably closer to about 33% range.

Ruben Roy:

Okay, great. That’s all I had for now. Thanks, guys.

Stephen Cooper:

Thank you.

Operator:

We’ll now take a question from Scott Searle with ROTH Capital.

Scott Searle:

Good afternoon, thanks for taking my question. Nice job on the quarter, guys. Just following up on Bressner, excellent quarter, I think it was a record quarter, could you give us a little bit more color in terms of where you are seeing some of the strength and the sustainability for Bressner looking out over the next couple of quarters? Then have some follow-ups.

Stephen Cooper:

Bressner has been extremely stable all year every quarter, over achieving what we have planned for them, having a great year. The strength has been pretty much across the board in the traditional products that they had been selling prior to the acquisition. In terms of Bressner, they have been extremely steady all year long. They have been performing well with their traditional products and then exceptionally well, more than doubling the revenue from the OSS products that we sold into Europe. That does not count as organic growth. Some of us would complain may be it should, but a lot of their growth is just a result of the OSS products being sold more successfully throughout Europe.

Scott Searle:

Thanks, and just to follow up on the gross margins, good job on the gross margins, I am starting to get some scale benefits there, but also flash pricing has been somewhat helpful I think. Can you talk a little bit about how you are feeling about gross margins sequentially and then thinking about next year, what is the target range that you are thinking about from a gross margin standpoint?

John Morrison:

We are looking to finish off the year right around 32.8% overall gross margin for the entire business and we hope to improve that by somewhere hopefully at least a 0.5%.

Scott Searle:

Okay. Just to follow up on big customers, Raytheon and Disguise, you have got some nice long term contracts with them, but there are also some other design opportunities within them, other storage arrays,
GPU accelerators, I believe, on the Raytheon front, as well as some additional products potentially with Disguise. I was wondering if you could just give us an update in terms of what you are seeing there, the opportunity set or there was a longer term opportunities as opposed to something that would materialize in 2020?

Stephen Cooper:

As you mentioned, there is new design activity going on in both Raytheon and Disguise. In the Raytheon, we mentioned before we were working on a GPU compute accelerator for them. We have done some prototypes and they are still in the proof concept phase. It has taken longer than expected, but we do still expect to win a major design win in the next couple of quarters to basically militarize our latest compute accelerator so that it can be used in the airborne application. We are also working with Raytheon and others on a new reduced size solid state disc, which will again be full meal spec and go into a variety of aircrafts. We are excited about that.

On the Disguise front, we just recently won two new designs. It is important because in the commercial market, designs turn over fairly quickly, meaning a singular design may have a three- to five-year lifespan, so it is important that we continue to win the next generation designs and we are pleased that we won all of their new design opportunities this year, including two that are under development right now.

Scott Searle:

Great, and just in terms of the pipeline, I think 16 new design wins, another 15 in the pipeline. Can you give us an idea in terms of verticals, how they are breaking down? In the past, I think you have made reference to autonomous vehicles, but there is a tremendous amount of activity going on when you think about computational power and intelligence (inaudible) required in industrial IoT application, so maybe help us understand where you are seeing the design activity, where you are seeing the interest, and maybe a channel strategy in terms of how you are attacking some of that?

Stephen Cooper:

For us, the pipeline is quite horizontal, so it does involve a lot of application, this concept of AI, level of computational power moving to the edge really affects a lot of different areas. In particular, we are seeing AI and self driving vehicles, we won several designs in that category now. We are seeing medical imaging, where again we won several designs; test and measurement is big for us, again with several designs; as well as IoT, which by itself can mean a lot of different kinds of applications, but all of those spectrum of applications seem to be resonating for our types of products.

In terms of your second question, was around sales channels, we believe because our products are the customized version of these things, the best sales channel is a direct sales force, which we have throughout the U.S. and now throughout Europe. We do continue to sell through distributors primarily in the Asia/Pacific region, but as we grow and over time, it is likely that we will establish more of a direct sales present in those regions as well.

Scott Searle:

Got you, and lastly, just to finish up, it is a little early, but thinking about 2020, I was wondering if you could share your initial thoughts from an organic growth perspective as we’ll be grandfathering the acquisitions, what you are seeing in your initial cut looking out to 2020, particularly given the level of new design wins? Thanks.
Stephen Cooper:

We are excited for 2020, we have got a tremendous amount of momentum going now and as we forecasted for Q4, even at the low end of the range, it is an all-time record, so we are quite confident that we are going to finish the year strong. Two thousand and twenty, we believe will be more of the same. At this point, there are no new brand new acquisitions to complicate matters. We are really focusing on organic growth, new design wins. Our growth rate for the year looks to be around the 9% organic rate, everything to come is included in organic starting Q1 of next year and we expect that 9%, hopefully into the double digit 10% or 11% growth for the year, and then with earnings growth, with all of our earnings growth strategies, should be quite a bit higher than that as a percentage, may be double that in terms of the growth rate.

Scott Searle:

Great, thank you.

Operator:

Again, if you would like to ask a question, please press star, followed by the number one on your telephone keypad.

We’ll now go to Joe Gomes with Noble Capital.

Joe Gomes:

Good afternoon. Let me add my congratulations for the quarter, thanks for taking the question.

Stephen Cooper:

Thank you.

Joe Gomes:

Just want to circle back here, the quarter, as you mentioned in the organic growth is kind of light. Last quarter you talked about the large dollar value of flash array sale for Raytheon and then you were somewhat concerned about some of that might slip out of the quarter, was all of that shift in the quarter or did some of that slip into the fourth quarter?

Stephen Cooper:

Yes, that pretty much explains the whole organic growth shift. You may recall that we announced that we had closed a $5.5 million Raytheon PO, that the product which shipped mostly in Q3 and Q4 and that as we commented on, the exact split between Q3 and Q4 was a little unknown. In Q3, of that $5.5 million, we ended up shipping $1.3 million of it. In Q4, we expect $3.8 million of that order to ship and there is about $400,000 of that order which will slip into 2020. That is part of why we have such high expectations and confidence that Q4 is going to be such a remarkable quarter.

If we go back to a year ago, Raytheon hit dramatically in Q3 and so that is what John pointed out, that even though we shipped $1.3 million to Raytheon in the Q3 of this year, we had shipped $2.7 million to Raytheon in the year-ago period. Both are significant numbers, the Raytheon shipments from quarter to quarter fluctuate quite a bit and because it is such a significant customer, it does tend to swing the whole
growth rate on a quarterly basis. I think if you look at our finances over a nine-month or one-year period, you could see the trends a little more clearly than just looking at a quarter.

Joe Gomes:

Right, okay. Thanks for the insight, and I know you mentioned that, for 2020, that you do not have any new acquisitions that would be skewing the numbers, so to speak, but you had also talked previously about how acquisition was a strategy of the firm and I know you were taking some time to digest the Bressner, the CDI, where do you guys see yourselves on that acquisition trail? Is it still more digesting? Is it starting to give, start looking again for other opportunities out there, where do we stand there?

Stephen Cooper:

Yes. We called it a strategic pause earlier this year, that we were going to pause on aggressively going after acquisitions. We have recently re-confirmed with our Board and Management team that we want to continue that pause for a number of good reasons. Perhaps the most important reason is that it gives us time to focus on the synergy and this earnings growth strategy that I alluded to, that is really our focus right now, how do we improve the efficiency of the Company and take full advantage of the much larger and more capable company that we built. I do not anticipate a new acquisition, at least not a strategic acquisition. There may be some tactical small things, but I do not foresee a new large strategic acquisition for at least the next six months. Something may come up and we may want to jump at it, but it is definitely on the back burner right now.

Joe Gomes:

Okay and one last one, we talked about Bressner and how well that has been performing, can you give us a little more update, a little more color on CDI and how that has been performing here recently?

Stephen Cooper:

The CDI business unit is healthier, particularly the first half of the year. There was tremendous turmoil within the in-flight entertainment sector, companies acquiring each other and companies having a tough time and a number of their key programs got pushed out. We talked about that in our Q1 earnings call where revenue was pushed into Q1 and into Q2 and it was just lower than it has been historically, so it has been a difficult year.

The good news is the second half is turning out much stronger. Q3 was an okay quarter, I would say; Q4 is looking like the best quarter that they will have since we acquired the company and we believe the prospects for next year are even greater. We think it is a bit of recovery where we are working on all three elements of improving margin and controlling or reducing expenses, but also there is a big element of increasing revenue in the CDI case. We still see a great potential with this business unit. In fact, with the size of the orders that they are closing, including the list design opportunity, we see that perhaps the highest growth element of our business next year will be the CDI business.

Joe Gomes:

Great, thank you very much.

Stephen Cooper:

Thank you, Joe.
Operator:

We have no more questions. I'd like to turn the conference back to our speakers for closing remarks.

Stephen Cooper:

Thank you, Jessica, and thank you, everyone, for joining us today. We look forward to talking to each of you in the future and reporting our progress. Meanwhile, feel free to reach out to John or me at any time. Operator?

Operator:

Thank you. Now before we conclude today's call, I would like to provide the Company's Safe Harbor statement that includes important cautions regarding forward-looking statements made during today's call. One Stop Systems cautions you that statements in the presentation are not a description of historical facts are forward-looking statements. These statements are based on Company's current beliefs and expectations. Such forward-looking statements include those regarding the Company's expectations for 2019 revenue growth generated by new products, design wins or M&A activity. The inclusion of such forward-looking statements and others should not be regarded as a representation by OSS that any of its plans will be achieved.

Actual results may differ from those set forth in the presentation due to the risks and uncertainties inherent in our business, including, without limitation: that the market for our products is developing and may not develop as we expect; our operating results may fluctuate significantly, which would make our future operating results difficult to predict and could cause operating results to fall below expectations or guidance; our ability to successfully integrate the operation systems, technologies, product offerings and personnel with acquired companies may prove difficult and adversely affect our financial results; our products are subject to competition, including competition from the customers to whom we may sell and competitive pressure from new and existing companies, may harm our business sales, growth rates and market share; our future success depends on our abilities to develop and successfully introduce new and enhanced products that meet the needs of our customers; the likelihood of our design proposals becoming design wins is uncertain and revenue may never be realized; our products fulfill specialized needs and functions within the technology industry, and such needs or functions may become unnecessary or the characteristics of such needs and functions may shift in such a way as to cause our products to no longer fulfill such needs or functions; new entrants into our market may harm our competitive position; we rely on the limited number of suppliers to support a manufacturer design process and if we cannot protect our proprietary design rights and intellectual property rights, our competitive position could be harmed or we could incur significant expenses to enforce our rights; our international sales and operations subject us to additional risks that can adversely affect our operating results and financial condition and we fail to remedy material weaknesses in our internal controls or financial reporting; we may not be able to accurately report our financial results and other risks described in our prior press release and in our filings with the Securities and Exchange Commission, SEC, including under the heading Risk Factors in our annual report on Form 10-K and any subsequent filings with the SEC.

You are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date of the conference call, and we undertake no obligation to revise or update this information to reflect events or circumstances after this date hereof. All forward-looking statements are qualified in their entirety by this cautionary statement, which is made under the Safe Harbor provision of the Private Securities Litigation Reform Act of 1995.
Before we end today's conference, I would like to remind everyone that this call will be available for a replay starting later this evening through November 21. Please refer to today's press release for dial-in and replay instructions available via the Company's website at ir.onestopystems.com.

Thank you for joining us today. This concludes our conference. You may now disconnect.