One Stop Systems, Inc.

Second Quarter of 2018 Conference Call

August 8, 2018

CORPORATE PARTICIPANTS

Steve Cooper, *President and Chief Executive Officer*

John Morrison, *Chief Financial Officer*

CONFERENCE CALL PARTICIPANTS

Scott Searle, *ROTH Capital Partners*

Rudy Miller, *The Miller Group*

PRESENTATION

Operator:

Good afternoon and thank you for joining us today to discuss One Stop Systems' Second Quarter ended June 30, 2018 Results. With us today are the Company's President and Chief Executive Officer, Steve Cooper, and its Chief Financial Officer, John Morrison. Following the remarks, we will open the call to your questions. Then before we conclude today's call, I'll 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 telephone replay via instructions in today's press release in the Investors' section of the Company's website.

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

Steve Cooper:

Thank you, Kari (phon), and good afternoon, everyone. Thank you for joining us on today's call. Today I'd like to discuss our financial and operational performance, our plan to acquire Concept Development Incorporated and our increased quarterly guidance. These are really exciting times for One Stop after a basically first had—basically flat first half, we're now on the cusp of a breakout growth and success in our marketplace. It's quite a step function where our quarterly revenues are expected to more than double over the next two quarters; really remarkable growth. The breakout growth is due to five factors that we've previewed in our other earnings call and said in the second half it's going to be great; well, now we're there and it's really happening.

First, our OEM media and entertainment customer has increased their forecast for Q3 and Q4 up to record levels and that's fantastic. Secondly, our military flash array program is ramping up. Third, we recently won two new design-ins, one for a new media and entertainment system and a second one for a new flash array using the Ion 5.0 software. Fourth, our products and design capabilities are really resonating with the marketplace. In fact, we've submitted more proposals with values in excess of $1 million than at any time during our Company's history. Typically we have one to two of those proposals outstanding; we currently have more than 10 outstanding so a lot of customers beating the path to the door, so to speak. Last but certainly not least, our M&A has just about concluded a new acquisition with Concept Development Incorporation. That, of course, is the big news of the announcement and let me talk a little bit more detail about that.

First, we're now in the final phases of the acquisition agreement for Concept Development, known as CDI, and we expect to close the deal by the end of August. CDI designs and manufactures specialized high performance computing products for the avionics in-flight entertainment markets. You can learn more about CDI from their website at cdvinc.com. The strategic benefits of the acquisition include: we get access to the in-flight entertainment market space and its customers; they have tremendous technical expertise in the design and manufacturing of airborne equipment; they already have significant OEM design-ins and have a number of new opportunities that we believe, together, we can win in the next few years; and fourth, it enhances OSS's technical capabilities in full. In fact, we have already been talking to some of our customers who are very excited that CDI's capabilities combined with One Stop's capabilities and really further what they would like to do with their products.

Some of the highlights of the financial elements of the deal include a consideration of roughly $4.9 million worth of stock and about $1 million of cash. As a result of the acquisition, we will add $4 million to $6 million in projected annual revenue and CDI is also currently profitable and running about 38% to 42% gross margin which is higher than One Stop typically runs so this deal will help increase our gross margin’s profitability. Together we have more capable resources for bringing high performance computing to the IFE, which is in-flight entertainment, marketplace and others while offering greater value proposition to our combined customer base. We plan to continue to operate as separate business units but with a dynamic exchange of talent, expertise and engineering know how, we also expect to realize synergies and efficiencies with our combined sales marketing, accounting, engineering and human resource departments.

Jim Reardon, the current CEO and President of CDI, will continue as President of CDI business unit and also as a major shareholder of One Stop. We expect to complete the merger later in August. Before I go further into our outlook for the remainder of the year, I'd like to turn the call over to our CFO, John Morrison, who will take us through the financial results for the second quarter of 2018. John?

John Morrison:

Thank you, Steve, and good afternoon, everyone. Thank you for joining us today. Earlier today, we issued a press release with the results of our second quarter ended June 30, 2018. A copy of the release is available in the Investor Relations section of our website at onestopsystem.com. Following our IPO in February, we launched this new Investor Relations section in order to provide our stockholders and other interested parties with important Company information. This includes SEC filings, stock information, corporate presentations, press releases and corporate governance documents. We plan to continue to use this site for disclosing both material and non-material information about OSS. We encourage you to visit the site often and sign up for email alerts.

Now, for the second quarter of 2018. Our revenue in the second quarter of 2018 was $5.9 million as compared to the year ago record quarter of $7.5 million. The decrease was primarily due to lower sales to our significant OEM media and entertainment customers versus a year ago, as well as a delay in the shipment of flash storage arrays that we anticipated to ship in the second quarter of 2018 which was valued at approximately $1 million.

Gross margin percentage decreased to 27.8% of revenue in the quarter as compared to 35.6% in the year ago quarter. The decrease in gross margin is primarily due to increased applied labor and overhead of $278,000 which had been previously capitalized and was released from the inventory. This charge-off eroded the overall margin by 4.9 percentage points. The consolidation of SkyScale contributed negative gross margin of $148,000 or 2.8 percentage points of the margin decrease due to under-utilization. Excluding the increase in the applied labor and overhead, the absolute core OSS operations contributed gross margin at a rate of 33.7% in the second quarter as compared to 35.6% in the year ago period which was mainly attributable to product mix, increased sales and those being laid over a cost of revenue base which was largely a component of fixed costs.

Operating expenses increased by $335,000 to $2.8 million or 47% of revenue as compared to $2.4 million or 32% of revenue in the second quarter of 2017. The change was primarily due to increased costs associated with the addition of the Ion software development team and costs associated with being a public Company.

Net loss attributable to common stockholders on a GAAP basis was $1.5 million or a loss of $0.12 per diluted share. This compares to net income attributable to common stockholders on a GAAP basis of $257,000 or $0.03 per diluted share in the second quarter of 2017. On a non-GAAP basis, net loss attributable of common stockholders was $724,000 or $0.06 per diluted share as compared to net income attributable to common stockholders of $457,000 or $0.05 per diluted share in the second quarter of 2017. Adjusted EBITDA was negative $576,000 as compared to a positive $609,000 in the same year ago quarter.

As we discussed on our Q1 call, we believe our non-GAAP earnings per share and Adjusted EBITDA metrics are helpful to assist in the evaluation of the Company's financial performance. Please reference our definition and use of these non-GAAP terms and the reconciliation to GAAP in today's press release. As I also discussed on our previous earnings call, I would like to describe an unusual tax situation we have in terms of the customary relationship between income tax expense and pretax income. The net loss for the second quarter of 2018 included an income tax provision of approximately $506,000 as compared to $65,000 in the year ago quarter. Customarily, when you have a pretax loss you would expect to have a tax benefit but similar to the first quarter, we recorded a tax provision in the second quarter despite having a pretax loss.

In determining our current quarter income tax expense, GAAP requires us to forecast our annual effective income tax rate, or better known as AETR, for the year ending December 31, 2018. Based on Management's projections, we expect income tax benefits related to research and development credit and equity compensation benefit to exceed our pretax earnings in 2018. As a result, we expect our AETR to be negative for the year ending December 31, 2018, and when this negative AETR is applied to our current quarter's pretax loss, the result is the quarterly income tax expense. If we experience pretax earnings in future quarters, we expect to report an income tax benefit as a result of the negative AETR that we are forecasting for the year ending December 31, 2018.

Now, turning to our balance sheet. Cash and cash equivalents totaled $9.3 million at June 30, 2018 as compared to $186,000 at December 31, 2017. The increase in cash was due to proceeds from our IPO in February. All outstanding notes, the balance of our bank line of credit and a significant portion of accounts payable were paid off in the proceeds, resulting in OSS operating debt free.

This wraps up our financial results for the quarter. I would like to turn the call back over to the Steve.

Steve Cooper:

Thanks, John. As I discussed earlier, we expect dramatic growth in the third and fourth quarter, including CDI and exclusive of any other M&A activity, we expect revenue of $10 million to $10.8 million in the third quarter, ramping up to $13 million to $14.2 million in the fourth quarter. This represents revenue growth of

68% to 82% in the second half of 2018 versus the second half of 2017, it's really quite an amazing growth. For 2018, revenue for the full year is anticipated to between $36 million and $38 million.

We continue to pursue additional strategic acquisitions and are optimistic that we'll announce an additional acquisition prior to year-end which could increase the revenue outlook for the latter part of this year and into 2019. As we stated previously, quarter revenue may fluctuate plus or minus 15% from the Company's plan in any given quarter due to variations in delivery such as what we saw in Q2. The ramp up of military flash array sales and the planned inclusion of CDI are anticipated to also increase gross margins in the third and fourth quarter. These two periods are also expected to be highly profitable, so for the full year 2018, a highly profitable Q3 and Q4 should bring us back to breakeven neutral or slightly profitable for the year.

We're also incredibly excited to move through this step change of growth. The pieces are all coming together, customers are ramping up, we are winning new design wins, our products and design capabilities are resonating in the marketplace and we're closing acquisitions. All in all, we believe the solid foundation we've laid for growth in the continued execution of our strategic vision will continue to strengthen shareholder value and position OSS as the leader in specialized high performance computing.

With that, I'd like to open the call to your questions. Operator?

Operator:

Thank you. If you would like to ask a question, you may do so by pressing the star keys, followed by pressing the one key on your telephone keypad. If you're using a speakerphone, please make sure your mute function is turned off to allow the signal to reach our equipment. Once again, if you would like to ask a question, please press star, one. We will pause for just a moment to allow everyone an opportunity to signal for questions.

We will take our first question from Scott Searle with ROTH Capital.

Scott Searle:

Good afternoon, guys. Congrats on the acquisition. Steve, just to follow up quickly on CDI from a revenue standpoint. It looks like it maps out that $1 million, $1.5 million per quarter, is that the correct calculus there and so you get about $500,000 in the third quarter and $1 million or so in the fourth quarter and what kind of growth rate have they been experiencing? I know it's off a small base but kind of early thoughts on how that looks into 2019?

Steve Cooper:

Yes, roughly $1 million to $1.5 million per quarter, not sure on the exact date of the close but a few hundred thousand in the Q3 and about $1 million-ish in Q4. Secondly, they have actually experienced some real nice new design wins just this year so they've got some pretty big customers that are just ramping up with new designs. I like design wins that are long term and I even more like design wins that are fairly recent and have a long life to them which is what we believe these have. Historically, the last couple of years, they've been roughly flat revenue but as I said, a real flurry of design wins earlier this year has positioned them really well for future growth.

Scott Searle:

Got you. Maybe a follow up on military (inaudible) with the storage arrays. Looks like you have a big quarter in the third quarter and it steps up sequentially again into December quarter. Is that going to be the new normal going forward? I think going back several months ago you talked about maybe doing $5 million or $6 million in 2018 in revenue with this customer. It seems like it's going to be bigger than that so as we look into 2019, how should we think about sizing that customer and maybe to throw a disguise (phon) in there as well, seasonally coming back very strong. Will they be up for the year and how much are you thinking about growth for disguise and the thoughts of that going into 2019 as well?

Steve Cooper:

Yes, starting with military program, the ramp up has been a little harder to predict than we had expected. We had expected to shift more than $1 million more in Q2 than we actually did. The good news is we did get the PO, the $3 million PO which we announced, and unfortunately it was all scheduled to ship in Q3 this quarter versus Q2 contributing to the huge growth but disappointing that it hurt our Q2.

For Q4 and even into 2019, as we go through the early phases of this ramp up growth, we still don’t have very clear data in terms of how many units they want by month or even by quarter. They're still talking in the yearly buckets so the yearly buckets are of the size that we've talked about before but the quarterly shipments are a little bit uncertain right now and so there could be some fluctuations due to that going forward.

The disguise, our media and entertainment customer, they have had a fairly soft first half. In fact, it's been a little bit down versus the previous year against their initial forecast of quite a bit of growth for this year. It just turns out they are very backend loaded and the sales have started to really ramp up just in the last couple of months. They've, in fact, increased their forecast every month for the last four months and are having us pull in what was previously forecasted in later periods of time. We're scrambling a bit for materials to be able to fulfill all their orders and their buffer stock has dwindled down to where they are basically taking everything we can build and shipping it straight to their customers. Demand is very strong and we're excited. We pretty well—highly confident that will continue throughout this year. Perhaps there's some seasonality early in the year. We hadn't seen that in past years so we don't know if that’s seasonality or just they went through about a six-month soft spot in their demand, can't really explain why but we're really pleased, though, that they're breaking out in a big way in Q3 and Q4.

Scott Searle:

Then lastly, if I could just follow-up on the pipeline of deals. It sounds like record level of RFP activity of larger deals. Can you talk a little bit about the timing, when you might start to see that materialize in the P&L and maybe as part of that, I know the military customer, there were some opportunities for some additional storage arrays and possibly (inaudible) solutions within that account. Maybe update on that front; and then, for John, on the gross margin front, it sounds like does the amortization of capitalized costs go away in this quarter? Do we still have that to contend with? Then as part of that, there's been some higher component costs or concerns related to GPUs and memory which you guys seem to have been managing pretty well. Can you just give us your quick thoughts on that as well? Then I will step off. Thank you.

Steve Cooper:

No problem. First on the pipeline of deals, most of the pipeline of deals are actually commercial deals. We've seen a real flurry in requests for specialized versions of our compute accelerators. We have two very major companies in the autonomous car sector that are looking to put considerably more artificial intelligence right in the car and so we are bidding two of those programs. We are bidding other—several commercial functions for compute accelerators but we also have several other flash array customers and, I believe, two expansion chassis opportunities as well. It's just our products seem to really be resonating right now and the whole concept of specialized computing, almost every one of those opportunities has specialized elements in it. I think there is one of the 10 or 11 that we have out there that is just a standard product but the others all have some custom engineering involved which is the kind of deals we really like where we can co-design and get a much stronger lock-in. Usually we will get a little bit higher margin for those kind of deals as well. The pipeline is very strong. John?

John Morrison:

Hi, Scott. On the gross margin question, with the applied overhead, labor and overhead that was charged off the cost of sales. Typically, as products are built those are a component of inventory until products are actually sold and so—and in addition to that, we are also doing valuation on a quarterly basis to make sure that inventory reflects the lower realizable value or cost and so, as a result, there was a charge to cost of sales of $278,000 in the current quarter which eroded that margin by 4.9 percentage points.

As you know, we continue to evaluate inventory on a quarterly basis making sure that we look for obsolescence or slow moving inventory as well as any other additional capitalized cost that might be an inventory and we evaluate that on an ongoing basis. With respect to cost of products, at this point in time we have not noticed the significant increase in our cost of products. We are starting to get some rumblings in the marketplace about potential increases attributable to tariffs but at this point in time we have not realized any such significant increase as the result of shortages or as a result of concerns over tariffs. We just haven't seen that yet but we are aware and concerned and are continuing to monitor it.

Do you want to add anything?

Scott Searle:

Great. Thank you.

Steve Cooper:

If I could just add, you asked about the amortization of intangible assets and the big piece that we've been amortizing is back from the Magma merger we did two years ago. That amortization was over a three-year total period and so we will continue to have that large hit per quarter through July of 2019. That's one of the things we back out between GAAP and non-GAAP measures. Then going forward, each time we do an acquisition, they're highly likely to have a fairly large element that's classified as an intangible asset, sales list, trademarks, website names, that kind of thing, and the accountants these days like us to put a large amount of dollars into that bucket versus goodwill. When we do that, we have to amortize that over some period of time; typically three, four or five years. Although Magma will go away next year, mid-2019, CDI will likely put at least that much P&L immediately going forward once we close that deal and each acquisition going forward, it unfortunately messes up the GAAP P&L pretty good. It’s a non-cash event but that is GAAP accounting as it is today.

Scott Searle:

Great. Thank you.

John Morrison:

Thank you. Good talking to you, Scott.

Operator:

Once again, if you would like to ask a question, please press star, one.

We will take our next question from Rudy Miller with The Miller Group.

Rudy Miller:

Gentleman, thanks a lot for taking 60 or so of my questions, so you only have to have 40% now. John, I'll just cut to the chase here. Certainly disappointing, there's no sense in being over the past. It's more about what you're doing today and tomorrow but on some of the factual items and some of the questions for the future on the strategic and tactical side, first of all you talked a little bit about SkyScale contributing negative $148,000 and I believe Steve just commented that you were down to shipping direct and bare bones and one of my concerns, not just with the future of SkyScale, which was asked by Rob (phon), but you're talking about having inventory deficiencies for those products and that, it makes me pause to ask the question on my list of, how is your inventory with your "projected guidance" for Q3 and Q4? You've never produced that historically in the Company's history. Of course, you're at a new place naturally, but A) do you have the inventory since you say you're having problems with inventory, just with the smaller division, their subsidiary partnership there. Do you have enough inventory in people the next two quarters to actually produce what you've never produced before at these higher levels? That's one question. I've got a number of other follow-ons.

Steve Cooper:

Yes, let me take that one to start. We believe we do. Anytime you venture into something you've never done before, there is an element of risk but we believe we have the personnel, the facilities, the test equipment, all of the various elements to produce product, the product that we anticipate. We do have the advantage that we have a very large backlog fairly early in the cycle right now so we know what to buy. It's not last-minute inventory, it's more built to order, for the most part, business, so we have had the orders for some time and have had plenty of lead time to get the products in. The other thing that helps us somewhat is that a big chunk of this quarter will be these flash arrays for the military and those have a very high dollar value per unit, approximately $250,000 each. It doesn't take—so we are not building lots of units. They're very expensive units but they're not lots of them.

Rudy Miller:

It's not a volume item for you, it’s a high end and a quarter million a pop item.

Steve Cooper:

Exactly, exactly, and that will be $3 million of the $10 million quarter but that’s only (inaudible) of the 13 units

Rudy Miller:

Okay. It sounds like that you've been able to use your liquidity partially from the offering and the orders being such in advance stage that you're able to bring in the majority of the required inventory with timeframes that—and have the liquidity acquired so that when you came to producing it, since it’s not like I'm producing 20,000 units or 10,000 or 5000, you just define those $3 million worth over the coming year at $250,000 a unit, so you're telling me that at least on a proceed deal, you've done a lot of pre-financial and inventory work thus far to get to this point, is that correct?

Steve Cooper:

Yes, exactly. In fact, because we for a long time believed we would ship some of these units in June, we're even further ahead of the game. The order just didn't come in time to ship them in June but we had materials in the pipeline ordered and ready to go should our customer pull the trigger as we expect. We're really good for Q3, we could get some upside surprises that we will have to scramble to meet but for what we are expecting, which are pretty big numbers, I think we're in a pretty good shape.

Rudy Miller:

Well, let me go forward onto my next list of questions. Let's go into—needless to say, as a shareholder and the stock down almost 20%, it's not a happy time for shareholders and the—probably how it was rolled out from a presentation point but you know what, today is the first day of the rest your life so it is what it is. We have averaged down a little bit along the way but going forward on the acquisition, proposed acquisition, the (inaudible) agreement; my first question is, what is the Company and the Board's policy on announcing potential acquisitions? Now, some people do it with the LOI, a majority of sophisticated companies do it only when they sign a definitive agreement because if you look at how many from LOI to definitive agreement, and we are talking about it goes into the meat and potatoes of my follow-up questions is, what is going to be your future policy? If you're two weeks away, or 30 days away because you know what? I'm going to—deals where they don't work out, so the first thing I would ask you, if this doesn't close, then how much do we back out of the revenue in the future profits and et cetera, but what is the policy on announcing done acquisitions? August sounds great but I've got deals that were supposed to close last December and still haven't closed, I'm still involved them. What is the policy on announcing an acquisition? Are you going to do it consistently the same way or are you going to do it by LOI or by definitive agreement or just whenever you think you need to announce it which helps the stock and or whatever? I mean, what is the policy?

Steve Cooper:

Our default policy—we reserve the right to do—have exceptions to it—our default policy is to not announce the Letter of Intent or term sheet but rather to announce only when we have a definitive agreement or are so close to a definitive agreement—

Rudy Miller:

Okay, that's the fuzzy area, Steve, we will cut to the other BS on the path. I understand the LOI. This fuzzy deal, I'm talking about the fuzzy-wuzzy; you either have a definitive agreement policy or you don't. That's it. You just need to tell me what it is. You're saying if it's similar fuzzy in between and then you're announcing it so what does that mean? Is that two months fuzzy, two weeks or just whenever you want to say it? If that's your policy, great, let us all know that in advance so that we—when we are sitting here and looking at two or three weeks away and you don't have a definitive agreement signed yet, but that's okay. You're telling me is you've got to fuzzy-wuzzy policy somewhere close to the definitive agreement when you think it may be appropriate, but you have the right to walk away from it. Is that what you're saying, is that the policy?

Steve Cooper:

Yes. In general, we will wait till we have the definitive agreement signed.

Rudy Miller:

Yes. I'm saying there's no consistency so why would you announce it then—if your policy, in general, is you wait till it's signed? Why would you announce it before you sign it? Then that's not a policy that's inconsistent.

Steve Cooper:

We made the decision earlier today with the definitive agreement is not signed and—

Rudy Miller:

Right.

Steve Cooper:

Because we believe it's within the next day or two, within 24 hours, perhaps.

Rudy Miller:

Okay. You made the judgement call, now we are talking maybe the next day or two. What you're saying, you made a judgement call so the policy is it's subject to change if you feel you need to announce it for whatever reason, even though it's not closed, not definitive agreement. That's all I'm asking. Whether I agree or disagree, it's not the issue, I just don't—I like to know at least what the policy is. Okay, I got it. Thanks for articulating that. That's what I needed.

Now I'll go into the Company itself and I haven't had a chance to look at the website because I'd just gotten the information as I came in but what's the number of employees and how long they've been in business?

Steve Cooper:

They have been in business 35 to 40 years. I believe they have approximately 12 employees, plus or minus a few depending on how you count contractors.

Rudy Miller:

Okay, and they are generally, the last three years, they've been cash flow positive the last three years?

Steve Cooper:

Neutral, I believe. Two years ago, they were plus. Last year, they were a little bit small, negative, but basically neutral cash flow.

Rudy Miller:

Okay. What makes you think they're going to have this, and how can you help them, what's going to have—after 35 years being maybe a $4 million business or $5 million or projected to potentially $6 million, but it looks like, since you said in your press release $4 million to $6 million in projected annual revenue. Can you tell us what roughly historical revenue's been the last 24 months?

Steve Cooper:

They've been running in the $3 million to $4 million range.

Rudy Miller:

Okay. That's why you had $4 million kind of as a base. Okay.

Steve Cooper:

They have been—I believe they have been as high as $10 million in any individual years over their history. They've been larger, been smaller. They have a large technical content and, in fact, back in the early history, were strictly in engineering house and would do the engineering for these programs and then give, as part of the deal, provide the design drawings back to whoever paid them so that they could have manufactured themselves. The model of moving to a design and manufacturing company more similar to what One Stop is, is for them fairly new, started occurring about four or five years ago, but over the last couple years, they've evolved to a pretty much 100% design and manufacturing model and that has a big impact on the amount of revenue you make. It lowers your margin but increases your revenue dramatically.

The other thing is that in the in-flight entertainment space, they have a fairly narrow number of customers, small number of customers, that are pretty large design-ins and their largest one is well over $1 million. For a small company to have a $1 million customer, that's really something and they've won several new ones just this year that should ramp up. It's a small enough number of customers that, during the due diligence, we visited customers representing over 80% of their revenue and through those conversations, we confirmed that they have a very good reputation, that customers want to give CDI more projects and business and they felt really optimistic that, if they were part of One Stop, they would have more confidence in putting more business through CDI. Very positive due diligence and introduction of One Stop. All of those factors come together to give us a high degree of optimism in terms of their growth next year.

Rudy Miller:

Okay. Well, I'm not there yet but I'm glad you have it. As an investor myself, I'll follow through on this. One of the things that you kind of hit upon was one of my follow-up questions, is what's the percentage of concentration? I've seen a lot of small companies lose a concentrated deal and if they're doing $4 million and one is doing $1 million, how many customers do they have and what's the percentage of concentration on this roughly $4 million revenue? One of them's got to be 25%--one of them because you already told me one's a million so what's the percent of concentration with—I was going to say, with their three biggest clients?

I mean, that's secondly and I'm still trying to figure out—I know you're buying it and the technical reasons why are you're saying it but why—and the follow-up, other than concentration, is, why do you think they can grow in future? Then I'll get in the pricing questions on the—what you're paying and how you're paying for it but let's go through the concentration first and then, once again, reaffirm to me why you feel warm and fuzzy inside that you're going to actually grow this business and why just clamping it on to your Company, other than having the accounting and HR and a bigger financial statement, why it's going to help them grow and what's impeded them from growing?

Steve Cooper:

I may not have caught all of the questions.

Rudy Miller:

Well, first part is concentration. We will start with that. I will keep it real A, B, C. Concentration, how many clients, what percent of concentration is it?

Steve Cooper:

Their top three accounts represent approximately 80% of the total revenue.

Rudy Miller:

Okay. You've got a highly concentrated business you're buying? Number one. Correct?

Steve Cooper:

Yes. Highly concentrated business.

Rudy Miller:

I am—a little B here. How do you think you can grow this when they've been up to 10, down to four, around three to four, breakeven back and forth; what's the synergy that I'm missing or don't understand yet? Because that's why I'm asking the questions, is what's the synergy to make this grow to be a growing component other then—give me the reasons. I know you've got more money than they have. How are they going to grow—how are you going to help them grow and why is this a one plus one equals three because if it's not three, four or five, because one plus one equals two; it's just bigger gross and help me understand that, educate me.

Steve Cooper:

The growth will come from new designs, primarily we believe, with the same customers. The in-flight entertainment business—there are only a few primes that sell in-flight entertainment systems to the airlines and the largest—

Rudy Miller:

Well, being a former Board member and CEO of airlines of public companies and building a couple myself and also being else around the avionics industry, I do understand that part.

Steve Cooper:

Yes. The largest one in the space is called Tallis (phon), a British Company, a very large Company and Tallis is CDIs number one customer and they make the in-flight entertainment system for probably about 60% of the world's commercial aircraft, including most of the AirBus. We think the growth will come in a higher level of penetration in existing customers rather than prospecting for new customers. There will be some of that as well. What we've discovered is that CDI, we believe, is fundamentally sales force and proposal constrained. In other words, their CEO is their best proposal writer but he only goes out to win new businesses when he's not overwhelmed running a small company and they don't have much of a sales force to take that off and work the deals with him. We believe that simply having a sales force as well as a marketing campaign, but mostly sales people, as well as a stronger engineering component, will dramatically increase the opportunities and he has a very high hit rate. Once he does a proposal for a deal, he has a very high hit rate of closing deals so we're encouraged by that as well.

Rudy Miller:

You are hoping the sales force and the existing customers expanding, since it's a pretty small market in general, which what they're component is. One of my concerns is, just to make a gross revenue and optics is when you bolt-on smaller businesses, does that really have either a large enough market or upside and you're so concentrated, if you lose one or two, that you have issues and that's just a question. I need to understand the philosophy and why you think you can make it for diluting the stock and giving a million dollars away, what you're getting for that in future and in cash flow, and so now, going a little bit more than the pricing of the transaction according to the press release that was put out—at least you're not tweeting like some CEO's are. But the $4.9 million stock, my first question is that—and $1 million in cash so you're roughly at the $6 million level, a million of that being cash and key is, what is the price of the share range? Are you doing it with a 30-, 60- or 90-day average of the bid and the ask, or on the bid, or what is the—what are the number, in general, and I know you haven't closed yet, you haven't signed a definitive agreement—we would know that because it would be in it, subject to the form where you did your final close period but—we are giving up $5 million in stock and at what price? At what average? A million dollars in cash for a business doing $4 million, roughly, with concentrated people that you hope to expand through your sales force. What's the basis of the value of the stock and what is the registration rights on those stock? Whether it's $4 million or $6 million or $2 million?

Steve Cooper:

The pricing will be—it's the 15-day average, 15 days prior to closing.

Rudy Miller:

I think that's pretty poor on your side of the aisle, whoever's negotiating it, but that's my opinion as a shareholder, but okay, you said 15 days, the average when you close, of the stock price.

Steve Cooper:

Average closing price for 15 days prior to closing.

Rudy Miller:

Right. We have been down as low as 390, too, and you've already got a 20% discount on your stock at times but okay, and a million dollars cash. Why do you think that's—can you give me any color on why you think that that value is equal to this Company's? I mean, how did you come up to valuation? I mean, how can you support that valuation for this business? Or what is your—whoever, your deal team or your Board, I mean, what—how did you, as a shareholder, how did you come up with the value you're paying, that $5 million? Can you give color? Go ahead.

Steve Cooper:

It's a combination of factors. Certainly if you look at the valuation of other companies that are in the avionics or military avionics, having a—typically for a deal like this, it would be a multiple of revenue and they would typically be in the 1.5 to 2.5 times revenue. This one is, depending on whether you think of them as a $4 million or $6 million, is somewhere in the 1 to 1.5.

Rudy Miller:

Where are you getting that? Are you talking about—what size of companies are you talking about that are selling at 1.5 or 2 times revenue in this particular space? Do you have some comparables in this space other than larger companies for the smaller company? You're just telling me that I'm just thinking that this is normal. Guys tell me all the time, it's normal to pay a 2 times the revenue. Well, depends on the industry and the size of the company, etc. How did you—what's your analysis? I mean, do you have companies you can tell me that you utilized that looked at that approach. You just threw out that 1.5 to 2 times so you've got to be an expert in it or somebody in your Company to be able to use that, if that's the basis you're using.

Steve Cooper:

We can talk, probably offline would be better.

Rudy Miller:

Okay, that's great. All right, that's fine. We will move on to the next question. Thank you. If this doesn't close, you'll have to put out a release that it didn't close and redo your forecast because you're forecasting roughly, what, $500,000 Q3 and $1 million in the question asked by Rob in Q4 with CDI's projected performance, is that correct? If the deal doesn't close, now we can ask all this. The stock is going to go down a little bit, probably, don't know. Maybe it will go up—is that the deal doesn't close, so how much of the projections in Q3 and Q4 were attributed to CDI of your guidance?

Steve Cooper:

Of the guidance, the Q3 is in the range of $200,000 to $500,000 was contributed to CDI because we are not certain on the close date, and in Q4, it was $1 million.

Rudy Miller:

Right, so I was correct, what you said to Rob. I was just reconfirming that. Okay. Well, like you said, I'm going to go with that, but the future is, as far as manpower, employee base, you feel, Steve, that you're comfortable for the next two quarters. You've got enough manpower because some of these units are highly priced and sounds like you have done a good job on inventory, cash, you and John on managing and buying parts in advance, and of course, we're—I went back questions when you did the offering about what happens to suppliers in China if things get tight, even before the turf wars were being talked about too much and everybody's going to deal with that but do you have any other alternative places or parts or things or options you could do and what is your strategic plan for if you run into some of these difficulties that are not—it's an event to occur, it's a tsunami in business and everyone's got to deal with it whether they like it or not but do you have a Plan B or C, if you're unable to obtain parts in China, for instance, or what is your emergency evacuation, as we say, if we get an earthquake here in Southern California? Do you have your kit ready to go, and your water and your flashlight?

Steve Cooper:

There's several different elements of that. We do have a disaster recovery plan, which we believe we could be up and running, in what I call a minor disaster, something like a building burns down.

Rudy Miller:

I was being facetious there, I'm sorry. I'm really talking about, what's your plan if you can't get parts or supplies or power units from China? What is your plan for that, not really—I was joking on the California as I'm staying here in (inaudible) right now looking at the ocean and hoping I don't have my house go in the water. I understand that one. I was talking about business-wise.

Steve Cooper:

Yes, so parts, first, we anticipate that the impact of the tariffs, if any, because they have been very minor on our business so far, we expect that the impact would be primarily financial, meaning the parts would cost more versus not be available. We do buy mostly from U.S. distributors so there's a fair amount of buffer stock in the supply chain. If things had gone on for a long time and got ugly, it's possible that that buffer stock runs out. Although almost all of the parts that are made in China, I can't think of a single one that's made in China that isn't—there isn't at least second sourcing, and usually many sources throughout the world. I don't think we're really locked into any specific part from China and even the price of China, we believe, will be more expensive, possibly, but I don't think they're shutting down factories.

Rudy Miller:

But at least your competitors and everyone else will have to deal with the same factor so at least you're in a level playing field.

Steve Cooper:

Yes. There was an issue—it's not always level in the sense that some of our customers and some of the players are outside the U.S. It does change the international competitive complexity, sometimes for the better, sometimes for the worse. We have one customer from Canada, it turned out, that they were very worried about Canadian—U.S. duties on Canadian imports and so they have contacted us about using part of our factory or shifting more business to us to manufacture so that they could have a U.S. source of supply for their U.S. customers.

Rudy Miller:

That’s happening with a few smaller businesses that we're dealing with right now, a very similar thing and also out of Canada so that's a good point. Okay, well, listen, I'm not going to take a lot more of your time. Let's go make some money and get the stock up and close this deal and you've got to approve to me with this deal before you start adding these other deals, really, I hope if we are giving out stock in cash—and I don't like the 15-day average personally, I think you could have done a lot better than that, but especially with your stock being down as low as it's been recently, and especially when you're talking about Q3 and Q4 to being the upside and I think one of the problems you face as a company, as a very small, semi-illiquid trading stock from my definition, maybe not yours, but what you do is that you don't have recurring revenue and I think that you get penalized for missing quarters when I think that this Company should be looked at on a 12-month run rate, on an annualized basis and that accounts for certain smaller companies and especially the way your product mix is.

I give you credit and I give you space because I think you need that and then I will look at this as an overall investment, where you're at in 12 months and what you've accomplished and I think you get penalized for that and I think you had a do-over on the first couple quarters, maybe with the guidance of either outside IR or banking or Board members, they would maybe approach it differently, but you’re where you’re at and you're going at a great pace so we hope Q3 and Q4. I will tell you what, if you don’t have people telling you (inaudible) and answer my questions, it’s not all rosy and dynamic and yada-yada, it's real world and I think that you are maturing as a smaller company into that space and you've got an opportunity but you don't get many if you don't get it done on an annualized basis. I just want to confirm that. Still support you, I'm tough love, just remember that.

Steve Cooper:

Thank you, Rudy. As always, we really do appreciate all your thoughts and insights.

Rudy Miller:

Well, thanks, guys. I appreciate the time and I wish you the best but you know what they say, you make your own luck. Preparation meets opportunity. Now here is the opportunity next two quarter. Go get it.

Steve Cooper:

Thank you.

Rudy Miller:

Thanks, guys. Have a nice day.

Operator:

At this time, this concludes our question-and-answer session. I would now like to turn the call back over to Mr. Cooper. Sir, please proceed.

Steve Cooper:

Thank you, Kari. Thank you, everyone, for joining today. We look forward to talking to you in the future and reporting on our progress. Meanwhile, please feel free to reach out to us at any time. Thanks, everyone. 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 made by Management during today's call, which are not a description of historical facts, are forward-looking statements. These statements are based on the Company's current beliefs and expectations. Such forward-looking statements include those regarding the Company's 2018 financial outlook and expectations for 2018 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 on this call due to the risks and uncertainties inherent in our business, including, without limitation, that the market of our products is developing and may not develop as we expect.

Our operating results may fluctuate significantly, which would make future operating results difficult to predict and could cause our operating results to fall below expectations or our targets. Our products are subject to the competition, including competition from the customers to whom we sell and competitive pressures from new and existing companies may harm our business, sales growth rates and market share. Our future success depends on our ability to develop and successfully introduce new and enhanced products that meet the needs of our customers. The likelihood of design proposals becomes design wins is uncertain and revenue may never be realized. Our products fill 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 function. New entrants into our market may harm our competitive position. We rely on a limited number of suppliers to support our manufacturing and design process.

If we cannot protect our proprietary design rights and intellectual property rights, our competitive position could be harmed or we could incur a significant expense to enforce our rights. Our international sales and operations subject us to additional risks that can adversely affect our operating results and financial condition. If we fail to remedy material weaknesses in our internal controls over financial reporting, we may not be able to accurately report our financial results and other risks described in our prior press releases and in our filings with the Securities and Exchange Commission, 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 hereof and we undertake no obligation to revise or update this information to reflect events or circumstances after the date hereof. All forward-looking statements are qualified in their entirety by this cautionary statement which is made under the Safe Harbor provisions 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 replay starting later this evening through August 22. Please refer to today's press release for dial-in and replay instructions available via the Company's website at ir.onestopsystems.com. Thank you for joining us today. This concludes today's conference call. You may now disconnect.