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One Stop Systems, Inc.

First Quarter 2018 Earnings Conference Call

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CORPORATE PARTICIPANTS

Steve Cooper, *President and Chief Executive Officer*

John Morrison, *Chief Financial Officer*

CONFERENCE CALL PARTICIPANTS

Scott Searle, *ROTH Capital Partners*

Gary Mobley, *The Benchmark Company*

PRESENTATION

Operator:

Good afternoon and thank you for joining us today to discuss One Stop Systems' first quarter ended March 31, 2018 results. With us today are the Company's President and Chief Executive Officer, Steve Coober, and its Chief Financial Officer, John Morrison. Following their remarks, we will open the call to your question. Then before we conclude today's call, I'll provide some important cautions regarding 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 replaying 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.

Steve Cooper:

Thank you, Kevin, and good afternoon, everyone. Thank you for joining us today. In the first quarter of 2018, we continued to lay the groundwork for ongoing growth and market expansion as one of the world's leading providers of specialized high-performance computing systems. In February, we successfully completed our IPO and began trading on the NASDAQ capital market. From the IPO, we raised $19.5 million in gross proceeds, which provided us the resources to eliminate our debt and accelerate growth, particularly through our M&A strategy. Revenue in Q1 increased 12.4% to $7.1 million. This set a new record for our first quarter, the Q1 historically being our slowest quarter of the year. First quarter revenue included about $1.9 million in shipments to our video display server customer and $1.5 million shipped under our military flash array program. The military shipments included ground station and airborne versions of our military flash arrays and they move us one step closer to full product deployment with the production ramp expected to accelerate in Q3 of this year.

In Q1 we won a new OEM design win for a medical imaging system and shipped the first custom servers for this application. These types of OEM design wins typically generate revenue for five or more years and are a key aspect of the OSS business model. In the first quarter we made significant progress with the development of new state-of-the-art products in three key areas. First, we shipped production units of our new GPU accelerator system based on eight NVIDIA SXM-2 Volta GPUs. This product represents the first SXM-2 based GPU expansion system on the market today. We've already received a purchase order for a proof-of-concept system that may lead to a full design effort to create a military version of this product for military surveillance aircraft.

Next, we introduced a new flash storage array based on a new release of our Ion flash array software. This product line is targeted towards former Western Digital flash array customers that are looking to upgrade to the latest flash array technology with Ion software. We also introduced our GPUltima-CI, which is our hardware and software solution for the emerging composable infrastructure marketplace. Composable infrastructure is a way in which systems can be rapidly reconfigured in the datacenter or in the cloud, facilitating greater utilization of system resources, particularly of GPU computing and storage resources. This is one of the hottest areas of the high-performance computing today.

These developments built the foundation for strong revenue growth this year and for many years to come. However, before I get into the 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 first 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 for our quarter ended March 31, 2018. A copy of the release is available in the Investor Relations section of our website at onestopsystem.com.

Along with our IPO in February, we launched a new Investor Relations section in order to provide our stockholders and other interested parties with important company information. This includes our SEC filings, stock information, presentations, press releases, corporate governance documents, as well as an events calendar. There is also an option to sign up for email alerts so you may automatically receive our latest news and notice of our latest filings. We plan to use this site to disclose both material and non-material information about OSS, so we encourage you to visit the site often and sign up for the alerts.

Now for the first quarter of 2018, our revenue increased 12.4% to $7.1 million as compared to the prior year first quarter. The increase was primarily driven by organic growth of $459,000, which represented 7.3 percentage points of the 12.4% increase. The addition of our Ion software business in July 2017 added $204,000 or 3.2 percentage points with SkyScale, which was launched in April 2017, contributing $121,000 or 1.9 percentage points of the total increase.

Gross margins decreased to 31.1% of revenue as compared to 32.5% in the year-ago quarter. The decrease in gross margin was primarily attributed to an increase in inventory reserve. Exclusive of this inventory reserve adjustment, gross margin was approximately 35% in the first quarter of 2018.

Operating expenses increased to $2.9 million or 41% of revenue as compared to $1.9 million or 30% of revenue in the first quarter of 2017. General and administrative expenses increased primarily due to increased third-party service costs associated with being a public company. SkyScale contributed $158,000 of the overall increase in G&A of which $90,000 was attributable to our reserve for bad debt. Our marketing and selling expense increase was primarily due to increases in third-party commissions and employee related costs. Research and development costs were also mostly due to inclusion of the Ion software development team costs of $300,000.

Net loss attributable to common stockholders on a GAAP basis was $794,000 or a loss of $0.08 per basic and diluted share. This compares to net income attributable to common stockholders on a GAAP basis of $79,000 or $0.01 per basic and diluted share in the first quarter of 2017. We believe that non-GAAP earnings per share and Adjusted EBITDA metrics are helpful to assist in the evaluation of the Company's financial performance. This is our first quarter presenting non-GAAP EPS.

On a non-GAAP basis, our net loss attributable to common stockholders was $443,000 or a loss of $0.04 per basic and diluted share. This compares to net income attributable to common stockholders of $248,000 or $0.03 per diluted share in the first quarter of 2017. Our actual common shares outstanding at March 31, 2018, are 12,773,289 for basic, and 14,910,731 for fully diluted. Adjusted EBITDA was negative $237,000 as compared to a positive of $383,000 in the same period a year ago. Please reference our definition and use of these non-GAAP terms and their reconciliation to GAAP in today's press release.

I would also like to describe an unusual situation in the customary relationship between income tax expense and pre-tax income. The net loss for the first quarter of 2018 included an income tax provision of $217,000 as compared to $45,000 in the prior year quarter. Customarily when you have a pretax loss, you'd expect to have a tax benefit. This was not the case for OSS in the first quarter. We recorded a provision in the first quarter of 2018 despite having a pretax loss. In determining our current quarter income tax provision, GAAP requires us to forecast our annual effective income tax rate or AETR for the year. Based on our projections, the Company expects its AETR to be negative for the year ending December 31, 2018, and thus we expect to realize an income tax benefit. As a result, when this negative AETR is applied to our current quarter's pretax loss, the result is a quarterly income tax revision. For further details about this provision, I refer you to the Management Discussion and Analysis section of our Quarterly Report on Form 10Q which is available in Investor Relations section of our website.

Now, turning into our balance sheet. Our cash and cash equivalents totaled $9.1 million at March 31, 2018 which compares to $186,000 at December 31, 2017. This increase is due to the proceeds from the Company's IPO on February 1. All of our outstanding notes, the balance of our bank line of credit as well as a significant portion of our accounts payable were all paid off from the proceeds which has resulted in the Company now operating debt-free.

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

Steve Cooper:

Thanks, John. Based on our OEM customer relationships, our military programs and the design working doing in Q1, we continue to anticipate significant revenue growth this year. We reiterate our outlook for the full year of 2018 and continue to expect revenue exclusive of M&A activity to range between $36 million and $38 million for the year. This represents an annual increase of 31% to 38%. We expect second quarter 2018 revenue between $6.7 million and $6.9 million with revenue in the third and fourth quarter to increase significantly as our military flash array program enters higher level production. The expected ramp up of these military sales will also contribute to expanding gross margins in the third and fourth quarter. We also caution that our quarterly revenue may fluctuate plus or minus about 15% from the Company's plan in any given quarter due to variable ship dates.

We're also making solid progress on the M&A front. We've engaged with several candidates and are targeting one or two synergistic and accretive acquisitions before the end of this year. We believe our results and execution on our strategic vision will further increase shareholder value.

With that, I'd like to open the call to any question. Operator.

Operator:

Thank you. If you would like to ask a question, you may do so by pressing the star key 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 your signal to reach our equipment. Once again, if you'd like to ask a question, please press star, one. We'll pause for just a moment to allow everyone the opportunity to signal.

We'll take our first question from Scott Searle with ROTH Capital. Please go ahead.

Scott Searle:

Hey. Good afternoon. Hi, Steve. Hi, John. Thanks for taking my question.

Steve Cooper:

Thank you.

Scott Searle:

Hey, John, just real quickly, in the gross margins from 35% adjusted for the reserves, can you just walk us through if this is a onetime event? Is that the normalized gross margin that we're going to see going forward and Steve, could you update us in terms of component shortages or other limitations that may affect the gross margins going forward.

John Morrison:

Our gross margins for the first quarter were very strong as a result of large shipments on our military flash array program which contributed to the higher margin, but overall we expect it to be more in line with the 32% to 33% for the year, and as for the adjustments that were made in the first quarter with respect to reserve, we believe that we have got a good clean inventory and that you'll see those reserves reduced over time.

Steve Cooper:

Regarding your components question, the component shortages were managed pretty well during the quarter. We're keeping an eye on a number of key areas including flash memory, DRAM memory, and GPU cards in particular. Those three were all managed. GPU cards were the biggest problem. We probably could have had another $0.5 million to $1 million worth of shipments had we had total unfettered access to the low-end GPU cards. We could have sold those. The other component shortage that we are struggling with a little bit is now power supply and power supplies have impacted our shipment somewhat basically by extending their lead times some as long as 12 to 16 weeks which is manageable but makes it difficult to ship things.

Scott Searle:

Thank you, Steve. Just I went up on the military Raytheon contracts, I think the expectation has been some would ship in the second quarter. It seems like some of that's slipped to the third quarter so you have a big backend loaded year. Can you give us some comfort in terms of what the visibility looks on that front that you feel comfortable that you will ramp up? What kind of the expectations are for Raytheon for the year and there have been some other potential design wins there for storage arrays. Any update on that front?

Steve Cooper:

Yes, you're—very true that with what's happening there, we shipped a little more than expected in Q1 and that pulled some of the shipments that we've previously been anticipated in April actually we were able to ship in March, which helped us exceed our expectations in Q1 but takes a little bit of revenue out of Q2. The next big shipments will occur probably in the July-August timeframe. We think Q3 is going to be a very nice ramp up and then also Q4 is the real big ramp up, is the latest information we're getting on the main program that we've won inside the PA Poseidon (phon) program. We've also talked about other opportunities for the military flash array and those are progressing nicely on a couple of products. We've got a number of proposals out. They're not what I would consider won and a done deal yet but we're highly encouraged by the prospect of that. We're also developing a new version of the flash array which will have full encryption built in and we think that's another added piece of value for the military marketplace that will help us win a couple more designs for that same unit or a very similar unit.

Scott Searle:

Okay and, Steve, also if you can give us an update maybe on d3, been a big customer, sounds like they had some decent revenues fully (phon) in the first quarter. They tend to be seasonally big as we go into the middle of this year. Maybe visibility in terms of what you're seeing on that front and then just real quickly, it sounds like you've been fairly active on the M&A front. It seems like you've got a couple of things that are closer rather than further away. If you could just remind us in terms of parameters for M&A in terms of size, accretion dilution, that would be helpful. Thanks.

Steve Cooper:

So, d3 has changed their name to Disguise (phon) by the way, for those of you who're following the customer names that we typically don't mention, and shipments to them are going quite well, but probably closer to flat this year versus last with an expected ramp up later this year and they were expecting about a 30% growth rate, which they still anticipate will happen this year but the first couple of quarters have been a little slower than expected but the business is still very good and in fact we've just begun design work on a new version. We've won another design win for a new model that will be announced and begin shipping late this year. We're really excited about that.

On the M&A front, we have been quite active. We've determined that we will not announce any deals at the term sheet level but wait until we get to the full definitive agreement, signed agreement before we make any announcements, but I can tell you were making good progress and are highly excited about having one or multiple deals closed this year. Our general rules are we're looking for businesses that are highly strategic in nature that could blend in with our existing business and have the upside growth rate that we're seeing across the rest of the business. We're looking for businesses that have strong OEM design win features, perhaps military program features but that sticky customer repeat businesses is really what we're looking for, cultural fit probably in the size of $5 million to $10 million per year of incremental revenue is the size range we're looking at. Those are some of the basic parameters. Depending on who we pick, we may go slightly outside of that but those are our starting point parameters.

Scott Searle:

Great. Thank you.

Steve Cooper:

Thank you.

Operator:

Once again, as a reminder, please press star, one if you'd like to ask a question. We go next to Gary Mobley with Benchmark. Please go ahead.

Gary Mobley:

Good afternoon, guys.

Steve Cooper:

Hi, Gary.

Gary Mobley:

I want to go back to a question you answered a minute ago regarding Disguise. Steve, did you say you expect your sales to Disguise to be flat this year or up 30%?

Steve Cooper:

We expect them for the full year to be up 30%. However, for Q1 and Q2, they've been relatively flat. For Q1 they were relatively flat and Q2 anticipate they will be relatively flat.

Gary Mobley:

Okay and with respect Raytheon, any change to—well first of all, can you remind us what you think the annual revenue opportunity is there when you're a full run rate and any change to the achievement or timing of the achievement for Raytheon, at that full run rate?

Steve Cooper:

We expect full run rate which we should be getting to by fourth quarter of this year, to be approximately $8 million to $10 million per year in revenue and that to last probably in the eight to 10 years. It's a long-term program with an initial commitment for the first four years.

Gary Mobley:

Okay.

Steve Cooper:

Nothing has really changed dramatically in terms of the timing or the expectations. We did ship additional units which will be airborne unit. They will be fully integrated in flying in the aircraft and we should ship additional units in March as I mentioned.

Gary Mobley:

Okay and can you give us an update on SkyScale with respect to bring in that business up and change in the revenue outlook for that business?

Steve Cooper:

This is—well it's just slightly over a year since we founded the Company and the Company has made tremendous progress in terms of getting up and running, and getting the name out there and getting the services all going and bringing in our first customer. This is really the year where we start to ramp customer sales. Our expectations are modest for revenue this year on the order of $1 million to perhaps $2 million in total revenue, but we think it's a very significant year to move the Company from startup mode into revenue and profit and positive cash flow generating mode.

Gary Mobley:

Okay. That's it for me. Thank you, guys.

Steve Cooper:

Thank you, Gary.

Operator:

Once again, please press star, one if you'd like to ask a question, again, please press star, one for questions. There are no further questions at this time. I'd like to turn the call back over to Mr. Cooper. Sir, please proceed.

Steve Cooper:

Thanks, Kevin, and thank you, everyone, for joining us 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. Before we conclude today's call, I'd 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 or OSS 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 because of the risks and uncertainties inherent in the Company's business, including without limitation that new market for OSS products is developing and may not develop as it expects.

Operating results may fluctuate significantly, which could make future operating results difficult to predict and cause operating results to fall below expectations or company guidance. OSS products are subject to competition, including competition from the customers to whom OSS sells and competitive pressures from new and existing companies that may harm our business, sales growth rates and market share. The Company's future success depends on its ability to develop and successfully introduce new and enhanced products that meet the needs of its customers. Products to build specialized needs and functions within the technology industry and such needs or functions may become a necessary or the characteristic 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 the HPC market may harm our competitive position. OSS relies on a limited number of suppliers to support its manufacturing and design process.

If OSS cannot protect its proprietary design rights and intellectual property rights, its competitive position could be harmed or could incur a significant expense to enforce these rights. International sales and operations subject OSS to additional risks that can adversely affect the operating results and financial condition. If OSS fails to remedy any material weaknesses in internal controls over financial reporting, it may not be able to accurately report its financial results and other risks described in prior press releases and in the Company's filings with the Securities and Exchange Commission, including under the heading Risk Factors in your Company's Annual Report on Form 10-K and any subsequent filings. You are cautioned not to place undue reliance on these forward-looking statements which speak only as of the date hereof. OSS undertakes no obligation to revise or update information provided on this call 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 this evening through May 22. Please refer to today's press release for dial 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.