Q4 & FY 2018 Earnings Conference Call Prepared Remarks

Operator

Ladies and gentlemen, good afternoon. At this time, I'd like to welcome everyone to QuickLogic Corporation's Fourth Quarter and Fiscal 2018 Earnings Results Conference Call. Today's conference call is being recorded. I would like to turn the call over to the company's Investor Relations representative Ms. Moriah Shilton of LHA. Ms. Shilton, please go ahead.

Moriah Shilton - LHA

Thank you, Valerie. Welcome, everyone, and thank you for joining us today for QuickLogic's Fourth Quarter and Fiscal 2018 Results Conference Call. With us today are Brian Faith, President and Chief Executive Officer, and Dr. Sue Cheung, Chief Financial Officer.

Before we begin, I will read a short safe harbor statement. Some of the comments QuickLogic makes today are forward-looking statements that involve risks and uncertainties, including but not limited to stated expectations relating to revenue from new and mature products, statements pertaining to QuickLogic's future stock performance, design activity and its ability to convert new design opportunities into production shipments; timing and market acceptance of its customers' products; schedule changes and projected production start dates that could impact the timing of shipments; the company's future evaluation systems; broadening our ecosystem partners, expected results and financial expectations for revenue, gross margin, operating expenses, profitability and cash. These statements should be considered in conjunction with the cautionary warnings that appear in QuickLogic's SEC filings. For additional information, please refer to the company's SEC filings posted on its website and the SEC's website. Investors are cautioned that all forward-looking statements in this call involve risks and uncertainties and that future events may differ materially from the statements made. For more details of the risks, uncertainties and assumptions, please refer to those discussed under the heading “Risk Factors” in the annual report on Form 10-K for the fiscal year ended December 31, 2017, the company filed with the SEC on March 9, 2018. These forward-looking statements are made as of today, the day of the conference call, and management undertakes no obligation to revise or publicly release any revisions of the forward-looking statements in light of any new information or future events.

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The conference call is open to all and is being webcast live. We will start today's call with the company's strategic update from QuickLogic’s CEO Brian Faith. Then CFO Sue Cheung will provide financial results and guidance. Brian will deliver closing remarks and open the call to questions. At this time, it is my pleasure to turn the call over to Brian Faith, President and CEO. Please go ahead, Brian.

Brian Faith – Chief Executive Officer

Thank you, Moriah and thank you all for joining our Q4 2018 conference call.

This is a very exciting time for QuickLogic. We are building traction in our core markets and layering on to that with our more rapid penetration in AI. The enthusiastic reaction from our partners, customers and distributors following our acquisition of SensiML™ has been very encouraging. They acknowledge that there is pent up demand for an end-to-end solution that we now provide.

Large customers are beginning to move EOS™ S3 designs into production and other key designs are scheduled to ramp during the first half of 2019. The Master Technology License Agreement or MTLA go-to-market strategy for our embedded FPGA IP continues to build traction and the customer and partner reception for our QuickAI™ and SensiML strategies have exceeded my expectations. I'll get into all this in much greater detail, but first, let's take a couple minutes to review 2018.

There were three factors that significantly reduced our new product revenue for Q4.

- First, the decline in Q4 display bridge and connectivity revenue was much larger than we had originally modeled. We are anticipating another significant decrease in combined display bridge and connectivity revenue in Q1 that will weigh on total new product revenue.

- Second, a Government contractor that we have been working closely with on an embedded FPGA IP MTLA and license agreement did not receive its anticipated government funding in time to execute the agreements in Q4.

- Third, while we recorded our first material QuickAI revenue in Q4, one of our QuickAI customers made a last-minute design change to our new EOS S3AI solution from the originally anticipated module solution. This lowered the ASP and resulting revenue from the sale.

The combined impact of these factors was over $600 thousand.

In our February 2018 conference call I forecasted our “baseline” revenue for 2018 would be approximately $10 million. In that call I defined baseline revenue as revenue from mature products, display bridges and existing connectivity designs.

For full year 2018, our total baseline revenue was in line with our forecast. However, within the baseline, higher than expected mature product revenue offset a significantly larger decrease in non-strategic new product revenue than we anticipated. This resulted in a decline of total new product revenue for 2018 and masked the greater than $2 million increase we saw in strategic new product revenue.

This shift towards strategic business is reflected in our full year non-GAAP gross profit margin of 51%, which is up significantly from 46% in 2017 and resulted in 15% growth of our non-GAAP gross profit dollars year over year.

While this analysis more accurately portrays the progress, we made towards realizing our 2018 goals than the aggregate decline in new product revenue shown on today's press release, the growth in strategic business was below the expectations we shared a year ago.

Looking forward to 2019, we anticipate mature product revenue will be flat to up slightly with 2018 and that non-strategic new product revenue will decline by approximately $1.5 million.

With that in mind, the question I'm sure all our investors have is, "what has changed?" My goal today is not only to answer that question, but also share with you some exciting new developments that I think will help you better understand the value of our expanding business model and with that, share my belief that we are very well positioned to deliver greater than 50% revenue growth in 2019 and continue our established trend of higher non-GAAP gross profit margins.

Let's turn now for an update on our ArcticPro embedded FPGA IP business:

After determining that our original go-to-market strategy resulted in us getting stuck in a catch-22 loop, we changed our strategy in mid-2018 by offering our targeted customers the interim step of an MTLA. Since then we have signed three MTLAs and have a fourth that is pending Government funding.

The MTLA strategy has benefitted us and our potential customers in many ways:

- It created a low-cost method for our targeted customers to develop test chips that they can use to evaluate the performance and benefits of embedded FPGA.
- It outlines all the criteria for subsequent embedded FPGA license agreements. This allows design groups to quickly and easily license our embedded FPGA IP for a targeted SoC or ASIC without the need or associated delays of extensive legal and executive level reviews.
- It also enables us to much more quickly and efficiently qualify whether or not a given engagement is likely to result in a license agreement.

We signed our first MTLA with Chinese semiconductor company C-SKY, which was subsequently acquired by Alibaba. We believe this MTLA, which carries a modest quarterly maintenance charge, will lead to multiple SoC license agreements beginning this year.

We signed our second MTLA with ETH Zurich, which was also licensed to develop its new RISC-V Parallel Ultra-Low-Power or PULP Platform using GLOBALFOUNDRIES advanced 22FDX fabrication process. Tape out of the PULP Platform incorporating our embedded FPGA IP was completed during Q4 2018 and we expect to receive first silicon in Q2 2019.

We signed our third MTLA with a semiconductor company and recognized several hundred thousand dollars in revenue during Q4. We expect this will be the first of many SoC license agreements with this company. While our NDA with this customer prevents me from adding more color, I'm confident that once the details become available you'll appreciate the significance and value of this agreement.

When we discussed our outlook for Q4 in our last quarterly conference call, we expected to sign a new MTLA and recognize revenue in Q4 from an ASIC license agreement with a Government contractor. However, due to delays in government funding, the agreements were delayed.

We've worked closely with this customer for a long time and we are confident this agreement will be executed. As it stands today, we anticipate the MTLA and license agreement will be finalized during the first half of 2019.

During Q4, we also expanded qualifications with our fabrication partners by adding TSMC's 40nm node. With this, we now have our eFPGA available at TSMC for 65nm and 40nm, at GlobalFoundries for 65nm, 40nm and its unique 22nm FDSOI nodes and at SMIC for its 40nm fabrication node. There is a good chance we will expand to additional process nodes during 2019, but that expansion is most likely to be driven by customer SoC or ASIC license agreements.

We will begin rolling out several new initiatives this quarter that we believe will not only add to the momentum we have established with our MTLA go to market strategy, but also improve the scalability of our engagement process, shorten the time it take us to qualify the likelihood of winning an engagement and provide cross-leverage for our other IP and product offerings.

- The ETH PULP platform will enable us to quantify the benefits of running offload engines like accelerators in our embedded FPGA vs running them in software on the RISC-V processor.

- The SensiML Analytics Toolkit enables designers to run AI models that offload neurons to our embedded FPGA. Here we can leverage the SensiML Analytics Toolkit in conjunction with EOS S3 to demonstrate how embedded FPGA can improve system performance and free up processor resources. This can be used to add new features or left idle to lower power consumption.

- During Q1 we will release a new Application Programming Interface or API that will enable software engineers to leverage the inherent benefits of embedded FPGA. The API is written in an industry standard format and enables software engineers to write code as they normally would and then easily evaluate the performance and/or power savings benefits of running math intensive operations in embedded FPGA.

- In conjunction with the API release, we will also introduce our hardware accelerator library. This will include tested software code to instantiate eFPGA-based accelerators optimized for voice recognition applications. We will follow this up with additional accelerators that are commonly used in time series AI applications supported by the SensiML Analytics Toolkit.

With these new tools and initiatives, we will:

- Increase the number of potential customers and cross-leverage for our embedded FPGA IP, SensiML SaaS license and EOS platforms

- Improve the scalability of our engagement process, which will increase the number of engagements we can manage at one time

- Significantly improve flow of the engagement process by enabling customers to understand and quantify the value of embedded FPGA more easily

- Shorten the time it takes us to qualify the potential of an engagement to produce an MTLA and revenue generating licenses

- And, I believe, increase the percentage of engagements we win

Let's turn now to update the status of our traditional EOS S3 business:

A year ago, after displaying nine design wins at CES 2018 and Amazon forecasting it would release its Close Talk specification for always on / always listening devices any day, we were very optimistic these and other similar designs in our pipeline would contribute significantly to our 2018 revenue growth.

However, the Close Talk specification wasn't publicly released until last October and the test certification files used in conjunction with the spec have been updated several times since. The headwinds we faced last year weren't just from Amazon though.

As we moved through 2018, we continued to win designs, including a major platform design with a large Japanese smartphone company, only to see production forecasts moved forward; often a quarter at a time.

The short story is design engineering groups and even product managers were fairly quick to see the benefit of always on / always listening devices. However, with still solid demand for push to talk, companies were hesitant to move our next generation design wins into production. As a result, outside a few specialty applications, the vast majority of our design wins that sat in a logjam last year were ready but waiting for a production schedule.

Underscoring the delays, we faced last year, a design we won in early 2018 with JD.com finally moved into production just last month and was proclaimed by FutureSource Consulting as being the industry's first always-on wake word Bluetooth® in-ear consumer headset.

In addition to the design with JD.com, two of the designs we displayed at CES 2018 have moved into mass production. Cleer has initiated production of its Amazon AVS compliant battery powered Stage Speaker and one of our ODM headset designs, which originally targeted Amazon, won a significant contract with SF Express. We had originally expected both of these designs to enter production during Q1 2018.

With the logjam clearly loosened and the Amazon Close Talk spec in hand, we anticipate a number of our other hearable design wins from 2018 to move into production during the first half of 2019.

I'm not going to tell you the logjam that stunted our growth last year has been totally cleared; we still don't have committed schedules for all of our design wins. However, the trend is definitely moving in the right direction and with several of our largest customers now committing to production schedules; the momentum seems to be building.

Last year, a major Japanese smartphone company selected our EOS S3 for a platform design it intends to use in several new models. Following this, we negotiated a broad MOU with this company that covers all MCU applications in smartphones, feature phones and IoT devices. This was a big win for us.

We originally expected the first smartphone to move into production in Q3 2018. However, the primary wireless carrier for the design asked our customer to push it out to 2019. This represented one of several significant headwinds we faced in 2018.

Things are moving forward well with this customer and we anticipate shipping meaningful EOS S3 volume during Q1 to support initial production of our first smartphone design win.

The consumer electronics company that is using our EOS S3 in a new always on / always listening application displayed the first model incorporating the design at CES last month. The customer constructed an environment more similar to the targeted home use case to demonstrate the voice interface, which we were told worked very well. There were two reasons the customer chose to do this versus demonstrate the feature on the CES floor. First, the scheduled release to retail outlets was pushed out to July 2019. Second, the floor at CES is a very noisy environment.

We currently plan to initiate production shipments for the first models from this lead OEM beginning in late Q2. We believe additional OEMs will introduce the platform design in various models during the second half of 2019. In addition to these design wins, we are also engaged with the original platform design customer on a second EOS S3 application.

The engagement with the large consumer goods company that I mentioned last quarter is progressing in line with our expectations. We remain hopeful that if EOS S3 is selected for this design that it will move into production during the first half of 2019. We are also working closely with this OEM as it evaluates EOS S3 for a new platform design that targets the variety of high-volume consumer products; all of which would represent new product categories for QuickLogic.

On January 17th, JD.com released its new Pilot U-LIFE N1 smart headset with EOS S3 enabled always on / always listening capabilities. With over 300 million active customers and over $60 billion in 2018 revenue, JD.com is China's largest online electronics retailer.

With the ultra-low power consumption of EOS S3, JD.com was able to limit battery size and weight to only 30 grams and still deliver 90 hours of standby time on a single charge.

Even more impressive, according to Chinese tech news source, EK21, The Pilot U-LIFE N1 provides a voice recognition rate of 95%, which is far better than the recent analysis by 9 to 5 Mac that rates Siri's accuracy at only 78%. This could explain why after only days in the market, there were thousands of reviews posted for the Pilot with what EK21 termed as a praise rate over 98%.

SF Express adopted one of the ODM hearable designs that we displayed at CES 2018 for its new Shunfeng Smart Bluetooth Headset. This all-weather design enables hands free access to the company's data base as well as cloud-based AI resources to accelerate decision making.

SF Express is one of the world's leading logistics companies and has said it intends to deploy the headsets to its 600,000 delivery agents in China. The company estimates that the hands-free voice interface enabled by EOS S3 will improve its efficiency by 70%.

Let's shift now to QuickAI and SensiML where things continue to come together more quickly and efficiently than we originally modeled.

As I noted earlier, we shipped our first material revenue for QuickAI last quarter. The total was less than I was anticipating because one customer made a last-minute switch from a module solution to our EOS S3AI SoC Platform, which has a lower ASP.

EOS S3AI can be used as an SoC running a soft neural network in the MCU and eFPGA, or for more compute intensive applications, in conjunction with a neural net processor like the nepes NM500. Please see the press release that was issued after the markets closed today for more information on EOS S3AI.

One of the more frequent questions I have fielded from investors since our conference call last November has to do with our forecast to ship material QuickAI revenue nearly one year sooner than we had originally forecasted.

The short story comes in two pieces. First, we underestimated the pent-up demand for a market-ready AI endpoint solution. There are obviously a lot of companies talking about AI, but surprisingly few have market ready solutions that are practical to deploy today for edge and endpoint applications.

The second reason is, together with SensiML Analytics Toolkit, we offer customers not only a market-ready solution, but even more importantly, an end to end solution that is quick and easy to adopt without the need for significant data science or even firmware engineering resources.

The EOS S3AI platform is a complete hardware and software solution that is ideal for endpoint applications such as predictive maintenance, structural health monitoring, manufacturing process control and context awareness for wearables.

This single chip solution leverages the SensiML Analytics Toolkit to efficiently identify which complex feature extraction algorithms are ideal for the customer-labeled data sets and generates the AI models and classifiers using machine learning techniques for code development.

The AI model that is subsequently generated is uniquely optimized and partitioned to fit in the EOS S3AI hardware blocks, which include its embedded FPGA, Flexible Fusion Engine and MCU. Following this, the device is programmed seamlessly by the SensiML Analytics Toolkit.

This tight integration of hardware and software ensures that the AI algorithms created with the toolkit are optimized for the EOS S3AI platform, enabling low power and efficient endpoint processing.

We are working closely with our channel partners and distributors to address this pent-up demand as quickly as possible. It has been a long time since QuickLogic has offered something that is attractive for our channel partners and distributors to market proactively, but with QuickAI and SensiML, that has changed, and our partners are excited.

To build on this early momentum, we have combined our QuickAI Hardware Development Kit or HDK with SensiML's Analytic Toolkit to offer a very efficient and low-cost way for OEMS to evaluate the benefits of AI and quickly integrate our unique solution into new designs.

With the purchase of an HDK the customer gets everything they need to develop and test their designs. If the customer likes the result, we end up with both a SensiML SaaS license and a new production design win for EOS S3AI.

We have already rolled out this strategy and our new HDK in Japan, Taiwan, South Korea, the US, and some European countries. In fact, our Japanese distributors have already committed to approximately 50 HDKs in this quarter. With the support of our distributor network, this is vastly scalable and a near zero touch initiative for QuickLogic.

In addition to our channel partner strategy, we are also leveraging our long-standing relationships directly with key OEMs. This layers on very well with the engagements and customer commitments SensiML had already established prior to our acquisition, some of which are with Fortune 500 companies.

The short story here is, we have not only hit the ground running, we have done so with good traction.

I would now like to turn the call over to Sue for discussion of the financials, Sue:

Dr. Sue Cheung– Chief Financial Officer

Thank you, Brian. Good Afternoon and thanks to everyone for joining us today. Please note we are reporting our non-GAAP results. You may refer to the press release we issued today for a detailed reconciliation of our GAAP to non-GAAP results and other financial statements. We have also posted an updated financial table on our IR web page that provides current and historical non-GAAP data.

For the fourth quarter of 2018, total revenue was $3.2 million, within our guidance range. Our new product revenue was $1.3 million, reflecting a higher than anticipated decline of display bridge and connectivity revenue and a customer design change from a QuickAI module solution to an EOS S3AI solution. Our mature product revenue was $1.9 million, reflecting higher demand from our military, aerospace and defense customers.

Our Q4 2018 gross margin was 52.6%, within our forecasted range. Excluding a one-time inventory reserve, our Q4 gross margin would have been 58.2%, reflecting the benefit of our eFPGA IP license, QuickAI and higher than anticipated mature product revenue generated in Q4.

Operating expenses for Q4 were $4.3 million, below our forecasted range due to the later than anticipated timing of engineering new hires. R&D expenses were $2.3 million and SG&A expenses were $2.0 million.

The net total for other income, expense and taxes in Q4 2018 was a $13 thousand charge, which was below our forecast due to capital gains from the sale of fully depreciated manufacturing equipment. Net loss was $2.6 million, or $0.03 per share.

Net cash usage during the fourth quarter was $3.8 million, within our forecasted range. Cash usage was negatively impacted by a net increase in working capital, driven mostly by end of the quarter shipments that increased the accounts receivable by nearly $1 million. During the quarter, we increased our line of credit from $9 million to $15 million, at the same interest rate. Our cash balance at the end of the year was $26.5 million, which includes a $15 million loan from the revolving line of credit.

Turning to the full year 2018 results:

Total revenue was $12.6 million, up 4% compared to $12.1 million in fiscal 2017. New product revenue for fiscal 2018 was $5.7 million, down 2% compared to $5.8 million the prior fiscal year. Mature product revenue was $6.9 million, up 9% compared to $6.3 million in fiscal 2017.

Due to our continued success in diversifying our customer base, we had multiple customers with greater than 10% for the full year.

Gross margin for 2018 was 51.2%, up from 46.4% in 2017. The higher gross margin in 2018 was primarily driven by revenue generated from eFPGA IP license, Sensor Processing, QuickAI and mature products.

Operating expenses for fiscal 2018 were $18.2 million, which were flat with the prior fiscal year.

Due to modest total revenue growth and our higher gross margin, our net loss for 2018 decreased to $11.9 million, or $0.14 per share, compared to $12.7 million, or $0.17 per share for 2017.

Now, let's turn to the first quarter 2019 forecast:

Our revenue guidance for Q1 2019 is approximately $3.5 million, plus or minus 10%. Total revenue is expected to be comprised of approximately $1.4 million of new product revenue and $2.1 million of mature product revenue. The increase in mature product revenue is due to continuing higher demand from our military, aerospace and defense customers. The increase in new product revenue is anticipated to be muted by further decreases in our display bridge and connectivity businesses.

On a non-GAAP basis, we expect our gross margin to be approximately 55% plus or minus 3 percent.

We are forecasting non-GAAP operating expenses at approximately $5.1 million, plus or minus $300 thousand. We expect our non-GAAP R&D expenses to be approximately $3.0 million, which includes the new employees obtained through our SensiML acquisition announced on January 4th. Non-GAAP SG&A expenses will be approximately $2.1 million.

We expect our other income, expense and taxes will be a charge of approximately $60 thousand.

At the midpoint of our forecast, our non-GAAP loss is expected to be approximately $3.2 million, or $0.03 per share.

As was the case in prior quarters, the main difference between our GAAP to non-GAAP results is our stock-based compensation expense, which we expect to be approximately $835 thousand for the 1st quarter, out of which, $210 thousand will be a one-time charge, related to our all-stock acquisition of SensiML that closed in the beginning of this year.

In Q1, we expect to use between $3.3 and $3.8 million in cash, reflecting the timing of working capital and increased R&D spending.

I'd like to note, in line with good corporate governance practices, we will be refreshing our $40 million shelf registration in the coming weeks. We will file Form S-3 right after we file our 10-K.

With that, let me now turn the call back over to Brian for his closing remarks.

Brian Faith – Chief Executive Officer

Thank you, Sue. 2019 is setting up to be a very good year for QuickLogic.

- Our EOS S3 design wins are finally moving into production and new strategic design wins with large OEMs are scheduled to begin ramping in the first half of 2019

- Our MTLA go to market strategy is working, and beginning this quarter, we are poised to introduce our open API strategy, accelerator library and have the PULP RISC SoC in hand to accelerate our momentum

- With our first material revenue recognized nearly a year earlier than we originally expected, QuickAI is already building serious traction and we are taking steps to further leverage what we believe is a very unique solution

- SensiML not only puts us in the very solid position of being in control of our destiny, but also enables us to offer customers the convenience and security of one stop shopping for a practical end to end solution for AI in edge and endpoint applications

- With the QuickAI platform and SensiML Analytics Toolkit, we have a compelling solution that we have combined into a single HDK that our channel partners and distributors are excited to take to market.

- Completing the package is the cross leverage we are building between hardware, software and IP and the improving scalability of our processes

The term Industry 4.0 dates back to 2011. There has clearly been progress towards realizing the Industry 4.0 vision in cloud computing, but not to the edge or endpoint. This is due primarily to a lack of practical solutions that can be applied without the need for extensive data science expertise. I believe we are strategically positioned to fulfill that pent-up demand.

Edge and endpoint represents a vast market with hundreds if not thousands of potential customers that together represent very substantial aggregate volume potential. To address these widely varied markets and customers, we are integrating the reach of channel partners and distributors in North America, Japan, Taiwan, South Korea and select European countries.

With this and our other initiatives, I believe we are well positioned to expand our market coverage and customer base beyond anything QuickLogic has realized in the past and deliver a balanced model of hardware, embedded software that can be monetized, recurring SaaS revenue streams and IP that is able to deliver sustainable high-margin growth.

Operator, I would now like to open the call for Q&A.

Brian Faith – Chief Executive Officer

We will be participating at The Embedded World 2019 Exhibition and Conference in Nuremberg, Germany on February 26-28th. And we look forward to potentially seeing some of you at this event.

Our next conference call is scheduled for Wednesday, May 8th at 2:30 PM Pacific Time.

Thank you for your participation and continued support. Good bye!