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One Stop Systems, Inc.

First Quarter of 2019 Conference Call

May 9, 2019

CORPORATE PARTICIPANTS

Steve Cooper, *President and Chief Executive Officer*

John Morrison, *Chief Financial Officer*

CONFERENCE CALL PARTICIPANTS

Joseph Gomes, *NOBLE Capital Markets*

Scott Searle, *ROTH Capital Partners*

PRESENTATION

Operator:

Good afternoon and thank you for joining us today to discuss One Stop Systems First Quarter Results ended March 31, 2019. With us today are the Company's President and Chief Executive Officer, Steve Cooper, and its Chief Financial Officer, John Morrison. Following their remarks, we will open the call to your questions.

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

Now, I would like to turn the call over to OSS President and CEO, Steve Cooper. Sir, please go ahead.

Steve Cooper:

Thank you, Gwen, and good afternoon, everyone. Let me start with a discussion of our revenue for the first quarter of 2019. Our revenue increased 41% to $10.1 million. This was below our expectations, with customer delayed shipments slipping out of the first quarter and into the second. There were two specific delayed shipments that totaled $3.2 million. One was for our primary military flash array customer, which was delayed due to the customer requested postponement of the shipment, and these products were subsequently shipped in April.

The second delayed shipment was for our largest in-flight entertainment systems customer, which was delayed due to late arriving materials that did not meet our specifications. The issues that delayed the second shipment have also been resolved, and these products are expected to ship later this month.

These two delays effectively shifted revenue from the first to our second quarter. This reduction in revenue in Q1 was partially offset by about $1 million in shipments to other customers that exceeded our expectations. Other than these delays, it was actually a strong first quarter in many respects. We're encouraged by several positive developments. The broader segments of our business are exceeding our expectations. Our major OEM customers are scaling up. We're winning new OEM design wins, and our technology and architectural leadership with PCI Express, Gen 4 and AI on the Fly are really resonating in the marketplace.

At this point, I'd like to turn the call over to our CFO, John Morrison, who will take us through the financial results for the quarter. John?

John Morrison:

Thank you, Steve, and good afternoon, everyone. Thank you for joining us today. Earlier today, we issued a press release with our first quarter results for the period ended March 31, 2019. The earnings release is available in the Investor Relations section of our website at onestopsystems.com.

Starting with our statement of operations, consolidated revenue in the first quarter of 2019 increased 41% to $10.1 million from $7.1 million in the same year-ago quarter. The increase was primarily driven by revenues from acquisitions, which contributed $4.8 million in the quarter. This was partially offset by $1.9 million decrease in organic revenue. Q1 was the first quarter that included three months of revenue from Bressner business unit, which contributed $4.5 million, or 45% of our consolidated revenue in Q1. Our CDI business unit contributed $300,000 or 3%.

As Steve discussed, our overall revenue for the first quarter was significantly impacted by the delay of shipments for two orders totaling $3.2 million, of which $2.6 million would have been organic revenue and $600,000 would have been CDI revenue. These delays effectively shifted revenue from the first to the second quarter and were partially offset by $1 million in shipments to our other customers that exceeded expectations.

Our gross profit in the first quarter was $2.4 million, or 24% of revenue. This compares to $2.2 million or 31% of revenue in the same year-ago quarter. The decrease in gross margin percentage was due to lower revenue from high margin flash array products and our in-flight entertainment systems that resulted from the shipment delays, as well as lower margins from Bressner due to a large bulk sale.

Our total operating expenses increased 52% to $4.4 million from $2.9 million with the increase primarily due to expenses associated with being a public Company, and increased expenses associated with inclusion of CDI and Bressner. Net loss attributable to common stockholders on a GAAP basis was $945,000, or a loss of $0.07 per share in Q1. This compares to a loss of $794,000 or $0.08 per share in the year-ago quarter.

We believe non-GAAP earnings per share and Adjusted EBITDA metrics can be helpful in evaluating the Company's financial performance. Adjusted EPS on a non-GAAP basis was a loss of $0.03 per share in Q1. This compares to a loss of $0.07 per share in the same year-ago period. Adjusted EBITDA was a loss of $1.4 million in Q1, as compared to a loss of $237,000 in the same year-ago period. Please reference our definition and use of these non-GAAP terms and a reconciliation to GAAP in today's press release.

Now, let's turn to the balance sheet. Cash and cash equivalents totaled $455,000 at March 31, 2019, compared to $2.3 million at December 31, 2018. The decrease was primarily due to cash used to pay down Bressner debt, working capital, and infrastructure investments. To provide for future liquidity, during the quarter certain members of our Board of Directors agreed to commitments of up to $4 million. Additionally, Bressner entered into a new line of credit for an additional €2 million.

Subsequent to the quarter end, the Company did borrow $1.5 million of the $4 million commitment from multiple parties inclusive of members of the Board of Directors. Bressner also entered into a new term loan agreement for €500,000 and currently, our cash on hand is approximately $2.4 million. In 2019, the Company is investing approximately $1.5 million in infrastructure projects to increase our capacity, improve operating efficiencies, and to stay on the forefront of high performance computing technologies. In Q1, the Company incurred cap ex expenditures of $803,000. These cap ex investments include a major expansion and remodeling of our corporate headquarters and our primary manufacturing facility in Escondido, the implementation of a new Company-wide ERP system, and investment to new hardware and software tools relating to high bandwidth systems design.

We are also developing plans for cost containment, as well as looking at debt and/or equity financing to ensure our liquidity will be sufficient to meet cash requirements for cap ex and operations, for at least the next 12 months.

Now, to help put these results into perspective, and discuss forward-looking guidance, I would like to turn the call back over to Steve. Steve?

Steve Cooper:

Thanks, John. As I mentioned earlier, we're encouraged by several positive developments. First, our technology and architectural leadership with PCI Express Gen 4 and AI on the Fly are resonating in the marketplace. A positive perception that comes from being a technology leader, combined with effective marketing is creating many new customer opportunities. Designers of state-of-the art future products want to partner with technology leaders, and thus our strategies and messaging are helping to increase our sales opportunities.

We're also winning new OEM design-ins. These include significant wins for autonomous self-driving vehicles, mobile signal analysis systems, instrumentation, and high-speed storage systems. We're also seeing an increase in our design win rate closing a higher percentage of our opportunities.

Further, our major OEM customers are scaling up. This includes our media and entertainment customer, for whom we’ve recently introduced new state-of-the art video display controllers. These products have been well-received in the marketplace and are driving additional sales. Finally, the broader segments of our business are also exceeding our expectations. In particular, our Bressner business was quite strong in Q1, and we're excited to see this strength continue.

Now, turning to our guidance for the remainder of the year. Due to the revenue shift we anticipate record revenue for Q2, and although the first half revenue is expected to be below our previous internal expectations, we believe that the full year will remain within the guidance range previously issued. The Company reiterates its outlook for the full year 2019. Revenue is anticipated to be between $54 million and $58 million, representing overall growth of 51% to 54% and organic growth of 12% to 18%. The Company expects revenue for Q2 to be in the range of $13.8 million to $15 million, representing growth of 134% to 155% with organic growth of 54% to 68%, as compared to the same year-ago quarter.

At the midpoint of the guidance, the revenue is expected to be approximately $9.6 million organically, with pressure contributing $3.8 million and CDI adding $1 million. As we've seen this quarter, quarterly revenue may fluctuate plus or minus 15% from the Company's guidance in any given quarter due to variations in delivery schedules and/or seasonal fluctuations.

In summary, this quarter's results were significantly affected by delays in shipping two key orders, the larger of these orders has already been shipped, and the other order will be shipping later this month. At a more strategic level, we’re encouraged that we've positioned the Company ahead of the emerging trends. We believe this will continue to move customers in our direction thus continuing to drive our corporate growth.

At this point, we will open the call to your questions.

Operator:

Thank you. If you do have a question at this time, please press star, one on your touchtone phone. If you are using a speakerphone, please make sure your mute function is turned off to allow your signal to reach our equipment. Once again, that is star, one if you do have a question at this time. We'll pause for just a moment.

We will take our first question from Joe Gomes with NOBLE Capital.

Joseph Gomes:

Good afternoon.

Steve Cooper:

Hello, Joe.

Joseph Gomes:

I was wondering if you might give a little more color detail. You talk about an increase in design win rate, historically you said about, I think 30% or about a third. You talked about many new customer opportunities, if you could provide more color with that along with we talked about some of the major million dollar design wins and you talked, I think, last quarter you had about 20 of them out there, where do we stand on that base today?

Steve Cooper:

Yes, of the 20 that we been talking about, these are design wins that are all above $1 million potential per year run rate. So, they're all fairly large. Of those 20 we closed about half a dozen in the first quarter and did not lose a single one. So, the other 14 or so are still pending, and we think we're in good shape to win perhaps many of those, if not all of them. So, that is why we're saying that our design win rate seems to have gone up whereas historically, we won about 30% of all of our large opportunities, at least recently, knock on wood, it will continue. We seem to be winning a much higher percentage now.

Joseph Gomes:

The half a dozen that you won in the quarter, are they already in this year's guidance or do you see some of this maybe that was not guidance that might help overcome the shift in revenues for the back half?

Steve Cooper:

Yes, we are very encouraged as these wins begin to ramp up. It does tend to be a fairly long cycle in that most of the wins require custom engineered products. So, we get some revenue for the design effort, the NRE charges, relatively small amount of revenue, and then that ramps up once the product go into production, which is usually about a six month delay after the initial NRE purchase order. These wins in Q1, we could expect some of them to start ramping up in the Q3, Q4 timeframe which gives us a nice push at the end of this year and then into 2020.

Joseph Gomes:

Just on the cash and, obviously, the first quarter was a big use, you guys went out and some of the members of the Board stepped up to the plate here. Can you just kind of walk us through how you see the cash burn for the rest of the year?

Steve Cooper:

Yes, we used a lot of cash in Q1 for the cap ex, the (inaudible) facility and the ERP in particular, and also the engineering tools. Those expenses are two-thirds complete. There will be another $500,000 in cap ex for the rest of the year. It was just mostly in Q1 timing wise. We did, as we got a little closer than we wanted to or a little lower than we wanted to on cash on hand, make the decision to do two things. One was put a commitment letter in place, including Board members. Then secondly, we also took out a $2 million line of credit over in Germany. Those gave us confidence.

Then subsequent to the end of the quarter, we have drawn down $1.5 million here in the U.S. and taken out another term loan in Germany. So, we've raised some funds. As of today, I think we're at about $2.4 million in cash on hand, and we're feeling more comfortable about that.

Joseph Gomes:

Okay, and then you mentioned that you've got about $1 million of shipments in the quarter that exceeded your expectations. Was any of that pulled from, say, the second or third quarter, or was that just new stuff that you were not expecting to come at all this year?

Steve Cooper:

It's a little bit clear, but I think it's probably fair that some of that we had previously assumed would have been in April or May. Some of that came out of Q2. Some of it—again, we're talking about the smaller customers now, some of it we—it just happened sooner than we expect, I think is the short answer to that. If the trend continues, that's obviously a very positive sign going into the later part of the year.

Joseph Gomes:

Okay, great. Thanks, guys. I'll get back in queue and let someone else ask the questions.

Steve Cooper:

Thank you, Joe.

Operator:

As a reminder that is star, one if you do have a question. We'll go next to Scott Searle with ROTH Capital.

Scott Searle:

Good afternoon. Thanks for taking my question. Hey, Steve, just to follow-up on some of the key customers, Raytheon sounds like some of the orders slipped out from the first quarter to the second quarter. Can you talk a little bit about the year? What you're seeing for these guys? Are they in the same realm as you thought earlier?

Also, there have been some additional sockets and opportunities you've been working with them both from a GPU accelerator standpoint, and some storage arrays. Can you give us your updated thoughts on that? Same thing for disguise (phon), highly seasonal business last year, really ramped up over the summertime period. Is that the same sort of cadence and flow of orders that you're looking for this year?

Steve Cooper:

Let me start with our large flash array customer. Yes, we see Raytheon purchases to be probably in the $6 million to $8 million in total for the year. The $2.6 million order that slipped from March to April was disappointing, but it was really a matter of a couple of weeks. So, we don't see that as any significant thing. They had a purchasing issue that made it difficult for them to receive the products, and they asked us to postpone that shipment. Although we weren't particularly happy about that, we agreed to do, what we say, do right by the customer, in that case.

On the other piece of Raytheon which is the GP—militarized GPU systems. We continue to work that, and we believe we will be winning additional business. As soon as this quarter perhaps next quarter, we should be prepared to announce some new business on that. It's looking very good at this point.

Scott Searle:

Hey, Steve, would that be 2020, or is that a 2019 opportunity then from a revenue standpoint?

Steve Cooper:

There will definitely be revenue this year, 2019. However, it'll be somewhat modest revenue. At first, as they're doing proof-of-concept and engineering development contracts, it'll probably be in a full year of development before we're ready to deploy the airborne full MIL-SPEC version, which would then be, say, 10 year run rate of production. So, there's some revenue, but the big revenue is out in time until after we develop the custom product.

Scott Searle:

Got you.

Steve Cooper:

Regarding our large video display control Company, I don't mean to be disguising who they are, regarding disguise, their sales are going through the roof right now. They've launched several new products that we developed for them late last year. They're getting very good reception throughout their general market. They've also expanded through their software in this new hardware into what they call the virtual studio market space. This had a major demonstration at the NAB Show in Las Vegas just about a month ago. They've got great reception from that. Basically, what these video display control systems historically have done is put on large shows like concerts and Super Bowls and Winter Olympics. This expansion allows them to participate in television studios and replace what used to be done with the green screen. Also, movie production sets. Again, replacing what used to be done with the green screen with actual display, so that the actors or newscasters can visualize what they're pointing at. It's a new way to do those things. The size and OSS are really leading the state-of-the-art in that new technology as it goes into those spaces.

that, we believe, will cause significant upswing in their business. Of course, with any new venture, the timing is yet to be determined. We believe there's significant upside to our revenue to disguise in 2019.

We think this could happen within the next the second half of this year in particular. So, we're very optimistic about that.

Scott Searle:

Got you. If I could shift over to John for a minute. A couple of questions on the gross margin front, certainly some mix issues this quarter as it related to Bressner. Lack of some of the storage array shipping which tend to have higher gross margins. What is the outlook for the rest of the year? How should we be thinking about gross margins second through fourth quarter this year, given the anticipated mix of business that you're seeing within the funnel?

John Morrison:

Why don't I address that by business unit. Our target for Bressner is 25% to 26% from a gross margin standpoint, the CDI business is going to be running 28% to 30%, and the OSS core business, we are projecting at 33% to 34%.

Scott Searle:

Got you. Lastly, on the cash front, John. Obviously, this is a tough quarter from a cash burn perspective, but inventory level seemed a little bit high, you got the top line coming back. What is your expectation in terms of cash consumption over the course of this year?

John Morrison:

We actually are sitting at a high point for both accounts receivable and inventory. Some of that was, first of all, the inventory increase was mainly attributable to our Bressner unit, which is required to purchase up-front inventory for a specific customer, which was about a $1.5 million in the quarter. So, that took about a $1 million. That was working capital. In addition, as we've been expanding the business, we have more working capital tied up in our accounts receivable. We do anticipate that accounts receivable balance coming down over time, hopefully by about June 30, which will free up some additional capital for us, and hopefully finish the year more closer in the $3.5 million to $4 million range.

Scott Searle:

Lastly, Steve, just if I could follow-up in terms of AI on the Fly, and PCI Express 4, kind of the demand the applications to how that pipeline is shaping up. Sounds like you're excited about some of the opportunities, but I was hoping you could give a little bit more color on some of the application, some of the timelines and the size of these deals and sales cycles related to closing. Thanks.

Steve Cooper:

When we talk about our $20 million plus deals that we're working, probably two-thirds of them are related to either PCI Express or AI on the Fly. So, even though those technologies are brand new, that's what people want. With PCI Express Gen 4, we're really ahead of the general–we're in a very high leadership position. We have products now shipping, whereas other companies are just now starting their development. So, we're probably about a year and a half to two years ahead of the marketplace, which is perfect for our business model and the other customers that want to use that technology go, well, who's got it? There are not that many people out there yet. So, the PCI Express, we're quite a ways ahead of–Gen 4 will really hit the market in general, in mid-2020 we expect when Intel comes out with a new family of servers. Some people are moving in the development phase already, but as I said, it's really a 2020 that's we're ahead of that game.

The AI on the Fly is really overall architectural switch that is now starting to gain significant traction. The overall concept is that it's much better, if you can do it, to put the high end compute power out in the field or out where the data is being collected, so that you can do the artificial intelligence analysis, where the data is being collected near the sensors, or if you're in a car, in the car, as opposed to collecting data, storing it somehow, getting it back to a big data center and analyzing it for a month, and then redeploying it back into the vehicle or something you want to use this. That's the traditional way of doing it. This AI on the Fly or what some people are calling AI on the Edge is really a new trend. When we looked at the NVIDIA conference just a few months ago, it was a major trend that was being discussed at the conference. It's one of those hot topics right now. They call it AI on the Edge, means the same thing as what we use the term AI on the Fly to mean.

So, we're really excited about that. Again, if that is the hot topic, and we're shipping products, it drives customers to us, that assuming they want customized specialized computers, we're a real good solution for them.

Scott Searle:

Great, thank you.

Operator:

As a final reminder it is star, one if you do have a question at this time. Star, one for questions. It appears there are no other questions at this time.

I'd like to turn the conference back to our speakers for any additional or closing remarks.

Steve Cooper:

Thank you, Gwen, and thank you, everyone for joining us today. We look forward to talking to each of you in the future and reporting on our progress. Meanwhile, feel free to reach out to John and myself at any time. Thank you, 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 in the presentation that are not a description of historical facts are forward-looking statements. These statements are based on Company's current beliefs and expectations. Such forward-looking statements include those regarding the Company's expectations for 2019 revenue growth, generated by new products, design wins, or M&A activity. The inclusion of such forward-looking statements and others should not be regarded as a representation by OSS that any of its plans will be achieved.

Actual results may differ from those set forth in the presentation due to the risks and uncertainties inherent in our business, including without limitation, that the market for our products is developing and may not develop as we expect, our operating results may fluctuate significantly, which would make our future operating results difficult to predict and could cause operating results to fall below expectations or guidance.

Our ability to successfully integrate the operations systems, technologies, product offerings, and personnel with acquired companies may prove difficult and adversely affect our financial results. Our products are subject to competition, including competition from the customers to whom we sell, and competitive pressure from new and existing companies may harm our business sales, growth rates, and market share. Our future success depends on our abilities to develop and successfully introduce new and enhanced products that meets the needs of our customers. The likelihood of our design proposals becoming design wins is uncertain and revenue may never be realized.

Our products fulfill specialized needs and functions within the technology industry and such needs or functions may become unnecessary or the characteristics of such needs and functions may shift in such a way as to cause our products to no longer fulfill such needs or functions. New entrants into our market may harm our competitive position. We rely on the limited number of suppliers to support our manufacturer design process, and if we cannot protect our proprietary design rights, and intellectual property rights, our competitive position could be harmed, or we could incur significant expenses to enforce our rights.

Our international sales and operations subject us to additional risks that can adversely affect our operating results and financial condition, and we fail to remedy material weaknesses in our internal controls or financial reporting. We may not be able to accurately report our financial results and other risks described in our prior press releases and in our filings with the Securities and Exchange Commission, SEC, including under the heading Risk Factors in our Annual Report on Form 10-K and any subsequent filings with the SEC.

You are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date of the conference call, and we undertake no obligation to revise or update this information to reflect events or circumstances after this date hereof. All forward-looking statements are qualified in their entirety by this cautionary statement, which is made under the Safe Harbor Provision of the Private Securities Litigation Reform Act of 1995.

Before we end today's conference, I would like to remind everyone that this call will be available for a replay starting later this evening through May 23. 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. You may now disconnect.