VIAVID
communications simplified.

One Stop Systems, Inc.

Fourth Quarter and Full Year 2018 Conference Call

March 21, 2019

CORPORATE PARTICIPANTS

Steven Cooper, *President and Chief Executive Officer*

John Morrison, *Chief Financial Officer*

CONFERENCE CALL PARTICIPANTS

Scott Searle, *ROTH Capital Partners*

Joseph Gomes, *NOBLE Capital Markets*

PRESENTATION

Operator:

Good afternoon and thank you for joining us today to discuss One Stop Systems Fourth Quarter Results and Full Year ended December 31, 2018.

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 telephone 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.

Steven Cooper:

Thank you, Anne, and good afternoon, everyone. Today I'd like to discuss our strong financial and operational performance for 2018, and our expanding portfolio of products and technologies that supported the growth, and our updated 2019 guidance.

Twenty-eighteen was a breakout year for OSS, driven by our successful IPO, tremendous organic customer growth and application design wins, and strategic acquisitions. In the fourth quarter, our revenue increased 104% to $14.4 million, and for the full year, revenue increased 34% to $37 million. On an organic basis, which excludes revenue from our two acquisitions, our revenue increased 42% in Q4, and for the full year it increased 18%.

We ended the year with a revenue run rate that's more than double that of the previous year. Given our business model of repeat revenue from major OEM and military programs, this represents tremendous momentum going into 2019. Our profitability on a non-GAAP basis also increased significantly throughout the year as the benefits of scale came into play. We're very pleased with such high growth results; they validate our vision and reflect our team's strong execution.

Going back, a few of the highlights from 2018 include: in February of last year, we went public on NASDAQ, generating proceeds of $19.5 million. Being public then allowed us to accelerate our growth rate, including providing the financing and publicly-traded stock that we used to complete our two acquisitions.

Throughout the year, we were able to grow our existing OEM and Defense program customers, in particular our large median entertainment customer grew over 30%. In addition, this customer hired us to design and produce a new state-of-the-art high end product that we began shipping at year-end.

In the Defense sector, we moved into full production with our MIL-SPEC/storage array, which is now being deployed in the P-8 Poseidon aircraft. We were awarded the 2018 TechConnect Defense Innovation Award for the state-of-the-art product, reflecting our technology leadership. Laying the foundation for future growth, we won several significant OEM design-ins during the year. These include specialized high-performance computing solutions for large scale video displays, image recognition, autonomous driving vehicles, medical imaging, satellite communication and advanced sensor data collection and analysis.

It was also a busy year for acquisitions. We acquired Concept Development in the third quarter, which expanded our engineering core competencies and market presence for in-flight entertainment systems. Then in the fourth quarter, we acquired Bressner Technology, which expanded our European presence, with over 800 European customers. It also brought us significant new product lines, OEM design-ins, and new opportunities.

In terms of advancing our products and technologies, we have a long track record of being first to market with the latest in high-performance computing, and this continued in 2018. We introduced the world's first Gen 4 PCI Express cable adapters, which double the performance between servers and I/O systems, and we introduced the world's first NVIDIA SXM2-based compute accelerator expansion system, which can add state-of-the-art AI compute capabilities to existing servers.

We also introduced an ExpressBox laptop expansion system that provides external high end graphics capabilities using Thunderbolt 3, and we introduced the new, high-bandwidth, ion accelerator/storage array product line.

These are all product breakthroughs in their own right, and we offer them as standard products, but the real value here is that we can demonstrate that we have the core design competencies that allow us to custom design similar products to meet the exact needs of our OEM customers. These award-winning, specialized hardware and software solutions, what we sometimes call technology demonstration vehicles, are a key enabler towards winning major OEM and government contracts.

Now, before I go into our outlook for 2019, I'd like to turn the call over to our CFO, John Morrison, who will take us through the financial results for the fourth quarter and the full year 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 fourth quarter and our full year ended December 31, 2018. A copy of the release is available in the Investor Relations section of our website at onestopsystems.com.

Turning to our income statement, our net revenue increased 104% to $14.4 million in Q4, and increased 34% to $37 million for the full year 2018. Revenue on an organic basis, excluding the 2018 acquisitions, increased 42% to $10 million in Q4, and increased 18% to $32.5 million for the full year 2018. The increase in organic revenue was primarily driven by increased sales of flash arrays to our airborne military customer and increased OEM media entertainment sales.

CDI, which was acquired in August of last year, contributed $568,000 or 3.9% of total revenue in Q4, and $755,000 or 2% of the total revenue in the full year. Bressner, which was acquired in October of last year, contributed $3.8 million or 26% of total revenue in Q4, or 10% of revenue for the full year. SkyScale contributed revenue of $2,000 in Q4 and $159,000 for the year. Management agreed to the dissolution of this joint venture company in Q4. As a result, OSS recognized dissolution costs of approximately $705,000. These costs are included in general and administrative expenses.

Our gross profit was $4.3 million or 30% of revenue in Q4, up from $1.9 million or 27.6% of revenue in the same year-ago quarter. This represents growth of 121% in gross profit over the year-ago quarter. For the full year, gross profit was $11.3 million or 30.6% of revenue; this is in comparison to the $8.7 million or 31.5% in 2017. This represents growth of 31% in gross profit. The improvement in gross profit was attributable to our overall business growth.

Our operating expenses totaled $5.4 million or 37% of revenue in Q4, up from $2.7 million or 38% of revenue in the same year-ago quarter. For the full year, operating expenses totaled $14.5 million or 39% of revenue, as compared to $9.1 million or 33% of revenue in 2017.

The increases in both periods are mainly attributable to increased general and administrative expenses, which include costs of being a public Company, amortization of intangible assets related to acquisitions, acquisition expenses, and costs resulting from the dissolution of SkyScale. To a lesser extent, expenses increased due to increased marketing and selling expense, and research and development expense for continued market development, and the development of new and enhanced product offerings.

Net loss attributable to common stockholders on a GAAP basis totaled $120,000, or a loss of $0.01 per share in Q4, as compared to a loss of $121,000 or $0.02 per share in the year-ago period. For the full year, net loss attributable to common stockholders was $1.1 million, or a loss of $0.09 per basic share as compared to $97,000 or $0.01 per diluted share in 2017.

As we discussed on our previous call, we believe our non-GAAP earnings per share and Adjusted EBITDA metric are helpful to assist in the evaluation of the Company's performance. Please reference our definition and use of these non-GAAP terms, and the reconciliation to GAAP in today's press release.

Our non-GAAP income increased to $1.4 million or $0.09 per diluted share in Q4, as compared to $39,000, or basically zero cents per diluted share in the same year-ago period, and increased 95% to $1.4 million or $0.10 per diluted share for the full year.

Adjusted EBITDA was $891,000 in Q4, as compared to an Adjusted EBITDA loss of $300,000 in the year-ago period. Adjusted EBITDA for the full year totaled $805,000, as compared to $979,000 in 2017.

Now, turning to our balance sheet; cash and cash equivalents totaled $2.3 million at December 31, 2018, as compared to $186,000 at December 31, 2017. The increase is due to the proceeds from the Company's IPO on February 1, 2018, which was partially offset by cash used for debt pay-down of OSS debt, working capital, and the acquisition of CDI and Bressner, and other infrastructure projects. We now have available credit facilities totaling $6 million. Based on our current plans and business conditions, we believe existing cash, cash generated from operations, and available credit facilities are sufficient to satisfy our anticipated cash requirements for at least the next 12 months.

Our balance sheet component, including accounts receivable, inventory, goodwill, and accrued expenses all increased dramatically due to the larger scale of our operations attributable to the acquired companies and organic growth.

This wraps up our financial results. I'd now like to turn the call back over to Steve. Steve?

Steven Cooper:

Thanks, John. The three key elements of our growth strategy, OEM customer ramp-up, new design wins and strategic acquisitions, all contributed to the record growth in 2018 and the strong start of this year. These elements, combined with our record backlog and strong sales pipeline, provide confidence that our rapid growth will continue in 2019 and beyond.

OSS is also well-positioned for the significant trends that are emerging within the specialized high-performance computing marketplace. Two of these trends include the shift from PCI Express Gen 3 to Gen 4, and the emergence of what we call "AI on the Fly" applications. OSS has demonstrated the core capabilities necessary to excel in these areas and expect to remain on the forefront of those technologies.

Beyond our technology investment, as the Company continues to scale up, we're also investing in the appropriate infrastructure for a larger and more sophisticated Company. Regarding facilities, we're remodeling and expanding our facility space at our Escondido headquarters to facilitate consolidation of our ex San Diego operation, and to increase our production capacity. We expect the project to be completed over the next few months.

We've also begun implementation of a new ERP system to facilitate business scalability and full integration of our operations. We expect the initial phase of our new ERP system to be operational in Q3 of this year.

Now, since our goal is both to be recognized as a leading, high growth technology Company, but also to be recognized in the marketplace, let me talk about the "be recognized" part of this. We continue to implement an aggressive Investor Relations outreach program that includes press releases, investor meetings and participation and investor conferences.

In January, we rang the opening bell on NASDAQ and completed a road show with institutional investors. In February, we presented at the Noble Capital Investor Conference. In March, we participated in the LD Micro Investor Webinar, and just this past week, we presented at the ROTH Investor Conference. Throughout the rest of the year, we're planning to participate in additional investor conferences and meeting with institutional investors.

We've been invited to participate in the Oppenheimer Emerging Growth Conference, the B. Riley Institutional Investor Conference, and the LD Micro Invitational Conference. Our goal with this investor outreach program is to increase awareness of OSS, thereby building upon our base of investors.

Turning to our outlook for the first quarter and full year of 2019; we expect 2019 revenue to be between $54 million and $58 million. This represents overall growth of 51% to 54%, with organic growth at 12% to 18%. We also expect revenue for Q1 2019 to be in the range of $11.9 million to $12.6 million. This represents overall growth of 67% to 77%, with organic growth at 10% to 12%. Additionally, the nature of our business is such that revenue from quarter-to-quarter may fluctuate plus or minus 15% from our plans due to variations in delivery and/or seasonal fluctuations.

In summary, our achievements in 2018 give us confidence and excitement going into 2019. The combination of a strong vision, strategies, and execution is expected to deliver record results.

Now with that, I'd like to open the call to your questions. Anne?

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 are 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 for questions.

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

Scott Searle:

Hey, good afternoon. Thanks for taking my questions. Nice quarter, guys.

Hey, Steve, John, if you could—just digging a little bit on the fourth quarter, you talked about some costs related to winding SkyScale down, but are there any other one-time costs in there associated with the closing of Bressner? Just want to get calibrated on the normalized op ex front, and what we can expect going forward.

Also, on the gross margin front, it tends to be a little volatile quarter-to-quarter, depending on mix. It looks like a lot of Bressner this quarter, which I'm assuming was impacting the mix. Was there anything else in there this quarter, and how are you thinking about gross margins over the course of 2019? I have some follow-ups. Thanks.

John Morrison:

Well, let me address the question about the costs associated with Bressner. During the fourth quarter of 2018, we incurred approximately $358,000 of acquisition expenses associated with the Bressner transaction. Outside of that, the only other anomaly was the dissolution of SkyScale, which we recognized approximately $705,000 of expenses, which is included in general and administrative expenses as an operating expense.

Steven Cooper:

We may also want to add to that list of unusual things, although it's recurring, the amortization of intangible assets. A portion of the purchase price of Bressner comes into play, and the first amortization was also in the fourth quarter.

Scott Searle:

Got you. Just in terms of the gross margins and your thoughts for 2019, how that mix is going to play out?

Steven Cooper:

In general, our gross margins have been trending upward, although Q4, the mix was—pushed it down a little bit. But we believe that throughout 2019 we're going to see a slight escalation, improvement in gross margin, each quarter, probably including this first quarter as well.

Scott Searle:

Okay, got you, very helpful. Maybe just kind of diving in—well, in the past, I think you've talked about the number of RFPs that you responded to that were in excess of a million dollars. Is there a number for this quarter, and how you're seeing so far going into this year in terms of the level of activity in the pipeline?

Steven Cooper:

The level of activity has been tremendous for—going on now, three to six months. It really kicked up in the second half of last year. We do track RFPs, request for proposals. Actually, what we track is proposals that are out at customers, in their hands. We typically, in the last few months, we've had between 15 and 20 at any given time and are seeing a win rate of about 30% of those. That's continued. We currently have about 20 right now, actually, proposals out, and expect to win a good number of those.

Scott Searle:

Got you. Maybe just in terms of some of the bigger customers, are you getting some better visibility on Raytheon deployments over the course of this year and getting comfortable with that?

Also, I think you referenced Disguise in your opening comments, that was 30% growth in 2018. How are you feeling about their participation in 2019; continue to be a growth customer for you?

Steven Cooper:

Yes. Regarding the military program, unfortunately the visibility there is still somewhat cloudy, for one reason or another. You'd sure think, since they're building billion dollar aircraft, they'd tell how many they're going to build, but it's surprisingly cloudy, particularly at the quarterly granularity. We have a pretty good idea that they'll be purchasing $6 million to $8 million throughout a year, but exactly which quarter that hits at is a little hit and miss right now. That one's a little fuzzy.

The median entertainment customer is quite a bit clearer. They're having a good start to the new year, and as I mentioned in my opening remarks, we have just started shipping the new VX 4 model, their new high end model. They have also agreed to have us design their next two products, so we've started design on two additional products that'll begin shipping late in the year. Between the new products, which usually have a nice bump in volume, the existing models, and the new models, we're extremely bullish about our median entertainment business (inaudible).

Scott Searle:

Got you. Lastly if I could, and then I'll get back in the queue; AI on the Fly, tremendous amount of interest going on in terms of edge intelligence, and you guys really play into an enablement of that aspect, of different types of solutions. You referenced at least one win in the quarter where you seem to have some visibility.

I guess a couple of questions; what is the pipeline there looking like? Can you talk us through some of the applications, the size of some of these deals and timing of when you would expect some resolution? I would imagine, given that these likely include some incremental design capabilities and GPU elements, that they're higher gross margin as well. Can you just kind of talk about, I guess, opportunity, pipeline and the gross margin impact as we think about 2019? Thanks.

Steven Cooper:

Yes. For people that haven't heard the expression much before, we've coined the term "AI on the Fly" to describe a major trend where, rather than doing the artificial intelligence computing in a datacenter or in the cloud, we're taking that artificial intelligence level of computing and putting it out in the field where the sensor data is being collected. We're seeing an outpouring of applications that want to do this AI on the Fly. In fact, of the 20 proposals we have out, probably two-thirds of them are AI on the Fly applications, so that's airborne applications with compute accelerators where they're doing visual recognition and radar recognition of different elements and tracking, artificial intelligence type applications.

We won some pretty major designs in an autonomous vehicle. We're working on two, actually, different programs for autonomous vehicles, one to deliver people, one to deliver packages. We're working on applications that are military, applications that have to do with visual recognition, just applications in a big variety where artificial intelligence on the fly, meaning out by where the data's collected, is extremely valuable. We think that's going to really drive our growth this year.

In terms of the margins for AI on the Fly, I had actually expected—it's very high-tech, and I would expect it to be slightly higher than our traditional business, but not hugely dramatic, maybe in the mid 30% gross margin range.

Scott Searle:

Great, thank you.

Steven Cooper:

Thank you, Scott.

Operator:

As a reminder, please press star, one if you have a question.

We'll go next to Joe Gomes with NOBLE Capital.

Joseph Gomes:

Good afternoon, guys.

Steven Cooper:

Hey, Joe.

John Morrison:

Hi, Joe.

Joseph Gomes:

Quick question, on the SkyScale, you took some charges in the fourth quarter. Is that the extent of them, or will some of that bleed over into the first half of 2019?

John Morrison:

Yes, that charge is related to SkyScale, which was our cloud operation. We decided to dissolve that joint venture, and we accrued, for all known expenses related to the closing of that operation, and we do not anticipate any costs going forward.

Joseph Gomes:

Okay, great. On the Poseidon, obviously that plane is used in a number of countries. Are you seeing any opportunities for what you have to go to some of the other countries that fly that plane, for the same capabilities, or is that just the U.S. program?

Steven Cooper:

Yes. We'll be, actually, involved in all sales of the Poseidon aircraft, whether it's international or U.S. Our storage subsystems are a part of the radar system; the next-generation radar system as known as the AAS, or advanced airborne sensor array. Obviously, it has more than just radar involved in it. But we'll be involved in both domestic and international sales of the aircraft.

Joseph Gomes:

Great. Then, on CDI, I was just wondering if you might be able to provide a little more color and detail on how that integration is going. I think when you guys acquired it, you were projecting annual revenues in the $4 million to $6 million run rate. When you look at the fourth quarter and you annualize that, it's more about a $2.3 million, so is there some seasonality there? Or maybe if you just discuss a little bit more how that integration is going.

Steven Cooper:

The integration is going quite well. We're integrating our finance and production teams and engineering teams in particular, well, our sales teams as well. CDI is an interesting one; they're smaller than Bressner and smaller than OSS but have the largest potential for growth. They actually have a number of very large proposals that could, fairly quickly, double the size of their business. In fact, one of those that they've just recently won is in one of these autonomous vehicle applications, so we think of them as opening up the door for in-flight entertainment, which they are, but their technology and their custom design capabilities are also applicable to many of these other applications that we've been calling AI on the Fly.

I see CDI absolutely true—having a slow fourth quarter and probably a slow first quarter as well but having the potential to really take off as the year progresses.

Joseph Gomes:

Okay, great. Thanks so much.

John Morrison:

Thank you, Joe.

Operator:

Again, it's star, one if you would like to ask a question.

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

Steven Cooper:

Thank you, Ann, 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 myself and John at any time. Thank you, everyone.

Operator?

Operator:

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 this presentation that 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 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 this 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, system, technologies, products, offerings, and personnel of 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 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 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 a 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 risk 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 this 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 April 4. 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.