



One Stop Systems, Inc.

Fourth Quarter and Full Year 2017 Earnings Conference Call

March 21, 2018

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*

Rudy Miller, *Miller Capital*

PRESENTATION

Operator:

Good afternoon, and thank you for joining us today to discuss One Stop Systems' fourth quarter and fiscal year ended December 31, 2017 results. With us today are the Company's President and Chief Executive Officer, Steve Cooper, and Chief Financial Officer, John Morrison. Following their remarks, we will open the call to your questions. Then, before we conclude today's call, I'll provide some important cautions regarding the forward-looking statements made by Management during the call.

I would also like to remind everyone that today's call will be recorded and will be made available for telephone replay via instructions in today's press release and in the Investors section of the Company's website.

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

Steve Cooper:

Thank you, Bethany, and good afternoon, everyone. This is our first earnings call as a publicly traded company and I'd especially like to welcome the new shareholders, as well as those who have been stockholders with us for many years, and a special message for those of you in the path of the nor'easter storm, our thoughts are with you and please stay safe.

2017 was a busy and exciting year for OSS, as we achieved strong financial results. Our revenues increased 46%, which includes organic revenue growth of 38%, plus the added growth effect of our M&A activities. Our margins improved by over two percentage points, as we continue to add increasing value to our customer base. We were profitable for the year and achieved positive cash flow. In February of this year, we successfully completed our IPO and began trading on the NASDAQ capital market.

2017 was also year where we set the stage for ongoing growth and market expansion as one of the world's leading providers of specialized high performance computing systems. We introduced multiple state-of-the-art products, including high performance GPU acceleration systems, mil-spec hardened airborne flash data storage units and multiple video display servers. To further accelerate our growth, we launched our SkyScale cloud service business to provide multi-GPU computing in the cloud. This new service also allows our customers the flexibility to "try before you buy" our high-end systems. In July, we acquired the Ion software business from Western Digital, providing the technology and customer base for expanding penetration into the flash array market.

2017 was a strong year that set the stage for our next phase of business. That new phase began with our IPO in February this year and as a public company we anticipate a number of strategic benefits to what I call the aura effect. Being publicly traded creates a positive aura with our employees, our vendors, our customers, and especially with our M&A prospects.

Now, let me turn the call over to John Morrison, who will take us through the financial results for 2017. John?

John Morrison:

Thank you, Steve, and good afternoon, everyone. Thank you for joining us today. Earlier this afternoon, we issued a press release with the results for our year ended December 31, 2017. A copy of the release is available in the new Investors section of our website at onestopsystems.com.

Along with our IPO last month, we launched the new investors website in order to provide our stockholders, customers, employees and other parties interested in our company important information about OSS. This includes our SEC filings, stock information, company presentations, press releases, corporate governance documents and an events calendar. There is also an option to sign up for email alerts, so you won't miss out on our latest news. 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, turning to our financial results, while not specifically disclosed in our Annual Report on Form 10-K, our results for the fourth quarter of 2017 can be derived from comparison of our nine-month financial statements as disclosed in our S-1 and our full year 2017 results as disclosed in our 10-K filing. Both of these filings are available for download from sec.gov or the Investors section of our website.

Our revenue in the fourth quarter of 2017 was \$7.1 million, which was lower than our expectations, primarily due to a delay in the shipment of some of our products for our military flash array program, which was approximately \$230,000, along with other smaller delivery delays which subsequently shipped in Q1 2018.

Gross margin in the fourth quarter was \$1.9 million or 27.6% of revenue. This was 382 basis points lower than the average gross margin for 2017. The decrease was mostly attributable to recording additional inventory reserves. These reserves were marginally offset by capitalization of labor in inventory, with a total fourth quarter negative impact of \$337,000.

Operating expenses in the fourth quarter were higher by approximately \$490,000, as compared to the previous three quarters' trend. This was due to the addition of the Ion Software Development Team and engineering consultants which added \$345,000, along with other compensation costs for wages and commissions that contributed an additional \$145,000. We expect that the cost of the Software Development Team and consultants will be ongoing in future quarters and that these costs will be offset by increasing gross profit associated with projected revenue growth from the Ion business.

Net loss attributable to OSS in the fourth quarter totaled \$120,676, or a loss of \$0.02 per basic and diluted share, on 5,507,007 weighted average shares outstanding.

Now, turning to the results for the full year 2017, revenue increased 46% to a record \$27.5 million, as compared to \$18.9 million in 2016. The increase was primarily driven by our existing customers generating organic growth of \$5.9 million or 69% of the total increase in revenue. The addition of Magma for the full year contributed \$2.1 million, or 24% of the total, with the acquisition of the Ion Software Development Team in July 2017 adding an additional \$567,000, or 6.6%. The April 2017 launch of SkyScale, which is our new cloud-based HPC-as-a-Service joint venture, contributed less than 1% of the total.

Looking at our revenue from a global perspective, in 2017, 47% of our revenue was generated by domestic sales, with international contributing 53%. This compares to the 56% domestic and 44% international in 2016. The majority of our international sales are to international sites, or third-party hubs, of our U.S. based customers, with product sales denominated in U.S. dollars.

Organic revenue in 2017 increased by \$5.9 million, which was up 38% compared to 2016. This increase was due to increased purchases from existing customers. Acquired revenue, or revenue attributable to the acquisitions we completed in 2016 and 2017, increased by \$2.8 million or 87%. The increase in acquired revenue was primarily due to the sales of Magma products in 2017, which were not available to us in the first half of 2016, given the timing of the merger.

Our total gross margin increased to \$8.7 million, or 31.5% of revenue, as compared to \$5.5 million, or 29.2%, in 2016. The increase in gross margin is mostly attributable to the inclusion of Magma for the full year, which contributed margin at a rate of 37.6%, and a shift in the mix of the products sold to higher end componentry and OSS-provided content.

Operating expenses for the full year of 2017 increased to \$9.1 million, or 33% of revenue, as compared to \$5.7 million, or 30% of revenue, in 2016. The increase was mostly due to increased compensation expense with having a full year Magma employees costs in 2017, as compared to less than six months in 2016, as well as the addition of the Ion Development Team and related facility which we took on in the last six months of 2017. In all, operating expenses increased year-over-year as a percentage of revenue about 2.7%.

Net loss attributable to non-controlling interest is a new line item for 2017, as this represents the 50% ownership attributable to a third party in the consolidated results of SkyScale that was formed in April 2017. Our share of the net loss from SkyScale totaled \$313,000 and reflects startup costs associated with this new venture. We expect to generate a reoccurring high-margin revenue stream as this company transitions from a development stage company to a full-scale operating business.

Net income attributable to OSS in 2017 totaled \$96,620, or \$0.01 per diluted share, which was an improvement from our loss of \$184,437, or \$0.04 per basic and diluted share, in the prior year.

Adjusted EBITDA totaled \$979,138. This represents an increase of 134% from the \$418,792 in 2016. Please reference our definition and use of Adjusted EBITDA, which is a non-GAAP term, and its reconciliation to GAAP in today's press release.

Finally, let me discuss the financial results from our recent IPO. After completion of our IPO at the beginning of February 2018, we received net proceeds of \$17.95 million. We subsequently paid \$3.9 million to retire all of our outstanding notes payable and the balance of our bank line of credit. Thus, at this point in time, OSS is completely debt free. We also paid \$1.2 million in offering issuance costs and paid all outstanding accounts payable, resulting in a cash position of approximately \$10 million.

This wraps up our financial results. I would now like to turn the time back to Steve.

Steve Cooper:

Thanks, John. With a strong year behind us, we have considerable momentum going forward. In 2018, we envision our rapid growth to continue, driven by many of the same forces that produced our 2017 results. In particular, we anticipate revenue growth from existing OEM designs and military program design wins ramping up. In addition, we are actively seeking acquisition candidates, with the target of acquiring one or two synergistic and accretive companies during 2018.

In terms of specific 2018 guidance, we anticipate our revenue, exclusive of any future M&A activity, to be between \$36 million and \$38 million for the year, representing organic growth of 31% to 38%. With anticipated M&A activity included, we expect to see a growth rate similar to those we've achieved in 2017. It's also important to note that we don't expect our revenue growth to be linear in 2018, with quarterly lumpiness due to uncertain timing of large-dollar shipments, such as those related to our military flash array program. We also estimate that 60% to 62% of our revenue in 2018 will be generated in the second half of the year. Further, our quarterly revenue may fluctuate plus or minus 15% from our plan in any given quarter due to the variable shipment dates.

For OSS, 2017 was a breakthrough year and 2018 is shaping up to continue the momentum and be another banner year.

With that, I'd like to open the call to any questions. 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 the mute function is turned off to allow your signal to reach our equipment.

Our first question today will come from Scott Searle of ROTH Capital.

Scott Searle:

Hey, good afternoon, guys. Just a couple of quick clarifications. John, if you could, could you just tell us again the one-time charges related to inventory reserves? Also, looking out into the first quarter, can you give us an idea of what op ex will look like? Maybe to follow up, as well, on the gross margin line, backing out, it looks like, those inventory reserves, you're back in the range that you've been the last couple of quarters. Will we see gross margin expansion over the course of 2018? Then, I have a couple of follow-ups.

John Morrison:

Thank you, Scott. The inventory reserves for the fourth quarter of 2017 were approximately \$500,000, and then we offset that against some capitalized labor that netted out to the approximately 300 and some odd thousand dollars that I referred to in my comments.

Your second question, could you repeat that for me, please?

Steve Cooper:

Margins.

John Morrison:

On margins? Could you specifically ask that again, please, Scott?

Scott Searle:

Yes. Well, maybe staying on the gross margin, looking out 2018, will we see some expansion or continued expansion in the overall blended gross margin in the course of this year?

John Morrison:

We are currently anticipating we are going to go from our 32.5% to approximately 33% gross margin percentage.

Scott Searle:

Okay, got you. Maybe just following up in terms of the back-end loaded nature of the year, being geared more towards the second half, Steve, what's the current assumption for the ramp-up of the Raytheon contract at the current time? I think you've got a little bit of revenue coming in, but it was expected to ramp in the second half. What's currently factored into your expectations?

Steve Cooper:

Yes, that is the predominant issue that's driving a somewhat back-end loaded year. We will be shipping production units. We began shipping production units in December for our military flash arrays. We're shipping additional units this quarter, Q1, and Q2, but the big ramp-up into what you might consider a full run rate production will occur beginning in Q3 and continue in Q4, and probably for the next four to 10 years.

Scott Searle:

Got you. Just following up, as well, Disguise has been a big customer for you. I'm not sure how big it was in the fourth quarter, maybe you could give us some idea of how large that was, and your current expectations for the growth of Disguise in 2018.

Steve Cooper:

I don't have the exact numbers in front of me, but they're certainly one of our largest customers for the year, and anticipated quite large going forward. The video entertainment systems that we provide continue to grow very nicely in the marketplace and we expect that business to grow approximately 30% this year over last. That's another big adder to our growth rate. That one tends to be fairly steady, although they do have a bit of a dip in Q1, so they do have a little bit of a growth pattern throughout the year, but, in general, that business has been quite steady for us now for three or four years.

Scott Searle:

Got you, and then lastly, and I'll jump back in the queue, maybe give us a quick update in terms of SkyScale, I think there have been things building in the pipeline, and maybe just the pipeline, in general, if you could characterize it for us in terms of level of activity. What's driving some of the interest right now?

Is it more storage arrays, is it more GPU accelerators? How is that pipeline kind of shaping up color, either in verticals or requirements that are driving it? Thanks.

Steve Cooper:

That business is starting to grow nicely. Certainly, the interest has been high ever since the introduction of the products the middle of last year. We believe we are very close to—in fact, have just closed one of our largest customers to date, which they will be leasing compute time on several racks' worth of equipment—for us, that's a pretty large sale—over the next year, it's a one-year commitment. We're closing business. We're also prospecting quite a bit. For a young business, up till now, it's been very modest in revenues, but I would expect somewhere between \$1 million and \$2 million in revenue in 2018. It's starting to get the point where it'll transition from a loss startup business to a breakeven to profitable business, with, we believe, very large upside growth in 2019, and beyond.

Scott Searle:

Great, thank you.

John Morrison:

Thank you, Scott.

Operator:

Our next question will come from Gary Mobley of Benchmark.

Gary Mobley:

Hey, guys, thanks for taking my questions. I wanted to start with a question that Scott asked, that I don't think was answered. Could you give us a sense of the run rate op ex, starting out with the Q1 2018 base, on a GAAP and non-GAAP basis?

Steve Cooper:

Subjectively, we think the run rate will be very similar to what we've announced here for Q4. There are no major increases or decreases in the immediate horizon. We look to stay relatively flat in our op ex for the first half of the year, ramping up in the second half of the year, corresponding with the anticipated increased revenue.

Gary Mobley:

Okay. I appreciate you giving us some revenue parameters for 2018. Looking at the midpoint of the revenue guide of \$37 million, could you give us a sense of what might be underpinning that as far the backlog metrics? I think you ended 2016 with \$6 million backlog revenue, and I don't think the 2017 backlog was disclosed in your 10-K, at least not what I saw. Can you give us a sense of where we ended the year?

Steve Cooper:

It wasn't disclosed, but I'm happy to disclose it now. It was about \$10 million at the end of the year in backlog.

Gary Mobley:

Okay. Obviously, you're expecting—it's implied in the linearity of your fiscal year '18 guide and your narrative there—roughly, I don't know, about 80% sequential improvement in revenue as the year unfolds. Can you support that given constraints in NAND flash and GPUs?

Steve Cooper:

We're definitely seeing—with the good, strong economy growing rapidly, we're definitely seeing increased lead times on a number of key components. That would include flash memories, DRAMs, GPUs, particularly recently, and even things such as power supplies. Every one of those, the lead times have stretched out. Our Purchasing Department is very talented and working very hard to mitigate those risks, but at some point those delays, and us being able to get materials, plus the added costs of those materials as they become short, can affect our timing of revenue, in terms of delaying things, as well as our cost of goods. The one right now that's affecting us probably the most would be GPUs, of those four, but certainly we're keeping a close eye. This is a fairly new phenomenon, in the sense that with the more modest economic growth over the last ten years, we really haven't seen much in the way of component shortages, but they've definitely started up again, starting about mid last year, and we're struggling with that a bit.

Gary Mobley:

Okay, and the last question I have is on the share count. John, can you give us a GAAP number and a non-GAAP diluted share count for 2018?

John Morrison:

Sure. What I can provide you with is our current balance as of today. I don't have any projections yet for the year end here on how it's going to come out. Just a moment, I'll look for that particular page here. As of February 28, we have 12,476,928 shares outstanding, and on a diluted basis—that's what I'm trying to pull up here, I've got to get to the right sheet—approximately 14.9 million, but I'll get you the exact number here in just a moment. Total fully diluted is 14,910,729 shares, fully diluted.

Gary Mobley:

All right, I appreciate that guidance, and thank you.

Operator:

Ladies and gentlemen, as a reminder, that is star, one to ask a question. Our next question will come from Rudy Miller of Miller Capital.

Rudy Miller:

Steve, John, good afternoon, guys. How are you guys doing today?

John Morrison:

Good, and how are you, Rudy?

Steve Cooper:

Hey, Rudy.

Rudy Miller:

Good, good. Just a couple of quick questions. One is, and you addressed it a little bit, one of the items covered, and that was having some of your supplier deliveries. Over the last 10 years, we haven't had the growth that we're now challenged with. One concern is China. Is China the majority percent of where your manufacturing suppliers are that you're missing components from, is that the country that's the key, or are there other parties throughout, other than China?

Steve Cooper:

It varies by commodity.

Rudy Miller:

Just ballpark (inaudible) percentage.

Steve Cooper:

It's China, but there's DRAMs and a flash, a lot out of Japan. Power supply is probably the most trouble with getting right now, happened to be a U.S. manufacturer, and GPUs come from NVIDIA, a U.S. manufacturer, as well, so, it's a real mix of international supply.

Rudy Miller:

Well, that's really a set-up question to (inaudible) follow-ups that I have, and one is that with trade issues and with the current political involvement of free trade or tariffs, etc., it goes back to what is the percent again of your international revenue that you guys are forecasting in 2018, what is the percentage of your international revenue, approximately?

Steve Cooper:

Currently, international versus U.S. revenue is about a 50/50 split. That is skewed somewhat, in that our large media and entertainment design win is for a company that's out of London, even though their products, we ship directly to their customers, which are more predominantly U.S. customers. It's skewed a little bit, but currently it's about a 50/50 percent revenue split.

Rudy Miller:

Okay. Would you mind giving me an update, a split on the percentage of your military revenue, which you did when you were doing your road show, just update me a little bit currently where you're at, your estimate of your military percent of revenue, government/military percent of revenue for '18?

Steve Cooper:

Backing up to 2017, it was roughly 15% of our total business, but that percentage, we anticipate will increase rapidly in 2018 to about 20%, maybe as high as 25% of our total.

Rudy Miller:

That's including the Raytheon build-up, them being military; is that correct?

Steve Cooper:

Yes, that's correct.

Rudy Miller:

Okay. My next question for you, Steve, is that I'm a little concerned about—the good news is you articulated, with your financial officer, you paid off all your debt, and what was the interest costs last year that you paid out, John, in your financial side, what did you guys pay in interest rates last year on the Company's debt, approximately, for 2017?

John Morrison:

Private placement debt was 11% and the line of credit was in the 3% to 4% range.

Rudy Miller:

Okay. What is that blended amount in U.S. dollars you paid out, which would have affected your earnings by what? I mean, what was the amount of that, \$500,000, \$700,000, \$300,000?

John Morrison:

For 2017, our total interest expense was \$199,000.

Rudy Miller:

Okay. Well, you're going in with no debt into the year, you have a good balance sheet. That follows to my next question, which is the interest rate increases. I'm a little concerned, is with interest rate increases going forward and the strengthening against the U.S. dollar, and doing 50% international revenue, how do you focus on that issue, which is going to be here the next couple of years? I mean, we're never going to have the low rates, in my opinion, from my experience, that we had or my parents had, at the kind of rates we've had for years, low interest borrowing rates. It's certainly going to increase, unless there's a catastrophe. How does Management feel—even though you have a good balance sheet today, with potential increased dollar, increased interest rates, with 50% of the international business, can you address that from your perspective as a Management Team?

Steve Cooper:

It has mixed effects is the answer. Since we do have cash on hand currently, if we can get a little bit higher interest rate on our money market funds, that helps us slightly.

Rudy Miller:

(Inaudible) don't help you (inaudible) better rate. That's a joke for the audience. I'm sorry.

Steve Cooper:

In the short term, it helps us get a little bit more interest on the money we have in the bank, but as you point out, the strong dollar may make our products slightly less competitive in international markets. We do price all of our products currently in U.S. dollars, so that the relative valuation of the currency, to the extent that the dollar goes up, will hurt us competitively overseas. Conversely, a strong dollar may make

some of our imports for components that we mentioned, the hard to get components, it might help that out a little bit. It's a real mixed bag when you talk about the higher interest rates, particularly since they're fairly slightly higher at this point. Whether that actually helps us more than it hurts us, at this point, with the modest interest rates, where they are, I think it's a pretty neutral effect going forward.

Ray Miller:

Well, Steve, I think, on a go-forward 2018 and 2019 basis, with all due respect, as a shareholder and investor, I understand that the current modest (inaudible) of a quarter of a point in your cash balance sheet, so getting higher interest than you currently got, which you didn't get much before because you were paying the debt fee, you got a low rate, but that's certainly a challenge that Management needs to focus a plan. Because, you know, unless there's a catastrophic event the other way, there are going to be additional increases in 2018, and projected in 2019, so I'm really interested in how you're going to gear your sales and marketing and business structure over the aspect of that.

We have good cash today and in the short term it's not an issue. I'm not worried about the short term with your balance sheet, which I've said now about six times. I'm concerned with how you think you would address your competition internationally with 50% of your revenue. If it was 10%, I probably wouldn't be making this strong of a point. I appreciate your comments, but I would look forward to hearing a more specific outline over the next 24 months.

You don't have the answer for me today, I accept that and understand that, it's your first public CEO call and your CFO call, but it's certainly a concern that is one to look at when you analyze the stock. We have investments in many companies and two reasons we invest in this company was (a) Management, that's you, and that's Randy Jones, your Vice Chairman, the new CFO you have, and the space that you're in, in general, and we've seen how you've integrated the Magma acquisition. Those are all check marks why we are investors in the Company, and we'll be bigger investors, too, but these are issues that, as a shareholder and an investor, and challenges that I wanted to ask you, and I appreciate the thought process thus far that you guys have answered the question, but I think I'm going to look forward to, over the near future, a more developed plan of how you're going to address that fact, that we know it's 90% going to be here.

Steve Cooper:

Very good, excellent. Thank you, Rudy.

Rudy Miller:

Thank you very much for your time, and of course we appreciate it and we support you 100%.

John Morrison:

Thank you.

Operator:

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

Steve Cooper:

Thank you, Bethany. I'd like to wrap up by expressing my sincere appreciation for the hard work and dedication of all of our OSS teams, from our design to manufacturing, to marketing and sales, as well as our administrative teams, who have created not only a fantastic 2017 and a great start to the new year, but have also laid the foundation for many strong years ahead for OSS. Also, I'd like to express my special thanks to the long-term shareholders and to our Board of Directors, whom, without their loyal support and encouragement, none of this would have been possible, and to our new investors, we thank you for joining us on this journey, we anticipate it'll be an exciting and rewarding experience.

With that, we look forward to talking with each of you in the future and reporting on our progress. Meanwhile, feel free to reach out to us at any time. Thanks, everyone. Operator?

Operator:

Thank you. Now, before we conclude today's call, I would like to provide the Company's Safe Harbor statement that includes important cautions regarding forward-looking statements made during today's call.

One Stop Systems, 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 due to the risks and uncertainties inherent in the Company's business, including, without limitation: that the market for our 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 our 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 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 the customers; 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 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 significant expenses to enforce its rights; international sales and operations subject OSS to additional risks that can adversely affect its operating results and financial condition; if OSS fails to remedy any material weaknesses in its internal control over financial reporting, it may not be able to accurately report its financial results; and other risks described in a prior press releases and in Company's filings with the Securities and Exchange Commission, including under the heading Risk Factors in the 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 later this evening through April 4. Please refer to today's press release for dial-in and replay instructions 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.