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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Intermolecular, Inc.'s First Quarter 2018 Earnings Conference Call. (Operator Instructions) Please note this call is being recorded. My name is David, and I will be your operator for today.

I would now like to turn your conference over to your host for today, Mr. Bill Roeschlein, Chief Financial Officer. Please proceed, sir.

Bill Roeschlein - *Intermolecular, Inc. - Senior VP, CFO & Principal Accounting Officer*

Thank you, David. Good afternoon, and welcome to Intermolecular's First Quarter 2018 Earnings Conference Call. After the market closed today, we issued our financial results for the first quarter ended March 31, 2018. A copy of the earnings release is available on our website at www.intermolecular.com. Joining me today on the call is Chris Kramer, our President and Chief Executive Officer.

Today's conference call contains forward-looking statements. Any statements that refers to expectations, projections or other characterizations of future events, including financial projections and future market conditions, is a forward-looking statement. Actual results may differ materially from those expressed in these forward-looking statements. Intermolecular assumes no obligation to update these forward-looking statements, which speak only as of today, May 8, 2018. For more information about factors that may cause actual results to differ materially from forward-looking statements, please refer to the press release we issued today as well as the risks described in our Form 10-K for fiscal year 2017 as filed with the SEC, particularly in the section titled Risk Factors.

Before we begin, please note that during this call, we will discuss non-GAAP financial measures as defined by the SEC in Regulation G. We believe non-GAAP financial measures provide useful supplemental information to both management and investors, but note that these measurements are not a substitute for GAAP and should only be used to evaluate the company's results of operations in conjunction with corresponding GAAP measures. All non-GAAP measures are reconciled to the most directly comparable GAAP financial measures in our press release issued today.

Now I would like to turn the call over to Chris. Chris?

Christian F. Kramer - *Intermolecular, Inc. - President, CEO & Director*

Thanks, Bill, and good afternoon, everyone. Thank you for joining us on today's call.

The first quarter of 2018 marked our third consecutive period of positive adjusted EBITDA, a consistency we have not seen in nearly 5 years. Much of this accomplishment is due to the business model shift to materials innovation services, which I will revisit later on today's call.

Our improved financial performance is a result of actions we have taken over the past year to both increase customer engagements and reduce our cost structure. Specifically, on a year-to-year basis, we increased program services revenue by $2.5 million or 36% for the quarter while reducing operating expenses by $4.5 million. This combination has more than offset the planned expiration of royalties from legacy programs and is key for sustainable profitability.

Before I dive into further details of our operational progress and outlook for the remainder of 2018, I would like to invite Bill to walk us through our financial results for the first quarter ended March 31, 2018. Bill?

Bill Roeschlein - *Intermolecular, Inc. - Senior VP, CFO & Principal Accounting Officer*

Thank you, Chris. Turning to our financial results for the first quarter ended March 31, 2018. Our revenue for the first quarter of 2018 was in line with our guidance at $9.7 million, which was down 8% from the prior quarter and down 3% from the first quarter of last year. While we do experience some seasonality from Q4 to Q1, the revenue decrease was primarily due to the absence of $1.25 million of royalties, as Chris mentioned, as well as a couple of customer programs that were pushed out into our second quarter.

Looking at revenue by source. Program revenue for the first quarter of 2018 was $9.3 million, which was up 5% from the prior quarter and up 36% from the first quarter of last year. As a percentage of total revenue, program revenue accounted for 96% of our total revenue in the quarter compared to 68% in the first quarter of last year.

Licensing and royalty revenue for the first quarter of 2018 was $0.4 million or approximately 4% of total revenue. This compares to $3.1 million or approximately 32% of total revenue in the first quarter of 2017. We had expected this as the royalties for legacy programs had generally expired in 2017, and we are pleased that we have been able to offset this with the growth in program revenue.

We had 2 customers that accounted for more than 10% of our total revenue in the first quarter of 2018. These 2 customers represented approximately 86% of our total revenue in the first quarter of 2018.

I would like to remind you to please review today's earnings press release for both GAAP and non-GAAP measures and the reconciliation between those results. As of some of you know, the key difference from our GAAP to non-GAAP measures is the exclusion of stock-based compensation expense.

On this basis, for the first quarter of 2018, our GAAP gross margin was 65.1% and our non-GAAP gross margin was 65.7%, which was 70 basis higher than our guidance of 65%. This compares with 65% and 65.4%, respectively, in the prior quarter; and 70% and 70.6%, respectively, in the comparable year-ago period. For the second quarter of 2018, we expect non-GAAP gross margins to be approximately 69%.

GAAP and non-GAAP operating expenses were $7.1 million and $6.9 million, respectively, in the first quarter of 2018. This compares to $6.9 million and $6.7 million in the prior quarter, respectively, and $12.9 million and $12.4 million, respectively, in the comparable year-ago period. For the second quarter of 2018, we expect non-GAAP operating expenses of approximately $7 million.

GAAP net loss totaled $0.6 million or $0.01 per basic and diluted share. This compares to net income of $0.1 million or $0.00 per basic and diluted share in the previous quarter and a significant improvement from the GAAP net loss of $5.8 million or $0.12 per basic and diluted share in the first quarter of 2017. Non-GAAP net loss for the first quarter of 2018 was $0.4 million or $0.01 per basic and diluted share. This compares to a non-GAAP net income of $0.4 million or $0.01 per basic share and diluted share in the fourth quarter of 2017, and a significant improvement from the non-GAAP net loss of $5.2 million or $0.10 per basic and diluted share in the first quarter of 2017.

Adjusted EBITDA in the first quarter of 2018 was $1 million or 10% of total revenue compared with an adjusted EBITDA of $2.1 million in Q4 of 2017 and an adjusted EBITDA loss of $1.9 million in the comparable year-ago period.

For the first quarter of 2018, we had $1.4 million of depreciation, amortization and accretion, and $0.3 million of stock-based compensation that was a noncash charges we netted against our GAAP net income.

As of March 31, 2018, our balance sheet included cash and investments of $27.2 million, an increase of $1.4 million from the $25.8 million at the end of the prior quarter.

Looking ahead, we have extensive customer engagements at various stages of development for our program services business. On this basis, we are projecting second quarter revenues in the range of $9.8 million and $10.2 million. Net income is projected to be between a loss of $0.3 million or $0.01 per share and a profit of $0.3 million or $0.01 per share. And non-GAAP net income, excluding stock-based compensation expense, is projected to be between breakeven and $0.6 million or $0 to $0.01 per share. Adjusted EBITDA is projected to range between $1.2 million and $1.7 million.

That concludes my prepared remarks, and I would like to now turn the call back over to Chris.

Christian F. Kramer - *Intermolecular, Inc. - President, CEO & Director*

Thanks, Bill. Intermolecular's improving financial performance and building operational momentum over the last several quarters is directly tied to the heavy lifting we did last year. As many of you know, 2017 was a pivotal year in our company's history, characterized by considerable positive changes that have established a solid foundation for us to profitably scale our business. Although I gave our business model transition considerable airtime in our last call, I believe that its importance is worth repeating, especially for those newer to the Intermolecular story.

Perhaps one of the most significant milestone last year was the successful transition of our business model from primarily an IP licensing model to a services-centric model built on materials innovation. Importantly, these customer programs are designed to generate predictable services revenue throughout the length of the engagement as multiquarter and multiyear contracts that are collected upon the completion of set milestones.

In parallel to this transition, we refocused our resources on the growing semiconductor market, expanded into China, broadened our customer base and implemented measures to optimize our cost structure and improve operational efficiencies. All together, these actions have made Intermolecular a leaner, more efficient and effective organization from top to bottom.

To put some numbers behind it, we were able to reduce our operating expenses in the first quarter of this year by $4.5 million or 39% over Q1 of last year. Importantly, these cost reduction measures enabled us to lower our quarterly revenue breakeven level to approximately $8.5 million or $34 million annually, providing us with high contribution margins above our breakeven revenue level.

But to be sure, we did not hinder our ability to grow. Rather, these measures have created more headroom and capability to scale our business, which we believe can support approximately $150 million in revenue without significant incremental investment. The result is a finely tuned business model and optimized structure that allows us to systematically scale profitability, just as we've been doing over the past several quarters.

In addition to the financial benefits, we are more capable of managing a broader and more diverse portfolio of customers and programs. Our sales and engineering teams are responding more rapidly to customers' demands, helping us to get more shots on goal, reduce sales cycles and win more business. It also means we can execute more effectively, manage our programs more efficiently and deliver increasing value for our customers. This has significantly strengthened and deepened our customer relationships, making us even more sticky with our customers.

Over the past several quarters, we've established a track record of consistently securing at least 2 or 3 new contracts, and Q1 was no different, where we secured 2 new contracts. These types of contracts enhance our stability and visibility. To use a baseball analogy, we view them as singles or doubles which eventually put runs on the board.

That being said, we are actively pursuing larger, more material programs with greater potential. In fact, we have a couple in the pipeline and are working diligently to move them forward. It is important to remember, however, these larger, more complex programs have more -- much longer sales cycles, typically 9 to 12 months.

The beauty of our business is that we are not tied to one specific type of semiconductor device or other related technologies. Our customers serve large and growing markets, including the semiconductor ecosystem and other microelectronics applications, such as display, LEDs, Internet of Things and quantum computing.

As we've talked about, success in these markets requires rapid and cost-effective product innovation, fast time to market, competitive pricing, production stability and the ability to achieve specific product performance requirements. Conventional R&D approaches are challenged by ever-increasing device complexity, short development cycles and rising development cost.

Along those lines, we are continuing to see increasing need for advanced materials innovation to meet the requirements for next-generation memory technologies that can deliver the performance, density and low power needed for the future. And while historically, our programs have focused on DRAM and nonvolatile memory, we're having increasing success in emerging memories and in adjacent applications that are providing new, diverse growth opportunities.

Looking ahead, we are ideally positioned to continue to benefit from the strong economics in the semiconductor memory market. In addition, our broader and higher-velocity pipeline is bringing in more customers who realize the benefits that Intermolecular provides. Our international growth opportunities look promising, particularly in Asia. We remain confident in our ability to continue to grow and scale our business profitably.

As such, we are reiterating our guidance of at least $40 million in revenue for 2018, with sustainable growth going forward.

And with that, I would like to return this call to the operator for any questions. David?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Dan Weston with WestCap Mgmt.

Dan Weston

Forgive me for the background noise. I'm traveling. So if it's noisy, I apologize. Chris, could you talk a little bit about the international opportunities in front of you and specifically relating to the SITRI partnership and any additional color you can provide on the progress there?

Christian F. Kramer - *Intermolecular, Inc. - President, CEO & Director*

Sure, Dan. We had 2 press releases, 1 in November, 1 in January outlining the strategic alliance that we formed with SITRI. If you remember from earlier calls, 1.5 years ago, Intermolecular had no position, no activities in China whatsoever. I felt it was important that we put someone on the ground. We hired a country manager and we've been actively working to explain and spread the good word about Intermolecular in China. SITRI, for us, is a good ally, is a force multiplier because they have relationships both with device makers, the budding China supply system or ecosystem and funding sources to provide money. So we're in the early stages and we are forming programs and look forward to revenue being generated out of the China market in the second half of this year.

Dan Weston

Great. No, I appreciate the color there. Also, when you look forward on your business for maybe the next, say, 12 to 24 months and as it pertains to the 2 large customers that comprise the lion's share of the revenues now, how confident do you feel in that business being stable at least, if not growing, with those 2 particular customers?

Christian F. Kramer - *Intermolecular, Inc. - President, CEO & Director*

I'm very confident that, that business will remain stable and, in all likelihood, grow. The trend has been with both of them that they have grown in terms of the number and scope of their programs. And because they are in the area of memory and advanced memory, that is a very hot area for the industry overall and sees no end in sight in terms of the need for -- in innovation, mostly materials-driven, in order to provide the performance required for these advanced memories.

Dan Weston

That's great to hear, Chris. Lastly, and I'll jump back in the queue, is, when you -- I think in your prepared comments, you were discussing the -- I guess, targeting some of the larger opportunities out there. Do you anticipate, if and when those larger deals are signed, you'll be able to sustain the kind of gross margins that you're seeing now?

Christian F. Kramer - *Intermolecular, Inc. - President, CEO & Director*

Yes, we will be able to maintain the gross margins that we're seeing right now. We've had quarter-on-quarter of being able to do that, even during the transition from the licensing-based model to more of a service-based model. There is some mix, product mix in there, some a little lower, a little higher, but we believe the overall mix will maintain, as Bill mentioned, in the high 60s.

Operator

Our next question comes from Kevin Dede with H.C. Wainwright.

Kevin Darryl Dede - *H.C. Wainwright & Co, LLC, Research Division - MD of Equity Research & Senior Technology Analyst*

I -- given improving financial prospects, Chris, I was wondering if you could speak -- I mean, I know you spoke to extending business into LEDs and IoT and such, but I was wondering how you might change the R&D focus. And what is the sort of frontline priorities for you?

Christian F. Kramer - *Intermolecular, Inc. - President, CEO & Director*

Our frontline priorities, Kevin, are pretty straightforward. It is continue to grow our materials innovation services business. We have primarily done that if you just look at our history in the memory area. But we have experience and expertise and technology that covers a broader swath of microelectronics. So as we are able to use our knowledge to -- and we have done work with LEDs, we have done work in display, we have done work with logic, we have done work in other areas of microelectronics. We see opportunities with this new model to be able to put them back into the sales funnel, where we can provide programs of various size and fully utilize our facility and our people skills that we have in place without having to make any incremental investments. So it's really not a big change, it's more a better commercial pipeline, a better commercial team, and we're utilizing our expertise that we've gained more effectively. To address your R&D question, we still maintain our own internal R&D capability and budget. We're very careful about how we address that, but we do need to keep investing in ourselves so our ongoing service offerings are meaningful and worthwhile to our biggest clients.

Kevin Darryl Dede - *H.C. Wainwright & Co, LLC, Research Division - MD of Equity Research & Senior Technology Analyst*

Okay. So I guess maybe more granular for me, still trying to work up the curve, does that entail increasing, I guess, your R&D staff? Or do you expect, really, to see sort of more operational leverage?

Christian F. Kramer - *Intermolecular, Inc. - President, CEO & Director*

It's more operational leverage. We don't intend to increase the R&D staff. We've reached a nice balance point where the R&D team is able to support the programs, initiatives. But that's the subtle shift coming away from the licensing IP model that we once had to a programs business. And we have certain core capabilities which are applicable across a broader swath of microelectronics. How we apply that is based on the needs of the clients and our capabilities at the time.

Kevin Darryl Dede - *H.C. Wainwright & Co, LLC, Research Division - MD of Equity Research & Senior Technology Analyst*

Okay, fair enough. Last question for me is just sort of the next line on the OpEx side on biz dev. Can you speak to how you might have to invest there in order to raise your profile on the services side?

Christian F. Kramer - *Intermolecular, Inc. - President, CEO & Director*

Bill, you want to take that?

Bill Roeschlein - *Intermolecular, Inc. - Senior VP, CFO & Principal Accounting Officer*

Yes. We -- I mean, we currently have -- are looking at some selective hiring within sales and marketing. And it's very kind of unique in who kind of the individual that we're looking for to hire in this particular category. And looking to just be able to expand our breadth of potential customers that we can cover within the pipeline.

Christian F. Kramer - *Intermolecular, Inc. - President, CEO & Director*

Yes. Another way to look at it, to sort of follow up on Bill's comments, is that if we threw an army of people at this, I don't think we'd be any more successful. If you remember when I took over 1.5 years ago, one of the first things I did was to change out the commercial team, sales and marketing organization. And fewer, more qualified experienced individuals have been able to build a substantial service business. So it's not the number of people in an investment, it's the right people. So we made the investment in China for last year, and that's starting to show progress. We have a very large customer concentration in other parts of Asia, we're adding to that. And we're also beefing up the United States. But it will be very measured, as Bill said.

Operator

(Operator Instructions) Our next question comes from [Al Shims] with American Capital Partners.

Unidentified Analyst

I'm relatively new to the stock. I've been in it for a few months, so I'm not real, real knowledgeable about the underlying business. But I can say we really need to get these revenue numbers up. And it doesn't look like we're at the inflection point yet. I mean, we're looking at revenues next quarter roughly the same level as they are today. It's good that our cash flow is positive at this point, but what's the probability or potential for some really breakout growth in top line revenues?

Christian F. Kramer - *Intermolecular, Inc. - President, CEO & Director*

Al, that's a great question, and thank you for your explanation that you're sort of new to the stock, new to the company. The reality of our business is that development programs, development services have an agree to start and an agree to stop. And as a result, there are always going to be a choppiness to our revenue. Things start, things stop. We're doing a better job of building the pipeline in order to smooth out that lumpiness and try to grow incrementally. So for every program we get, one stops. And that's why you don't see a net big, big improvement in the top line revenue. Now having said that, we do have a couple of things in the offing right now that we're working on that could be additional larger programs, and that would be a pop for us. So as we've guided from -- for this year at $40 million, there is potential upside above that. And we'll be more confident on an ongoing basis to be able to report that to investors as we actually make those contracts happen.

Unidentified Analyst

Okay. Well, I'd like to see us make a dent in that negative retained earnings number.

Bill Roeschlein - *Intermolecular, Inc. - Senior VP, CFO & Principal Accounting Officer*

We would like to see that as well, Al.

Operator

This does conclude the Q&A session for today. I would now like to turn the call back over to Chris Kramer for any closing remarks.

Christian F. Kramer - *Intermolecular, Inc. - President, CEO & Director*

Just thank you all. Bill and I look forward to speaking with everyone next quarter. Thank you.

Operator

Ladies and gentlemen, this does conclude today's program. Thank you for participating in today's conference. You may all disconnect. Everyone, have a great day.
