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IMI - Q3 2016 Intermolecular Inc Earnings Call

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CORPORATE PARTICIPANTS

Rick Neely *Intermolecular, Inc. - SVP, CFO*

Chris Kramer *Intermolecular, Inc. - President, CEO*

CONFERENCE CALL PARTICIPANTS

Edwin Mok *Needham & Company - Analyst*

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to Intermolecular Incorporated's Third Quarter 2016 Earnings Conference Call. (Operator Instructions) Please note this call is being recorded. My name is Sonia and I will be your operator for today.

I would now like to turn the conference over to your host for today, Mr. Rick Neely, Senior Vice President and Chief Financial Officer. Please proceed, sir.

Rick Neely - *Intermolecular, Inc. - SVP, CFO*

Thank you, Sonia. Good afternoon and welcome to Intermolecular's third quarter 2016 earnings conference call. We announced our results after the market closed today and you will find a copy of the press release on our website at www.intermolecular.com.

On the call with me today are Bruce McWilliams, Executive Chairman; and Chris Kramer, President and Chief Executive Officer.

Today's conference call contains forward-looking statements. Any statement 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.

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 the fiscal year 2015 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 measure in our press release issued today.

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

Chris Kramer - *Intermolecular, Inc. - President, CEO*

Thank you, Rick. Good afternoon everyone and thank you for joining us on today's call. My first three months at Intermolecular have been productive and positive. I have quickly been able to get my arms around our operations and have begun to address the challenges to restarting growth. I remain extremely confident in IMI's solid foundation, unique platform and value proposition. I have made several changes since our last call that I believe will reinvigorate growth and our company moving forward.



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Our revenue for the quarter exceeded previous Q3 revenue guidance with revenue for the third quarter of \$10.6 million. At the same time, we've begun to streamline and optimize our operations with a goal of achieving cash flow breakeven as soon as possible. Rick will share with you our financials after my remarks.

Since I joined the company as CEO in August, I have made it my priority to talk to our current and former customers to determine their level of satisfaction and how IMI is creating value for them. I have overwhelmingly found that they highly value IMI services and knowhow and will consider doing more business together. Our flexible service-based model for IMI Labs resonates with customers that consider us an extension or complement to their own R&D capabilities.

I remarked on our last call that building a solid base of business with a more robust pipeline was my top priority. To effect positive change, I have quickly revamped the sales and marketing functions of the company to be more capable and attuned to our markets and service model. I have optimized our commercial teams with new people who have specific experience and skills for the markets in which we anticipate the most growth in 2017 and beyond. These markets include both semi and non-semi global opportunities with a keen focus on Asia where we see some of our largest opportunities.

While it is too early to discuss our complete strategy for 2017 and beyond, I want to give you a high level overview of what I have found, the changes I am making and what I believe the company priority should be going forward.

The semiconductor market is and will remain a core part of our business. Our immediate work is to win back former customers and expand opportunities at our current customers. To this end, we intend to focus on building a base of anchor customers who will renew on an annual or longer term basis to create more predictable revenue and to smooth out quarterly lumpiness experienced by IMI in 2016.

Executing contracts with existing customers having program service periods of greater than one year will receive highest priority. The company believes that securing these anchor customers along with other current business will provide revenue that could generate positive EBITDA during 2017. This overarching goal is well underway as discussions with our largest customers to secure longer term contracts have begun. If successful, these longer term contracts could potentially represent a large portion of our internal corporate revenue goals.

Expanding and diversifying our customer base outside the semiconductor industry remains a key initiative. These efforts will involve building IMI's capabilities to provide material screening, discovery and/or optimization. Targeted application areas include displays, optical coatings, alloys, protective coatings as well as magnetic materials. We can't do everything nor serve every market. We will focus on prioritizing and growing these new business opportunities where IMI has a differentiated value proposition based on our unique capabilities and knowhow.

We have already identified target customers, some of whom could grow into strategic partners and have been developing workflows that can be applied, adopted and/or extended to deliver compelling value to customers in those application areas.

There are opportunities for IMI to grow in both short and long term with our unique capabilities and significant knowhow. My initial focus has been improving sales, restructuring our go-to-market organization, and expanding new business opportunities to build a more robust pipeline that will yield a larger and more predictable base of business. I plan to share more details of the ongoing improvements at IMI with you over the coming quarters as our business grows and improves.

In summary, in future quarters, you should see these three things. One, a more stable revenue stream; two, revenue that is growing steadily; and three, IMI's operating and cash flow breakeven and above, which will preserve and improve our strong balance sheet.

Rick Neely - Intermolecular, Inc. - SVP, CFO

Thank you, Chris. Let me review some selected financials for the third quarter of 2016. IMI revenue for the third quarter was \$10.6 million which was down 10% from the second quarter of 2016 and down 8% from Q3 of the prior year. We were above our Q3 revenue guidance range as we did more work in one of our newer program than anticipated. Program revenue of \$8.8 million represented approximately 84% of total revenue in Q3 2016, with licensing and royalty revenue coming in at 16% for the quarter. Our total program revenue was about flat year-over-year, but our



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third quarter program revenue was down \$1.2 million from the second quarter of 2016 as we completed a large memory program while we are still working on adding new customers and revenue.

This result is often typical of the significant quarterly swings you see in semiconductor memory markets. Our new IMI Labs business typically has shorter contracts and we will likely continue to see some variation in our quarterly revenues given the size of our current customer base. As Chris mentioned our 2017 strategy is to develop a baseline of longer term contracts and grow our business into ancillary areas of the semiconductor supply chain as well as expand our footprint in the glass and coatings markets.

In Q3 2016, we had three customers, which were each greater than 10% of total revenue. These three customers represented approximately 72% of total revenue in the third quarter 2016. Net loss in the third quarter of 2016 on a GAAP basis was minus \$6.8 million or a loss of \$0.14 per basic share. This compares to a net loss of minus \$4 million or a loss of \$0.08 per basic share in the previous quarter.

Our Q3 2016 net loss increased from the second quarter due to lower revenues and various significant restructuring activities undertaken by the company, which I'll explain shortly. Looking at our year-over-year figures, our net loss increased slightly compared to the net loss of \$5.8 million or a loss of \$0.12 per share in the third quarter of 2015. This year-over increase was driven by the same factors, lower revenues and significant restructuring costs.

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 these results. The key difference from GAAP to non-GAAP measures is the exclusion of stock-based compensation expense. On this basis, we reported a non-GAAP net loss for the third quarter of 2016 in the amount of \$5.9 million or a loss of \$0.12 per basic share. This compares to a non-GAAP net loss of \$3.1 million or a loss of \$0.06 per basic share in the second quarter of 2016. Compared to the prior year, our non-GAAP net loss grew by \$1.2 million, as our non-GAAP net loss was \$4.7 million or \$0.10 per share in Q3 2015.

Included in the third quarter non-GAAP number is a significant group of restructuring and impairment charges that I would like to go over in detail. First, we reorganized the company to streamline our operations, reduce executive overhead and improve our sales and marketing team. These organizational changes resulted in reduced headcount for IMI with severance costs having an impact of approximately \$1.1 million in Q3. In addition, we have been working diligently to improve our asset utilization and we wrote-down \$900,000 in equipment and \$950,000 in unused patent assets for the quarter. In total, these third quarter restructuring charges of \$2.9 million will improve our balance sheet and P&L going forward, lowering our revenue cash flow breakeven point to the \$11 million to \$11.5 million per quarter range.

Per SEC guidelines, we are only showing the severance charges separately in our published financial statement, but we wanted to make sure all investors understood the significant steps we are taking to get to profitability.

Gross margin in the third quarter on a non-GAAP basis was 68%, which was up slightly from the 66% gross margin in the prior quarter, but up substantially from one year ago when our gross margin was only 58%. Our improved gross margin demonstrates the potential profit in program revenue run under the new business model.

As you can see from the restructuring activities we undertook this quarter, we continue to be highly focused on getting back to positive cash flow and the proxy we are using internally is positive adjusted EBITDA. We had two quarters in a row of positive EBITDA in Q4 2015 and Q1 2016, but slid below our target in the third quarter as a result of the revenue decline quarter-over-quarter and restructuring efforts. Our third quarter 2016 EBITDA was a negative \$2.5 million compared with a negative EBITDA of \$1.5 million in the second quarter.

For the third quarter, we had \$1.7 million of ongoing depreciation and amortization; \$1.8 million of asset impairments; and \$0.9 million of stock-based compensation.

As of September 30, 2016 our balance sheet included cash and investments of \$31.9 million, which was down \$2.3 million from the combined totals of \$34.2 million at the end of the second quarter of 2016.



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IMI remains in a strong cash position to turn around our business. We are fully committed to improving both the scale and stability of our revenue line and we are equally committed to achieving cash flow breakeven and then P&L profitability as early as practical.

We took significant managerial steps this quarter as we reorganized and restructured our business for more effective sales coverage, operational effectiveness and expense control. We look forward to communicating improved results as our recent actions bear fruit.

Now, I would like to return this call to the operator for any questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from Edwin Mok of Needham and Company. Your line is now open.

Edwin Mok - Needham & Company - Analyst

I noticed you guys stopped providing guidance for the quarter or did I just miss that on the call?

Rick Neely - Intermolecular, Inc. - SVP, CFO

No, that's correct, we aren't -- we're no longer giving guidance relative to the discussion we had during the call of until we can get a more stable revenue outlook, it doesn't behoove us to give guidance at this point in time.

Edwin Mok - Needham & Company - Analyst

I see. Okay, that's fine. Can I ask you -- like this quarter, it seems like you have higher increase of customer concentration, one customer account for half your business. Is that by design or is that customers ramping certain program that's drove that high concentration. And as we go forward, do we expect that customer to at least stay in the same level of business with you guys or is it -- should we expect some adjustment around this?

Chris Kramer - Intermolecular, Inc. - President, CEO

Edwin, hi. This is Chris Kramer. Let me answer your question. First, you're right, there is a customer concentration. As I came on board in August, one of my first things was to try to work in building the pipeline and increasing the number of customers that are working with us in various service programs in order to de-concentrate that plus add some stability. The one customer that you are referring to is an anchor customer and they are working with us and will continue to work with us next year.

Edwin Mok - Needham & Company - Analyst

I see. But one of your large -- relatively larger customer, I think last year accounted for 36% in total sales has come down quite a bit over the last few quarters. Is that just end of those programs, are you guys reengaging back with that customer for -- to add additional activity? Maybe you can give us some color there.



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Chris Kramer - *Intermolecular, Inc. - President, CEO*

It's the challenge of having programs that have start dates and stop dates and these stop dates and start dates happen usually on a quarter or three- to six-month, which is why we're trying with great success I think moving forward to build longer term contracts, one year or longer, that will allow us to smooth out that lumpiness.

Rick Neely - *Intermolecular, Inc. - SVP, CFO*

And the other part as you said Edwin was, as we referred to in the script, I mean when we talk about a major memory program completing earlier in the year that that was with the prior customer and you can see that reflected in the 10-Q customer percentages.

Edwin Mok - *Needham & Company - Analyst*

I see. Did you guys give any color in terms of mix between semi and non-semi and also within semi, I think historically you guys have a very high exposure to memory customers, have you -- can you give any -- have you seen any kind of change around that?

Rick Neely - *Intermolecular, Inc. - SVP, CFO*

I think it's been consistent with the prior quarter. I'd say our non-semi business is in the 10% to 15% range and the rest is semi or semi-related.

Chris Kramer - *Intermolecular, Inc. - President, CEO*

It's more, 20%.

Rick Neely - *Intermolecular, Inc. - SVP, CFO*

Yes. About 20%, there is 10% or 15% that is our traditional glass business and then there is another 5% to 10% that's rolling into new alloys and things we're working on, but the rest of it, call it, 80% is semi-related.

Edwin Mok - *Needham & Company - Analyst*

I see. And then within that semi-related, a vast majority of that is memory customers?

Chris Kramer - *Intermolecular, Inc. - President, CEO*

That is correct.

Rick Neely - *Intermolecular, Inc. - SVP, CFO*

That's correct.

Edwin Mok - *Needham & Company - Analyst*

I see. Okay.

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Chris Kramer - *Intermolecular, Inc. - President, CEO*

And the advantage of having a concentration in memory, Edward, is that we're able to utilize our expertise and knowhow more effectively, we're able to utilize our workflows. It actually has a benefit to our business when we can work in a similar area.

Edwin Mok - *Needham & Company - Analyst*

Okay. Last question I have, Rick, you talked about obviously bring yourself back to a profitable at least EBITDA, profitable business, right? So that way you can manage your balance sheet better. How do you think about that? Is this just wait for some of these growth drivers to kick in or are you taking additional step to work on your cost structure? Can you give us some color on that?

Rick Neely - *Intermolecular, Inc. - SVP, CFO*

I think we took significant steps this quarter. As you can see, there was a fairly large reduction in force that resulted in the severance charges that you've seen and there were changes in the executive management team as well. We're bringing on several new sales people that Chris has brought in and we let some others go. So I think we've made significant changes in our go-to-market strategy, so I think those need to settle in.

I think the only area we're not really looking at -- I mean we've done a lot of trimming on all the efficiency areas of G&A and things like that. The area where we're looking to go forward is as we combine our program and development groups together is to get more efficiency in the utilization of equipment. And what you'll see in the balance sheet then is that as we grow revenue, we won't have to buy a lot of CapEx, I mean that's -- or add many people. That's the goal of the operating group is to combine those programs in a way that we can add new customers without adding them, putting a lot of pressure on the balance sheet.

Operator

(Operator Instructions). And I'm showing no further questions. I would now like to turn the call back over to Rick Neely for any further remarks.

Rick Neely - *Intermolecular, Inc. - SVP, CFO*

Thank you, Sonia. Thanks everyone for listening to our call this quarter. We look forward to the year-end call in 2017. Thank you very much.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This concludes today's program. You may all disconnect. Everyone, have a great day.

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