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IMI - Q2 2018 Intermolecular Inc Earnings Call

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PRESENTATION

Operator

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

I would now like to turn the conference call over to your host for today, Mr. Bill Roeschlein, Senior Vice President and Chief Financial Officer. Sir, please proceed.

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

Thank you, Tiffany. Good afternoon, and welcome to Intermolecular's Second Quarter 2018 Earnings Conference Call.

After the market closed today, we issued our financial results for the second quarter ended June 30, 2018. A copy of the earnings release is available on the Investors section of our website at www.intermolecular.com. Joining me on the call today is our President and Chief Executive Officer, Chris Kramer.

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 these expressed in the forward-looking statements. Intermolecular assumes no obligation to update these forward-looking statements which speak only as of today, August 6, 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?



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

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

As you can see from our earnings release, our financial performance in the second quarter was strong across-the-board, building on the solid momentum we established in Q1. Our top line grew 21% year-over-year in the second quarter to \$9.8 million. This growth was driven by 45% year-over-year increase in our program revenue, demonstrating our continued success securing new customer engagements. On top of this, we reduced our operating expenses by 6% sequentially and 22% year-over-year to \$6.7 million, our lowest quarterly level since our IPO. Taken together, we were able to generate significantly higher gross margins, solid GAAP profitability, along with our fourth consecutive quarter of positive adjusted EBITDA. Furthermore, we generated \$4 million of positive operating cash flow in the second quarter.

I would now like to invite our CFO, Bill Roeschlein, to provide more detail on the financial results for the second quarter ended June 30, 2018. Then I will return to discuss our operational progress and outlook. Bill? Bill?

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

Yes. Thank you, Chris. Turning to our financial results for the second quarter ended June 30, 2018. Our revenue for the second quarter of 2018 was in line with our guidance at \$9.8 million and 1% up from the prior quarter and 21% higher than the second quarter of last year. Looking at revenue by source, program revenue for the second quarter of 2018 was \$9.4 million, up 1% from the prior quarter and 45% higher than the second quarter of last year. As a percentage of total revenue, program revenue accounted for 96% of our total revenue in the quarter compared to 80% in the second quarter of last year.

Licensing and royalty revenue for the second quarter of 2018 was \$0.4 million or 4% of total revenue. This compares with \$1.6 million and 20% of total revenue in the second quarter of 2017. As we've talked about on our prior calls, 2018 is the transition year in which we've been able to offset the planned decline in licensing and royalty revenue with growth in program revenue.

We had 2 customers that accounted for more than 10% of our total revenue in the second quarter of 2018. These 2 customers represented approximately 82% of our total revenue in the second quarter of 2018 compared with 2 customers that represented approximately 83% of our total revenue in the second quarter of last year.

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 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 second quarter of 2018, our GAAP gross margin was a record 70.8% and our non-GAAP gross margin was a record 71.2%. This compares with 65.1% and 65.7%, respectively, in the prior quarter and 68.5% and 69%, respectively, in the comparable year-ago period. For the third quarter of 2018, we expect non-GAAP gross margins to be between 68% and 70%.

GAAP and non-GAAP operating expenses were \$6.7 million and \$6.5 million, respectively, in the second quarter of 2018. This compares to \$7.1 million and \$6.9 million in the prior quarter, respectively, and \$8.5 million and \$8.3 million, respectively, in the comparable year-ago period. For the third quarter of 2018, we expect non-GAAP operating expenses of approximately \$6.9 million to \$7.1 million.

GAAP net income totaled \$0.5 million or \$0.01 per basic and diluted share and with a record 5% of revenue. This compares to a net loss of \$0.6 million or \$0.01 per basic share in the previous quarter and a significant improvement from the net loss of \$2.9 million or \$0.06 per basic share in the second quarter of 2017.

Non-GAAP net income for the second quarter of 2018 was \$0.7 million or \$0.01 per basic and diluted share. This compares to a non-GAAP net loss of \$0.4 million or \$0.01 per basic share in the first quarter of 2018 and a significant improvement from the non-GAAP net loss of \$2.5 million or \$0.05 per basic share in the second quarter of 2017.



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Adjusted EBITDA in the second quarter of 2018 totaled \$1.8 million or 19% of total revenue, an improvement from an adjusted EBITDA of \$1 million in Q1 of 2018 and adjusted EBITDA loss of \$1 million in the comparable year-ago period.

For the second quarter of 2018, we had \$1.3 million of depreciation, amortization and accretion and \$0.2 million of stock-based compensation that were the noncash charges we netted against our GAAP net income.

Turning to our balance sheet. As of June 30, 2018, we had cash and investments of \$31.3 million or \$0.63 per diluted share. Our cash position increased by \$4 million from the \$27.2 million at the end of the prior quarter.

Turning to our financial outlook. We anticipate that our third quarter financial results will be impacted by the successful completion of certain programs coupled with temporary delays in the execution of other program opportunities in our pipeline.

For those newer to the IMI story, it's important to understand that it's not uncommon for a customer to conclude a particular program with us as per the scope of work and then evaluate their R&D road map and opportunities before engaging with us on other programs.

We would like to emphasize that our relationships with our major customers are excellent and that the completion of an existing program was a result of the successful collaboration that bodes well for future business.

For the third quarter of 2018, we're projecting revenues in the range of \$6.5 million and \$7.5 million. On a GAAP basis, we're projecting a net loss to be between \$1.7 million and \$2.8 million or \$0.04 to \$0.06 per share. On a non-GAAP basis, which excludes stock-based compensation, we're projecting a net loss to be between \$1.4 million and \$2.5 million or \$0.03 to \$0.05 per share. Adjusted EBITDA is projected to range between a loss of \$0.6 million and \$1.7 million.

We expect many of the opportunities in our sales pipeline to materialize in the fourth quarter of this year, giving us a high degree of confidence that our financial results for Q4 will be substantially better compared to the third quarter, both from a top and bottom line standpoint.

Looking at the fiscal year as a whole, we are updating our revenue guidance to be between \$34 million and \$36 million, highlighted by a 15% year-over-year growth in our services business at the midpoint. As we look toward 2019, we have remained confident in our ability to grow and scale our business profitably.

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

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

Thanks, Bill. IMI's growth strategy remains focused on 3 core tenets: broadening our customer base, furthering our leadership position in emerging markets in the semiconductor ecosystem, and longer term, expanding our presence in Asia.

The first core tenet is centered around securing a broader, more diversified base of customers as well as doing more business with existing customers. Our success in this area was yet again demonstrated during the second quarter by our ability to secure 2 new customer contracts, building on our track record of securing at least 2 new contracts per quarter. These types of contracts not only enhance our overall organizational stability but also financial visibility as well.

In many ways, our success is due to the effectiveness of our sales and engineering teams who are better positioned today to respond to customers' growing needs and demands and, thereby, delivering increasingly more value for our customers.

Our expanded customer base helps to mitigate the temporary effects of program conclusions, a situation we are facing in our current quarter. As Bill mentioned, it's not unusual for a customer to successfully conclude a program with us and then evaluate their R&D road maps and opportunities before reengaging with us on other programs. We are confident our customers will continue to leverage IMI's state-of-the-art capabilities to accelerate their technological innovations, which gives rise to attractive growth opportunities for IMI going forward.

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Another aspect of our growth strategy involves expanding leadership in the emerging memory markets. IMI is often contracted by a customer to explore new exotic or possibly toxic material sets that are needed for a specific application. As some of you know, the emerging memory field is exploding with opportunities for new material sets to be explored for nonvolatile memory and storage class memory applications with perhaps the most notable contender being phase-change memory.

However, as we've talked about, current technologies face inherent limitations in meeting these requirements, making it more important to find new materials that can solve these challenges. This is where IMI comes in. With our more than 10 years of expertise in materials innovation and our patented high-throughput technology platform, we are uniquely positioned to provide the materials innovation services needed to advance in the industry road map.

We also continue to actively pursue longer-term growth opportunities in Asia. Both the DRAM and 3D NAND markets remain especially strong in this region. This, in turn, is fueling increased R&D investments in next-generation devices, including multilayer 3D NAND devices, next-generation DRAM and newer memory devices incorporating phase change, magnetic and resistive random technologies. These companies need partners like Intermolecular to help with their materials selections, testing and evaluation.

Our pipeline has grown over the past year, and we're actively engaging with new and existing customers on many of these technologies just mentioned. Looking ahead, while we expect a temporary slowdown in Q3 due to the successful conclusion of certain programs, we remain confident in our ability to continue to grow and scale our business profitability -- profitably going forward.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Jaeson Schmidt with Lake Street Capital.

Jaeson Allen Min Schmidt - *Lake Street Capital Markets, LLC, Research Division - Senior Research Analyst*

I just want to start with the temporary delays. And Chris, I know you mentioned that it's common for your customers to pause here, but could you provide some more color surrounding these delays? And if possible, quantify the impact from these delays that you will see here in Q3.

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

Sure, Jaeson. We talked about it before that the challenge with our business has been and remains the inherent lumpiness, when a program comes to its logical planned conclusion. We've been working very hard to gain a broader pipeline that would allow us to smooth out these bumps, but that's still a work in progress.

So the drop in Q3 is the result of several programs that came to their plan conclusion. We've been working since January with those same customers to come up with extensions or alternate programs. Many of those are in the works right now, and we expect by fourth quarter, we will have those closed and in process and in working. So the dip or the delay we have in Q3, we expect to improve on in Q4.

Jaeson Allen Min Schmidt - *Lake Street Capital Markets, LLC, Research Division - Senior Research Analyst*

Okay, that's helpful. And the 2 contracts you secured in the quarter, were those from existing customers or new customers?

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

They were -- one, I would say existing, meaning that we worked with them last year. And we concluded the program, and they came back to us, just as Bill said in his remarks. After reevaluating their road map, they came back to us for another program, and one was an extension of an existing program.

Jaeson Allen Min Schmidt - *Lake Street Capital Markets, LLC, Research Division - Senior Research Analyst*

Okay. And last one from me. I'll jump back in the queue. Given the macro backdrop, have you seen any changes in your engagement with China? And any update on how that's progressing as we look into '19?

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

China is complex, ever-changing, and I'm not going to be able to provide much insight into what's driving or how that's going to change. I will say though that our relationship with SITRI, CMIT and others continues to be positive. I expect that by the end of this year, we'll be able to announce a revenue-generating program in China, and that hasn't changed.

Operator

And our next question comes from Edwin Mok with Needham.

Yeuk-Fai Mok - *Needham & Company, LLC, Research Division - Senior Analyst*

So first, just to clarify the reduction in the third quarter, it comes from multiple customer and not one big customer? And I have 2 follow-ups.

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

Edwin, Chris here. The answer is it's from multiple customers whose programs were timed to conclude in the summer time frame. And in both cases, as I mentioned to Jaeson, we've been working with both sets of customers with either an extension or an alternate program. Some of those are in the works right now, some that I think, third quarter will close some and fourth quarter will close others.

Yeuk-Fai Mok - *Needham & Company, LLC, Research Division - Senior Analyst*

Are these memory customers, may I ask?

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

They are.

Yeuk-Fai Mok - *Needham & Company, LLC, Research Division - Senior Analyst*

I see. And then Bill, I think you might have mentioned, actually in your remarks. Sorry, I jumped late in the call. But did you mention your OpEx targets for the third quarter? And is there a way to think about the cadence, assuming business start to recover in the fourth quarter and beyond? Is there a way to think about the cadence of your OpEx? Because your OpEx has been performing ahead of our model and your plan.



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

Yes. So for the third quarter, we would expect our OpEx between \$6.9 million to \$7.1 million, so \$7 million at the midpoint. And as we ramp back up, we will be able to deploy some additional R&D personnel into revenue-generating programs. And that really gives our OpEx more leverage, and that's what's been able to allow us to drive our OpEx down in closer to the \$6.5 million mark.

Operator

And our next question comes through Dan Weston with WestCap Management.

Dan Weston

I think some of them have been answered already. But just to drill down on the contracts that came to a successful completion, just refresh what you said before, please. Were those 3 programs that ended?

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

We -- I don't think we clarified exactly how many programs there were. I think I did answer that they were 2 separate companies.

Dan Weston

Okay. Two separate companies with multiple programs is what you said?

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

Correct, Dan.

Dan Weston

Got it, okay. And then the 2 customers, are those the 2 big customers of yours?

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

They are.

Dan Weston

Okay. And then the -- excuse me. Then the guidance that you're kind of alluding to for Q4 to be up sequentially from Q3, does that assume contracts will be replaced by those same 2 customers? Or is it going to come from somewhere outside of that too?

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

A combination. Not -- just to be clear, not all of the programs have ended. So that's one. But we're trying to -- we have to maintain a certain level of, as you would expect, confidentiality in terms of the size and scope and nature, only things that we're required to reveal well. But some of the programs are continuing. Some are on a short -- I would call it a short break while we reassess the results, and we'll restart some of those. And other programs will be generated by new clients that are not yet in our backlog.



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Dan Weston

Okay, got it. And then the 2 contracts that you announced closing in Q2, were those contracts from customers that were not part of your 2 big ones?

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

Correct.

Dan Weston

Got it. And will those start contributing to revenue in Q3 or more so in Q4?

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

Q3. And one will be in Q3, and one will contribute in Q3 and Q4.

Dan Weston

Got it, okay. And then Bill, if you can, if you have to kind of estimate what your customer concentration would be with your 2 current big customers at year-end of this year, what would you predict those 2 to be?

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

Yes. It would be 80% or below, most likely. So it's going to depend on the final mix. But as Chris said, we are engaged with not just existing customers but with some new customers as well. And so given that our pipeline has got a lot more new customers in the mix, we would look to bring that number, that concentration number down a bit.

Operator

(Operator Instructions) And 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*

Your China comments notwithstanding, can you offer a little more granularity. I guess, it goes hand-in-hand with the last question. Just on customer diversification, given that's one of the objectives.

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

Yes. Kevin, what we're trying to accomplish in Intermolecular, and this has been part of our ongoing strategy, is to diversify where we're strong, and that's in semiconductor. And semiconductor, we break up into 2 major pieces, we -- the device makers and the ecosystem players. And the ecosystem players could be a toolmaker, somebody that builds the process tools or it could be the process material makers themselves.

And we're able to provide value, and we engage with all 3 of those parts of the ecosystem separately and in sometimes together. The 2 programs that we signed were from the ecosystem, and one was a process toolmaker and the other was, I'm going to call it, a quantum-computing special



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company in that respect. So we're seeing our ability to diversify outside of the very large entities that we've been serving quite successfully with other types of companies.

Now inside of those large memory makers, there are different groups, and we started working with those different groups. So I expect that we're going to be able to diversify not just with different corporate companies, but inside of companies working with different organizations that we haven't worked with previously. And that's just opening up our TAM, that's giving us more markets to serve, and I think this will help to smooth out the anticipated starts and stops of our R&D programs that we've had today.

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

Okay, fair enough. Could you approach that same question from a geographic perspective? I guess, given the concern in general with what's going on in China and however it might spillover in other countries.

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

All right. Well, with China, I mean, we -- China was a greenfield for us and continues to be somewhat of a greenfield. So we've not baked in any sort of China numbers into our forecast. But we, geographically, have historically had a strong position in Korea, and we work in the United States, in Japan and Europe. So if you're asking about our geography, we're trying to broaden that as well outside of just Asia for our clients.

Operator

At this time, I'm showing no questions in queue. I'd like to turn the call back over to Chris Kramer for further remarks.

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

Well, thank you all. I'll speak with you next quarter. Take care.

Operator

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

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