

Netlist's (NLST) CEO Chuck Hong on Q3 2016 Results - Earnings Call Transcript

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Q3: 2016-11-14 Earnings Summary



EPS of $-\$0.08$ **beats by $\$0.00$** | Revenue of $\$2.59\text{M}$ (60.11% Y/Y) **misses by $\$911.00\text{K}$**

Netlist, Inc. ([NLST](#)) Q3 2016 Earnings Conference Call November 14, 2016 5:00 PM ET

Executives

Mike Smargiassi - IR

Chuck Hong - CEO

Gail Sasaki - CFO

Analysts

Netlist EX2077
Samsung v. Netlist
PGR2025-00071

Richard Shannon - Craig-Hallum
Craig Ellis - B. Riley & Co.
Gary Mobley - The Benchmark Company

Operator

Good day and welcome to the Netlist Third Quarter 2016 Earnings Conference Call. All participants will be in listen-only mode. [Operator Instructions] Please note that this event is being recorded.

I would now like to turn the conference over to Mike Smargiassi. Please go ahead sir.

Mike Smargiassi

Thank you, William, and good afternoon everyone. Welcome to Netlist third quarter 2016 conference call. Leading today's call will be Chuck Hong, Chief Executive Officer of Netlist; and Gail Sasaki, Chief Financial Officer. As a reminder, our earnings release and a replay of today's call can be accessed on the Investors section of the Netlist website at www.netlist.com.

Before we start the call, I would note that today's presentation of Netlist's results and the answers to questions may include forward-looking statements, which are based on current expectations.

The actual results could differ materially from those projected in the forward-looking statements, because of the number of risks and uncertainties that are expressed in the call, annual and current SEC filings and the cautionary statements contained in the press release today. Netlist assumes no obligation to update forward-looking statements.

During this call, non-GAAP financial measures will be discussed. Reconciliations for those directly comparable GAAP financial measures are included in the press release, which was filed on Form 8-K.

I would now like to turn the call over to Chuck.

Chuck Hong

Thanks Mike and good afternoon everyone. Since our last call, we've made significant progress in the execution of our strategic initiatives and are seeing positive momentum in our business.

We introduced our first generation Storage Class Memory product HybriDIMM to significant industry buzz and excitement that we continue to broaden the funnel of potential customers and partners for our base products and we commenced legal proceedings to protect our intellectual property with legal actions against SK Hynix.

At Flash Memory Summit in early August, we introduced and held the first public demonstration of our HybriDIMM Storage Class Memory product in partnership with key industry leaders.

A live demonstration at FMS allowed us to showcase HybriDIMM's plug-and-play capabilities. We had a strong flow of customers, analysts, and media at our booth during the conference and our discussions highlighted a clear industry need for an SCM solution like HybriDIMM.

Industry analysts' objective analysis is forecasting a \$3 billion market through 2019. Over the past several months, we have built upon the success, success of FMS, continuing discussions with our partners, and engaging new players in the industry as we pave the road for the rapid adoption of this product.

These discussions include potential partners to expand the ecosystem and inquiries from new customers, which span OEMs, data center players, and end-users who look to rapidly deploy HybriDIMM.

While there is still more work to do in our commercialization efforts, we have been very pleased with our progress to-date and we are on track to sample with initial alpha customers over the next few months.

We will position -- this will position us for broad market sampling followed by customer qualification and ultimately, initial sales later in the year. In HybriDIMM, we are poised to deliver a cost-effective SCM product as scales memory to terabyte storage capacities and accelerate storage to nanosecond memory speeds and addresses the growing pressure to extract real-time insights from big data.

Turning to our patent monetization efforts, as we have noted in the past, we have an extensive portfolio of patents related to the fundamental architectures of high speed modules operating on the memory channel. This includes the industry's largest LRDIMM portfolio with patents surviving reexamination, inter-parties reviews, and Federal Circuit review.

We also have a growing RDIMM portfolio that will become increasingly valuable as RDIMM continue to adapt to high speed enabling technologies covered under our patents.

We're focused on making sure the industry recognizes Netlist's innovative contributions to high performance server memory and that our shareholders receive appropriate compensation for our patented technology.

In this regard, in September, we commenced legal proceedings against SK Hynix in the U.S. International Trade Commission, or ITC, alleging infringement of six Netlist patents by Hynix's RDIMM and LRDIMM products. We also filed suit in the Central District of California, alleging infringement on the same six patents.

Hynix is one of the largest players in the worldwide server memory market that according to De Dios & Associates had total shipments of nearly \$8 billion in 2015. The ITC investigation has so far proceeded as we expected.

In response to the filing of our complaint, the ITC instituted an investigation of the unfair trade practices of SK Hynix on October 3rd. We are currently in active discovery, which will continue for the next several months.

Also we are pleased to report today that we received an order from the ITC setting the target date of final initial determination of this case no later than October 10th, 2017 and a trial date for May 8th, 2017, scheduled several months ahead of what was initially anticipated.

As we reported in September, we are represented in both of these actions by DLA Piper one of the largest law firms in the world DLA's team of attorneys has extensive experience in the ITC as well as District Court.

Our financial arrangement with the LA will significantly reduce our out-of-pocket costs related to the Hynix litigation. We remain confident in the strength of our legal positions and look forward to providing updates as the process moves forward and as we are able to do so.

We also continue to strengthen our intellectual property portfolio in August the USPTO issued a certificate for our 537 patent marking the successful conclusion of the reexamination process brought by N5 [ph]. The 537 patent covers the fundamental concept of low reduction, a technology integral to the high performance memory modules, which is forecasted to be a \$37 billion market through 2021.

Further we were recently issued a new patent covering multichannel hybrid memory architectures that use nonvolatile memory to protect critical data in the event of a power loss.

The continued expansion of our patent portfolio highlights the research and development efforts of our engineering team over the past 10 years and the innovation they continue to bring to the industry.

Now, turning to our current base product efforts. Customer engagement continues with our NV4 and EV3 products and we continue to move forward with sampling testing and validation with both current and new customers.

As we noted, on the last call, we were formally selected as a strategic supplier of non-volatile memory by Inspur, the largest server provider in China. They had found that our EV3 is at least five times faster than C Drives in a sustained right environment, allowing their customers to cost effectively upgrade performance from traditional storage systems.

We anticipate initial production orders from Inspur's media streaming and cluster groups before the end of the year and are working closely with other large customers in China such as Baidu, a result -- as a result of our success with Inspur. We continued to be encouraged by ongoing industry wide efforts to broaden adoption of non-volatile memory, driven by customer recognition of how products like NV4 and EV3 can improve performance for their applications and save costs for enterprises.

During the third quarter, multiple Linux enterprise distributions are in our support for NV them as a category including Red Hat, DMV dams as a category including Red Hat, [Indiscernible] Canonical.

Additionally, Microsoft released support for non-volatile memory with their Windows Server 2016 Operating System in September. While development of ecosystem and our sales pipeline have taken longer than we initially hope.

The broader hardware and software support for non-volatile memory is expanding. This will be reflected in new storage and server systems and available sockets in 2017 and drive demand for our products.

Finally, in our partnership with Samsung, we continue to benefit from the unique access we have -- we have to certain Samsung products in the enterprise space. This includes enterprise grade high-capacity SSDs and high density DRAM modules.

Product lines with Samsung is committed to supporting for the long-term. We have continued to grow the customer base for these products since we began shipments earlier this year.

We expect that they will be the key drivers of improved revenue performance and incremental profitability moving forward including this current quarter. Further, the Samsung Companion products provide synergistic value for our own product portfolio and open doors allowing our sales team to establish relationships with OEMs and data center customers, many of which may also be customers for NV4, EV3 and HybriDIMM.

I'll now turn the call over to Gail for the financial review.

Gail Sasaki

Thanks Chuck. Revenues for the third quarter ended October 1st, 2015 were \$2.6 million compared to revenues of \$1.6 million for the third quarter ended September 26th, 2015, an increase of 50%. The year-over-year increase in product revenue primarily reflects the addition to synergistic Samsung products to our product line, which is a direct result of our strategic relationship with Samsung.

Quarter-over-quarter our product revenue was down reflecting the bumpy nature of the Samsung product revenue, which we believe will become more predictable as we continue to product our customer base.

Also as a reminder, we recognized \$3.4 million in NRE from Samsung during the prior quarter as we completed initial phase of our product development work together on HybriDIMM.

Gross profit for the third quarter ended October 1st, 2016 was \$9,000 compared to \$24,000 for the third quarter 2015. Net loss for the third quarter was \$4.4 million or \$0.08 loss per share compared to a net loss in the prior year period of \$5.4 million or \$0.11 loss per share.

The narrower net loss primarily reflects reduction in interest expense from the debt we repaid to Fortress last year and other expense in last year's Q3 which included a one-time payment of a bond associated with litigation.

These results include stock-based compensation expense \$0.3 million for the third quarter of 2016 and \$0.4 million for the third quarter of 2015. Adjusted EBITDA loss after adding back net interest expense, income taxes, depreciation, stock-based compensation, and net non-operating expense was a loss of \$3.8 million for the 2016 third quarter compared to an adjusted EBITDA loss of \$3.6 million for the prior year period.

Operating expenses for \$4.3 million in third quarter compared to \$4.1 million in the last year's third quarter, a 5% increase. The increase in operating expenses reflect strategic investments in the development and marketing of HybriDIMM, Storage Class Memory solution and in our sales and marketing teams focused on our extended product portfolio, which were partially offset by a net reduction in legal fees.

We ended the quarter with cash, cash equivalents and restricted cash at \$16.5 million as to \$11.4 million at the end of the second quarter. The increase in our cash position reflects net proceeds from the following offering in September cash burn essentially unchanged from the second quarter after adjusting for cash used for temporary increase in Samsung product inventory of approximately 1 million, which was sold during the first week after the quarter end.

As we said, we view this product line as highly complementary and strategic to our overall plan. But normally do not plan to carry inventory from one quarter into the next. We will remain disciplined in managing our asset balances as well after the founders as well as our expenses while continuing to invest in future growth.

Our working capital line of credit with Silicon Valley Bank remains available to us with a total capacity of \$5 million limited by 80% of eligible accounts receivable balance. Finally, we remain virtually debt free due to the nature of \$15 million convertible debt from Samsung, which carries no principle or interest payments and will optionally convert to equity at the end of the six-year term in December 2021.

Finally, we do not formally guide based on our shipments and bookings today. We expect to see significantly improved Q4 20216 product revenues of consecutive and year-over-year basis.

I'll now turn the call back over to Chuck for concluding remarks.

Chuck Hong

Thanks Gail. As we enter the final months of 2016, we continue to make tangible progress in the three areas of strategic importance to our business; development of HybriDIMM, revenue ramp of base products, and IP monetization.

And believe that actions taken during this year have set the stage for growth and diversification in 2017.

Thank you for listening. Operator, we're now ready for questions.

Question-and-Answer Session

Operator

Thank you, sir. We will now begin the question-and-answer session. [Operator Instructions]

And the first questioner today is Richard Shannon with Craig-Hallum. Please go ahead.

Richard Shannon

Well, hi Chuck and Gail. Thank you for taking my questions. Let's see I guess my first one to be Gail one of your last comments regarding qualitative outlook for the fourth quarter and revenues, I'd love to get some characterization of where are you seeing the improvement.

Where are those coming from the EV3 and NV4 products, maybe coming from Inspur, I think you said you had some orders there versus pickup in the Samsung enterprise branded products?

Gail Sasaki

Sure Richard. Yes, it should be a combination of both. In the third quarter, the majority of the increased revenue was generated from Samsung. With the remaining from our specialty DIMM and some from NV EV, and we're looking forward and into the next year, we expect of the continued growth in the Samsung product line, traction in NV EV as the broader hardware and software support for NV, non-volatile memory expands.

And further we have the commercialization of HybriDIMM and ITC action to look forward to 2017.

Richard Shannon

Okay, perfect. Thanks. And let me follow on one other threads going -- pass the fourth quarter and that's some of the topic of your base products EV3 and NV4, you had mentioned Inspur as a customer who's starting to land some orders for Chinese customers.

So, let me get a sense of -- across those two product lines, what the breadth of customer list looks like today? Where it could be in a few quarters the used cases here, is it more storage appliances versus servers? And just to get a sense of how big this can grow as you go well into next year?

Chuck Hong

Richard, we've got EV a good activity, particularly in China and Inspur being the largest server manufacturer, they supply many of the largest Chinese portals. So, engaging with that server customer led us to Baidu. We're working with qualifying it our EV in their applications. They are -- Inspur is getting us introduced to half a dozen other major Chinese hyperscale/portals. So, I think we'll see some results -- some tangible results out of those engagements. We're starting to see some production orders, small ones right now. We'll expect to see more before the end of the year.

So, on the EV -- on EV, I think most of the activities are in China. We've got a couple of storage appliance customers, major ones in the U.S. that we had been working with. And couple of the big opportunities that we've -- qualification that we achieved were with companies that had undergone a sale on acquisition and through that process, there's been some delays, but we expect to pick up on those in the U.S. about midyear.

So, I think it's those two areas, storage appliance in the U.S. and server manufacturers as well as portals over in China.

Richard Shannon

Okay. Perfect. That's very helpful Chuck. Maybe if I jump over to HybriDIMM, Chuck I'd love to get your sense of how the process of qualification and sampling has gone since u introduced a product at Flash Memory Summits about three months ago.

And getting -- I'd love to get your sense of the pace of the coalescing of ecosystem, your software, hardware, et cetera, that enables HybriDIMM, has that been to your expectations or is it slower or faster, any details that will be great to hear as well please.

Chuck Hong

Yes, I think we want to declare that we have not sampled. We will -- we are on track to sample to alpha customers in the next few months and we're preparing for that sampling. So, the product has gone through most of the hardware development. Now, it's moving on to the software work, but we are on track to the schedule that was initially laid out at the Flash Memory Summit in August.

In terms of ecosystem work [ph], we have continued to work with all the partners that made the announcement with us in terms of facilitating their use of HybriDIMM into their applications and swapping information about the product and their application.

So, there's a flurry of activity and once we get the product into their hands, I think we'll have a better idea of some of the tweaks that we'll have to make to get the product to the next step.

Richard Shannon

Okay. Fair enough. I think that answers my questions for now. I will jump in line, and thanks a lot guys.

Chuck Hong

Thanks.

Gail Sasaki

Thanks Richard.

Operator

Our next question today is Craig Ellis with B. Riley. Please go ahead.

Craig Ellis

Thanks for taking the question. Gail and Chuck, I'll start-off with Samsung. So, nice to see that Samsung is growing in the fourth quarter. Can u provide some context on how mature you think Samsung could be more in the intermediate to long-term?

And then secondly, how helpful or consequential is it that we have of a memory fundamentals backdrop that seems to be firming up here?

Chuck Hong

Yes, Craig, so the Samsung selling of reselling and distribution of the Samsung product is part and parcel to the joint development and licensing agreement that we have in place with them.

They do not have very large distribution network when it comes to enterprise-grade SSDs. So, there is a vacuum there. As you've noted, there is an overall shortage of product both in DRAM as well as in NAND base SSDs. So, it is an opportunity to the extent that we're able to secure supply product from Samsung. And we're able to do that and it's an opportunity to the extent that they don't have a big footprint in the enterprise SSD space on the U.S. versus PC-grade SSDs.

So, we think the volume certainly the topline can grow quite a bit because these are big dollar -- high dollar value items. And -- but in terms of gross margins, it's limited. We're seeing about 10% gross margins. So, we -- so, it in terms of that business alone, it can grow the topline I think quickly and grow it to a significant level over an intermediate long-term.

In terms of the strategic value, we see some crossover and synergy overlap with NV EV products and HybriDIMM. So, the users of Samsung or potential customers of Samsung's SSDs are also potential buyers for NV EV and HybriDIMM.

Craig Ellis

And the follow-up question I realize is comparing apples-and-oranges from product standpoint and a geographic sales standpoint. But as we look at Samsung's resales potential and the traction you're starting to see at Inspur, as we look out over the next six to 12 months, how will both compare in size? Are those likely to be fairly comparable or would you expect either Samsung or Inspur to be much larger than the other?

Chuck Hong

I think the Samsung number will be larger, simply because the ASPs are very large -- it's thousands of dollars in ASPs for these a high-capacity enterprise drives. But EV NV products albeit the smaller ASPs and small revenues, the margins -- gross margins will be much more significant there, 40 to 50% gross margins.

Craig Ellis

Make sense. And then to follow-up on Richard's questions with regards to HybriDIMM, so sampling starts in the next few months to your alpha customers, it will occur more broadly than that later. Does that mean that with some of the software and other tweaks in customer feedback that you mentioned that we should expect our revenue ramp sometime the second quarter chart or we looking at something that would be beyond the midpoint of next year?

Chuck Hong

On the prepared statements, I'd mentioned that the revenues will be towards the end of the year. I think there is going to be -- we know that there will be an extensive validation/qualification process at many of the bigger customers.

We expect that early revenue generation can come from end customers. And those could be -- those could be earlier than end of the year, let's say Q3, but the bigger traditional names for this kind of storage SCM products will take probably six months of qualification design and work.

Craig Ellis

And then lastly from me, as you look at the broader ecosystem and some of the some of the initiatives that are underway for persistent memory from some of the other players? How satisfied are you that some of the standardization work that needs to be done and some of the software development work that needs to be done is moving in the right direction. And how has your view changed over the last three months in that regard.

Chuck Hong

Well, I think it's a significant way. We know that HP adopted NV4 and introduced NVDIMM in their servers early without adoption in the software side integration into some of the OS that's where the demand will come.

And we noted that Microsoft just a couple months ago announced that NVDIMM will be will be integrated into their server. So, that is the development and as we mentioned, Red Hat and applications like [Indiscernible], they are formally porting their software and formally announcing that NVDIMM will be integrated into their application. So, those are big steps.

JEDEC, the industry standards body is also taking steps to standardize NVDIMM. So, I think there is a movement foot across the industry to adopt NVDIMM.

Craig Ellis

Thanks for that. And then lastly Gail, there was a nice sequential decrease in operating expense in the quarter is that a decrease in sustainable or could even have further downside or should we expect to see OpEx increase in the fourth quarter as the company looks at sales resources, engineering resources, or are other resources to fund growth and things like HybriDIMM and as you evolved the business model?

Gail Sasaki

Well, epically, the short-term Q4 outlook we should continue to see about the same level of OpEx. And going into next year, I think each quarter maybe somewhat reliant on the ITC legal case, which we know is -- we're paying for some small percentage of it, but it changes from quarter-to-quarter. But I'd say overall that the expenses should be relatively flat going into next year.

Craig Ellis

Great. Thanks Chuck, thanks Gail.

Chuck Hong

Hey, thanks Craig.

Gail Sasaki

You're welcome.

Operator

The next questioner today is Gary Mobley from Benchmark. Please go ahead.

Gary Mobley

Hi, Chuck, hi Gail, thanks for taking my question. I appreciate the fact that you're hopeful that HybriDIMM generates revenue by the end of 2017 if I hear you correctly. But if I'm not mistaken, there may be a next phase in your Samsung relationship that might involve some joint marketing for which you would generate some revenue recognition.

I'm just wondering if that's still an opportunity ahead of any actual product sales and according to conversations with Samsung, where do you stand with their right of first refusal for -- I guess their ownership of the product.

Chuck Hong

Gary that -- the items that you're talked about are part of the TBD, what is to be determined in the second phase of this Joint Development and Licensing Agreement that we have with Samsung.

As you mentioned, they have a first right of refusal on the technology as it stands they had no rights to it today. So, there is a potentially -- we are working closely with them today. There is potentially a monetization of that prior to high volume sales of HybriDIMM as we get the samples out.

Obviously, Samsung will be testing our samples. And then assessing its value and I suspect, at that point, we will be talking to them regarding the second phase of the agreement.

Gary Mobley

Okay, that's helpful. I realize there is some question surrounding the mix in Q4 revenue, how much will be comprised of Samsung SSDs, how much will be EV, but we're talking about a wide range of gross margins, 10% versus 45%, so Gail, to the best of your estimation, where would you expect gross margin to land for Q4?

Gail Sasaki

I think I repeat that Q4 revenue will be -- I think increase will in the Samsung, side of the business. We will continue to have a nice product margin mix, which includes the specialty DIMMs. They have been predictable over the last several quarters as well as some in the EV which will be new.

Gary Mobley

Okay, all right. Fair enough. Last question I have, most of them have been asked and answered, but I do have a follow-up question relating to the Samsung enterprise class DDSs, which you are --- in essence, which selling. Is it up to you to spur demand for these products? And what would you say is the largest governing factor to sales of those products from your vantage point, would it be the supply side or is it really to you spring demand?

Chuck Hong

Yes, Gary, I think there are both components that are relevant. One is, today, there is a worldwide shortage of SSDs, particularly in the high end enterprise space. So, to the extent, we have access to the product. You have -- the demand appears to be there because there's a shortage.

On the other hand you cannot count on that type of market condition to continue to persist. We are fortunate that that there is overlap between the customers that we had been calling on for NV EV and down the road for HybriDIMM. These are -- some of these are -- many of them are same customers, they currently buy SSDs.

And lastly Samsung does not have -- they have a huge footprint in standard SSD products, but in the enterprise space that we're calling on, it don't have a huge presence. So, that we're certainly filling a vacuum and adding value in that way.

Gary Mobley

Okay. All right. That's it for me. Thanks everyone.

Gail Sasaki

Thanks Gary.

Chuck Hong

Okay.

Operator

This concludes our question-and-answer session, and this will also conclude today's conference. Thank you all for attending, and you may now disconnect your lines.

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