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Netlist's (NLST) CEO Chuck Hong on Q4 2016 Results - Earnings Call Transcript

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Q4: 2017-03-29 Earnings Summary

EPS of -\$0.06 **beats by \$0.01** | Revenue of \$5.54M (94.18% Y/Y) **beats by \$1.57M**Netlist, Inc. ([NLST](#)) Q4 2016 Earnings Conference Call March 29, 2017 5:00 PM ET

Executives

Mike Smargiassi - Investor Relations

Chuck Hong - Chief Executive Officer

Gail Sasaki - Chief Financial Officer

Analysts

Netlist EX2090
Samsung v. Netlist
PGR2025-00071

Gary Mobley - Benchmark

Jamison Phillips-Crone - B. Riley

Richard Shannon - Craig-Hallum

Operator

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

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

Mike Smargiassi

Thank you, Andrea, and good afternoon everyone. Welcome to Netlist's fourth 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. We assume 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. I would like to start off today's call by recapping some of the significant accomplishments of 2016. First, we deliver solid financial growth with annual revenues and gross profit more than double the prior year. Fourth quarter revenue was also up by more than double on a year-over-year and consecutive basis. And although we don't formally guide, we are very close to the end of the first quarter and anticipate another period of substantial revenue growth in the first quarter of 2017.

Second, during 2016 we built the more diverse base of revenues as we completed the first phase of joint development work with Samsung's memory business unit and earned \$8 million of engineering fees. We also commenced the selling of Samsung's enterprise-grade storage and memory products, a synergistic and scalable addition to our product offering, and we've received initial qualification orders for EV3 and NV4 from key customers in Asia and the U.S. who are progressing to next steps.

Third, we introduced HybriDIMM, our first generation plug and play storage class memory product to the industry. Fourth, we strengthened our IP portfolio with the issuance of new key patents for our RDIMM and LRDIMM, and a number of wins at the USPTO and the Federal circuit.

Finally, we took a major step in our strategic plan to protect our intellectual property by commencing legal action against SK hynix in the U.S. International Trade Commission. These accomplishments set the stage for continued strong business momentum in 2017. Let's review the key accomplishments starting with revenue ramp from the sale of Samsung high-end memory and SSDs.

We started selling Samsung enterprise products into our current and new customer base during the second half of 2016 with a focus on companion products that are synergistic with our existing product line. Samsung is the undisputed market leader in memory and SSD and we have been fortunate to have unique access to their product offerings through our multifaceted relationship, which started in late 2015 with the five-year joint development agreement.

We have grown this product line exponentially over the last few quarters and we expect this growth to continue in 2017. With Q1 just about completed, we expect a significantly better quarter than Q4 2016 with a strong backlog of orders going into Q2.

Moving on to intellectual property, last September we commenced legal proceedings against SK hynix in the U.S. International Trade Commission based in Washington D.C. alleging infringement of six Netlist patents that are implemented in SK hynix products. We also filed a lawsuit in the Central District of California, alleging infringement of the same six patents. In both cases, we accuse SK hynix RDIMM and LRDIMM products as patent infringement.

As we discussed at that time, we took these actions only after extensive and prolonged efforts to reach a fair and reasonable resolution with SK hynix. We approached SK hynix in 2015 regarding its need for license to our patent portfolio. Despite our best efforts, we were unable to reach an agreement and cannot allow SK hynix to continue using our intellectual property without authorization, and without fair compensation to Netlist.

Our strategy has been to pursue remedies against SK hynix both in the ITC and the federal district court in Santa Ana, California.

In the ITC, we are seeking an exclusion order that directs U.S. Customs to stop infringing hynix RDIMM and LRDIMM products from entering the U.S. We believe that these products account for multi billion dollars of revenue for SK hynix today and is expected to grow rapidly over the next decade. A substantial portion of these RDIMM and LRDIMM products are imported into the U.S. and therefore subject to an ITC exclusion order.

In the District Court action, we are seeking monetary damages, as well as injunctive relief directed to the same product categories. As anticipated, the ITC investigation has moved forward at a rapid pace. We have been working very closely with litigation counsel to complete fact and expert discovery, and we are pleased with the progress today. We began this investigation with high confidence in the strength of our legal positions, and remain confident as the case moves toward trial.

We are currently preparing for the weeklong trial in the ITC, which will begin on May 8. There we will have the opportunity to present our case to the administrative law judge, handling the investigation. In the ITC, an experienced judge rather than a jury hears the evidence and makes determinations as to both legal and factual issues. The judge will issue his detail findings of fact and conclusions of law and an initial final determination in October.

The District Court action is also moving forward the court set a trial date of July 2018. We are currently preparing for a claim construction hearing, which is scheduled for July of this year. In both the ITC and District Court, we will continue to execute on our comprehensive strategy that remains unchanged. While we welcome continued dialogue with hynix, we are fully prepared to proceed through the entirety of the legal process to achieve a successful outcome.

We also continue to strengthen our intellectual property portfolio in the U.S. and overseas and recently were issued a new U.S. patent, the 623, which covers critical hand-shaking technologies for DDR4 RDIMM and LRDIMM memory modules that help to resolve the challenges created by the increasing speed of the memory channel.

As noted earlier, the steps we are taking at the ITC and federal court are in defense of Netlist intellectual property assets and years of innovative engineering solutions contributed to the industry. Our ultimate goal is to ensure that our shareholders receive appropriate compensation for our patented technologies.

Moving on to HybriDIMM, since the last call, our development team has made substantial progress towards meeting the status schedule for Alpha customer sampling by mid-year. We have successfully stress tested full data transfer verifying the operation of our precise technology, the patented productive algorithm that enables the seamless transfer of data between NAND and DRAM on the memory bus.

Customer education of HybriDIMM has also commenced as we work with partners on characterization testing and the development of real world applications. To this end, we have released both our driver stack, and our software development kit or SDK. The SDK provides the application interface for software developers to directly write to HybriDIMM as a persistent memory device, an important step in the market.

From an ecosystem standpoint, momentum continues to grow in the storage class memory marketplace. Major vendors have demonstrated benefits and performance and ease of software integration. Last year for example, Microsoft, Redhat, and others released for the first time operating systems as support persistent memory. We have seen no shortage of interest in HybriDIMM and remain selective in choosing initial partners for evaluation and product testing.

We continue to work closely with Samsung on HybriDIMM, including regular update meetings, most recently last month in Korea, as well as upcoming project reviews scheduled for April and June. Once the product is ready to be sampled to Samsung, we expect that the two companies will begin discussions around the terms of the second phase of engagement as laid out in the joint development agreement. We expect the availability of engineering samples in the second half of this year.

Turning now to ND4 and EV3, our sales and marketing team is moving actively to expand the funnel of potential customers for these base products. We continue to work with previously mentioned customers in the U.S. and China on their test and integration and expect volume shipments to several of these customers in the second half of this year.

As Next Generation x86 servers with BIOS support for NVDIMM come to market in the second half of 2017, we are encouraged by the number of customers who have started testing NV4. Consistent with this heightened levels of activity, a recent forecast by transparency market research projects exponential growth and NVDIMM demand to more than \$1.3 billion by the end of 2021.

In summary, our extensive investment in R&D for high performance memory DIMM solutions and technologies have allowed us to develop innovative and critical technologies. With HybriDIMM, we are a first mover and technology leader in storage class memory, a market which is expected to grow to multi-billion dollars over the next few years. We are the inventor of LRDIMM and NVDIMM and possess a seminal patent portfolio covering these rapidly growing products.

We continue working towards monetizing the value of these intellectual property assets via both the product position path and the licensing path. Samsung is a valuable strategic partner for HybriDIMM development and provides the framework to support its successful commercialization. In addition, the access to Samsung's enterprise products is diversifying our revenue base and provides synergistic value by opening new doors with OEM's and data center customers.

Finally, I would like to take this opportunity to recognize Jay Bhakta, who recently passed away. Jay was a good friend and colleague. Co-founder of the company, a longtime board member of JEDEC, and a visionary in the field of memory modules. Our thoughts and prayers go out to his family.

I will now turn the call over to Gail for the financial review. Gail?

Gail Sasaki

Thanks Chuck. As noted earlier, we delivered substantial improvement in our 2016 financial performance and showed increased momentum in our product revenue as we move to the last couple of quarters. Revenues for the full-year ended December 31, 2016 were \$19.7 million, compared to revenues of \$8 million for the 2015 period, an increase of 145%.

The year-over-year increase in revenue primarily reflects the multiple benefits of our joint development agreement with Samsung, which included the addition of NRE revenue for the initial engineering phase of HybriDIMM, and synergistic Samsung high end memory products to our product offerings.

Revenues for the fourth quarter ended December 31, 2016 were \$5.5 million, compared to revenues of \$2.9 million for the fourth quarter ended December 31, 2015, an increase of 94%. On a consecutive quarterly basis, product revenue also more than doubled. The increases in the revenue primarily reflect the addition of Samsung high-end memory products to our product offering.

Full-year 2016 gross profit was \$7.4 million, an increase of 2.5x from the 2015 period, as we've benefited from the high margin NRE. Gross profit for the fourth quarter was \$275,000 compared to \$1.3 million for the fourth quarter 2015, reflecting a change in product mix and the inclusion of \$1.1 million of non-recurring high profit engineering revenues in the year ago quarter.

Gross profit over the next few quarters will be dependent on a number of factors, including the continued revenue growth absorption of fixed to manufacturing capacity and changes in the product mix. Net loss for the full-year 2016 was \$11.2 million, compared to a loss of \$20.5 million in 2015. Fourth quarter net loss was \$3.9 million, compared to a net loss in the prior year period of \$4.3 million.

The narrower net loss in both periods primarily reflects improved operating performance and a reduction in interest expense from the high cost debt that we repaid last year with the capital infusion from Samsung. Adjusted EBITDA loss after adding back net interest expense income taxes, depreciation, stock-based compensation and net non-operating expense was a loss of \$9.3 million in the full-year 2016, compared to an adjusted EBITDA loss of \$15.3 million in 2015.

Adjusted EBITDA loss was \$3.8 million for the 2016 first quarter compared to an adjusted EBITDA loss of \$1.4 million for the prior-year period. Operating expenses for the full year 2016 declined to \$18.4 million and reflect lower legal fees, which were partially offset by higher SG&A. Operating expenses were \$4.4 million in the fourth quarter, compared to \$3.2 million in the last year's first quarter.

Excluding the impact of IP legal fees, operating expenses declined in comparison to last year's fourth quarter, primarily due to reduction in headcount-related costs. We ended the year with cash and cash equivalents and restricted cash of \$12.6 million as compared to \$16.5 million at the end of the third quarter.

The cash usage during the quarter included an incremental purchase of approximately \$1 million of Samsung inventory, which we carried into Q1 2017 in order to take advantage of lower costs and higher margins, which we realized in Q1. Again, although we don't guide, we do expect to see ongoing reductions in our quarterly cash burn as we move through 2017, due to the margin dollar contribution from increasing product revenue, as well as careful management of the overall cash cycle.

Our working capital line of credit with Silicon Valley Bank was also recently renewed through next April 2018 with a total capacity of \$5 million capped by 80% of our eligible accounts receivable balance. We will continue to take advantage of this line for working capital to support the increases in our product business volume, due mainly to our special access to Samsung high-performance memory module.

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

Question-and-Answer Session

Operator

[Operator Instructions] Our first question comes from Gary Mobley of Benchmark. Please go ahead.

Gary Mobley

Hi Gail, hi Chuck, thanks for taking my question. I had a multifaceted question related to basically the same topic, so you mentioned in your prepared remarks some qualitative commentary about how you expect first quarter revenue to be, I guess substantially above the prior quarter? I'm hoping that you can put some quantity on that and I'm assuming that the mix is still going to be mostly comprised of Samsung enterprise SSDs, very little in EV3 and NV4, and despite that, if the answer is, despite that do you think you can expand gross margin sequentially just based on the rising prices for solid-state drives in the float that you get from that?

Chuck Hong

Yes Gary, I thank - we have got a few more days left in the quarter, but we expect to see the substantial increase in revenues and I think it would be correct to characterize most of that increase coming from the Samsung enterprise SSD and memory module products.

Gary Mobley

Okay. With respect to legal expense, the ITC case is scheduled to start on May 8, so should we take that to mean that legal expense in the first quarter is going to be much lower and then we will see a sharp increase in the second quarter or is your new legal firm like the previous one, putting most to build on that?

Chuck Hong

We've mapped out Gary the legal expenses for the rest of the year based on the activities that are projected to occur over the next three quarters. And those dollars are - there is a cap on those legal dollars. As you mentioned, we have a cost-sharing arrangement whereby the - our legal firm Mintz Levin will pick up a big chunk of the legal fees and there is agreement if and when a settlement is reached that they will receive a share of those proceeds.

Gary Mobley

Okay.

Gail Sasaki

I just want to add Gary that, I think last quarter, we indicated that legal expenses would increase during the first half of 2017 but due to the cooperation of the legal firms involved in the case we are expecting in fact to see the legal fees go down.

Gary Mobley

Got you. All right, that's it from me. I'll hop in the queue and let somebody else ask some questions. Thanks again.

Gail Sasaki

Thanks Gary.

Operator

Our next question comes from Craig Ellis of B. Riley. Please go ahead.

Jamison Phillips-Crone

Hi guys this is Jamison calling in for Craig.

Gail Sasaki

Hi Jamison.

Jamison Phillips-Crone

Hi, how are you guys, congratulations on the good quarter and sounds like a good guide. So, I was hoping that we could discuss maybe cash use. So, even if we see a slight decline in cash burn in the March quarter that would imply cash balance of maybe between \$5 million and \$6 million. At what level would you guys need to possibly raise more funds and do you think that you can - you will have the ability to maintain enough cash until the ITC closes?

Gail Sasaki

Well we're starting with 12.5. Part of that is restricted cash, but we are working on getting that unrestricted. So we are assuming that that will be usable and based on this work, we are at the end of the quarter and I guess we don't guide. We are really expecting to see a much decreased cash burn from Q4.

Jamison Phillips-Crone

That's helpful. And then looking towards HybriDIMM, you guys had said that you have made some good progress towards a second-half launch, I was under the understanding or the impression that some additional employees might have been needed for the HybriDIMM expansion, how was this tracking and can you give, I guess a little color on anything that needs to be done further in regards to employees?

Chuck Hong

We have the right mix of employees, engineers - as we've indicated this is a product that has both a hardware and a software component to it. And as we move through different phases of the development, as we get through the control or RTL and move more on to the design verification work, you adjust - we would need the composition of the engineers, the skill sets may change, but the overall overhead that we have budgeted out through the rest of this year we don't believe we need to add any additional cost beyond what has been budgeted out.

Jamison Phillips-Crone

Great thanks. And then lastly, I was wondering if we could get a little bit more color on EV3, I know that there was production orders last quarter and it would be helpful to, I guess get an idea of the size and the ramp as you see this going forward?

Chuck Hong

Well it is, we continue to work with Inspur and Baidu in China. We also are engaged with a handful of big names here in the U.S. The qualifications have taken a long time. We are qualified at Inspur and couple of accounts in the U.S., a couple of big names. In terms of driveway this to higher volume, it is based on used cases, different applications and so our customers need to go out and find their customers where the EV world net performance benefits in their applications. So, it's an ongoing process and as I indicated in the remarks, we believe that we will see some decent volumes in the second half of the year.

Jamison Phillips-Crone

Okay, thank you.

Chuck Hong

Thank you.

Gail Sasaki

Thank you, Jamison.

Operator

Our next question comes from Richard Shannon of Craig-Hallum. Please go ahead.

Richard Shannon

Well, hi Chuck and Gail, thanks for taking my questions.

Chuck Hong

Hi, Richard.

Gail Sasaki

Hi, Richard.

Richard Shannon

Hi. I apologize, I got in the call a little bit late as I'm on the road today, but I had a couple of questions, I guess first of all with development of HybriDIMM, I know you obviously have been working where with Samsung, but I know you've also been trying to unparallel, start to market this more broadly to the market and Chuck I love for you, if you could tell us anything about the interim steps, engagements, et cetera that you've had with the rest of the potential market for HybriDIMM?

Chuck Hong

Yes Richard, as you know our primary partner is Samsung and we are making good progress with those guys and we believe we will be in a position to sample them over the next, you know by mid-year and engage in a demonstration so that we can move on to the second phase of the engagement under the joint development agreement. So that's our main focus. However, there are other major parties that are out there where we have scheduled demonstrations of our Alpha sample as those go out and we're pretty excited to talk to and meet with these potential partners. Some of them are in the server CPU space, and some of them are in the memory controller space.

Richard Shannon

Okay, great. And Chuck may be on a different angle, I wonder if you could tell us, obviously your fourth quarter had a very nice revenue bump here better than we had expected and you are talking about growth in the first quarter, it sounds like you are starting to have some success in generating a customer base outside of what Samsung has built for their own products, I wonder if you could help us think of how big you think your Samsung reselling business can get over time. I'll let you pick the time frame, either in this year, next year or whatever, but love to get a sense of how big you think that can get over time?

Chuck Hong

I think we will see a very nice increase in Q1 and we see strong building of the backlog of orders for the second quarter, I think we had indicated in the previous quarter that we believe that the revenues can get into the tens of millions and we are certainly headed in that direction now. So, the margins are certainly not as high as our base products. However, I think with the bigger dollars, we see an overall help to the cash flow, as well as at bigger dollars even with the lower margins you are starting to see tangible benefits to the business. So, yes I think in the second half you will see this business certainly exceeding \$10 million a quarter as would be a good target for us.

Richard Shannon

Okay, fair enough. And then one last question from me and I will jump off the line as well. You got a earlier question about EV3, I would love to ask more specifically on the NV4 product, again it is something that's expected to be a little bit later time frame relative to EV3, but wonder if you could characterize the engagements there, any customers or preliminary design wins you might have had and when we should expect to see that ramp in the noticeable volume?

Chuck Hong

We are not able to name the names of these customers, but there has been very good activity on NV4 as you know for Skylake, many of these customers are enabling NV on that platform and that platform is due to release second half of this year. So, there is a lot of activity on testing and qualifying NV4 and we hope to be able to make some announcements next quarter.

Richard Shannon

Okay. Well look forward to hearing about that. I think that's all the questions from me guys, thank you very much.

Gail Sasaki

Thanks Richard.

Chuck Hong

Thank you.

Operator

This concludes our question-and-answer session. The conference has also concluded. Thank you for attending today's presentation. You may now disconnect your lines.

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