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Netlist's (NLST) CEO Chuck Hong on Q1 2017 Results - Earnings Call Transcript

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Q1: 2017-05-16 Earnings Summary

EPS of -$0.05 beats by $0.01 | Revenue of $9.43M (104.91% Y/Y) beats by $1.26M

Netlist, Inc. (NLST) Q1 2017 Earnings Conference Call May 16, 2017 5:00 PM ET

Executives

Mike Smargiassi - Investor Relations
Chuck Hong - Chief Executive Officer
Gail Sasaki - Chief Financial Officer

Analysts

Netlist EX2091
Samsung v. Netlist
PGR2025-00071

Gary Mobley - Benchmark
Jamison Phillips-Crone - B. Riley Financial
Jorge Rivas - Craig-Hallum
Richard Shannon - Craig-Hallum

Operator

Good day and welcome to the Netlist First Quarter 2017 Earnings Conference Call. [Operator Instructions] Please note this event is being recorded. I would now like to turn the conference over to Mike Smargiassi. Please go ahead.

Mike Smargiassi

Thank you, Nicole and good afternoon everyone. Welcome to Netlist's first quarter 2017 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 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. Our last call was just 45 days ago, but much has been accomplished as we continue to execute on the 2017 business plan, including further progress in the areas of revenue ramp, the commercialization of HybriDIMM and the licensing of our intellectual property.

Turning first to our top line performance, we delivered a substantial increase in first quarter revenue of more than double the prior period and up by 70% consecutively. The $9.4 million in revenue was driven primarily by sales of Samsung high-capacity SSD, solid-state drive products. The access to these products, made possible by our strategic relationship with Samsung Electronics, allows us to offer complementary solutions to our data center customers and is thus synergistic with our base business. Although we are only halfway through the second quarter, we are confident that we are on track for another period of revenue growth for this business.

We are also seeing additional customer activity for NV4 and EV3 products with ongoing qualification orders from Inspur, for example. We continue to engage with customers interested in using the NVDIMM products as a faster tier of access to data. During the quarter, multiple new customers have purchased sample quantities for their system level testing tied to the launch of next-generation of Intel servers, which are expected to come to market later this year. We look forward to working through their testing and moving them towards production and revenue.

Moving now on to intellectual property, last week, we completed the weeklong trial at the International Trade Commission in Washington, DC, a significant undertaking, where we presented our case to the administrative law judge handling the investigation. The judge heard evidence regarding the alleged infringement of Netlist's asserted patents by SK hynix's RDIMM and LRDIMM products and will issue his detailed findings of fact and conclusion of the laws in a final initial determination this October. We believe we articulated comprehensive and compelling arguments supporting our case and overall, made a strong showing at the trial.

As discussed previously, we took these actions only after extensive and prolonged efforts dating back to 2015 to achieve a fair and reasonable resolution with SK hynix. Despite our best efforts, we were unable to reach an agreement and could not allow hynix to continue using our intellectual property without authorization and without fair compensation to Netlist. In the ITC, we are seeking an exclusion order that directs U.S. customs to stop infringing hynix RDIMMs and LRDIMM products from entering the U.S. We believe these products account for multibillions of dollars of revenue for SK hynix today and are 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.

We are also pursuing remedies against hynix in the Federal District Court in Santa Ana, California, where we are seeking monetary damages as well as injunctive relief directed to the same product categories, alleging infringement of the same patents asserted in the ITC. We are currently preparing for a claim construction hearing in the District Court case, which is scheduled for July 18 of this year. In both the ITC and District Court, we will continue to execute on our comprehensive strategy remains steadfast. We began this investigation with confidence in the strength of our legal positions and remain confident post-ITC trial.

Days before the ITC trial, we entered an agreement with the experienced litigation finance team at TRGP Capital Management. The agreement covers all obligations for legal fees and cost of the ITC and District Court actions as well as certain fees and costs associated to inter-partes review proceedings filed by hynix. The financial arrangement provides additional resources to see the legal process against hynix to its full conclusion, and thus maximizes our strategic flexibility and strengthens our liquidity position with no equity dilution. This allows us to continue to focus on execution of our product strategy, including the commercialization of HybriDIMM.

In April, the Board of Directors adopted a short-term shareholder rights agreement to guard against any coercive or unfair attempts to acquire the company that may arise in connection with the SK hynix proceedings, thus providing the board an additional tool to maximize shareholder value. The exercise price of $6.56 per right equates to an aggregate market value of the company's outstanding securities, assuming full exercise or conversion of all outstanding derivative securities of approximately $500 million. This focused and short-term plan will expire in 12 months of adoption or earlier upon final resolution of hynix proceedings.

Now, moving to HybriDIMM, our first generation DDR4 LRDIMM storage class memory product. The development team continues to make progress with a near-term goal of providing HybriDIMM samples to key customers in the months ahead. We are also engaged in preliminary discussions with potential partners who have shown interest in participating in the commercialization of HybriDIMM. Momentum continues to grow across the industry for storage class memory, a market which is expected to grow to multibillions of dollars over the next few years. With HybriDIMM as a standard LRDIMM product, we believe we are in a good position to take advantage of this emerging trend. We look forward to continuing our efforts with partners and customers on HybriDIMM in the months ahead.

In summary, we believe we are well-positioned for continued business momentum in 2017. With a base of innovative engineering solutions and intellectual property assets accumulated over many years, as well as the Samsung partnership, we continue to work towards maximizing return to our shareholders via both product revenue and licensing.

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

Gail Sasaki

Thanks, Chuck. As noted earlier, we delivered improvement in first quarter revenue and marking the sixth quarter in a row of year-over-year increases. Revenues for the first quarter ended April 1, 2017 were $9.4 million compared to revenues of $4.6 million for the 2016 period, an increase of 105%. The year-over-year increase in revenue primarily reflects the multiple benefits of our Joint Development Agreement with Samsung, which added the synergistic Samsung high-end memory products to our product offering. On a consecutive quarterly basis, product revenue improved by 70%.

First quarter 2017 gross profit was $680,000 compared to $3.5 million in the year-ago period, reflecting product mix and the inclusion of $3.4 million of nonrecurring high-profit engineering revenues in the year-ago quarter. Net loss for the first quarter was $3.3 million compared to net loss in the prior year period of $1.4 million. The increased net loss between periods primarily reflects the same high-margin engineering revenues from Phase 1 of the Samsung Joint Development Agreement in the year-ago period.

Adjusted EBITDA loss after adding back net interest expense, income taxes, depreciation, stock-based compensation and net non-operating expense was a loss of $2.9 million in first quarter 2017 compared to an adjusted EBITDA loss of $800,000 for the prior year period. Operating expenses were $3.8 million in the first quarter compared to $4.7 million in the last year’s first quarter. Expenses declined on an absolute basis across R&D, legal and SG&A.

We ended the quarter with cash and cash equivalents and restricted cash of $10.9 million as compared to $12.6 million at the end of the fourth quarter. As expected, we saw a reduction in quarterly cash burn between quarters due to careful management of the overall cash cycle as well as contribution from increased product revenues. Going forward, we will also benefit from the financial arrangement with TRGP which will fund the legal expenses incurred since the beginning of the year related to the proceedings against SK Hynix.

During the first quarter, we realized an income statement and balance sheet benefit from the TRGP arrangement of approximately $4.2 million reduction in legal expense. TRGP's cumulative investment will be reimbursed only upon a successful settlement with SK Hynix, which we consider a strong vote of confidence in our legal position. The working capital line of credit with Silicon Valley Bank has a total capacity of $5 million, capped by 80% of eligible accounts receivable, and we continue to leverage the facility for working capital to support the growth in the product business volume, due mainly to the special access to Samsung high-performance memory modules.

Finally, I would like to announce that we will be presenting at B. Riley and Co.'s 18th Annual Investor Conference in Santa Monica next Wednesday, May 24, at 8:30 a.m. Pacific Time. We look forward to seeing many of you there.

Thank you for listening. And operator, we are now ready for questions.

Question-and-Answer Session

Operator

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

Gary Mobley

Hi, Gail. Hi Chuck. Hope all is well.

Chuck Hong

Hi Gary.

Gail Sasaki

Hi Gary.

Gary Mobley

Chuck, you mentioned that you expect for the revenue growth in Samsung enterprise-grade, solid-state drives. I don't know if you meant sequentially or year-over-year, but I did notice your inventory was up rather substantially sequentially. Is that indicative of another substantial sequential revenue increase on this particular product line?

Chuck Hong

I think their – as I mentioned, that we are on track for an increase. I don't know whether it will be substantial. But halfway through this quarter, we are doing well with the sale of these products. And the inventory, which we don't hold for very long, is required to support the short-term demand creation and fulfillment of that demand.

Gary Mobley

Okay. I am assuming one of the parties evaluating HybriDIMM is Samsung, and I understand they have a right of first refusal. Is there a line in the sand or a date when they have to exercise that right of first refusal? And how are they impacting discussions with other potential systems companies?

Chuck Hong

Yes, one of the parties clearly is Samsung. We are working under the JDLA agreement. In fact, we will be having another meeting, a large meeting, with their technical team that will be coming to Irvine in June. In terms of the right of first refusal, the way that is envisioned is once the product is ready for commercialization and there is another party that is – that would show an interest in acquiring the technology, at that point, that ROFR would be trigger.

Gary Mobley

Okay. And with respect to EV3 and NV4, do you still feel that some revenue recognition may take place by the conclusion and perhaps second half of this fiscal year?

Chuck Hong

Yes. We are, as I indicated in the prepared remarks, are sampling very actively. And the Intel – the ProLiant's platform that will be launching later in the year is where a lot of these new NVDIMM samples are going into. So we believe that some of these will come to fruition in terms of qualifications – successful qualification and revenue generation in the second half.

Gary Mobley

Okay. Are there hop in the queue I have no further questions I appreciated thank you.

Gail Sasaki

Thanks Gary.

Operator

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

Jamison Phillips-Crone

Hi. This is Jamison calling in for Craig. Thanks for taking the call.

Gail Sasaki

Hi, Jamison.

Jamison Phillips-Crone

Hello. Actually I was hoping to get a little bit more color on HybriDIMM. So it sounds like everything is on track for sampling in early second half. At this point, what needs to be done? What is left? Is the product complete? Does it needs more software development? Or you just guys – are you guys just waiting on negotiations? Just kind of the – a little bit of color from here until then will be helpful.

Chuck Hong

There is a lot of work that continues to be done. We have demonstrated the product now in front of multiple parties, but there's a lot of work on the software side that still needs to get done. And we are actively – we are very busy working on both the software driver as well as the API software. The – and then there is the reliability part of the product that as the product goes through qualification at the customers, at the target customers, they will run it through very robust conditions. And those are the things that we need to do before we send the samples out.

Jamison Phillips-Crone

Okay, that's helpful. Thanks. And then moving towards the ITC case, so it seems like you guys have a good case and I think it sounds like everyone's expecting a favorable ruling. Assuming that there is the final ruling in October, what is the latest time that you guys could see payments for licensing assuming everything goes as planned?

Chuck Hong

Jamison, I don't want to speculate on the timing. There is a ruling I believe its October 10th is the date. That will really be the first ruling from the judge that oversaw the case, the trial. We are – we have spoken to hynix through this process. And I am sure we will have opportunities to continue to speak to them. So – and we did our – we believe we made a strong showing at the trial. So I believe we are in a good position overall in this case.

Jamison Phillips-Crone

Thank you very much.

Operator

[Operator Instructions] Our next question comes from Jorge Rivas of Craig-Hallum. Please go ahead.

Jorge Rivas

Thank you for taking my question. So you have provided an update on HybriDIMM since the time frame is driven by the Sky lake launch towards the end of the year. I am wondering if you could provide an update on EV3. You touched on NVDIMM, but I wonder what would developments are being achieved in the quarter for the EV3, if there's any certainty on the timing for any qualifications for the remainder of the year.

Chuck Hong

Hi, Jorge. We are working on a couple of major projects on EV3. There's a lot of qualification work that is going on and we believe that those will materialize into revenues in the second half of the year.

Jorge Rivas

Okay. And then I am wondering if you can provide an update as far as the potential for a second licensee for your HybriDIMM product. Have you been able to engage with a potential secondary license agreement or maybe even a third or fourth?

Chuck Hong

We don't have a licensee per se on HybriDIMM. That may well happen. As I indicated, we are in discussions with a number of parties at different levels to cooperate in the commercialization in – commercialization of HybriDIMM. And those may end up to become a licensing agreement, but HybriDIMM – with HybriDIMM we are pursuing a product strategy. We plan to get the engineering samples out the door to customers, and we will be building the finished DIMMs and we will be shipping them. But we are talking to other parties who have interest in becoming a vendor for the DIMM and possibly parties that may want to become a vendor of the controller and the chipset. So it is a – today, it is a product-based strategy.

Jorge Rivas

Okay, thank you for the caller. And then one last question, maybe for Gail, the relationship with TRGP Capital that's going to fund legal expenses so you said in the prepared remarks that there will be a reimbursement for about $4 million. I wonder how that's going to work and how is that going to impact your balance sheet and the time frame for that?

Gail Sasaki

So Jorge, I guess you can think of TRGP as a contingent arrangement. So during the first quarter, we incurred about $4 million of legal expense, which TRGP will be pay for on our behalf. That is considered their investment in this case. And it will be much more direct going forward, so we will see the invoices, but they will be addressed to them. Did that help? So, there is really no liability to us.

Jorge Rivas

Yes, okay. So those expenses, they are really not flowing through your financial statements. Is that correct?

Gail Sasaki

That's correct. Yes.

Jorge Rivas

Okay. And then I guess I noticed the decline on your SG&A in the first quarter versus the fourth quarter versus your sales increasing by – increasing significantly. I am wondering if that's the run-rate that we should expect for the rest of the year at around $2 million per quarter.

Gail Sasaki

On SG&A?

Jorge Rivas

Yes.

Gail Sasaki

Yes. I believe, yes.

Jorge Rivas

Okay, alright. Thank you. That's all for me.

Gail Sasaki

You are welcome.

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. I apologize I jumped on late as I was traveling here. And it's noisy again I will apologize profusely later on that. But I did want to ask a question about your Samsung-branded product sales. It sounds like you had a good first quarter. And I think, Chuck, for your comments earlier, you mentioned you think you are going to see continued growth in that. Anyway that you can help us think about that revenue stream looking a little bit beyond the second quarter? Is that something where you can continue to see that growing? If so, how can you provide – give us the thought process about how to think what kind of scale you think you can sell that product line or even other product lines over time via Samsung?

Chuck Hong

Yes, Richard. The SSD product line is obviously – Samsung has a very large position. They are trying to grow the enterprise part of that SSD product line, particularly with the high-capacity SSDs, particularly with NVMe SSDs that they are just starting to bring to market. So I think there is tremendous upside there, our customer base, particularly those in the data center where we are selling some of our existing products. The Samsung product line is very complementary and synergistic. And we think we have – this will continue to grow nicely through the rest of the year. We are building a very strong relationship with the Samsung sales and marketing team both in the U.S. and in Korea and they are supporting it and facilitating it the best they can. So we are looking forward to continued growth and execution. We have brought on additional personnel as well to – for continued demand creation.

Richard Shannon

Okay, great. I think I will take rest of my questions offline. Thanks for fitting me into the call guys. Thank you.

Gail Sasaki

Thanks, Richard.

Chuck Hong

Okay, thank you.

Operator

This concludes our question-and-answer session and concludes the conference. Thank you for attending today's presentation. You may now disconnect.

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