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IMI - Q1 2016 Intermolecular Inc Earnings Call

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Bruce McWilliams *Intermolecular, Inc. - President and CEO*

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Edwin Mok *Needham and Company - Analyst*

Adam Cristofoli *JPMorgan - Analyst*

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to your Intermolecular Inc. fiscal first-quarter 2016 earnings conference call. All participants are in a listen-only mode. Please note this call is being recorded. My name is Noemi and I will be your operator for today.

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

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

Thank you, Noemi. Good afternoon and welcome to Intermolecular's first-quarter 2016 earnings conference call. We announced our results after the market closed today and you will find a copy of the press release on our website at www.intermolecular.com. On the call with me today is Bruce McWilliams, President and Chief Executive Officer.

Today's conference call contains forward-looking statements. Any statements that refer to expectations, projections or other characterizations of future events including financial projections and future market conditions is a forward-looking statement. Actual results may differ materially from those expressed in these forward-looking statements. Intermolecular assumes no obligation to update these forward-looking statements, which speak only as of today.

For more information about factors that may cause actual results to differ materially from forward-looking statements, please refer to the press release we issued today as well as the risks described in our Form 10-K for the fiscal year 2015, as filed with the SEC, particularly in the sections 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 corresponding GAAP measures. All non-GAAP measures are reconciled to the most directly comparable GAAP financial measures in our press release issued today.

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

Bruce McWilliams - *Intermolecular, Inc. - President and CEO*

Thank you, Rick. Good afternoon, everyone, and thank you for joining us on today's call and webcast. Intermolecular has made great progress in transforming its business. We entered 2016 with clear and focused goals to create a scalable and profitable business as a trusted partner for advanced materials innovation.

Our Q1 results are a validation of the direction we have set last year and a demonstration of the substantial progress we're making towards our goals.

We are achieving strong revenue growth and our operational efficiency is improving. With \$4.5 million of revenue in Q1 of 2016, we achieved more than 40% growth over the first quarter of 2015. In the same period, we reduced our pro forma loss to \$600,000 from a loss of \$5.1 million in Q1 of 2015.

Furthermore, in this quarter we had an EBITDA profit of over \$1 million.

We are debt-free and hold over \$32 million in cash. Financially we are much stronger than we were a year ago.

Our expansion into new markets and applications outside of the semiconductor industry is progressing. Customers are learning about IMI's value, and we are expanding our capabilities. Our equipment and development facility and expanded metrology make this a very unique place for materials innovation.

We are now organized into two primary businesses: technology-enabled services, what we are now calling IMI Labs; and licensed products, called IMI Discoveries. IMI Labs customers use our high-throughput experimentation platform, deep materials understanding and analytics excellence to accelerate and de-risk materials decisions they need to make for their future products.

We have made significant changes in the way we run this side of the business to serve a much larger set of customers.

In the old model, we had to agree to the exclusive licenses and specific fields of use in return for the potential of long-term royalties. We had to establish dedicated teams and equipment, and we restricted our engagements with other customers.

Furthermore, our demands for royalties kept us from working with market leaders in the semiconductor industry.

In the new model, we are simply offering IMI Labs, our technology-enabled services, and our expertise to help our customers to search for their optimal materials for their future products. For example, our older DRAM contracts have ended but we have been able to expand the business to a larger number of customers who also engages through follow-programs in that same area.

Our new model allows us to serve more customers but it will also come with shorter program lengths. This will likely generate some quarterly lumpiness in our revenues win programs and before new ones start generating revenue. You'll see an occurrence of this in our guidance for the second quarter 2016. However, I remain very confident in continued revenue growth over time.

The new model has allowed us to centralize operations and increase efficiency. We have been improving our tool management software and process controls to a level not often found in R&D environments. Changes are paying off. With \$12 million in technology-enabled services and IMI Labs revenue in Q1, we achieved over 60% year-over-year growth. Even more significantly, we realized a gross margin of 67% in Q1 of 2016, up from 44% in Q1 of 2015.

We also continue to make progress in our 2016 goals to solidify and grow our semiconductor business. In semiconductors four of the five major memory customers now use IMI Labs, up from only two in Q1 of 2015.

The growth of our technology-enabled services revenue is a clear indicator that our customers are recognizing the value IMI brings in accelerating and derisking new material choices for the next-generation product. We believe IMI Labs can continue to scale and go well beyond semiconductor industry long term and generate great returns for our shareholders.

Now let me talk about IMI Discoveries, which is what we're calling our license and royalties. And to grow our licensing revenues by investing in new materials. Today we announced our new IMI Discoveries licensing business with the portfolio of materials, technology and know-how to help our customers accelerate and derisk their materials innovation.



IMI Discoveries will offer customers technology that we have developed either internally or under prior customer development programs. We are now offering licensing and services for our ReRAM technology.

The ReRAM technology was developed as part of the SanDisk Toshiba CET. The technology was exclusively licensed to SanDisk Toshiba during the development program and for the last [few] years. Our relationship is moving to a nonexclusive agreement this month.

Near-term, this switch to a nonexclusive license will lower our royalties and license fees by roughly \$2 million for the remainder of the year. However, longer term, this change provides IMI with the potential of much more revenue upside, since we can make the technology available to everyone.

Going forward we think that focused R&D investments in targeted areas where material is the key differentiating aspect of the end product could lead IMI Discoveries' business to grow significantly and also generate healthy returns for our shareholder.

In summary, IMI Labs, our technology-enabled services, is growing and on its way to generating profit. IMI Discoveries, our licensing and royalties business built on previously developed technology as well as R&D investments we are now making, should provide a growing stream of revenues longer term.

My goals for 2016 are staying the same, namely -- strong revenue growth, solidification and continued of our semiconductor business, expansion into new markets and applications, growth of our IMI Discoveries revenue by -- long-term, by investing in new materials and continued improvements in operational efficiencies. I expect 2016 to be a good year for the addition of new business, added capabilities in markets which will position us for strong future growth.

Rick?

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

Thank you, Bruce. Let me review some selected financial results for the first quarter of 2016. As Bruce pointed out, IMI revenue for the first quarter was \$14.5 million, which is up 12% sequentially from the prior quarter but up 47% compared to the first quarter of 2015. Program revenue of \$12 million represented approximately 82% of total revenue in Q1 2016, and licensing and royalty revenue came in at 18% for the quarter.

We saw outstanding growth in our program revenue on a year-over-year basis as Q1 2016 was up \$4.9 million or 69% in the first quarter of program revenue in 2015. This result is a good indicator that our new business model that opens up our technology-enabled services to a broader range of engagement with top-tier customers is working well.

As Bruce mentioned above, our new IMI Labs business typically has shorter contracts and we will likely see some variation in our quarterly revenues, given the size of our current customer base. Our second-quarter revenue guidance is lower than Q1 2016 results, primarily due to these program timing effects as well as reduced licensing fees.

In Q1 2016 we had four customers which were each greater than 10% of total revenue. These four customers represented approximately 74% of total revenue in the first quarter of 2016.

Net loss in the first quarter of 2016 on a GAAP basis was \$1.7 million or a loss of \$0.03 per basic share. This compares to a net loss of \$2.5 million or a loss of \$0.05 per basic share in the previous quarter.

Our Q1 2016 net loss was a dramatic improvement from the first quarter of 2015 as new program revenues came in at significantly higher gross margins. In the first quarter of 2015 we reported a quarterly net loss of \$7 million or a loss of \$0.15 per basic share. So our Q1 2016 result was a very positive profit swing of \$5.3 million from 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 these results. The key difference from GAAP to non-GAAP measures is the exclusion of stock-based compensation expense. On this basis we reported

a non-GAAP net loss for the first quarter of 2016 in the amount of \$0.6 million or a loss of \$0.01 per basic share. This compares with non-GAAP net loss of \$1.6 million or a loss of \$0.03 per basic share in the fourth quarter of 2015.

Compared to the prior year, our non-GAAP net loss improved by \$4.5 million and our non-GAAP net loss was \$5.1 million or \$0.11 per share in the first quarter of 2015. As mentioned before, gross margin in the first quarter was 67%, which was flat sequentially from the prior quarter but up substantially from one year ago, when our gross margin was only 44%. Our higher gross margin reflects both the growing percentage of our program revenue run under the new business model as well as significant improvements in our operational efficiency. While our main focus continues to be on improving our total operating margin, we're very pleased with the gross margin results this quarter.

Going forward, we would expect our typical gross margins to be in the 60% to 65% range.

We achieved another quarter of positive adjusted EBITDA in Q1 2016, which was one of the key goals we set for IMI. This result is largely due to the improved revenues and the operational leverage we are getting for our revised business model.

Looking at our quarterly GAAP loss of \$1.7 million on an adjusted EBITDA basis, there would be a profit of \$1.2 million when we remove \$2 million of depreciation and amortization and \$0.9 million of stock-based compensation.

As of March 31, 2016, our balance sheet included cash and investments of \$32 million, which is down \$3.3 million from the combined total of \$35.3 million at the end of the fourth quarter of 2015, primarily due to working capital changes.

Please note that we now have \$5 million of long-term investments classified as other assets on our balance sheet, but that we consider liquid for operating purposes.

The overall financial results of our first quarter of 2016 indicate that our new business model is working. We can scale new customers profitably and our operational improvements are observing excess capacity and lowering overall costs, allowing us to operate in positive cash flow if we can maintain revenues greater than about \$14 million per quarter.

Now I would like to go over the financial outlook for the second quarter of 2016. I would like to remind everyone that the following statements are based on current expectations as of today and include forward-looking statements. Actual results may differ materially.

Our guidance for the second quarter of 2016 is as follows. We project revenue in the range of \$12.0 million to \$12.5 million. Non-GAAP net loss, which excludes stock-based compensation expense, is projected between \$2.6 million and \$3.6 million or between \$0.05 loss and \$0.07 loss per share on approximately 49 million shares outstanding.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Edwin Mok, Needham and Company.

Edwin Mok - Needham and Company - Analyst

Thanks for taking my question. Good quarter. So the first question I have is just on a sequential basis you mentioned there is some contract that is completing and another one not starting yet. Can you give us a little more color on that? I know that you have one big customer historically that is, let's say -- I think last year that customer was 36% of your sales rate. Is that that customer, just changes at that one particular customer? Or was it across a few customers? Just kind of give us some color on that, please.



Bruce McWilliams - *Intermolecular, Inc. - President and CEO*

So, you are right. We have one contract that has come to an end, as we have announced, in the DRAM area. And within some of our other big semiconductor memory customers, we have contracts in place but they are statements of work that get amended. And so, there's a gap in two of these contracts. And so, the ramping of those programs that's happening late in the quarter -- we'll see any risk there, but that's -- so anyway, Q2 is going to be low because of the start and stop of new work.

We can't really tell you the names. We are forbidden by the contracts to say who they are with. Yes; it's an unfortunate aspect of this model that we don't have three- or four-year-long contracts. There's -- more flexibility is good for the customers. We remain very confident about the revenue, long term. And that's the primary reason for this down quarter.

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

And I'd like to add, too, as Bruce said with the new contracts, the good news is that we can sign off work very quickly. The contract's actually already done. It's just a specific statement of work for a specific amount of things to be done. So we can spool those up in three or four months instead of 18 months of negotiations for a new deal. So it does have advantages of faster start but also has corporate stops.

So you will have some of these quarters where you don't have it lined up.

Bruce McWilliams - *Intermolecular, Inc. - President and CEO*

And actually I'm very happy with the change in the mix of the customer base. I think actually, with our new customer mix, we can grow a lot more than we could in the past.

All in all, I'm very positive. I just -- it's a little bit of a letdown to have a lumpy quarter like this.

Edwin Mok - *Needham and Company - Analyst*

Right. So Bruce, just to dive into your commentary, you mentioned that there was some contract that you guys have already gotten deep into negotiation and potentially get signed late into 2Q? Is that mean that in 3Q at least some of those -- as you said right now, you have the contract that has fallen off [whereas] 3Q as some of those newer contracts could potentially kick in, bringing you back to a growth trajectory.

Bruce McWilliams - *Intermolecular, Inc. - President and CEO*

Right now we feel good about Q3. And we're not giving any guidance on it. We have solid relationships with these companies; it's just -- it's the nature of this work. It starts or comes to an end. They analyze the results and then start up their next activity.

And we would like to -- ultimately, we are going to have, we believe, many customers, especially as we expand outside semi. And this will solve the problem.

But -- or go to some kind of subscription model or some kind of a guaranteed them. But in the current situation this is what we are living with. But the relationships are very healthy. We get visibility at the very tops of these companies. They like what we're doing for them. We are just living with the way we have to recognize the revenue in this particular quarter.

Edwin Mok - *Needham and Company - Analyst*

Okay, great. That's very helpful color there. Rick, I got a question on gross margin -- so just last quarter you did high end of what you have said before, which is the 60% to 70% range that you guys are targeting. Right?

Am I reading too much into it? I was thinking of all of your business, and you have a fixed cost part of your business because you have to build up these lab tools and capacity to support your customer. And if you are running at a high end of your guidance range doesn't mean that your capacity utilization are going up there? And let's say you start your new contract in 3Q and your revenue get above this \$14 million, and you get like \$15 million-, \$16 million.

Does that mean that we should start to see some increased CapEx coming?

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

Yes. I think internally that the mythical figure what's your capacity is always something we are working to -- because as you make improvements in your operating practices, your capacity expands without spending.

But we did spend some on CapEx this quarter. You will see in the cash flow statement about \$1.4 million. And some additions, as you noted, are needed to keep growing to the next level. But we think we can keep the total capital spend around \$3 million a year, \$3 million to \$4 million range or less.

On the gross margin, again, the margin was better than we expected this quarter by a few points, and that's good. Our long-term model is 60 to 65. I think we will probably be in the middle of that range this quarter, so I think quarters where you are a few points up is good. But it's really not -- it's more indicative of the type of work we are doing and the way we are able to get good price quoting to our business.

Bruce McWilliams - *Intermolecular, Inc. - President and CEO*

But to your point, we have a fixed cost business. There's a large fixed cost of being Intermolecular and offering what we have. And overall, the expenses as we grow IMI Labs -- that expense is not going to go up much. This is why we think this is a very attractive business, a high-growth margin business.

And these capital investments we are making in some sense, but they are making all of our tools very equivalent and uniform. So we can get very good utilization.

Edwin Mok - *Needham and Company - Analyst*

All right, great. That's helpful. Last question I have and I'll let the other guys ask questions -- but on the IMI licensing or IMI Discovery business that you talk about, I have the same question on the ReRAM announcement you guys had this morning. So it sounds like your -- my understanding is that [Sanders] have this call it ongoing payment to you guys to keep it exclusive. What makes the customer decide not to keep that exclusivity? Is it because -- any kind of coloring or reasoning why they decide not to do that? And then, in terms of licensing in that [10RG] it seems like those leading memory guys already have their own ReRAM program. So where would that license opportunity come from?

Bruce McWilliams - *Intermolecular, Inc. - President and CEO*

SanDisk Toshiba does not yet have that technology in production. And we don't know how far that's out.

They also have quite a bit of their own IP around that. So, they made a business decision that they didn't need to keep IMI's portion exclusive.

That being said, we have one of the oldest, strongest portfolios in this area and a very good capability here to demonstrate and optimize this technology for different voltage branches. Maybe you want it for ITO or microcontrollers that operated 3 volts or 5 volts or different voltage ranges or in leading-edge technologies.

So, we think our services are very valuable in this regard, and we have a very strong portfolio in that area.

So, we think it's a valuable asset. And it is, like you say, on everybody's roadmap. Now we are free to license it.

Edwin Mok - *Needham and Company - Analyst*

Is there any kind of restriction as far as restriction from you to license this to any Chinese entity?

Bruce McWilliams - *Intermolecular, Inc. - President and CEO*

Not that we know of, no.

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

Not that we know of.

Edwin Mok - *Needham and Company - Analyst*

All right. That's very helpful. (Multiple speakers).

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

As you asked, Edwin, where would you go, I think that's a likely market. There's certainly foundries and other participants that are not necessarily (technical difficulty). It's embedded memory or additional memory. So there's a fair number of people who don't have the technology developed or there's people who may want alternative methods of developing this choice of -- from something they've got already.

Edwin Mok - *Needham and Company - Analyst*

Great, thank you. That's all I have.

Operator

(Operator Instructions) [Adam Cristofoli], JPMorgan.

Adam Cristofoli - *JPMorgan - Analyst*

I just had two quick questions. The two contracts that are starting at the end of Q2 -- are those new customers that you did not have previously? Or is this a new form of relationship with an existing customer?



Bruce McWilliams - *Intermolecular, Inc. - President and CEO*

They are both existing customers (multiple speakers).

Adam Cristofoli - *JPMorgan - Analyst*

So different programs with existing customers?

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

Exactly.

Adam Cristofoli - *JPMorgan - Analyst*

Okay. Were there any new customer signed in the quarter?

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

Not this quarter. If you look at the 10-Q, there's movement in who went on and off the 10% plus. But all those customers -- some customers expanded their work with us, which you can see in our 10-Q. And some have lowered their work. But we all have the same -- we haven't added any new customers of substantial size this quarter.

Adam Cristofoli - *JPMorgan - Analyst*

And then I remember on the last call you mentioned that you could have -- you may have published a press release talking about some of the non-semiconductor wins. Was that just not released because of a confidentiality issue?

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

Exactly. Yes.

Adam Cristofoli - *JPMorgan - Analyst*

Okay. But that work continues with -- in terms of the non-semi-business?

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

Yes, that work does continue.

Adam Cristofoli - *JPMorgan - Analyst*

Okay. And then just last, have you had any interest in the ReRAM patents at all from a third-party company that would be interested in that type of asset?



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

This is the first. Today we just announced it. So, before this point, they were exclusively licensed to SanDisk Toshiba.

Adam Cristofoli - *JPMorgan - Analyst*

Great, thank you.

Operator

I would now like to turn the call over to Mr. Rick Neely for closing remarks.

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

Thank you. Thank you, everyone, for listening to our earnings call and we look forward to seeing you next quarter. Thanks again.

Operator

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

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