Sequans Second Quarter 2020 Results Call

Operator:

Welcome to the Sequans Second Quarter 2020 Results conference call. At this time, all participants are in a listen-only mode. Later, we will conduct a Question and Answer session. Instructions will be given at that time. As a reminder, this conference is being recorded.

Before I turn the conference over to our host, Mr. Georges Karam, I would like to remind you of the following important information in behalf of Sequans.

This call contains projections and other forward-looking statements regarding future events, or our future financial performance and potential financing sources. All statements other than present and historical facts and conditions discussed in this call, including any statements regarding our expected revenue for the third quarter and fourth quarter of 2020, future results of operations and financial positions, business strategy and plans, expectations for Massive IoT and Broadband and Critical IoT sales, the ability to continue to operate remotely (as required) at high levels of productivity, increasing backlog of orders, the impact of the coronavirus on our manufacturing operations, and on customer demand, and our objectives for future operations, are forward-looking statements (within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended). These statements are only predictions and reflect our current beliefs and expectations with respect to future events and are based on assumptions and subject to risk and uncertainties and subject to change at any time. We operate in a very competitive and rapidly changing environment. New risks emerge from time to time. Given these risks and uncertainties, you should not place undue reliance on these forward-looking statements. Actual events or results may differ materially from those contained in the projections or forward-looking statements. More information on factors that could affect our business and financial results are included in our public filings made with the Securities and Exchange Commission.

Thank you.

Please go ahead, sir.

Georges:

Good morning, ladies and gentlemen. This is Georges Karam speaking. I am with Deborah Choate, our chief financial officer. Welcome to our second quarter results conference call.

We have added a number of new shareholders since our last call and we expect that some are listening to this call . . . so we'd like to welcome you and say that we appreciate your interest and investment in Sequans.

In the press release, I characterized Q2 as a "pivotal" quarter for us. It was, indeed, and I'd like to recap some of our most important achievements:

- Q2 revenue increased nicely both sequentially and year-over-year in all three of our businesses
- We significantly reduced our operating loss . . . and
- We raised $32.6 million in equity capital to strengthen our balance sheet

Other major accomplishments that are not apparent from looking at the financial statements include the following:

- We met important technical and business milestones related to our large strategic partnership for 5G. In fact, we are running slightly ahead of schedule and are seeing growing interest from an expanding list of potential customers.
- We secured important new design wins and projects in each of our businesses. One of them is a major long-cycle industrial platform win in our Massive IoT business. It can scale up to many projects that will ship over many years with the same marquee customer, and it has the potential to generate up to $100 million in total revenue.

- We continued engaging, with almost no impact from COVID-19 restrictions, with many new prospective deals most of them with Tier1 customers, again covering all 3 business segments.
- We strengthened and expanded our partnerships with multiple distributors and microcontroller vendors, reinforcing the go-to-market strategy to scale our Massive IoT business I have described on previous calls. . . . and
- We made very good progress on the 5G strategic partnership front where we have a few deals under discussion and one of them is now in active negotiations.

While, we, like many other companies, had supply chain challenges to overcome during the quarter . . . we are happy to say that we managed to limit the impact. Also, we faced COVID-19 impact on demand in our existing automotive-related business but we are seeing some recovery in Q3. Lastly, we were expecting to close one major vertical project but the final decision regarding the award of the deal to our customer was delayed by about one quarter . . .

In summary, we are very pleased with the achievements of the quarter and we are very excited about our future.

We believe the positive impact of COVID-19 on demand for our solutions will continue to offset any negative impact, and we continue to assume the same order-of-magnitude of revenue growth for 2020 as we were targeting prior to the pandemic. More important, we continue to build a solid foundation for significant growth next year and beyond. While some external challenges and risks remain, our own operations are nearly back to normal, with only one location in a work-from-home mode. During the first half of the year, we proved that we can maintain a high level of productivity while working 100% remotely, but we are happy to be able to be in the office together in almost all locations with appropriate social distancing and other precautions.

Now we'd like to discuss some of the specific reasons for our confidence in the future and update you on recent developments in each of our businesses.

Broadband and Critical IoT

During Q1, a surge in demand in the U.S. for portable routers resulted in a very large increase in orders for our modules that power Verizon's JetPack mobile hotspot. We believe a lot of the demand was to serve schools for use by students. Our main challenge in addressing this demand during Q2 was the extended lead times for some components. Through our collective creativity and persistence, we were able to obtain enough components to satisfy a significant portion of this large order. As a result, our Broadband IoT revenue more than doubled sequentially. We will continue to fulfill the backlog of orders in Q3. The component situation looks like it will begin to improve soon, even if we continued to struggle with getting enough components throughout July.

We expect the expanded use of JetPack to continue, specifically to help schools and students with remote learning applications as many students may not be able to return to classes full-time since most of the U.S. States are considering not opening the schools in fall or reducing on-campus classes. Even if we don't have yet the full picture for Q4 and beyond, all indications point to the "new normal" for JetPack being at a higher level of demand than before the pandemic.

The coronavirus has focused everyone’s attention on the importance of being able to work and study remotely, which is dependent on having a broadband connection. Even in an advanced country such as the United States, we have seen estimates ranging between 20 million and 40 million people without physical access to a broadband. This is not counting those who can’t afford it or are dependent on mobile plans with data limits. Globally, the digital divide is much wider. In fact, it is estimated that nearly 50% of the world’s population still lacks access to the Internet. Federal and local governments, and even the United Nations’ Broadband Commission for Sustainable Development, are setting goals designed to connect the “other half” of the world’s population to bridge the digital divide. Devices to enable broadband in underserved areas have been part of our core business since our company was founded. Until, recently, industry observers agreed that Broadband IoT was likely to see steady, fairly slow growth. Now, forecasts are being revised upward . . . not only in emerging markets, but in developed countries as well. For example, Ericsson’s widely-followed Mobility Report forecasts fixed wireless access to grow from 51 million connections in 2019 to 160 million by 2025, a CAGR above 20%. Our long-time presence in this market, plus our technical knowhow, position us to capitalize on fixed wireless access growth as well as higher demand for portable routers over the medium term.

As we move into the second half of this year, we expect the emerging markets portion of our Broadband IoT business to accelerate, specifically from the new customers we secured at the end of last year, as their products are now in production. Therefore, we should see more growth coming from the emerging market starting in Q3.

In addition, we are well positioned to capture a significant share of the developing CBRS market in the U.S. As you know, CBRS or Citizens Broadband Radio Service, refers to the 3.5GHz band in the US, which is currently underused. So, the Federal Communications Commission is opening 150MHz in this band for access to licensed users with a Priority Access License, and to registered users with General Authorized Access. 70MHz of spectrum is being auctioned in unpaired 10MHz blocks and the remaining 80MHz will be available for general access at no cost but without the ability to ensure quality of service. This auction of Priority Access licenses attracted over 270 bidders. The bidders include, in addition to Tier 1 telecom operators and Tier 2 and 3 wireless access service providers, many non-traditional companies such as cable companies, utilities and some other large corporations, as well as potential neutral host providers. Who the successful bidders will be remains to be seen . . . but one thing is certain: all these networks will require devices that support the 3.5GHz band. Our Cat 4 and Cat 6 products have been supporting 3.5GHz bands worldwide for nearly a decade, and last year we launched modules that are cost-optimized for CBRS in the U.S. As we have reported in the past, we have enjoyed strong interest in our CBRS solution for various types of devices and applications, including CPEs and gateways for broadband access and various industrial IoT applications. During Q2, we added new CBRS customers, and one of them in particular has very large potential. We believe that our CBRS business could contribute several million dollars or more to revenue next year.

Finally, we continue seeing traction with new customers looking to our Broadband IoT Cat4 and Cat 6 platforms. We are in an advanced stage negotiating two very large deals, one in the U.S. and one in Asia.

Longer term, we expect to play a significant role in 5G with our Taurus platform, currently under development. The high-end Taurus 5G platform will serve two major groups of 5G use cases. One is Enhanced Mobile Broadband, or eMBB, supplying solutions for high-bandwidth wireless connectivity, large-scale video streaming, and virtual reality. The second is Ultra-Reliable, Low-Latency Communication, or URLLC, for connected devices used in factory automation, robotic and remote management. Some of these use cases in both categories are not likely to be in mass production until mid-decade. Meanwhile, some of the applications for which we are seeing immediate interest include: residential and enterprise fixed wireless, embedded or independent devices for mobile computing such as portable routers, factory automation, high-definition cameras, and connected car applications.

Note that current 5G-related revenue is virtually all services and it's reported as part of our Vertical and Strategic business. Once we are shipping products based on our Taurus platform, those revenues will be recorded as part of the Broadband and Critical IoT business.

We feel very good about our prospects in 5G because the large chip companies are focused on the smartphone market, and it's not possible to create one design that is optimized for both markets. Also, there is only one Western company currently serving the 5G market, and the non-smartphone portion of the market is not their primary focus. Therefore, with a head-start on 5G technology, the support of outstanding strategic partners, and generally high barriers to entry, we believe we are very well-positioned to capitalize on this major opportunity. We believe 5G can fuel our growth for the next decade.

Massive IoT

The third major group of use cases for 5G is Massive Machine-Type Communication, or MMTC, which we refer to as Massive IoT. This business currently includes our Cat 1 Calliope platform and our Cat M/NB platform, Monarch. The second generations of both platforms are 5G-ready. This will allow our customers to transition seamlessly to 5G with no hardware change as Massive IoT applications will evolve from 4G to 5G. These solutions are optimized for low power-consumption and low-cost in order to run on batteries and provide low-cost cellular connectivity with limited throughput in comparison to what is provided by Broadband IoT.

Even though the Massive IoT market has been slower to develop than we expected, working with customers and partners through the entire infancy of the market and sharing our vision and roadmap had built relationships that are difficult for a newcomer with one product to displace. We expect the ramp in Massive IoT solutions to fuel strong growth over the next 2 to 3 years.

Both Cat 1 and Cat M revenue grew sequentially in Q2. We are past the inventory issue we had with our module customer in Cat 1, and we continue to believe Cat 1 revenue will increase in the second half of the year. While COVID-19 caused soft demand for applications related to the car industry, the demand from a customer developing a health monitoring device has increased significantly. We expect to see this increase continuing in the second half of the year and stay at a relatively high level next year. In Q2 COVID-19 had an impact on our Cat 1 supply chain for the same components as we use in portable routers, and we were not able to completely serve higher demand in Cat 1, but expect to be able to serve these customers in Q3. So, on balance, the Cat 1 business is moving in line with our plan.

We remain very positive on our Cat M business despite some delay caused by the pandemic on some customer projects not yet launched, and some softness in the automotive-related business. The projects already in production are moving very well and we are very happy about the level of demand coming from the Comcast security system we are supplying in the US. We expect Cat M revenue to be higher in the second half compared to the first half and to show a very big increase for the full year versus 2019, mainly driven by new projects that will be launching both in the US and Japan.

Overall, we are confident that we have reached the inflection point in the Massive IoT market. We believe Cat M revenue will continue to grow significantly next year. Cat 1 is likely to be mostly steady until we start shipping our next generation platform, Calliope 2, in the second half of next year. So, we believe Massive IoT as a whole is likely to grow well over 50% next year. Our confidence for the medium term is based on several important design wins during Q2 as well as the significant increase in the total estimated value of projects that are currently in the technical feasibility stage. Also, the new opportunities we are identifying are generally larger than most of those already in production.

The categories of applications where we see a high degree of current interest include various types of tracking devices, metering, security, connected speakers, and health-monitoring. During Q2, we secured a tracking design win that is connected with a major retailer, as well as a parking application in Japan. Our most important IoT design win in Q2 was the first phase of a large metering opportunity that we've mentioned in the past. As we've been saying, the metering space is an important one for us – particularly gas and water meters where the low-power requirements and the harsh environment poses particular challenges. Our joint promotion of the Monarch SiP with Skyworks is showing results, particularly in this metering space. We have an excellent solution and we are getting strong support and feedback from customers' engineering teams. We are close to another significant metering design win and are engaged in discussions on several more metering projects. This area holds significant promise for the second half of next year and beyond.

Our go-to-market initiatives with our distribution partners, Avnet and RFPD, are going well. We are expanding the scope of our relationship with Avnet to include Europe and we have a number of design wins based on Monarch GO. We are also expanding the scope of our relationship with Arrow RFPD outside the U.S. and a funnel of opportunities from Japan and Europe is developing.

We are very pleased with the progress with our existing MCU partners. We are moving into next steps of engagement with both Microchip and NXP. You will hear more about the work we are doing with them later in the year. For confidentiality reasons, I will be commenting in detail only after the announcements. Our unique position as a technology provider of cellular connectivity makes us an ideal partner to all MCU vendors. We help them address the Massive IoT market and they help us address the fragmented "dark pipe" of this market. While we continue working with the publicly announced MCU vendors, we are also pursuing discussions with other partners and we expect to solidify additional relationships before year-end.

Vertical and Strategic

Our Vertical and Strategic business remains on track for a significant increase in 2020, mainly due to revenue recognition related to the large strategic deals signed last year. As we've mentioned previously, we were selected by our existing customer for a project they are pursuing in the satellite space. We had hoped to find out if they were successful in landing the business by now. However, the decision has been postponed to Q4. On the positive side, we are close to finalizing the terms with a new customer for a project that has been on hold for a while but is now moving ahead. Also, we are seeing our pipeline of opportunities increase among both existing and new customers. We are optimistic about our ability to show good growth in this business next year.

Regarding potential new strategic deals, we are still involved in multiple discussions. We are pleased to report that we have reached the point of actively negotiating terms for the one that is most advanced. Since we were able to strengthen our balance sheet with additional equity funding in Q2, discussions with prospective customers and partners have become easier, and we are able to focus on getting the best possible deal rather than on how to close the deal as quickly as possible.

We are continuing to work on additional government innovation funding from the French government and we had very good progress in Q2. We have received recently an official notification that we are now in the last phase of the process that we hope to close in Q4.

To summarize, despite ongoing macroeconomic uncertainty and potential further impact from COVID-19, we remain optimistic that we can be above 50% growth for this year and have a similar growth level next year.

Over the medium term, we expect continued growth in broadband for emerging markets, to sustain a relatively high level of demand for portable routers, to add new CBRS-related business, and to add revenues from a few more major deals that we are working to close. We expect the Massive IoT ramp to continue accelerating. Cat 1 should continue its steady growth then accelerate with the introduction of our Calliope 2 solution. Cat M is expected to keep accelerating its ramp with existing projects shipping, plus new design wins and platform projects we have secured, supported by the introduction of our second generation Monarch 2 solution. Finally, our Vertical Market business is expected to grow significantly thanks to the deals we are closing this year and will add to the revenue generated from our existing and new Strategic 5G projects.

Helping to fuel further growth over the long-term will be our new high-end 5G Taurus platform for Broadband and Critical applications, plus the continued growth in Massive IoT. Both should continue growing for the rest of the decade as the market continues to grow.

We know that some of you became interested in us as a leader in 4G-optimized solutions. Some of you became interested in us as an IoT play, and others as a company benefitting from initiatives to bridge the digital divide. More recently, some interest has come because we are seen as a 5G company. The fact is that we are all of those things: we are the only company with a comprehensive range of 5G/4G cellular connectivity optimized for Internet of Things market and this will contribute to maintaining our momentum over the next decade.

Now, I'd like to turn the call over to Deborah.

Deborah:

I'd like to add some details about our Q2 results and other developments.

Our Q2 revenue was $12.2 million, a sequential increase of 39.4% from the first quarter, primarily driven by a 59% increase in product revenue, reflecting the surge in demand for modules for portable routers, but also increases in product sales for Massive IoT. Revenue in Q2 increased 54.6% compared to the same quarter a year ago. We continue to expect further sequential growth in the final 2 quarters of the year, and we are on track to reach our goal of at least 50% topline growth for 2020.

We had three greater-than-10% customers in the second quarter: one is an OEM and two are ODMs.

Gross margin in Q2 was 48.3% compared to 51.3% in the first quarter, and compared to 37.7% in the second quarter of 2019. The Q2 2020 gross margin reflects a greater proportion of modules in the product mix than in Q1 and a lower proportion of service revenue.

Operating expenses were $11.5 million in Q2, down from the $12.3 million in Q1, primarily due to fewer trade shows and less travel, as well as the one-time charges in Q1 related to bringing on board the new 5G development team in Israel. Non-IFRS operating expenses were $10.8 million, down from $11.6 million in Q1.

Our second quarter operating loss was $5.6 million, compared to an operating loss of $7.8 million in the first quarter, and a $6.9 million loss in the second quarter of 2019.

Our net loss in Q2 was $19.0 million, or ($0.70) per diluted ADS, and included a non-cash $9.1 million loss on revaluation of the embedded derivative arising from the March 2020 amendments to the convertible debt agreements. This compares to a net loss of $15.3 million, or ($0.64) per diluted ADS in the first quarter, which included a non-cash loss on the revaluation of the embedded derivative of $5.6 million, partially offset by a one-time non-cash gain of $1.4 million recognized as a result of the amendments to the convertible debt agreements. The net loss in the second quarter of last year was $9.2 million or ($0.39) per ADS and was not affected by the convertible debt amendments.

For new investors who may be unfamiliar with the March 2020 amendments, the purpose was to provide us the flexibility to extend the maturity of each convertible note, solely at our option, by one year increments, up to three times. In certain cases, this could result in a reduction in the conversion price. Consequently, the equity conversion price is now considered potentially variable. So, IFRS accounting requires that the conversion option be recorded as an embedded derivative, which must be marked to market each quarter with any change in value reflected as a non-cash financial gain or loss. Previously, the estimated values of the conversion options were recorded through equity. The Q1 results we reported in April were marked as “preliminary”, because we had not yet finalized the valuation of the amendments, which was a highly complex task. The accounting entries resulting from this process led to changes in our financial and deferred tax expenses for Q1. Therefore, in our Q2 financial statements the comparative Q1 results have been updated to reflect the non-cash impact of this valuation process; and full updated and final Q1 financial tables have been filed with our Form 6-K today. Those of you maintaining financial models will want to update the relevant Q1 IFRS line items.

Our weighted average number of ADSs in Q2 was 27.2 million, an increase of 3.3 million ADSs, reflecting the equity offerings in May.

On a non-IFRS basis, our net loss for Q2 was $7.5 million, or ($0.28) per diluted ADS, compared to a non-IFRS net loss of $8.7 million, or ($0.36) in the first quarter, and net loss of $7.9 million or ($0.33) per diluted ADS in the second quarter of 2019. Our non-IFRS net loss excludes non-cash items related to stock-based compensation expense, and the non-cash impact of the fair-value and effective interest adjustments related to the convertible debt with embedded derivatives and other financings, the non-cash impact of convertible debt amendments, and the non-cash deferred tax benefit or expense related to the convertible debt and other financings.

In analyzing the difference between our actual non-IFRS net loss in Q2 and the various analysts' estimates, we noted that, where there was a difference related primarily to the assumptions used regarding foreign exchange gain or loss for the quarter. In Q2 we had a foreign exchange loss of over $500 thousand related to the revaluation of Euro-denominated liabilities on the balance sheet. By contrast, in Q1, we had a $675 thousand forex gain. Investors should be aware that possible swings in foreign exchange related to balance sheet liabilities and the marking to market of the embedded derivative from the convertible debt amendments can cause significant differences in net income or loss from quarter to quarter. While the impact of swings in the value of the embedded derivative is excluded from our non-IFRS presentation, foreign exchange gains and losses are not.

Cash flow used in operations during Q2 was $1.4 million, compared to cash flow used in operations of $7.7 million in the first quarter. Our cash and short-term deposits at June 30, 2020 totaled $35.5 million, compared to $5.1 million at the end of Q1. This increase reflects the proceeds of our equity offerings in May, the recovery of the 2019 French research credit, and an additional €5 million government loan as part of the COVID-19 stimulus package aimed at helping French technology companies.

As Georges mentioned, we believe we are on track to receive French innovation financing as part of a technology consortium for 5G and we have applied for innovation financing through the Israeli government as well.

Accounts receivable at June 30, 2020, increased to $10.7 million from $8.8 million at the end of Q1, reflecting higher product sales. DSOs improved to 61 days compared to 91 days the end of Q1.

Inventories decreased slightly to $5.9 million compared to $6.1 million at the end of Q1.

Current trade payables increased to $17.0 million from $12.2 million, reflecting large capex purchases in June for the 5G program.

Short-term debt from financing receivables increased to $9.6 million from $6.6 million at the end of Q1.

Turning to the financial outlook, we are targeting at least 10% sequential revenue growth in Q3. In addition, we continue to expect sequential quarterly revenue growth in the fourth quarter. Therefore, we continue to expect full year revenue in 2020 to grow more than 50% compared to 2019, although we remain somewhat cautious about encountering further challenges with the supply chain due to COVID-19.

For those of you developing financial models, we continue to assume that non-IFRS gross margin will average around 45% during the second half of the year, with the potential to fluctuate from quarter to quarter based on the proportion of modules vs service revenues in the mix.

We also continue to expect non-IFRS operating expenses to average around $10.5 million during the second half of 2020. And we expect non-IFRS financial expenses to be around $2.1 million per quarter during the remainder of 2020, excluding any foreign exchange gain or loss.

Finally, for modeling purposes, the exact number of ADSs on June 30, 2020 was 30,269,536.

Before I turn the call back to Georges, I'd just like to remind you that at the conclusion of this call, we will post a written version of our formal remarks in the Investor Relations section of our website on the "Webcasts and Presentations" page . . . the same location where you will find the audio replay.

Also, Georges and I will be participating in the virtual Canaccord Conference on August 12. We look forward to speaking with you if you plan to participate.

Now I'll turn the call back to Georges . . .