Sequans Second Quarter 2022 Earnings Conference Call

Operator:

Welcome to the Sequans Second Quarter 2022 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.

I would now like to turn the call over to Kim Rogers of Hayden IR. Ms. Rogers, you may begin.

Thank you, [name],

And thank you to everyone participating in today's call. Joining me on the call today from Sequans Communications are Georges Karam, Chairman and Chief Executive Officer, and Deborah Choate, Chief Financial Officer. Before turning the call over to Georges, I would like to remind our participants of the following important information on behalf of Sequans.

Sequans issued the earnings press release this morning, which was posted to the Company's website at www.sequans.com under the "Newsroom" section.

Before we start, I would like to remind everyone that this conference 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 contained in this call, including any statements regarding future results of operations and financial positions, business strategy and plans, including ability to enter into and close a new 5G strategic agreement on presently negotiated terms and the expectation that the potential agreement will fully fund the development of our first 5G platform, expectations for Massive IoT sales, the impact of the Covid-19 on our supply chain and on customer demand, the impact of component shortages and manufacturing capacity, our ability to convert our pipeline to revenue 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 rely on or 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.

And now, I would like to hand the call over to Georges Karam. Please go ahead, Georges.

Georges:

Thank you, Kim. Good morning, ladies and gentlemen. Welcome to our second quarter 2022 financial results conference call.

Once again in the second quarter, our growth was boosted by our Monarch Cat-M product family, which grew 13% sequentially and 122% year-over-year, notable because Cat-M's first-quarter annual growth was also triple-digit. Revenue for the quarter increased 11% year-over-year, with Massive IoT growing 12% and the Broadband category growing 9%, due to services revenue. Broadband's sequential decrease was due to the timing of services and licensing revenue generated by our existing 5G agreements and was fully compensated by the growth in our Massive IoT Cat-M and Cat1 businesses which have driven our sequential product revenue growth.

This increase in second-quarter service and licensing revenue delivered a year-over-year improvement in gross margin of 430 basis points to 60.9%. The increased gross margin contribution and a reduction in our operating expenses narrowed our operating loss versus last year. This, along with a benefit from foreign exchange, helped to reduce our non-IFRS net loss to $1.1 million compared to a non-IFRS net loss of $5.6 million in the second quarter of 2021.

Let me start by giving an update on the new 5G strategic partnership.

I am pleased to announce that we finalized all the terms of a licensing agreement with a new strategic 5G partner, as we had planned. Execution of the deal is expected within a few weeks. A few final logistical steps experienced delays beyond our control, but they are now moving forward to the completion stage. We will provide more details once the deal is announced, but I can share with you today that the agreement is expected to generate more than $50 million of licensing revenue in the first three years, followed by royalty revenue in the future. This deal is anticipated to fund the balance of the development of our Taurus 5G platform and to turn our operations to cash flow break-even or better going forward. I appreciate your patience. This last stage has taken more time than anticipated. Please stay tuned and we look forward to updating you with the full details in the coming weeks.

Now let me give you some more business update starting with our Massive IoT.

The Massive IoT category delivered year-over-year growth of 12% and sequential growth of 36%, with the Monarch Cat-M platforms being the primary driver as more design wins moved to mass production and shipped in the quarter. Our Monarch Cat M products family has delivered eight sequential quarters of growth, and we anticipate it will continue to ramp through 2023. We continue to have solid and steady shipments of our first generation Cat 1 product category, and our new Calliope 2 Cat-1 platform design wins are advancing at an increasing rate. We expect this new product to add growth to our Cat 1 business starting in 2023.

We continue to advance our business in our key Massive IoT target markets, as evidenced by the new designs wins we added this quarter, including two for applications in smart city, two for tracking and a few others for Industrial. Almost all of these wins are with our Cat M/NB Monarch 2 platform except one with Cat 1 Calliope 2, which represents our first design win with this new platform. We are successfully leveraging the potential of our Cat M and Cat 1 products and increasing market share with our Massive IoT platforms.

We also made progress with several design win projects, moving them towards mass production, and we are happy to share that we started volume shipment to a new sizable project. However, the shutdowns in China have impacted customer execution on several projects, delaying their ramp by 2-3 months. Also, the shutdowns have impacted some of our customers that have not finished their buildouts as planned and are holding sufficient inventory levels for now. Although this is limiting our product revenue ramp in the second half of 2022, it is not impacting our growth potential.

Our pipeline supports our future growth objectives

Our business pipeline keeps building with new design wins and opportunities. It has now close to $330 million of three-year lifetime of product design wins. Note that this does not reflect services revenue and specifically our existing 5G strategic deals and the new one we believe we are close to signing.

This gives us good visibility of our revenue growth for the next few years. Currently, over 85% of the design wins are for Massive IoT applications, predominantly for the Cat M Monarch 2 platform. In addition, positive reception of our new Cat 1 Calliope 2 solution is creating an incremental and growing revenue pipeline for applications requiring throughput that exceeds the maximum Cat M speed. Being unique in the market, with a new non-Chinese Cat 1 platform, fully optimized in cost and power, we expect to win a large portion of new Cat 1 opportunities and increase our market share in this category. We anticipate that Cat 1 Calliope 2 will be a growth driver next year and beyond as design wins move to mass production. Please note that our pipeline represents an expected revenue contribution over three years of the design life. There are several large projects that may have a design life exceeding three years and in some cases reaching ten years, which would be incremental to the $330 million figure I just mentioned.

The design wins are in alignment with our key verticals in Massive IoT. Smart city and metering remains our strongest vertical, followed by asset tracking, smart home, eHealth and other industrials applications.

Shifting to the Broadband category

Broadband as a percentage of revenue was impacted in the quarter by lower contribution from licenses and services, as expected due to the timing of revenue recognition, along with lower CBRS revenue. In general, the demand for CBRS projects remains lumpy as the highly fragmented private network market is still developing. We had anticipated acceleration with one major CBRS project that moved to mass production late last year. However, the lockdowns in China have impacted production and delayed the next phase of the deal. Another similar project is also impacted by these lockdowns and its ramp phase is now delayed to 2023. As a result, the outlook for CBRS revenue is expected to remain variable during the second half of 2022.

The good news is that we have a number of irons in the CBRS fire for exciting enterprise and IoT applications. Several metering customers are exploring Cat 4 CBRS as a complement to the LTE-M/NB and Cat 1 categories. We expect these opportunities to develop further in 2023. We also expanded our licensing agreement with Renesas to cover our Cat 4/6 broadband modules and this should strengthen our go-to-market in this category.

A new development in our Cat 4 category is our partnership with Anterix for utility companies in the US. For those unfamiliar with Anterix, it a large holder of 900MHz spectrum in the US and provides private wireless connectivity to critical infrastructure. Anterix is re-selling this spectrum to several utilities to deploy private networks. Sequans is working on a module supporting Anterix band to address this market. With this new module, we will have a comprehensive, differentiated offering for the utility segment with the three modem categories (Cat 4/Cat 6, Cat 1 and Cat M/NB) supporting all frequency bands required (MNO, CBRS and Anterix).

The most significant long-term growth driver of our Broadband IoT business remains our Taurus 5G platform. 5G will transform and broaden the use of cellular connectivity in IoT, and Taurus is uniquely positioned as a leading 5G solution fully optimized for fixed wireless, enhanced broadband, and critical IoT applications. The Taurus 5G platform will meet the throughput performance and low latency required for these market segments, allowing Sequans to address a meaningful market opportunity that could potentially exceed $2 billion by 2025, tripling our addressable market. The pending 5G strategic deal will strengthen our execution ability to achieve this goal.

The 5G Taurus platform development which is the largest segment of our R&D spending, is progressing as expected. We received the engineering sample of our RF chip in May, and we were pleased with the results. The team remains on track to sample the full solution in 2023.

Our MCU partnerships continue to play a key role

Our MCU partnerships continue to deliver new opportunities and exposure for the Sequans product portfolio. In June, MicroChip launched a new platform incorporating our Monarch 2 GM02S cellular module. The launch received tremendous media exposure to its large social media audience and customer base. We expect this platform to generate a new flow of design opportunities and to contribute to our future growth.

On another front, Renesas is promoting a cellular IoT roadmap with a comprehensive portfolio of modules featuring our LTE-M/NB and Cat 1 solutions. This quarter they have added our Cat 4/Cat 6 technology and they are fully engaged with our 5G Taurus. This makes Renesas an important go-to-market partner as they are promoting all our 4G/5G portfolio to address a broad range of cellular IoT opportunities. We have a number of ongoing projects with Renesas worldwide and they have already secured many design wins. We see a tremendous level of engagement from this partner, and we are confident that they will be driving a significant portion of our Massive IoT revenue in 2023.

Lastly, I'd like to update you on our supply chain and other macro challenges impacting our operations

I am happy to report that our Ukraine-based R&D team continues to successfully meet its deliverables. However, the Chinese COVID lockdowns affected our customers' manufacturing of devices in China and impacted our business as explained before. We are watching this closely, but the zero-tolerance approach to COVID imposed in China creates a cycle of disruptive shutdowns and re-openings that makes it difficult to determine, with any certainty, when this situation may end.

Lastly, regarding our wafer supply from TSMC. We have sufficient wafer supply to meet our customers' demand for the remainder of 2022, and our allocation for 2023 looks good as well. As you may know, TSMC announced a price increase of 6%, and we anticipate passing this price increase on to our customers.

In summary, Q2 was a solid quarter with continued strong growth in Monarch LTE-M/NB-IoT and strong interest in Calliope 2, both of which we expect will be future growth drivers.

Today, with a growing pipeline and a new 5G strategic deal soon to close, we are confidently managing through the complexity of the current environment to deliver sustained long-term growth. Sequans remains well positioned to expand our market share, grow revenue, and improve profitability. Thank you to all our shareholders for their ongoing commitment to Sequans. Our global team is working hard to execute our strategy, and I appreciate their loyalty.

I'll now turn the call over to Deborah.

Deborah:

Good morning everyone.

Our revenue for the second quarter was $14.2 million, an increase of 10.6% versus Q2 2021 and up 2.4% compared to $13.9 million in Q1 2022.

- Product revenue, which accounted for 54% of total revenue, increased 29.5% sequentially vs. Q1, reflecting primarily higher product sales in our Massive IoT categories. License and service revenue decreased 17.8% vs. Q1 as expected, mainly due to one-time license fees recognized in Q1 that were not repeated in Q2.
- Revenue from Massive IoT in Q2 2022 increased 36% quarter-on-quarter and accounted for approximately 59% of our total revenue.
- Revenue from Broadband IoT decreased 25% from Q1 2022 primarily due to the expected decline in one-time license revenue.

For the quarter, we had three customers that each represented 10% or more of our revenue. As Massive IoT design wins move into production, we expect to diversify the number of end customers served.

Gross margin in Q2 2022 was 60.7%, up from 56.6% in Q2 2021, and down from 68.1% in the first quarter of 2022. The improvement year-over-year was primarily due to the increase of services and licensing in the Broadband category and, the increase in the mix of chipset revenue versus module revenue overall, compared to prior periods.

IFRS operating expenses were $10.7 million, down 6.1% from $11.4 million in Q1 2022 due to a decrease in R&D expense of $539,000, a decrease in general and administrative expense of $141,000 and a modest decrease in sales and marketing of $22,000. Year-over-year IFRS operating expenses were essentially flat at $10.7 million in Q2 2022 and Q2 2021.

Non-IFRS operating expenses, which **exclude stock-based compensation expense,** were $9.5 million in Q2 2022, compared with $10.1 million in Q1 2022.

Our second quarter 2022 operating loss was $2.1 million, an improvement compared to an operating loss of $3.4 million in the second quarter of 2021 and an operating loss of $2.0 million in the first quarter of 2022.

We posted a net loss in Q2 of $3.2 million, or $0.07 per diluted ADS, which **included a non-cash benefit of $663,000 from the revaluation of the embedded derivatives related to our convertible debt and $1.5 million of non-cash interest expense from the IFRS accounting for convertible debt and other financing**. This compares to net income of $2.0 million, or $0.04 per diluted ADS in Q1, which included a non-cash benefit of $6.4 million from the revaluation of the embedded derivatives and $1.2 million of non-cash interest expense. The net loss in the second quarter of last year was $1.3 million or ($0.04) per diluted ADS, which also included non-cash benefit totaling $5.4 million on the revaluation of the embedded derivatives, non-cash interest expense and the impact of debt reimbursement.

On a non-IFRS basis, our net loss for Q2 was $1.2 million, or ($0.02) per diluted ADS, again an improvement compared to a non-IFRS net loss of $1.8 million, or ($0.04) per diluted ADS, in the first quarter, and a non-IFRS net loss of $5.6 million, or ($0.15) per diluted ADS, in the second quarter of 2021.

In Q1, we had a **gain on foreign exchange of $1.2 million, primarily related to the revaluation of Euro-denominated net liabilities on the balance sheet**. This compares to foreign exchange gains of $370,000 in Q1 2022 and foreign exchange losses of $1.0 million in Q2 2021.

Investors should be aware that the company's results are subject to certain market risks, and as a result, our net profit and loss may fluctuate quarter to quarter. Specifically, **the financial income (expense) category on the income statement,** which is below our operating results, **includes foreign exchange gains or losses primarily related to the remeasurement of Euro-based balance sheet items, and the marking to market of the embedded derivative related to the convertible debt,** can cause significant differences in net income or loss from quarter to quarter. These fluctuations **may be more extreme during periods of increased market volatility in foreign exchange rates or the company's share price**. While swings in the value of the embedded derivative are <u>excluded</u> from our non-IFRS presentation, foreign exchange gains and losses, whether realized or unrealized, are <u>not</u>.

And please remember that our IFRS net loss includes significant non-cash interest expense related to our convertible debt that is excluded in the non-IFRS presentation.

Cash and short-term deposits totaled $16.8 million at the end of Q2 compared to $4.8 million at the end of 2021. We had expected to receive a $3 million payment of a government grant in the quarter; this actually was received on July 1st. With the grant payment, cash at the end of the quarter would have been $19.8 million if the payment had been received a day earlier.

Cash used by operations for the first six months of 2022 was $7.7 million, compared with cash generated by operations of $6.5 million in the first six months of 2021 due to the timing of some large working capital items in that period.

Short-term debt from financing receivables increased to $12.1 million versus $9.5 million at the end of 2021.

Regarding the outlook for Q3, given the impact this deal is expected to have on revenue and gross margin, we will update our guidance when the pending 5G strategic agreement is announced.

We expect that non-IFRS operating expenses, which exclude stock compensation expense and a stable euro/dollar exchange rate, will average close to $10.5 million per quarter in the coming few quarters.

We expect IFRS interest expense in Q3 2022 to be approximately $2.9 million and non-IFRS interest expense to be around $1.3 million, meaning that we expect our non-IFRS net loss to have lower interest expense by $1.6 million. We are not providing guidance on any impact of revaluing the embedded derivative nor possible foreign exchange gains or losses given this is largely determined by market conditions.

Finally, for modeling purposes, the number of ADSs outstanding today is 47.8 million.

And finally, a few housekeeping items:

- We expect to file a Form S-8 registration statement in the coming days related to our new equity plans. French regulation requires that equity plans be approved by the shareholders annually, and therefore we register our new plans each year.

- 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.

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

Georges:

Thank you, Deborah. Operator, we are now ready to open the call for Q&A…

Post-Q&A comment from Georges:

Thank you again for joining the call today. We look forward to catching up with you with the update on the new 5G strategic deal and then during our third quarter 2022 earnings call in November. Please note that we are participating in the Canaccord Annual Growth Conference on August 10th. Please contact your Canaccord representative to book a one-on-one meeting.

We look forward to speaking with you soon.