

THOMSON REUTERS STRETEVENTS

EDITED TRANSCRIPT

IOTS - Q1 2018 Adesto Technologies Corp Earnings Call

EVENT DATE/TIME: MAY 09, 2018 / 9:00PM GMT



MAY 09, 2018 / 9:00PM, IOTS - Q1 2018 Adesto Technologies Corp Earnings Call

CORPORATE PARTICIPANTS

Leanne K. Sievers *Shelton Group - EVP IR*

Narbeh Derhacobian *Adesto Technologies Corporation - Co-Founder, President, CEO & Director*

Ronald K. Shelton *Adesto Technologies Corporation - CFO & Secretary*

CONFERENCE CALL PARTICIPANTS

Aman Raj Gulani *B. Riley FBR, Inc., Research Division - Associate Analyst*

Auguste Philip Richard *Northland Capital Markets, Research Division - MD & Senior Research Analyst*

Harsh V. Kumar *Piper Jaffray Companies, Research Division - MD & Senior Research Analyst*

Sujeeva Desilva *Roth Capital Partners, LLC, Research Division - Senior Research Analyst*

PRESENTATION

Operator

Good afternoon, and welcome to the Adesto Technologies first quarter financial results conference call. (Operator Instructions) As a reminder, this conference call is being recorded today, May 9, 2018.

I would now like to turn the call to Leanne Sievers, President of Shelton Group Investor Relations. Leanne, please go ahead.

Leanne K. Sievers - Shelton Group - EVP IR

Good afternoon, and welcome to Adesto Technologies First Quarter 2018 Earnings Conference Call. I'm Leanne Sievers, President of Shelton Group, Adesto's Investor Relations firm. Joining me today are Narbeh Derhacobian, Adesto's President and CEO; and Ron Shelton, Chief Financial Officer.

If you've not received a copy of press release, you can access the copy under the Investor Relations section of the Adesto's website at www.adestotech.com. There's also a slide presentation that we will be using in conjunction with today's call that may be accessed through the webcast link on Adesto's website and is also posted as a PDF in the Investor Relations section.

Before I turn the call over to Narbeh, I'd like to remind our listeners that during the course of this financial call, the company will provide financial guidance, projections, comments and other forward-looking statements regarding future market developments, the future financial performance of the company, new products or other matters. These statements are subject to risks and uncertainties that we discuss in detail in our documents filed with the SEC, specifically the final prospectus related to our initial public offering, our 10-K and our most recent 10-Q, which identify important risk factors that could cause actual results to differ materially from those contained in the forward-looking statements.

Also, the company's press release, slide presentation and management statements during this conference call will include discussions of certain non-GAAP financial measures. These financial measures and related GAAP to non-GAAP reconciliations are provided in the company's press release and related current report on Form 8-K and also as an appendix in the presentation material.

For those of you unable to listen to the entire call at this time, a recording will be available via webcast in the company's website.

And now, I'll turn the call over to Adesto's President and CEO, Narbeh Derhacobian.



MAY 09, 2018 / 9:00PM, IOTS - Q1 2018 Adesto Technologies Corp Earnings Call

Narbeh Derhacobian - *Adesto Technologies Corporation - Co-Founder, President, CEO & Director*

Thank you, Leanne, and welcome to everyone joining us today. As you saw in this afternoon's press release, we are very excited to announce the acquisition of S3 Semiconductors, and I would like to spend some time discussing this great development for Adesto in today's call.

First, in order to cover all of today's updates, I'd like to start with a brief overview of our first quarter business highlights, after which, I'll turn the call over to Ron to review the financials. I'll then spend more time discussing the S3 Semi transaction in great detail. As Leanne mentioned, there is a slide presentation that I will be reviewing as part of today's call, which is included in the webcast or can be accessed as a PDF on our website.

As we indicated in our last earnings call, our momentum in the second half of 2017 carried forward into 2018. Adesto's revenue in the first quarter was \$15.3 million, which exceeded the high end of guidance and represented our fourth consecutive quarter of above 30% year-over-year revenue growth. We also continue to closely manage operating expenses, which were below our expected range, contributing to our fourth consecutive quarter of positive adjusted EBITDA.

First quarter revenue breakdown by verticals for top 20 customers followed our historical trend of approximately 55% coming from the industrial market and 28% from consumer. Computing, communications, medical and automotive constituted the remaining 17%.

Our new business activities were also robust in the first quarter as we secured the highest number of design wins of any quarter in the past. More than half of the designs wins in the quarter were with our new customers, indicating continued expansion of our global footprint. We secured a good number of design wins with our newly released DataFlash-L family for smart home applications as well as new wins in our strongholds of smart metering and advanced remote control platforms.

We had significant traction in the industrial market, with design wins in our traditional metering platforms globally, theater lightning systems in China, environmental data logging in North America and traffic management systems in Europe. These wins included not only DataFlash, which is our workhorse in the industrial vertical, but also our other product families as well.

This quarter, we also saw an uptick in design wins as well as sampling activity in the medical and connected health area. Secured design wins included sleep trackers in Europe, several remote patient monitoring wins in Europe and medical patches based in companies in Korea and North America. Our product families that had design wins or sampling in this space included DataFlash, Fusion, Mavriq and Moneta. Additionally, we had a design win with Emaptica on their award-winning Embrace smart watch, which has recently received FDA approval for a wearable device to manage epilepsy. The value DataFlash commands as an efficient data logger was highlighted by the customer as the deciding factor for selecting Adesto.

Let me now update you on one of our strategic initiatives, penetrating Tier 1 OEMs. As I have been stating on the past calls, we have been actively targeting several large Tier 1 OEMs with whom we either had no business at all or did very little transactions historically. Our strategy for these accounts has been to use our Standard Serial Flash family to secure design wins and become a certified supplier to these accounts, and then to build upon these relationships and engagements to explore opportunities for our high value-added product families. As I've been reporting over the last several quarters, we've been executing successfully on this strategy. In fact, we saw in the first quarter, some of the early design wins beginning to ramp into production. And more importantly, we managed to secure design wins with one large OEM on an opportunity with our Fusion family of devices. This validated our approach to these large OEMs, and we expect now to expand our engagements with them across all of our other product families.

Now let me update you on our new product families. We taped out next-generation Fusion device. This is the derivative of the successful Fusion family, and we call it Fusion HD because it covers higher-density opportunities for the Fusion family devices.

We also announced last quarter, a collaboration with STMicroelectronics for our EcoXiP under STM32L4 family of MCUs. ST becomes second MCU player alongside NXP to announce compatibility of their new MCU platforms with our EcoXiP high-performance execute and play solution.

In last earnings call, we also discussed that we had our qualification completed with MavriqCM, the Camera Module part, with our first targeted camera module maker. During the quarter, we started to sample MavriqCM to other module makers, and we expect to secure a design win for this product by mid-year.



MAY 09, 2018 / 9:00PM, IOTS - Q1 2018 Adesto Technologies Corp Earnings Call

In summary, we're entering the second quarter with strong momentum, continued ramp to production of past design wins and roll out of our new products. The solid foundation of growth will be further enhanced by the acquisition of S3 Semiconductors through increased opportunities for content and some expansion.

With that, I will now turn the call over to Ron Shelton to review the first quarter financial results and the second quarter guidance, and then I will discuss today's announced transaction in greater detail before opening the call to questions. Ron?

Ronald K. Shelton - *Adesto Technologies Corporation - CFO & Secretary*

Thanks, Narbeh. And thanks, everyone, for joining today. As Narbeh mentioned, we're pleased to report revenue in the first quarter of \$15.3 million. That's an increase of 35.3% from the \$11.3 million in the first quarter of 2017. And as expected, it was down 5.3% from \$16.2 million last quarter due to seasonality.

Gross margin in the first quarter was 46.9%, that's compared to 49.1% in the first quarter of '17 and 47.9% last quarter and remains in our targeted range. As Narbeh mentioned, we continue to use our Standard Serial Flash products to rapidly expand our presence with new and existing large OEM customers. We've been successful in our execution of that strategy and this has taken hold to allowing us the opportunity within those customers to sell more value-added products, such as Fusion and next-generation products like EcoXiP. As a result, we're now seeing increased revenue contributions and opportunities from these customers. Consistent with our previous comments, as revenue with these customers continues to grow, our overall product mix may fluctuate from one quarter to the next and that could lead to a fluctuation in gross margins for this business of 100 basis points to 200 basis points over the near term.

GAAP operating expenses in the first quarter were \$8.1 million, that's compared to \$8.1 million in the prior year quarter and \$7.7 million last quarter. On a non-GAAP basis, operating expenses in the first quarter were \$7.4 million, that's compared to \$7 million in the first quarter of 2017 and \$6.8 million last quarter.

Now looking at first quarter non-GAAP OpEx in little more detail. R&D expenses were \$3.4 million compared to \$3 million in the first quarter of 2017 and \$3.1 million in the prior quarter. We continue to focus our R&D resources on market opportunities that we believe can drive near-term revenue contribution while also positioning us for growth later in 2018 and into 2019, especially from new product families, such as EcoXiP and Mavriq CM.

Non-GAAP sales and marketing expenses were \$2.5 million, that's compared to \$2.2 million in first quarter of last year and \$2.3 million last quarter.

Non-GAAP G&A was \$1.6 million, that's compared to \$1.8 million in the prior year quarter and \$1.4 million last quarter. Stock-based comp in the first quarter was \$443,000, amortization of intangible assets was \$294,000 and depreciation and amortization was \$488,000. Accounting for these items, adjusted EBITDA for the first quarter of 2018 was approximately \$0.3 million as compared to a loss of \$1.1 million in the first quarter of 2017 and a positive \$1.4 million last quarter. This presents the fourth consecutive quarter of positive EBITDA.

GAAP net loss for the first quarter of 2018 was \$1.1 million or a loss \$0.05 per share, that's compared to a loss of \$2.8 million or \$0.18 per share in the first quarter of 2017 and a net loss of \$165,000 or \$0.01 per share in the prior quarter.

First quarter non-GAAP net loss was \$0.4 million or \$0.02 per share compared to a net loss of \$1.6 million or \$0.10 per share in the first quarter of 2017, and net income was \$0.8 million or \$0.03 per diluted share in the prior quarter. Share count used to compute first quarter GAAP and non-GAAP results was \$21.4 million.

In terms of the balance sheet, we ended the first quarter with \$29.5 million in cash, that's compared to \$30.1 million at the end of the prior quarter. As we indicated in our press release announcing the acquisition of S3 Semiconductors, we financed that transaction using a combination of existing cash and a new credit facility. The new credit facilities is in the amount of \$35 million. And as part of putting that in place, we paid off the \$12 million term loan from our prior facility.



MAY 09, 2018 / 9:00PM, IOTS - Q1 2018 Adesto Technologies Corp Earnings Call

Inventory at the end of the first quarter was \$7.6 million, that's up from \$5.8 million last quarter as we increased inventory levels in anticipation of higher levels of revenue. We expect that inventory levels will continue to rise going forward. As revenues increase, I expect that they will remain above our target of 4x turns.

Net accounts receivable was \$7.6 million, that's down from \$8.7 million last quarter, and our actual weighted average days outstanding is now less than 50 days.

Now I'll turn to guidance for the second quarter of 2018, and my guidance will include approximately a half-quarter of results from S3 Semiconductors' operations. With that, revenue is expected to range between \$18.1 million and \$19 million, and that would include approximately \$1.5 million to \$2 million of revenue from S3. Excluding S3semi, the midpoint of our guidance would reflect 25% year-over-year growth and record revenue.

Including results from S3semi, gross margin for the second quarter is expected to range between 46% and 48%. GAAP operating expenses are expected to range between \$9.1 million and \$9.7 million, and non-GAAP OpEx between \$8.2 million and \$8.8 million. Stock-based comp in the second quarter will be approximately \$600,000. Amortization of intangible assets will be approximately \$300,000, and depreciation and amortization will be approximately \$500,000. Weighted average shares outstanding are expected to be approximately \$21.5 million for the second quarter.

And one final note, today, we filed a shelf registration statement in the amount of \$40 million. As we've indicated in the past, while we do not believe we need additional capital to run our business, we are interested in being prepared to consider additional strategic initiatives as well as having increased financial flexibility. We don't have anything else to report on that currently, but will update you as required.

So with that, I'll turn it back over to Narbeh to talk about our acquisition in greater detail.

Narbeh Derhacobian - Adesto Technologies Corporation - Co-Founder, President, CEO & Director

Thanks, Ron. Now let me turn to the big news regarding the acquisition of S3 Semiconductors. First, we encourage you to read our safe harbor statement and refer you to associated documents filed with the SEC that also can be found on our website.

Diving right into the transaction. S3 Semiconductors based in Dublin, Ireland is a global supplier of mixed-signal and RF applications, specifically integrated circuits or ASICs and IP focused on the industrial IoT and communications market.

The acquisition is an all-cash transaction, valued at approximately \$35 million, with a \$15 million earnout based on certain performance metrics over a 2-year period. By adding high-margin revenue to our strong revenue base, we expect this deal to be immediately accretive to our gross margins and EBITDA and accretive to non-GAAP EPS within 12 months. We financed the transaction with existing cash and a new credit facility in the amount of \$35 million.

Concurrent with the close of the new credit facility, Adesto terminated its former credit facility with Western Alliance Bank, which included paying off an outstanding term loan with a principal amount owed of \$12 million.

In order to better understand the benefit and value that this transaction provides for Adesto, let me give you a brief overview of S3 Semiconductors' business.

The company has a legacy of designing and delivering custom integrated circuits to leading OEMs, operators and semiconductor companies since 1986. With core expertise in analog and mixed-signal and RF design, as well as IP cores, S3 Semiconductors create complex ASICs and has completed over 200 successful chip designs for a broad range of applications, including industrial IoT and satellite communications.

S3 Semiconductors has developed a proprietary ASIC development model with a very accomplished team of engineers, most of whom have advanced technical degrees. Even more notable, S3 Semi is one of only 7 Arm Approved design partners in the world. And the company's strong RF and analog mix signal libraries complement our combined development work. Going forward, almost all IoT and connected devices have some type of sensing, controlling and communications capabilities, and these were not building blocks that Adesto previously offered.



MAY 09, 2018 / 9:00PM, IOTS - Q1 2018 Adesto Technologies Corp Earnings Call

We also acquired critical core and better controller technology and expertise. This leads me to Slide 5 regarding the strategic rationale since there are a number of compelling points that support our decision to acquire the company. When we coupled S3 Semiconductors' mixed-signal ASIC design competencies, digital and extensive analog IP blocks with Adesto's proprietary nonvolatile memories, we have a complete solution for IoT edge device across a number of applications and market segments, aside from the peripheral sensors that complete the package. As such, the combined company can compete in more markets and more of the IoT bill of materials through significantly increasing IC content. The deal also allows us to cross-sell and leverage respective customer bases and target markets with minimal overlap. Taken together, this means higher revenue potential, higher margins and earnings due to the added value we bring to the equation for OEMs and ODMs. In short, this deal provides a step-function growth and earnings potential for Adesto.

Slide 6 highlights S3 Semiconductor's unique market position. Over the past few years, S3 Semi has built on its position as a respected provider of design services by also licensing a broad portfolio of analog and mixed-signal IP, and recently commencing a full turnkey ASIC model offering differentiated mixed-signal products to its OEM customers in industrial and communications market.

The industrial internet encompasses the broad transformation underway that will make pervasive sensing across connected machines not just a competitive advantage but an essential fundamental capability.

Industrial IoT starts with the edge nodes, which is where the physical world interacts with the computational data analytics. S3 Semi has developed a very unique position in this market by providing advanced level of intelligence, sensing and communications through highly differentiated ASIC solution that are required to actualize these IoT devices. Most of industries large design services and ASIC companies focus primarily on the high-volume opportunities between the consumer and mobile, and there are -- and these are areas where there is a high number of suppliers. But S3 Semiconductors' focus is on the underserved industrial IoT are of the market, and this has enabled them to command gross margins above 60%, retain very sticky customers and enjoy long product life cycle, attributes that very closely align to Adesto's market position as well. These are compelling strategic factors that were pivotal in our decision to pursue this deal.

Looking at these points further on Slide 7. We're looking at an IoT edge node. The requirements for semiconductor content are very unique for the systems that they're going into. These essential building blocks consist of a sensor that monitors something physical, analog and power management, a controller or processor, a communications module and, of course, memory to store code and data and to give the node intelligence. As you all know, Adesto specialized exclusively in providing the application-specific memory portion of that content equation. Now with S3 Semiconductors, we're able to greatly expand our content, result in a 10x expansion of our bill-of-material opportunity. We and others have spoken in the past about unprecedented volume of the connected node in IoT network. It's estimated there will be 20 billion connected nodes by 2020 that connects everything in our lives from homes, cars, factories and machines. The applications and opportunities intersect across many end markets. We believe this expands Adesto's SAM from approximately \$1 billion opportunity to over \$10 billion opportunity as a result of the additional BOM and content opportunity we can pursue across these IoT markets and verticals, and we're very excited about the expanded growth opportunities this bring to the company.

Turning to Slide 8. There is also extensive reach across each of company's customer bases and potential cross-selling synergies to further drive growth. We'll not only be able to offer S3 Semiconductors' comprehensive ASIC development model to our customers but also increase the opportunity pipeline for S3semi's organic business with Adesto as a supplier. We will also be able to target expanded opportunities in China and Japan where Adesto has a strong market position in the industrial space with our memory technologies.

Overall, this results in a broader product portfolio that we are able to sell across respective sales channels with an integrated marketing approach.

Slide 9 shows what we think represents the powerful combination of our 2 companies. Although we target similar end markets today, we do so with very different products, technologies and technical competencies. But as a result of this combination, we will be able to not only have deeper penetration within each of our target markets but also broader reach as a result of the expanded content and offerings. Additionally, the combined companies will have increased scale with over 180 employees and over 100 engineers as well as a global presence in U.S., Europe and Asia.

With that, now I'd like to talk a little bit about the financial model. In Slide 10 -- in addition to the strategic rationales highlighted by me earlier on the business and product side, there are also key financial benefits of this acquisition as we discussed earlier.



MAY 09, 2018 / 9:00PM, IOTS - Q1 2018 Adesto Technologies Corp Earnings Call

On Slide 10, if we look at the combined 2017 financials on a pro forma basis, revenue would have been \$69 million, with gross margins of 51% and adjusted EBITDA of \$3.3 million, highlighting the potential uplift we expect to see in our financials, and have also included a longer-term model here that outlines the increased ranges we believe we can attain in our operating metrics once S3 Semiconductors has become fully integrated and realizing the benefits from the synergies and cross-selling opportunities. This financial potential is compelling and further reflects why we are excited about this deal.

In conclusion, Slide 11 sums up why we believe this transaction is transformative for Adesto, creating a leading provider of innovative application-specific semiconductor solutions for the IoT era. This transaction not only expands our revenue, gross margin as well as our server addressable markets through increased silicon content, but also strengthens our leadership and differentiation across multiple verticals of the vast IoT markets.

With that, I'd like to open the call to questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Suji Desilva of Roth Capital.

Sujeva Desilva - Roth Capital Partners, LLC, Research Division - Senior Research Analyst

Congratulations on the transaction as well as the continued strong core business performance. Can you give us a sense, Narbeh and Ron, on the S3 revenue model, the mix of chip sales or licensing or services, just so I understand? And it was helpful to get the '17 revenue bump of \$13 million, what kind of growth rate could we expect for S3's revenues longer term?

Ronald K. Shelton - Adesto Technologies Corporation - CFO & Secretary

Yes, it's Ron. So the way to think about S3 right now is they're making this migration towards becoming more of a chip company, a product company, right? And I think putting us and them together, we think we can accelerate that path. So when you look back over the last year, it's been mostly ASIC development and IP and services. So what we'll see going forward is you'll see a greater and greater percentage of their revenue coming from product sales, and that's how we're going to transition that business. I think historically, we're -- I think it's a little too early to start breaking out IP sales versus NRE activity and so on. I think the way to think about it is, this quarter, we guided \$1.5 million to \$2 million. It's about half a quarter of business of activity right now. We expect it to grow off of that. And I think earlier in the commentary, Narbeh, we indicated that it'd be -- help accelerate revenue growth. So it should grow faster than our overall kind of the previous business. But again, I think it's -- we'll stick to the guide right now. But we think going out into the future as we bring in product sales, that can grow at a significantly higher rate than what Adesto has done historically.

Sujeva Desilva - Roth Capital Partners, LLC, Research Division - Senior Research Analyst

Okay. No, that's helpful color, and we'll watch how S3 fries out here. Narbeh, can you talk about the customer feedback that got you kind of motivated to expand the portfolio? Were there things that they thought you could bring by having these 2 assets under one roof? Any commentary there would be of help.



MAY 09, 2018 / 9:00PM, IOTS - Q1 2018 Adesto Technologies Corp Earnings Call

Narbeh Derhacobian - *Adesto Technologies Corporation - Co-Founder, President, CEO & Director*

Yes, so a couple of things. One is, in discussing with S3semi management, we understood that -- of course, we did our diligence, understood the quality and the competency that the company historically has had and the traction they've been getting. One of the -- as they started to grow, one of the challenges they had was as they started to grow into a full time ASIC chip supplier is that they didn't have a history of supplying products. They were great IP and design services company. So some -- as we all know, some, specialty industrial customers who are extremely sensitive about continuity of supply, reliability of supply from a product perspective, would be a little hesitant in terms of signing up a new supplier as we've indicated in the past in our efforts trying to go into Tier 1 OEMs. Well, in the industrial space, which is half of our business, we have a very good reputation of being a solid supplier. So we believe that in -- when we look at the mix of the target customers that they were trying to target to grow their business, we saw a lot of overlaps of our existing current customers. And that's a fantastic news to our sales guys because now we can go back to, again in a targeted way, to a handful of industrial customers and offer them more than memory, basically, offer them the big value of the semiconductor content of the modules they're building with S3 under us, and we as a certified supplier. The other part that I'd like to highlight is, I'm sure the question will come up, when we did our diligence in discussing with current S3 customers, the overwhelming theme that came from, again, from some very large satellite communications company, who build very high-value sort of product, the #1 theme that came across as S3's competencies, their technical expertise, the quality of the work and the timeliness and quality of the deliverables that they've done in the past. So they have a unmatched reputation within the customers that they've been dealing with, and it's also -- you can see that from repeated business that they get historically from previous customers.

So all the diligence turned out extremely well. And also internally, when we start to look at the opportunities for growth, we saw immediate areas of -- that we would have to -- we believe that we can focus on to expand the business.

Sujeva Desilva - *Roth Capital Partners, LLC, Research Division - Senior Research Analyst*

Okay. And then two last questions on the core business. First, Ron, on the balance sheet, a new category showed up, price adjustment and other revenue reserve, can you explain what that is?

Ronald K. Shelton - *Adesto Technologies Corporation - CFO & Secretary*

Yes, I'll attribute that one to the accountants. So I think on the transition -- the revenue recognition transition to SE 606, I think there's -- this relates to how we account for inventory and distribution, and it's basically a reserve for ship and debit reserves. Historically, we admitted that against AR. But with the change in accounting rules, you have to grow through that. So you see AR is higher than last quarter, and you see this category show up. I think, fundamentally, nothing's changed in terms of distribution or distribution accounting, cash flow, none of that's changed. It's just an accounting journal entry effectively.

Sujeva Desilva - *Roth Capital Partners, LLC, Research Division - Senior Research Analyst*

Okay. And then last question and I'll go away. The Tier 1 Bluetooth opportunity here, congratulation on that. Can you talk about the end application to the extent that you can, and the volume potential there?

Narbeh Derhacobian - *Adesto Technologies Corporation - Co-Founder, President, CEO & Director*

You mean for the Fusion?

Ronald K. Shelton - *Adesto Technologies Corporation - CFO & Secretary*

Correct. Fusion, I believe.

MAY 09, 2018 / 9:00PM, IOTS - Q1 2018 Adesto Technologies Corp Earnings Call

Narbeh Derhacobian - *Adesto Technologies Corporation - Co-Founder, President, CEO & Director*

Yes, I don't think I mentioned it's Bluetooth, but it's -- historically, yes, Fusion was used for Bluetooth. But -- yes, so this is a peripheral device for just broad consumer application, and it's a very large Tier 1 OEM.

Operator

Our next question comes from Gus Richard of Northland.

Auguste Philip Richard - *Northland Capital Markets, Research Division - MD & Senior Research Analyst*

Just quickly, in the quarter, the gross margins were down sequentially. Is that mix? Or volume? Or both?

Ronald K. Shelton - *Adesto Technologies Corporation - CFO & Secretary*

Yes, it's primarily mix. I think what we've talked about over the last 2 to 4 quarters is to accelerate our entry into some Tier 1 strategic set historically who haven't been customers, we've been using Serial Flash -- Standard Serial Flash products as the quickest point of entry. We've been successful in that. And depending on any 1 quarter, the mix of that might be higher than it otherwise would be. And so that -- those are generally lower margin products. So that's what we saw. But once we're in, and we're in those customers, and Narbeh touched on Fusion, I mean, I think there are many, many cross-selling opportunities for higher-margin products. So that had -- again, that's like -- I put some color around my commentary on gross margins that they can move 100 to 200 basis points, and it's for that reason exactly.

Auguste Philip Richard - *Northland Capital Markets, Research Division - MD & Senior Research Analyst*

Got it. Very helpful. And then in terms of the increase in OpEx, I'm assuming, with the acquisition of S3, it's primarily going to be in the SG&A line. Could you just walk through how that's going to modify the OpEx?

Ronald K. Shelton - *Adesto Technologies Corporation - CFO & Secretary*

Actually, it'll probably be more in the R&D line. So if you look at S3 historically, they've -- majority of the employees will be in R&D. So you're going to see most of that -- or I shouldn't say most, but a large piece of that to show up in the R&D line.

Auguste Philip Richard - *Northland Capital Markets, Research Division - MD & Senior Research Analyst*

Right. And then in terms of the serial flash market and just more flash in general, what are you seeing in pricing trends and sort of up-and-down densities? Are you seeing any trends one way or another?

Narbeh Derhacobian - *Adesto Technologies Corporation - Co-Founder, President, CEO & Director*

Yes, so again, where we get sensitivity to serial flash pricing is typically with our Standard Serial Flash part. Last year, about this time, we saw serial flash prices move up, actually, at the densities that we compete, which is typically less than 64 meg. And we -- entering the year, we saw that the pricing pressure upward started to relieve itself. So it's a little bit more stable pricing and on spot. Depending on the densities, you start to see prices coming back to their normal trends. Historically, those densities that we compete with on the commodities stuff, the year-over-year price degradation is not much because these, again, are fully depreciated products that were probably introduced more than a dozen years ago. So the



MAY 09, 2018 / 9:00PM, IOTS - Q1 2018 Adesto Technologies Corp Earnings Call

price reduction year-over-year is around 4%, 5%. And historically, that's been that. So I think we probably will see in the second half that, that trend will return to its normal behavior. We had a trend going up in pricing last year about this time.

But on our proprietary product, we are -- again, we do not compete on them because we're typically single-sourced for this product. Where we do -- where -- if the prices do move significantly in one direction or another, and it has to be significant, we will see that impacting the opportunities that we're able to secure with designers because that's where we compete with commodity early on before the customer's designing their system.

Auguste Philip Richard - *Northland Capital Markets, Research Division - MD & Senior Research Analyst*

Got it. And then last one for me. Design wins in the the quarter, I didn't catch the number.

Narbeh Derhacobian - *Adesto Technologies Corporation - Co-Founder, President, CEO & Director*

Guidance for the next quarter?

Auguste Philip Richard - *Northland Capital Markets, Research Division - MD & Senior Research Analyst*

No, no, no, design wins.

Ronald K. Shelton - *Adesto Technologies Corporation - CFO & Secretary*

Design wins?

Auguste Philip Richard - *Northland Capital Markets, Research Division - MD & Senior Research Analyst*

Yes.

Ronald K. Shelton - *Adesto Technologies Corporation - CFO & Secretary*

Okay.

Narbeh Derhacobian - *Adesto Technologies Corporation - Co-Founder, President, CEO & Director*

For the previous quarter or next quarter?

Ronald K. Shelton - *Adesto Technologies Corporation - CFO & Secretary*

Q1 design wins.

Narbeh Derhacobian - *Adesto Technologies Corporation - Co-Founder, President, CEO & Director*

Yes, we didn't give number. We simply said it's a ---- we had our record highest number of design wins. So I think, historically, if we go with what we had spoken, we had over 120 design wins. So we're over that. So...



MAY 09, 2018 / 9:00PM, IOTS - Q1 2018 Adesto Technologies Corp Earnings Call

Operator

(Operator Instructions) Our next question comes from Aman Gulani of B. Riley.

Aman Raj Gulani - *B. Riley FBR, Inc., Research Division - Associate Analyst*

Congratulations on a solid quarter and the transaction. So with the acquisition of S3, now that you've sort got that under your belt, do you plan to seek out additional acquisitions? And if so, like what sort of areas are you looking at if you are interested in making further acquisitions?

Ronald K. Shelton - *Adesto Technologies Corporation - CFO & Secretary*

It's Ron. I think -- again, it's -- this one literally just closed about 7 hours ago so it's probably too early to talk about more. But I think, again, what we've been talking about over the last 6 to 12 months is part of the broader strategy here is to look for opportunities outside the kind of what's formerly our core business, and we'll continue to do that. I couldn't point you in any one direction. I think if you look at the themes around this acquisition, IoT, industrial IoT, nodes, kind of expanding BoMs, bringing in technologies that we didn't have previously, that would give you some form of indication as to where we would look. But I would just say, look, we did the one. We're really excited about it. And again, this is part of our broader strategy, so we'll continue to be active in that area.

Aman Raj Gulani - *B. Riley FBR, Inc., Research Division - Associate Analyst*

Got it. Yes, and I did notice that Teledyne came out with a press release last month for the availability of the Mavriq. Can we expect that to be a meaningful part of revenue in 2018? Or is this still sort of too early to tell?

Narbeh Derhacobian - *Adesto Technologies Corporation - Co-Founder, President, CEO & Director*

Yes, so let me comment on that. So one of the features of our resistive RAM, our CBRAM product families is that it has a very good, strong tolerance for radiation hardening. So it's good for operating in environments that are quite harsh. And that could be in federal or it could also be in medical areas. We're actually seeing now, as I indicated in my remarks, the largest number of sampling with medical companies for medical devices using that family that I've ever experienced in the last 10 years. And in this case with Teledyne was we worked with a company that was acquired by Teledyne called e2v. And they basically built module using the Mavriq, and those are the modules which are available that announcement was done. And the volumes in that sector is very low compared to what we are used to. But obviously, the gross margins are extremely above our target. So we expect business, obviously. But again, it's -- I think comparing to some of the other end market that we serve, the overall units are not going to be as comparable to those, but gross margins will be very nice.

Operator

Our next question comes from Harsh Kumar of Piper Jaffray.

Harsh V. Kumar - *Piper Jaffray Companies, Research Division - MD & Senior Research Analyst*

Congratulation, nice results. Congratulation on the deal as well. Narbeh and Ron, did you guys say what area -- I think you were leaning towards industrial applications for your Tier 1 customer, but did you say what specific end market it would be in? And then I've got a couple -- one or two more follow-ups.

Narbeh Derhacobian - *Adesto Technologies Corporation - Co-Founder, President, CEO & Director*

Yes, you're talking about the business -- S3's end markets?



MAY 09, 2018 / 9:00PM, IOTS - Q1 2018 Adesto Technologies Corp Earnings Call

Harsh V. Kumar - *Piper Jaffray Companies, Research Division - MD & Senior Research Analyst*

No, no, I'm talking about your Tier 1 win. The big win that you have.

Narbeh Derhacobian - *Adesto Technologies Corporation - Co-Founder, President, CEO & Director*

The Teir 1 OEMs that we talked about.

Harsh V. Kumar - *Piper Jaffray Companies, Research Division - MD & Senior Research Analyst*

Yes.

Narbeh Derhacobian - *Adesto Technologies Corporation - Co-Founder, President, CEO & Director*

No, so the Teir 1 OEMs that we've -- historically we've been talking about, they are primarily in consumer computing market. And these are half a dozen companies that are household names that's indicated in the past that we either had very little business with or we had almost no business in. So for us to go in as a certified supplier, our strategy was to go in with our Standard Serial Flash because it's an easy proving ground to be able to become on their certified supplier list. And then after that, we get dragged into more value-added engineering solutions they did across the platform. So the companies that I referred to broadly at Q1, they have multiple product lines and they're usually in consumer and computing end markets.

Harsh V. Kumar - *Piper Jaffray Companies, Research Division - MD & Senior Research Analyst*

Okay. And strategically, analog is a little bit different than what you guys do. All of your memory has a lot of proprietary aspects. What do you think would be the biggest things you would need to do to make this acquisition highly successful?

Narbeh Derhacobian - *Adesto Technologies Corporation - Co-Founder, President, CEO & Director*

Yes, so it's interesting because, again, like you indicated, if -- there are 2 ways to cut this, right? One is, internally, you look at the company, our company, and say, well, how do you engage customers? How is your customer concentration? Where do you serve to? And if you compare that to any analog company, the -- you'll see a lot of similarities between what we do. We don't have customer concentrations. We're -- half of our business is in industrial space, and we are very much design win-oriented sell into these things. So now if you look at -- internally, again, you look at the engineering expertise within the company, we are today heavily memory-oriented. That's what S3 has, right? S3 brings in the analog and mixed-signal internal expertise to cover that. But once you put that together, then you look at the -- our ecosystem, our -- the customers we sell into. How we selling into, how we engage with the customers? It's no different than any large analog mixed-signal company today.

Harsh V. Kumar - *Piper Jaffray Companies, Research Division - MD & Senior Research Analyst*

Narbeh, as a follow-up, if I can ask, if there are any cost-saving opportunities that you guys envision. And then also the \$15 million earn-out, I want to understand, is that on top of the price paid? Or is that the total you will pay?



MAY 09, 2018 / 9:00PM, IOTS - Q1 2018 Adesto Technologies Corp Earnings Call

Ronald K. Shelton - *Adesto Technologies Corporation - CFO & Secretary*

This is Ron. So a couple of things on the transaction. It was \$35 million cash now, and then it's \$15 million and the earn-out on top of that. And that earn-out is tied to activities and performance requirements that we think will lead to accelerating growth in the business and expanding the business. So those metrics and those milestones are over -- go through the end of 2019.

So that was the first question. And in terms of cost savings, I think right now, it's not that. I think it's a business you want to invest in. So any synergies there would be in the context of cost synergies, in the context of supplier where I'm doing more volume with them or activity like that. But it will absolutely not have anything to do with people or headcount.

Operator

And I'm showing no further questions at this time. I'd like to turn the call back to Narbeh Derhacobian for closing remarks.

Narbeh Derhacobian - *Adesto Technologies Corporation - Co-Founder, President, CEO & Director*

Thank you for your participation on today's call. Before closing today's call, I want to mention that we'll be attending the B. Riley conference in Santa Monica on May 23 and also the Cowen conference in New York City on May 30. We will also be hosting NDR roadshows during the quarter. So please contact Ron Shelton or the Shelton Group if you'd like to meet with us at any of these events. Thank you, again, for joining us on today's call, and we look forward to providing further updates next quarter.

Operator

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

DISCLAIMER

Thomson Reuters reserves the right to make changes to documents, content, or other information on this web site without obligation to notify any person of such changes.

In the conference calls upon which Event Transcripts are based, companies may make projections or other forward-looking statements regarding a variety of items. Such forward-looking statements are based upon current expectations and involve risks and uncertainties. Actual results may differ materially from those stated in any forward-looking statement based on a number of important factors and risks, which are more specifically identified in the companies' most recent SEC filings. Although the companies may indicate and believe that the assumptions underlying the forward-looking statements are reasonable, any of the assumptions could prove inaccurate or incorrect and, therefore, there can be no assurance that the results contemplated in the forward-looking statements will be realized.

THE INFORMATION CONTAINED IN EVENT TRANSCRIPTS IS A TEXTUAL REPRESENTATION OF THE APPLICABLE COMPANY'S CONFERENCE CALL AND WHILE EFFORTS ARE MADE TO PROVIDE AN ACCURATE TRANSCRIPTION, THERE MAY BE MATERIAL ERRORS, OMISSIONS, OR INACCURACIES IN THE REPORTING OF THE SUBSTANCE OF THE CONFERENCE CALLS. IN NO WAY DOES THOMSON REUTERS OR THE APPLICABLE COMPANY ASSUME ANY RESPONSIBILITY FOR ANY INVESTMENT OR OTHER DECISIONS MADE BASED UPON THE INFORMATION PROVIDED ON THIS WEB SITE OR IN ANY EVENT TRANSCRIPT. USERS ARE ADVISED TO REVIEW THE APPLICABLE COMPANY'S CONFERENCE CALL ITSELF AND THE APPLICABLE COMPANY'S SEC FILINGS BEFORE MAKING ANY INVESTMENT OR OTHER DECISIONS.

©2018, Thomson Reuters. All Rights Reserved.