BSQUARE Corporation

Fourth Quarter 2022 Conference Call

March 7, 2023

Ralph C Derrickson, Bsquare President and Chief Executive Officer

Thank you. Good afternoon investors and welcome to the Q4 2022 Bsquare quarterly earnings call. Joining me today for the first time is Cheryl Wynne, Bsquare's Chief Financial Officer. Though this is the first time you will actually hear from Cheryl, you have heard her words as she has played a significant role in drafting our prepared remarks in prior periods. Cheryl joined us as our Sr Director of Finance and Controller in November of 2020. Since joining Cheryl has significantly improved our accounting systems as well as our internal reporting and analysis. Chris' departure and her transition to this new role has been natural and without any issues. I look forward to working closely with Cheryl as we strive for breakeven operations in 2023. Cheryl and I appreciate your interest in Bsquare and thank you for taking the time to be with us this afternoon.

Before we go any further, we'd like to remind you that this call is being webcast and that a recording of the call, and the text of our prepared remarks, will be available on the Bsquare website. During today's call, we will be making forward-looking statements. These statements are based on current expectations and assumptions that are subject to risks and uncertainties that could cause actual results to differ materially. In our commentary, we may also refer to GAAP and non-GAAP financial measures. Please refer to the cautionary text regarding forward-looking statements contained in Bsquare's earnings release issued today and on our website at www.bsquare.com under "Investors". All per share amounts discussed today are fully diluted numbers where applicable.

We will be taking questions after our prepared remarks. For anyone who would like to arrange a follow up conversation with us, please send an email to investorrelations@bsquare.com. This mailbox is monitored regularly, and you will get a response within 1 business day.

Okay with that out of the way let's get started.

Q4 was really a mixed bag. Partner Solutions revenue was down and SquareOne revenue did not materialize as we had hoped. On the plus side, higher than expected margins and interest income from our investments helped to reduce our net loss. But those were offset by the one-time restructuring charges associated with the workforce reduction we implemented in December of 2022. The 20% workforce reduction in December, while difficult was an important part of our preparation to achieve breakeven operations in 2023. I will talk more about our plans for 2023 after Cheryl takes us through the fourth quarter results.

Cheryl, over to you.

Cheryl Wynne, Bsquare Chief Financial Officer

Thank you, Ralph, and good afternoon investors. Today I'll be providing an overview of our financial results for the fourth quarter of 2022. Most of my comparisons will be to the third quarter; I'll let you know when I'm comparing to other periods. I'll start with a review of our income statement and then move to a discussion of our balance sheet.

Total revenue for the fourth quarter was approximately $8.0 million which was a decrease of $500,000 or 5% from the third quarter. The Partner Solutions segment drove the decrease as revenue from the Edge to Cloud segment was up slightly quarter-over-quarter.

Despite the revenue decrease, total gross profit was up $100,000 as compared to the previous quarter, driven by gross margin rate improvement in both segments.

Let’s take a look at our revenue and gross profit results at a segment level, starting first with Partner Solutions.

Partner Solutions revenue decreased $500,000 or 6% quarter over quarter. Continued supply chain disruptions and other macroeconomic factors affected the ordering patterns of this segment’s customers. In spite of the revenue decrease, gross profit dollars in this segment increased just over $60,000 driven by a 180 basis point improvement in gross margin rate. This rate improvement was primarily due to higher quarter-over-quarter recognition of rebates stemming from Microsoft’s distributor incentive program. A portion of these rebates are recorded as a reduction of cost of goods sold and, accordingly, impact our gross margin rate in the Partner Solutions segment.

In the Edge to Cloud segment, revenue was up very slightly - $29,000 or 3%. This increase was driven by the timing of feature completion for one of our key customers. Cost of revenue in this segment is relatively fixed and, accordingly, was essentially flat quarter-over-quarter. Thus, the increase in revenue drove an increase in gross profit dollars.

Turning our attention now to expenses –

As we've noted before, our cost structure is stable and well-managed. Nevertheless, there is some seasonality to our expenses which causes fluctuations quarter to quarter. We saw this in our fourth quarter selling, general and administrative - or SG&A – expenses, which were $250,000 higher than the third quarter. A portion of the increase was due to professional fees related to Q4 activities, specifically the once-a-year expenses that we incur related to our annual shareholder meeting. The rest of SG&A increase was driven by marketing spend primarily related to an overhaul and upgrade of our website. We knew this was a critical investment to make and are pleased with the changes.

Research and development expenses, which consist primarily of labor and benefits, were flat quarter-over-quarter.

As Ralph noted earlier, during the fourth quarter we executed a reduction in force as part of broader efforts to align our cost base with our 2023 strategic priorities, which include breakeven operations. We reduced our headcount by nearly 20%, and recorded expenses of $200,000 related to the one-time termination benefits provided to impacted employees. These restructuring charges are presented as a separate line-item within Operating Expenses on our income statement.

As you may recall, during the third quarter we implemented an investment strategy intended to take advantage of rising interest rates while maintaining a focus on liquidity. Our Q4 results include $300,000 of interest income, reflecting a full quarter of strategy execution. We intend to continue investing our cash reserves for the foreseeable future, until there is an alternative use of the reserves that will produce a higher return. We are utilizing a laddered investment strategy, staggering maturity dates so that portions of our portfolio mature are regular intervals. This strategy ensures that our liquidity is readily accessible and available to fund strategic growth investments.

Overall, loss from operations for the quarter was $1.5 million compared to the third quarter loss from operations of $1.2 million. About half of this deterioration was driven by the one-time restructuring charges and the other half was driven by the increased SG&A expenses.

Net loss for the quarter was $1.2 million, or $0.06 per diluted share, compared to a net loss of $1.1 million, or $0.05 per diluted share, in the third quarter of 2022. The quarter-over-quarter decline was driven by loss from operations, partially offset by an improvement in interest income.

Turning now to the balance sheet -

In total, cash, cash equivalents, restricted cash and short-term investments totaled $35.6 million at year-end. This reflects a net cash use of $4.5 million during 2022, which was primarily driven by the loss from operations. A small portion of our cash use, however, did relate to the share repurchase program that we announced in November. As a reminder, we announced a plan to repurchase up to $5 million worth of our common stock. The plan is intended to return value to our shareholders without compromising our ability to pursue organic growth or strategic alternatives. During the fourth quarter, we repurchased nearly 180,000 shares for approximately $200,000.

Despite the cash decrease during 2022, we continue to have a strong financial position with healthy reserves, current receivables, and no debt.

I'll turn it back to Ralph now for more color on our operations and plans for 2023.

Ralph C. Derrickson, Bsquare President & Chief Executive Officer

Thank you Cheryl.

The decline in Partner Solutions revenue was a continuation of what we have experienced since the onset of the COVID pandemic. While we continue to add new customers with new product designs, the reality is new customers are generally buying lower priced licenses, and their order activity typically starts small and increases over time. In 2022 the wins simply didn't grow fast enough to make up for the decay of revenue from existing customers whose product lines were reaching the end of life or were disrupted by supply chain issues. Total revenue from our top 20 customers didn't change much between 2021 and 2022. Where we saw the decay was in the middle of our book of business.

At the same time the SquareOne launch didn't go as we hoped. Our 2022 plan assumed we would acquire "some" customers with existing fleets of devices that would ramp revenue in the second half of the year and that didn't happen. We encountered two problems: potential customers had a solution that was, in their words, "good enough" or that SquareOne didn't provide a specific feature they required. Where we did find opportunity was with new Partner Solutions customers, but again they are early in their life cycle and the per-device revenue potential is low initially.

For 2023 we knew we had to make some changes. We knew it would be unwise to assume revenue growth so we did our planning based on flat Partner Solutions revenue, predictable revenue from our Edge-to-Cloud customers, and a very small amount of revenue from SquareOne or related projects. With those assumptions we knew we would need to reduce expenses so in early December we implemented a reduction in the team. The timing wasn't ideal, but we didn't like the idea of not telling our team what was happening and in hindsight I'm glad we did it ahead of the onslaught of tech industry layoffs that occurred in January and February.

For 2023 we established 3 initiatives that drove our planning and budgeting:

Our first initiative is to achieve breakeven operations. The first step towards this was the reduction I discussed earlier. We also eliminated in our 2023 budget any spending that wasn't generating revenue or wasn't vital to our other initiatives.

Achieving breakeven operations also requires us maximize the existing business assets for reinvestment in revenue growth, which is our second 2023 initiative. To do this we are changing how we're going to market and managing our business assets.

In Partner Solutions we will emphasize our reputation as the premium provider of technical support and business services. In an effort to improve our ability to attract new customers we have simplified and re-packaged our OS consulting services creating a "starter" bundle of services for customers with new product designs. Early experience with this approach has been positive. We believe the re-packaging has the potential to increase the initial value of a new customer and improve our ability to up-sell our OS consulting services. It also gives us visibility into the nature of their business model and the potential opportunity for SquareOne our device operations and management solution. If their business model is to simply sell devices to their customers, SquareOne isn't likely relevant. If their business model is to charge their customers a monthly fee for the service provided by their device – some form of digital transformation – then SquareOne could be highly relevant. I will say more about SquareOne in a moment but I want to call out the importance of being able to understand how and if companies are evolving their businesses model to a recurring revenue model. It would be easy to assume that the Partner Solutions segment is just a low-margin, commodity business and for a portion of it that is true. But for the portion that is evolving their business model it has the potential to provide valuable information that could inform our product and strategic decisions.

Maximizing business in the Edge-to-Cloud segment means continuing to provide great service while we look for opportunities to expand our relationships with those customers, and when possible replicating the success we've had using SquareOne as a solution accelerant.

For SquareOne maximizing the business means dialing back heavy investment in general marketing and, instead, working closely with our customers and technology partners to understand where there is opportunity and where development is needed. We are modularizing the SquareOne design making it easier to configure in new capabilities that support customer requirements and selling partner components. In 2022 we positioned SquareOne as a "complete solution"; in 2023 we are positioning it as a solution accelerant that can be valuable to customers and other players in the IoT eco-system. We see potential selling partnerships with our customers and other technology players especially in building and facility management, healthcare, point-of-sale, and energy. We believe this approach has the potential for generating revenue – albeit at a much slower pace than we assumed in 2022, and it can provide valuable input to our third initiative.

Our last initiative is to identify and pursue strategic opportunities with the potential for high-growth revenue and margin. This effort will be informed by the first two initiatives as well as other efforts to find strategic opportunities.

So to summarize we are entering 2023 with an operating plan and cost structure that aligns with reality. We will seek every avenue for organic revenue growth within our means, but we will only invest in repeatable success. We are running and will continue to run the business as efficiently as possible while we will aggressively consider a range of strategic options. We believe our understanding of our business assets, our operating discipline, and our cash reserves provide a strong foundation for building value for our shareholders in 2023 and beyond.

Before we close-out the call I want to remind shareholders that we are planning to put forth a plan to declassify the board of directors in a phased manner over 3 years ultimately resulting in one-year terms for all directors. We intend to present this plan at the Annual Shareholder meeting that will take place in June of this year, which is back on our historical cadence. Declassification of the board will bring us in line with governance best practices and reflects the input of several of our shareholders.

Okay with that, Operator please open the line for questions. Because we don't often get many questions on our calls I will remind you that if you would like to arrange a follow up conversation, please send an email to investorrelations@bsquare.com. Operator please open the line.

Thank you and thank you investors. I really appreciate the question today and thank you for taking the time to participate in our call. We appreciate your interest in Bsquare.