
These prepared remarks should be viewed in conjunction with the related quarter's conference call webcast, earnings press release, and periodic filings with the United States Securities and Exchange Commission (SEC), including Form 10-Q Quarterly Report and Form 10-K Annual Report. The webcast includes the prepared remarks as well as a question and answer session, if applicable. The earnings press release provides summary financial statements and commentary regarding the financial highlights for the periods presented. The Form 10-K Annual Report is the annual financial report that we file with the SEC and the Form 10-Q Quarterly Report is the quarterly financial report we file with the SEC.

The prepared remarks below include "forward-looking statements" within the meaning of the safe-harbor provisions of the U.S. Private Securities Litigation Reform Act of 1995. Forward-looking statements can be identified by words such as: "expect," "believe," "plan," "strategy," "future," "may," "should," "will," and similar references to future periods. Examples of forward-looking statements include, among others: statements we make regarding expected operating results in future periods, such as anticipated revenue, gross margins, profitability, cash and investments; and strategies for customer retention, growth, new product and service developments, and market position. Forward-looking statements are neither historical facts nor assurances about future performance. Instead, they are based on current beliefs, expectations and assumptions about the future of our business and other future conditions. Because forward-looking statements relate to the future, they are subject to inherent uncertainties, risks, and changes in circumstances that are difficult to predict and many of which are outside of our control. Our actual results and financial condition may differ materially from those indicated in the forward-looking statements. Therefore, you should not rely on any of these forward-looking statements.

Important factors that could cause our actual results and financial condition to differ materially from those indicated in the forward-looking statements include, among others: our ability to execute our development initiatives and sales and marketing strategies around DataV™, the Internet of Things, and our product and service offerings more generally; the extent to which we are

successful in gaining new long-term customers and retaining existing ones; our success in leveraging strategic partnering initiatives with companies such as Microsoft and Amazon Web Services; whether we are able to maintain our favorable relationship with Microsoft as a systems integrator and distributor; and such other risk factors as discussed in our Annual Report on Form 10-K and other filings with the SEC. Any forward-looking statement made by us in this release is based only on information currently available to us and speaks only as of the date on which it is made. Except as may be required by law, we undertake no obligation to publicly update any forward-looking statement, whether written or oral, that may be made from time to time, whether as a result of new information, future developments or otherwise.

BSQUARE Corporation

First Quarter 2018 Conference Call

May 15, 2018

Leslie Phillips, Investor Relations

Thank you and good afternoon everyone. Before we begin, 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 Bsquare's website. During this 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. Please refer to the cautionary text regarding forward-looking statements contained in Bsquare's earnings release issued today and in the posted version of these prepared remarks, both of which apply to the content of this call. All per share amounts discussed today are fully diluted numbers where applicable.

Now, I'd like to turn the call over to Andrew Harries, Bsquare Executive Chairman.

Andrew Harries, Bsquare Executive Chairman

Thank you, Leslie and good afternoon, everyone. As most of you know, I've been the chairman of Bsquare's board of directors for the last five years. As a board we have been, and continue to be, fully committed to building sustainable shareholder value.

Several years ago we decided to pursue the emerging industrial internet of things market with a proprietary software product, DataV. We continue to believe that the Industrial IoT market is going to be very large, in fact Gartner projects 2.7 billion business and industrial IoT endpoints by the year 2021, roughly 500 million of which are in industries we directly address. We also continue to believe that with DataV, Bsquare has the potential to become a significant player in this market. However, it has been well documented that the rate of adoption across the industry has been slower than many anticipated, and we have been similarly impacted.

Thus far, progress in our DataV business has not met our expectations in terms of the rate of conversions and broader customer adoption. That is why the board, in conjunction with our CEO Jerry Chase, agreed that it was the right time to change leadership. As we announced last week, Jerry has stepped down and I have stepped up my level of involvement with the company to Executive Chairman. Kevin Walsh, our head of marketing and product management, has assumed the role of acting CEO. I would like to thank Jerry for his role in leading

the development of our new strategy and welcome Kevin into his new position. We have a great deal of confidence in Kevin and the leadership team and their ability to refine the company's strategy and meet our goal of scaling DataV. With that, I will turn it over to Kevin to review our first quarter 2018 results.

Kevin Walsh, Bsquare Acting CEO

Thank you, Andrew. I'd like to start out today by providing a brief overview of our first quarter 2018 activities, and then I'll discuss our refocused strategy for DataV as well as our priorities for the remainder of the year.

In the fourth quarter of last year we announced a major DataV subscription renewal with Itron, a global provider of smart energy distribution systems. Itron has integrated DataV into their OpenWay Riva system to provide a software distribution layer that allows utilities to dynamically and securely download apps to targeted populations of smart meters. Pursuant to this renewal, in the first quarter of 2018 we successfully delivered the associated engineering services work to reach customer acceptance, allowing us to recognize \$1.9 million in revenue. Peter will provide more detail on revenue recognition for the remainder of this contract.

During the first quarter we also entered into a DataV engineering services contract with a Fortune 100 firm valued at just under \$1.0 million; that work was the result of a DataV pilot conducted during the fourth quarter of 2017.

Today, we announced that that same customer has signed the associated DataV SaaS agreement. We expect the SaaS value to approach half a million dollars per year once the customer is fully deployed. With this contract, the customer will use DataV to onboard, manage, update, and ensure compliance across tens of thousands of devices in North America and Europe. This deployment leverages a number of IoT specific services provided by Amazon Web Services. This customer is the largest in their segment and our agreement represents significant validation of our DataV IoT device management strategy.

Building on Andrew's remarks, while DataV had some early successes, the pace of converting pilots to deployments and overall customer acquisition over the past year has not met our expectations. We still have confidence in the product and believe that wider customer adoption is an achievable goal. We believe now is the appropriate time to revamp our go-to-market approach and refine our focus in rolling out DataV, which brings me to our three priorities for the remainder of the year.

Our number one priority is to delight our customers across all areas of our business. Toward that end, we are re-aligning our structure to more effectively deliver on customer needs.

Our second priority is to accelerate the pace of DataV customer acquisition and conversion. In 2017, we closed 19 new DataV pilots across an array of customer types and industries. Since reporting our 2017 results, we have re-evaluated the likelihood of these pilot customers moving forward with production deployments and determined that roughly half are unlikely to proceed within the next twelve months. To our knowledge, we did not lose these potential customers to competing IoT solutions. Looking back on our pilot activity in 2017, we did not adequately qualify those opportunities to ensure their capacity for production deployment following completion of an evaluation period, and this is something we intend to correct going forward. We will no longer focus purely on the number of pilots signed, but rather will focus more on engaging customers who have clear and funded plans to move from pilot to production deployment. We did not close new pilots in the first quarter, but several of the pilots we initiated in 2017 still have potential to move forward towards production deployments.

This brings me to our third priority, which is improving Bsquare's overall financial performance. Beginning in the current quarter, we are reducing our annualized administrative, sales and marketing costs by an estimated \$5.0 million as part of sharpening our DataV product and go-to-market strategy. A key part of this strategy is lowering our customer acquisition costs made possible through collaboration with Amazon Web Services and Microsoft. In the current quarter we made progress to this end and solidified our collaboration with AWS in the IoT

device management segment. We believe these changes are appropriate given our current position and our goals for DataV.

Now, I would like to turn the call over to our CFO, Peter Biere, to address our financial performance in the first quarter.

Peter Biere, Bsquare Chief Financial Officer

Thank you, Kevin.

First, let's review our revenue for the first quarter.

Total revenue was \$20.7 million, which includes \$1.9 million of revenue recognized under our Itron contract. Excluding Itron, our total revenue was \$18.8 million, coming in at the upper end of the \$17.5 million and \$19 million range announced in our Q4 earnings call. Compared to the prior year quarter, total revenue was down 9% from \$22.8 million, and up 6% from \$19.5 million sequentially.

I'll break down the changes by revenue grouping:

Third-party software revenue was \$16.1 million, lower compared to Q4 2017 which reflected heavier customer purchases before year-end. Year-over-year, third-party revenue declined 4%.

Over the past few quarters we stated that we believed we had seen the bulk of any competitive fallout due to changes in Microsoft contract terms, but that there might be variability in this revenue line. Late in the first quarter, we participated in a competitive auction for Honeywell's EMEA business. We were unwilling to match the winning bid at the expense of gross margin, and, as such, we will no longer be selling to this Honeywell division starting in the second quarter. We expect this customer loss to impact quarterly revenue by approximately \$1.2 million to \$1.5 million going forward.

While we've we had some success in winning back business that had been previously lost and will push to win new opportunities, we do expect third-party software revenue to fluctuate moderately.

Proprietary Software revenue was \$1.8 million and included \$1.4 million of revenue recognized on our Itron contract. This value represents two years of the five-year license revenue and we expect to recognize the remaining \$2.0 million of license revenue annually in Q4 over each of the contract's remaining three years. First quarter proprietary software revenue increased sequentially due to the Itron revenue recognition. Proprietary software declined \$0.8 million compared to Q1'17 as we recognized the entire value of PACCAR's license revenue in that quarter.

Professional engineering service revenue, which include our DataV and traditional service contracts, was \$2.8 million this quarter, down 17% year-over-

year and up 45% from the sequential quarter. During 2017 a number of traditional service contracts reached their final delivery point, which explains the year-over-year decline. The sequential increase was primarily due to services revenue recognized upon customer acceptance from Itron in the first quarter.

During the first quarter of 2018 we recorded approximately \$2.6 million in total DataV revenue between both Proprietary Software and Professional Engineering Services segments.

Next, I will turn to our gross profit and margins in the first quarter:

Gross profit totaled \$5.2 million, or 25.1% of revenue, which included \$1.6 million of gross profit recognized under our Itron contract. Excluding the impact from the Itron transaction, total gross profit was \$3.6 million, or 19.1% of revenue, slightly exceeding our guidance range of 17% to 19% due primarily to some end-of-life buying for a non-Microsoft product.

Gross margin slightly decreased from the prior-year period, primarily driven by a shift in our revenue mix. Higher margin proprietary software revenue comprised a lower portion of our overall total revenue. Total gross profit was down \$1.1 million from the year-ago quarter, primarily due to lower revenue levels in our third-party software business and proprietary software. The

sequential increase in both gross margin and gross profit was primarily driven by higher proprietary software revenue.

Next, I'll speak to Operating Expenses and our bottom line results in the first quarter:

Total operating expenses were \$7.7 million, up \$1.5 million from Q1 2017 and down \$235,000 from Q4 2017. The increase from the prior year period reflects our investment during 2017 in product development, sales, marketing and customer support teams to scale DataV. The decrease from the sequential quarter was primarily due to lower overall sales and marketing costs.

As Kevin mentioned earlier, as part of our sharpening of focus with DataV, we are reducing annualized marketing, sales and administrative costs by approximately \$5.0 million. This will begin in the second quarter, but will be partly offset by one-time costs associated with severance payments. We expect the full impact of the cost reductions to materialize in the third quarter 2018.

We recorded a net loss of approximately \$2.4 million, or (\$0.19) per share for the first quarter of 2018, compared to a net income of \$202,000, or \$0.02 per share, in the year-ago quarter and a net loss of \$4.2 million, or (\$0.33) per share, for the fourth quarter of 2017.

Adjusted EBITDAS, a non-GAAP measure defined as operating income before depreciation, amortization and stock-based compensation, was negative \$2.0 million in the first quarter of 2018, compared to positive \$0.6 million in the year-ago quarter, primarily due to lower third-party software and proprietary software revenue, combined with higher DataV expenses incurred compared to the prior year.

Moving to the balance sheet

Cash and investments totaled \$21.4 million as of March 31, 2018, down \$3.3 million sequentially. Cash usage for the quarter was \$1.3 million higher than Q4; the increased cash usage was primarily due to timing of DataV payments in Q4 as well as seasonally-driven operating expense payments in Q1.

Our accounts receivable balance totaled approximately \$18.0 million at March 31, 2018, approximately \$9.1 million of which is due from Honeywell. We extend 270-day terms to Honeywell; net of payments due to Microsoft, approximately \$7.6 million of this receivable will convert to cash. Related to the loss of Honeywell's EMEA business, we expect approximately \$4 million of cash conversion during the balance of 2018.

I will now turn the call back to Kevin to provide an outlook for the second quarter and closing remarks.

Kevin Walsh, Bsquare Acting CEO

Thank you, Peter.

As noted in today's press release, we currently have the following expectations for Q2 2018:

- Revenue in the range of \$16.0 million to \$18.0 million, reflecting a reduction in third-party software sales to Honeywell, which we expect will impact revenue by \$1.2 million to \$1.5 million per quarter;
- Blended gross margin will be in the 17% to 19% range;
- A net loss, reflecting moderated investments to grow DataV and one-time realignment costs, partially offset by reduced marketing, sales and administrative costs.

Moderator, please open the call for questions.

Before concluding the call, on behalf of the entire Bsquare team I would like to thank our investors and our customers for your interest and for your business. We look forward to reporting back to you next quarter.

Thank you for joining us.