Impinj Third Quarter 2017 Earnings Conference Call
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MARIA RILEY, INVESTOR RELATIONS FOR IMPINJ

Thank you, Operator. Thank you all for joining us to discuss Impinj's third quarter 2017 results. On today's call, Chris Diorio, Impinj's Co-Founder and Chief Executive Officer, will provide a brief overview of our performance and market. Evan Fein, Impinj's Chief Financial Officer, will follow with a detailed review of our third quarter 2017 financial results and fourth quarter 2017 outlook. We will then open the call for questions. Impinj's President and COO, Eric Brodersen, is also on the call and will join Chris and Evan in the Q&A session. Please note that management's prepared remarks, along with quarterly financial data for the last eight quarters, are available on the company's website.

Before we start, note that we will make certain statements during this call that are not historical facts, including those regarding our plans, objectives and expected performance. To the extent we make such statements, they are forward-looking within the meaning of the Private Securities Litigation Reform Act from 1995. Any such forward-looking statements represent our outlook only as of the date of this conference call.

While we believe any forward-looking statements we make are reasonable, our actual results could differ materially because any statements based on current expectations are subject to risks and uncertainties. Please see the risk-factors sections in the annual and quarterly reports we file with the SEC for additional information about these risks. We do not undertake, and expressly disclaim, any obligation to update or alter our forward-looking statements, whether as a result of new information, future events, or otherwise except as required by applicable law.

Also, during today's call, all statement of operations results, except for revenue, or where we explicitly state otherwise, are non-GAAP financial measures. Balance sheet metrics and cash flow metrics are on a GAAP basis.

Before moving to the financial results, I'd like to announce that Impinj management will attend the RBC Technology, Internet, Media and Telecommunications Conference on November 7th in New York. We hope to have the opportunity to see many of you there.

I will now turn the call to Chris Diorio, Impinj Co-Founder and Chief Executive Officer. Chris.

Chris Diorio, Impinj Co-Founder and Chief Executive Officer

Thank you, Maria. Thank you all for joining the call. I'm delighted to be here with you today.

We delivered a solid third quarter, with revenue just above the midpoint of our guidance. Our fixed-reader sales were strong, with third-quarter unit-volumes growing 68% year-over-year. Our 2017 endpoint IC unit guidance remains unchanged, at between 7.0 and 7.2 billion units. Notably, several of the delayed end users we cited on our last earnings call have recently committed or recommitted to RAIN RFID publicly, reinforcing our adoption expectations, but their pace remains mostly unchanged since our last call.

Today I will discuss why we believe our fixed-reader unit volumes are growing rapidly, and why this trend reinforces our conviction in our platform strategy. I will also discuss softness in our second half 2017 endpoint IC unit volumes versus first half, and the market dynamics we believe may underlie that softness.

Technology adoption tends to come in waves. For example, think mainframes to minicomputers to microcomputers, or first-generation mobile phones to flipphones to smartphones. In RAIN, the first adoption wave was offline handheld inventory counting and purpose-built RAIN software. Impinj leveraged that first wave to establish our industry-leading market position, but we chose not to build handheld readers or purpose-built RAIN software. Instead, we predicted that a second adoption wave was coming, built on real-time fixed reading and enterprise software. For years we invested in fixed readers, gateways and our ItemSense operating system; in enterprise software partnerships, our channel and our solutions go-to-market team; and in ubiquitous reading, all in anticipation of that second adoption wave.

Today, analyst reports cite expanding handheld-driven retail RAIN deployments. We see that trend. But we also see momentum building behind the next, second trend – a growing number of retailers wanting more transformative business value from RAIN are turning to real-time fixed reading; RAIN data integration with their existing enterprise software systems; and deploying a broad array of RAIN-enabled use cases. As an anecdotal but telling example C&A, a large European retailer, at the RAIN Alliance meeting in Lille, France said that even as they are rolling out handheld reading to nine countries they are also driving towards a future of ERP integration, automatic reading and RAIN-based point-of-sale transactions. That second adoption wave.

We and our partners are also engaged with healthcare, airline, logistics and automotive end users to deploy shipment-verification and asset-tracking use cases that demand real-time fixed reading and RAIN data integration with enterprise software systems. Recall Faurecia, the large automotive supply company we cited on our last two earnings calls, or the many hospitals we've mentioned in the context of asset tracking. Again, that second wave.

I raise these points because our 68% third quarter year-over-year reader and gateway volume growth significantly exceeded our expectations. We sold out of several SKUs, including our newly introduced Speedway R120 reader and xSpan gateway, pushing meaningful order volumes into the fourth quarter. We also see strong fourth-quarter demand. Our market data, sales volumes and, for me personally, deep discussions with partners and end users reinforce my belief that the second RAIN adoption wave is upon us.

Yet even as we see that second wave driving significant reader and gateway volume growth, we see a few percentage points decline in second half 2017 endpoint IC unit volumes versus first half. The reasons aren't completely clear to us, but we do not believe our market share has changed materially. Rather, we believe several factors may be in play: the delays at several large retailers; our inlay partners adjusting to our transition from constrained supply and long lead times mid 2016 thru early 2017 to buffer stock and short lead times now; some seasonality in retail deployment timing which our previously long lead times may have masked; a rebound from 2016's rapid volume ramp through a long supply chain; and some retailers only partially deploying while they evaluate second-wave solutions. Over time, we expect our endpoint IC growth rates to return from this year's 18% to more historical norms, albeit with continued volatility. In the meantime, we are seeing a few percentage points larger endpoint IC price erosion than we planned in the second half of 2017 due to stiffened competition in a time of slower growth, causing a modest decline in second half 2017 endpoint IC gross margins rather than the increases we saw in the past few years.

In light of these new market dynamics we are rebalancing inventory, ramping reader and gateway production and slowing endpoint IC production. Still, we are unable to build enough readers and gateways in the fourth quarter to catch up with growing demand. So we expect revenue constraints, at least in the fourth quarter and perhaps into early 2018, as we push meaningful fourth-quarter reader and gateway orders into 2018.

To summarize the market dynamics, we see today:

1. a growing pipeline of new retailers deploying RAIN, but as we've noted before, with deployment or expansion delays by a few large, notable apparel retailers,
2. a second half 2017 slowdown in endpoint IC volume growth and a few percentage points

larger endpoint IC ASP erosion than we planned,

3. increasing interest among retailers, existing and new, in second-wave solutions even as they pilot or deploy handheld-reader-driven inventory counting,
4. a broad array of logistics, airline, healthcare and automotive providers piloting or deploying second-wave solutions,
5. growing demand for fixed readers and gateways, with 53% year-over-year unit-volume growth in the second quarter and 68% in the third quarter; the latter could have been larger but for the operations constraints I just noted,
6. strong demand for our newest reader and gateway SKUs, with some second-half 2017 gross-margin pressure due to us substituting SKUs to meet demand, and
7. connectivity revenue growing as a fraction of total revenue.

We are today supporting more than 30 fixed-reading pilots and deployments in retail, healthcare and logistics, with a strong pipeline of fourth-quarter opportunities. We are ramping our go-to-market initiatives to meet the demand – for example, a few weeks ago we held our first partner acceleration forum with fifteen key partner companies that have the know-how and scale to support second-wave rollouts. We are also partnered with enterprise software providers, such as SAP and Stanley Healthcare, to meet the needs of second-wave end users.

As an example of our SAP partnership, a few weeks ago we and SAP deployed our platform at the SAP Hybris Global Summit in Barcelona. ItemSense and 45 Impinj readers and gateways captured in real-time the activity of 2500 attendees across 300 scheduled events. Our platform delivered RAIN data to the SAP Hybris Galaxy Experience application, which, in turn, allowed conference attendees to visualize their conference experience and understand how a RAIN system could enable their applications. The power of SAP Hybris delivering RAIN IoT data from Impinj's platform was readily apparent.

For several years, we've made significant investments in our technology and in every layer of our platform in anticipation of this second adoption wave. Those investments will allow us to make significant 2018 product announcements that we believe will increase our differentiation, enhance our market position and help drive second-wave adoption. Expect us to maintain low EBITDA as we bring these products to market.

I said on our last earnings call that we are learning in real time the dynamics of leading a nascent but gigantic opportunity. Those words feel ever more relevant to me as we navigate today's market challenges. At the same time, I feel ever more certain that we are on the right path. We predicted the second adoption wave, long ago began investing into it, and today see early market signals confirming our prediction. Expect us to continue finding current revenue opportunities, for example by us introducing our Monza R6-A endpoint IC targeted at European retail, even as we drive hard into the second wave, investing-in and delivering fixed-reading solutions and enterprise partnerships that leverage our platform, accelerate adoption and drive scale in this gigantic opportunity.

In summary, I am proud of our team's execution this quarter and our continued progress toward our vision of digital life for everyday items. We grew to 310 employees and exited the quarter with 225 issued and allowed patents, an increase of nine over last quarter. Most importantly, our path forward, although not without its challenges, to me has never been clearer. I will now turn the call over to Evan to give you a detailed look at our third quarter financial results and our outlook for the fourth quarter. Evan.

Evan Fein, Impinj Chief Financial Officer

Thanks, Chris. Before I review our third quarter 2017 financial results I want to remind you that with the exception of revenue, or unless explicitly stated otherwise, today's statement of operations is on a non-GAAP basis. All balance-sheet and cash-flow metrics are on a GAAP basis. A reconciliation between our non-GAAP and GAAP measures, as well as how we define our non-GAAP measures, is included in our earnings release available on our website.

We delivered third-quarter revenue of $32.6 million dollars, representing 5% growth over third quarter 2016. Gross margin was 53.7%, compared with 54.7% in second quarter 2017. The sequential gross margin decrease partially reflects the decrease in endpoint IC prices.

Consistent with our plan to invest in our enormous market opportunity, total operating expense in the quarter was $19.0 million, or 58.4% of revenue, compared with $17.2 million, or 50.5% of revenue in the prior quarter. R&D expense was $7.9 million, or 24.1% of revenue. Sales and marketing expense was $7.1 million, or 21.7% of revenue. G&A expense was $4.1 million, or 12.6% of revenue. We ended the quarter with 310 employees, compared with 283 employees at the end of last quarter. We delivered an adjusted EBITDA loss of $1.5 million, compared with $1.4 million income in the prior quarter.

GAAP net loss for the quarter was $4.9 million. On a non-GAAP basis, we reported a third quarter net loss of $1.6 million, or a loss of 8¢ per share, compared with net income of $1.9 million, or 10¢ per diluted share in third quarter last year. Our third-quarter 2017 weighted-average diluted share count was 20.8 million shares.

Turning to the balance sheet, we ended the quarter with cash and cash equivalents and short-term investments of $62.5 million, compared with $74.5 million in the prior quarter. Accounts receivable balance was $25.6 million, up slightly from last quarter.

We increased inventory by $2.4 million over the prior quarter, driven primarily by previously committed endpoint IC production, bringing our inventory balance to $45.8 million. As Chris noted, we will moderate endpoint IC production consistent with our plan to have a billion units of endpoint IC buffer at year end, at the same time ramping reader and gateway production.

As Chris also noted, our fourth quarter outlook is impacted by a decline in endpoint IC demand as well as by insufficient reader and gateway inventory, with the latter causing us to push meaningful revenue into 2018.

Turning now to that outlook, we expect fourth quarter 2017 revenue to be in the range of $28.25 to $29.75 million. We expect adjusted EBITDA to be a loss between $4.85 million and $3.35 million. We intend to maintain our current level of investment in the business, so on the bottom-line we expect non-GAAP earnings to be a loss between $4.95 million and $3.45 million, or a loss between 24¢ and 16¢ on a per share basis using a weighted-average basic and diluted share count in the range of 20.9 million to 21.4 million shares.

I will now turn the call over to the operator to open the question-and-answer session.