
These prepared remarks should be viewed in conjunction with the related quarter's conference call webcast, earnings press release, 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 United States Securities and Exchange Commission (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 most recent Annual Report on Form 10-K and other filings with the Securities and Exchange Commission. 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

Second Quarter 2017 Conference Call

August 8, 2017

Jerry Chase—Bsquare Chief Executive Officer

Thank you and good afternoon everyone.

Before I begin, let me 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 our 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 our 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.



During the first half of 2017 we continued making progress building a sustainable, high-margin enterprise software business around DataV, our Industrial Internet of Things offering. We are currently experiencing strong momentum with large, high-quality customers. Many of these customers have annual revenues in the billions of dollars. Since the beginning of Q2 we have entered into a total of eight paid pilot deployments with new customers, four of which closed after the end the quarter.

You may recall that over the past few quarters we have stated our goal to shorten our sales cycles. As a result of those efforts, we have seen a marked compression in sales cycles leading to initial contracts. Several factors have contributed to this positive development. The most significant contributor is our focus on IoT applications, which substantially reduces complexity and time-to-value for our customers. We also believe that general market readiness is improving the general outlook for industrial IoT solutions.

The pilots we are deploying cover all seven of our DataV applications, including our newest application released during Q2—DataV Discover. DataV Discover provides a standardized method for customers to determine if their data sets have the richness necessary to deliver on specific business objectives. It was built in response to specific needs we saw in the marketplace.

And, while we currently have active DataV deployments with PACCAR, in the transportation industry, Itron, in the energy industry, and a customer in smart vending, our most recent pilots span an array of new industries, including Oil & Gas, petrochemical, retail, and government. These pilot deployments are, for the most part, with large, multi-billion dollar leaders in their respective industries. A few examples include:

- A European heavy-duty equipment manufacturer plans on using DataV Repair to reduce service costs and improve fleet uptime for its customers.
- A global provider of services and equipment for the Oil & Gas industry is looking at DataV Manage to control remote, difficult-to-access machinery.
- A major petrochemical firm piloting a variety of DataV applications to improve refinery uptime and reduce maintenance and service costs.

Given that these pilots are paid commercial endeavors, we believe they are strategic to our customers and will, in most cases, lead to production deployments upon successful completion of the respective pilots.

Additionally, our demand generation programs and sales pipeline leads us to believe that we can more than double our DataV pilots closed by the end of 2017. Given the size of our customers and their various capital investment



requirements, the timing and recognition of revenue for these opportunities will vary.

Finally, DataV, which was recently covered by Gartner Group in an IoT platform report, as a solution focused on solving business problems, is performing well with existing customers. We continue to explore expansion opportunities with these customers.

For all of these reasons, we continue to invest in DataV Sales, Marketing, Customer Solutions, and R&D. In order to maximize our pipeline and ensure customer success, approximately two-thirds of the Bsquare team are currently focused on DataV.

Now let me turn to our traditional revenue drivers.

With regard to our embedded software resale business, and in-line with expectations that have been regularly communicated in the past, our Microsoft Windows embedded business continues to soften from a top-line perspective. As we have discussed, this is due to changes in Microsoft's distribution agreements. Fortunately, gross margins on this business were higher than anticipated resulting in stronger bottom line contribution than we had forecasted.

Our professional engineering services business remains profitable at lower revenue levels and continues to generate cash.



Before turning the call over to Peter, I'd like to welcome a new member to the Bsquare Board of Directors, Bob DeSantis. Bob is currently Chief Operating Officer at Conga, a provider of enterprise SaaS solutions. Prior to serving as COO at Conga, Bob has had a very successful career as a Sr. Sales Executive in enterprise software and SaaS offerings at IBM Blue Box and DocuSign. Bob brings tremendous value to the company and we look forward to working with him as a friend and colleague to grow the value of Bsquare.

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

Peter Biere, Bsquare Chief Financial Officer

First, let's review our Revenues for the Second quarter.

Our revenue during the second quarter totaled \$18.8 million. In our last quarterly call, we expected Q2 revenues to be in the \$18.5-\$20 million range, and, given the unknowns of early adopting new revenue recognition rules, we were in that range. We did not report material DataV revenue during the second quarter.

Overall, revenue was down 17% from both \$22.7 million in the second quarter of 2016 and sequentially from \$22.8 million in this year's Q1. For the first half of 2017, revenue was \$41.7 million, down \$6.5 million or 13% from \$48.2 million in the comparable 2016 period.

I'll break down the changes by revenue grouping:

Third-party software revenues totaled \$15.5 million for the second quarter and were in-line with our expectations; the year over year decline of 15% moderated during the second quarter, falling only 8% sequentially. We've been discussing changes in Microsoft's distribution pricing and policies for the last several quarters. With the end of Microsoft's volume purchase programs on December 31, 2016, certain customers bought-in additional product to lock in pricing during the fourth quarter which has impacted levels of 2017 purchases for these customers. During the past two quarters we have also seen increased competition for larger third-party software accounts which were previously protected under our Microsoft agreements; a large part of the revenue decline comes from the loss of several of these accounts to very low margin competitors. We believe our third-party software business is finding its level; overall, we are fighting hard to keep and grow our more profitable accounts as evidenced by relatively stable margins.

Professional engineering service revenue totaled \$2.9 million this quarter, 29% below the second quarter of 2016 and 16% lower than the sequential quarter. A year ago we were completing a number of services contracts prior to our restructuring of this business which explains the decline. Since Q3 2016, we began reporting DataV service revenues in this segment of our business; in Q1

2017 we completed a couple of more significant service deliveries; in Q2 2017 we completed one pilot and delivered hosting services, explaining the sequential decrease.

As you may be aware, we adopted new revenue recognition accounting rules, or Topic 606, effective January 1, 2017. The new rules essentially clarify how we measure our various contract performance obligations and then determine the periods in which to recognize the revenue. We chose to early adopt these rules while DataV is in its infancy and changing to start 2017 was more advantageous for us than waiting for 2018, the mandatory deadline for adoption. The switch to new rules had little impact on our legacy software and services businesses but materially affected our DataV contracts, which contain differing license types and multiple performance obligations. As a result of adopting Topic 606, we were able to recognize an *incremental* \$2.8MM of DataV revenue during the first quarter of 2017, most of which came following PACCAR's acceptance of contract deliverables. Under the old rules, we would have spread the PACCAR revenues over the life of the contract following acceptance.

During the second quarter, without significant software or service deliveries, our revenue for DataV totaled about \$270K under the new Topic 606 rules.

Next, I will turn to our gross profit and margins:

Gross profit totaled \$3.9 million in the second quarter, or 21% of revenue, above our expected range of 16.5% - 18%; this improvement reflects our efforts to maintain margins from third-party software sales as well as contribution from improved labor utilization rates. Gross profit dollars in quarter two were unchanged from the year-ago quarter, with contributions from higher service margins offsetting the impact of lower third-party software sales. Sequentially, gross profit and margin percentages are lower due to the effect of high-margin DataV revenues recognized in quarter one.

Gross Profit and margin will continue to **vary** for some time depending on our mix of DataV revenues, but you can certainly see from quarter one results how margins will grow significantly when DataV begins to predominate our revenue stream.

Next, I'll speak to Operating Expenses and our bottom line results:

Total operating expenses were \$6.5 million this quarter, up from \$4.0 million in Q2 2016 and from \$6.2 million in Q1 2017. The sequential quarterly increase reflects additional investment in sales, marketing and R&D personnel to grow DataV. Operating costs increased \$2.5 million or 63% from the year-ago quarter. As discussed each quarter, we are steadily investing in product

development, sales, marketing and customer support teams critical for the success and scaling of DataV.

We recorded net loss of \$2.6 million, or negative \$0.20 per share for the second quarter of 2017, compared to net loss of \$185,000, or negative \$0.02 per share, in the year-ago quarter. The sequential quarter showed net income of \$202,000, or \$0.02 per share, which included significant initial DataV revenues.

Cash and investments totaled \$27.3 million as of June 30, 2017. Including profits from both of our legacy businesses, we invested a net amount of \$5.9 million to grow our DataV business in the first two quarters of 2017. Our high quality Accounts Receivable balance totaled \$17.9 million at June 30, 2017, approximately half of which is from Honeywell.

I'll next discuss several non-GAAP metrics we will be providing on a regular basis to help investors better understand our Cash flows and DataV business.

We use Adjusted EBITDAS, defined as operating income before depreciation, amortization and stock based compensation, to monitor our ability to generate cash from the operations of our business. We use Bookings, Backlog and Unbilled Deferred Revenue as non-GAAP measures we believe provide meaningful information related to our new DataV product sales, since revenue

will often be recognized in different periods than those in which orders have been received or cash has been collected.

- Our Adjusted EBITDAS was a negative \$2.0 million this quarter, down \$2.3 million compared to a positive \$282,000 in the year-ago quarter, and down \$2.6 million compared to a positive \$593,000 in Q1 2017. This was due to lower engineering services revenue and higher DataV expenses compared to last year.
- *Several measures we are using to describe **DataV** include:*
 - **Bookings** is a non-GAAP measure defined as the value of new agreements signed with customers. We recorded \$473,000 in new DataV bookings during the second quarter of 2017. We collected approximately \$1.5 million in cash from DataV contracts in the first half 2017.
 - **Backlog** is a non-GAAP measure defined as total bookings less revenue recognized to date, and was approximately \$3.4 million at June 30, 2017 compared to \$5.7 million at December 31, 2016; of the June 30 balance, \$1.4 million is **Unbilled deferred revenue** and \$2 million is reflected on our Balance Sheet as Deferred revenue.

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

Jerry Chase—Bsquare Chief Executive Officer

Thank you, Peter.

As noted in today's press release, we currently have the following expectations for Q3 2017:

- Revenue will be in the range of \$18.5 to \$20.0 million; DataV revenue recognized in the quarter will not be significant; blended gross margin will be in the range of 19% to 21%.
- We successfully closed four paid pilots with new customers in the third quarter and expect additional pilots to close during the quarter;
- We will be working closely with customers to complete those pilots in a timely manner as we believe this is a critical step to converting to production.
- We will report on progress towards conversion as well as any increased visibility on the timing and mix of SaaS and perpetual license revenue in subsequent calls.

- Commensurate with the success we are having in the market with DataV we will be increasing our level of investment in Q3. Though we will incur losses for the near term, we expect cash flow from DataV, our traditional businesses, and cash on hand will be sufficient to fund these investments.

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.