FINAL TRANSCRIPT

Quarterhill Inc.

Second Quarter 2018 Financial Results Conference Call

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CORPORATE PARTICIPANTS

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Shaun McEwan
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CONFERENCE CALL PARTICIPANTS

Gavin Fairweather
Cormark — Analyst

Todd Coupland
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PRESENTATION

Operator

Good morning, and welcome to Quarterhill's second quarter 2018 financial results conference call.

On this morning's call, we have Doug Parker, Quarterhill's President and Chief Executive Officer; and Shaun McEwan, Quarterhill's Chief Financial Officer.

At this time, all participants are in a listen-only mode.

Following management's presentation, we will conduct a question-and-answer session, during which analysts are invited to ask questions. To ask a question, please press *, 1 on your touch-tone phone to register.

Should you require any assistance during the call, please press *, 0.

Earlier this morning, Quarterhill issued a news release announcing its financial results for the three and six months ended June 30, 2018. This news release, along with the Company's MD&A and financial statements, will be available on Quarterhill's website and will be filed on SEDAR and EDGAR.

Certain matters discussed in today's conference call, or answers that may be given to questions, could constitute forward-looking statements. Actual results could differ materially from those anticipated. Risk factors that could affect results are detailed in the Company's Annual Information Form and other public filings that are made available on SEDAR and EDGAR.

During this conference call, Quarterhill will refer to adjusted EBITDA. Adjusted EBITDA does not have any standardized meaning prescribed by US GAAP. Adjusted EBITDA is defined in the Company's quarterly and annual filings and are made available on SEDAR and EDGAR.

Please note that all financial information provided is in US dollars, unless otherwise specified.

I would now like to turn the meeting over to Mr. Parker. Please go ahead, sir.

Doug Parker — President and Chief Executive Officer, Quarterhill Inc.

Good morning, everyone, and thank you for joining us on today's call. I'll start things off with an overview of our businesses in Q2, followed by some comments on our M&A-related activity. Shaun will then take a more detailed look at some of the key numbers, and then we'll open it up to questions.

For Q2, revenue was 20.4 million, of which 34 percent was recurring revenue. Adjusted EBITDA was negative 4 million, cash used in operations was 2.4 million, and we ended the quarter with cash and equivalents of 73.1 million, a very solid cash position with which to fund our existing businesses and continue to pursue our acquisition strategy.

At a high level, our number showed a marked improvement sequentially from Q1, which was largely a result of strong revenue … recurring revenue and adjusted EBITDA from IRD and VIZIYA. On the M&A front, we made some important progress in the quarter, which we'll get to in a moment, but first I'll spend a few minutes on each of the businesses, highlighting some of the respective developments in the quarter.

WiLAN's results in Q2 again reflect the variability in the overall transformation going on in the patent licence industry. WiLAN is a unique asset capable of generating significant cash flows, as it did in 2017, and its results need to be viewed over a longer period rather than quarter to quarter. The announcement we made on August 1st regarding our trial results with Apple is a case in point.

In a trial verdict rendered that same day in the US District Court for the Southern District of California, a jury awarded WiLAN $145.1 million in damages against Apple for infringement of two of WiLAN's US patents related to cell phone technology. We're obviously very pleased with the jury's decision, and believe that it reflects well on our team, our portfolio, and our process and enhances our already strong reputation in the industry.

We have a rich portfolio of intellectual property and a seasoned team with a proven multiyear track record of identifying high-quality intellectual property and maximizing its value.

Apple is business as usual for us. We have a strong pipeline of licence opportunities with many active licensing programs in place today. Our preference is always to avoid litigation where reasonably possible and to obtain a fair licence. However, when litigation unfortunately becomes necessary, we have the confidence to see the process through to the end.

Our level of litigation activity remains constant with suits outstanding in various technology areas against global companies such as Sharp, VIZIO, OmniVision, LG, Bell, Sony, and Kingston, to name just a few.

We also will continue to pursue and acquire patent portfolios where we believe appropriate returns can be met. So far in 2018, we have acquired three patent portfolios via our partner model. Acquiring patents gives us an inventory for future licence opportunities. And doing so under the partner model means we pay little to nothing up front for the patents, and then share the licence proceeds with the seller.

This keeps … this helps us keep the costs down and expands the revenue opportunities for the business.

In June, we announced that Keaton Parekh will join WiLAN as its President and CEO, and that as previously announced, Jim Skippen was retiring from his position as Executive Chair of Quarterhill and interim CEO of WiLAN while continuing as an outside director and chair of the Quarterhill board.

Keaton is an accomplished patent attorney and an experienced business leader with significant experience related to running a patent licensing enterprise. He obviously has big shoes to fill at WiLAN. But with 20 years of experience in all aspects of IT—IP, including licensing, litigation, sale and purchase of patent assets, and patent prosecution, Keaton has the skills, global perspective, and proven track record to drive WiLAN forward through its next phase of success.

IRD had a strong Q2, which is generally a seasonally stronger quarter for the Company. As we said on our last call, a few agreements had slipped from Q1 and we picked up some of those in Q2. Among our new contracts in the quarter was a $5 million agreement with the California

Department of Transportation. This included an up-front component, with the remainder spread out over the three-year term of the agreement.

Overall, results for IRD in Q2 reflected the type of performance we believe the business can deliver more regularly, and importantly, from which it can grow. IRD's Q2 revenue was 12.7 million and adjusted EBITDA margin was 12 percent, which were both very significant improvements sequentially from Q1.

We think the outlook for IRD is very promising. We have a loyal sticky customer base and several new and exciting products in the market that are complementary to their existing solutions, and provide the potential for new recurring revenue streams. We expect these products to become meaningful over time. And in the short term, we expect them to help strengthen our value proposition when pitching for new business. Also, we believe the improved the margin profile for some of these new products is attractive.

Shortly after the end of Q2, IRD announced the retirement of Terry Bergan as President and CEO and the appointment of Randy Hanson to that role. Prior to this, Randy was COO and Executive VP, a role he held beginning in 2000. Both Terry and Randy have been instrumental in helping IRD become a world leader in the ITS industry.

Randy is a natural successor to Terry, as he has deep institutional knowledge of the business and close relationships with many of the key customers.

Earlier this year on our Q1 call, I spoke of my commitment to work with our portfolio of companies to help them optimize their operational and financial performance. Based on my initial views of IRD and in collaboration with Randy and his team, subsequent to quarter-end, IRD made the decision to consolidate or eliminate certain roles where it made sense to do so, and remove some excess costs from the business.

While such a process can involve difficult decisions along the way, we think that because of it, IRD will become a more … have a more competitive cost structure and focused strategy, which we believe will help put it in a better position to capitalize on its growth opportunity.

VIZIYA also had a strong quarter with good top-line performance and an adjusted EBITDA margin of 34 percent. We like what we've seen so far with VIZIYA. They're bringing in new licence customers, courting larger and more intricate business opportunities, expanding the scope of their partner relationship with the likes of SAP and Oracle, and driving good financial results. They fall into the category of verticalized software companies that we think are well suited for our M&A strategy, and I've been impressed with the team's ambition, entrepreneurial spirit, and customer focus.

As with IRD, we think there's the potential for financial performance to improve in the coming quarters, for the business to scale profitably, and I'm committed to working with the team there to drive those results.

On the M&A front, building our pipeline remains a top priority, and we're seeing real progress in this area. Expanding the scope of our targets to include verticalized software companies has led to a promising expansion at the top of our target pipeline funnel.

As most of this work goes on behind the scenes, I'd like to shed a light here on some of the metrics we use to gauge activity. Despite being somewhat of a seller's market right now, in Q2 alone we submitted multiple nonbinding expressions of interest and held discussions with several companies in various disparate market verticals, such as health care, ITS, fintech, and analytics.

In terms of specific deal flow metrics, in Q2 we signed more than a dozen NDAs and reviewed an equivalent number of sale process documents and held discussions with more than 70 sell-side financial advisers, typically an excellent source of transaction opportunities.

This level of activity and the scope of market opportunity in our sweet spot in a relatively short period of time is very encouraging and validates the strength of our strategy and ability to expand our deal ecosystem.

We know investors are eager for the next transaction, but while deal flow is robust and the pipeline is growing, we will remain patient negotiators. We're not going to do a deal for a deal's sake. We're going to do the right deal, which means remaining disciplined with our criteria, returning revenue, stable cash flows and margins, sticky customer relationships, et cetera. But when we see the right opportunity, we won't hesitate to aggressively pursue it and execute to deploy our capital.

To summarize, a key priority for us now is to invest capital and to build a critical mass of businesses in our portfolio, but it is critical that we stick to our playbook in terms of doing deals, and that we remain financially disciplined when pursuing them. There are a few we have walked away from recently. And as hard as that can be to do, it was the right thing to stay disciplined and stick to our criteria.

The wait can be difficult, but ours is the type of strategy that builds momentum over time, so the periods between transactions will narrow longer term.

A second top priority is to ensure that the companies we own today are operating as effectively as possible, and that they are getting the support needed to generate the growth, profitability, and reliable cash flow streams that we believe they can deliver. At the same time, we won't hesitate to be proactive with any businesses if we feel action is required to improve profitability and align costs more effectively to invest sustainably in growth.

We believe that executing well on those two fronts will ultimately drive performance in our financials and value in our stock price.

With that, I'll pass it over to Shaun for a closer look at the numbers.

Shaun McEwan — Chief Financial Officer, Quarterhill Inc.

Thanks, Doug, and good morning, everyone. One thing to note as we begin the review of our Q2 financials, the comparison period in Q2 2017 includes one month of IRD operations and two months of VIZIYA's operations.

I'll start off with a look at the Q2 revenue in a little more detail. Top-line revenue was 20.4 million, which was up 10 percent from Q2 last year, and probably more importantly, 70 percent sequentially from Q1. As Doug said earlier, this was driven largely by IRD and VIZIYA, which generated revenue of 12.7 million and 3.8 million, respectively, in the quarter. IRD and VIZIYA represented 81 percent of our total Q2 revenue.

On a segment basis, revenue in the licence category represented 28 percent of total revenue compared to Q2 last year when it represented more than 66 percent of total revenue. This change is due to lower revenue in the patent licensing business and the positive contribution from the acquired businesses.

Systems revenue, which generally includes revenue earned on contracted projects and more or less recognized on a percentage of completion basis, was 35 percent of total revenue in Q2 as compared to 16 percent last year. So this reflects revenue from our acquired businesses.

Driven by IRD and VIZIYA results as well, recurring revenue was 34 percent of total revenue in Q2 compared to 35 percent last year and 35 percent in Q1 of 2018. As Doug mentioned, adding revenue from recurring sources and building this percentage of our total revenue is one of our primary investment criteria.

And finally, services revenue, which relates largely to professional services-type activities, was nominal in Q2 at about 3.5 percent of our total revenue.

Adjusted EBITDA was a negative 4 million in Q2 compared to a positive 3.6 million in Q2 last year. The decrease is due primarily to lower revenue in our higher-margin patent licensing business. In Q2, IRD and VIZIYA generated positive adjusted EBITDA with margins of 12 percent and 34 percent, respectively.

Cash used in operations was 2.4 million in Q2 compared to cash generated from operations of 3.1 million in the comparative period last year. Cash flow in Q2 2018 and for the year-to-date period primarily reflects the impact of the variability in the financial performance of our patent business.

On the balance sheet, cash, cash equivalents, and short-term investments, including restricted investments, all of which we refer to as equivalents, totalled 73.1 million at the end of Q2 compared to 86.6 million at the end of 2017.

As Doug outlined, we still have substantial cash on the balance sheet to pursue our M&A strategy, but we're obviously mindful of the importance of the existing portfolio of businesses contributing to that number over time in order to help fund our strategy. As we said on our last call, we are keeping a close eye on our expenses, and will remain absolutely ready to pull the trigger on any M&A opportunity that meets our investment criteria.

In terms of capital allocation, our focus remains on deploying the cash to acquire other portfolio of businesses and on the maintenance of our dividend. We get asked frequently about doing a share buyback. And while we have done them in the past, and may do so again in the future, right now we believe the best use of our funds for building long-term value in the business is to support our M&A diversification strategy and to continue supporting our quarterly dividend.

Finally on that note, this morning in our earnings release we announced details of our next dividend. The Board of Directors has declared an eligible dividend of C$0.0125 per share, payable on October 5, 2018, for shareholders of record on September 14, 2018.

This concludes my review of the financial results. And I'll now turn the call back to the Operator for questions.

Q&A

Operator

At this time, I would like to remind everyone in order to ask a question, please press *, then the number 1 on your touch-tone phone.

Your first question comes from the line of Gavin Fairweather from Cormark. Please go ahead.

Gavin Fairweather — Cormark

Hey, there. Good morning.

Shaun McEwan

Good morning.

Doug Parker

Morning, Gavin.

Gavin Fairweather

Nice to see the uptick at IRD this quarter, and you talked about some of the drivers there, but just curious on the new products specifically. When do you expect those to begin contributing to the top line there? And can you give us an idea of the margin profile of those?

Doug Parker

Yeah. And thank you for the question, Gavin. I mean, we're starting to see some traction on the new products. As you know, they're sold as part of kind of the existing suite of product opportunities with a lot of the customers.

I think, for example, we're seeing a couple of them looking at a pipeline of sort of north of $1 million in potential opportunity. Their contributing is still relatively modest to the overall business, but they're very much a long-term play to the business. And I think there's been a lot of customer interest in them.

They tend not to be sold as a separate product. They're just an addition to existing product offerings that IRD has in the market. But we're seeing the pipeline build in a meaningful way.

I don't know, Shaun, if you have any other context from the margin or otherwise a perspective on that?

Shaun McEwan

No, I think on the margin those products, in particular the TACS, the Tire Anomaly Classification System, it's a lower-cost product in terms of the total dollar investment by the customer, but a considerably higher-margin product for us, given the new technology that's in it.

So I wouldn't go on record yet with the full margin structure price point because we're not entirely through all of the build-outs and trial versions of it. But we do think the margins are considerably higher than the existing business.

Doug Parker

And as I said, the pipeline is building; particularly in TACS you're seeing it get north of that 1 million on a high-level pipeline, which is encouraging. There's been definitely take-up and interest in the product.

Gavin Fairweather

Okay. That's helpful. And then just secondly staying on IRD for a sec, can you give us an idea of the size of the cost reductions that you put through on an annualized basis? I think your SG&A over the past 12 months has been running around $6 million?

Shaun McEwan

Yeah. Gavin, it's Shaun. The restructuring, again, it's a fairly small restructuring. It's less than 5 percent of the workforce. But it will have, we expect on an annualized basis, about 2 million, $2.2 million of incremental adjusted EBITDA over the existing run rate.

Gavin Fairweather

Okay. I'll re-queue. Thank you.

Shaun McEwan

Okay. Thanks.

Doug Parker

Thanks, Gavin.

Operator

Your next question comes from Todd Coupland from CIBC. Your line is open.

Todd Coupland — CIBC

Yeah. Good morning, everyone.

Shaun McEwan

Good morning, Todd.

Doug Parker

Morning, Todd.

Todd Coupland

I had a question on IRD. I had a couple questions, but let's start on IRD. So it seems like you've been now running 11 million, 12 million a quarter for a while. Is this, like you say, a baseline where we should start to assume some growth? Is there confidence in this level of business? Maybe give us a little colour on that.

Doug Parker

Yeah. Hi, Todd; it's Doug. Yeah. I do think that that sort of, if you were to pick a baseline, that's kind of the steady state of the business. Obviously, Q1 this year was on the soft side for them. Q1 is historically soft for them. I think it was a little bit softer than they had seen previously. But I think that's fair. They seem to have a certain amount of seasonality. This quarter and the next quarter tend to be stronger, particularly in the rollout of contracts in the US market. And they had some softness last year, at the end of last year because of weather and some of the things, particularly in the US market, and some delay, pushout of some projects.

But if you look at sort of the steady state that we look at growing the business from a revenue perspective, I think that's fair.

Shaun, would you kind of share that view as well?

Shaun McEwan

Yeah. I think that's probably correct.

Todd Coupland

Okay.

Shaun McEwan

Not a lot of extra colour.

Todd Coupland

And is there sort of a baseline EBITDA off of 11-ish million as a margin or percentage that we can baseline from as well?

Doug Parker

Yeah. I think on an annualized basis we're looking at trying to get kind of the adjusted EBITDA as a percentage of sales to sort of high single-digits, low double-digits, kind of that's where we want to see on a regularized basis based on this kind of annualized run rate, Todd. That's kind of how we look at it.

And obviously, the business is managing itself accordingly for those goals. That's where we see it.

Todd Coupland

And so that restructuring with the 2 million, 2.2 million, that would be embedded in that comment of 10-ish percent EBITDA margin?

Doug Parker

Yeah. It's part of ensuring that the business kind of on a regularized basis can achieve that, yeah.

Todd Coupland

Yeah. Okay. And then if I can just ask you about the Apple settlement. So like I get there's now positioning and maneuvering and all of that. Could you just sort of lay out your view of how that's likely to play out? And if you have any expectations on getting to the cash, et cetera? Any colour on that would be helpful.

Doug Parker

Yeah. I mean, it's obviously difficult, Todd, for us to give—to look into the crystal ball. And we're obviously happy with the jury verdict. We think it's the right verdict. We are always open as an organization to a fair and reasonable licence. That's our general default approach and a reasonable one.

We understand that Apple has publicly declared they're going to have an appeal. We obviously feel strongly about our position, but we're open, as we always are, towards a reasonable and fair settlement. So it's very difficult for us to know ultimately where that process will go.

We know that we're happy with the result. We know that we're open to a fair and reasonable negotiated settlement. And as a result of that, it's difficult for us to know specifically when that would occur. Appeal process, it's difficult to predict as well. They typically can take 18 months might be a reasonable estimate. But it's not an easy thing to give a prescribed date and timeline to.

Todd Coupland

Okay. That's helpful. And then just more broadly on the IP portfolio. I guess if I were to look at this quarter, I would say it wasn't horrible; it wasn't great. What does the pipeline look like for second half of the year?

Doug Parker

Yeah. I mean, I think what I will say is that the level of activity we've seen in the licence discussions and the level of activity and the ongoing litigation is consistent with our historic levels.

Obviously, we have an interest in getting fair and reasonable licences for the remainder of the year. And we do have those quarterly pressures.

Once again, those are complicated negotiations, and we're not going to put ourself in a position where we're going to take a significant reduction in the value of our IP to hit a short-term quarterly result in Q3 and Q4. So we're remaining disciplined on that front.

We still generally feel very happy with the pipeline, the level of opportunities both on the licensing side and some of the litigation we have ongoing. I mean, Apple is an example on the litigation side.

But coming in, being in the seat in my second full quarter, I'm impressed at the level of activity and the strength of intellectual property portfolio the Company has. But as you know, there's increased lumpiness as a result of just the longer process, particularly in the US. And we expect that lumpiness to continue. But certainly we see no lack of ongoing opportunity for us to get fair and reasonable licence revenue.

Todd Coupland

Okay. That's good. And then just one last question. So if I were to sort of think about positioning of the Company, it seems like you've settled in on the business strategy, the M&A focus. You've built up the pipeline, so you're churning through that, and whatever pops up will pop up, as it does. You've made a couple of refinements in terms of getting the recurring businesses sort of on track to target models. Would you say it's now focused on executing the business model and not having much else to do on fixing what you have?

Doug Parker

Yeah. I think it's fair to say execution is a key focus. We'll always be there to work closely with particularly VIZIYA and IRD, which are new in the family. As I said, I'm very confident with their business plans and the strength of their management team. But yeah, now we're focusing in. One of the two components is making sure they deliver their business plan. We think Q2 is a more normalized cadence for their businesses, which is good.

And then I think on the M&A, yes, it's—I don't—I said we're obviously, as we all are, feeling pressure to do a deal, but we don't feel a key need to do a deal right now because I think the next deal we do will be the right one. And we're going to be disciplined on that.

But short answer to your question is yes. Execution is a primary focus for us. I don't see any big radical changes within the core businesses that are required at this time. But we always will have a watching brief on our businesses. And if we don't like the profitability and cash flow profiles, we'll work in partnership with the businesses to try to improve them.

But we're very happy with the progress we're seeing.

Todd Coupland

Okay. That's great. Appreciate the answers.

Operator

And your next—

Doug Parker

Thanks, Todd.

—question … your next question is from Gavin Fairweather from Cormark. Your line is open.

Gavin Fairweather

Yeah. Just to follow up on the M&A side, you mentioned how it's a seller's market out there a little bit. Are you—just curious—the proportion of things that you're looking at that are going through structured processes versus targets which you're kind of in full negotiations with?

Doug Parker

Yeah. It's a good question. We're seeing a bit of both. I mean, we're seeing—we've got—frankly, a lot of our management, myself included, have some deep connections with kind of natural sources of processes. So we're probably—if you're looking at where the opportunities are coming, I'd say about 70 percent are coming from existing processes. I'd say the balance of them are coming from either targets that make sense our businesses are aware of that have been watching or have relationships with. And some of them are just sort of cold call process.

We're very … I mean, we're extremely happy with the level of understanding and engagement we've had from referral sources, particularly bankers, who sort of get our model and understand it. And those referral sources are coming from Europe, Canada, and the United States.

But I would say right now about 70 percent were kind of inbound traditional-run processes. Some of them, Gavin, have been processes that have run for a number of years. They may be in their second round of it. Some of them are new processes. Some of them are testing the market. But we're seeing a good level of engagement.

Is there pressure on valuation generally in M&A right now in technology? Yes. But we still seeing enough in our sweet spot to be encouraged.

Gavin Fairweather

And you're still thinking that kind of 15, 20 percent IRR is the hurdle rate as you look to get these deals done?

Doug Parker

Yeah. I think that's right. That's a good range, Gavin.

Gavin Fairweather

Okay. Thank you.

Operator

As we have no further questions at this time, this concludes Quarterhill's second quarter 2018 financial results conference call.

You may now disconnect your line. Thank you.

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