FINAL TRANSCRIPT

Quarterhill Inc.

Fourth Quarter and Fiscal 2018 Financial Results Conference Call

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CORPORATE PARTICIPANTS

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CONFERENCE CALL PARTICIPANTS

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PRESENTATION

Operator

Good morning and welcome to Quarterhill's fourth quarter and fiscal 2018 financial results conference all.

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 12 months ended December 31, 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 that 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 business activity in Q4 and for the year, followed by some comments on our M&A efforts. Shaun will then take a more detailed look at some of the key numbers, and then we'll open it up to questions.

While overall, 2018 was challenging in certain respects, we ended the year on a positive note in Q4 with strong revenue, adjusted EBITDA, and cash from operations. Q4 revenue was 25.4 million, with 4.7 million of recurring revenue. Adjusted EBITDA was 3.2 million, cash from operations was 9.6 million, and we ended the quarter with cash and equivalents of 67.3 million, up from 62.4 million at the end of Q3.

In general, I would characterize the year as one of operational stabilization while making tangible progress on our M&A diversification strategy. Adding new companies to our portfolio remains a primary objective of the strategy, but ensuring that our existing portfolio of companies are optimizing their performance is equally important.

To that end, the restructurings we initiated in 2018 at WiLAN and IRD are expected to save approximately 6 million per year in expenses. We believe these changes put those businesses on firmer footing and on a clearer path to generate superior performance and more reliable cash flows going forward.

Looking briefly at each of our businesses, I'll start with WiLAN. WiLAN did 10.6 million of revenue in the quarter and 2.3 million of adjusted EBITDA. These numbers were up, year over year, and were the strongest of 2018 by a good margin. They were driven by robust and varied license activity and included agreements with Cisco, OmniVision, and ESMT, among others.

As touched on earlier, in Q4 we initiated restructuring at WiLAN that we believe will save us approximately 3.5 million a year in expenses. The restructuring required some difficult decisions, and we reduced the overall WiLAN workforce by about a third. This resulted in a streamlined management team now led by Mike Vladescu, WiLAN's former Chief Operating Officer and a licensing industry veteran who is now President and CEO of WiLAN, effective today.

Mike played a key role in developing our very successful partnership program, and he's a semiconductor guy, which is a real focus for us today and will continue to be, going forward. His proven revenue-generating track record speaks for itself, and I'm excited he'll be leading the WiLAN team going forward.

We believe the current staff level is more than capable of delivering the type of results we expect from the business, and that we have ample resources to follow through on all existing litigation activity and to ensure activity remains robust in the future.

WiLAN remains one of the preeminent patent-licensing firms in the industry, and its prospects are sound. In fact, in Q4 we acquired a patent portfolio via our partnership program, which shows that we believe in and will continue to support the future potential of that business. Furthermore, we will not hesitate to add additional staff as needed if we believe it is necessary for continued growth of the business.

In terms of an update regarding our trial victory versus Apple in August 2018, in January, as part of the JMOL process, the court upheld the jury's verdict on infringement but granted Apple's motion for a new damages trial and/or remittitur.

The court then presented WiLAN with an option of either: one, accepting a judgment of $10 million; or two, a new trial on the issue of damages only. We've chosen to pursue a new trial on damages and expect that that will take place approximately six months from now.

We've also filed a motion of reconsideration. As we said previously we're confident in our position and the quality of our patent portfolio. And if required, we look forward to presenting our damages case to a new jury later this year.

IRD has had a very good year in 2018 and another solid quarter in Q4, with 12.5 million of revenue and 1.9 million of adjusted EBITDA. Q4 results were up, year over year, with stronger revenue generated from contracts like Arizona and South Dakota renewals and better margins that reflect, in part, the restructuring undertaken there in Q3.

As discussed in our last call, those changes should result in the annual savings of approximately 2.5 million per year, and we think the Company is well positioned to deliver a higher rate of business with better margin profile going forward.

2018 was a good year for new product activity, as well as both the—as both the Vehicle Information in Motion and the tax products saw greater implementation in the market and are proving very helpful in growing the sales pipeline. Both have a higher margin profile and make use of data and analytics, which is clearly a trend in just about any industry today.

We expect more innovation in 2019, including a new Advanced Axle Classification for Toll, AACT, solution that is used to improve toll audit systems and which will be deployed for the first time in Mexico.

We think the outlook for IRD remains strong. IRD starts 2019 with a good portion of its 2019 business plan already signed, a level higher than what we normally see at this time of year. It has sticky, diversified, and global customer relations and a very broad market reach.

There is good opportunity with its core services, as well as the analytics-based products, and the new products are regularly working their way through the R&D pipeline and into the market.

IRD is also well positioned for potential tuck-in transactions because of the nature of the future software requirements of the business and of its very strong professional management team.

VIZIYA had a lighter quarter in Q4 than we were looking for, but for the year, it generated decent margins and positive cash flow and saw a 20 percent growth in licence revenue year over year. VIZIYA's numbers in Q4 and Q3 of 2018 reflected some of the lumpiness you get in software license sales and the impact that one or two large contracts getting pushed out can have.

However, it fits the type of financial profile we like, in so much as when the revenues may be lighter, the business can still generate positive cash flow. We're still very positive on the business, as its pipeline continues to build, and we still expect some of the larger deals in the pipeline to come to fruition in due course.

In the meantime, VIZIYA continues to make good progress on its partnership efforts with SAP and with Oracle. A number of client milestones were reached with Oracle during the year, as VIZIYA sees this partnership has having the potential to expand its SaaS-based business.

The business was also—the business will also focus in fiscal '19 on investing in accelerating its cloud offering and other areas of development priority, such as STO, or shutdown/turnaround operations. Overall, VIZIYA's the category of verticalized software firms that we like, and we remain optimistic for its scale—for its scalable and profitable growth profile. We also see some potential for tuck-in opportunities here as well.

On the M&A side, the 2018 environment reflected somewhat of a seller's market, but we still made real progress, assembling our deal team, evolving our target focus, and building our M&A ecosystem, which ultimately helped to generate a strong deal flow and a growing pipeline of opportunities. With the progress at both IRD and VIZIYA as mentioned, we are seeing a number of small tuck-in opportunities suitable for them, while also continuing to aggressively pursue other, more stand-alone acquisition targets.

With a long history of making M&A transactions, I'm obviously keen to get going and deploy capital, and there are some interesting opportunities that we believe we are close—that we are close on. While there are no—while there are no certainties, we would expect activity to pick up this year.

But the reality is, we won't do any deal unless it's—absolutely fits the financial and operational criteria we've outlined previously: things like recurring revenue, positive EBITDA, stable cash flows and margins, dedicated teams, and great customer relationships, among others. We're going to be disciplined financial buyers, but when we find the right deal and align on terms with the seller, we'll move quickly to complete it. We believe there is no ample supply—we believe there is ample supply of opportunities in our target segments.

In 2018, we received and reviewed 94 opportunities, 85 teasers, and entered into 27 NDAs to assess acquisition targets. With that level of activity and with a deal team that has 20-plus years of M&A experience and that has completed more than 100 transactions, the right deals will come with continued focus, tenacity, and patience.

Looking into 2019, our priorities are:

One, deploy our capital on intelligent acquisition opportunities. We feel the sense of urgency, but we need to stay disciplined with our criteria. I'd rather spend less on acquisitions, to tick the boxes from our playbook perspective, than do a large deal just for the sake of doing a large deal. I think the discipline is key, if you're an aggregator.

Two, continuous improvement among the portfolio of companies from an operational performance perspective is part of the DNA that I take very seriously, and the senior management team takes very seriously. You saw us take decisive action here in 2018, reducing expenses without sacrificing upside, and effectively adding approximately 6 million of adjusted EBITDA to the run rate of the business. Throughout 2019, we will remain focused on cash flow and expenses in all our businesses and keep an eye out for even further savings.

And three, I've been working closely with the board to introduce a plan that better aligns our compensation with our long-term share price performance. Full details will be available on our upcoming proxy mailing, but we're effectively looking to shift more of the variable executive compensation from short-term cash focus to long-term return that more directly correlates to an increase in share price.

If the share price doesn't go up, a meaningful portion of executive compensation will not be paid. I think for this model to work, it is very important that we stand shoulder-to-shoulder with shareholders in this regard.

And finally, as announced in our earnings release this morning, as we look at Q1, we anticipate continued momentum from our operations, including from license deals, such as SK hynix. And while we do not anticipate providing regular guidance on a quarterly basis, we do expect Quarterhill's consolidated revenue for Q1 2019 to be in the range of 33 million to $36 million.

To the question of why give such an outlook now, well, we've experienced a number of operational changes over the past 12 to 14 months. And in the context of that environment, we felt that since we are in a position to share some visibility into Q1, that we would do so. The fact that we're already two quarters in—through Q1, also helps in this respect.

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

Shaun McEwan — Chief Financial Officer, Quarterhill Inc.

Thanks, Doug, and good morning, everyone. I'll start off with a look at revenue in a little more detail.

Q4 revenue was 25.4 million, up 12 percent and driven largely by both IRD and WiLAN. Quarterhill revenue was down year over year, as Q3 2017 included a blockbuster quarter from WiLAN with more than $72 million in revenue coming from that business. That's a clear indication of variability in the WiLAN business model.

Q4 revenue for IRD and VIZIYA was 14.8 million, up 4 percent from last year, with IRD's gains offset in part by VIZIYA. IRD and VIZIYA revenue for 2018 was 56.6 million compared to 34.1 million in 2017, when we had partial year of contributions from both those entities.

IRD and VIZIYA represented 58 percent of revenue in Q4 and 73 percent of revenue in 2018. Overall, on a segment basis, Q4 percentages were relatively similar to a year ago, while on a full year-over-year basis, the segment percentages are skewed by the big WiLAN quarter in Q3 of '17.

Revenue in the license category, which includes contributions from WiLAN and VIZIYA, represented 42 percent of total revenue compared to 45 percent in Q4 last year. For the year, licence revenue was 30 percent of total revenue, so you can really see the impact of a stronger Q4 from WiLAN here.

Systems revenue, which generally includes revenue earned on contracted projects, was 30 percent of total revenue in Q4 compared to 35 percent last year.

Recurring revenue was 4.7 million or 18 percent of total revenue in Q4, up 15 percent compared to 4.1 million, which happened to also be 18 percent of total revenue in Q4 last year. This is a component of revenue that we are looking to grow over time as we acquire other businesses. For 2018, recurring revenue was 22 million compared to 13.4 million for 2017. And finally, services revenue, which relates to professional services-type activities, was again nominal in Q4, at just over 2 percent of total revenues.

For Q4 2018, gross margin was 30 percent, up from 26 percent in Q3 2018 and flat to Q4 last year. On the operating expense side, Q4 SG&A was down 12 percent year over year, reflecting in part the restructuring at IRD and our overall efforts to keep a close eye on costs throughout the year.

A couple of items to note under operating expenses. For fiscal 2018, we incurred a onetime 6.2 million expense related to the organizational changes that Doug's spoken about. And we expect to incur another 300,000 to 400,000 in 2019 as we continue to refine our operating facilities in Kanata, specifically. As Doug mentioned earlier, these changes are expected to save approximately 6 million annually going forward.

For fiscal 2018, we also had a 16.1 million noncash impairment loss on goodwill. We test goodwill for impairment annually in the fourth quarter under accounting standards—and for those that care, ASC 350—by comparing the carrying value of each reporting unit with its fair value.

With such a significant difference between the carrying value of our reporting units and our overall market value of the entire public Company, we determined that there was a need to take an impairment-of-goodwill charge, and as a result we incurred this charge in Q4. I will remind you that, that is a noncash charge.

Adjusted EBITDA, as a result, was a positive 3.2 million in Q4, which is an improvement from 1.5 million in Q4 '17, and a significant improvement from a negative 2.5 million in Q3 of '18. The year-over-year improvement was primarily due to better results at WiLAN and IRD, and ultimately lower SG&A. Adjusted EBITDA for 2018 was a negative 10.6 million, but for the combined operations of IRD and VIZIYA, adjusted EBITDA was a positive 5.8 million.

The overall performance in 2018 from our acquired companies—as I said, approximately 57 million in revenue and 6 million in adjusted EBITDA—has brought scale to the Quarterhill business and done so on a profitable basis. We think that these businesses have the potential to build on this performance and deliver enhanced results in the coming quarters and years.

Cash generated from operations was 9.6 million in Q4, compared to cash used in operations of 9 million in Q3 of '18. That's a pretty significant change, quarter over quarter. Cash generated from operations of 49.2 million in Q4 '17 reflected collections from the significant quarter WiLAN had in Q3 '17, so not directly comparable, year over year.

As a result of positive cash from operations in Q4 '18, cash, cash equivalents, and short-term investments, including restricted investment, increased to 67.3 million at the end of Q4 compared to 62.4 million at the end of Q3. On a year-over-year comparison basis, cash and equivalents were 86.6 million at the end of '17.

We continue to have a strong balance sheet from which to pursue our M&A strategy. And as Doug mentioned earlier, we continue to work closely with each of our portfolio businesses to help them create conditions where they can optimize growth while delivering steady cash flows. The changes made in 2018 alone should save us upwards of 6 million per year in expenses, which basically, the equivalent of having acquired yet another business at that level of EBITDA.

And finally, on that note, this morning in our earnings release, we announced details of our next dividend payment. The Board of Directors has declared an eligible dividend of C$0.0125 per share, payable on April 5, 2019, for shareholders of record on March 22, 2019.

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, if you would like to ask a question, please press *, then the number 1 on your telephone keypad. We'll pause for just a moment to compile the Q&A roster. And again, that is *, 1 on your telephone keypad if you would like to ask a question.

Our first question comes from the line of Todd Coupland with CIBC. Your line is now open.

Todd Coupland — CIBC World Markets

Hi. Good morning, everyone.

Doug Parker

Morning, Todd.

Shaun McEwan

Good morning.

Todd Coupland

Can I start on the restructuring, if I could? So can we use Q4 as a baseline against the 6 million savings? So roughly 7 million OpEx or 28 million annualized, so you hope to take that down by 6 million? Is that how to think about it?

Shaun McEwan

I would say, you're probably—sorry, Todd. It's Shaun here. I think it's a little bit lighter than the 6 million because part of Q4 already had a bit of the reductions from IRD in there.

Doug Parker

Yeah.

Shaun McEwan

So when you think of IRD, sort of 2.5 million a year, roughly 600,000, 700,000 a quarter, take that out of the 6 million for a second, if you're doing that run rate, but pretty close.

Todd Coupland

Okay. So take 0.5 million to 1 million off the 6 million. Sorry, was that a quarterly number in IRD?

Shaun McEwan

IRD, about 600,000 a quarter in Q4.

Doug Parker

And annualized 2.3 million.

Shaun McEwan

Yeah.

Todd Coupland

So you—okay. So you've already realized 2.3 million. Okay. I got it. So 3.5 million to 4 million is remaining against a, essentially, roughly 28 million run rate in OpEx?

Shaun McEwan

Yep. That seems right, Todd.

Todd Coupland

Is that—and it should come from that line, not at the gross margin line? Is that the way to think about it?

Shaun McEwan

Yes.

Todd Coupland

Okay. Okay.

Shaun McEwan

There'll be a small impact on gross margin, but it's pretty small.

Todd Coupland

Okay. Very good. And then just—like, I get the—you've had like a few good quarters of IRD now in a row. Is there enough in the pipeline with the new business and products that you called out, where the last few quarter trend can continue through '19? Or might we see some choppy quarters there as well?

Doug Parker

Yeah. I think that—it's Doug here, Todd. Q1 is always their seasonally weakest quarter—

Todd Coupland

Mm-hmm.

Doug Parker

—and that's the nature of a lot of just the field deployment side, particularly in North America. So that seasonality in Q1, you're going to see every year. I will say that the trend that we're seeing on book business, and what we expect to come through, will be slightly higher than last year, which was on the low side. There were some delays, if you remember, particularly in some of the weather in the United States and the California contract—

Todd Coupland

Late last year in Q1. Yeah.

Doug Parker

Yeah. So we see us being slightly better—the visibility we have to Q1 for them—but it will be—it will be on the lighter side. I will say, though, that we're fairly confident that we're going to see, at least, GDP level growth in that business. The pipeline is—going into the year, is the best it's been over the last couple years, as kind of what opportunities are there. And I think, clearly, the more—the tax product in particular, I think the bookings there are over 2 million in revenue—and that's got margin that's much more software-focused.

So I think the improvement—the more of the mix on that side should help the gross margin as well. But yeah, I think—I mean, it's clearly a business that doesn't grow as you see in some large software organizations. But it's consistently performing, and we'd expect—the momentum you saw at the tail end of 2018, on the year as a whole, to continue in 2019.

Todd Coupland

Okay.

Doug Parker

Yeah.

Todd Coupland

Okay. That's helpful. On the WiLAN side, I mean, the numbers have been all over the place. I know it's hard to predict. You've restructured down by a third. I mean, is there anything for us, just from a planning perspective, to think about for that line item over the next little while? Or is it just it comes when it comes?

Doug Parker

Yeah. I think it comes when it comes. I mean, obviously, there's an element of visibility we give into Q1, and when you kind of—the goal here is when we look at kind of the fixed cost basis of WiLAN, following the restructuring, we're kind of looking at that kind of fixed cost to be 5.5 million per quarter, roughly. And so that's—there's a certain amount of inherent investment there.

Todd Coupland

Okay.

Doug Parker

But yeah—no, I think we felt, we had enough insight into all our businesses, including WiLAN, to give some sort of perspective on Q1. But as it stands right now, the kind of lumpy nature and the episodic nature of the business is what it is.

I will say that the pipeline of opportunities and the litigation cadence is the same it's been. In fact, in certain areas, it's getting stronger, particularly in semiconductor. So we don't see any sea change in that rhythm of activity on the litigation or license or partnership side, Todd. It changes in—

Todd Coupland

I mean, I don't know if this is a relevant comparison, but two years ago or so, BlackBerry essentially outsourced its patent-licensing activities, and a professional group has been pushing that. And then they've just hit a major rhythm the last year or so in terms of upside in the licensing of their very large patent portfolio. So like they've gotten better at harvesting, I guess would be one observation. But I'm just wondering, is there a little bit shift back in favour of the patent-licensing companies, so you can actually get business done here? Or am I reading too much into the improvement of BlackBerry?

Doug Parker

Yeah. I mean, it's a constant debate, and it's a really good question. I think there's—we're seeing some shift in the legislative environment, in the case law environment in the United States. I don't think it's a material sea change, but I think the pendulum, I would say, is shifting a little bit more positively to businesses like ours and others in that space. I think it's a mixed bag internationally. I think some of that depends on the strength of people's partnerships and some of the specific technology.

But we ultimately in the long term remain bullish in the space, but I don't think that there has been, from my perspective, a significant shift. The real issue is the timing. Our semiconductor materials starting to hit—it's starting to deliver in our partnerships, and some of the litigation we have on the semiconductor side is really starting to hit its stride.

So where it is in the timing, it's not so much the changes in the legislation and the environment. All that hard work we've put into those partnerships, assessing the portfolios, they're really starting to hit their stride in two areas on the licensing side, and we're seeing real progress.

And that's—you know, Mike Vladescu's an expert in that; was really key in building that business. And some of the litigation is coming to fruition, that obviously triggers settlement as well or potential awards. So in our case, unique to us, we're starting to bear fruit in this kind of long-term strategy. It's not so much driven by a material change in the environment.

Shaun McEwan

Yep.

Doug Parker

Was that helpful in anyway?

Todd Coupland

Yeah. Yeah. No, that's for sure helpful. Like I mean, BlackBerry just got a little bit better, I think, in the last year or so. They weren't doing it as efficiently as they could. So I mean, I take your point.

Doug Parker

I think one of the things that you're also seeing is—and this is my observation at year-end and I'll get Shaun has any other comments on it as well—is that there's really a recognition that our ecosystem is something that the partners can take advantage of, so that we have the skill and ability to get the value from the portfolio. So we do see more opportunity on the partner side, where you see companies are saying, we would like to partner with you because of your proven track record and because of your skill set, and that's a very encouraging trend.

Todd Coupland

Yep. Okay. Last question for me is, like VIZIYA seems to have sort of had trouble in having consistent revenue. And I'm just—just from a business perspective, what's actually going on in terms of getting a little bit more regular rhythm there? Because I would've thought that a lot of that is recurring revenue. So help us understand what's going on there and how to think about it?

Doug Parker

Yeah. And so I think what—part of this, I think, is a product of the graduation of VIZIYA into larger opportunities, particularly with SAP and Oracle; they're being dragged into larger licensing deals that are driven by the corporate office. So in some of the industries, historically, a software license would be given site by site, specifically, and some of that still definitely occurs. But you're getting a lot more drive for larger transactions that are being driven corporately, and so the deals are getting larger. They're becoming more whale-like in opportunity. And certainly, we think VIZIYA's well positioned, from a technology perspective and a go-to-market perspective, to benefit from it.

But as you know, those sales cycles are longer and they—at certain point, they're harder. It means you can get a significant, large, immediate injection of software licence revenue. But they're chasing smaller opportunities as they always have, but they're kind of getting into the ZIP code where this dynamic's part of their business, and it just elongates the cycle of timing of software license.

At the same time, though, they're obviously investing in the cloud piece, which is a good—and there's a certain amount of the market that's shifting there. I think the shift on the cloud side's been, frankly, a little bit slower in their space than in other spaces we've seen. But with that successful switch to cloud, we'd expect what would be, from my perspective, more standardized recurring revenues you'd typically see in a SaaS model.

Shaun McEwan

Yep.

Todd Coupland

Okay. That's very helpful. Thanks for the colour.

Doug Parker

Pleasure.

Operator

As we have no further questions at this time, this concludes Quarterhill's Q4 and year-end 2018 financial results conference call. You may now disconnect your line. Thank you.