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GSIT - Q4 2012 GSI Technology Inc. Earnings Conference Call

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by. Welcome to GSI Technology's fiscal 2012 fourth-quarter conference call. At this time, all participants are in a listen-only mode. Later, we will conduct a question and answer session. At that time, we will provide instructions for those interested in entering the queue for the Q&A. Before we begin today's call, the Company has requested that I read the following Safe Harbor statement:

The matters discussed in this conference call may include forward-looking statements regarding future events and the future performance of GSI Technology that involve risks and uncertainties that could cause actual results to differ materially from those anticipated. These risks and uncertainties are described in the Company's Form 10-K filed with the Securities & Exchange Commission. Additionally, I have also been asked to advise you that this conference call is being recorded today, May 3, 2012 at the request of GSI Technology.

Hosting the call today is Lee-Lean Shu, the company's Chairman, President and Chief Executive Officer. With him are Douglas Schirle, Chief Financial Officer, and Didier Lasserre, Vice President of Sales. I would now like to turn the conference over to Mr. Shu. Please go ahead sir.

Lee-Lean Shu - *GSI Technology Inc - Chairman, President, CEO*

Good afternoon everyone. Thank you for joining us. As reported in this afternoon's press release, and despite extraordinary legal expenses approaching \$4 million, GSI was able to report its 34th consecutive quarter of profitability with earnings of \$829,000, or \$0.03 per diluted share, on net revenues of \$18.7 million. On balance, results for the quarter were about what we had expected when we spoke with you three months ago.

Net revenues were slightly higher than the top end of the \$15 million to \$18 million guidance we provided, thanks largely to higher-than-anticipated sales to a number of telecom customers. It is worth noting that these additional sales were not from Cisco or Huawei, our two biggest customers, where sales were actually down from the third quarter.

At 46.2% compared to 43.9% in the prior quarter, gross margin was considerably better than the 43.5% we had projected. This was due largely to a more favorable mix of products with higher ASPs. This is above our 43% to 45% target range and is not, we believe, sustainable on a regular basis. Despite lower net revenues in fiscal 2012 -- \$82.5 million compared to \$97.8 million in fiscal 2011 gross margin of 44.4% remained well within our target range.

Unlike fourth quarter net revenues and gross margin, fourth quarter operating margin was substantially lower than expected. In fact, with fourth quarter litigation-related expenses of \$3.7 million versus our estimate of \$3.0 million, we reported a small loss from operations in the quarter. For the year, litigation-related expenses totaled \$9.4 million, whereas in fiscal 2011 we had no such expenses. Operating margin for the year declined accordingly, to 8.1% from 23.9% in fiscal 2011.

As we have discussed on various occasions during the last year, the litigation-related expenses stem from a patent infringement lawsuit brought against GSI by Cypress Semiconductor in March of 2011. You may recall that last June, Cypress expanded its complaint to include a filing with the International Trade Commission. Much of last year's legal expenses were incurred in anticipation of a hearing before the ITC.

That hearing took place as scheduled in March of this year, followed by a post-trial briefing in April. Based on the hearing and the post-trial briefing, we continue to believe that GSI infringed no valid Cypress patents and that the ITC complaint is without merit. We expect that the Administrative Law Judge will issue an initial determination before the end of July, with a final determination by year end.

In gauging the outlook for fiscal 2013, then, we face three unknowns, any one of which could have a material impact on GSI's financial results for the year. The first, of course, is the possibility that the ITC, in whole or in part, rules in Cypress' favor. Although we consider this unlikely, if it were to happen it could significantly harm our business.

Second is the likelihood that even with a favorable initial determination in July, for the next several quarters we will continue to incur legal expenses related to the Cypress litigation. At this point, we expect that in the first quarter of fiscal 2013 these expenses will be substantially lower than they were in the fourth quarter of fiscal 2012, we expect them to be less than \$450,000, but we could be wrong. And while acknowledging that in the past we have not been entirely successful in estimating these legal expenses, we currently expect that they will be substantially lower in fiscal 2013 than they were in the year just ended.

Last but not least is the global economy in general and the demand for GSI's products in particular. Although most of our sales are in Asia, which appears to be doing reasonably well, we cannot discount problems in Europe. Cause for concern is the degree to which the eurozone is able to address its precarious monetary system and its sluggish economies. The UK appears to have fallen back into recession, and a double-dip recession in Europe would clearly have an adverse effect on the global economy and GSI's sales.

With these caveats in mind, we are cautiously optimistic regarding the year ahead. In fact, we consider it likely that a year from now we will be reporting our 38th consecutive quarter of profitability. Regarding the first quarter ending June 30th, where the outlook is somewhat clearer, our optimism is less guarded. Currently, we fully expect to see measurable improvements in both operating margin and net income. With that, I will now turn the call over to Doug.

Douglas Schirle - GSI Technology Inc - CFO

Thank you, Lee-Lean. For the year we reported net income of \$6.8 million, or \$0.23 per diluted share, on net revenues of \$82.5 million, compared to net income of \$18.9 million, or \$0.64 per diluted share, on net revenues of \$97.8 million in the fiscal year ended March 31, 2011. Gross margin was 44.4% compared to 45.8% in the prior year.

The decrease in net income, as well as the sharp decline in operating margin -- to 8.1% from 23.9% in the prior year -- was largely attributable to \$9.4 million in litigation-related expenses in fiscal 2012; there were no such expenses in fiscal 2011.

Research and development expense was unchanged at \$10.6 million, but selling, general and administrative expense, which included the litigation-related expenses, was \$19.4 million compared to \$10.7 million in fiscal 2011, an increase of \$8.7 million. Total operating expense increased by \$8.6 million, to \$30.0 million from \$21.4 million in fiscal 2011.

The quarter ended March 31, 2012 was our 34th consecutive profitable quarter. For the quarter ended March 31, 2012, net income was \$829,000, or \$0.03 per diluted share, on net revenues of \$18.7 million compared to net income of \$3.4 million, or \$0.11 per diluted share, on net revenues of \$21.9 million in the comparable quarter a year ago. Third quarter 2012 net income was \$991,000, or \$0.03 per diluted share, on net revenues of \$20 million. Gross margin was 46.2% compared to fourth quarter 2011 gross margin of 44.1% and third quarter 2012 gross margin of 43.9%.

At \$2.7 million, fourth quarter R&D expense was essentially unchanged from both the prior quarter and the comparable quarter a year ago. Fourth quarter selling, general and administrative expense was \$6.1 million, including \$3.7 million in litigation-related expenses compared to \$2.5 million

a year ago, when there were no litigation-related expenses. In the prior quarter, selling, general and administrative expense was \$5.5 million and included \$2.9 million in litigation-related expenses.

Fourth quarter direct and indirect sales to Cisco Systems were \$6.0 million, or 32.1% of net revenues, compared to \$9.9 million, or 49.5% of net revenues, in the third quarter, and \$6.8 million, or 31.3% of net revenues, in the same period a year ago. For the full year, sales to Cisco were 40.5% of net revenues compared to 37.0% in fiscal 2011.

Sales to Huawei Technologies, the Company's second-largest customer, were \$1.4 million, or 7.2% of net revenues, in the fourth quarter, compared to \$1.5 million, or 7.6% of net revenues in the prior quarter, and \$2.2 million, or 10.1% of net revenues a year ago. For the full year, sales to Huawei were 6.1% of net revenues compared to 9.7% in fiscal 2011.

Military/defense sales were 11.1% of shipments compared to 6.3% of shipments in the third quarter and 8.3% of shipments in the comparable period a year ago. For the full year, military/defense sales were 9.0% of shipments compared to 8.2% in fiscal 2011. SigmaQuad sales were 38.3% of shipments in the fourth quarter of 2012 compared to 27.3% a year ago and 32.1% in the prior quarter; for the year, they were 34.5% of shipments compared to 31.7% in fiscal 2011.

Total fourth quarter pre-tax stock-based compensation expense was \$539,000 compared to \$532,000 in the third quarter and \$408,000 in the comparable quarter a year ago. For the year, pre-tax stock-based compensation expense was \$2.1 million compared to \$1.7 million in fiscal 2011.

At March 31, 2012, we had \$58.7 million in cash, cash equivalents and short-term investments, \$33.5 million in long-term investments, \$82.7 million in working capital, no debt, and stockholders' equity of \$128.8 million.

Accounts payable at March 31st is \$5.5 million, down from \$5.6 million at March 31, 2011. Net inventory was \$16.7 million at March 31st, down from \$20.5 million at December 31st. Inventory turns at March 31, 2012 are 2.4 times compared to 2.3 times at March 31, 2011. Depreciation and amortization expense was \$2.6 million in fiscal 2012 compared to \$2.8 million in fiscal 2011.

We currently expect revenues in the first quarter of fiscal 2013 to be in the range of \$17 million to \$19 million, with gross margin of approximately 44%. Although fourth quarter fiscal 2012 revenues exceeded our earlier forecast, we believe that they were negatively affected by uncertainty regarding our pending patent litigation with Cypress. We believe that this uncertainty will continue to affect our revenues, and will likely have a continued impact in the first quarter.

We also expect that ongoing legal expenses related to the patent litigation will continue to affect our operating income and our bottom line. These expenses are estimated to be approximately \$450,000 during the first quarter of fiscal 2013. We expect operating expenses for the quarter to be approximately \$5.6 million.

On November 6, 2008, our Board of Directors authorized the repurchase, at management's discretion, of up to \$10 million of our common stock. On January 26, 2012, the Board of Directors adopted a new program authorizing the repurchase of up to an additional \$10 million of common stock. Under the expanded repurchase program, we may repurchase shares from time-to-time on the open market or in private transactions. The specific timing and amount of the repurchases will be dependent on market conditions, securities laws and other factors. The repurchase program may be suspended or terminated at any time without notice.

During the quarter ended March 31, 2012, we repurchased 402,573 shares at an average cost of \$4.64 per share. To date, we have repurchased a total of 2,820,060 shares at an average cost of \$3.72 per share for a total cost of \$10.5 million. Operator, now we're ready for Q&A.



QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

We'll pause for just a moment to compile the Q&A roster.

(Operator Instructions)

Your first question comes from the line of Tristan Gerra. Your line is open.

Daniel Marquardt - *Robert W. Baird & Company, Inc. - Analyst*

Hi. This is Daniel Marquardt for Tristan.

Can you give us an update on your RLD RAM and, you know, when you expect it to sample, what's the designing cycle, and when we can expect meaningful revenue?

Didier Lasserre - *GSI Technology Inc - VP - Sales*

The samples for what we feel is our silicon, went out a couple of weeks ago actually. So, we have talked about in the past there were a couple of minor bugs that were left. And we believe we have worked through those, and we did a general sampling, as I mentioned, a few weeks ago.

One customer has already given us feedback that the part works fine, and they're closing up qualification. In general, we do feel the qualifications will take longer than that throughout the calendar -- second calendar third quarter for sure, so there's a chance we might see some small revenue in the end of this calendar year, but certainly starting in -- beginning of next year we should see it start ramping.

We did sample one of our top customers for one of their high volume sockets, and so far the initial feedback has been positive that the part works well with their ASIC and there's no issues, but the qualification cycle there will take some time so that we don't anticipate much this calendar year on that particular socket.

Daniel Marquardt - *Robert W. Baird & Company, Inc. - Analyst*

And -- if you can remind me, is this RLD RAM 2 or RLD RAM 3 or both?

Didier Lasserre - *GSI Technology Inc - VP - Sales*

Just two.

Daniel Marquardt - *Robert W. Baird & Company, Inc. - Analyst*

Okay. And then --

Didier Lasserre - *GSI Technology Inc - VP - Sales*

But it is the 576 meg and the 288 meg, but it is only the RLD RAM 2 equivalent.



Daniel Marquardt - *Robert W. Baird & Company, Inc. - Analyst*

OK. And then in terms of -- if you guys could talk a little bit about the Samsung market share and perhaps the visibility you have into, I guess, what their market share is in terms of the mix. And, you know, specifically I'm looking for, you know, what parts are you currently multi-sourcing with Samsung, so the parts that you already qualified? And what portion would require qualification?

Didier Lasserre - *GSI Technology Inc - VP - Sales*

That's a very difficult question to answer. So in many cases, we are multi-source with Samsung already. It's when we see that at a couple of our largest customers and in a lot of areas we're not qualified yet.

As far as the transition, the majority of the market has, in the end of June of this year [last time buy] within the end of December last time ship, but a lot of the majors have extended terms beyond that. So I don't see any major shift happening, you know, in the next quarter or two. I certainly see that transition won't be happening in the second half of the year, mostly the end of the year when we start seeing some of that.

As far as the size of Samsung, it's difficult to really estimate, but we've, you know, it can be anywhere between probably a low of 15% of the market to a high of 25% of the market. So I guess, it's still certainly somewhere between there. But again, we anticipate that transition will happen more towards the end of this year.

Daniel Marquardt - *Robert W. Baird & Company, Inc. - Analyst*

Thank you.

Operator

Your next question comes from the line of Tim Shelton. Your line is open.

Tim Shelton - *Needham & Company - Analyst*

Hi, guys. This is Tim Shelton. On behalf of Raj Gill, I appreciate you taking my call.

I just had a few. First one to start out and see if you had a sense for just the general demand environment for the SRAM market that you're seeing.

Didier Lasserre - *GSI Technology Inc - VP - Sales*

So, we're seeing that the bookings were up a bit going into this quarter.

So in general, we think it's a touch better. You know, as Lee-Lean mentioned earlier, there's still some uncertainty happening in world economies so it's hard to predict what's going to happen going forward. But certainly in a short -- I just want to look at a short view or a snapshot, you know, the bookings have been up recently.

Tim Shelton - *Needham & Company - Analyst*

Okay. Great. And then, you know, I know you just touched on the Samsung part a little bit in the last question, but, you know, I wanted to see if you could drill down a little bit and if you had any sense for, you know, some of the actual revenues or color around that that you might be seeing from Samsung's exit.



Didier Lasserre - *GSI Technology Inc - VP - Sales*

Not yet. As I mentioned, this still hasn't kicked in yet. You know, certainly we have spoken a lot of customers that are starting to put, you know, strategies in place. I mean, certainly we know that they're going to be going with us going forward, but there hasn't been any action as far as transferring of orders or anything yet. Right now, it's just putting the processes in place to make sure that GSI gets brought into their supply strategy going forward if we're not already there. So, you know, we see the activity happening on a dialogue basis. But as far as an order basis, the transitioning will happen a little later this year.

Tim Shelton - *Needham & Company - Analyst*

Okay, great. And then lastly, I know you touched on, you know, some of the numbers the next quarter for the legal fees. But I just want to get a sense for, you know, any color you have into how confident you are for some of these numbers and, you know, how likely it is that some of these expenses could increase more than anticipated.

Douglas Schirle - *GSI Technology Inc - CFO*

You know, our spending is relatively consistent from a quarter-to-quarter [near to dear]. You know, R&D is a good example. You can see essentially the same numbers last year.

SG&A would have been very similar also. You know, the biggest impact there has been the legal fees related to the ITC, you know, Cypress litigation. You take that out, it's a very similar number to last year.

You know, in terms of what we expect to increase, you know, we don't see a lot of need for equipment additions to this point so we don't see depreciation going up. In terms of headcount, I think, for the most part, we're probably stepped there. We don't see a need for either maybe one or two engineers in the next year. We'll see a lot of changes there.

So the biggest unknown to me is what the revenue numbers going to be. You know, there still is a lot of overhang. And the Cypress ITC litigation, we know it's impacted us. It's just, you know, the question is I think people are waiting until July and November when we get the initial and final decision from the administrative law judge. For me, it's just a revenue issue. We could control the expenses; we know what they are.

Tim Shelton - *Needham & Company - Analyst*

All right. Great. Thanks so much.

Operator

Again, if you would like to ask a question, please press star then the number 1 on your telephone keypad. Your next question comes from the line of Chris Segala from B. Riley. Your line is open.

Chris Segala - *B. Riley & Company - Analyst*

Yes. Thanks for taking my questions. Just to follow up a little bit on the last questions, curious on your visibility into Q1 here. Maybe you can talk a little bit about the book-to-bill, so the bookings increase. And just in general, how much of the Q1 quarter do you have booked already and how does that compare to some of the historical trends that you've seen?

Didier Lasserre - *GSI Technology Inc - VP - Sales*

Yes. We don't generally report book-to-bill just because two of our largest customers work on a consented model, and so it's just unfortunately not -- it just doesn't translate well when you have zero dollar backlog.

In general, from what we see in the other customers is where we saw the billings or -- I'm sorry -- the bookings were trending up. As far as booking into the quarter, it's a similar type of loading that we usually see, which is about a third of our backlog booked in revenue orders, about at least a third of our backlog booked in consignment orders. And then we need to turn the other third. So we're running about normal kind of a turns environment at this point.

Chris Segala - *B. Riley & Company - Analyst*

Okay. And then switching over the gross margin, nice to see that number come down here or go up here. I'm curious when you say the mix had a beneficial impact, can you kind of elaborate a little bit on that? And, you know, what specific product categories are contributing to that?

Didier Lasserre - *GSI Technology Inc - VP - Sales*

Sure. Part of it was our new product, the SigmaQuad-III, so the SQ3, which we've discussed in the past is (inaudible) one of our largest customers. So this past quarter, they actually had build out for a few more trials for their customers and then also for some internal system.

And so, you know, again it's only some internal and some trial systems, and you could see how it benefited our gross margins. So certainly we're anticipating when this actually become true customer ships a little later on this year. But I would say some of that margin increase was due to the -- again the higher performance SQ3, and also some more of the higher density SigmaQuad-III in general.

Douglas Schirle - *GSI Technology Inc - CFO*

In addition, the military business is up during the quarter.

Didier Lasserre - *GSI Technology Inc - VP - Sales*

True.

Chris Segala - *B. Riley & Company - Analyst*

Yes, the large profile and the military business is a bit more than average. Correct?

Douglas Schirle - *GSI Technology Inc - CFO*

Correct.

Didier Lasserre - *GSI Technology Inc - VP - Sales*

Yes. The military business dipped down in the December quarter, and now we're kind of back up to the more normal levels that we've seen in the past.



Chris Segala - *B. Riley & Company - Analyst*

Okay. Yes, that's very helpful. And then, I'm curious on seasonality. Is it fair to say that the March quarter is typically a weaker seasonal quarter for you with some rebound in the June quarter expected. I guess, I'm curious if that is true, how does that sort of correlate with your revenue guidance being basically flat to down (inaudible).

Douglas Schirle - *GSI Technology Inc - CFO*

You know, our revenue isn't seasonal; we're cyclical. We go with the networking talk time guys, but we have a very small percentage of our revenue that's consumer-related. It's next to nothing.

Chris Segala - *B. Riley & Company - Analyst*

Okay. And then just finally then, because -- how you're looking at the size of LLDRAM market and, you know, what are some of the substance built into your estimates there?

Didier Lasserre - *GSI Technology Inc - VP - Sales*

The numbers we've been hearing are similar, and these numbers haven't changed much, although we just got in the past \$200 million to \$300 million for the -- and this is for the RL2 market. You know, someone questioned earlier about the RL3. That's a new market that doesn't have much revenue yet.

So most of the [TAM] right now is in the RL2 and it's similar in the neighborhood of \$200 million to \$300 million. And what we've always discussed in the past is that we are looking for, in the neighborhood of \$10 million a quarter, once we get up and running in full production with our qualifications closed.

Chris Segala - *B. Riley & Company - Analyst*

Okay. And then just final question, I guess, is RL3 somewhere around the product roadmap here and how do you look at, you know, that is a competitive threat to the RL2?

Didier Lasserre - *GSI Technology Inc - VP - Sales*

Right. So, when we get to the next generation after the RL2, the market actually splits; there's an RL3 and there's something -- there's a different solution out there. And we are working on the other -- the different solutions. So the RL3 is offered by Micron, and they've recently signed the agreement with ISSI. And the other area would be ourselves and Renesas REC, so we're doing something a little bit differently.

You know, the largest consumer in the world of RL technology is actually committed to the device namely that we're making with, you know, I should say with, but second sourcing with Renesas. They're not committed to be RL3.

So the answer is, as of now, we don't have a true RL3 pin-for-pin compatible parts on the roadmap. We're looking at something that has a similar density, but a little bit different feature setting and performance levels, and so they won't be pin-for-pin compatible with the RL3. But again, we do have a built-in customer for this technology, which today is the largest consumer of this type of a technology.

Chris Segala - *B. Riley & Company - Analyst*

Okay. All right. Yes, that's very helpful. Thanks a lot, guys.



Didier Lasserre - *GSI Technology Inc - VP - Sales*

Thank you, Chris.

Operator

There are no further questions at this time. I turn the call back over to the presenters.

Lee-Lean Shu - *GSI Technology Inc - Chairman, President, CEO*

Thank you all for joining us. We look forward to speaking with you in July when we already pull off first quarter fiscal 2013 results. Thank you.

Operator

This concludes today's conference call. You may now disconnect.

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