

BSQUARE CORP /WA
Form 10-K
February 21, 2017

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2016

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF
1934

For the transition period from _____ to _____

Commission file number: 000-27687

BSQUARE CORPORATION

(Exact name of registrant as specified in its charter)

Washington 91-1650880
(State or other jurisdiction of (I.R.S. Employer
incorporation or organization) Identification Number)

110 110th Avenue NE, Suite 300, Bellevue, Washington 98004

(Address of principal executive offices, including zip code)

Registrant's telephone number, including area code: (425) 519-5900

Securities registered pursuant to Section 12(b) of the Act:

| Title of each class | Name of each exchange on which registered |
|----------------------------|--|
| Common Stock, no par value | The NASDAQ Stock Market LLC (NASDAQ Global Market) |

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Securities registered pursuant to Section 12(g) of the Act:

NONE

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act. Yes No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

The aggregate market value of common stock held by non-affiliates of the registrant on June 30, 2016 was approximately \$54,461,983 and was determined using the closing price of our common stock on June 30, 2016 on the NASDAQ Global Market (\$5.58) and excludes 2,483,118 shares of Common Stock held by directors, officers and shareholders whose beneficial ownership exceeded 5% of the registrant's Common Stock outstanding. The number of shares owned by such persons was determined based upon information supplied by such persons and upon Schedules 13D and 13G, if any, filed with the SEC. Exclusion of shares held by any person should not be construed to indicate that such person possesses the power, direct or indirect, to direct or cause the direction of the management or policies of the registrant, that such person is controlled by or under common control with the registrant, or that such person is an affiliate for any other purpose. There were 12,243,330 shares of our Common Stock outstanding on June 30, 2016.

The number of shares of common stock outstanding as of January 31, 2017: 12,540,945

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive proxy statement to be delivered to shareholders in connection with the 2017 annual meeting of shareholders are incorporated by reference into Part III of this Annual Report on Form 10-K.

BSQUARE CORPORATION

FORM 10-K

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PART I

Item 1. Business.

CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-K contains "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 often be identified by words such as: "expect," "believe," "estimate," "plan," "strategy," "future," "potential," "continue," "may," "should," "will," and similar references to future periods. Examples include, among others, statements about: expected operating results, such as revenue and earnings; anticipated levels of capital expenditures; future market conditions; our belief that we have sufficient liquidity to fund our business operations for at least the next 12 months; expectations of the effect on our financial condition of claims, litigation, contingent liabilities and supplier audits; 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 only predictions, based on current beliefs, expectations and assumptions about the future of our business and other future conditions. Forward-looking statements are subject to known and unknown risks, uncertainties and changes in circumstances that are difficult to predict and many of which are outside of our control. Actual events and results may differ materially. Therefore, you should not rely on any of these forward-looking statements.

Any forward-looking statement made by us in this report is based only on information available to us on the date of this report. Except as may be required by law, we undertake no obligation to publicly update any forward-looking statement, whether as a result of new information, future developments or otherwise.

Our forward-looking statements can be affected by inaccurate assumptions we might make or by known or unknown risks, uncertainties and other factors. We discuss many of these risks, uncertainties and other factors in this Annual Report on Form 10-K in greater detail under the Item 1A—"Risk Factors." We caution readers that our business and financial performance are subject to substantial risks and uncertainties.

BUSINESS

Overview

As used in this Annual Report on Form 10-K, "we," "us", "our", "the Company" and "BSQUARE" refer to BSQUARE Corporation.

Since our inception, our business has largely been focused on providing software solutions (historically including reselling software from Microsoft Corporation ("Microsoft")) and related engineering services to businesses that develop, market and sell dedicated purpose standalone intelligent systems. Examples of dedicated purpose standalone intelligent systems include smart, connected computing devices such as smart phones, set-top boxes, point-of-sale terminals, kiosks, tablets and handheld data collection devices, as well as smart vending machines, ATM machines, digital signs and in-vehicle telematics and entertainment devices. We focus on systems that utilize various Microsoft Windows Embedded operating systems as well as devices running other popular operating systems such as Android, Linux, and QNX, and that are usually connected to a network or data cloud via a wired or wireless connection. Our customers include world-class original equipment manufacturers ("OEMs"), original design manufacturers ("ODMs"), corporate enterprises ("Enterprises"), silicon vendors ("SVs") and peripheral vendors. A significant portion of our business historically has also been focused on reselling software from Microsoft, from which a majority of our revenue currently continues to be derived.

Beginning in early 2014, we initiated development efforts focused on new proprietary software products addressing the Internet of Things (“IoT”) market, which is the interconnection of uniquely identifiable embedded computing devices within the existing internet infrastructure. While IoT is a relatively new market, we believe the work we have engaged in since our inception—namely adding intelligence and connectivity to discrete standalone devices and systems—embodies much of what is central to the core functionality of IoT. These software development efforts have driven a new business initiative for BSQUARE, which we refer to as DataV™. Our DataV solution includes software products, applications and services that are designed to render raw IoT device data into meaningful and actionable data for our customers.

We launched DataV late in the first quarter of 2016 and announced our first three major customer bookings later that year. These bookings comprised software licensing, software maintenance and related systems integration services and are, we believe, indicative of the potential customer demand for DataV.

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We believe that DataV presents high growth opportunities in a large, expanding addressable market, at substantially higher gross margins as compared to our traditional business. Over time, we intend for DataV to become our primary focus, representing a transition away from dependence on resale software and engineering services toward increased reliance on our own proprietary software and related systems integration services. As a result, we focused virtually all of our research and development and marketing efforts, as well as a majority of our sales efforts, on DataV during 2016. We intend to continue to run our legacy software resale and engineering services business for the foreseeable future.

We were incorporated in the State of Washington in July 1994. Our principal office is located at 110 110th Avenue NE, Suite 300, Bellevue, Washington 98004, and our telephone number is (425) 519-5900.

Industry Background

The IoT market is still emerging, but we believe it will present a large market opportunity for us. This market includes consumer, business, government and industrial segments, and encompasses software, hardware, connectivity and cloud providers as well as systems integrators. While larger research firms do not yet widely track the IoT market, available research anticipates that over time, the deployment of hundreds of billions of connected devices may generate trillions of dollars of economic value.

The IoT marketplace is currently being influenced by the following factors:

- Development of machine learning and data analytics software that advances the understanding of complex systems but lacks the capability to effectively process the proliferation of resulting data. This provides an opportunity for solutions such as DataV to develop models of complex mechanical equipment that can be used for predictive reasoning;
- Nearly ubiquitous wireless connectivity, including near-field communications (“NFC”), Bluetooth, Wi-Fi, and cellular, allowing connectivity and data exchange with large populations of small, remote, and frequently mobile devices;
- Competitive pressures that are forcing a wide array of businesses to invest in automation as a way to improve productivity, reduce costs, and enhance the value of their own offerings; and
- The availability of inexpensive cloud compute and storage capabilities able to scale to the extent likely to be demanded by IoT.

Software

Software revenue for the last two fiscal years was as follows (in thousands):

| | Year Ended | | | |
|--|--------------|-----------|----|---|
| | December 31, | | | |
| | 2016 | 2015 | | |
| Software revenue: | | | | |
| Third-party software | \$ 80,231 | \$ 82,885 | | |
| Proprietary software | 1,939 | 3,323 | | |
| Total software revenue | \$ 82,170 | \$ 86,208 | | |
| Software revenue as a percentage of total revenue | 84 | % | 81 | % |
| Third-party software revenue as a percentage of total software revenue | 98 | % | 96 | % |

DataV Software

DataV is a comprehensive software solution developed by BSQUARE intended to address a variety of business use cases specific to industrial IoT applications. DataV addresses the following business use cases:

- ◆ **Predictive Failure:** By employing machine learning and advanced data analytics, DataV is able to predict, with varying levels of accuracy, future operational conditions for equipment or devices that are part of the overall IoT system. For many industrial concerns, the operational condition of greatest interest is a failure state. By being able to predict failures before they occur, DataV customers are able to take steps to remediate the condition more quickly, less expensively and with less operational disruption.
- ◆ **Adaptive Diagnostics:** For equipment that has already failed, DataV can dynamically proscribe diagnostic and repair steps that have the highest probability of quickly and less expensively resolving the problem. DataV uses historical repair data coupled with machine learning and data analytics to achieve this.

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•**IoT Device Management:** The spread of data-generating devices in IoT systems introduces a new set of operational problems for industrial concerns. DataV is able to facilitate IoT device management, including software and configuration updates, over large-scale populations of connected devices.

•**Condition-Based Maintenance:** DataV allows organizations to move beyond maintenance cycles based solely on time or usage, which inevitably result in over- or under-servicing of equipment. DataV develops maintenance schedules based on actual equipment condition using not only device data but environmental data as well. This results in lower overall service costs and improved asset longevity.

•**Asset Optimization:** Industrial concerns with large fleets of similar equipment want to ensure the performance of their equipment is maximized. DataV, again by employing machine learning, data analytics, and historical data, can help these customers identify underperforming assets and proscribe remediation steps.

•**Asset Utilization:** DataV can assist our customers in tracking how their products are used in the field. This can help ensure that equipment use is as intended, an important requirement for heavy equipment rental firms. It can also provide product designers with feedback that can help improve product performance and differentiation.

The DataV solution is designed to be implemented in a wide variety of industrial sectors and vertical markets, including commercial transportation, oil and gas extraction, manufacturing, water and power, medical devices and others. These industrial sectors share common operational characteristics, such as the dependence on complex capital equipment where the cost of failure or sub-optimal performance is relatively high. In other cases, our customers seek new revenue-generating products or services to enhance operating profitability. We license our DataV software through various customer licensing models, including perpetual and subscription, and we are flexible in providing DataV on-premises, hosted or via a software as a service (“SaaS”) model.

We officially launched DataV as a commercially available product in March 2016. Although we had previously engaged in several paid proof-of-concept tests with customers prior to that, we secured our first order in May 2016. This order, valued at \$4.3 million over a three-year period, allowed PACCAR, Inc., a heavy-duty truck manufacturer, to employ adaptive diagnostics in order to more rapidly service and repair trucks. The order included a perpetual license to use DataV for that specific application on certain engines in North America, as well as annual maintenance and custom systems integration services.

In November 2016, we secured our second DataV order. This order, placed by Itron, Inc., a large global manufacturer of electric, water, and gas meters for utilities as well as smart city solutions targeting IoT device management, is valued at \$1.9 million for the first year with a \$2.9 million four-year extension option. The deal includes a subscription license to use DataV in addition to maintenance and systems integration services.

In December 2016, we secured an order from a global provider of candy and beverages. This contract is for a smart vending initiative that adds intelligence to existing fleets of vending machines, allowing them to better track real-time sales data and, in the future, better predict equipment failures within these machines.

Third-Party Software Products

We have distribution agreements with multiple third-party software vendors. Our ability to resell these third-party software products, whether stand-alone or in conjunction with our own proprietary software and engineering service offerings, provides our customers with a significant solution source for their project needs. Our primary third-party software offerings include the following:

•For 18 years, we have been a Microsoft authorized Value-Added Provider (“VAP”) of Windows Embedded operating systems and toolkits for the complete line of Windows Embedded products, including major product families such as Windows Embedded Compact, Windows Embedded Standard and Windows Embedded Server. We are authorized to sell Windows Embedded operating systems in the United States, Canada, Mexico, Argentina, Brazil, Chile, Columbia, Peru, Puerto Rico, the Caribbean (excluding Cuba), the European Union (“E.U.”), the European Free Trade

Association, Turkey and Africa. Of our total revenue, 72% in 2016 and 64% in 2015 resulted from the sale of Windows Embedded operating systems. Our current distribution agreements related to Windows Embedded expire on June 30, 2017 and are typically renewed annually or bi-annually;

• We have been a Microsoft authorized VAP of Windows Mobile operating systems since November 2009. Along with Windows Mobile operating systems, we also sell Microsoft's Office Mobile product. We are currently authorized to sell Windows Mobile operating systems and related products in North America, South America, and Central America (excluding Cuba) (the "Americas"), Japan, Taiwan, and the region comprised of Europe, the Middle East, and Africa ("EMEA"). Of our total revenue in 2016, 9% was generated through the sale of Windows Mobile operating systems, compared to 12% in 2015. Our current distribution agreements related to Windows Mobile expire on June 30, 2017 and are typically renewed annually or bi-annually;

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