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SPCB - Q1 2019 Supercom Ltd Earnings Call

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PRESENTATION

Operator

Good morning. Welcome to SuperCom's First Quarter 2019 Earnings Conference Call. Joining us on today's call are SuperCom's President and Chief Executive Officer, Arie Trabelsi; and President of SuperCom Americas, Ordan Trabelsi. Before we start, I would like to point out that this conference may contain certain projections or other forward-looking statements regarding future events or future performance of the company. These statements are only predictions, and SuperCom cannot guarantee that they will in fact occur. SuperCom does not assume any obligation to update that information. Actual events or results may differ materially from those projected, including as a result of changing market trends, reduced demand and the competitive nature of the security systems industry or due to risks identified in the documents filed by the company with the Securities and Exchange Commission.

In addition to disclosing financial results calculated in accordance with the United States generally accepted accounting principles, GAAP, this call also contains non-GAAP financial measures, which SuperCom believes are the principal indicators of the operating and financial performance of its business.

Management believes non-GAAP financial measures provided are useful to investors' understanding and assessment of the company's ongoing core operation and prospects of the future as the charges eliminated are not part of the day-to-day business or reflective of core operational activities of the company. However, such measures should not be considered in isolation or as substitute for results prepared in accordance with GAAP. Reconciliation of the non-GAAP measures to the most comparable GAAP measures are provided in the schedules attached in the earnings release.

At this time, I will turn the call over to Mr. Ordan Trabelsi. Sir, please proceed.

Ordan Trabelsi - *SuperCom Ltd. - President of Supercom Inc.*

Thank you, operator. Good morning, everyone, and thank you for joining us today. Remarks will be short and focused this time. Earlier today, we issued a press release for the financial results for the first quarter 2019, a copy of which will be available in the Investor Relations section of our website. We had some meaningful results for the first quarter of 2019, continuing year-over-year quarterly improvements in earnings, reaching EBITDA of \$1.7 million and non-GAAP EPS of \$0.06. In revenue, there has been some interesting shifts and movements. Our revenue has declined to \$5.7 million compared to \$7 million for Q1 last year, a closer look shows that it's in line with our overarching strategy, with the decline coming from our e-Gov segment as we've diverted focus and resources away from developing countries towards North America and Europe in our IOT and Cyber segments. e-Gov segment revenue decreased by 84% year-over-year, while at the same time IOT segment revenue increased by over 25%, and a subsegment, IOT product revenue, increased by over 50%. Our IOT segment consists of product-related revenues and service-related revenues. The products, which is mainly the lease of our equipment and Software-as-a-Service to our proprietary Electronic Monitoring PureSecurity Technology suite, which has been performing excellently in competitive tenders around the world. The remainder of the revenues fall into IOT services, which is mainly the service we provide to customers in the criminal justice space in unison or complementary to electronic monitoring of offenders. We've seen growth in IOT service revenues as well. Cyber segment had minimal growth of 1% year-over-year and maintained a high retention as we are preparing for new cyber product deployment to the strong long-term customer base.



The revenue breakdown and composition of this quarter reflects significant progress in our multi-year strategy and business plan. We've been able to leverage our strong global brand of over 30 years as a government contractor in national security and our proprietary technology to shift most of our business to developed nations and recurring revenue based segments of IOT and Cyber security software. Our percentage of revenue from developed countries out of our total revenues, which is less than 5% in 2015 and approximately 67% in the first quarter of '18, has reached a high of over 90%. Over 90% of our revenue this quarter came from developed countries, mainly North America and Europe.

We had a big focus this quarter and in recent quarters on recurring revenue-based deployments for customers in developed nations, such as U.S.A., Denmark, Sweden, U.K. and Canada with numerous ongoing project deployments in our IOT business segment and various new ones in Cyber Security segment.

In the recent past, we're expanding to new countries and governments faster than ever before with an exceptionally high win rate. Last year, we announced 8 project wins in IOT. This year, we are not yet halfway through and have announced the launch of 6 new project launches in 2019 and expect continued wins and success going forward as our global presence and technology improve with every new project. These projects are expected to also generate long-term recurring revenue for years to come as well as additional business from customer references they provide.

As the revenues from each of our business segments grow, we expect gross margins to grow as well, leveraging the fixed costs which make up part of our COGS, such as the 24/7 maintenance and tech support center. Furthermore, our team of outstanding employees around the world have been working exceptionally hard this year to tightly manage costs, unleash operational synergies and cut out redundancies. And this is significantly improved operating structure we've reached this quarter, non-GAAP gross margins as high as 58% and sequential and year-over-year quarterly improvements in non-GAAP core operating expenses reaching a low of \$2 million, a 39% improvement from \$3.3 million in the previous year period. We've seen sequential and year-over-year improvements to EBITDA margins as well reaching a high of 29% this quarter compared to 17% in the previous year period. We haven't seen these kind of numbers at SuperCom in years. They resemble the lean operating structure of 2015, before acquiring 5 additional companies, much of -- most of which were in distress.

Yet today, our business prospects are multiples higher, with 2 additional business segments and growth engines, IOT and Cyber Security, over 50% growth this quarter in our IOT products revenues, high recurring revenue percentages, a major presence in developed markets, more predictable revenue and payments and significant enhancements to our technology portfolio backed by 119 patents.

Some additional updates. At the end of 2018, we've secured a \$20 million credit facility from funds managed by Fortress Investment Group, a large U.S. investment management firm with above \$40 billion under management as of June 2018. This allows us to grow our working capital to properly deploy our numerous ongoing multiyear projects as well as a signal to potential customers and partners that we have capacity to do even more. We're still working on collecting our trade receivables. It's important to note that when dealing with POC, percentage of completion, projects and national governments in developing regions such as Africa, collections have historically taking more time. This is not unusual. What helps here is our track record in collections and the understanding that the systems we operate, national biometric, passports, ID cards, visas, to name a few, are critical to the core operations of the government. So we have some leverage.

Updates in some of the business segments. In e-Gov, we continued development and enhancement of project in Iceland, given its geographic location in Europe, and maintained relationship with customers in Africa and other developing regions with existing SuperCom systems in place. We've also diverted some of the resources from this segment to support growth in IOT and Cyber.

In IOT, we continued development of new innovative and market-disrupting features and capabilities to the PureSecurity Electronic Monitoring Suite, supporting new project deployments and allowing for increased competitive advantages in new bids; continued to bid and maintain high win rates in competitive tenders for electronic monitoring, both in Europe and in California, with some expansion into additional states in the U.S. In January, we announced a \$7 million project deployment with the national government of Sweden for the Ministry of Justice. We also announced that month a new project with the national government of Estonia to deploy PureSecurity EM suite to track and monitor up to 400 simultaneous enrollees. In February, we secured additional contract to provide PureSecurity to Southern Georgia to an established service provider. In April, we had another win in North California valued at up to \$6 million. In May, secured additional project to provide the EM Suite to Tennessee through an established service provider. In May, we announced a new project in California valued at up to \$3.7 million. And we continued support and deployment of more units in other new and existing customers in IOT globally.



In Cyber Security segment, as noted, had minimal growth of 1% year-over-year, which is in line with our focus. We are trying to maintain our customer base and have high retention, as we prepare for deployment of new cyber security products that we are developing. We continued to progress on these advanced cyber security products, adding more capabilities including anti-malware, advanced data loss prevention and location-based port and device protection to be incorporated into the Safend cyber security platform.

To reiterate, on \$5.7 million revenue this quarter, we generated non-GAAP EPS of \$0.06 and EBITDA of \$1.7 million, resembling a 29% EBITDA margin. It was hard to reach this optimized cost structure with a strong core, and with top line growth, we expect profitability margins to grow further. On top of that, we have large pipelines of more project deployment opportunities across our business lines. And while the time lines and wins for these project opportunities carry a lot of uncertainty, our recent performance with increasing win rates gives us confidence that we're on the right track.

In summary, we're working diligently on building a strong core operating structure which is lean and effective, and in parallel, are setting the runway for continued and more predictable growth in our steady-state recurring revenues. These items are a matter of execution, and we are performing according to the business plan. Turning the call over to Arie? Arie?

Operator

Ladies and gentlemen, please stand by. Your conference will resume momentarily.

(technical difficulty)

Ordan Trabelsi - *SuperCom Ltd. - President of Supercom Inc.*

My apologies. Arie got disconnected. He is calling back on.

Arie Trabelsi - *SuperCom Ltd. - CEO, President & Acting CFO*

Thank you, Ordan. As you just heard, we had a good first quarter at SuperCom, highlighted by significant growth in our IOT business and revenue from North America and Europe as well as an improved operational cost structure and profitability. Moving forward, we remain focused on growing our margin to even greater level by winning new businesses and transition our various ongoing deployment into long-term steady-state recurring revenue generator. We have confidence in our prospect for the upcoming year and beyond.

And with that, we're ready to open the call for analyst questions. Operator, please provide appropriate instructions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Kevin Dede with H.C. Wainwright.

Kevin Darryl Dede - *H.C. Wainwright & Co, LLC, Research Division - MD of Equity Research & Senior Technology Analyst*

Just a couple of housekeeping items, first. So you've got IOT segment now in product and total, right? Can you give us a ballpark on what those actual values were?



Arie Trabelsi - SuperCom Ltd. - CEO, President & Acting CFO

Yes, okay. On the IOT, in general, we do not share -- reveal the numbers, but I would say that right now the product is about 40% of the overall IOT revenue.

Ordan Trabelsi - SuperCom Ltd. - President of Supercom Inc.

And IOT was the majority of the quarter. We just haven't been breaking them out on a quarterly basis. The majority of revenues were there. And the product is -- over 25% growth in IOT year-over-year, and we also broke out the top of the products because we're seeing significant growth for the EM Suite, which is growing by over 50% year-over-year.

Kevin Darryl Dede - H.C. Wainwright & Co, LLC, Research Division - MD of Equity Research & Senior Technology Analyst

Okay. What was the share count because I didn't -- I couldn't find that in the press release. Do you have the share count for the quarter?

Arie Trabelsi - SuperCom Ltd. - CEO, President & Acting CFO

The average was 15.7.

Kevin Darryl Dede - H.C. Wainwright & Co, LLC, Research Division - MD of Equity Research & Senior Technology Analyst

Okay. Arie, can you talk about where your loan stands? I know you've bought some stock, I was just wondering where your loans stood?

Arie Trabelsi - SuperCom Ltd. - CEO, President & Acting CFO

In general, as you know, we have agreement with Fortress for the credit line. One of the conditions there is that we minimize the -- our loan to the company. The majority loan, okay, should come from Fortress, so we're being forced to minimize our loan, but still we have some figure there.

Kevin Darryl Dede - H.C. Wainwright & Co, LLC, Research Division - MD of Equity Research & Senior Technology Analyst

Okay. Clearly, you've migrated resources, less emphasis on e-Gov, but I'm wondering if you were chasing new tenders there at all? Or if you're just maintaining relationships with the governments that you have to maintain the business that you have already won?

Arie Trabelsi - SuperCom Ltd. - CEO, President & Acting CFO

Yes, okay. Thank you very -- this is an excellent question for us. As we said, we are focusing on developed countries for reasons that we described, I believe, in the last conference call, mainly our collection and some other problems. At the same time, we have commitment to support our existing customers. We are supporting them by -- both by upgrading their system, we continue to provide them with the recurring revenue, which has been maintenance, software upgrade and material as needed. But we are not focusing on bids and chasing new opportunity in this kind of area. We are shifting most of our effort in sales and marketing and other to -- towards Europe and North America. As we said, we would like to have the majority of our revenue come from this area, and we are very successful lately. Now what we see, the IOT and Cyber Security are very strong in developed countries like Europe and North America, while the e-Gov was mainly generating revenue from emerging countries, Africa and South America, and we are shifting them. So we're working very hard with generating revenue for the e-Gov also in Europe and Africa. We are making small step there. We want to small bids in this area. And we are -- we believe that because of our great technology and experience, that we will see a shifting also in revenue from emerging countries to developed countries, like we mentioned earlier. We are very happy that in this transition period, we have the growth under the IOT which is really keeping our revenue up, so we have right now the IOT as strongest growth engine, which as we mentioned earlier, the product -- the IOT products grew over 50% year-over-year and from the latest bids, we believe with this number, we're

going to keep this kind of rate. At the same time, we're hoping and we're putting effort of getting back revenue. I'm talking about new revenue or new customer in the e-Gov from Europe and North America. But still we're supporting our customer -- existing customers in many countries, and we believe that we're going to continue to see accordingly these customers for many years as the contract we have with them are for many years.

Kevin Darryl Dede - *H.C. Wainwright & Co, LLC, Research Division - MD of Equity Research & Senior Technology Analyst*

Okay. I understand that you don't have all the accounting beans in place for the fourth quarter. But can you talk to the sales trends? Clearly, you're down year-over-year. I was just wondering if there is an indication of whether or not you're up sequentially. Can you talk to that at all?

Arie Trabelsi - *SuperCom Ltd. - CEO, President & Acting CFO*

Yes, I believe so. We are -- as you are talking about comparing to the fourth quarter, I cannot indicate it, but I believe there is a growth there. We're growing from quarter-to-quarter. What I see -- I think it's very important to look at the segment because it's the first time that in-depth analysis of the segment is more important here because of transitioning from emerging country to developed country. So we see a major, major growth in our IOT division, which is working mainly in North America and Europe. So you can see this kind of growth are the main growth engine right now. And when we look forward, we see this kind of growth even getting stronger. And once we are successful in shifting revenue in the e-Gov also to Europe, we believe that the growth is going to be higher overall company.

Ordan Trabelsi - *SuperCom Ltd. - President of Supercom Inc.*

As you are aware, e-Gov has some lumpiness, so some quarters it can go up and down, but consistently you're seeing nice growth in IOT along the quarters, and you're also hearing about the new project deployments which stack on and continue growing revenues for years.

Arie Trabelsi - *SuperCom Ltd. - CEO, President & Acting CFO*

The important really with that is the contract is -- again, they have multi-years contracts and we have the great visibility of what we're going to see every quarter from now and also for the next 5 years, and we believe that even this period is going to be extended.

Kevin Darryl Dede - *H.C. Wainwright & Co, LLC, Research Division - MD of Equity Research & Senior Technology Analyst*

Right. Okay. Now historically, you've always talked about recurring revenue. I know you can't really offer that on an annual basis yet, but can you talk to the change there maybe?

Ordan Trabelsi - *SuperCom Ltd. - President of Supercom Inc.*

What do you mean by change there?

Arie Trabelsi - *SuperCom Ltd. - CEO, President & Acting CFO*

So the major growth in recurring revenue right now, we see it on the IOT. As I do see, every new contract, they'd provide us with the recurring revenue for each contract. Now the Cyber Security has a nice -- we're steady state, as Ordan mentioned earlier, so we have a nice recurring revenue and about 2% growth as we are preparing our -- this division to incorporate new product to be delivered under the same suite to all our customers and what -- which we believe is going to generate a nice growth as well in the Cyber Security. On the e-Gov, as I said, we are right now only in recurring revenue state. We are not working on new contracts, maybe a small one, but not a new contract and not chasing new bid in this area except for Europe and the U.S. It's going to take a little bit more time to win large contract in the U.S. and Europe for the e-Gov, but we see some sign that we will be securing this kind of contract in future.

Ordan Trabelsi - *SuperCom Ltd. - President of Supercom Inc.*

In IOT, most of the revenues are billed daily, per unit per day essentially, and they are recurring in nature. There are sometimes revenues from specific deployment or if a customer wants to buy equipment, but more and more, we're seeing in the industry and also in our customers that they're choosing the lease model, where essentially you have units spread out over 5, 6 years. And you have that consistent rate similar to Software-as-a-Service for leasing our equipment and also leasing the cloud software that we provide.

Arie Trabelsi - *SuperCom Ltd. - CEO, President & Acting CFO*

I think that it's important to mention again that we have very improved visibility for revenue, with improved visibility to ARs, our customers in Europe and North America paying on time, so our ARs are going to go to very low level as we all used to see in the developed countries. Visibility is very high, recurring revenue is going to grow, and we see at least for the next 5 years in the IOT and Cyber Security. We hope and we are working on that, that we see similar behavior both for visibility and connectivity -- collection in the e-Gov once we will complete our shift from developing countries to developed countries.

Kevin Darryl Dede - *H.C. Wainwright & Co, LLC, Research Division - MD of Equity Research & Senior Technology Analyst*

Okay. Arie, the cash balance at the end of September quarter was in -- including both restricted bank deposits was in the \$3 million range. Can you offer a figure?

Arie Trabelsi - *SuperCom Ltd. - CEO, President & Acting CFO*

Yes. The end of March, the number is higher than \$3.5 million.

Kevin Darryl Dede - *H.C. Wainwright & Co, LLC, Research Division - MD of Equity Research & Senior Technology Analyst*

Okay.

Arie Trabelsi - *SuperCom Ltd. - CEO, President & Acting CFO*

But I think it's important to mention the use of cash. As we know that every IOT contract we win, we have to invest capital to build the product. In general, payment in this kind of contract is monthly or daily as was done in the interest of the initial investment, is the beginning of the contract with the product and we send to our customer. So the cash needed, in general, in the beginning of the contract. Later on, we get paid pretty fast to cover all our cost. So you will see with every contract we win, there is a small jump in cash required to build the product and later on we are hoping we could balance with the rate of getting back return on our investment in this product. And we believe that -- and I believe we're already seeing less cash flow in this kind of cost -- costing.

Kevin Darryl Dede - *H.C. Wainwright & Co, LLC, Research Division - MD of Equity Research & Senior Technology Analyst*

Okay. Just a couple of more things. One is on the EM side. You're introducing new products. I was hoping you could talk about that and how you see your products and their competitive position, given -- you seemed to be bringing a superior technology to market, I just was wondering if you could offer a little color on that? And where your development is going?

Ordan Trabelsi - SuperCom Ltd. - President of Supercom Inc.

I'll share some color, Arie. Thanks. Yes, as we mentioned, we're deploying a lot of new projects. In every new project, we try to add some new capabilities. I'll give you a few examples. We are launching a project now in Sweden. And in Sweden, there is electronic monitoring of offenders at their homes, but there is also inmate monitoring while they're in prison. And we are providing the solution that uniquely connects between the inmate monitoring and the house arrest. So it's all in the same platform and the same person is monitored on the same bracelet essentially, which is new. In other places, such as Czech Republic, we added alcohol monitoring. So not just monitoring where the person is, but also the alcohol levels, and some people are restricted from drinking alcohol, and in that situation, the officers will get an alert. Our general technology has a very long-term battery life, where the bracelet instead of lasting just for a day or 2, which is common in industry, our bracelet battery lasts for years, and it communicates to the smartphone offering the abilities for a whole platform of video calls and content, communication, helps you provide so much more when you're trying to do electronic monitoring of offenders. So essentially we keep on developing features. And most of our power right now in IOT, I would say, is with R&D team. We're developing and we're bidding on projects. We've less focused on big sales team. Most of our capabilities and resources will continue to improve the product. And with these new projects, the product becomes bigger and stronger and makes it that much more likely to win the next project that we're bidding on. So we're in a very good momentum and good trend with winning new projects, and along the way, enhancing our technology.

Arie Trabelsi - SuperCom Ltd. - CEO, President & Acting CFO

I think it's important to add some -- the important feature that we believe that we have the major advantage, which is in the security features brought on the communication between the end unit to the receiver or to the cloud. We have in-depth knowledge in the security area, and as a requirement in Europe, especially GDPR and also in the U.S. to keep all the information, position, location, et cetera, for the offenders and others, that there are more and more government regulation to have this kind of security in the IOT product. And we believe that we have a major advantage there. The same thing, we have security renowned products. We have a very light product. And we believe that the coverage we have both in cellular, Wi-Fi or bluetooth has a quite different technology, among the best in the market. We believe that our customers like our product, and we see that in the very high rate of -- the winning rate that we have in -- both in Europe and in the U.S.

Kevin Darryl Dede - H.C. Wainwright & Co, LLC, Research Division - MD of Equity Research & Senior Technology Analyst

Okay. I'm sort of curious about the sort of the similar line of questioning with regard to Cyber Security. You think that overall market is growing by leaps and bounds, yet -- and you are introducing new products and not just now, but you have been. And I'm curious why you don't think you've seen the kind of growth there?

Ordan Trabelsi - SuperCom Ltd. - President of Supercom Inc.

Okay. Great question. So in Cyber Security, essentially we take the Safend suite, which brings customers for -- that some of which have been with us for over 5 or 10 years. It's a very strong and loyal customer base. And it's very hard to deploy a new system like this, a port and device protection and DLP. And to do that in an organization with 50,000 or 70,000 seats, it could take months upon months, and sometimes even more than a year. So it's very comfortable for them to stay with us. And it's very hard for them to put a new customer in. And there's a lot of new technologies out there like advanced persistent threat, new-age antivirus, anti-malware. And many companies are competing in this space. But they're having a hard time entering, for example, to some of our customers. While we on the other hand have these customers, have our software already deployed there, so we are planning to take a new development in this space and put it on existing customers that we have a much easier way to deploy these new technologies. We have to date not yet fully deployed these products. So they're in POC stages, that's why you're not seeing an increase in revenues there. The revenues right now in Cyber are still from the old generation products, and the new ones are in various stages of POC with various customers and resellers. But we have received good indication, and when the products are ready, do a launch and we hope to see a nice potential uptick in revenues from Cyber, which are annual and recurring in nature.

Arie Trabelsi - *SuperCom Ltd. - CEO, President & Acting CFO*

I think it's important to understand that our Cyber Security division, the Safend product has been seeing loyal customers and outstanding reputation. This product is running for years and our customers are happy and this is a stable product. So before we inject the industry with a new product, we must make sure that the new product is clean and working very nicely also in this area. And before we incorporate in the suite and sell it to our existing customers, we'd like to make sure that's going to be very -- even the addition feature is going to be very stable, we don't cause any problems to our existing customers, so we take longer than maybe some other startup in this regard will do that. We would like to make sure that everything is clean, stable before we sell it to our existing customers. It's very important for us to keep our reputation of this product suite within our existing customers around the world.

Ordan Trabelsi - *SuperCom Ltd. - President of Supercom Inc.*

Good point.

Kevin Darryl Dede - *H.C. Wainwright & Co, LLC, Research Division - MD of Equity Research & Senior Technology Analyst*

Okay. Fair enough. Ordan, you touched on introduction of new products. Now is this something you expect this year? And taking that one step further, can we look at what you expect to happen on a top line for the balance of the year for the consolidated company's operation?

Ordan Trabelsi - *SuperCom Ltd. - President of Supercom Inc.*

Okay, good questions. The Cyber Security products, we're likely not going to deploy production-ready versions this year, probably it's going to fall into next year. As Arie mentioned, if we were more of a startup, we probably would have deployed this already, but our reputation is mainly around having a very stable product in Safend. And we're deploying on different environments, showing different challenges to overcome. So it's probably going to be not this year. And in terms of revenues, we don't have -- we don't give guidance essentially. And while we do have visibility on our current projects that we're deploying and the 6 new ones that we've talked about for in this year in EM, it's hard to tell which new ones we'll win. And we expect to have many more wins if things continue as they are going now.

Arie Trabelsi - *SuperCom Ltd. - CEO, President & Acting CFO*

I think that, just to give you some color about distribution of revenue this year, I'm talking just about 2019, because of the transition, we believe that by the end of the year, if we look at the 2019 revenue, I believe that our IOT contribution to revenue is going to be between 55% to 65% of our total revenue; our Cyber Security is going to be around 20%; and the e-Gov, which was our strongest revenue generator in the past, is going to be only in the range of 20%. We definitely are going to see, because of the fast growth of the IOT, an increase of this share of our revenue, but I do hope and believe that in the year 2020, we're going to see a rebound on the e-Gov revenue, especially from developed countries, so we will see the e-Gov share in revenue are growing. But still, for the year 2019 and 2020, we still believe that the majority of revenue will come from the IOT division because of its strong growth.

Operator

At this time, this concludes our question-and-answer session. I would now like to turn the call back over to Mr. Arie Trabelsi for closing remarks.

Arie Trabelsi - *SuperCom Ltd. - CEO, President & Acting CFO*

Thank you for joining us on the call today. I especially want to thank our employees, partners and investors for their continued support. We appreciate your interest in SuperCom and look forward to updating you on our next call. Operator?

Operator

Ladies and gentlemen, this does conclude today's teleconference. You may disconnect your lines at this time. Thank you for your participation, and have a wonderful day.

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