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ATOM - Q3 2016 Atomera Inc Earnings Call

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PRESENTATION

Operator

Good afternoon and welcome to the Atomera third quarter 2016 earnings call. (Operator Instructions) This event is being recorded and will be available for replay for approximately one week.

I would now like to turn the conference over to Nick Kormeluk. Please go ahead.

Nick Kormeluk - *Atomera Incorporated - IR*

Thank you, Esther, and hello, everybody. I'm Nick Kormeluk, and my role at Atomera is leading the Investor Relations effort. Joining me on today's call are Scott Bibaud, our President and CEO; Frank Laurencio, our CFO. After comments by Scott and Frank, we will open the call for questions.

Before we begin, I would like to remind everyone that during today's call, the company will make forward-looking statements. These forward-looking statements, whether in prepared remarks or during the Q&A session, are subject to inherent risks and uncertainties. These risks and uncertainties are detailed in the Risk Factors section of the company's filings with the Securities and Exchange Commission, specifically in the final prospectus dated August 5, and filed with the SEC on August 8, 2016. Except as otherwise required by federal securities laws, Atomera disclaims any obligation to update or make provisions to such forward-looking statements contained herein or elsewhere to reflect changes and expectations with regard to those events, conditions and circumstances. Also please note that during this call, the company will be discussing non-GAAP financial measures as defined by SEC Regulation G. Reconciliations of these non-GAAP financial measures to the most directly comparable GAAP measures are included in today's press release, which is posted on the company's website.

Now I'd like to turn the call over to Atomera's President and CEO, Scott Bibaud. Go ahead, Scott.

Scott Bibaud - *Atomera Incorporated - President and CEO*

Thank you, Nick. I'd like to welcome everyone to Atomera's first quarterly results call as a publicly traded company covering the third quarter of 2016. As Nick said, joining me today is Frank Laurencio, our Chief Financial Officer.

I will begin the call with a discussion of how our new capital structure will benefit the company followed by a review of some of the achievements we've made since our IPO. At that point, I'll turn the call over to Frank, who will review our financial results for the third quarter. Finally, in order to assist you with understanding some of the timing and drivers of Atomera's business, I'll take the opportunity to share in some more detail the process by which Atomera engages with customers.



Atomera is a development stage company with a very unique material technology, which improves the performance and power of transistors without adding significant cost of manufacturing complexity. Chipmakers using this technology will be able to make better mobile phones; network devices; and IoT products due to the longer battery life, higher performance, and lower cost it may enable. Although we have no revenue at the moment, we are currently in long-term engagements with three potential customers, which we hope will lead to royalty bearing license agreement.

Our GAAP operating expense for Q3 was \$2.8 million. Included in this number are non-cash, depreciation and stock compensation expenses. Excluding the \$1 million of these non-cash charges, the non-GAAP operating expenses for Q3 was \$1.8 million, which remains below our targeted annual cash burn rate of \$9 million per year.

As Frank will discuss in more detail later in the call, the financial structure that we have in place as a result of our recent IPO has put us in a dramatically better position not just to bring our products to market but to refine our core technology and to accelerate our engagement process with customers.

Exiting Q2, Atomera had \$5.3 million in the bank. Although we have laid the groundwork for taking our technology to market, we were capital-constrained. As we exit Q3 with \$28.2 million in the bank, we have been able to accelerate our commercialization efforts, which are already yielding some very encouraging results.

Atomera has recently began fabrication of our own wafers through a specialty fab partner, which gives us the ability to rapidly design, build, and test enhancements to our technology. This is a dramatic improvement over our old process. As you can imagine, over time, this knowledge base will allow us to offer additional products, enhance the know-how to complement our patent portfolio and meaningfully shorten time to revenue in our customer engagements. These are all big wins for Atomera.

Over the last few years, we've been working with three lighthouse customers. Our working relationship with these customers is very close and collaborative, and each of them has invested a great deal of time and money in working with Atomera. During Q3, all three of these customers received the results of an earlier wafer run, analyzed the results of those runs with Atomera, and elected to start additional wafers for further optimization and testing. While I cannot share specific results with you, this decision to continue their evaluation cycle with Atomera is testimony to their continued belief in the value that Atomera's technology can deliver.

Atomera seeks potential customers among the world's semiconductor foundries, integrated device manufacturers, or IDMs, and fabless semiconductor vendors. There is a relatively small number of large foundries in the world and a much larger number of IDMs and fabless vendors. It should be emphasized that any one of these potential customers can provide a significant revenue opportunity for Atomera. So any new customer engagement is an important event.

Since July, we have started discussions with five new potential customers and continued discussions with several others. I mentioned this because it has significant increase from the number of potential customers we have historically experience entering our funnel. Recently, the mainstream press has become interested in writing about one of the semiconductor industry's biggest problems, the slowdown in Moore's law. This quarter, Atomera's technology has been mentioned as a possible solution to this problem in several articles. Those pieces are very meaningful since they put this industry trend squarely at the intersection of the value proposition of Atomera, which is making material improvements in semiconductor performance without resorting to a costly process shrink.

We continue to believe that Atomera's technology is reaching the market just at the time when the industry is seeking solutions to these problems. You can find links to these stories in the Publications section of our website.

Finally, I would like to announce that effective November 14th, Atomera will be changing its ticker symbol to ATOM. We feel this symbol change is more aligned with our brand and will assist with awareness and marketing with partners.

I will now turn the call over to Frank for comments on the company's financial results for Q3.

Frank Laurencio - *Atomera Incorporated - CFO*

Thank you, Scott. As you saw at the close of the market today, we issued a press release announcing our operating and financial results for the third quarter ended September 30, 2016. We closed a very successful IPO on August 10th, bringing in net cash proceeds of \$24.7 million.

Prior to our IPO, we funded our operations primarily through convertible notes. Upon closing the IPO, all of our debt, which consisted of \$23.5 million with principal and accrued interest, converted into shares of our common stock. This extinguished all of our debt. After the IPO and including the conversion of the notes to equity, we have a little over \$12 million shares outstanding. We have not begun to generate revenue so our total operating expenses and operating losses are equal for the time being.

At the outset of my comments, I'd like to point out that our results for the third quarter were heavily impacted by two items that affect comparisons with prior and future quarters. First is our interest expense of \$1.3 million in the third quarter. As I mentioned, our convertible notes converted the common stock at the IPO so we will not incur interest expense in the future quarters. This should help with modeling purposes. Please also keep in mind that this interest expense was non-cash.

Secondly, our stock-based compensation expense was \$1.02 million for the quarter compared to fairly small amounts in the second quarter of 2016 and the third quarter of 2015. Part of the increase reflects a special incentive bonus put in place in late 2015 by our Board of Directors, which granted contingent upon the IPO shares of restricted stock to certain directors and officers who had served the company for a number of years.

These restricted shares vest over one year from the IPO. In addition, the board granted to certain officers of the company, who did not get shares of restricted stock, options that vest over four years as is typical for companies like Atomera. Over the next three quarters, you should expect that we will incur about \$1.2 million per quarter of non-cash stock-based compensation expense. After August 2017, when the special one-year grant of restricted shares is fully vested, you should expect ongoing quarterly charges to drop to about half the current levels. The components of these interest in stock compensation charges are described in greater detail in our 10-Q, which was filed with the SEC earlier today and is posted on our website.

Third quarter GAAP operating results totaled \$2.77 million, an increase of approximately \$921,000 over Q2, driven primarily by an increase of \$973,000 of stock compensation expense in Q3. Year-over-year, third quarter GAAP operating expense increased by \$1.99 million. \$1.27 million of the annual increase was due to an increase in general and administrative expense. Out of the total \$1.99 million increase in operating expense, \$990,000 related to increased equity compensation expense. And of that \$990,000, \$816,000 was non-cash stock compensation expense recorded in G&A.

Our GAAP net loss for the third quarter was \$4.1 million, compared to a net loss of \$2.6 million in the second quarter and a net loss of \$1.35 million in the third quarter of 2016. The significant difference of \$1.32 million between our \$4.1 million GAAP net loss and \$2.77 million operating loss is due to \$1.33 million of non-cash interest expense, which had accrued on our convertible notes prior to their conversion to equity at the IPO.

On a per share basis, our GAAP net loss for the third quarter was \$0.55 per share compared to a net loss per share of \$1.61 for the second quarter of 2016. The lower loss per share was due to the increase in our share count as a result of the IPO and the conversion of our convertible notes to equity, which more than offset the larger net loss.

I'd like to now review our non-GAAP results as we believe adjusted or non-GAAP EBITDA provides a better view for investors especially when used in conjunction with GAAP information. It's also what we use to better plan for the business.

Excluding approximately \$1.32 million of net interest expense and \$1.02 million of stock-based compensation and depreciation, on a non-GAAP basis, the adjusted EBITDA loss for the third quarter was \$1.75 million. This compares to non-GAAP adjusted EBITDA loss of \$1.8 million in the second quarter of 2016 and a non-GAAP adjusted EBITDA loss of \$751,000 for the third quarter of 2015.

Research and development is the largest component of our operating expense. Our research and development expense in the third quarter of 2016 was \$940,000, which was a \$73,000 increase over \$867,000 of R&D expense in the second quarter. The increase was primarily due to stock compensation expense.

I would like to highlight one element of our R&D expense can fluctuate significantly between quarters, which is spending on what we call fab outsourcing. The amount and timing of fab outsourcing expense depends heavily on evaluation activity by our potential customers. Although our fab outsourcing expense is relatively flat in the third quarter as compared to the second quarter of 2016, these expenses increased by over \$214,000 over the third quarter of 2015, reflecting the increased engagement with potential customers that Scott referred to earlier. Overall, we expect our spending on fab outsourcing to increase as we engage with more potential customers and test additional wafers for the existing potential customers.

Turning to the balance sheet, our cash and cash equivalents at September 30 were \$28.2 million. We anticipate our annual cash burn will be around \$9 million in 2017. We anticipate adding new employees in the next year, mostly in engineering and to a lesser degree in business development.

I will now turn the call back to Scott for him to discuss our customer engagement process and our closing remarks.

Scott Bibaud - *Atomera Incorporated - President and CEO*

Thank you, Frank. I would now like to provide you some background on our customer engagement process to help you better understand how we secure potential customers. We thought this would be valuable to share given that we are still pre-revenue.

Atomera's engagement process with customers involves six phases. During phase one, meetings with new potential customers, we exchange high-level performance details of our technology. For our potential customers, the specifics of how they process their wafers is their most confidential information. So until they understand the promise of our technology, they are very reluctant to reveal their own process details or to become tainted by deep understanding of ours.

Therefore, executing an NDA is a very important early hurdle, an indication of a potential customer's acknowledgment of our technology's value and commitment to go through the time-consuming and expensive effort of evaluating and integrating our technology with theirs. After the NDA is signed, we typically start planning to fabricate wafers together during a set of designed experiments.

Before I go on, let me briefly explain how we worked together to build wafers with our customer. Fabricating wafers involve several hundred process steps, which effectively put increasing numbers of layers on a base silicon wafer. Our customer performs this in their factory or fab. To evaluate our technology, they might put above 10% of the layers on the wafer, take the wafers out of their fab and send them to Atomera. We then deposit our MST film on the wafers and send them back to the potential customer. After they process the remaining 90% of the wafer, we and the customers are ready to test and evaluate the results. This entire process can take three to six months.

In phase two, we perform a short process set-up wafer run with our customer, analyze the results and use that information to plan for phase three, which is the evaluation phase. It starts as we initiate the first complete wafer run with our potential customer. The customer's goal in this phase is to verify our technology claims, fit our MST implementation steps into their highly tuned fabrication process, and then optimize for performance and integration of the film over several additional wafer runs.

It is typical that we have provided an improvement in one area, but caused problems in other areas that need to be cleaned up in a subsequent wafer run. Customers may be satisfied with the performance after only three or four runs or they may decide to take even more. And since each run can take three to six months, the time duration of this phase is very difficult to predict.

When the customer has enough confidence that our technology can hit their performance and integration goals, phase four begins as they execute a license agreement with Atomera and install the machines necessary to build MST into their factory. Execution of the license agreement will typically include some upfront license fees so this is our most critical milestone. After customers complete MST installation, they will continue to optimize the process through additional wafer runs.

At this point, they enter the process qualification phase, or phase five, which usually takes eight to 12 months. Semiconductor factories regularly perform process qualification phases so the time frame of this process is much more predictable.



Finally, the customer enters phase six, which is production release where wafers shipments will generate royalty payments to Atomera. It's important to recognize that as we move through the customer engagement process, both the customer and Atomera are making significant investments in time and money to achieve process qualification. This is not something either party takes on lightly. As a result of this investment, each wafer run that customers undertake with Atomera is a reaffirmation of their commitment to working with us. I hope this review of our customer engagement process has been helpful in understanding our business and our road to commercialization.

Before we turn the call over to the operator for questions, I would like to thank all of you for your support, our employees for their hard work and especially our potential customers as we continue to move through process evaluation stages and approach commercial adoption.

Operator, we will now take questions.

QUESTIONS AND ANSWERS

Operator

We will now begin the question-and-answer session. (Operator Instructions) At this time, we will pause momentarily to assemble our roster.

Our first question comes from the line of Brett Conrad with Longboard Capital.

Brett Conrad - Longboard Capital - Analyst

So, I just had a couple of questions in terms of will you start to break out the number of customers you've got in each phase? And just to back up that question, too, so these six new engagements you got going, are they at least at the NDA? You've signed NDAs with those or where are those? And that's two questions to start off with here.

Scott Bibaud - Atomera Incorporated - President and CEO

Okay. Thanks, Brett. Let me answer your second question first. So I mentioned the five new customers that we've engaged with since the IPO, and there's two of them we have signed NDAs/ And, obviously, the other ones, we are in the process of getting that done. So, all five of those customers you could put in the phase one of the customer engagement cycle I just spoke about. And obviously the three customers that we gave similar details on are deep in the evaluation phase with us; so that's phase three.

I guess to answer the second part of your question, as we go forward, I will try on quarterly conference calls to give you guys an idea of how many customers we have in phase two, which is the set-up phase and in the other phases. I don't think it makes sense to talk about the customers that we have in phase one because they kind of come and go, but I'll try my best to give you an indication of the progress that we're making with them. And that's one of the reasons why I went through the customer engagement on this call.

Brett Conrad - Longboard Capital - Analyst

Okay, thanks. In terms of the customers in phase three, maybe you could just give us some, you know, idea of the progress there. And is there a catalyzing event that really gets them over the hump and says, all right, let's sign a license agreement? Or is it a bit fuzzy depending on each customer's needs and progress. And are all of these processes so different than from one another, like you said, that they could take more time? But maybe you can just shed some light on some of the catalyzing events that will turn phase three into a phase for the license agreement.



Scott Bibaud - *Atomera Incorporated - President and CEO*

Right. So, it is true that our technology can be used by different customers to achieve different ends. So, for example, one customer might be trying to use it in a process technology to get much lower power consumption and another one might be using it to try to get better noise performance, for example.

With each of these customers, they have some kind of an internal hurdle that says, you know, if we start to see that this achieving some level of improvement, then we would want to, at that point, sign a license agreement. In many cases, they might even be seeing that level of improvement. But as I mentioned a few minutes ago, something else got broken when they saw it. And so they want to go through another round of evaluation to try to make sure they can fix the other thing and continue to see the improvement before they pull the trigger.

It's very hard for us to predict exactly or even for them to predict exactly when they will reach that level. But we have gone through several evaluation runs with each of those three customers I spoke about. And our hope is that they reach that level soon. Now, when a customer does see that the target is in sight, we believe they will sign a license agreement with us because after they sign the license agreement and we can install our technology in their factory, the whole integration process on their side will speed up dramatically because, at that point, they can run wafers as fast as they want and it only takes a few hours to put our technology on where today it takes a couple of weeks for them to pull the wafers out, send them to us and have us return them. So, yes, there's big advantages for them to sign a license agreement, but the specifics about how they make that decision are a little bit fuzzy to understand.

Brett Conrad - *Longboard Capital - Analyst*

Okay. Will they require some CapEx to go to production with the Atomera technology? And where does it come from?

Scott Bibaud - *Atomera Incorporated - President and CEO*

Well --

Brett Conrad - *Longboard Capital - Analyst*

Where did the machines come from that they have to add?

Scott Bibaud - *Atomera Incorporated - President and CEO*

Okay. So the machines are standard available tools that are available from a few of the different semiconductor equipment makers. We partnered with many of them so that we already know our process works on their tools. Most of our customers already have some of these tools in their fab. So if they were going to run at low volume, they probably -- they may not even have to buy any additional tools, in which case, there'll be no CapEx.

In all likelihood, if they were going to go through this process with us, they're intending to go into higher volume production, and they'll want to buy additional tools to add them to their facility. So to give you an idea, one of the tools come in various sizes and shapes, but the range to buy one of these tools is between a million and, say, \$6 million. So they may want to buy several of them to get started. For a semiconductor fab, that level of CapEx is very, very small. So even though they might want to add CapEx to get to higher volume with us, it's not going to be a big driver to their increased CapEx spending.



Brett Conrad - *Longboard Capital - Analyst*

Okay. So it'd be easy to budget -- like they may have a budget range being rolled out, that kind of thing to make the decision quickly instead of waiting for a whole new budget cycle. They could potentially just have -- since the budgets are so huge, this isn't going to be a big effect on -- that was a new one. They have to wait a whole budget cycle to install them -- as a possibility anyway, if I got that right.

Scott Bibaud - *Atomera Incorporated - President and CEO*

And that's our belief. That is absolutely our belief.

Brett Conrad - *Longboard Capital - Analyst*

Okay. In terms of the customer interaction and the kind of intellectual property that you're probably gaining, maybe you can just shed some light on what you're learning? Have you gained in your intellectual property base that could speed up further installations with other customers, for instance? Or these all are so unique to one that any kind of intellectual property intelligence you get from one, you can't really use on another, or kind of explain some of that? I'm just looking if there's any accelerators in there.

Scott Bibaud - *Atomera Incorporated - President and CEO*

Yes. So, Brett, I think (multiple speakers) we do learn something from every customer that we're working with that helps us to accelerate the process for everybody. There's no doubt about it. There are some people who are trying to optimize very specific things. And we might -- I mean that might be learning that not a lot of other people are trying to find. But, in general, most of the know-how that we're picking up as we run wafers is something that we will benefit from long-term.

I mentioned earlier in the call that we are starting to work with the specialty foundry partner. This is a very, very important development for the company because now we'll be able to go and launch our own wafers inside this factory and have them run tests with different kinds of our films, allow us to test new series on the way that we're fabricating them, different process conditions, and then come out with comparisons that tell us what is the best way to move forward doing this.

As we gain more -- so, basically, what I'm illustrating is a dramatic increase in the amount of know-how that we're gaining over time since we put in place this facility with the specialty foundry. That will definitely allow us to shorten the amount of evaluation cycles that we do with potential customers. And it also has the ability of -- since we are running these wafers, we own all of the data. And so we are free to go out and share that data with all of our potential customers.

Brett Conrad - *Longboard Capital - Analyst*

Okay.

Scott Bibaud - *Atomera Incorporated - President and CEO*

We're a little more --

Brett Conrad - *Longboard Capital - Analyst*

Yes, we're --



Scott Bibaud - *Atomera Incorporated - President and CEO*

-- [affected] what data we can share when we're learning from our customers.

Brett Conrad - *Longboard Capital - Analyst*

Yes, yes, exactly. Do you see any -- kind of one more question, I don't know if there's others in the queue, I'm happy to hop off here.

Scott Bibaud - *Atomera Incorporated - President and CEO*

There are a few folks.

Brett Conrad - *Longboard Capital - Analyst*

Do you -- oh, there are -- okay, I'll ask one more question. So do you see the point to where -- I'm just kind of wondering how the relationship is, what the relationships are like with these companies. They're obviously tiny, they're huge. Is there -- do you get the kind of sense that they're kind of waiting to get a better deal? Are they seeing enough improvements that they're like, this makes complete sense from an ROI standpoint? What does it feel like dealing with these massive customers [or actually] potential customers?

Scott Bibaud - *Atomera Incorporated - President and CEO*

It's definitely David and Goliath, no doubt about it. But we're bringing them a technology that took us 15 years to develop. And because our funding was somewhat constrained in many cases, maybe that could have been done in 10 to 12 years, but it is not possible to do in just three or four years. I don't believe that any of the customers that we're talking to has any potential competitive technology in their pipeline that could duplicate what we're offering to them, and they've told us those type of things.

So I would characterize our relationships with all of our existing customers as extremely cooperative. And these guys are not -- they're really hoping we succeed because from their perspective, the amount that they have to pay to get this type of improvement is not very much. So they're really bending over backwards to help us be successful.

It costs them a lot of money to have dedicated engineers, working with us and continue to take capacity out of their production facilities to run these tests wafers with us. And they keep doing it, which is an indication that they really are trying to make this successful.

Operator

Our next question comes from the line of Lou Basenese of Disruptive Tech.

Lou Basenese - *Disruptive Tech - Analyst*

Hey, Scott. Thanks for taking my questions. Just two quick ones for you. You talked a good amount about the specialty fab partner. Can you give us -- can you quantify for us perhaps how much time this could shave off the typical process? I mean, is it a matter of weeks or potentially months? I know you can't say definitively what gets you to a license agreement, but just trying to quantify what the time savings might be.

Scott Bibaud - *Atomera Incorporated - President and CEO*

Well, Lou, we just had a meeting with our engineers and we're doing some planning for this, and we actually talked about that. One thing we all believe is that very rapidly this will cut out at least one full evaluation cycle by our customers. I mentioned those evaluation cycles takes three to six months so you could say that that's what we believe we're going to be able to eliminate very quickly here.

Lou Basenese - *Disruptive Tech - Analyst*

Okay.

Scott Bibaud - *Atomera Incorporated - President and CEO*

There's a big deal.

Lou Basenese - *Disruptive Tech - Analyst*

Yes. Okay, great. And then one of the last question just really gets to, I know that for industry confidentiality reasons, you can't talk about specific customers. But can you give us some color on the end markets these customers are targeting for improvement with the Atomera technology?

Scott Bibaud - *Atomera Incorporated - President and CEO*

I'll give some color, but when a customer creates a process technology, they will sell it in all kinds of markets. If it's a foundry, in particular, they have customers that are coming in from all different walks of life to use this technology, and so that's why we talk about IoT, and mobile and network infrastructure, which we all know -- we know are things that we've had and customers tell us they're very interested in getting the type of benefits we offer.

Our first customers, I know that we do have some big engagements in analog and power management. Power management could potentially be in the mobile phones space because that is where a lot of the power management volume goes. Analog is kind of spread across all markets. I don't know, but again -- and even power management can go into virtually anything with a battery or with -- complex system product has power management chips in it so (multiple speakers) --

Lou Basenese - *Disruptive Tech - Analyst*

That's helpful. I was just trying, I guess, put in context with the investor slide deck. You list six different verticals and just trying to prioritize what may be the first ones you could see revenues from.

Scott Bibaud - *Atomera Incorporated - President and CEO*

Yes, yes, and that is probably right. We talked about analog and we talked about some digital logic. And those are areas that I would see would be the first product as the first priorities.

Operator

(Operator Instructions) Our next question comes from the line of [David Willingurn].



David Willingurn

Scott, can you provide a little more detail on the three relationships and what's happened with those prospective customers since the IPO? For example, the wafer runs that you're doing now for them, are they subsequent wafer runs to what you had at the IPO stage?

Scott Bibaud - *Atomera Incorporated - President and CEO*

Yes. So, David, all three of those customers, while we were in the process of the IPO, they had just gotten wafers from a prior run, and we were kind of in the stage where they were reviewing the data and deciding what to do next. So, everything I talked about with starting new wafers happened after the IPO closed. And there are all new wafers that are underway right now. And we haven't even gotten the results yet on those runs.

David Willingurn

So does that mean that if you would have been hoping for a license agreement by yearend, is that still a hope or is that something that's realistically now a Q1 event?

Scott Bibaud - *Atomera Incorporated - President and CEO*

Yes. I don't think we ever said that we -- I mean, obviously, we hope to get a license agreement as early as possible, but we haven't been forecasting a license agreement by yearend. Obviously, we're getting closer to the yearend now and so the probability is declining just because of that. It's very possible that some of these wafer runs could come out before the end of the year and the results could be good enough that we initiate discussions with customers on a license agreement then, but I really have no ability to predict at this point.

David Willingurn

Great. Thanks.

Operator

The conference has now concluded. I want to return the call over to Mr. Bibaud for closing remarks.

Scott Bibaud - *Atomera Incorporated - President and CEO*

Okay. I want to thank you all for attending today's presentation. We are very pleased with the progress on the customer and financing fronts this quarter to help us advance our business plan. Should you have any additional questions, please feel free to call Frank, Nick or myself and we'll be happy to follow-up. We look forward to our Q4 earnings call in March. Thank you.

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