

Energy Recovery ([NASDAQ:ERII](#))

Q3 2019 Earnings Call

Oct 31, 2019, 5:00 p.m. ET

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Prepared Remarks:

Operator

Greetings. Welcome to the Energy Recovery third-quarter 2019 earnings call. [Operator instructions] Please note this conference is being recorded. I will now turn the conference over to your host, Mr.

James Siccardi, vice president of investor relations. You may begin.

James Siccardi -- *Vice President of Investor Relations*

Good afternoon, everyone, and welcome to Energy Recovery's earnings conference call for the third-quarter 2019. My name is Jim Siccardi, vice president of investor relations at Energy Recovery. I'm here today with our president and chief executive officer, Mr. Chris Gannon; and our chief financial officer, Mr.

Joshua Ballard. During today's call, we may make projections and other forward-looking statements under the safe harbor provisions contained in the Private Securities Litigation Reform Act of 1995 regarding future events or the future financial performance of the company. These statements may discuss our business, economic and market outlook, the company's ability to achieve the milestones and commercialization under the VorTeq licensing agreement, growth expectations, new products and the performance, cost structure, and business strategy. Forward-looking statements are based on information currently available to us and on management's beliefs, assumptions, estimates or projections.

Forward-looking statements are not guarantees of future performance and are subject to certain risks, uncertainties and other factors. We refer you to documents the company files from time to time with the SEC, specifically the company's Form 10-K and Form 10-Q. These documents identify important factors that could cause actual results to differ materially from those contained in our projections or forward-looking statements. All

statements made during this call are made only as of today, October 31st, 2019, and the company expressly disclaim any intent or obligation to update any forward-looking statements made during this call to reflect subsequent events or circumstances unless otherwise required by law.

In addition, we may make some references to non-GAAP financial measures during this call. You will find supplemental data in the company's earnings press release, which is released to news wires and furnished to the SEC earlier today. The press release includes reconciliations of the non-GAAP measures to the comparable GAAP results. At this point, I'd like to turn the call over to our chief financial officer, Mr.

Joshua Ballard. Josh, the floor is yours.

Josh Ballard -- *Chief Financial Officer*

Thank you, Jim. The third quarter ending September 30th continued Energy Recovery strong 2019 results. We generated a total revenue of \$24.9 million representing 12% growth year over year. Year to date, we've achieved revenues of \$67.4 million, 19% growth over the same period in 2018.

We reported GAAP net income for the quarter of 5.1 million or \$0.09 per diluted share. Note that our GAAP net income includes a one-time tax benefit of \$1 million related to federal research tax credits. Our adjusted net income excluding that one-time benefit is \$4.2 million or \$0.07 per diluted share. Our product gross margin grew 210 basis points year on year to 75.1%.

And our overall gross margin grew 80 basis points to 78.2%. While product gross margin was especially strong this quarter, we have achieved 72% year to date, and we expected to settle around 71% to 72% for the full fiscal year. Note that we do see some weakening of our product margin in 2020 and 2021, as we begin to experience a combination of pressure on sales prices, due to the growing size of projects in the Middle East, as well as an overhang from tariffs. That said, we still expect margins remain strong, averaging between 68% to 70% next year.

Our water business generated \$21.8 million in revenue during the third quarter, representing growth of 18%. And year to date, we have achieved revenues of 57 million, a 22% increase over the same period last year. As I've mentioned in previous quarters, there will be a softening of growth in the fourth quarter related to the timing of shipments of our larger mega-project orders. However, we should end the fiscal year with water sales growth between 15% to 17%, an increase from our expectations last quarter.

Our oil and gas business generated a total revenue \$3.1 million for the third quarter, a slight decline from the second-quarter revenue of \$3.6 million. This decrease is entirely

related to the ASC 606 recognition of VorTeq license revenue. Overall, operating expenditures grew 28% year on year to \$14.9 million for the quarter and have increased 19% year to date. As in prior quarters, this growth in spend was largely related to investments in R&D in both the water and oil and gas businesses and we should see a 20% to 22% year-over-year increase for the full fiscal year by end of the fourth quarter, right within the guidance from the last two earnings calls.

As we look to 2020, you can expect annual growth and operating expenditures to slow to 10% to 12%. Sales and marketing expenses are expected to grow close to the rate of 2020 revenue growth, which Chris will reference in his remarks. Administrative and R&D spend is expected to grow 10% to 12%. The fixed expense of our oil and gas R&D operations has largely reached its cap.

However, we do have the potential for significant growth in variable testing expenses throughout 2020. These variable testing expenses such as sand and diesel, for example, are difficult to project today and we will communicate this spin as it occurs. Our cash and securities balance remained relatively flat at \$97.3 million at the end of the quarter, an increase of about \$500,000 from June 30th. Our overall 2019 CAPEX investment is still expected to end the fiscal year between \$8 million to \$10 million and 2020 will likely see a slight increase investment of roughly \$10 million.

We remain in a strong cash position and debt-free. With that, I'll hand it over to our president and CEO. Chris?

Chris Gannon -- *President and Chief Executive Officer*

Thank you, Josh, and thank you, everyone, for joining us today. I will now begin with our base water business, which is growing rapidly. Our focus here remains on, one, executing against our increasing backlog and pipeline; two, expanding capacity to meet our growing demand; and three, further developing and executing our water initiatives. For the past several quarters, we have spoken of a surge of growth in global water infrastructure spend that is coming.

Today, as I look out on our Water business, I can tell you that this growth is no longer expected; it is here. As indicated by recent press releases, the size and the flow of projects continues to increase. Since our last earnings call, we have further strengthened our backlog in the pipeline for the remainder of 2019, 2020 and even 2021. And we are continuing to successfully execute against this backlog as evidenced by the growth estimates Josh provided earlier.

Given what we see ahead of us, we now have the confidence to enhance our outlook. Based on current 2019 consensus estimates for Water revenue of \$69 million, we expect our Water business to experience growth of at least 20% to 25% in 2020 and an

additional 10% to 15% in 2021. We've talked previously about the drivers of our industry in the macrostate of global water supply. As a reminder, more than 2 billion people or roughly one-quarter of the world's population already live in a high-water-stressed territory.

According to the United Nations, half of the countries worldwide will face water storages or stress by 2025. These numbers are significant, but they can sometimes seem intangible. Take one look at the headlines and it's clear that water scarcity is a reality in many places around the world. With that in mind, we want to provide a view of what we see happening on the ground.

In the Middle East, water availability has long been a concern, and the region continues to invest heavily in desalination to ensure continued growth. In Australia, dozens of cities are facing day zero, an estimated date of when they could run out of water. Cape Town, South Africa, faced the same threat last year and is now considering additional desalination capacity to address shortages. In addition, two-thirds of global population growth is expected to occur in Asia between now and 2030 representing an increase of 500 million people that this region already has less freshwater per person than any other continent in the world.

More than 40% of India's population is suffering from water shortages. Pakistan is dependent on other countries for more than 70% of its water resources. Bangladesh 90%, Cambodia more than 70%. These being just a few examples of severely water-starved economies.

However, more and South America are not immune. Drought persists in the United States, most notably in the West and South West. And in South America, water availability in countries, such as Peru and Chile, are creating challenges for the mining industry, one of the primary contributors to local economic growth. In short, global water scarcity is a real and pressing issue that their need for desalination, along with other water treatment solutions, is very clear.

Further, the conversion of thermal desalination to reverse osmosis is beginning to emerge and will likely continue throughout the coming decade. We first highlighted this trend in the first quarter and now thermal replacement projects are starting to move from our pipeline into our backlog. Long term, this thermal capacity conversion of more than 20 million cubic meters per day creates an additional layer of sales potential for Energy Recovery. Our confidence in the strength of our water revenue over the next few years is reflected previously announced manufacturing capacity expansion.

Phase one of this expansion is complete and contributing to current production. Phase two is under way. By the end of next summer, we expect to have doubled our capacity. This capacity expansion is necessary to meet growing demand from our customers,

many of whom I saw last week at a large industry event, the IDA World Congress in Dubai.

My conversations there reinforced my optimism about our base business. They also further validated our focus on expanding our water solutions, which I'd mentioned in previous quarters. We are looking at several near-term initiatives, both organic and inorganic, designed to deliver more value to our customers. We expect to announce some of these initiatives early next year with sales potential beginning in late 2020 we are confident in our ability to aggressively grow our business based on the strength of our engineering, manufacturing and sales teams.

We intend to leverage these strengths to: one, broaden our share of the water wallet in our existing market, seawater reverse-osmosis desalination; two, expand our market presence in the OEM and mega-project channels via these products; and three, increase the revenue potential for aftermarket and service sales channels. Lastly, I want to emphasize that our current revenue outlook only reflects our base business, does not include any impact from these growth initiatives. I'm excited to share more when we speak again. I believe the call for more potable water around the world and the vigor in which this call is being made has placed us at an inflection point of growth in the SWRO desalination industry.

The surge in industrial growth expectations, which historically was always projected to occur a year or two out, is now upon us. There is a swelling activity, and Energy Recovery is ready for it. Now let's turn to oil and gas where our focus remains: one, commercializing the VorTeq; two, building out our Houston operations; and three, preparing the organization for commercialization and beyond. It's important to remember that VorTeq is an entirely new potentially game-changing technology to be deployed in a mature and vastly competitive industry.

The successful commercialization of the VorTeq is appended on our ability to prove the system's durability in the field. That proof comes from consistent and repeated testing. Our decision last year to secure experienced frac crews, equipment and a testing site has significantly increased our ability to repeatedly test the VorTeq in real-world conditions. We are seeing the payoff of these decisions every day, now that we are fully operational at Katy.

Through increased runtime, we are gaining insight and advancing the technology. Our work today is focused on failure modes of the system, while we essentially look for any possible means by which we can force the PX cartridges to stall, break or otherwise fail to perform. Throughout the quarter, we have had a number of visitors to our site in Katy, including investors and analysts. These visitors have seen firsthand how

significantly technology is advanced and how seriously we are taking our responsibility to commercialize this technology.

During these visits, people expressed interest in our test bench. Last year, in a move to design to speed our development process, we looked closely at our testing operations and made the decision to bridge the gap between testing a single Pressure Exchanger in the lab and testing at full scale with the VorTeq missile, which contains 12 cartridges. As such, we commissioned a smaller, more modular VorTeq, which is four pressure exchanger cartridges or one-third of that of a full-scale VorTeq missile. The modular test system is representative of the full-scale VorTeq.

However, because of its smaller size, we implemented changes to the system at an accelerated pace. Our testing protocol is as follows: we design and execute tests to focus on specific operating conditions and/or failure modes. We gather information on how the system performed during this test and then we design and implement those solutions on a modular VorTeq and test again. This is an iterative process, which can sometimes take more attempts.

Once we find a robust and reliable solution, we then implement the solution on the full-scale VorTeq missile and begin again. You can imagine how much slower this testing process was on a full-scale VorTeq. We are making changes across the system three times as large. This smaller, more agile system allows us to develop and test solutions much faster using the smaller system as the test bench and accelerate the research and development process. We continue to test at an unprecedented rate now.

In addition to our advances in testing, we have made significant progress in our facility in Katy, Texas, and are close to commissioning our manufacturing operations. Further, we continue to make progress in developing our supply chain. In summary, our technology and manufacturing readiness programs are more robust than ever before, and I'm extremely proud of the work our team is doing to advance the system. Commercialization is the priority, and we are executing against our plan.

In closing, our base Water business is growing rapidly as trends we have tracked for years are converging to drive demand, which is reflected in the largest third quarter in the company's history. The optimism for the future of our Water business is stronger than ever as evidenced in our robust growth outlook for 2021. In oil and gas, we continue to methodically execute our technology and manufacturing right in these programs and preparation for commercialization. I'm extremely pleased with where we are today.

As we approach the start of a new decade, I can say with great pride that I truly believe the best is yet to come for Energy Recovery. Happy Halloween to everyone, and I look forward to your questions.

Questions & Answers:

Operator

Thank you. [Operator instructions] The first question comes from Pavel Molchanov with Raymond James. Please go ahead.

Pavel Molchanov -- *Raymond James -- Analyst*

Thanks for taking the question. I wanted to ask about the international de-sell opportunities. You referenced the lower margin on some of the Middle Eastern business that you recently won. If you were to hypothetically get opportunities in places like South Africa or India, I'm curious whether those would continue to be at a lower margin structure than what you have traditionally been accustomed to north of 70%?

Josh Ballard -- *Chief Financial Officer*

Pavel, this is Josh. No. What we're seeing today is, especially in the Middle East, these massive projects that are being awarded is what's really driving that. We're not seeing it across the board by any means.

And a lot of the margin degradation that we're seeing -- I mean, it's not a lot, it's only a couple of percentage points, but it's also due to tariffs and some other cost increases, so the overall effect is not too big as you can see.

Pavel Molchanov -- *Raymond James -- Analyst*

Understood. Capital spending this past quarter was close to zero. Do I take that to mean that you have concluded the buildout of the facility near Houston?

Josh Ballard -- *Chief Financial Officer*

Not quite. We had -- we did have a small amount this quarter, but you're going to see that go back up in the fourth quarter. While we bought -- we had bought all the equipment last year. We've been working on the building this year.

We still have -- you probably are going to see a couple of million dollars going into Houston, give or take, here in the fourth quarter.

Pavel Molchanov -- *Raymond James -- Analyst*

OK. Appreciate it, guys.

Operator

Thank you. Our next question comes from Joseph Osha with JMP Securities. Please go ahead.

Joseph Osha -- *JMP Securities -- Analyst*

Hi there. Yeah. A couple of questions. I'm wondering if you might be able to step through, again, that math on the de-sell growth into 2020? I thought I heard a 2019 base number of \$68 million, maybe I was wrong.

I'm wondering if you can clarify that, and then I have another one.

Chris Gannon -- *President and Chief Executive Officer*

Yeah. Hey, Joe. Thanks for the question. So we're really looking at the \$69 million from the standpoint of the consensus estimate that's out there.

And so off of that base, assuming that that's the number, right, we're looking at a growth of 20% to 25% for water into 2020.

Joseph Osha -- *JMP Securities -- Analyst*

OK. It does. I mean understanding, of course, that you've just done \$57 million in the first three quarters, are you still saying that that would either imply that Q4 drops off a lot or that \$69 million isn't a reasonable number? I mean, I'm just curious about that in the context of this very strong first three quarters?

Chris Gannon -- *President and Chief Executive Officer*

Yes. It's really based on the consensus estimates. I'm not going to comment specifically about the Q4, but we've given some guidance to that in the past. Josh?

Josh Ballard -- *Chief Financial Officer*

Yes. I mean, I did give guidance in the prepared remarks, Joe, that we're going to do between 15% and 17%. And so how that fits, obviously, is going to show a lower Q4, much like last year. Last year was also lower Q4.

And that's just all based on the timing of our mega-project shipments is all that really is.

Joseph Osha -- *JMP Securities -- Analyst*

OK. So -- but again, not to belabor the point, you would be happy with supplying that 15% to 17% kind of, whatever, the outcome for 2019 ends up occurring? Is that what you're saying?

Josh Ballard -- *Chief Financial Officer*

Yes. That's where we're getting to.

Joseph Osha -- *JMP Securities -- Analyst*

OK. And then on -- by the way, thank you for hosting us down the Katy, that was great. As regards -- I know we are not going to ask about Schlumberger timing, but I'm wondering if you can just talk a little bit about how you're thinking about the go-to-market strategy at this point? And whether you would tend to prioritize that testing regime versus perhaps fracking a well with Liberty? Or any insight you could give us into the thought process if not the timing?

Chris Gannon -- *President and Chief Executive Officer*

Well, our priority right now is to test in our own yard, right? We invested heavily there as you know. We made that decision last year. We made tremendous progress there, and we're executing against that specific plan. And so when you look at what we're focusing on, we're focusing on extending the meantime to failure and the inherited liability of our specific system.

What that means is that we want to ensure that our system isn't the cause of unplanned downtime in the field, right? We don't want to get in the way of our customers' operations and so we're focusing on those activities. And we're focusing on testing as much as possible in our yard to, again, cause failures, to figure out what will cause failures and then fix-up. It's all about liability. Until we get to that point, where we are confident there or confident enough with that that will be the deciding factor when we go out and deploy.

Joseph Osha -- *JMP Securities -- Analyst*

OK. And I gathered that from your comments that we really shouldn't expect any more specific comments as regards commercialization time line for the intermediate term?

Chris Gannon -- *President and Chief Executive Officer*

Yes. I think that's fair.

Joseph Osha -- *JMP Securities -- Analyst*

Thank you very much. Thank you.

Operator

Thank you. [Operator instructions] And our next question comes from Ryan Pfingst with B. Riley. Please go ahead.

Ryan Pfingst -- *B. Riley FBR -- Analyst*

Hey, guys. Happy Halloween. We always run at Schlumberger, since the CEO transition that became effective August 1st. Has there been any new appointments to Schlumberger's VorTeg team or any changes to their approach to -- or communications around the timing of M1 or the path of commercialization?

Chris Gannon -- *President and Chief Executive Officer*

The simple answer is no. There's been no changes.

Ryan Pfingst -- *B. Riley FBR -- Analyst*

OK. Great. And then along those same lines, the new CEO said that they are now conducting a deeper view of their entire North American business. What implications can a merger, partial sale or significant rationalization of Schlumberger's OneStim frac business have on the licensing agreement and commercialization to that?

Chris Gannon -- *President and Chief Executive Officer*

Well, that's a big question. And right now we have to see where they decide to go with that business. I'm not going to comment specifically on where they are headed. That there's still I think in the process of deciding that.

At the end of the day, what we're focused on is commercializing our technology, period.

Ryan Pfingst -- *B. Riley FBR -- Analyst*

Fair enough. Chris, when it comes to your strategic objective of expanding the water -- company's water TAM, have you reached the point now or when might you decide to move forward with trying to organically develop an offering, rather than waiting for the right acquisition to materialize?

Chris Gannon -- *President and Chief Executive Officer*

Well, interestingly -- a great question. Interestingly enough, we're doing a lot of internal development right now. So we have a two-prong strategy and organic growth strategy, meaning, developing technology in-house, and so we've been working on that for a better part of the year. We are also out there talking to various parties on -- from an inorganic standpoint, but that's principally related to partnerships and supply agreements versus acquisitions at this point.

Ryan Pfingst -- *B. Riley FBR -- Analyst*

Thanks for the color. I'll turn it back.

Operator

The next question is a follow-up question from Joseph Osha. Please go ahead.

Joseph Osha -- *JMP Securities -- Analyst*

Well, I didn't think I'd get back on this quickly. I wanted to understand some of the comments you made about adding capacity for de-sell PXs because I know that you'd had some VorTeq capacity and some silicon -- tungsten carbide, excuse me, in San Leandro. Is the idea basically that all of the VorTeq has been pulled out and that you are able to ramp -- you're able to accomplish this additional expansion just with the San Leandro force base? Or is some of that going to be in Texas? Or just wondering if you can explain how that all works?

Chris Gannon -- *President and Chief Executive Officer*

Yeah. Great question. So we really have two approaches. Right? I'll comment on the water and then leave oil and gas for your question.

So we completed phase one of our water production increases this year. So that was in the middle of the year in June. We are now on what we're calling internally phase two capacity expansion again for our Water business and that's going to be completed mid next year. That will effectively double our capacity on the water side.

And based on my earlier comments, we have a very, very robust backlog and feel very comfortable there. We are also -- that's all in California, by the way. In terms of oil and gas, yes, we established our Katy facility specifically to manufacture our pressure exchangers, the core to the VorTeq technology in Katy, Texas. So that's the facility -- I think when you saw -- when you were there, you were seeing it being built or it was very, very far along there, and we're going to turn that on in terms of manufacturing very shortly.

Joseph Osha -- *JMP Securities -- Analyst*

OK. So the idea would be, you have some ceramic PX capacity in Katy as well, is what you're saying?

Chris Gannon -- *President and Chief Executive Officer*

No, no, no. So all ceramic manufacturing capacity for the Water business is in California.

Joseph Osha -- *JMP Securities -- Analyst*

OK. OK. So I misunderstood.

Chris Gannon -- *President and Chief Executive Officer*

All of our oil and gas VorTeq-related manufacturing is in -- is down in Texas and that does not impact our manufacturing here in California.

Joseph Osha -- *JMP Securities -- Analyst*

OK. Thank you.

Chris Gannon -- *President and Chief Executive Officer*

Absolutely.

Operator

Thank you. We have reached the end of the question-and-answer session. I'll now turn the call over to Mr. Gannon for closing remarks.

Chris Gannon -- *President and Chief Executive Officer*

Great. Well, thank you for joining us this afternoon, and we appreciate your continued support to our company. And we are looking forward to talking to you in the next earnings call. I mean, with that, have a great rest of your day, and once again, Happy Halloween.

Operator

[Operator signoff]

Duration: 30 minutes

Call participants:

James Siccardi -- *Vice President of Investor Relations*

Josh Ballard -- *Chief Financial Officer*

Chris Gannon -- *President and Chief Executive Officer*

Pavel Molchanov -- *Raymond James -- Analyst*

Joseph Osha -- *JMP Securities -- Analyst*

Ryan Pfingst -- *B. Riley FBR -- Analyst*