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Q2 2018 Energy Recovery Inc Earnings Call

EVENT DATE/TIME: AUGUST 02, 2018 / 9:00PM GMT



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PRESENTATION

Operator

Greetings, and welcome to the Energy Recovery Second Quarter 2018 Earnings Call. (Operator Instructions) As a reminder, this conference is being recorded. I would now like to turn the conference over to Manuel Mondragon, Vice President of Investor Relations. Thank you. Please begin.

Manuel Mondragon *Energy Recovery, Inc. - VP of Investor Relations*

Good morning, everyone, and welcome to Energy Recovery's Earnings Conference Call for the second quarter of 2018. My name is Manuel Mondragon, Vice President of Investor Relations, and I'm here today with our President and Chief Executive Officer, Chris Gannon.

During today's call, we will 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 their performance, including the MTeq system, cost structure and business strategy.

Looking forward -- forward-looking statements are based on information currently available to us in -- on management's beliefs, assumptions, estimates and 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 10-Q. These documents identify important factors that can cause actual results to differ materially from those contained in our projections or forward-looking statements.

All statement made during this call are made only as of today, August 2, 2018. And the company expressly disclaims 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 will make some references to non-GAAP financial measures during this call.

You will find supplemental data in the company's earnings press release, which was released to news wires and furnished to the SEC earlier today, which includes reconciliations of the non-GAAP measures to the comparable GAAP results.

At this point, I will turn the call over to our President and Chief Executive Officer, Chris Gannon. Chris, please go ahead.

Chris M. Gannon *Energy Recovery, Inc. - President, CEO, CFO & Director*

Thank you, Manny. And thank you, everyone, for joining us today for Energy Recovery's Second Quarter 2018 Earnings Call.

I will begin with an overview of our financial results and then transition to the strategic and commercial update.

Following a record year in 2017, we were determined to continue the positive momentum in 2018. I'm happy to report we have done just that.



For the second quarter ended June 30, 2018, we generated total revenue of \$20.8 million, representing a 49% top line growth year-over-year, with product gross margin of 66% and total gross margin of 71%.

In addition, we reported GAAP net income for the quarter of \$15.7 million or \$0.28 per diluted share. This was largely driven by an \$11.9 million, onetime tax benefit, related to simplifying the company's international tax structure in Ireland in light of the 2017 U.S. Tax Cuts & Jobs Act. On an adjusted basis, removing the impact of this tax benefit, net income was \$0.07 per diluted share for the quarter.

Our Water business recognized total revenue of \$17 million for the second quarter, representing a 75% growth year-over-year, which was partially driven by strong MPD and aftermarket shipments.

With an operating income margin of 53%, our Water segment performance underscores the strength of our position within desalination. We plan to further expand on this business segment, and I will discuss our approach to growth here shortly.

Our Oil and Gas business generated total revenue of \$3.6 million for the second quarter of 2018, a reduction of \$500,000 or 12% year-over-year. The decline in revenue was associated with lower cost to total cost revenue recognition, associated with the sale of multiple IsoBoost systems. This was partially offset by higher VorTeq license revenue recognition, as a result of the new ASC 606 accounting standards.

As a reminder, the adoption of the new revenue accounting standard resulted in the restatement of our historical financials, the impact of which are detailed in our Form 10-Q filed with the SEC earlier today.

Let's now transition to the strategic and commercial update where I will reiterate our corporate strategy broken down into both our long-term and near-term strategic objectives as well as discuss our progress in meeting these objectives.

First and foremost, the long-term strategy of the company is focused on: one, the commercialization of the VorTeq system; two, the continued market leadership and growth of our Water business; three, the commercialization of the MTeq system; and four, the continuous innovation of our core PX technology for use in new product applications.

Our near-term strategic priorities and focus remain, in no particular order: one, the growth of and reinvestment in our Water business; two, the commercialization of the VorTeq system; and three, the further development of the MTeq system.

Let's now begin with a discussion of our Water business, which remains a phenomenal, healthy and vibrant enterprise, and is a key area of focus and growth for our company moving forward.

The second quarter of 2018 saw excellent results for our Water segment. This quarter rounds out a very strong first half for 2018 even compared to our record-breaking year in 2017, with revenue up 38% year-over-year for the 6-month period.

Growth in our desalination business has been broadly driven by demand in the Middle East, North Africa and Asia. We continue to see substantial activity and expansion in each of these regions, all of which are critical markers of the health of the overall industry.

Just last week, we announced an additional \$3.3 million award in Egypt, our second contract there this year. This and other recent market activity across our megaproject and OEM segments and still further confidence in the strength of our Water business throughout the second half of 2018 and continuing into 2019.

Furthermore, our aftermarket business, which historically represents roughly 15% to 20% of our ongoing Water revenue, remains robust.

Our Water business continues to generate tremendous positive cash flow and is the foundation from which the company has and will continue to grow. While we are excited about this segment's performance and overall growth trajectory, we are not content to simply maintain the status quo. As such, we are actively investing resources back into our Water segment, pursuing multiple paths to further



grow this business unit.

To understand our views on growth, we must first reflect on our existing business. Currently, our pressure exchangers are the dominant technology in the desalination Energy Recovery marketplace, as they offer customers the lowest lifecycle cost, an exceptional performance and reliability when compared to competitive products. The pressure exchanger offers a distinct competitive advantages and has allowed Energy Recovery to build an extensive distribution network throughout the desalination industry.

Our extraordinary worldwide sales and service team lead the desalination industry in terms of customer and plant connections. These advantages combine to make Energy Recovery a recognized and a well respected brand globally, as evidenced by the fact we captured nearly 100% market share in megaprojects globally over the past several years and hold a significant portion of the OEM energy recovery market with our PX Pressure Exchanger and turbocharger technologies.

However, while we dominate our market, energy recovery devices only represent approximately 1% to 2% of the typical desalination plant capital spend. This despite their integral importance in making desalination affordable by dramatically reducing energy consumption, and therefore, generating substantial cost savings annually for desalination plant operators worldwide.

While we enjoy our position, I strongly believe being a dominant player within a relatively small portion of the desalination pie, is not sufficient. Rather, I believe, this represents an opportunity to further strengthen and grow our business. This is an opportunity I do not intend to overlook.

For example, in contrast to Energy Recovery devices, pumps represent roughly 8% of the total desalination plant capital spend. At present, Energy Recovery has a relatively small footprint here with our high-pressure and booster pumps, meaning there are significant opportunities in this space for market share growth and expansion.

Moving forward, we will continue to explore growth in the pump and other product categories within Water desalination where we feel there are opportunities for ERI to leverage our core competencies.

As such, to evolve and advance our Water business, we plan to aggressively pursue growth opportunities. We will accomplish this through a combination of internal product growth opportunities as well as partnerships, distribution agreements and M&A activities.

We are excited about the water initiatives currently underway, and I will provide further updates as we progress.

Turning now to our Oil and Gas business, I will begin with an update on our VorTeq solution and our steadfast focus on driving this technology to commercialization.

Since taking the reins as CEO, I have conveyed to all stakeholders our primary goal is full-scale commercialization of the VorTeq, not simply the milestones tied to economic considerations. At our annual meeting and in our corresponding investor presentation, we updated the market that our product licensees' testing facilities were being closed for planned renovations.

Additionally, we disclose that we were in the process of scheduling our steering committee meeting in which we were to discuss the results of the technical design review. We have since completed our steering committee meeting. As a result and working closely with our product licensee, we have decided to accelerate several system-level design enhancements. These enhancements have always been required for commercialization. However, given their importance, we made the decision with the support from our product licensee, to introduce these system-level enhancements ahead of milestone 1 testing.

As I have stated numerous times, our collective focus is on full-scale commercialization of the VorTeq system, period. We remain actively engaged with our product licensee and will be ready to resume testing once resources and schedules permit.

Let me be clear, due to timing uncertainties surrounding the completion of these enhancements, as well as the scheduling of resources -- both facility and equipment -- I will refrain from providing discrete timing around the milestone test. Rather, let me state, that we believe



we will be ready to conduct milestone testing once these system-level enhancements are completed and scheduling uncertainties, if any, are resolved.

What is important here is we are continuing to advance the technology toward commercialization, along what we believe to be the most efficient path. We fully expect these system-level design enhancements to shorten the timeframe from the successful completion of milestone 1 to commercialization, which I trust our investors can understand and appreciate fully is in the best interest of the company, our licensees and ultimately our shareholders.

I have frequently reiterated the experience gained through increased VorTeq system runtime is critical to advancing the technology as quickly as possible. Following the unavailability of our product licensees' facilities, which I referenced earlier, we took advantage of this opportunity to continue testing with our other VorTeq partner, Liberty Oilfield services.

As such, during the second quarter, we moved the VorTeq missile to Liberty's facilities to continue testing at scale.

I mentioned at the annual meeting that we were exploring and evaluating alternative test, field test options for the VorTeq system and this continues to be true. While tests are currently underway at Liberty's facility in Texas, we are also exploring opportunities for private testing as well as additional tests with both our product licensee and Liberty, including at a well.

However, in this current environment with E&P companies increasingly focusing on optimizing operations, finding the right customer who is willing to introduce a new technology in live operating conditions will be more challenging. With the VorTeq now located within a hotbed of activity, we believe we are well-positioned to take advantage of an opportunity, should one arise.

While the path to commercialization is not a straight one, these and other efforts have not been misplaced. We are developing a product that I'm confident will be a disruptive and transformative technology for hydraulic fracturing.

Moving now to the MTeq, as we discussed in past calls and at our annual meeting, we learned a great deal from round 1 testing earlier this year and those learnings have been converted into design enhancements to our mud-pumping system. The MTeq is now ready for new -- next round testing, and we have identified a testing site. Testing is currently being scheduled, and we will provide updates when appropriate. Overall, we remain on track, and we are ready and excited for upcoming testing.

In closing, the company continues to experience success in our core Water business unit, of which I could not be prouder. In addition, we continue to be -- make incredible progress towards VorTeq systems commercialization and our MTeq system is advancing as anticipated.

With that, I will turn the call over for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from line of Joe Gibney with Capital One.

Joseph Donough Gibney *Capital One Securities, Inc., Research Division - Senior Analyst*

Just a question on some of the system-level enhancements you're talking about, curious if you could refresh us there. It sounds like they've always been in the queue, and you're taking the opportunity to accelerate on some of that for VTeq (sic - VorTeq). Just curious if you can talk to me what some of other specific enhancements are?

And I just wanted to clarify that comment about private testing as well as additional testing with Liberty and Schlumberger. Was that a live well potential test with Liberty as well potentially on the table there? Just trying to understand what you're intimating there? Appreciate it.



Chris M. Gannon *Energy Recovery, Inc. - President, CEO, CFO & Director*

Sure, sure, sure. Great to hear you, Joe. So we're not going to discuss the specific details around the system-level enhancements. We historically have, and I'm getting away from that practice because I think it's just plain confusing to investors. But our goal with our product licensee and us is to shorten the path to commercialization. And that's what we're doing.

Joseph Donough Gibney *Capital One Securities, Inc., Research Division - Senior Analyst*

Okay. Fair enough. And on MTeq, the next round of testing being ready, you've identified a testing site, it sounds like. Just to clarify. This is working towards field trials with -- in conjunction with Sidewinder, or this is separate individual testing, as you continue to round out the system a little bit more in its nascent stages?

Chris M. Gannon *Energy Recovery, Inc. - President, CEO, CFO & Director*

Yes. So with MTeq, what we're doing is we're actually doing private testing. When you look at a company like Sidewinder, I think you probably saw their recent announcement that there is a transaction going on there. And plus they're very, very busy, in general.

So we're going to be doing private testing there. Something that we're able to do because it's a closed-loop system.

Operator

(Operator Instructions) Our next question comes from the line of Tom Curran with FBR.

Thomas Patrick Curran *B. Riley FBR, Inc., Research Division - Senior VP & Equity Analyst*

So to follow-up on Joe's questions, regarding the design enhancements you'll be making to the VorTeq prototype, could you share with us just the estimated time required solely for the enhancements, putting aside all the variables on the Schlumberger side that will determine when ultimately you'd be able to resume the M1 test? Just in terms of what's within your control with regards to these enhancements? What's the estimated time range for them?

Chris M. Gannon *Energy Recovery, Inc. - President, CEO, CFO & Director*

Yes. So I'm not going to provide specific timing, partially because you like to wring my neck when I do. We're focusing on system-level designs to shorten the path to commercialization. And so we will resume our testing with Schlumberger, specifically M1, once we can schedule that testing with them.

Thomas Patrick Curran *B. Riley FBR, Inc., Research Division - Senior VP & Equity Analyst*

Okay. I had to try. And then on the Liberty front, are these enhancements that you would either have to under the Liberty contract, or maybe simply prefer to make before you'd move forward with Liberty as well? Or could we potentially see you advance with Liberty on a parallel track at the same time that you're still working towards an M1 resumption with Schlumberger?

Chris M. Gannon *Energy Recovery, Inc. - President, CEO, CFO & Director*

Sure, sure. So we're currently working with Liberty in Texas. So we're testing with them right now. All of the enhancements we make with Liberty or with our licensing partner end up accruing to both of them. So all -- everything that we're doing, regardless of who we're doing it with, benefits each of them. And everything we're doing currently is, again, focusing on commercialization.

We're going down parallel paths with them, but we're trying to get to commercialization as rapidly as possible with both.

Thomas Patrick Curran *B. Riley FBR, Inc., Research Division - Senior VP & Equity Analyst*

Okay. And just so I'm clear. That could result in commercialization happening first with Liberty, before it might with Schlumberger?

Chris M. Gannon *Energy Recovery, Inc. - President, CEO, CFO & Director*

Yes. It could. It is possible.

Thomas Patrick Curran B. Riley FBR, Inc., Research Division - Senior VP & Equity Analyst

Okay. Turning to Water, when it comes to your 2019 visibility on megaproject and OEM demand, how far and broadly does it extend? And how does that visibility compare to this stage in prior up cycles?

Chris M. Gannon Energy Recovery, Inc. - President, CEO, CFO & Director

So we have -- we actually have very good visibility past '19, and so where we are right now, we feel very comfortable with -- certainly with '18, as I mentioned, and then ultimately with '19, given the environment we're in. However, as we look past '19, different economic considerations come in play and change that. So it's all about timing.

Thomas Patrick Curran B. Riley FBR, Inc., Research Division - Senior VP & Equity Analyst

Okay. And then could you just give me the standard breakdown for water, that I always ask for between megaprojects, OEM and aftermarket please?

Chris M. Gannon Energy Recovery, Inc. - President, CEO, CFO & Director

Yes. So MPD was roughly 50%. OEM was, call it, 28% or almost 30% and aftermarket was about 20%.

Operator

We have reached the end of our Q&A session. I'd like to hand the floor back over to Mr. Gannon for closing remarks.

Chris M. Gannon Energy Recovery, Inc. - President, CEO, CFO & Director

All right. Thank you for joining us this afternoon, and we appreciate your continued support of the company. We look forward to providing an update on our next earnings call. Thank you, again. And have a great rest of your day.

Operator

Thank you. This concludes today's conference. You may disconnect your lines at this time. And thank you for your participation.

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