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Q3 2018 Energy Recovery Inc Earnings Call

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PRESENTATION

Operator

Greetings, and welcome to the Energy Recovery Third Quarter Earnings Conference Call. (Operator Instructions) As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, James Siccardi, Vice President of Investor Relations. Thank you. You may begin.

James Siccardi *Energy Recovery, Inc. - VP of IR*

Good afternoon, everyone, and welcome to Energy Recovery's Earnings Conference Call for the Third Quarter of 2018. My name is Jim Siccardi, Vice President of Investor Relations of Energy Recovery. I'm here today with our Chief Financial Officer, Joshua Ballard; and our President and Chief Executive Officer, Chris Gannon.

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 their performance, including the MTeq system, cost structure and business strategy.

Forward-looking statements are based on the 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 that the company's 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 today during this call are as of today, November 1, 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 may make some references to non-GAAP financial measures during the call. You will find supplemental data in the company's earnings press release, which was released to newswires and furnished to the SEC earlier today, which 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, Joshua Ballard.

Joshua Ballard *Energy Recovery, Inc. - CFO*

Good afternoon, everyone, and thank you for joining us today. Before I begin, I would like to first thank Chris and the board for providing me the opportunity to join Energy Recovery as its Chief Financial Officer.

Since 2015, Energy Recovery increased its overall gross margin from 57% to 75%, created sustainable profit and operating cash flow, continued to advance its leadership position in the water desalination business and made tremendous progress developing its disruptive



VorTeq technology.

I'm honored to step into this role and work alongside the team who built this company to where it is today. My own background is focused on high-growth companies and markets, and I'm excited to now be collaborating with everyone at Energy Recovery during this exciting time in the company's growth.

The positive momentum we experienced in the first half of 2018 has continued in the third quarter. For the third quarter ending September 30, 2018, we generated total revenue of \$22.2 million, representing 30% top line growth year-over-year. This top line growth translated into a product gross margin of 73% and an overall gross margin of 77%.

In addition, we reported GAAP net income for the quarter of \$4.7 million or \$0.08 per diluted share. Year-to-date, we have generated \$56.8 million in revenue, \$11.3 million over the same period in 2017, a 25% increase year-over-year.

As in previous quarters, our Water business has continued to drive growth at Energy Recovery. Water alone generated \$18.5 million in revenue during the third quarter of 2018, a growth of 40% over 2017 and \$47 million year-to-date, a 38% increase over the same 9 month period last year. This strong growth has been driven largely by mega projects, those generating over 50,000 cubic meters of water or more per day.

By their very nature, mega projects are somewhat unpredictable when it comes to the timing of shipments and this unpredictability has generated a stronger than expected third quarter. As such, we believe our overall year-end growth rate will moderate itself to single-digit percent growth, as was communicated earlier this year.

Our Oil and Gas business generated total revenue of \$3.8 million for the third quarter of 2018. Of the total Oil and Gas revenue, \$3.7 million was related to ASC 606 recognition of VorTeq license revenue, with the remaining associated with lower cost to total cost revenue recognition related to the sale of multiple IsoBoost system. As in past quarters, we continued to invest heavily in the commercialization of our VorTeq and advancement of our MTeq solutions.

Our third quarter operating cash flow was \$11.4 million, especially strong due to the timing of several large customer receipts. We ended the quarter with nearly \$102 million in cash and securities. These high customer receipts in the third quarter, however, will not continue into the fourth quarter and we'll end the year with operating cash flow more in line with the past 2 years.

I look forward to talking more with current and potential investors as well as our sell-side analysts.

And with that, I will hand it over to our President and CEO, Chris Gannon.

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

Thank you, Josh, and thank you, everyone, for joining us today. As in past calls, I will begin my commentary by reiterating our strategic objectives and I will then discuss our progress in meeting these objectives.

Our near-term strategic priorities and focus remain: one, the commercialization of the VorTeq system; two, the growth of and reinvestment in our water business; and three, the further development of the MTeq system. In addition, over the long-term, we will begin to reprioritize the continuous innovation of our core PX technology for use in new product applications, something you will note I've halted earlier this year to focus development efforts on MTeq and VorTeq.

Let's now begin with a discussion of our core Water business, which is a phenomenal, healthy and vibrant enterprise and continues to be a key strategic area of focus and growth for our company moving forward. As we look to the future, I'm extremely bullish on this business. For instance, 2018 is shaping up to be a potential record year for our Water segment and will likely represent the fourth consecutive year of top line revenue growth.

Year-to-date, we have generated \$47 million in revenue from our desalination business, putting us in a position to potentially surpass



last year's record level of \$54 million. In addition, we continue to produce robust gross profit margins, averaging over 70% year-to-date. Our large-scale or mega projects division continues to deliver impressive results.

During 2018, we have not lost a single mega project, while generating roughly \$23 million in revenue so far this year. This represents an 83% increase year-to-date as compared to the same period last year and nearly 7% increase over our 2017 full year mega project revenue. This strength in mega projects has largely driven our growth in pressure exchanger sales and the corresponding increase in product gross margin.

In addition, our OEM and aftermarket businesses remain strong, posting year-to-date growth for 2018 as compared to the same period in 2017 of 5% and 26% respectively, truly a wonderful performance.

Looking forward, I'm further encouraged at the activity level we see within our Water business. As of today, our backlog and pipeline for mega projects is extremely robust and still in confidence as we look to 2019 that we are likely to see continued growth within this area with the momentum potentially carrying into 2020.

As I've noted in the past, our pressure exchanger is the premier Energy Recovery technology in desalination today, providing customers with the lowest lifecycle cost, leading industry efficiency and the greatest reliability. In fact, the competitive advantage of our PX Pressure Exchanger is so compelling that we are often spec'd into most mega projects directly by the end user.

Our PX Pressure Exchangers are also sought by plant owners who have chosen to replace their existing competing technologies with our PX Pressure Exchangers, further underscoring the dominance of this wonderful technology.

In addition, our backlog and pipeline for our OEM segment remains robust, with continued demand for a whole suite of Energy Recovery devices, namely the PX Pressure Exchanger and the turbochargers as well as our pumps.

We also continue to grow our recurring aftermarket revenue stream and capitalize on an unmatched installed base of 20,000-plus devices globally. In the past, when we have discussed the cyclicity of the Water business, we have pointed to its historical 4- to 6-year cycle. We are currently in the fifth year of an up-cycle. However, from where we stand today, we do not see any slowdown in either demand or corresponding desalination plant activity.

I believe this market activity is supported by global water scarcity, driven by significant global population growth in an exploding industrial landscape, coupled with the related pollution of fresh water sources, aging infrastructure and climate change. This is leading to a renewed call for the desalination industry to solve the world's growing water problems.

Due to these underlying issues, the demand for potable water continues to grow and significantly outpaces the current supply. Importantly, less than 1% of the world's available water is fresh and this percentage continues to decline as the imbalance in water supply and demand trends continue. For example, according to the OECD, global water demand is slated to increase by 55% between 2000 and 2050, while reserves are expected to dwindle. If current usage trends don't change, the world will have only roughly 60% of the water it needs in 2030.

Against this backdrop, our core Water businesses remain strong. Yet we are not content with the status quo. Rather we view this as a great opportunity to further bring our business and brand to where it is needed most, which is why Energy Recovery is focused on substantial reinvestment in this area.

Water growth initiatives and capturing the substantial market opportunity further supports our ability to protect Energy Recovery's core business, maintain and grow our market share, reinforce the Pressure Exchanger and grow our overall business.

As I mentioned last quarter, to fully achieve our long-term growth potential, we need to diversify beyond the Energy Recovery market, which represents only 1% to 2% of desalination capital spend. Our goal with these initiatives is to expand our overall desal market share, mitigate our cyclical exposure to water and increase over our cash flow generation.



I have challenged our Water team to explore strategic avenues for growth and they have under covered opportunities within our current SWRO, desalination business as well as across other water applications, where we can grow the breadth of our offerings and provide our customers with a greater value proposition. Importantly, we seek to leverage our world-class sales and distribution channel by increasing the scope of products we can offer to our customers.

We anticipate growth will occur through multiple avenues. We seek to fill gaps in our existing product portfolio and to explore tactical initiatives with others within the water industry. Eventually, we expect these products and initiatives to provide a springboard into the broader water market outside of SWRO and desalination.

To summarize, market activity and trends appear in our favor. We're beginning to identify opportunities, both organic and inorganic that will hopefully serve as the foundation of our future growth plans. We're incredibly proud of the performance to-date of our Water business and even more excited about the growth and the clear opportunities we see ahead.

Turning now to our Oil and Gas business. Our collective focus remains the full-scale commercialization of the VorTeq system. We are working with both our product licensee and product partner as well as independently to advance the technology and shorten the path to commercialization through increased component, system-level and full-scale runtime testing and development.

We continue to make progress on the system-level design enhancements we discussed during our last earnings call. As a reminder, following our technical review with our product licensee in the second quarter, we collectively decided to accelerate certain technical enhancements in advance of Milestone 1. These were always required to achieve full-scale commercialization, which remains the key objective for all parties involved.

So while these enhancements have the initial impact of delaying the timing of Milestone 1, we expect they will shorten the overall time to market, which we believe is the most efficient path. Now from a process standpoint, as with past development cycles, once we finish the system-level enhancements, we will again meet with our product licensee to review progress before scheduling Milestone 1. As such, we will provide updates when appropriate.

As many of you have probably noticed, since I became the CEO earlier this year, I have been focused and probably a bit obsessed with shortening the timeline to commercialization. I've been proud of this company's ability to rapidly and continually innovate and to solve all of the issues and design challenges we have faced to-date.

But the challenge we face today is not our ability to engineer and design solutions, but our -- rather our ability to test frequently at full-scale in real-world conditions. With this in mind, I firmly believe that our organizations need to further enhance our internal testing capabilities to enable us to frequently test design iterations of the system at our cadence on our schedule at full-scale and in real-world conditions. This capability should allow us to further and more rapidly enhance the VorTeq technology and hopefully satisfy my obsession with shortening the path to commercialization.

To date, while we have been able to continuously effectively design and test individual cartridges for the VorTeq system at our in-house test facility, the results and learnings of which have proven invaluable to our system development, our ability to test the VorTeq missile at full-scale has been limited by our dependence on the availability of our product licensees and product partners' equipment, resources and facilities. Given the market conditions over the last 2 years, we, of course, appreciate the need for our product licensee and product partners to allocate such equipment, resources and facilities to revenue-generating activities.

However, while our product licensee and product partners have been incredibly supportive, our dependence upon them could at times result in timing delays and disruptions that handicap our ability to move forward in an expedited pace.

To be clear, I will not accept this as a barrier to innovation here or in any other aspect of our business. With this in mind, I made the decision to proactively begin increasing our autonomy over the testing process by beginning to invest in the resources needed to conduct full-scale testing independently.



We've already begun acquiring high-pressure in the ancillary equipment necessary for full-scale testing and we'll continue to build our internal capabilities, including our own test facility until we have all the resources necessary to match our ability to rapidly design and innovate. Again, all of this is focused on the end goal of more quickly commercializing this disruptive technology.

In summary, we have made great progress on the system-level design enhancements as we continue to work down parallel development paths with both our product licensee and product partner. Additionally, we are maximizing our ability to test independently to ensure we have consistent system runtime to test VorTeq design iterations at our cadence, on our schedule at full-scale in real-world conditions.

Again, we are entirely focused on commercializing the VorTeq system in the most efficient way and I'm confident this path will do just that.

Moving now to MTeq, where we've also made progress since our last earnings call. I'm excited to report we successfully completed our most recent round of testing and validated our ability to run drilling fluid through the system under a variety of operating conditions, simulating real-world drilling activities. We have taken an important step forward in validating the technology and building confidence in our ability to manage drilling fluid within the application.

Following a comprehensive analysis of our most recent test results, we intend a more extensive round of endurance testing. We remain on track in our development cycle here. I will provide further updates on our VorTeq and MTeq during our next earnings call.

In closing, I'm tremendously proud of the company and team's continued strong growth in our core Water business unit. I'm confident in the incredible progress being made towards VorTeq system, 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 is coming from the line of Joseph Osha with JMP Securities.

Hilary Elizabeth Cauley *JMP Securities LLC, Research Division - Associate*

This is actually Hilary Cauley on for Joe Osha. My first question for you is, if you could just talk a little bit more about what some of those other water growth opportunities might look like? I know you had previously said that pumps were something you were looking at. And just what that timeline might look like?

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

Certainly. Thanks for the question, Hilary. When we think about our Water business, what we're focused on is really growing our overall product offering. So we have certain, I'll call it, holes in our pump offering, certain size ranges and whatnot that we need to fill. We took an initial step forward on that when we entered our agreement with Düchting Pumpen, a German manufacturer. And we will continue to work with them and look at potentially others to continue to grow that. In addition, as we think about the overall opportunity in the Water segment, there are other system-level enhancements or products we can offer to that customer base around the globe for things that they're actually asking for us to do.

Hilary Elizabeth Cauley *JMP Securities LLC, Research Division - Associate*

And as you start to bring some of those online, is this going to kind of support that 3% to 5% growth rate or could we actually see some upside to that?



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

Yes. When we think about maybe next year, we actually are seeing an enhanced growth rate than the kind of, let's say, the historical guidance I provided or -- and we're really looking at more of a 5% to 8% growth. On top of that, as we think about the other activities, with regards to other future growth activities, that would layer on top of that.

Operator

The next question is coming from the line of Mike Urban with Seaport Global.

Michael William Urban Seaport Global Securities LLC, Research Division - MD & Senior Analyst

So last quarter you had talked about -- and I think you referenced it again on your prepared comments on this call -- just your partners are often busy and focused on field operations and that gives you great difficulty in getting testing opportunities. We've seen a pretty dramatic slowdown in frac activity over the last quarter and a real acceleration just in the last month or 2 and that looks like that's going to continue for some period of time. Has that given you any opportunities or have they made equipment or facilities available to you given that they are seeing that pause in their business?

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

Well, so in the -- as in the past, I'm not going to comment specifically on our product licensee or product partners' activities. We are always looking for opportunities to get runtime on our technology. We are currently at our product partners' facilities and have access to the facility and equipment. So both our product licensee and product partner have continued to be supportive of us. And that is -- that's obviously a massive positive for us.

Michael William Urban Seaport Global Securities LLC, Research Division - MD & Senior Analyst

And as you look to establish your own testing capability, presumably you don't need to buy a whole frac spread here. It's just going to be select equipment and the relevant equipment and then the facility itself. What's the cost of that?

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

So to-date-- and you'll see that in our financials -- we spent about \$3 million and we're going to continue to add on to that. I think -- but going back to your past question, what I think -- let me just finish answering that I guess. When you think about why we're doing this, it's for us to control our ability to test whenever we want to and not have to schedule it with either our product licensee or product partner. And that is key for us. We need to be able to test anytime we want to and not be subject to them needing to run their business.

Michael William Urban Seaport Global Securities LLC, Research Division - MD & Senior Analyst

So you spent \$3 million, yes, I think you said on it so far. Is there kind of a total estimate for what that will ultimately cost to establish that independent testing ability?

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

Yes. When we think about the testing capability as well as potentially adding in a facility, you're looking at \$6 million to \$10 million over time.

Michael William Urban Seaport Global Securities LLC, Research Division - MD & Senior Analyst

And then the last one for me is -- and it may be a difficult question to answer given that it's going to be a technology-oriented business and inherently unpredictable. But how do you -- and I recognize you don't want to give targets publicly. But how do you evaluate it internally in terms of the spend, in terms of the timeline? How you're evaluating your -- the folks who are working on this and are you making -- in terms of making adequate progress? And just is this something -- regardless if I get the technology, is it that just makes sense in the grand scheme of things and relative to the very stakeholders in the company?

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

Well, yes. I mean, the -- when you think about the VorTeq technology, the thing that we're focusing on is commercialization, because that's exponentially more important than Milestone 1 when we think about the value of that technology to our shareholders. So, yes, we are always evaluating our spend and where we're allocating our resources. I made the decision to invest in our testing capability, as an

example, so that we could more quickly ideate and test. We are always going to need to continue to invest and expand our capabilities as we focus on commercialization.

Operator

(Operator Instructions) Our next question is coming from the line of Ryan Pfingst with FBR.

Ryan James Pfingst B. Riley FBR, Inc., Research Division - Associate

Just coming back to growth for Water and your M&A effort, we're just wondering how the pipeline has evolved for prospects given the new growth strategy for Water and when the earliest might be we see initial transaction?

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

There are certain things that are in my control and others that are not. We have -- we're going down multiple paths when we think about Water growth, both organic and inorganic. As far as the timing of various inorganic initiatives, I'm going to pause on that one and you'll see that as it plays out.

Ryan James Pfingst B. Riley FBR, Inc., Research Division - Associate

And then just on mega projects, wondering if you could share an update on how your visibility is looking to late 2019 into 2020?

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

Yes, so on the mega projects side, we're seeing really nice growth into 2019, into 2020. So when I think about our business, our base business right now, Water, I am very bullish on where things are headed for us. And really are -- when I think about mega projects, the OEM segment, even aftermarket, the -- that business is doing wonderful.

Ryan James Pfingst B. Riley FBR, Inc., Research Division - Associate

And then just one on VorTeq, if I could get anything out of you. If you have any further update on discussions with Liberty and how they're thinking about the technology since moving to Texas?

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

Well, yes. I certainly -- I mean, I guess I'll -- what I'll tell you is that I'm not going to comment specifically on our product partner or our product licensee and their positions on it. What I can tell you is that both are -- have been very supportive of us. Obviously, we are in their -- one of their facilities right now. So hopefully that speaks to their support.

Operator

Thank you. It appears we have no further questions at this time, so I like to pass the floor back over to Mr. Gannon for any additional concluding comments.

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

All right. Well, thank you for joining us this afternoon and we appreciate your continued support of our company. We certainly look forward to providing updates in our next earnings call. And again, thank you again, everyone, and have a great rest of your day.

Operator

Ladies and gentlemen, this does conclude today's teleconference. Again, we thank you for your participation and you may disconnect your lines at this time.

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