

Energy Recovery
Q4 Fiscal Year 2019 Earnings Call
March 5, 2020

Presenters

Bob Mao, Chairman, Interim President, Chief Executive Officer
Joshua Ballard, Chief Financial Officer

Q&A Participants

Pavel Molchanov – Raymond James
Tom Curran – FBR

Operator

Greetings, and welcome to the Energy Recovery Q4 fiscal 2019 earnings conference call. At this time, all participants are in a listen only mode. A question and answer session will follow the formal presentation.

If anyone should require operator assistance during the conference, please press star, zero on your telephone keypad. As a reminder, this conference is being recorded.

It's now my pleasure to introduce your host, James Siccardi. Please go ahead, sir.

James Siccardi

Good afternoon, everyone, and welcome to Energy Recovery's 2019 earnings conference call. My name is Jim Siccardi, vice president of investor relations at Energy Recovery. I'm here today with our chairman and interim president and chief executive officer, Bob Mao; and our chief financial officer, Joshua Ballard.

During today's call, we may make projections and other forward-looking statements from 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, March 5, 2020, 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 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. 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 chairman and interim president and chief executive officer, Bob Mao. Bob, the floor is yours.

Bob Mao

Thank you, Jim. And thank you, everyone, for joining us today. 2019 was yet another great year for Energy Recovery. It was our third consecutive year of record-setting revenue in our water business, our fifth consecutive year of revenue growth, and our fourth consecutive year of 100 percent market share in the mega project channel, our fastest growing channel.

The reputation of our PX Pressure Exchanger and its lifetime value proposition is unmatched by our competitors. How do you compete against a product that rarely, if ever, fails and needs no maintenance? The value proposition is increasingly important today as mega plants grow even larger and will have nearly double the size from an average of roughly 150,000 cubic meters per day in 2018 to nearly 270,000 by 2021.

We just recently announced a contract with the largest seawater reverse osmosis plant in history that will produce over 700,000 cubic liters of water per day. This is not only a major milestone for Energy Recovery, but for the entire industry. The reverse osmosis desalination is indeed (unintelligible) as evidenced by DesalData's recent estimates of seawater reverse osmosis CapEx spending, which is expected to increase from roughly \$3.3 billion in 2018 to over 8.9 billion in 2021.

In such large plants, the cost of unplanned downtime can cost operators hundreds of thousands of dollars per day. Plant operator knows that our PX rarely fail. This reputation should continue to serve us well, given what is shaping up to be yet another record year in 2020. We are confident in our ability to continue to execute, even as our backlog and pipeline grow.

Even though our strong 2019 end of year results increased the base from which our outlook was calculated, we remain confident in our ability to generate 20 to 25 percent revenue growth

in 2020, with an additional 10 to 15 percent in 2021. Additionally, we will say that there is an upward bias to this year's range, which we will address in coming quarters.

In fact, that largest contract we announced was also the largest thermal conversion contract to-date. While the size of the announcement was significant for our company, the more important longer-term implication involves the potential trend of installed thermal desalination capacity transitioning to seawater reverse osmosis production.

In 2020 and 2021, thermal conversions could be as high as 10 to 15 percent of our total water revenue as the potential switching trend started to materialize. More than 20 million cubic meters per day of thermal water production was commissioned from 1980 to 2018. These plants will likely all be replaced by reverse osmosis plants either at the end of their useful life or perhaps earlier due to the immense cost savings obtained from conversion to reverse osmosis.

We estimate this potential conversion to create an energy recovery device total addressable market of approximately half a billion dollars at today's prices. As the coming decade plays out, our goal is to capture as much of that new market as possible. To meet this growing demand, we began to double our manufacturing capacity in 2019.

We're (unintelligible) the second phase of this expansion to come--to be completed during the summer of this year. However, the second phase of our expansion will be located at our new facility in Tracy, California, located about an hour east from our headquarters in San Leandro. Once commissioned, we will produce about 20 percent of our pressure exchangers at this new plant in the first full year of production.

With respect to coronavirus, we are not currently seeing a significant effect on our revenue outlook or supplies. However, as we source some components from China, we are continuing to monitor the situation.

In summary, the water business remains strong and highly profitable. We are excited by the immense growth we see upon us. The team is executing and we are confident in our ability to deliver on that growth, in what should be yet another record year.

Now, I would like to turn to our oil and gas business where we have made tremendous progress as the VorTeq transitioning from R&D project to a commercialized product. Just a year ago, we secured our own testing location. Today, I will update you on the progress made due to our increased capability to test it well with our own crew and equipment.

During the final weeks of the fourth quarter, we successfully phased the--we successfully passed 2.1 million pounds of sand through the VorTeq, the equivalent of roughly seven frac stages, using a range of sand sizes, including 30 to 50 mesh, 40 to 70 mesh, and 100 mesh. We did this to be consistent with most frac job today, which uses multiple sand types depending on the frac design.

Moreover, we successfully tested VorTeq while passing sand concentrations of four to eight pounds of sand per gallon. The ability to handle higher concentrations has the possibility of expanding the technical capabilities of the VorTeq pressure exchanger.

The VorTeq cannot be the cause of implant downtime at a frac site. Therefore, the (unintelligible) to failure of our technology must be longer than that of the equipment already onsite. Based on our results in the fourth quarter, we believe this is achievable with our technology.

The investment to procure our own frac site has been to integral to our progress, testing continually while making design enhancements all in our own facility, let us rapidly identify and resolve critical issues with the VorTeq and the system around it. We have been able to replicate most of the aspects of a working frac site and the VorTeq has responded well to the challenges of this environment.

We have spent the better portion of 2019 testing the durability of the VorTeq and its ability to work using a simulated frac site. In addition to simulate a testing in our own yard, our next steps will include live frac testing, which is critical on the path to commercialization. With the assistance of our product partner, we're in the process of identifying potential wells to approach.

We look forward to providing updates once we and our product partner has successfully identified live wells where we can deploy our VorTeq system. We have well utilized the resources of our testing facility and are ready to tackle this next challenge on the path to commercialization.

In addition to our progress in the water with the VorTeq, we officially commissioned and opened our Katy, Texas production facility. We now have a full operational testing and machining facility that will enable us to more efficiently support the VorTeq during this critical phase of testing as well as upon commercialization.

I am pleased with the team and the progress we have made in recent months. However, I have never lost sight of the significant investments that this company has made in VorTeq and on the need to create real value for our shareholders or to stop investing. As such, we're focused on getting the VorTeq commercialization and beginning to derive a return from our investment as quickly as possible. I look forward to what is to come in 2020.

Finally, we recently completed reorganization of our team intended to strengthen the ability of our business units to execute and grow their businesses, as well as enabling a disciplined approach to longer-term growth and to assure we deliver commercialized products to greatly enhance the value of Energy Recovery.

In the near-term, we remain focused on putting new water products into beta tests this year and advancing the VorTeq towards commercialization. In parallel, this reorganization creates a centralized corporate development and R&D function that will focus on incubating new products and businesses outside our existing water and the oil and gas business units.

R&D is at the heart of who we are as a company and we believe in the potential of our pressure exchange technology. This technology is unique, capable of handling columns of fluid from relatively clean seawater through harsh fracking propellant and within the pressures from 1,000 to 10,000 psi. The development of the VorTeq pushes the technology boundaries of pressure exchanger technology.

As we further expand the technology to functional envelope, it is becoming apparent this potential industrial application using the current boundaries are significant. We will continue to explore new applications of our technology to deliver the next level of value to our shareholders. You can see that we ended 2019 confidently and with strong momentum as we step into 2020.

We as a team continue to execute at a high level focused on building this business for the long-term. There is no slowing down. I am excited by what 2020 and the future has in store for us.

I now hand over the call over to Josh to discuss the financials.

Joshua Ballard

Thank you, Bob. We ended the year strong and somewhat above our Q3 2019 guidance, generating total revenue of \$19.5 million, representing 10 percent growth year-over-year for the fourth quarter ending December 31st. For the full fiscal year, we achieved total revenues of \$86.9 million, 17 percent growth over the same period in 2018.

Our water business generated \$16 million in revenue during the fourth quarter, representing growth of 14 percent year-over-year. We achieved revenues of \$73 million for the total fiscal year, a 20 percent increase over the same period in 2018. Our mega-project channel led this annual growth, increasing 40 percent in 2019. We expect mega-projects to continue to drive growth in 2020 and 2021.

The significant annual growth in our mega-project channel drove its revenues up to 52 percent of our water sales, an increase from 45 percent in 2018. OEM was 32 percent of water sales and aftermarket 16 percent for the year.

While the majority of our water growth was in the Middle East, more than 20 percent of our 2019 increase occurred in Latin America, where we are seeing increased project activity related to industrial sectors as water needs increased in the region.

We couldn't be proud of our water team for this tremendous growth. As Bob mentioned, we are currently guiding growth of 20 to 25 percent in 2020 off these higher end year results, which increases our guidance 3 to \$4 million for 2020 or about 4 percent. We hope to adjust this guidance further in the coming quarters as bookings finalize and any potential effect from the coronavirus becomes clear.

We recognized total revenue of \$3.7 million for the fourth quarter in our oil and gas business, an increase back to normalized levels from our decline in the third quarter. For fiscal year 2019, we recognized a total of \$14.1 million in license revenue. This revenue, of course, is entirely related to the ASC 606 recognition of VorTeq license revenue.

Note that, while we currently expect to recognize between 12 to \$14 million in 2020, this revenue will be more weighted to the second half of the year as we focus on performing live well testing with our product partner in the first two quarters. We expect our quarterly license revenue to be in the range of 2 to \$3 million in the first half of the year and then to increase to 3.5 to \$4.5 million in the second half.

We reported a GAAP net loss for the quarter of \$0.6 million or 1 cent per diluted share. This loss is largely due to a one-time expense related to the resignation of our CEO. However, we achieved 19 cents of diluted EPS for the year, 2 cents less than 2018, once adjusted for the large one-time tax benefit related to our prior international tax structure.

Our product gross margin ended the year at 72.1 percent, an increase of 60 basis points over fiscal year 2018 due to our strong mega-project sales. This increase was realized despite a decrease in the fourth quarter relative to Q4 2018 by 300 basis points to 71.5 percent due to a larger percentage of non-PX sales. As a reminder, we do expect some slight weakening of our product margin in 2020 and 2021 to between 68 to 70 percent due to pricing pressure and tariffs related to China.

We do not see any effect in our product gross margin from the coronavirus as of today. However, if we were forced to rely more on our suppliers outside of China, we could potentially see some downward pressure on our gross margin. We do not expect any significant reduction in margin as of today. We will update you on these numbers in the first quarter call.

Overall, operating expenditures grew 21 percent in 2019, right within the guidance we provided the last few quarters. Over half of that increase was due to research and development spend related to the VorTeq as well as new products and improvements to existing technologies in our water business. Note that of the total \$56 million in operating expense, nearly \$10 million is related to non-cash items such as stock-based compensation, depreciation and amortization.

We do not have an update to our 2020 guidance on operating spend at this time except to note that as we turn to new projects outside of water and oil and gas, we will begin to break out these numbers in our filings to provide a sense as to the size of the investments we are making.

We are taking a vigorous commercial-based approach to these projects focused on achieving specific research and commercial milestones prior to investing significant funds. This is also true in our water business, as we vet all projects to ensure that they will create real value for our shareholders.

In terms of VorTeq, our investments in 2020 are focused on introducing an initial production ready prototype. Note that once we begin to transition into the commercialization phase of this business, we should see a significant drop in our R&D spend. Testing should decrease as we move to this field and a significant portion of our costs in Katy will move to cost of goods. We will provide further guidance on this when appropriate.

Our overall 2019 CapEx spend ended the year at a total of \$7.4 million, slightly below our guided minimum of \$8 million due to the timing of our Houston facility spend. Our expectations for 2020 are slightly higher than our prior guidance with investments of up to \$12 million. This increase is due to the decision to expand our capacity in a second location in Tracy, California. We should not see significant CapEx investments in our oil and gas business until we begin to ramp up for commercialization, at which time we'll provide additional guidance.

Our cash and securities balance increased to \$101 million at the end of that--of the year. And, of course, we remain debt free.

With that, we can move to the question and answer portion of our call.

Operator

Thank you. We'll now be conducting a question and answer session. If you'd like to be placed in the question queue, please press star, one on your telephone keypad. A confirmation tone will indicate your line is in the question queue. You may press star, two if you'd like to remove your question from the queue.

For participants using speaker equipment, it may be necessary to pick up your handset before pressing the star keys. Once again, that is star, one to be placed in the question queue. One moment, please, while we poll for questions.

Our first question today is coming from Pavel Molchanov from Raymond James. Your line is now live.

Pavel Molchanov

Thanks very much. First, a question on the water revenue guidance. You said up 20 to 25 percent for the year as a whole. Do you anticipate any front end weighted or backend weighted cadence or should it be fairly stable from quarter to quarter?

Joshua Ballard

This is Josh. Hi, Pavel. I'd assume a weighting of probably 40 to 60--40 percent in the first half and 60 percent in the other--in the second half.

Pavel Molchanov

Okay, very clear. And on the testing progress with regard to VorTeq, given that 2020 marks the five year mark or milestone from the original Schlumberger agreement, are you committing to get to at least step M1 before the year is out?

Bob Mao

Yes. This is Bob.

Pavel Molchanov

Okay. And what gives you the confidence in that?

Bob Mao

As we described in my update, we passed 2.1 million pounds of sand. That's seven stages. I'm sure you'll remember, M1 is five stages. And also, we have frozen our production prototype. So we are not--it is still tinkering around in R&D.

And furthermore, our product partner has enough confidence in what they have seen. And we are actively sourcing potential live frac. These are the data points.

Pavel Molchanov

Okay. We'll look forward to hearing more about it. Thank you.

Operator

Thank you. Our next question today is coming from Tom Curran from FBR. Your line is now live.

Tom Curran

Good evening. Bob, it sounds as if so, in your prepared remarks, the product partner you referenced, presumably with Schlumberger, and then by live well, my understanding is that M1 was going to be conducted with a Schlumberger crew and frac spread I believe originally intended at Kellyville. Is that what you mean by live one?

Is that a reference to the original plan for M1? Or has that changed? And are you referencing by live well, a frac job site that would include an actual operator that's a customer?

Bob Mao

It is--our product partner is Liberty in this effort and it will be at a live frac site. That's where we're searching. A live frac site and a end customer of Liberty's.

Tom Curran

I see. So, you expect, over the course of this year, to both move forward and conduct testing with Liberty at a live frac job site with one of Liberty's actual customers as well as resuming and completing M1 with Schlumberger. You expect to move forward with both this year.

Bob Mao

That's correct, yes.

Tom Curran

Great. And then, regarding the recent full-scale testing you've done in Katy, the sand data you shared was very helpful. Would you perhaps quantify what your recent testing ranges had been for BPM, meaning flow rate and then pressure?

Bob Mao

Pressure is up to 10,000 psi. Flow rates--the more important one, as I mentioned, is that the--we're testing four to six and eight pounds of sand. Since you are apparently quite familiar with M1, M1, in fact, was only envisioning two pounds of sand. And with the sand density, if you will, changes, the flow rate would also vary because of that sand density.

Tom Curran

Right. Makes sense. And that all sounds technically very encouraging. When it comes to milestones one and two, have you yet agreed to or do you expect to have to negotiate any changes, including potential modifications to the KPIs for each test? It doesn't sound as if those KPIs have changed.

Bob Mao

No. We are not contemplating nor are we negotiating any changes to those KPIs.

Tom Curran

Great. Thanks for fielding my questions.

Operator

Thank you. As a reminder, that's star, one to be placed in the question queue. One moment, please, while we poll for further questions.

We've reached the end of our question and answer session. I'd like to turn the floor back over for any further or closing comments.

Bob Mao

Well, this is Bob. And thank you for joining us this afternoon. We look forward to providing an update on our next earning call in eight weeks. Have a good day. Thank you.

Operator

Thank you. That does conclude today's teleconference. You may disconnect your lines at this time. And have a wonderful day. We thank you for your participation today.