Energy Recovery
Q1 Fiscal Year 2020 Earnings Call
April 30, 2020 5:00 PM ET

Presenters
James Siccardi, VP of Investor Relations
Bob Mao, Chairman, Interim President and CEO
Joshua Ballard, CFO

Q&A Participants
Pavel Molchanov, Raymond James
Mels Thomasis, Fearnleys

Operator
Greetings, and welcome to the Energy Recovery Quarter One Fiscal Year 2020 Earnings 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 the telephone keypad. As a reminder, this conference is being recorded. I would now like to turn the conference over to James Siccardi, Vice President of Investor Relations. Thank you, please begin.

James Siccardi
Good afternoon, everyone, and welcome to Energy Recovery's First Quarter 2020 Earnings Conference Call. My name is Jim Siccardi, Vice President of Investor Relations at Energy Recovery. I am here remotely 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 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, cost structure, and business strategy.

Forward-looking statements are based on information currently available to us, and our 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, April 30th, 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 new 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 would 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. I want to start today's call with the sincere hope that everyone listening and their respective families are safe and well. I am happy to report that the energy recovery team remains healthy and well. The COVID-19 pandemic has turned our personal and professional lives upside down. All any of us can do in response is rise to the challenge that is presented. To that end, I am tremendously proud of our team's response. Our employees have displayed a remarkable calm and determination, that has allowed us to navigate these uncertain times.

Two considerations have guided our response; how do we protect the lives of our employees, while protecting our business, and by extension, the livelihood of our employees? It is with great pride that I can report we have not laid off or furloughed any employee due to COVID-19. We're also in the fortunate position of being able to give back, including donating personal protective equipment from our manufacturing facilities to healthcare providers.

The safety of our employees has been our primary focus from the beginning. Prior to the implementation of the state and local shelter-in-place orders, we had already determined that all employees who could work remotely should do so. As a result, with the exception of our manufacturing activities, nearly all of our functional business areas continue to operate fully and efficiently, though remotely in most cases.

On March 19th, when the Bay Area shelter-in-place was announced, we elected to temporarily suspend manufacturing activities at our San Leandro headquarters, to assess the impact of those orders, review additional local, state, and federal guidance, and to implement health and safety measures recommended by health officials to protect our employees that are required to be present at our facilities.

We have since partially reopened our San Leandro manufacturing facility, in full accordance with federal, state, and local regulations and guidance. We have also implemented the enhanced safety measures at each of our manufacturing facilities. Those measures include, smaller, staggered shifts to ensure social distancing between employees, personal safety.

equipment for each worker, including masks and gloves, and most importantly, cleaning between shifts. Fortunately, for us, those measures did not have a material impact on the company in the first quarter.

As a critical supplier to the domestic and global desalination industry, I am happy to report that we have not missed a single contract UPX delivery since the introduction of the Bay Area orders. We had ample product inventory on hand, we continued shipping customer orders on time. In fact, based on what we know today, I expect that we will be able to fulfill most, if not all, of our existing deliver obligations for the remainder of this year. We're also continuing to take new orders for all of our products, including newly-awarded megaprojects in Egypt and China, which makes me hopeful that there is an economic light at the end of the tunnel.

In short, we're attempting to conduct our business as close to usual as we can in this new normal. We expect this new normal to be here for a while, so we are adjusting and planning for the long term. The strength of our balance sheet gives us some flexibility and confidence in that effort. Energy Recovery, like everyone else, is facing more uncertainties, but I do believe we can safely navigate these events.

Now turning to our water segment. With so many lives depending on the water produced by these large plants, operators turn to the name they trust. Our flagship PX, with its strong reputation and the lifetime value proposition, remains the technology of choice operators, who demand proven quality, efficiency, and unmatched reliability. The first quarter of 2020 was the highest revenue-generating first quarter in the company's history. Our megaproject channel continues to drive this growth. Despite COVID-19 and the recent volatility in the oil markets, we have not seen a significant impact on our megaproject activity, or backlog in 2020. This could still change, but if history is a guide, in today's environment, impacts to our sales tend to lag market downturns.

We realize that we are only a phone call away from a project delay in these uncertain times, but remain encouraged that megaproject customers have not yet communicated significant project delays or suspensions. Because projects in our backlog have already been financed, then we typically ship later in the schedule of. a construction project. There is a greater potential for negative impacts for pipeline projects in 2021 and beyond. For example, despite the recent volatility in the oil markets, according to recent industry publications, Megaprojects in oil-dependent countries, such as Saudi Arabia, appear stable in the near-term, which represent a significant source of our future revenue.

Of our other business channel OEM, our smaller project channel, which caters to a diverse source of industries, including tourism, may see the largest relative impact from COVID-19. The degree of impact is likely dependent on the duration of the pandemic, and subsequent economic downturn. However, we believe any effect of OEM on our overall guidance should be minor. Overall, I remain cautiously optimistic. As of today, the desalination industry is showing some stability in 2020. And we are therefore, maintaining our 2020 outlook, as guided last quarter.

Finally, I want to follow up on my comments on our water growth initiatives from last quarter. Despite the uncertainties from COVID-19, we are continuing to prepare for product launches later this year. And our water segment continues to move forward, despite today's challenges. I would like, now, to turn to our oil and gas segment, where we are focused on delivering two proof points for the Vorteq; first, a live well frack with our product partner, and second, achieving milestone one.

As you know, the oil market has changed dramatically since we last spoke. In late March, we identified a well in Texas, with Liberty, to conduct a live well frack. Unfortunately, sudden negative changes in the oil market led to the cancellation of that frack, mere hours before the scheduled commencement. In mid-April, a second opportunity to conduct a live well was cancelled as a result of the oversupply of oil. Immediately, we were disappointed by these cancellation, but continue to work with Liberty to identify other opportunities to test our Vorteq system, in live, real world conditions, which is critical to our step towards commercialization. Due to the state of the oil market, our opportunities to deploy our technology at a live well may remain limited for the near-term, but we will be ready when the opportunity arises. In parallel, we're focused on passing milestone one.

As we mentioned during our last earnings call, we believe the technical hurdles of M1 have been cleared, and our confidence in achieving certification is high. While we have not had recent discussions with our product licensee regarding M1, our goal is to attend and document M1 during the second quarter. Whether if our product licensees cite our own or with a third-party, we look forward to updating you with the results of that test. A documented M1 will also provide a basis for a substantive review with our product licensee, on our respective near and longer term commercial and operational plans.

In the meantime, we continue to manufacture and test at our Katie facility, in accordance with government health and safety guidance. Our focus is on improving our field operations, further enhancing Vorteq's reliability, and extending the useful life of the cartridges. As mentioned during our last call, we have settled on a more simplified and effective production model, and expect the eventual live well will support those decisions.

Our confidence is at an all-time high today. While we do face headwinds in today's oversupplied environment, oil and gas is cyclical in nature. We believe the Vorteq can ultimately deliver potentially more value during a down cycle than an up cycle, as it may allow our customers to realize meaningful cost of savings relative to their peers. With that, I would like to comment our incubation initiatives, which we touched upon last quarter while outlining the technical boundaries within which our PX technology platform can successfully address new market verticals.

We have identified two or three potential verticals that appear promising from a technological and a commercial perspective. While our priorities remain protecting our base business in water during these uncertain times, and commercializing the Vorteq, we're also devoting resources to expand our market reach, with financial discipline and transparency. We look forward to providing more color around these efforts in subsequent quarters. In summary, our employees are safe, our business is successfully adjusting to our new normal. Our finances are secure, and our plan towards evolution of our core competence into new technologically and commercially viable verticals, is moving forward. With that, I will turn the call over to Josh to discuss the financials.

Joshua Ballard
As Bob mentioned, this was a very good quarter. We generated total revenue of $21.5 million, representing 9% year-over-year growth. Our water business generated $19 million in revenue, or 19% year-over-year growth. Megaproject revenue grew 50%, for both OEM and aftermarket experienced decreases of 20% and 48% respectively. These decreases in OEM and aftermarket should not be attributed to COVID-19, or any other macroeconomic challenge, but were simply normal quarter-to-quarter fluctuations.

No megaprojects were delayed due to COVID-19, and the value of any delayed orders in our other channels were immaterial in the first quarter. Due to these decreases, megaprojects made up 76% of our water sales, OEM was 19%, and aftermarket five. We recognized $2.5 million of revenue for the first quarter of our oil and gas business. This was lowered by nearly 32% over the last quarter, but is in line with our guidance for this year. As a reminder, this decrease was planned as we expended more resources on achieving a live oil frack with our product partner, which is not directly related to the ASC 606 recognition of the Vorteq license revenue.

At this time, my guidance of 12 to $14 million in license revenue for the year has not changed. However, revenue recognition is highly dependent on use of our resources, our live well tests with our partner, and on M1 tests directly related to Vorteq license revenue. Therefore, revenue will likely increase to our more typical $3.5 million level in the second quarter, assuming we pivot away from live well tests, and back to milestone one. This will be a bit of a moving target in the coming months.

Our product gross margin as 70%, an increase of 80 basis points over the first quarter of 2019, and at the upper end of the guidance I provided in prior quarters. However, despite landing within guidance, we did experience a negative effect on our gross margin due to COVID-19. Because we underutilized our plant at the end of March and chose not to furlough our workforce, we experienced an increased cost of goods during that period, which decreased gross margin by approximately 2.5% for the quarter. Had we not been affected by COVID-19, we would've exceeded guidance by that amount. We will likely to feel this drag on our gross margin while we remain underutilized. However, the effects should be more muted now that we are back to producing. Note that, assuming we get back to full production in Q2, we do have the opportunity to call back a portion of this large of margin during the second half of the year.

In addition, the potential change in the mix of our revenue this year due to COVID-19 may mean that our gross margin will experience a positive bump as well. OEM sales have a product mix that is higher in pumps and turn-mills which are lower margin products. If sales of our OEM channel decrease in 2020, pressure exchangers may make up a higher percentage of sales, thereby increasing margin. We'll have to wait and see how this plays out in the coming months. But despite the effect of COVID-19, we have a reasonable chance of staying within our guidance for the year.

Overall, operating expenditures were $15.7 million, reflecting 29% growth in the first quarter when compared to Q1 last year, relatively flat against last quarter and well within our guidance for the year. Please note that as promised last quarter, we have expanded our disclosure of segmented operating expenditures in our filing, as well as in our press release, to increase a break-out of corporate spend. Within that number, you will see a significant increase in corporate R&D spend year-on-year, which reflects our work on new incubation initiatives. We reported a GAAP net income for the quarter of $621,000, or one cent per diluted share.

From a cash and liquidity perspective, we remain in a good position. Our negative operating cash flow for the quarter had nothing to do with COVID-19. The first quarter's typically negative at these levels, and this is reflective of large, end-of-year payments such as bonuses and 401(k). Of our $93 million in cash and securities, 33 million is in cash or liquid money market funds, another $41 million is in short-term corporate securities, largely maturing in the next three to four months, and the remaining $19 million is in longer term corporate securities between 12 to 18 months in duration. We have a very diverse portfolio invested only in highly-rated investment grade securities. We have no current need to trade any of these securities, as our cash reserves are sufficient for our operations, and therefore the illiquidity of the markets we experienced in the first few weeks of this crisis, had no effect on our operations.

From where we stand today, we feel comfortable in our liquidity. We have not drawn on any debt, nor taken advantage of the lines of credit made available by the laws recently passed by Congress. In fact, it is in part, for uncertain times such as these, that we have kept a healthy amount of liquidity on our balance sheet, and I think that prudence is paying off today. It is the financial health of our balance sheet, and the resiliency in the desalination industry to date, that has allowed us to forego the difficult personnel decisions that so many others are currently facing.

Our cash position is strong, and our balance sheet remains flexible in these challenging times; we are being prudent with our spend. Although we have not furloughed any employees, we have scaled back operating capital expenditures where possible for the time being. Due to the global uncertainty today, we are putting in clear contingency plans if the situation were to deteriorate. However, we see no need to implement these plans as of today. And with that, let's move to the question and answer portion of our call.

Operator
Thank you. At this time, we will be conducting a question and answer session. If you would like to ask a question, 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 would like to remove yourself from the queue. For participants using speaker equipment, it may be necessary to pick up your handset before pressing the star keys. One moment please while we poll for your questions. Our first questions come from the line of Pavel Molchanov of Raymond James. Please proceed with your questions.

Pavel Molchanov
Thank you for taking the question. Your reaffirmed guidance, and I just want to be very clear on this, in March, you were targeting water segment revenue growth of 20 to 25% versus last year's levels, and that still remains the case, correct?

Bob Mao
That's correct, Pavel.

Pavel Molchanov
And what gives you the confidence that even with the reduced utilization, or the slower pace of manufacturing in San Leandro, you can accommodate all of the customer demand, you know, at the levels, you know, prior to the pandemic?

Bob Mao
First of all, we have a healthy inventory. Secondly, we also expect our Tracy facilities to come online in the second half of the year. And also, we were working on one ship, before.

Pavel Molchanov
Understood. One last question, are you aware of any desal construction projects that have been delayed or slowed because of lockdowns or other social distancing regulations?

Bob Mao
No, we are not aware of any. That's why we have the confidence that we will deliver the guidance.

Pavel Molchanov
Very clear. Thank you again.

Operator

As a reminder, if you would like to ask a question, please press star one on your telephone keypad. Our next question comes from the line of Mels Thomasis (SP) of Fearnleys. Please proceed with your questions.

Mels Thomasis
Hi, Josh, Bob, thanks for taking my question. Just to make it clear, because last earnings call you guided for 2021 revenue of 10 to 15% growth in the water segment. Given that you're not mentioning anything now; does that mean that you're contracting your guidance for 2021 revenues?

Bob Mao
We are not retracting. At the same time, yes, we're not reconfirming because we do see some delay, two to three months, in some of the announced bidding, although we have not seen any consolation of the announced bidding. So, we should have a better picture at the July call.

Mels Thomasis
Okay. Thank you.

Operator
Our next questions come from the line of Pavel Molchanov of Raymond James. Please proceed with your questions.

Pavel Molchanov
I just wanted to ask one about the Schlumberger relationship. You mentioned not having any dialogue with Schlumberger recently, but you're planning, you know, to attempt M1 in the next, I mean, you said 60 days, Q2. Given that oil prices right now are obviously at, you know, 20-year lows, is there a risk that the same kind of cancellation may happen with M1, as what happened with Liberty, where that frack was cancelled?

Bob Mao
First of all, the M1--we can do M1 on our own and document M1, present it to Schlum, and also, we can request that Schlum will do M1 with us, after we documented our own M1, to do at Schlum's facilities. And this is not a live frack, so therefore, it does not contribute to the oversupply of oil.

Pavel Molchanov
Okay. So--

Bob Mao
--So, of course, Pavel, we will do M1 first ourselves, just to be sure that we pass all the requirements. And then we will--in fact, per contract, we will request to do an M1 with Schlum. Although, the completion of M1 is not dependent on Schlum doing M1. But we need to document that we have done one.

Pavel Molchanov
And what--who determines whether you get the $25 million?

Bob Mao
Of course, eventually, it's Schlum who has to pay it, so therefore--

Pavel Molchanov
--Yeah--.

Bob Mao
--In that sense, they determine, right, Pavel? But first thing is, we have to demonstrate and document that we have accomplished M1. Then, as I said just now, that we really--it's been a long time since we've signed an original contract with Schlum. Much has changed, particularly much has changed in recent weeks, and that affects the outlook for the next year or two, or maybe longer. So therefore, I expect that we will actually go into a comprehensive discussion, review our respective operational commercialization plans. So, M1 will be viewed in that overall context.

Pavel Molchanov
--Okay--.

Bob Mao
--But, first thing, we'd have to demonstrate we have done M1.

Pavel Molchanov
Alright. Thank you again.

Operator
As a reminder, if you would like to ask a question, please press star one on your telephone keypad. We have reached the end of the question and answer session. I will now turn the call back over to management for any closing remarks.

Bob Mao
Well, this is Bob Mao, I will thank you all for joining us this afternoon. In fact, we see close to 80 participants joining us this afternoon. We look forward to speaking with you in July. In the meantime, please keep yourself and your families safe. Please also check our IR website for updates. Have a good day and evening. Thank you.

Operator
This concludes today's conference. You may disconnect your lines at this time. Thank you for your participation, and have a great day.