

Energy Recovery
Q4 Earnings Conference Call
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Presenters

Jim Siccardi, VP of Investor Relations
Bob Mao, Chairman, President, and CEO
Josh Ballard, CFO

Q&A Participants

Jason Bandel, Evercore ISI
Pavel Molchanov, Raymond James
Nils Tomlinson, Firms Securities
Tom Curran, B. Riley Securities

Operator

Greetings, and welcome to Energy Recovery's Q4 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. Please note, this conference is being recorded. I would now like to turn the conference over to your host, Jim Siccardi, Vice President of Investor Relations. Thank you, you may begin.

Jim Siccardi

Good afternoon, everyone, and welcome to Energy Recovery's 2020 Fourth Quarter and Full Year Earnings Conference Call. My name is Jim Siccardi, Vice President of Investor Relations at Energy Recovery, and I'm here today with our Chairman, 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 commercialize VorTeq, growth expectations, new products and their 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 they 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 11, 2021, and the company especially 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. At this point, I would like to turn the call over to our Chairman, 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, as I did last quarter and every quarter since the pandemic started, with the sincere hope that everyone listening and your families are safe and healthy.

Although the past year has been challenging for everyone, I am happy to report that the Energy Recovery team and our business remains healthy and strong. Our goal has always been to protect the lives and livelihood of our team. We have robust testing and monitoring protocols in place for all our manufacturing sites. To our knowledge, there has been no spread of COVID-19 at our facilities. It is a testament to our team that we were able to keep everyone safe, even while producing and selling a record number of PXs.

Beyond these achievements, our continued evolution as a company is exciting. We have settled into our long-term strategy, which is expanding the (INAUDIBLE) range of our pressure exchange strategy, and introduce it to new industries outside of these elements. As an example, we diversified our water product offering with the introduction of our Ultra PX Energy Recovery device, for use in industrial wastewater treatment.

We are now partnering with the leading global member in manufacturing, DuPont Water Solutions, to market our product in this space. We also issued our first ESG report, formalizing the focus we have always had on environmental sustainability. Our efforts around this path led to an A rating by Morgan Stanley, MSCI. We know there is more we can do to be a good global corporate citizen, and we'll continue to update you on our ESG efforts through 2021.

Finally, the recognition of our achievements. Forbes named Energy Recovery as number 16 in its list of Top 100 Small Cap Companies, and IR Magazine shortlisted us for top investor relations department for small cap companies. I am proud of how the team responded to 2020's challenges, but I am not surprised. The evolution underway in energy recovery is what I envisioned when I accepted the permanent role of President and CEO. We are now building off our momentum of 2020, and are positioned to deliver another great year in 2021 and beyond. In today's call, I will update you on our base desalination business, industrial wastewater, VorTeq, and our emerging introversion projects.

With that, let's begin with desalination, where we once again generated a record year of revenue despite the global pandemic. Our megaproject channel remained strong throughout the year. Megaprojects were the main driver of our 27% water revenue growth in 2020, beating the 25% outlook we had maintained throughout the year. We anticipate this segment to lead the way again in 2021 and 2022, as large-scale projects are built to meet the needs of a thirsty world. We're also seeing concrete proof of the technology shift from thermal to reverse osmosis in our revenue and backlog, which should further drive growth.

Then, we affirm the outlook of what we offered during our third quarter call. That is about a 10% growth in 2021, and up to 25% growth in 2022. Over the last year, we had repeatedly spoken of the secular shift in global water demand. Water scarcity is growing in communities across the globe, and seawater reverse osmosis desalination is a drought-proof option to deliver water in water scarce locations. Governments around the world are seeking solutions to the water needs of their people, which is leading to a third of growth in seawater reverse osmosis.

As countries evaluate their paths forward, many are prioritizing sustainable solutions. This is where our PX can add significant value. The PX generates no emissions in operating and reduces the energy intensity of seawater reverse osmosis. It decreases energy use by up to 60%, making seawater reverse osmosis far more cost effective and environmentally sustainable.

Importantly, our customers do not have to compromise on quality for sustainability. The reliability, efficiency, and lifetime value proposition of our PX make it seawater reverse osmosis' most trusted and widely used Energy Recovery device. This win-win value proposition through desalination supports our strategy to apply the PX to other verticals to improve efficiency and the environmental sustainability.

I will now talk in more detail about our new product applications, starting in industrial wastewater. Since we announced the Ultra PX Energy Recovery device late last year, we received two orders. The first has already been shipped to India, and it is expected to be commercialized--commissioned by mid-year. And the second is scheduled to be shipped to China by the second quarter. We also hosted yesterday a successful webinar with (INAUDIBLE) as part of our partnership agreement to drive market acceptance of ultra-high pressure reverse osmosis, or for the sake of this discussion, RO for short.

Our Ultra PX can significantly reduce the energy needs, costs, and environmental impacts of treating industrial wastewater in RO applications. RO is increasingly used to achieve zero and minimal liquid discharge treatment requirements. VLD and MLD systems seek to eliminate or minimize wastewater discharge by purifying and recycling concentrated industrial wastewater. In traditional VLD and MLD setups, up to 50% of the costs come from costly and energy-intensive thermal treatments. VLD and MLD systems adopting RO can lower energy intensity and potentially generate significant cost savings. Then, our Ultra PX and RO become even more

attractive compared to the thermal option. Given this, we believe our Ultra PX has the potential to make RO the preferred treatment option to achieve VLD and MLD treating--treatment requirements, just as our PX helped RO to become the leading method for seawater desalinization.

Where do we sit today? RO adoption in industrial wastewater treatment is in the early stages. However, environmental regulations are beginning to drive growth, and we believe regulatory changes plus companies' own ESG commitments will push this new segment forward. Sectors such as metals and mining, canning, chemicals, pulp and paper, pharmaceuticals, and others, could all benefit from RO as a means to remove toxins from the industrial wastewater. As this demand emerges, we expect to be in a similar position to desalinization. That is, preferred--prepared to meet customers' demands and positioned as the industry's solution of choice.

We are actively building our team and sales pipeline in India, and increasing our marketing efforts. We are excited by this new business line, and see it as further proof of our ability to deliver solutions that make industrial processes interesting and sustainable.

Now, we turn to VorTeq. Over the past few quarters, we have stated that we must successfully complete two to three live well fracs, validate our value proposition, and maximize the life of the PX cartridges. As a reminder, if we do not pass any one of the three hurdles, we do not have a commercialized product.

Let's begin with live well fracs. We are pleased to announced that we have completed one light frac in Texas, and we are currently taking part in the frac operations for a multi-well pad in New Mexico. Our first trial was a small frac on a vertical well. That job was like a dress rehearsal for the multi-well pad and large frac stages. Since March 1st, we have been outside at a multi-well pad owned by one of the largest independent oil producers in the United States.

We have experienced challenges which represent valuable learning for us as we work to fine tune the technology. By end of the day on Sunday, March 7th, VorTeq was realized in 10 frac stages. We expect to continue for additional 50 to 100 stages. In these stages, we will accumulate data to further validate our work on oil stream produced. You can expect a more wholesome report at the next earning call in eight weeks as the frac completes, and we are able to fully evaluate the data.

As a reminder, cartridge life remains the key hurdle to success. Cartridges and the maintenance of them are the main cost drivers for VorTeq. We consider R&D to now be complete on the VorTeq. However, manufacturing of the cartridges remains a real challenge for commercialization. We still have work to do to prove that we can reduce cartridges profitability. In addition, fuel engineering will continue as we work to improve the VorTeq in the fuel. If you remember, we committed to commercialize by mid-year this year, and/or since investing. We remain on that schedule, and the coming weeks will prove pivotal to define our next steps. Let's now move on to our future PX applications.

Last quarter, I explained how Energy Recovery is transitioning into a growth company with our versatile pressure exchanger. As a reminder, this technology can handle relatively clean to dirty liquids at pressures from 1,000 pounds per square inch to over 10,000 PSI. Today, I would like to talk about the work our team has done to expand the sandbox in which the pressure exchanger operates.

Specifically, we have now proven that the PX can also expand and compress gas, therefore widening the parameters of our sandbox. This technical achievement opens up potential applications in industries where our technology could provide significant energy savings, such as refrigeration, air conditioning, power generation, and liquid natural gas. Our first target is to address the challenge faced in industrial and commercial refrigeration.

The refrigeration industry is facing a shift in technology, as regulation phases out refrigerants like hydrofluorocarbon, known as HFC, and replace them with natural refrigerants such as carbon dioxide. Within our defined 12-month period, we have technically proven that PX is capable of processing gas, as needed, in the refrigeration cycle. While we do not have a commercial product yet, we believe that PX can serve as a critical solution for this industry, by helping to reduce the energy costs inherent in utilizing natural refrigerants such as CO₂.

The PX can potentially create new value for the customers, much as we have in desalination. We are, of course, mindful of our two-year deadline to commercialize a new technology. And therefore, over the next 12 months, we will provide a deeper discussion on this topic as we proceed.

In summary, the momentum in which we ended 2020 has carried into the new year. Our desalination business continues to ride the secular wave of demand. We are excited to join DuPont in marketing the benefits of RO as a means to gain acceptance for industry wastewater solutions. At long last, we have VorTeq on site and operating at a live well, and we have expanded operating sandbox of PX to handle gases, opening up potential solutions to advance the environmental sustainability of new markets. I look forward to providing further updates on our progress when I speak with you next--in eight weeks' time. And with that, I will hand it over to Josh.

Josh Ballard

Thank you, Bob. The dynamics in our revenue that I described last quarter, with megaprojects leading growth and OEMs and aftermarkets showing weakness, played out through the end of the year as expected. Megaproject sales grew 75% in 2020, while OEM and aftermarket ended the year having decreased 31 and 18% respectively.

As I mentioned last quarter, the weakness in the OEM and aftermarket channels was entirely due to the impacts of COVID-19, which especially affected our travel and hospitality markets. As we look forward to this fiscal year's revenue, we expect a different set of dynamics in 2021. We

expect MPD will continue to grow, but the growth will likely be more tempered this year, in the range of six to 12%, before likely accelerating in 2022. Due to the ongoing pandemic, it is unclear whether our OEM and aftermarket channels will return to their highs in 2019, but we do not expect them to continue to decline.

Our revenue will also likely be recognized in a different quarterly cadence this year, whereas in 2020 revenue was more heavily weighted to the final two quarters. In 2021, we expect more of a dumbbell result. Q1 to Q4 should be very strong, accounting for as much as 60 to 65% of revenue, while the remaining 35 to 40% of revenue will be split between two considerably smaller second and third quarters. This cadence is entirely being driven by the timing of megaproject shipments, and is another example of the lack of seasonality in our business.

We are pleased that we ended 2020 at 69% gross margin, which is in the middle of the guidance we provided for the year. Despite losses due to manufacturing slowdowns earlier in the pandemic, we were able to claw back a good portion of the lost manufacturing and ended the year in a good place. As I mentioned last quarter, we expect gross margin of between 68 and 70% this year. Our operating expenditures grew at a much slower pace in 2020, while overall opex grew 6%.

Once you factor out the \$2.3 million impairment charge related to the termination of the Schlumberger agreement, our recurring opex grew less than 2%. Some of that lower growth was due to reduced spend related to COVID-19, such as the 14% reduction in sales and marketing spend from less travel, tradeshow, and other marketing events. However, a significant portion also came from a decrease in R&D activities related to VorTeq. Looking at the quarterly trend of oil and gas R&D spend, you will see that we peaked in the first half of 2020, and the second half of the year spend was nearly half that of the first. I provided guidance on our opex on the last earnings call and have no changes to that guidance as of today.

We closed the year with an increased cash and securities balance of \$115 million. Our cash for 2021 is expected to stay roughly level, but depending on Q4 collections could increase as high as 120 to \$125 million. Because of our increasing cash balances, we have made the decision to begin a share buyback program. The total program will be for \$50 million beginning over the next week, with no specific term in place. The buybacks will be done in the market, and we will seek to maximize the number of shares that we purchase.

I would also like to give you a heads up as to some changes coming to how we present information in our filings. Beginning in the first quarter, we will transition our oil and gas business unit into a new category that we are calling emerging technology. This business unit will include not only our VorTeq activities but also our incubation efforts in refrigeration, new enabling technologies, as well as other new products that have not been fully realized in the markets. We believe this will better highlight to our shareholders how we are investing into new products, and how we will create value over the long term on these investments.

Our new Ultra PX product line will be rolled up into our water business unit for recording purposes. You will note changes in our 10-K to be filed tomorrow in our Business section outlining this new structure, but new financial reporting will start only in the first quarter. We have also begun to include sales channel information in both our press release and financial filings, in light of the importance of these channels and how they affect our growth and profitability.

My final comments relate to our team. Although everyone is a bit tired, as I'm sure you are as well, our team has held up admirably. Roughly three-fourths of our employees are regularly working on-site today. We have been actively preparing our offices in California to allow the remaining members to return as restrictions are eased in coming months, including an upgrade to our HVAC system for better air flow, increased office space to allow for easier social distancing, temperature testing, weekly testing of all on-site employees, and strict adherence to CDC guidelines. We look forward to getting everyone back on-site in the coming weeks and months. Thank you.

Operator

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 your question 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 as we poll for questions. Our first question comes from the line of Jason Bandel with Evercore ISI. Please proceed with your question.

Jason Bandel

Thanks. Hello, Bob, Josh, and Jim. My first question, can you talk more about your partnership with DuPont? How was the partnership formed? How do you see yourself going about marketing your combined expertise to customers? And are there other opportunities to partner in your wastewater initiatives to drive faster adoption?

Bob Mao

Okay. This is Bob. Thank you. The partnership is this, you know, it takes two to do a dance. You need a PX that can push higher pressures, but you also need a membrane that can withstand this higher pressure. So, we come up with the ultra-high pressure PX, and DuPont comes up with the next generation membranes. So it's a natural team, so we do--yeah, we did join the webinar yesterday, and we will do more co-marketing everywhere that we can do. And we will also share our pipelines.

Jason Bandel

Got it, okay. And then, on the water side of the business, it sounds like you reiterated your growth targets for '21 and '22. Where do you see potential upside in '21 for water growth? I

know Josh had talked about in his comments that, you know, OEM and aftermarkets essentially stop its decline. As the world starts to open up, do you see opportunities in OEM channel for growth? And I guess further and to that point, we've seen many stimulus plans announced, of course, over the globe. Do you see any actually address water infrastructure, that could possibly add to the underlying positive growth trends?

Bob Mao

Josh?

Josh Ballard

Yep. So, we are seeing--I mean, we're unsure we'll have an issue, obviously, due to COVID, you know, how the OEM and aftermarkets will play out. We are seeing a stronger resurgence of aftermarket currently, so we think we've got some good potential to claw that back to more 2019 levels or so. The OEMs a little less certain. We don't think it's going to fall any more by any means, whether it'll grow or not is up to question, for sure. And what was the last second half of your question?

Jason Bandel

Yeah, the second part was the--we've seen many stimulus plans last week be announced globally, over the past year. Have you seen any specifically address water infrastructure?

Josh Ballard

Ah. Yeah, I don't think we've seen anything that specifically touches our business globally, that I'm aware of, at any rate. I mean, with the exception of the fact that, when you look at the large megaprojects, I mean, obviously those are being supported regardless of any of the economic downturns that may be occurring. Water's needed, and those projects are moving ahead as they were planned, for the most part.

Jason Bandel

Yep. Thanks, guys. And then, my last question, I guess for Josh, why do you feel like the timing is right here to start the share repurchase program? And I know you touched on it a little bit, but do you see yourself likely to use the authorization opportunistically all at once, or maybe more likely over time? And I mean, I missed this, but is there an expiration for the authorization?

Josh Ballard

There's no expiration. We'll do this over time. And the reason why we're doing it today is because we see more certainty in our cash flows than we have in prior years, right? We've got a better sense of where we're headed. We're coming out of COVID, and so we're more comfortable making this kind of commitment. And with the share buyback, we can manage through our day-to-day cash flow, right? We can kind of handle that over the coming period, if that makes sense.

Jason Bandel

It does. Great. Thanks for the help. I'll turn it back.

Operator

Our next question comes from the line of Pavel Molchanov with Raymond James. Please proceed with your question.

Pavel Molchanov

Thanks for taking the question, and congrats on the live well deployment. You talked throughout last year about making a final decision on VorTeq by the middle of 2021, so, three months from now. Is that still the timetable that you are working towards in terms of yes or no on commercialization?

Bob Mao

Yes, and we'll give you much more clarity in eight weeks at the next earnings call. Yes, we absolutely stick to that timeline.

Pavel Molchanov

Okay. That's clear. The timing of this first well deployment in early March, was that related at all to the recovery in the oil market that we have seen in the last 60 days or so?

Bob Mao

Not really, no.

Pavel Molchanov

So, what drove the timing?

Bob Mao

The timing, if you remember a year ago, March, we were literally on the path and hours from oil flow. And yes, market change stopped that. And in April, we did that again. So, what we have learned, maybe the most difficult part of introducing a technology is to get somebody willing to try in the live well, where they're pumping real commercial oil. And that has proven to be more difficult than we thought. But as we continue to work at it, continue to connect with customers, it finally clicked. So, that's the story.

Pavel Molchanov

Understood. And finally, when you talked about renaming the oil and gas segment to emerging technologies, should we assume that there will be other product, other adjacent industries included within that, not just oil and gas, in other words?

Bob Mao

Well, actually, in today's call, we said in the emerging technology includes the ultra-high pressure PX for wastewater treatment. Though, financially, we would record that as part of water revenue. And we also talked about the new ability, we have proven that PX can push gas.

And that opens up a lot of new markets, and the first of which we are addressing is refrigeration market. They all come under the emerging technology. Of course, over time, when any one of the emerging technologies grow and into substantial revenue, we would separate it out as another type of business unit to report. And hopefully, we have more emerging technology applications to take the place of the graduations, if you will.

Pavel Molchanov

Understood. Thank you very much.

Operator

And once again, if you would like to ask a question, please press star one on your telephone keypad. Once again, if you would like to ask a question, please press star one on your telephone keypad. Our next question comes from the line of Nils Tomlinson with Firm Securities. Please proceed with your question.

Nils Tomlinson

Good afternoon, gentlemen. I have a question on the DuPont partnership. You previously highlighted a total addressable market of \$100 million in China and India. Was just wondering if this partnership has highlighted some other markets outside of this, or are these the markets you plan to forge together with DuPont now?

Bob Mao

We--together, in fact, we are learning this market. So, we just reported that the industrial wastewater market is emerging, evolving partly driven by regulations, which basically forbids people to dump dirty water and damage the environment. So, what we have said previously is we identified a \$100 million one-time market. It was just one of the initial sub-verticals we view in that vertical, if you will.

But as I mentioned in my earning call just now, that waste industrial water actually covers from metals mining to textile to tanning, that's leather, from (INAUDIBLE) and etcetera. And we'll continue to identify, to measure this market. For example, our first order from India was in the chemical industry, and our first order from China was in the natural gas industry. So, we don't have a lot of data on how large this market is. And why we push--pick China and India is at the moment, these regulations are tightest in China and India, but we expect the rest of the world to follow.

Nils Tomlinson

Okay, great. And then, just another question on the last quarterly call, you mentioned there's some progress on your zero mix PX. Is this in any way related to the PX you can apply for gas purposes, or is this a different vertical?

Bob Mao

Zero mix is not a vertical. Zero mix is enlarging that sandbox we can play in, where you must not have liquid, you know, seeping back and forth. And we'll have new vertical applications as the zero mixing technology is complete. But for the moment, no.

Nils Tomlinson

Great. Thank you.

Bob Mao

Although, I have said, pushing gas is also enlarging the sandbox, which we said. It covers many sectors, but refrigeration and air conditioning are the initial new verticals that we can now address.

Operator

And now our next question comes from the line of Tom Curran with B. Riley Securities. Please proceed with your question.

Tom Curran

Hi. Bob, a few follow-ups on the VorTeq. First, is this multi-well pad--where you're currently utilizing the VorTeq with one of the biggest independent oil producers, it sounds like it's in the New Mexico side of the Delaware, is it with Liberty?

Bob Mao

Yes.

Tom Curran

And then, are you counting this as the first of the two to three live well fracs or the second? And do you already have the next one lined up? And if you do, is there anything about the outcome of this current job that will determine if and when the next one moves forward?

Bob Mao

Actually, the--we count this New Mexico one as second. But as I mentioned, it is a multi-well pad, in fact, we move from pad to pad. And we expect to go, you know, by the time we finish, maybe 50 to 100 stages. So, that in itself is a multi-live frac. And on one--on top of one hole, and we continue to pump. By the way, as of the end of day yesterday, we have done 25 stages. So, in a way, we are fortunate with the tremendous interest shown by this largest independent oil producer, that we are actually on multi fracs, if you will.

Tom Curran

Great. And then, does the key technical challenge--when it comes to getting the cartridge durability and lifespan to where you need it to be, does it remain the total volume of frac sand that the cartridge compresses before it needs to be repaired or replaced? And to the extent that does remain the defining, you know, technical issue, could you give us a rough estimate of how far along you think you are to solving? Are you 50% of the way, 75%?

Bob Mao

Actually, this is a new technology. So, in some ways, Tom, until you--when you get into something entirely new, it's not just new for us for our suppliers. Until you finish, you don't know what is 100%, so it's hard for me to say 30% or 50%. We may be literally at 95%, but when you don't finish that 5%, you could be just as well at 5% with 95% to go. But in eight weeks, I can give you much more clarity.

The cartridge life is the most important part of our cost. As I mentioned before, what is needed is to have validation on the value proposition, that is what are the savings, not only savings but the improvement in on-frac safeties, etcetera. That is what I call X. But then, what is the costs for us to provide the equipment as well as the service to allow the--VorTeq to be part of a frac, that is Y. And X minus Y equals Z, that is the net contribution. And that, we will give you a much better report in eight weeks, Tom.

Tom Curran

Understood. It makes sense. Thanks for, you know, doing the best you can as of now with those questions.

Bob Mao

Thank you.

Operator

And with that, we've reached the end of our question and answer session, and I would like to turn the call back over to Mr. Ballard for any closing comments.

Josh Ballard

Yep, everyone, thank you for joining us today. If it's helpful, you can find our prepared remarks on our Investor Relations website, and we look forward to speaking with you in eight weeks' time. Thank you.

Operator

This concludes today's conference--.

Bob Mao

--Thank you--.

Operator

--You may now disconnect your lines at this time. Thank you for your participation, and have a wonderful day.