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Q1 2019 Energy Recovery Inc Earnings Call

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PRESENTATION

Operator

Ladies and gentlemen, greetings, and welcome to the Energy Recovery's First Quarter 2019 Earnings Call. (Operator Instructions) As a reminder, this program is being recorded. It is now my pleasure to introduce your host, James Siccardi, Vice President of Investor Relations. Thank you, sir. You may begin.

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

My name is Jim Siccardi, Vice President of Investor Relations with Energy Recovery. And I'm here today with our President and Chief Executive Officer, Mr. Chris Gannon; and our Chief Financial Officer, Mr. 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 and 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 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, May 2, 2019, 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 yesterday 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 Chief Financial Officer, Joshua Ballard. Josh, the floor is yours.

Joshua Ballard *Energy Recovery, Inc. - CFO*

Good afternoon, everyone. I appreciate you joining the call today. The first quarter started the year off strong, reflecting the strengthening water demand that we have highlighted on the recent calls. For the first quarter ending March 31, 2019, we generated total revenue of $19.8 million, representing 43% growth year-over-year. This top line growth translated into a product gross margin of 69% and an overall gross margin of 75%.

In addition, we reported GAAP net income for the quarter of $2.7 million or $0.05 per diluted share. Our Water business alone generated $16 million in revenue during the first quarter of 2019, growth of 45% over the first quarter of 2018. This strength continues to be driven

by mega-project demands, those projects that generate over 50,000 cubic meters of water or more per day.

While we are proud of the quarter and remain very bullish on 2019, you should not expect such year-on-year growth experienced in this first quarter to be representative of the remaining year. As often happens in our business, we will likely see quarterly volatility due to the timing of our larger OEM and mega-project sales. We expect our revenue to remain robust but it will moderate throughout the year, and Chris will touch upon our expectations later in this call. Our Oil & Gas business generated total revenue of $3.8 million for the first quarter of 2019. Of this total, $3.7 million was related to ASC 606 recognition of VorTeq license revenue.

Our overall operating expenditures grew 3% year-on-year to $12.1 million. Please keep in mind that Q1 2018 included a onetime expense of $1 million related to the CEO transition last year. Removing this, our recurring operating expenditures grew 12.4% year-on-year. This increase occurred in R&D in support of our water growth initiatives, in general and administrative expenses as we prepare our back office for growth as well as the naturally elevated sales expenses related to our expanding base Water business.

Last quarter, we discussed growth and operating expenditures roughly in line with what we experienced in 2018. But based on our testing over the last few months as well as our intention to further expand our testing capabilities throughout 2019, which we will discuss during this call, you should expect overall growth in spend to increase to roughly 18% to 23% for the full fiscal year. The majority of this increased expense will occur in R&D, but also includes spend to provide the resources we need to support growth.

Our operating cash flow was negative $6 million, which was analogous to 2018. Our first quarter operating cash flow tends to be negative historically, and like revenues, varies considerably from quarter-to-quarter due to the timing of shipments and customer receipts. We do expect operating cash flow to improve throughout the year. In addition, we expanded $1.6 million on fixed assets, largely related to the build-out of our Commercial Development Center in Texas and other spend related to the commercialization of the VorTeq system. Our cash and securities balance decreased from $96.7 million at the end of 2018 to $91.5 million on March 31. We remain in a strong cash position, and we're debt free.

With that, I will hand it over to Mike 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 the past, I will begin with a brief review of our strategic objectives. First, in our Water business, we are focused on growth and reinvestment. Second, in our oil and gas business, we are focused on VorTeq commercialization. I am very pleased with the progress in both areas.

I'll begin with our core Water business where we continue to build on our momentum from last year. We have executed against our record-breaking backlog resulting in an extremely successful first quarter generating $16 million in revenue and a gross margin of 70%. This represents the largest revenue-generating first quarter in our history.

Before I go any further, I want to celebrate an internal milestone we accomplished during the quarter, namely, the shipment of our 20,000th PX. It took 15 years from 1997 to 2012 to ship our first 10,000 devices. Now and less than half that time, we've doubled that number. This is the testament, not only to the growth of seawater reverse osmosis desalination, or SWRO, but also to the global acceptance of our PX technology. Today, PXs are found on all 7 continents, save nearly $2 billion in global energy costs annually and help meet the freshwater consumption needs of roughly 52 million people.

We expect our installed base will continue to expand rapidly delivering even further greater benefits. In fact, favorable industry demand trends, our base business as well as our water growth initiatives give me great confidence in the potential of our Water business. Leading macro indicators of growing water demand include, population growth, industrialization, rapid urbanization and climate change. These trends are all connected to freshwater scarcity. Importantly, the recent United Nations worldwide water report stated that water has risen approximately 1% per year since the 1980s, more than 2 billion people, over a quarter of the world's population now live in countries experiencing high water stress. The same report expects potable water demand to further increase by roughly 30% by 2050.

Potable water demand is not the only issue, rising sea levels and the resulting salinity intrusion is also negatively impacting farmland at

a significant rate. This trend is creating even more demand for freshwater for irrigation purposes. These growing demand gaps require an increase of global water supply. As such, desalinating seawater is an even more important part of this effort, and as the industry scales, SWRO has emerged as a technology of choice, thanks largely to the introduction of the PX Pressure Exchanger.

For background, thermal seawater desalination was a dominant technology until the end of the 1990s. However, thermal has always been costly and energy intensive. These negative attributes, therefore, restricted where thermal desalination was viable. The introduction of the PX in that decade changed the calculus. SWRO capacity started increasing exponentially as the operational savings from the devices like the PX gave SWRO a significant cost advantage over thermal desalination. The gap has only widened since then.

SWRO operating cost have decreased by half since 2004, driving development and industry growth. Today, these competitive economies are beginning to lead to opportunities for Energy Recovery in brownfield desalination plants. And most specifically, the retrofit of aging thermal infrastructure. As older thermal plants reached the end of their useful life, they are being phased out and replaced by SWRO plants.

From 1980 to 2018, nearly 23 million cubic meters per day of thermal desalination capacity was commissioned. The freshwater production capacity of these plants is still needed to maintain water supply. What this should mean is roughly 100 to 150 new SWRO mega-projects will be necessary to simply maintain the water supply status quo. Additionally, thermal plant owners and operators see real immediate value in SWRO solutions.

For example, desal data estimates that a $1 billion SWRO retrofit of 2 thermal plants in Saudi Arabia will generate operational savings of roughly $360 million per year when compared to the thermal counterparts. This is just one example demonstrating SWRO savings are real and can no longer be ignored. These savings potentials also mean that decommissioning time lines, even for newer thermal plants built after the year 2000 may accelerate. Combining these global water demand trends as well as the transition of thermal plants to SWRO, we believe there is a potential upside to our 5% to 8% growth forecast.

As we are experiencing an acceleration of project activity, we are, therefore, extending the upper bound of this growth range to the low teens. Our confidence in this demand forecast is primarily based on detailed market intelligence from our global water sales team. Building on our team's strong industry relationships and extensive database. We have invested in our forecasting and analytical capabilities, assuring that we are systematically tracking projects opportunities at each and every stage.

By rigorously analyzing the timing of the project milestones, including the execution of water purchase agreements and EPC contracts, we can identify opportunities early and forecast with a high degree of accuracy when procurement will occur. Moreover, our market intel indicates the proposed SWRO plants are closing financing faster and awarding contracts to EPCs, our customers, earlier than experienced previously. Added to these leading macro indicators that I highlighted earlier, all signs point toward significant growth opportunities for Energy Recovery and a rapidly expanding water industry.

To meet anticipated future demands, we are working to double our manufacturing capacity over the next 12 to 18 months. Our facility was originally designed with substantial capacity increases in mind, which will make our expansion faster and more capital efficient. Please note that this growth in our core Water business is not dependent on our water growth initiatives, which we continue to aggressively pursue and for which I am very excited. Rather, my comments on anticipated Water business growth over the next several years is based on our project backlog and pipeline, which is the strongest we have ever seen.

Now turning to Oil & Gas, where we are fully focused on VorTeq. I have said before that accumulating testing run-time at scale is critical to successful commercialization. Since the fourth quarter of 2018, we have been regularly testing in Odessa, Texas, at our product partner's facility with our own crew and equipment. We have now taken our testing capabilities a major step further.

During the first quarter, we moved our crew and equipment to our own facility outside Houston, which we selected due to its proximity to our product licensees technical center. The transition went smoothly. We hit the ground running and we have already begun accumulating valuable testing run-time in our own yard. In fact, we are so pleased with our progress that we are hiring additional personnel to expand our testing capabilities to further accelerate our work on the reliability and repeatability of the VorTeq system that

I've so often spoken about.

Our testing facilities use industry standard equipment to simulate the pressures, flow and general operating conditions of a real frac site, including positive displacement pumps, a blender, sand kiln, frac tanks, dewatering tanks and high-pressure iron. When testing with clean fluid, we run a closed-loop setup that allows us to conduct extended duration testing. When testing with sand, we run a one-pass setup that allows us to process roughly one stage with sand per run.

Additionally, our facility is designed to scale according to our needs. This allows us to bridge the gap between testing with a single PX in the lab and testing at representative scale with the VorTeq system. It also helps accelerate the R&D cycle from design concept to prototype, to single PX testing, to validating R&D concepts at representative scale and representative conditions. Our ability to completely control when and how we test VorTeq is a major factor in the progress we have made on the system. Ideas are being translated to solutions more quickly and efficiently.

To reiterate my comments from last quarter, as we test more frequently at representative scale, the technical challenges we are solving have become less complex in nature. Much of our focus has shifted confirming system reliability and repeatability in imperfect real-world operating conditions, this to ensure the systems is durable enough to withstand these real-world challenges. In fact, we have made substantial progress in advancing and implementing the system-level design enhancements I have often spoke of in recent quarters, which are critical to increasing the durability and performance of the system in field conditions.

As you will recall, these enhancements were advanced in front of M1 so as to compress the overall commercialization time line. We recently completed the design of many of these elements and outfitted the VorTeq to test and validate their performance in the field. These improvements will address many of VorTeq's important commercialization needs. Our pace and momentum have increased dramatically as a result of the ability to test and validate the VorTeq in the field continuously.

The pace at which we are testing and the progression, reduction and technical complexity we have achieved gives me further confidence we'll be able to meet M1 requirements prior to year-end. Furthermore, and more importantly, we are making real progress towards our ultimate goal, commercialization of the VorTeq system. Finally, as the year progresses, we intend to host investor's at our Houston facility, so they may too view the VorTeq system in operation.

In closing, the first quarter was a great start to the year. Water continued to deliver real growth, and our future outlook remains bright. There is a long-term ongoing secular shift in water, a growing supply-demand disconnect that must be addressed. I believe Energy Recovery is well positioned to be part of the global supply solution.

In our Oil & Gas business, our investments in people and capital resources are paying dividends as we progress VorTeq towards commercialization. I am exceedingly pleased with where we are and where we will be by the end of the year. 2019 has started strong, and I believe we are well positioned to deliver solid results this year and beyond.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Joseph Osha from JMP Securities.

Joseph Amil Osha ***JMP Securities LLC, Research Division - MD & Senior Research Analyst***

I'm wondering if we might talk a little bit -- thank you for the comments on M1, whether we might talk a bit about that VorTeq commercialization comment you made, particularly in the context of your relationship with liberty. Could you help me understand a little bit more what you're thinking there?

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

Well, yes, I mean, we are focused naturally on commercializing the VorTeq technology for both our product licensee and our product partner. They are the most important customers to us on this product. And so we're doing everything that we can at our testing facility to meet their needs and move the technology forward as rapidly as possible, which will ultimately benefit them.

Joseph Amil Osha ***JMP Securities LLC, Research Division - MD & Senior Research Analyst***

Okay. But you have one missile, right? Can only be in one place at one time. Is the idea still that the primary emphasis here is on M1 and Liberty after that? Or you've built another missile? I guess I'm trying to understand operationally a little more what the plan is here.

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

Well, yes, so we are in our -- at our facility right now testing, and we are making great progress there, right? And so just because we only have one missile that does not get in the way of us advancing the technology with both parties whatsoever. When we need to, we'll build more missiles. We're not at that stage yet.

Joseph Amil Osha ***JMP Securities LLC, Research Division - MD & Senior Research Analyst***

Okay. And then finally on that point, you had indicated to us at one point that it's quite a long lead time associated with building this expensive and rarified piece of machinery. I think I heard 6 to 9 months or something like that. Is -- would there be a point maybe at some point this year given the progress that you're making that we might hear that you're going to start building some more of these machines?

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

Yes. I mean when we're ready for -- like first production release, we'll definitely let everybody know.

Operator

Our next question comes from the line of Tom Curran from FBR.

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

Let me pick up Joe's line of questioning and try to approach it from a different angle. At one time, Chris, it sounded as if there was a possibility, maybe even an increasing one, that Liberty might be ready to deploy its first unit before you'd be at a point where it made sense to resume and attempt to accomplish M1. Is that scenario still in play? And where it can materialize? Would you be willing to deploy that initial unit with Liberty, and perhaps delay M1 until Liberty was maybe between jobs or even as long as it would take to manufacture a second unit? Or are you going to move forward and prioritize resuming and achieving M1 before you consider deploying unit for Liberty, even if Liberty decides they're ready to go before M1 has been accomplished?

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

Yes. Yes. Sure. I got your question. Thanks for that. I mean our focus is developing a technology that is ready for commercialization for both parties, right? And so our testing in doing M1, for example, or testing outside of M1 is again, it's not mutually exclusive. And so we can -- we are -- everything we're doing is advancing that technology for both parties.

So I don't see a specific difficulty in doing that right now with our current VorTeq. As we prove out the reliability of our system, as it stands today, then we'll -- we continue to reevaluate that, whether we are ready to develop or -- sorry, produce the first production release. But we're not there yet.

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

Okay. And then for the new Commercial Development Center. Would you update us on how the staffing is progressing? Where are you at in the hiring process, both for crews out in the field and then for the facility, such as machinist and quality control personnel?

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

Yes. So we're going to roughly double our personnel over the next, call it, year or so. But we're staffed where we need to be for right now. So what we're trying to do is going down 2 paths. One, we are hiring field personnel, and we're also hiring some machinists as well, who

that we're training, so the one we -- yes, that we're training here at our facility in California. And ultimately, those machinists will transfer down to Houston when we have our facility up and running. Our other goal right now is to move to 7 days a week of testing. And so as a result, we're hiring some additional personnel to accomplish that as well.

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

And when at this point would you expect to start construction on the actual building at the CDC?

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

We're -- we've already basically broken ground. So that's in the works right now. And so that should be -- our goal is to complete that prior to year-end.

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

Okay. Great. And then Chris, it wouldn't be an earnings call if I didn't include my routine request for the breakdown of Water's revenues? Or perhaps it's better for Josh now, yes.

Joshua Ballard ***Energy Recovery, Inc. - CFO***

Yes. I can give you that now. So our Mega Projects made us 60% of revenue this quarter; OEM, 28%; and aftermarket, 12%.

Operator

Our next question comes from the line of Mike Urban with Seaport Global.

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

So clearly a lot of exciting things going on, on the water side of the business and you talked about some of the investments that you've made and kind of increasing the scope of the market growth. So you had what you thought was a good bit of capacity to grow. You don't have the good problem of needing to grow again. So the investments you're making on the manufacturing side, how much -- I guess, I'm trying to understand kind of the scalability here and kind of where would that leave you relative to kind of the growth assumption you have now? And kind of how much further would you be able to scale that up if this does continue to grow as it has here over the last couple of years?

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

Sure. Great question. Let me comment on a couple of parts. So this facility that we're in right now was originally designed to more than double capacity. And we over the years have added some incremental capacity. We're now at a stage where all of what we see over the next, call it, 3 or 4 years of growth, we would be able to accomplish here at this facility.

We were -- it was designed now to scale very easily. So all of that, call it, civil work has already been done, which is a great thing for us, which means that we just need to simply buy the kilns and the other machinery to accomplish that. And that's what we're doing. So that's where we're at. And so our goal is to add the capacity that we're seeing over that longer-term horizon as we -- and what we're also seeing in there right now is this continued acceleration of projects. They're getting let more and more quickly.

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

Okay. Great. That's helpful. And in the past, you talked about potentially trying to increase your addressable market and maybe expand into some adjacent verticals. Where do you stand on those efforts? Whether that's internal, organic or potentially some kind of tuck-in where -- if you could just update us on your thoughts there.

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

Yes. Sure. One area that where we're seeing actually the increase in the total addressable market is really that thermal discussion, right? Where we're seeing these retrofits occur. And so we're seeing a substantial opportunity there in the coming years that, frankly, last year wasn't as prevalent. In addition, those initiatives that I've talked about in the past are also focused on addressing or growing the total addressable market in seawater reverse osmosis desalination.

That said, we have not spent a tremendous amount of time on adjacent markets yet. That's something we're going to start looking at this

year. So I don't have a lot to say about that today. But our growth is focused on organic growth, meaning, designing and developing new technologies in-house and partnerships. And so we're in active discussions with many different players. And I'm not, at this stage, ready to talk about those discussions.

Operator

(Operator Instructions) Our next question is a follow-up from the line of Joseph Osha with JMP Securities.

Joseph Amil Osha ***JMP Securities LLC, Research Division - MD & Senior Research Analyst***

I'm not going to ask about Oil & Gas. Given -- following on from the previous question and obviously, perhaps not dragging in some of the additional addressable markets that you don't want to discuss yet, Chris. Could I get you to put a sort of a rough 2- to 3-year CAGR out there for your Water business? How might we think about it in 2020 and '21?

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

I mean one of the things that I've always said -- and this is going to be contradictory but a little bit. One of the things I've always said was that the -- I don't really like to talk about demand multiple years out because of potential credit shocks and whatnot when we think about that. Though we have a great deal of line of sight to a tremendous amount of project activity in -- out in those years. But the one thing that I cannot predict, of course, is credit availability.

That said, we -- what we're seeing is immense amount of projects being brought into those years and discussed and even being let. So we're starting to see a great deal of activity, which is very encouraging. So I'm not going to address that specific question in terms of the exact amount. Over the next 2 years, though, we're looking at low double-digit growth. And the market, again, is the strongest we've ever seen at Energy Recovery. And I think that if you were to talk to others in the industry, they're probably saying much the same thing.

Joseph Amil Osha ***JMP Securities LLC, Research Division - MD & Senior Research Analyst***

And I would assume, given your dominant position obviously you're executing well. But what you're seeing is probably more reflective of the market than of market share gain. I mean obviously, SWRO is gaining share from thermal but within your TAM, I mean, you don't have that much market share left to gain, right? So what we're seeing here is your market expanding.

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

That's correct. That's correct.

Joseph Amil Osha ***JMP Securities LLC, Research Division - MD & Senior Research Analyst***

Okay. So -- but I guess not to press you, I understand you don't want to get dragged into a conversation about credit or emerging market debt crises or whatever, but a logical person might conclude that barring those scenarios showing up that this is sustainable, yes?

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

Well, that's one of the reasons why -- yes, the answer is yes. And the other is, that's one of the reasons why we're doubling our capacity.

Joseph Amil Osha ***JMP Securities LLC, Research Division - MD & Senior Research Analyst***

Okay. And I'm sorry to press you.

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

No. No. These are great questions. Thanks so much, Joe, and again, go blue.

Operator

Ladies and gentlemen, we have no further questions in queue at this time. I'd like to turn the floor back over to Chris Gannon for closing comments.

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

All right, well, thank you everyone for joining us today. We look forward to talking to you next quarter and updating you further on our progress.

Operator

Thank you, ladies and gentlemen. This does conclude our teleconference for today. You may now disconnect your lines at this time. Thank you for your participation, and have a wonderful day.