Energy Recovery
Energy Recovery 2nd Quarter Earnings Call
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Operator: Greetings and welcome to the energy recovery second quarter earnings call. At this time all participants are in a listen only mode. A question and answer session will follow the presentation. If anyone should require operator assistance during the conference, please press *zero on your telephone keypad. As a reminder, this conference is being recorded. I would now like to turn the conference over to our host James Siccardi, vice president of investor relations. Thank you, you may begin.

James Siccardi: Good afternoon everyone and welcome to Energy Recovery's earnings conference call for the second quarter of 2019. My name is Jim Siccardi, vice president of investor relations at 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, the economic and market outlook, the company's ability to achieve the milestones and commercialization under the board tech 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 guaranteeing 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 FCC specifically the company's forms 10K and 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 August 1, 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

newswires and furnished through the FCC 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 floors yours.

Joshua Ballard: Thanks Jim and good afternoon everyone. The second quarter ending June 30, was another strong one for Energy Recovery . We generated a total of $22.8 million, representing 10% growth year-over-year. Year-to-date, we've achieved revenues of $42.6 million, 23% growth over the first half of 2018. Our top line growth translated into a Prada Gross Margin of 71% and an overall gross margin 76% for the quarter. Our gross margin continues to show strength, despite downward pressures from terrorist and other cost increases. In addition, we reported GAAP net income for the quarter of $3.7 million or seven cents per share.

Our water business generated $19.2 million in revenue during the second quarter, representing growth of 12%. In year-to-date, we have achieved revenues of $35.2 million, a 25% increase over the same period last year. As I mentioned last quarter, this slowdown in growth from the substantial 45% increase we saw in the first three months of the year was expected. Our full-year revenue expectations remain the same as last quarter, forecasted to grow on a percentage basis as high as the low teens by year end, as compared to fiscal year 2018.

Our oil and gas business generated total revenue of $3.6 million for the second quarter, a 6% increase over the same period last year, all related to ASC 606 recognition of board tech license revenue. Overall operating expenditures grew 26% year on year to $13.3 million for the quarter and have increased 14% year-to-date. This growth and spend was largely related to investment in R&D in both water and oil and gas businesses. As we discussed last quarter, R&D spend will continue to push our operating expenditures higher throughout 2019. And you should expect overall increases in operating expenditures of roughly 18 to 25% for the year.

As expected, our operating cash flow improved from a $-6 million in the first quarter, to a $6 million in the second. Bringing our cumulative operating cash flow through June 30th, to break even. We expect our operating cash flow to end up a roughly in line with the past few years by year end. Ultimately, due to the typical volatility of our quarterly cash flow and our final year end results will depend on the timing of upcoming shipments and related customer receipts.

We expended a total of $3.1 million on Cappex. This Cappex spend reflects a large increase over 2018 and is as largely related to our oil and gas testing operation as well as the compacity buildout for our water business. Our cash and securities balance increased from $91.5 million at the end of the first quarter two $96.8 million on June 30th. You will remain in the strong cash position and debt-free.

And with that, I was handed over to our president and CEO Chris Gannon.

Chris Gannon: Thank you, Josh. And thank you everyone for joining us today. As in the past, I will begin with a brief overview of our near-term 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 board tech commercialization. I am very pleased with our progress in both areas.

I will begin now with our water business. As you saw from our financial results, we continue to execute against our strong backlog and pipeline. The robust growth experiences this quarter was once again driven by the megaprojects base. Today, we see a growth cycle that is extended further than we anticipated just a few years ago and we now believe that the growth may continue over the next 2 to 3 years. Macro demand trends drive an increased water scarcity, namely, population growth, industrialization, rapid urbanization, climate change and growing agricultural needs are all contributing to increased capital investment and desalination.

The excitement in the industry is tangible as projects are being awarded at a rapid rate. On the supply side, we are seeing customers proactively reaching out to secure supply sources. Project financing is occurring more quickly, and project timelines are accelerating. In addition, thermal

plant conversions highlighted last quarter, provide an additional layer of incremental capital investment occurring simply to maintain existing water supply.

In fact, these cell data project more than 20,000,000 m^3 of daily water compacity will be commissioned over the next three years. This volume is over twice the more than 10,000,000 m^3 of daily water supply commissioned between 2016 and 2018. Taken together, these supply and demand trends continue to drive our optimism surrounding our base water business. While much of the activity I have been discussing is concentrated in the Middle East and Africa, we are also beginning to see signs of increased capital investment in other regions experiencing water scarcity.

Take India for example, where we've had a strong presence for many years. Although India's water issues are not new, India made headlines recently for their massive and growing water crisis. A 2018 report by an Indian government think tank found in 600 million people in India are so high to extreme water shortages due to recent droughts. That's more than 40% of India's population of over 1.3 billion people. By 2030, the countries water demand is expected to be twice the projected available supply.

So, why are countries like India relevant to Energy Recovery and our investors? Quite simply, we believe India will need to make substantial water infrastructure investments over the next

decade to address its dire water needs. Under the leadership of Prime Minister Modi, India has taken the initial steps to centralize decision-making by consolidating its various water ministries into a single ministry of waterpower. Desalination is one component of multi-part strategy. India and other water starved economies can utilize to address their water scarcity issues.

Other methods include wastewater treatment, rainwater capture, proper maintenance of existing infrastructure, variable water pricing, and water rationing, among others. Given the current and expected water security, we believe that India and many other countries will be potential areas of new demand for energy Recovery. In fact, we are already seeing India plan for sizable desalination investment beginning in 2021. Only until the water scarcity we're seeing in our strong project backlog and pipeline, we have made the decision to invest in our water infrastructure.

In fact, we are completing the first phase of our compacity expansion right now. The second phase is also underway, and we anticipate this compacity will be fully online around this time next year. At that point, we believe we will have enough capacity to meet customer demand for at least the next three years.

In summary, I want to stress that this is a historic period for our water business and our industry at large. Our team and saw this demand trend coming. We've taken proactive

measures to be ready for it. And we are well-positioned to capitalize on this unprecedented growth. Water scarcity is not an abstract concept. It's here, it's real and it's affecting billions of people. I am so proud to be part of a company that's helping the world meet its water scarcity challenges head on.

Now, let's turn to oil and gas. Where our focus remains the commercialization of the VorTeq, building out our Houston operations and preparing the organization for commercialization and beyond. We continue to make material progress in the advancement of our VorTeq technology. As a reminder, we have moved past testing the basic science of the VorTeq.

Our challenges today center around how the vortex technology interacts with the fracs prep. We must provide a reliable, repeatable system that can handle the sometimes-unpredictable conditions on a frac site. We have uncovered and solved many system related issues through access to significant run time at representative scale. We now control the system in ways that were not possible year ago, such as ensuring fluid flow is moving in a controlled symmetrical manner.

In addition, we have established baseline operating procedures and parameters that allow us to build a critical point of reference as we prepare this technology for a production environment. To restate my comments from prior quarters, as a test more frequently at representative scale

the technical challenges we are solving are becoming less complex in nature, but still must be addressed prior to commercialization. I want to reiterate that we have largely addressed many of the system-level design enhancements identified last year as necessary for commercialization.

While commercialization remains our top priority, we know that a successful launch of our technology is only the first step. We are also preparing the overall organization to support a smooth rollout of our technology when the time comes. This includes developing our own internal manufacturing and testing infrastructure, a robust supply chain and the appropriate human resources and infrastructure.

During the second quarter, we completed the design of our Houston-based commercial development center. As a reminder, our facility will house PX manufacturing, certain R&D and testing functions, and will become the center of our oil and gas operations. Our facility is now under construction and our goal is to finish by the end of the year. We have already procured the necessary advanced equipment to precision machine, inspect and test tungsten carbide components to support testing and commercialization.

In addition, we continue to expand our supply base to include multiple suppliers for key VorTeq system level components. Of note, we're working with our tungsten carbide partners to identify

and manage potential bottlenecks, lead-time issues and compacity constraints to prevent issues. Once we commercialize the technology and advance the full-scale production. As we ramp up our Texas-based operations, key members of our oil and gas team have relocated to the Houston area. We continue to hire experienced field operations personnel, including engineers and technicians to allow us to further expand our testing and maintenance operations to multiple shifts seven days a week. We're also hiring machinist and other manufacturing personnel and training them at our California headquarters, so we can begin manufacturing operations as soon as our facility is ready.

In short, while we continue to advance the VorTeq technology towards commercialization, we know that our work doesn't stop there. Our proactive efforts to prepare for commercialization underscore our confidence and progress with the technology. Once again, the challenges they face continued to diminish and complexity and are now more related to the interaction of VorTeq with the frac equipment around it, not with the core technology itself. We must provide a reliable, repeatable system that can handle the sometimes-unpredictable partitions on a frac site. I am extremely proud of the progress our team has made during the past 12 months and encouraged by our current pace.

In closing, the second quarter saw great performance in our water business as well as material progress towards VorTeq commercialization. Our outlook to across both business sections

remains strong and I believe our investment in infrastructure throughout our company will position us for long-term success. This is a fantastic time to be at Energy Recovery and I look forward to taking your questions.

Operator: Thank you, at this time we will be conducting a question and answer session. If you would like to ask a question, press *one on your telephone keypad. That's the *key, followed by the one key on your telephone keypad. A confirmation tone will indicate your line is in the question queue. You may press *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 *keys. Once again, to ask a question, press *one on your telephone keypad. Our first question comes from Mike Urban (SP) with Seaport Global. Please state your question.

Mike Urban: Thanks. Good afternoon guys.

Chris Gannon: Hey, how's it going Mike?

Mike Urban: Good thanks. So, I realized that you don't want to really give much guidance around VorTeq, and you are focused on commercialization, but you still do you have the milestones out there. How do you think about those or approach that internally, whether it's in

terms of you know targets or incentives for the folks that are working on internally or however you want to frame it?

Chris Gannon: Sure, sure. Thanks for the question Mike. Basically, if you look at what I've said in the past quarters, we've made really material progress over the last year in advancing of VorTeq. This gives me confidence. We can demonstrate the technical requirements of M1 before year-end. Whether that's from our facility or somewhere else. So, when you look at our Houston facility. It enables us to test around-the-clock at representative, scope and scale and really stimulate a frac site which is really key for us. We're also further building out our infrastructure, right, including our manufacturing, our supply chain in our personnel. Which I hope that underscores our confidence overall on the technology but bottom line over the last year we analyzed our VorTeq development efforts and created a plan to improve them. (INAUDIBLE) made tremendous positive progress in doing that and we're executing against our plans. So, I'm extremely pleased that where we're at today and you know listen, I'm--I feel very good. Where we are today.

Mike Urban: Okay, that's very helpful. And you mentioned that you are preparing the organization for commercialization you know in terms of a smooth rollout here manufacturing things like that. How are you scaling that? How do you think about you know at what point you

reach commercialization, how to scale that and you know at what kind of compacity are you targeting, at least initially?

Chris Gannon: Yeah, sure, so I'll break it down. Really into our internal compacity and then our suppliers and so forth. So, when you think about our manufacturing capabilities that we're developing in Houston, it's focused on the first several years of anticipated demand. That's the compacity were putting into place right there, right now. In terms of our supply base, where doing the same thing. So, when you think about tungsten carbide which is the most complex part of our technology that scenario where we're working on--with multiple suppliers to ensure that their compacity is available to us when that time comes that they can manufacture to a very high precision and so forth. So, that's where we're focused there. When you also then look at all of the other components as well, on the VorTeq we're doing the same thing. So, we're sourcing multiple suppliers, so again we don't have a compacity constrain it all.

Mike Urban: Okay.

Chris Gannon: In terms of--go ahead.

Mike Urban: No, no, no, sorry. Go ahead.

Chris Gannon: Yeah, just one last comment. In terms of personnel, we are actively hiring both field personnel, these are the very people that will go out eventually and work with our customers with the VorTeq on-site with them. I imagine we are going to have--we will do that early on. As well as rehiring machinist and other manufacturing personnel, which we actually are training here at our Stanley (SP) indoor facility right now.

Mike Urban: Great. That's all for now. I'll turn it back. Thank you.

Chris Gannon: Thanks, Mike.

Operator: Our next question comes from Joseph Osha, (SP) with J&P Securities. Please state your question.

Joseph Osha: Hello gentleman.

Chris Gannon: Hey Joe, how's it going?

Joseph Osha: That's on a question, but hello. The--a couple of questions. First, it's interesting to hear you talk about wastewater treatment. I'm wondering if, as you look at that market you

think there might be any potential applications for your UP (SP) access? And then I have a follow-up.

Chris Gannon: Sure, sure, thanks for the question. Yeah, when you think about the treating pressures within wastewater, they are much, much lower. So, in terms of our PX technology, I don't specifically see an opportunity other than I mean we're not looking at that industry.

Joseph Osha: Would there be--I guess following on that. Then would there. Perhaps be some opportunity to you know to talk about retooling or repurpose thing that technology to operated at lower pressures or is that not viable?

Chris Gannon: Well, when you think about the pressure exchange or--and the application of that technology. It really revolves around energy density how much energy within a system so that we can transfer that energy to recycle it or in the case of VorTeq, to use as a barrier. We are of course naturally looking at pumps. We do sell pumps into SWRO. We have a line there and also turbochargers, so you know were naturally looking at other industries right now, but our focus today on the water side is SWRO and building out that overall our product offering or solution offering their first.

Joseph Osha: Okay, thank you. As relates to VorTeq, and I believe I've asked this before, as you all build out, you know your own internal testing capability and unless something's changed, I assume that M1 still at least part of it has to be met on Schlumberger's site. Why would you not build another missal and when might we expect to see you guys undertake that?

Chris Gannon: Great question, as always. You know we are focused on utilizing the you know the VorTeq we have today. When it makes sense to build another missal, we'll do so, but we don't need it right now. You know, once the design is finalized, will do that, but we're you know we're still tweaking this.

Joseph Osha: Okay, so the idea is then--and I'll get off after this. The idea is then that despite the fact that you know you may have to toe this thing around a lot you would rather finalize the design before you spend more money to build another one.

Chris Gannon: Yeah, I think that's kind of an unnecessary investment today. We've been spending you know to build up our technical capability, right, our testing, our manufacturing footprint and so forth. So, I'll wait until that's absolutely necessary.

Joseph Osha: Okay. And last, last, last one. I believe that you had set on the prior call that we might see some type of investor event down in, I think it's Lubbock where this site is. Is that still potentially in the cards?

Chris Gannon: Yeah, so it's in Katie and I'm glad you asked that question because we will start hosting people at our site here in the next you know in the coming months. So, reach out to Jim on that, but yeah, we definitely plan to start bringing people through.

Joseph Osha: Thank you very much.

Chris Gannon: Absolutely. Thanks, so much Joe.

Operator: Thank you. Just a reminder, to ask the question. Just press *one on your telephone keypad and you can press *two to remove yourself from the queue. Once again, to ask a question, press *one on your telephone keypad. Our next question comes from Tom Curran, (SP) with SBR. (SP) Please state your question.

Tom Curran: Good afternoon guys.

Chris Gannon: Hey, Tom. How's it going?

Tom Curran: Good. Chris, when you say you expect the CDC in Houston, the commercial development center to be up and running by year end. Does that include fully staffed, including all the personnel yet to be relocated from San Leandro? And then, once it is fully staffed, you know, ready to go, but before you where to reach the point at which can commercialization begins what sort of quarterly operating expenses should we expect for the fully staffed operational CDC pre-commercialization?

Chris Gannon: Well, so for the first part of you question. Yeah, we do expect to be fully staffed by the end of the year in our Katie facility. And so, that's a mix of manufacturing personnel and then also feel personnel. Josh, do you want to answer the other question?

Josh Ballard: Yeah, I was going to say Tom, from an expense perspective. I mean we might have a small case. I'm looking at Q2 here. It's probably not going to be a ton larger prior to commercialization them what you're seeing in Q2. We're probably going to add a few people, but these aren't massive numbers by any means. Once we commercialize, of course, that will change because we will be hiring a lot more field personnel and so on. But leading up to commercialization from basic operating spends I don't see a major change, except for the one variable in there, of course is testing and it depends on how much we test. That can kind of

fluctuate the spin back and forth. You know, that's a little harder to peg, but the base operations will be roughly the same.

Tom Curran: Okay, that's helpful. And then, Josh, for 2020. On the water side, what range does it look like the Cappex budget is going to come in at? And will that range include any potential organic investments as part of the initiative to ultimately expand the suite of waters offerings?

Josh Ballard: Sure. Well, from a Cappex perspective, our overall Cappex I suspect will be lower. I mean, we're still going over the budgeting cycle, but our compacity increases that we have to make are not super large investments for us. So, it's not like there's going to be massive change going in the next year from that perspective. And on the initiative perspective, that's more--those are more expenses, rather than Cappex. Either way, you'll more see that role through R&D then you would through Cappex.

Tom Curran: Okay, so for now, maybe assume just flat Cappex for water in 2020, with 2019?

Josh Ballard: Yeah, I think if you did a flat overall Cappex--and we talked last quarter about a roughly $10 million Cappex this year, but I think if you kept that roughly cap--you know, roughly flat within that range you would be okay.

Tom Curran: Great. And then, a final one for me, standard housekeeping question. Could you please provide the breakdown for water for Q2 revenue between MPD OEM and AM?

Josh Ballard: You bet. So, MPD megaprojects for 52%, OEM were 34%, and aftermarket 14%.

Tom Curran: Great. Thanks guys.

Unknown: You bet.

Operator: Thank you, ladies and gentlemen. There are no further questions at this time. I'll turn it back to management for closing remarks. Thank you.

Chris Gannon: Great. Well all right, thanks so much for joining us this afternoon, everybody. We again appreciate all of your support of the company and we look forward to talking to you in a few months time. Have a great day.

Operator: Thank you. This concludes today's conference. All parties may disconnect. Have a good day.