Energy Focus, Inc.
Q1 2020 Earnings Conference Call
May 13, 2020

Operator:

Greetings, and welcome to the Energy Focus 2020 First Quarter Conference Call. At this time, all participants are in a listen-only mode. A question-and-answer session will follow the formal presentation. As a reminder this conference call is being recorded.

I would now like to turn the conference call over to your host, Brett Maas with Hayden IR. Thank you. You may begin.

Brett Maas:

Thank you, operator and good morning, everyone. Joining me on the call today are James Tu, Chairman and Chief Executive Officer; and Tod Nestor, President and Chief Financial Officer.

Before we begin today's call, I'd like to remind you that we will make certain forward-looking statements. These statements are based upon information that represents the company's current expectations or beliefs. The results realized may differ materially from those stated. For a discussion of the risks that could affect our results, please refer to the discussion under the heading, risk factors on our most recent 10-K, as well as the most recently filed 10Q with the SEC. The company undertakes no obligation to publicly update or revise any forward-looking statements whether as a result of new information, future events or otherwise, except as required by law.

Also, please note that during this call and in the accompanying press releases, certain financial metrics are presented on both a GAAP and non-GAAP adjusted basis. Reconciliations of adjusted results to the GAAP results are available in the tables attached to the earnings release, which is posted on our corporate website at www.energyfocus.com in the Investor Relations section of the site.

Now I'd like to turn the call over to James. James the floor is yours.

James Tu:

Thank you, Brett. Good morning, everyone, and thank you for joining our First Quarter 2020 Earnings Conference Call.

First of all, I hope all of you and your family continue to stay safe and healthy in this challenging social and economic environment due to the COVID-19 pandemic. Like everyone participating in this call, we have been watching the development of the pandemic and following our coronavirus contingency plan very closely and responding to changes as timely as possible. We are fortunate that our employees remain healthy and that our factory has remained open throughout the pandemic. In addition, I have to say that despite of the ongoing macroeconomic challenges and "stay-in-home" orders, our progress towards building Energy Focus into the next generation lighting industry leader had not stalled at all. Our employees, either at our factory or from home, have been working very hard and very smart. And I believe that the pandemic has challenged our team to be more creative, more efficient, more passionate and more collaborative to accomplish our short-term and long-term goals. So for you as an investor of Energy Focus, as both Tod and I and our board directors are, I'd like to say that the future of Energy Focus is not only much brighter than an year ago when we started the restructuring and relaunch programs, but also better than 3 months ago.

As you have seen from our Q1 earnings release that came out this morning, our sales growth momentum continued to pick up in the first quarter, despite the unprecedented economic challenges posed by the pandemic. As consistent over the past year since the management change in April 2019, we continued to make incremental but collectively significant progress, month after month, quarter after quarter, towards stabilizing and economizing our operating infrastructure as well as rebuilding and expanding our engineering, sales and marketing capabilities, all the while reigniting our growth and delivering improving financial results, regardless of the macroenvironment.

Equally important, within the past 12 months, we had successfully transformed Energy Focus from an energy efficiency centric LED lighting company to a broader sustainability enabling force with the introduction of EnFocus, our patent-pending lighting control platform to bring human centric lighting specifically to existing buildings. Despite of all the buzz we might have heard about LED being everywhere and getting cheaper by the day, an overwhelming majority of the country's and world's existing commercial buildings today are still lit by fluorescent lighting. DOE's latest estimate was that in 2017 only 11% of the country's more than 1.1 billion linear lighting fixture were lit with LEDs. Today the penetration is likely to still be well below 20%, and % of lighting fixtures with controls are even lower. That represents tens of billions of dollars of opportunities in the coming years to upgrade these fixtures to LEDs and connected lighting, just in the United States. And since EnFocus is designed for universal electrical setting to replace fluorescent lamps, it is also well-positioned to enter the international markets that are several times larger than the US market. We are confident that building owners and occupants worldwide will be much more motivated to convert to LED lighting if significant human benefits such as dimming and circadian rhythm outside of energy efficiency are available and affordable. With EnFocus, we aim to maximize the financial, environmental and human—or triple-bottom-line—benefits from LED lighting, and capture a meaningful share of the coming retrofit opportunities as LED lighting move onto the next phase of accelerating adoption driven by human-centric lighting.

Quarter Results

Turning to the results for the first quarter of 2020. Our net sales of $3.8 million exceeded the high-end of our revenue guidance of $3.5-3.6 million and grew 19.1% year-over-year over the first quarter of 2019 and 7.1% sequentially over the fourth quarter of 2019. The increases over prior periods were primarily driven by our expanding number of wins of military contracts over the past six months. We also continued to grow our commercial customer network that added several new colleges and school districts as customers, and sales of our patented emergency backup LED tube, RedCap, continued to grow and registered the best quarterly sales ever as well.

As we mentioned in our 2019 annual earnings call, our military wins over the past six months—including over $2.5M of globe lights, $3.4M military Intellitube and $1.7M new ship lighting fixtures for a foreign Allied Navy, and several other smaller ones—were particularly encouraging as we were able to compete favorably through engineering innovations to reduce our product cost while maintaining our superior product quality against competitors. When we have a combination of better products and better costs, we should win most if not all the time. In the meantime, our Navy ships benefit from our continuing innovations. Due to these significant wins, we expect military sales to remain strong throughout 2020 and we look forward to winning more new Navy opportunities and contracts when they emerge.

For our commercial business, as we warned in our last earnings call, due to COVID-19 and the continuing shutdown of non-essential economic activities across most of the country, we had clearly seen sales fall starting in March, not unlike most businesses have been experiencing. As we mentioned in the earnings release this morning, at this point, barring an extreme economic freeze that lasts beyond the next few months, we do not expect such softness and stagnation to remain for a prolonged period of time as facilities of our target customers in the government, healthcare and education, and industrial sectors, are still going to be mostly occupied. Meanwhile, we have been taking this time to introduce the EnFocus lighting control platform, which we officially launched this past Monday, to existing and new customers., We have received an overwhelmingly positive reception on EnFocus so far and interests and inquiries about this product family are literally growing by the day. We continue to believe that EnFocus is not just a better lighting control platform but also a unique offering for the retrofit market where affordable, simple and secure lighting controls had not been available before, and we expect that it will take us to a much broader network of distribution channel partners that we had not tapped into before.

Accordingly, we recently took two important steps to strengthen our organizational readiness to propel EnFocus into our most significant growth engine over the next few quarters. First, we now have three expanding business development teams that reach out to national distributors and ESCOs, regional contractors and distributors, and small-to-medium size customers that could buy directly from our inside sales team as well as our online e-commerce website. Second, in conjunction with the EnFocus launch, we rolled out a new, multi-tier pricing system for our products to both reinforce our brand image of high quality at a great value but also to ensure fair pricing, protect our channel partners' margins, and avoid potential channel conflicts, as we start engaging with multiple layers of distribution partners. We believe that with a broader distribution strategy EnFocus will be taking Energy Focus to another level of industry leadership not only on product innovation but also in market presence in the timeliest manner. As part of our official launch of EnFocus, we have started to provide demos and initiate discussions about project opportunities with our customers for EnFocus over the past few weeks, and we plan to start providing production samples later this month and shipping EnFocus products to customers in early Q3. If the broader economy reopens and commercial activities start to recover over the next few months, as expected, we look forward to having meaningful sales contribution from EnFocus from Q4 on.

Product Development

Now I’d like to provide some highlights on our engineering efforts and initiatives. One of the most important initiatives we had laid out in the 2019 company relaunch is developing impactful and differentiated products based on LED lighting technologies. EnFocus was born and developed under this overarching goal. During the last quarter, in addition to finalizing EnFocus designs and bolstering our patents surrounding this control platform, we have also started to move onto the next generation EnFocus platform that will expand to provide autonomous and wireless lighting control capabilities that further improve energy efficiency, optimize circadian rhythm lighting, and provide a whole new suite of functionalities surrounding building automation and building management.

Equally important and probably an even more urgent priority for us since the beginning of the year is our initiatives to develop UV disinfection applications built upon the EnFocus platform. We believe that demand for disinfection technologies and products, which in the past had been a niche market mostly for hospital uses, is emerging very rapidly and broadly as literally all indoor spaces today are opening up as addressable opportunities for effective and affordable disinfection products. In addition to the fact that coronavirus is still impacting countries across the world and might not be going away anytime soon, the world’s sudden awareness and realization that the risk of pandemics is here to stay will likely push demand for air and surface disinfection to unprecedented heights and stay permanent and universal to a large extent going forward. The UV disinfection technologies and products we’ve been developing follow our consistent philosophy of making innovative, high quality and impactful lighting products, and we believe that our UV disinfection lighting fixture that is designed to provide both general lighting and UV disinfection capabilities based on the EnFocus lighting control platform will be a powerful and timely offering for organizations across all enterprise sectors that seek to minimize virus infection risks. I’m pleased to announce that we had achieved several design milestones and we had also filed provisional patents surrounding our UV disinfection technologies over the past month. Currently we are on schedule to finalize our prototype designs by the end of May, and to launch the first UV products in by early Q4. We are very excited about the timely and significant impact we could make on our customers’ daily lives with our UV disinfection technologies and products, and we plan to continue to build and expand our intellectual properties, core competencies and operations surrounding the UV disinfection theme. I'm sure we'll have much more to share with you on our progress in the UV disinfection market in the coming months.

COVID-19 Impact to Operations

Now I'd like to turn to the impact of COVID-19 on our business. As we mentioned from the last earnings call and in the beginning of this call, we moved rapidly to protect employees and ensure business continuity. To minimize infection risks of our employees and their social and professional contacts, we activated our COVID-19 Contingency Plan, or CCP, that allows our employees that could work remotely to do so while implementing strict sanitary and disinfection measures and procedures for our production facility in Solon, Ohio. We are designated an "essential business" so, with proper safeguards, our team members at the production facility are allowed to continue working, and we expect that our factory will continue to operate in full capacity under CVOID-19.

Meanwhile, our commercial sales across nearly all the targeted verticals are being impacted, due to facility closures and slow economic activities. On the other hand, although we're seeing lighting retrofit projects being put on hold or postponed, we have not seen opportunities lost due to COVID-19. Again, while economic reopening remains a challenging and somewhat unpredictable exercise, we do believe that the slowdown would be temporary, and we are also hopeful that some organizations might actually start to take on retrofit projects during this period when buildings are much less occupied.

Outlook

With regards to our business outlook, although we had started to grow from Q4 2019, we are still early in our long-term growth trajectory, and large accounts and opportunities could still sway our financials significantly. The newfound layer of economic uncertainties resulting from COVID-19 makes it even harder to project our business several quarters out, especially on our commercial business. Therefore, we're still not in a position to provide annual outlook at this point. However, we will continue to provide quarterly forecast in the best way we can.

Regarding our second quarter of 2020, as we stated in the press release, we expect net sales to be in the range of $4.5 million to $4.8 million, representing sequential growth of 19%-27% compared with the first quarter of 2020, and a 46%-56% growth over the second quarter 2019. Now midway through the second quarter, we have already booked more than 70% of the forecasted sales, mostly from our military business, and therefore we are relatively confident of our Q2 sales hitting this target range. As we had stated in the fourth quarter and full year 2019 earnings call two months back, we believe that after the restructuring and relaunch effort during 2019 we had turned the corner and started growing in Q4. We continued to grow from Q4 2019 into Q1 2020, and despite of the myriad challenges posed by the pandemic, we expect to continue to grow from Q1 to Q2, built upon the first arrow of our rejuvenated growth from our military business where we are now more competitive than ever. With the recent launch of EnFocus we also look forward to having this second arrow of growth propel our commercial business as well as our overall sales from the second half and especially 4th quarter on.

With that, I will turn the call to Tod to review our financial performance during the quarter. Tod.

Tod Nestor:

Thank you, James.

Net sales for the first quarter of 2020 were $3.8 million compared with 2019 first quarter net sales of $3.2 million, an increase of 19.1% year-over-year. The year-over-year increase in net sales was driven by timing of Military sales. When compared to $3.5 million in the fourth quarter of 2019, net sales were up 7.1% on a sequential basis. Sales to our Top 10 customers increased 10% compared to the first quarter last year and sales to our Top 20 customers increased 16% compared to first quarter last year.

From a mix perspective, in the first quarter Military sales were $2.0 million, representing 54.1% of total net sales compared to $1.2 million, or 37.6% of total net sales, for the first quarter of 2019. The year-over-year increase in military sales was primarily due to timing of sales to one customer, which increased 113% compared to the first quarter last year. We also had a new military customer enter our top 10 customers with a six-figure order not present last year. Sales to Commercial customers were $1.7 million, representing approximately 45.9% of total net sales for the first quarter of 2020, down from $2.0 million, or 62.4% of total net sales, for the first quarter of 2019. The year-over-year decrease in Commercial sales was mainly due to some delayed orders due to COVID-19, which specifically impacted our largest commercial customer, partially offset by increases from several other top-10 customers. Overall, sales to our top 10 commercial customers declined 35% year-over-year and sales to our top 20 commercial customers declined 21%. This was more than offset by our military segment. Sales to our top 10 military customers increased 81% and sales to our top 20 military customers increased 74%.

Gross profit for the first quarter of 2020 was $1.0 million compared with $98,000 in the year ago quarter, a significant increase mainly driven by higher military sales and reduction in cost of sales. On a sequential basis, gross profit was slightly higher compared to $957,000 in the fourth quarter of 2019.

As a percentage of revenue, gross profit margin was 27.3% in the first quarter of 2020 compared to 3.1% in the first quarter of 2019 and 27.1% in the fourth quarter of 2019. Adjusting gross profit margins for ‘excess and obsoletes, in-transit and NRV Inventory Reserve results in Adjusted Gross Margins of 25.2% for first quarter of 2020 compared to 5.5% in the first quarter of 2019, and 29.2% in the fourth quarter of 2019. We continue to expect our gross margins to be in the mid-20s in the near-term and begin to approach the high 20s or low-30s percent range as we introduce new products and make further improvements to our supply chain and depending on our sales mix and inventory valuations, we may see some fluctuations quarter-to-quarter.

Operating expenses in the first quarter of 2020 were $2.3 million or 60.7% of sales compared to $2.9 million or 91.3% in the year ago quarter, a decrease of $606,000 or 20.9% year-over-year, which was driven by lower payroll and stock-based expenses offset by slightly higher legal fees and dues.

Product development expenses decreased by $244,000 year-over-year to $282,000 in the first quarter of 2020 as a result of lower product testing expenses due to the timing of new product introductions and lower salaries and related benefits due to the re-organization and re-alignment of the company last year. Sequentially product development expenses decreased compared to $249,000 in the fourth quarter of 2019.

SG&A expense decreased 9.5% to $2.0 million in the first quarter of 2020 compared to $2.2 million in the year ago quarter. The decrease was the direct result of decrease in stock-based compensation, which was partially offset by increases in fees and dues for various services. Sequentially, SG&A expenses increased slightly compared to $1.9 million in the fourth quarter of 2019.

Loss from operations during the first quarter of 2020 was $1.3 million, an improvement of $1.5 million compared to a loss from operations of $2.8 million in the first quarter of 2019. Sequentially, the loss from of operations was almost flat from $1.2 million in the fourth quarter of 2019.

Net loss for the first quarter of 2020 was $541,000, or a $0.04 loss per basic and diluted share, an improvement of $2.3 million compared with a loss of $2.9 million, or $0.24 loss per basic and diluted share in the year-ago quarter. Sequentially, this compares to a net loss of $1.3 million, or an $0.11 loss per share, in the fourth quarter of 2019.

Adjusted EBITDA, which excludes depreciation and amortization, Interest expense, stock-based and other incentive compensation and a gain of $873,000 related to the fair value of warrants, improved to a loss of $1.1 million for the first quarter of 2020 compared with a loss of $2.0 million in the first quarter of 2019 and a loss of $1.1 million in the fourth quarter of 2019.

Now, I would like to turn to the balance sheet.

As of March 31, 2020, we had cash of $2.9 million compared to $350,000 at the end of 2019. The increase in cash was primarily due to the issuance of new capital through a shelf-registered sale of equity in the first quarter and cash generated from operations. During the first quarter, we issued approximately 3.4 million shares of our common stock at an at-the-market purchase price of $0.674 per share and unregistered warrants to purchase up to 3.4 million shares of common stock at an exercise price of $0.674 per share at $0.125 per warrant for gross proceeds of $2.75 million, before expenses. Proceeds from this offering provide short-term funding for our operations and initiatives for growth, as well as a required paydown on our Iliad note of $275,000. If the warrants were to be exercised at their exercise prices of $0.674/share and $0.998/share by the current warrant holders, these exercises could provide additional capital of up to $2.3 million from the shareholders and another $0.43 million from the placement agent for a total of $2.73MM.

Subsequent to quarter-end on April 17, 2020, the company was granted a loan for approximately $795,000 as part of the Paycheck Protection Program (the "PPP") under the Coronavirus Aid, Relief and Economic Securities or "CARES" Act. We intend to use the entire loan amount for qualifying expenses as defined under the Act, however we can provide no assurances the entire loan will be forgiven.

We continue to analyze our cash needs considering sales prospects, current performance of the business and our targets for continual improvement. Simultaneously, we also continue to explore and consider a variety of financing sources should the need arise for additional external financing.

Total debt, excluding the Warrant Liability, as of March 31, 2020 included short-term credit line borrowings of $790,000, outstanding notes payable of $854,000 for total debt outstanding of $1.7 million. Netted against cash of $2.9 million, we had a net cash position of $1.2 million at the end of the first quarter. This compares to $3.4 million in total debt as of December 31, 2019, which was comprised of short-term credit line borrowings of $715,000, convertible notes outstanding of $1.7 million and notes payable of $1 million. Netted against cash of $350,000, we had a net debt position of $3.1 million at year-end.

We increased our total availability from the fourth quarter of 2019 to the end of the first quarter of 2020 from $2.0 million to $4.1 million, respectively, primarily as a result of the increase in our cash balance. Accordingly, as of March 31, 2020, we had total availability of $4.1 million which consisted of $2.9 million of cash and $1.2 million of excess borrowing availability under our credit facility.

As a reminder, total availability is a measurement of our 'access' to cash at any given point in time and is a much more relevant metric than simply looking at a cash balance on the balance sheet, while excess borrowing availability under our credit facility represents the difference between the maximum borrowing capacity of credit facility and actual borrowings on the credit facility.

Accounts receivable were $1.9 million at the end of the first quarter of 2020 compared to $2.3 million at the end of 2019, a decline of $433,000 on higher sales, reflecting more efficient collections.

Net inventories declined to $4.7 million as of March 31, 2020, compared to $6.2 million at the end of 2019. The decrease was due to our continued efforts to reduce slow moving inventory, as well as prudence in ordering inventory needed for future sales. This reduction in inventory was also a tremendous source of operating cash flow for the Q1 2020.

Accounts payable declined slight to $1.2 million as of March 31, 2020, down from $1.3 million as of the end of 2019.

Cash generated from operations was $504,000 for the first quarter of 2020, which was largely driven by our effective management of inventory throughout the quarter as a continuation of efforts undertaken during the second half of 2019, which included addressing both slow moving inventory and more prudent ordering practices for new inventory.

Our warranty liability remains manageable and not material. The combination of low failure rates of our tubes has allowed us to continue to experience minimal costs for our warranties and still be able to afford to offer valuable 10-year and 5-year warranties to our customers. Energy Focus's hallmark quality remains a strong selling point for our products and is reflected in our ability to offer these warranties.

At year-end I briefly spoke to the impact of COVID-19 on our supply chain and logistics efforts. While we are not experiencing any significant disruption in either our supply chain or sales due to coronavirus pandemic, we do periodically update our contingency plan as a result of the virus. As James mentioned, the virus reduced our Commercial sales at the end of Q1, and into Q2, resulting in some reduced spending and expenses, but we have also been vigilant with suppliers ensuring they continue to ship components and products to us during the shutdowns in the United States. To-date, we have been successful working around any challenges we have faced, but there is risk in the supply chain. However, as the US opens back up, we expect to see more of a return to normal operations in our suppliers and fewer supply chain hiccups. Regarding China, we have not experienced as many supply chain disruptions during the past month to month and one-half as we experienced initially, when we had to shift some production outside the country. We have been able to reliably source most of our product as we had prior to the pandemic from China. This continues to be a dynamic and changing world that we live in and our plans are updated in real-time as we respond appropriately.

With that, we would like to open the call to questions.