Energy Focus, Inc.
Q4 and Full Year 2019 Earnings Conference Call
March 19, 2020

Operator:
Greetings. Welcome to Energy Focus 2019 Fourth Quarter and Year-End 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.

As a reminder, this conference is being recorded. I would now like to turn the conference over to your host, Brett Maas with Hayden IR. Thank you, you may begin.

Thank you, Operator, and good morning, everyone. Joining me on the call today to discuss prepared remarks is James Tu, Chairman and Chief Executive Officer and Tod Nestor, President and Chief Financial Officer at Energy Focus. Before we begin today's call, I would 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 Form 10-K filed with the SEC.

The Company undertakes no obligations 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 release, certain financial metrics are presented on both a GAAP and a 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 would like to turn the call over to James. James, the floor is yours.

James Tu:

Thanks, Brett. Good morning, everyone, and thank you for joining our Fourth Quarter and Full-Year 2019 Earnings Conference Call.

Before I start discussing our 2019 whole year and fourth quarter results, on behalf of Energy Focus staff and board of directors, I'd like to wish you the best in coping with the ongoing outbreak of coronavirus, or COVID-19. It's an unprecedented time for all of us and maintaining safety and health is the foundation of prosperity. Throughout this call I will also touch upon what we are doing and what we are expecting at the moment as an organization in response to the COVID-19 outbreak.

As you have heard over our past few quarterly earnings calls, during 2019, we spent the greater portion of the year transforming a number of key elements in our business as part a broader program to relaunch Energy Focus with superior sales and operating infrastructures that will drive innovative and competitive performances and achieve sustainable, long-term growth. With less than a year into our relaunch plan, significant progress has been made, and I am encouraged by the momentum we are building and the opportunities we are pursuing in the enterprise LED lighting markets that are now seeing accelerating LED adoption and poised to grow substantially as LED lighting technologies expand beyond energy savings into human and health impacts.

For the fourth quarter 2019, we came in right above the high-end of our revenue expectation with $3.5 million in sales, which was up 21% from $2.9 million in the third quarter of 2019. The sequential improvement was due to increased net sales in both our commercial and military and maritime businesses, and to a lesser extent, military sales that would have been recognized in Q3 but came in Q4 instead.

On the commercial side of our business, net sales were $2.0 million, up 18% sequentially from $1.7 million in the third quarter of 2019. This increase was due primarily to new sales to several colleges and K-12 school districts, where our proven, flicker-free, 10-year-warranty solutions are clear differentiators. As we repositioned our sales focus on serving end users and contracting partners, we increased sales of our RedCap emergency backup product, which has been adopted as the standard emergency lighting solution by a leading, national Energy Service company. Sales of our fluorescent T5 replacement LED tube products, which are now in the early stage of being rolled out by a premium national retailer chain with more than 800 stores, also started to pick up.

Our military business also started to grow again during the fourth quarter of 2019. Since our corporate relaunch in April 2019, we have been focusing on enhancing our overall competitiveness in the Navy business by strengthening our engineering design, improving supply chain efficiency and lowering production costs. The result is simple and powerful: we started winning more contracts. As we stated in the earnings release, we received over $7.6 million of new contracts from the US Navy and a foreign allied Navy over the past six months, which represents our highest order rate for our military and maritime business since 2016 and which demonstrates our strengthening leadership and competitiveness in the Navy ecosystem.

Since 2007, Energy Focus has always been a trusted LED lighting supplier to the U.S. Navy and the Navy's shipbuilding defense contractors. As the market continued to evolve over the past few years, we did not. Now we are confident that Energy Focus is back on track to be an all-around leader to supply US and allied Navy advanced LED lighting systems, and we are excited about the continuing recovery and renewed growth in our military business.

Overall, on business development, we continued to execute our strategy of providing high quality and most trusted LED lighting products in the marketplace, and we continued to expand our sales team internally through adding new regional sales managers, and externally through new end customers and contracting and distribution partners. Meanwhile, we have also been expanding our brand outreach with increasing media exposure through industry publications to showcase our industry expertise and leadership and educate our target customers about the value and importance of sustainable LED lighting.

Another exciting and expanding area of Energy Focus during the quarter is our R&D operation. As a premier LED lighting brand, one of the keys to our sustainable growth is distancing ourselves from the commoditized landscape of lighting. Energy Focus has always been focused on developing high quality, high value added and customer centric LED lighting products and solutions that differentiate us from the competition. As we mentioned in the last earnings call, we are very excited about our coming wireline dimming and color tuning control product portfolio that we plan to launch by the end of this month and start to deliver later in Q2. Over the past few months, we continued to strengthen our product designs and expand our patent portfolio surrounding the control platform, which we call EnFocus, and our initial pilot installations continued to generate very positive feedback from customers.

It can replace existing wall switched and fluorescent or tubular LEDs with our control package that includes switches and LED lamps, without requiring additional wiring and electrical labor. We have filed several provisional patents surrounding EnFocus, which is slated to be launched by the end of this month with first product deliveries expected by the end of the second quarter.

As we mentioned previously, we believe EnFocus will be the most disruptive technology we have ever introduced and will further differentiate us from the competition by bringing to end users significant human health, safety and productivity benefits. The responses we have been getting from our large strategic accounts that we have showcased to have been overwhelmingly positive indicating significant demand across multiple verticals including the educational space, where its installation can be impactful to classrooms, and healthcare facilities, government and other commercial and industrial businesses.

For the fourth quarter of 2019, our gross profit margin excluding inventory reserve impacts was 26% which improved from 20.6% in the third quarter of 2019. We continued to make significant improvements to our supply chain, consolidating it where appropriate and focusing on developing and launching differentiated products to stay away from commoditized markets that could lead to excessive inventory buildup and cause quarter-to-quarter swings in our margins due to inventory reserves accounting. Over the coming quarters, we are going to focus on gross profit dollars as opposed to profit margin percentages. This key performance metric will better depict the progress we are making on the aforementioned competitive strategy.

Moving on to our operating expenses. A key initiative in our relaunch program is the streamlining of operations with a focus on reducing our delivery and overhead costs. As you might recall, we took drastic measures in the second and third quarters last year to eliminate operational redundancies and inefficiencies and to implement rigorous spending approval process. As a result, we reduced operating expenses by nearly 30% from the first quarter to the second quarter and another 9% from the second to the third quarter of 2019. By cleaning up and clearing out some of the noise and excess in our infrastructure, we are now better able to identify the resources needed for a higher functioning, higher performance organization.

In the third quarter, we started opening hiring for specific needs and positions that will drive growth, most notably engineering and sales staff, and other key financial and operational positions that will support our growth. As a result, our operating expenses increased 14% sequentially to $2.1 million for the fourth quarter of 2019. However, this remains significantly lower than a year ago when operating expenses were $3.0 million for the fourth quarter of 2018 on lower net sales. As a result, we narrowed our year-over-year loss from operations by 60% from $3.0 million in the fourth quarter of 2018 to $1.2 million in the fourth quarter of 2019. We have now filled most of the non-sales positions and looking ahead we only expect continuing and more significant hiring on sales related staff that could further boost our sales, and our operating loss should shrink from here on as we grow our sales in the coming quarters. Obviously, we are actively following the development of the COVID-19 outbreak and will make further cost adjustments as timely as possible to balance our growth initiatives with the need to preserve our capital.

Last but not least, earlier in the first quarter of 2020, we issued approximately 3.4 million shares of common stock in a direct offering priced at-the-market for gross proceeds of approximately $2.75 million. We also issued equal number of warrants that could be exercised in the future at 67 cents per share to provide additional capital infusion in the future when our stock price rises above the level. The equity capital proved to be a timely support of our balance sheet to prepare us to meet with the challenges and impacts we might experience from COVID-19 in the coming months.

At this time, the company projects first quarter 2020 net sales to be in the range of $3.5 million to $3.6 million, representing sequential growth of 0%-3% compared with the fourth quarter of 2019, and a 13%-16% growth over the first quarter 2019. As a reminder, at this point of time, our business is comprised of a relatively small number of large accounts that drive the majority of our sales. While we are working diligently to diversify our customer portfolio, a small number of large accounts can drive unexpected and significant quarter-to-quarter fluctuations. We encourage investors and analysts to look at the direction of longer-term trends of our business, which we believe are improving.

Before closing my remarks, I'd like to summarize our perspectives about the ongoing COVID-19 pandemic, which clearly poses unprecedented uncertainty for the global economy and business. Although our military sales have not been impacted yet, we have started seeing

commercial projects being put on hold, as well as minor supply chain disruptions caused by the pandemic. We have been diversifying our supply chain sources over the past 9 months, so we are not totally subject to any one particular country's supply chain bottlenecks. Nonetheless, it is challenging for us to foresee how the pandemic will impact our business over the ensuing 6 to 12 months until the virus clearly is under control and economic activities resume close to normal. What we will do is to stay extremely vigilant on the development of the pandemic and as I mentioned, we stand ready to adjust and scale our operations in a dynamic and timely manner to ensure that the business can be run and expanded sustainably.

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 full-year 2019 were $12.7 million compared with $18.1 million in 2018, a year-over-year decrease of 29.8%. This decrease was driven by lower sales of our military globe, flood light, fixture and Intellitube® product lines and was mostly due to a one-time large order in 2018; as well as a decrease in sales of our commercial products, reflecting fluctuations in the timing, pace and size of projects in that market.

2019's full year net loss was $7.4 million, or a loss of $0.60 per basic and diluted share, compared with a full year loss of $9.1 million, or a loss of $0.76 per basic and diluted share, in 2018.

However, most importantly, and very relevantly, we believe it is important for investors to look closely at the steady and meaningful improvements we made between the second and fourth quarters of 2019 to reinvigorate sales, reduce costs and create a substantial platform for growth and improve financial results in the future, while mitigating the bottom-line losses experienced for 2019 in total.

Sales for the fourth quarter of 2019 were $3.5 million compared with 2018 fourth quarter sales of $3.1 million, an increase of 13.2% year-over-year. When compared to $2.9 million in the third quarter of 2019, sales were up 21.1% on a sequential basis. The sequential increase in sales can be attributed primarily to traction we are gaining from the introduction of new products, an increase in our direct sales team, a shift in our sales mix - which was weighted more heavily towards the commercial market - the timing of military sales, which had been delayed from prior quarters due to budgetary constraints at the Defense Logistics Agency and an increased value proposition, primarily for our commercial products. These increases were partially offset by a decline in sales to a major Northeast Ohio hospital system.

From a mix perspective, Military sales were $1.5 million, representing approximately 42.5% of total sales for the fourth quarter of 2019 compared to $1.9 million, or 61.7% of total sales, for

the fourth quarter of 2018 and $1.2 million, or 40.5% of total sales, for the third quarter of 2019. The sequential increase in the percentage mix of military sales as a percentage of our total sales quarter-on-quarter is primarily due to the timing of military sales, which had been delayed from the third quarter due to budgetary constraints at the Defense Logistics Agency. The year-over-year decrease was driven primarily by reduced sales to one large distributor to the Navy.

Sales to Commercial customers were $2.0 million, representing approximately 57.5% of total sales for the fourth quarter of 2019 compared to $1.2 million, or 38.3% of total sales, for the fourth quarter of 2018 and $1.7 million, or 59.5% of total sales, for the third quarter of 2019. The increase in dollar sales was mainly due to new sales to several school districts and colleges, as well as increases in sales of our RedCap™ products.

Gross profit for the fourth quarter of 2019 was $957,000 compared with $19,000 in the year ago quarter, a significant increase mainly driven by unfavorable "excess and obsolete, and related reserve" adjustment in the fourth quarter of 2018 of $590,000. On a sequential basis, gross profit dollars was roughly flat compared to $1.0 million in the third quarter of 2019.

As a percentage of revenue, gross profit margin was 27.1% in the fourth quarter of 2019 compared to 0.6% in the fourth quarter of 2018 and 35.3% in the third quarter of 2019. However, when adjusting gross profit margins for 'excess and obsoletes, and related reserves,' our 'normalized' gross profit margins become 29.3% for the fourth quarter of 2019 compared to 18.2% in the fourth quarter of 2018 and 23.6% in the third quarter of 2019. The sequential decrease in gross profit margin was the result of fluctuations in our "excess and obsolete, and related reserves," which we experience from quarter to quarter. Moving forward, we expect our 'normalized' gross margins to be in the mid-20s in the near-term and begin to approach the low-30 percent range as we introduce new products and make further improvements to our supply chain. However, depending on our sales mix and inventory valuations, we may see some fluctuations quarter-to-quarter.

Operating expenses in the fourth quarter of 2019 were $2.1 million compared to $3.0 million in the year ago quarter, a decrease of $865,000 or 29% year-over-year, which was driven by both lower product development and selling, general and administrative expenses and the inclusion of restructuring expenses in the fourth quarter of 2018.

Taking those one-by-one, product development expenses decreased by $408,000 year-over-year to $249,000 in the fourth quarter of 2019 as a result of lower salaries and related benefits, driven by a lower headcount, which resulted from office closures in San Jose and Taiwan in the first half of 2019 and lower outside testing fees.

SG&A expense decreased 15% to $1.9 million in the fourth quarter of 2019 compared to $2.2 million in the year ago quarter. The decrease was the direct result of our directed efforts to streamline our operations and create an agile infrastructure that supports sustainable, long-

term growth. Key drivers of the decrease were lower salaries, including stock-based compensation and related benefits, on lower headcount resulting from office closures in San Jose and Taiwan in the first half of 2019, which were partially offset by an increase in recruitment and legal costs.

Sequentially, operating expenses increased 14.3% compared to $1.9 million in the third quarter of 2019. This increase was primarily driven by an increase in salaries and related benefits, as well as increased legal and recruitment costs. Most of the new headcount that we added in the fourth quarter of 2019 was related to sales driven activities, and we consider all hires made as an investment in our future growth.

Loss from operations during the fourth quarter of 2019 was $1.2 million, an improvement of $1.8 million compared to a loss from operations of $3.0 million in the fourth quarter of 2018. Sequentially, this compares to a loss from operations of $833,000 in the third quarter of 2019. The sequential increase in the loss was due primarily to lower gross margins resulting from inventory valuations and an increased investment in sales-driven SG&A salaries and related benefits costs.

As James mentioned, we encourage investors and analysts to look at the direction of longer-term trends of our business and the actions we are taking to accelerate growth and narrow our losses along a trajectory that will ultimately return us toward sustainable profitability.

Net loss for the fourth quarter of 2019 improved to $1.3 million, or a net loss of $0.11 per basic and diluted share, compared with a loss of $3.0 million, or a net loss of $0.25 per basic and diluted share in the year-ago quarter and a net loss of $946,000, or a net loss of $0.08 per share in the third quarter of 2019.

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

As of December 31, 2019, we had cash and cash equivalents of $350,000 compared to $6.3 million at the end of 2018 and roughly in line with the $634,000 of cash and cash equivalents at the end of the third quarter of 2019. We continue to maintain a low, yet acceptable minimum cash balance to fund working capital and other short-term needs as part of our financial strategy to optimize the deployment of cash and reduce borrowing costs as much as possible. As we have said in the past, we no longer borrow money by adding both cash and debt at the end of a quarter but leaving net debt unchanged on the balance sheet.

Total debt as of December 31, 2019 included short-term credit line borrowings of $715,000 and convertible notes outstanding of $2.6 million for a total debt balance of $3.3 million, or net debt of $3.0 million. This compares to $2.2 million in total debt as of December 31, 2018, which was comprised solely of credit line borrowings while $6.3 million in cash sat idle on the balance sheet for a negative net debt balance.

Starting now and moving forward, we would like to introduce you to a metric we view as very important, and that is a metric we refer to as total availability. We determine total availability at any point in time by taking the cash on hand, plus any excess borrowing capability we have on our short-term borrowing facility. Effectively, this 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. As of December 31, 2019, we had total availability of $2.0 million, which consisted of $400,000 of cash and $1.6 million of additional borrowing availability on our credit facility. Also, as of September 30, 2019 we had total availability of $1.3 million, which consisted of $600,000 of cash and $700,000 of additional borrowing availability on our credit facility. We intend to continue to communicate this metric to you in future Earnings Releases and SEC filings.

Also, as James mentioned during the fourth quarter we raised additional capital of $1.1 million in net proceeds through the issuance of a single note to a single lender, and subsequent to year-end, we raised additional capital through a private placement of 3.4 million shares of our common stock at an at-the-market purchase price of $0.799 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 for gross proceeds of $2.75 million and net proceeds after expenses of $2.37 million, and finally $2.09 million after a mandatory debt repayment on the note to the single lender from the loan in the fourth quarter. Proceeds from these offerings will provide short-term funding for our operations and initiatives for growth. We continue to analyze our cash needs considering sales prospects, current operations and our plans for continual improvement, and it is our current view that we may need additional external financing during 2020. We expect to explore and consider a variety of financing sources given the timing of when a need may arise and market conditions at that time.

Our operating cash burn for the fourth quarter slowed to $464,000, largely driven by very effective working capital management.

Accounts receivable were $2.3 million at the end of 2019 compared to $2.2 million at the end of 2018, a modest decline of $136,000, reflecting the decline in sales as well as continued, effective collection of accounts receivable.

Inventories declined to $6.2 million as of December 31, 2019, compared to $8.1 million at the end of 2018. The decrease was due to low procurement in the first half of 2019 as a result of a purchasing freeze implemented by the current management team. During the second half of 2019, we also negotiated cost reduction terms with suppliers on certain products and introduced a price adjustment strategy on products we have in excess inventory, which resulted in a net reduction of our gross inventory levels and excess inventory reserves of $1.9 million compared to 2018. Please bear in mind that as we launch new products and deplete popular product inventory, we did begin purchasing more inventory late in the fourth quarter of 2019 and into the first quarter of this year.

Accounts payable declined significantly to $1.3 million as of December 31, 2019, down from $3.6 million as of the end of 2018, which reflects the large buildup in inventory the occurred during 2018 and the need to pay suppliers for those goods during 2019. One other significant change to the balance sheet between 2018 and 2019 was an increase in current assets resulting from the adoption of a new changes from period-to-period you see on the earnings release because of our adoption in the new standard for lease accounting.

In addition, I wanted to update you on tariffs. Tariffs continue to be manageable for Energy Focus with no material impact on our business, with only about $140,000 for all of 2019. In fact, recently we have been able to eliminate certain 25%-level tariffs on electronic components charged toward the end of 2019 by sourcing those components from alternate suppliers in 2020. Also, we continue to work with our vendors on price reductions to mitigate the need to increase prices and are also evaluating alternative sourcing locations and sources as necessary. Currently, we have no need to pass along the minimum level of tariffs we have incurred from the products we source out of China at this time, but we'll continue to monitor the situation, and we'll respond accordingly. Finally, the recent US/Chinese settlement deferred planned tariffs that would have impacted some of our products, which was a favorable outcome for us.

Our other potential meaningful liability remains manageable and not material, and that is our warranty liability. The combination of very low failure rates of our tubes and a replacement tube that was identified for an existing customer, has allowed us to continue to experience minimal costs for our warranties and still be able to afford to offer very valuable 10-year and 5-year warranties to our customers.

Finally, as James mentioned, to date we have not experienced any significant disruption in either our supply chain or sales due to coronavirus pandemic. However, we have had to make some significant adjustments in our supply chain to ensure we continue to receive product in a timely and affordable fashion, and we readily acknowledge that it is much too early to assess how the coronavirus will impact our sales as we move forward. This is a very dynamic and changing world we currently live in and our plans will have to be real-time and we will respond appropriately.

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