ENERGY RECOVERY, INC.

Third Quarter 2020

Earnings Call

Opening Remarks - James Siccardi

Good afternoon everyone, and welcome to Energy Recovery's 2020 third quarter earnings conference call. My name is Jim Siccardi, Vice President of Investor Relations at Energy Recovery. I am here today with our Chairman, President and Chief Executive Officer, Bob Mao and our Chief Financial Officer, Joshua Ballard.

During today's call, we may make projections and other forward-looking statements under the Safe Harbor provisions contained in the Private Securities Litigation Reform Act of 1995 regarding future events or the future financial performance of the Company. These statements may discuss our business, economic and market outlook, the Company's ability to commercialize VorTeq, growth expectations, new products and their performance, cost structure, and business strategy.

Forward-looking statements are based on information currently available to us and on management's beliefs, assumptions, estimates, or projections. Forward-looking statements are not guarantees of future performance and 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, October 29, 2020 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.

At this point, I would like to turn the call over to our Chairman, President and Chief Executive Officer, Bob Mao. Bob, the floor is yours.

Strategic and Commercial Update – Bob Mao

Thank you, Jim, and thank you everyone for joining us today. I want to start today's call as I did last quarter, with the sincere hope that everyone listening, and your families, are safe and healthy. Once again, I am happy to report that the Energy Recovery team, and our business, remains healthy, well and strong.

Energy Recovery is evolving well into a COVID-inspired "new normal" where we continue to achieve growth our base business, while embarking on our new business initiatives. We are executing against the disciplined financial and time-bound approach to our new initiatives that we discussed in our last earnings call, which should translate to greater bottom-line results and increased returns for our investors.

Following the format of my previous earnings calls, I will update you on our Water business and VorTeq development in our Oil & Gas business. In addition, in our last earnings call, we committed to provide more details on our incubation efforts for the pressure exchanger technology platform, which we started towards the end of the first quarter this year. Today, we will provide an update on two of these efforts: Zero Liquid Discharge, or ZLD, and zero-mixing.

Water

Let's begin with our water business, which continues to be healthy and strong. We are benefiting from incredibly robust global desalination growth, even amidst the COVID pandemic. During the third quarter, we generated a new all time quarterly record for product revenue, surpassing the record set in last year's third quarter, by 26 percent. At this time, we feel confident increasing our previously projected 20 to 25% water revenue growth for fiscal year 2020 up to 25%. We also feel confident increasing our 2021 growth outlook to 10%, from the flat to 5% growth rate we communicated last quarter. Finally, existing desalination industry trends provide us the optimism to project a Water revenue growth rate in 2022 similar to what we are anticipating for 2020.

The strong global SWRO desalination growth trend is anchored in the increasingly critical need to provide access to clean water in many parts of the world. In addition to this basic need, three other trends are helping fuel growth in SWRO:

- First, the technological shift from inefficient thermal desalination plants to reverse osmosis is becoming a growing portion of our pipeline
- Second, acceptance of private financing into desalination construction in places like Saudi Arabia, Dubai, Egypt and India is increasingly decoupling desalination capital projects from national fiscal budgets susceptible to oil price swings and Covid-19.
- Finally, geopolitical shifts are creating an urgent strategic need for desalination in countries such as Egypt, where the construction of the Nile River dam in Ethiopia threatens Egypt's water independence.

In addition to our fundamentally strong baseline SWRO outlook, our first incubation initiative, Zero Liquid Discharge, or ZLD, is focused on our water business – specifically, the wastewater industry. In fact, we are excited to announce that we received our first commercial purchase order for our new wastewater product from a customer in India just this last week, which is very encouraging.

A global regulatory push is currently being led by China and India to implement more environmentally friendly practices in industrial wastewater treatment. Both countries are struggling with maintaining clean water sources, and they are seeking to maximize the recovery of clean water and minimize the impact of wastewater disposal polluting their waterways. ZLD allows for this by fully removing the harmful industrial waste from the water, allowing for the reintroduction or recycling of clean water.

The ZLD market is in its nascent stages with a fragmented market and multiple competing technologies, none of which has emerged as a dominant technology. Much like in the desalination market, we believe that reverse osmosis is the optimal solution. However, unlike desalination, the pressures required to achieve zero, or minimal, liquid discharge, are nearly 2,000 PSI, or roughly double that of seawater desalination. To address this, we are using our pressure exchanger technology platform to build a high-pressure PX application, which we call the Ultra PX. We believe our technology has the potential to become the dominant solution in ZLD wastewater, just as our legendary PX has dominated the SWRO market.

Our preliminary ZLD market research identified existing wastewater treatment applications of our Ultra PX with a potential TAM in China as high as $100 million, which would not include future annual growth as the market expands. We see a similar opportunity in India, where we recently received our first purchase order, and we believe that markets globally will move further towards both zero and minimal liquid discharge technologies over time as clean water becomes a more critical resource.

Now that it has achieved commercialization, ZLD will move out of Incubation and into our Water business unit. We are proud of our both our R&D and commercial teams, and their ability to commercialize our new Ultra PX within six months from initial incubation, well below our two-year commitment. ZLD should achieve an ROI exceeding 20%, and we anticipate ultimately achieving margins at levels comparable to our base water business. Finally, we anticipate positive operating cash flow from the on-set with our first purchase order already in hand.

We are confident in the potential of our water business as we look forward. Our baseline SWRO desalination business continues to enjoy a secular upswing with no end in sight over the next few years, and we are excited about the potential opportunities for our new wastewater business. We look forward to continuing to update you on both in the future.

Oil and Gas

Next, we turn to our Oil and Gas business and VorTeq, where I continue to view the progress we have made with great pride. We have developed our production model 1.0, which was utilized during our previously reported field simulation frac with Liberty Oilfield Services. However, the three hurdles we outlined last quarter must still be cleared before we commercialize: (1) successfully complete 2-3 live well fracs, (2) validate our customer value proposition, and (3) maximize the amount of sand that can be processed through the cartridges before any repairs or replacement.

Let's begin with live well fracs and, by extension, our value proposition. We are aggressively seeking to get on a live frac before year end. Live frac verification is critical to establish the VorTeq value proposition for our customer and to verify our VorTeq cartridge service span. In addition to our ongoing dialogue with Liberty, we have taken calls from and, hosted in Katy, additional Oilfield Service companies interested in the potential use of VorTeq. We are pleased with the response companies are giving us and the willingness to introduce VorTeq to their own customers. We are working hard to achieve the live well requirements as outlined last quarter and quantify our value proposition. As soon as we have achieved our first well, we will let you know.

With regards to the final hurdle, we are making solid progress in cartridge life extension design and manufacturing refinements. We believe we have identified the solution to achieve our target cartridge life, or at minimum a solution that will give us a material step forward to this end goal and will be testing this solution as we end the year.

We continue to remind ourselves of the need to commercialize VorTeq by mid-year 2021 or else stop investing. Our committed timelines have not changed.

Incubation

I discussed earlier our ZLD initiative, the first incubation effort to graduate to an existing business unit. In addition to the ZLD market, there are a multitude of potential applications for our ultra-high pressure PX in a variety of industries within, and outside of, water. We see significant future potential for our ultra high-pressure PX technology and believe it could become a significant percentage of our revenues in the coming years.

We are also making progress on a second PX incubation initiative targeted at a very large global industry currently undergoing a regulatory-driven transformation. While this product has the potential of being transformative in much the same manner the PX transformed the desalination industry, we are at the technical feasibility stage and so will forego a deeper discussion at this time. We expect to report on the progress of this incubation effort when we speak to you again in March, at which time we will have likely either proved its technical feasibility or ceased investing.

Finally, we mentioned last quarter that we are working on a project that will expand the aperture of our PX technology platform, thereby creating new PX applications in new industries. This project is a zero-mixing PX. Zero-mixing simply means that there is no co-mingling of fluids as columns of fluid transfer their pressure energy within the PX. Such mixing does occur in our current applications in desalination and oil & gas. Mixing, however slight, can exclude the PX from being applied in many applications, such as gas processing, chemicals among others where our technology could potentially help reduce energy consumption, and thereby costs, in existing systems.

We have already proven the technical feasibility of this extension of our technology and are now working on longer life and reliability. As we begin to apply this technology to new applications, we will update you on our progress and the potential of these new markets.

ESG

With that, let's turn to ESG.

As you know, we released our inaugural ESG report in September. While our business has always been aligned with sustainability issues such as addressing global water scarcity and improving access to affordable and clean energy, our ESG report reflects our commitment to becoming a more sustainable and resilient business. The initial drive to build out our ESG program was based on business growth, as well as input from our key stakeholders.

The pursuit of more efficient, sustainable customer solutions has been core to our DNA since our founding more than 20 years ago. We are proud of the impact our technology has in making desalination more efficient and sustainable, particularly as our world confronts growing water scarcity. Our new initiatives will continue to focus on energy efficiency and the environment. As we use our pressure exchanger technology to drive new growth opportunities, we desire to do so while providing new, efficient and sustainable solutions to industrial needs.

Wrap-Up

This is an exciting time at Energy Recovery. Our water team is focused on maintaining the momentum in our desalination business, as well as expanding our reach with the launch of our new ZLD product. Our Oil & Gas team is focused on finalizing and commercializing VorTeq. And, finally, our incubation efforts are focused on achieving technical validation on one product that could prove transformative and another that could further expand the aperture of our PX based platform.

We are transitioning Energy Recovery into a growth company on the basis of our very versatile Pressure Exchanger. We are giving you ring side seats to this event by reporting our progress, our wins, and our failures. We are investing our hard-earned cash, and you should know how and why we are investing it. We will continue to tell you what to expect, give you updates on our progress, and provide details on the outcomes. If we fail, you will know why. But, when we succeed, you should not be surprised. In short, you will see every punch we land and every hit we take. And we don’t plan to take many hits.

And with that, I will hand it over to Josh.

Financial Update – Josh

Thank you, Bob.

As we saw last quarter, each channel in the water business continues to experience differing dynamics. Mega projects remain dominant, growing 70% year-on-year in the quarter, and an impressive 48% year-to-date. As expected, both the OEM and aftermarket channels remain weak as compared to 2019, falling 22% and 40% respectively in the quarter from a year ago.

Based on Bob's affirmation of at least 25% growth in our water business this year, you should expect a very strong fourth quarter. I have mentioned in past calls that it is hard to pinpoint quarterly trends in our business. In both 2018 and 2019, we experienced a drop off in sales in the fourth quarter. However, this year our fourth quarter sales should be comparable to that of the third quarter.

As we look to 2021 and 2022, we do expect to see our OEM and aftermarket channels recover, however the extent of that recovery will largely depend on the global effects of Covid over this winter and next Spring. While some industries will remain weak within these channels regardless, most notably travel and hospitality, at this time we believe pent up demand in other industries may help return the OEM and aftermarket channels to more normalized levels, which is lending to our increased confidence in projections for next year.

I should also note that revenue from our new ZLD market is not yet included in these projections. As we build our pipeline and grow more comfortable, we will provide more clarity. That being said, it is probably fair to assume that our initial revenue will be in the single digit millions the first couple of years, with considerably more growth in the future. Also, note that these projects will be of a different nature than the large mega project desalination plants driving our water growth today. A typical ZLD project will be in the range of $50-$150k in revenue, but there are potentially a much larger number of these projects than we have seen in desalination. For example, if we assume a $100 million market in China, as Bob outlined, this would imply roughly 100 projects, whereas in desalination it could be as low as 10.

Our product gross margin decreased by 360 basis points as compared to Q3 2019 but showed a healthy 550 basis point increase from our low mark in the second quarter of this year and somewhat exceeded our expectations this quarter. Our margin strengthening over last quarter is largely due to our return to normal production levels at the end of Q2. While we did have a small effect from Covid due to a delay in the commissioning of our new ceramics plant in Tracy, California, that effect was muted compared to prior quarters. We are pleased with how well our manufacturing team is operating within the restrictions of Covid, and we continue to work under strict protocols to ensure the safety of our employees as well as the continuity of our business. In addition, our decreased OEM sales led to lower than expected sales of turbochargers and pumps, which proved accretive to margins, as these products are less profitable than our PX sales in this channel.

Last year we mentioned some margin pressure owing to lower ASPs as a result of bigger order sizes as we serve ever larger desalination projects. We expect this trend to continue in Q4 and to round out the fiscal year with roughly 68-69% gross margin, despite a reduced effect from Covid. As we look to 2021, the fundamentals of our gross margin will remain largely the same, excluding the potential of any temporary Covid-19 related effects. At this time, we do not expect to see a shift in our water business outside of this 68-70% range.

Let's now turn to our operating expenditures, where we have reported a decrease of 9% compared to Q3 2019. While our OPEX is somewhat lower than planned today due to Covid, the real story is in R&D where you will see a 23% decrease compared to Q3 last year, and a similar decrease as compared to the first half of 2020. While we expect R&D expense may increase somewhat in Q4, we expect it to remain roughly 15-20% lower than the first half of 2020.

If there is a single theme that Bob and I want you to hear it is that of discipline – discipline in our R&D efforts, as well as our operations and by extension our expenses. For example, this year we terminated some projects altogether that would not have achieved our commercial KPIs and the R&D expenditures from these projects have ceased.

As we look at our OPEX going forward, while we expect OPEX to grow, we are focused on reducing our spend as a % of revenue over the next 2-3 years to a more normalized level as related to our peers in the market. Over the past decade, we have reported annual OPEX higher than 60-65% of revenue every year and would have been in a similar range this year if not for the second quarter termination of the Schlumberger contract and subsequent GAAP recognition of the additional license and development revenue. We are targeting our OPEX to drop to a range of 35-40% of revenue by 2022, and subsequently to reduce it to the low 30s, which will be more in line with our peers in the market.

This taming of OPEX will be done in two ways: First, we will be capping our R&D as a % of revenue in our baseline budgets. Our R&D expense has averaged over 20% of revenue the past few years due to our elevated spend on VorTeq. In 2021, we will be targeting a range closer to 15-20%, with the goal of lowering it further in 2022, towards a 10-15% range. Keep in mind that this percentage will be decreasing despite the fact that we are guiding total revenues lower next year due to this year's artificial increase in revenue from the termination of the Schlumberger contract. You can expect a clear reduction in R&D by the second half of next year as we reduce spend on the VorTeq and wind down those R&D activities. In addition, base R&D spend on our incubation projects is expected to remain in the single digit millions – a far cry from the level of spend we saw with the VorTeq.

Second, we will continue to leverage our existing infrastructure, which will slow G&A growth in the coming years. We have invested significantly into new systems the past 18 months to better modernize our operations and leverage our back office as we grow, and we should see the fruits of this labor as we expect G&A spending growth to continue to lag that of revenue. This year G&A spend is somewhat lower than planned due to Covid-19. Next year, we expect more normalized G&A growth owing to inflation and a reversion to the norm, rather than increasing resources. I expect total G&A to grow no more than 10% in 2021, and further decrease in growth in subsequent years as, like R&D, we aim to reduce G&A as a percent of revenue to the mid- to high-teens over the mediumto long-term. Sales & Marketing spend is expected to stay roughly where it is today, around 10-12% of revenue.

Lastly, as it concerns OPEX, please keep in mind that our current level of spend assumes success with the VorTeq. If the VorTeq does not commercialize in 2021, our overall OPEX spend would decline considerably as we reduce activities in our Oil & Gas business unit and cease R&D. If, in modeling, you keep similar levels of OPEX, you should then assume revenue from the commercialization of the VorTeq. If we commercialize the VorTeq, we expect up to a 40-50% reduction in Oil & Gas OPEX spend overall, with about half of that reduction due to shifting of spend into cost of goods sold once we begin to generate revenue, and the other half due to decreased R&D. All told, this will result in an overall reduction in total R&D spend of at least 20-25% next year. Total reductions will depend on how quickly we commercialize or cease operations.

Finally, a few words on our cash and investments position, which ended at $106 million for the quarter. We continue to see no effect on cash from the global economic uncertainty. In fact, our accounts receivable is the cleanest it has ever been, which is reflective of the strong position the desalination industry finds itself in despite these strange times. For now, we continue to shift our corporate bond portfolio into cash as securities mature. As the future becomes a more certain we will revisit our longer-term plans.

Capex investments look to finish the year in the mid- to lower-end of the $8 - $10M I guided this time last year. Our baseline capex for 2021 is planned at $5-$7 million. This baseline excludes any Capex related to the potential commercialization of the VorTeq, which will become clearer if and when we commercialize.

With that, let's move to the question and answer portion of our call. Thank you.