

ENERGY RECOVERY, INC.

Third Quarter 2021

Earnings Call

November 4, 2021

Opening Remarks – James Siccardi

Good afternoon everyone, and welcome to Energy Recovery's 2021 third quarter 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, 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, November 4, 2021 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

Introduction

Thank you, Jim and thank you everyone for joining us. Our approach today will differ from recent quarters. Today, I will discuss the opportunities we see before us in more detail and our strategies to achieve our revenue targets in three of our industries:

- Desalination
- Industrial Wastewater, and
- Refrigeration

I will also provide updated expectations on the VorTeq. Josh will then discuss our results, guidance for the next two years, as well as our financial targets over the next five years.

As usual, we will start with our water businesses, but I would like to preface the discussion with some context. We often speak about the growing

global water supply gap. The world is already experiencing the effects of this phenomenon, and the supply gap is expected to grow to 40%, or 2,700 trillion cubic meters, by 2030.

A 40% gap – and 2,700 trillion for that matter - is almost impossible to wrap your head around. It's an annual equivalent to nearly 3/4ths of the water in the Mediterranean Sea, or over 1 trillion Olympic sized swimming pools. Water scarcity related to this gap is not felt evenly across the world. Areas of greatest water need include the Middle East and North Africa, where we continue to see strong desalination demand, as well as southern Africa, Asia, the western United States, and the western coast of South America.

Let's take just two coastal countries in Asia who are experiencing water stress as examples: China and India. China has 21% of the world's population, but has only 6% of the world's freshwater, and India accounts for 18% of population with only 4% of the world's freshwater. Both countries are experiencing high water stress and beginning to invest proactively to address it.

This water gap must be bridged, and there are limited ways to do so. We, of course, address two of these methods via our desalination and industrial wastewater businesses.

Desalination

We can already see the effect of this supply gap in our desalination revenues today. We have consistently guided roughly \$127 million in desal revenue in 2022, which means we will have generated average revenue growth of

17% per year over the five years since 2018. We expect this trend to continue over the next five years.

If only 5% of the water gap is addressed by desalination, we could potentially *triple* our desal sales over this decade and generate roughly 20% average annual growth.

Over the next five years, we believe we can double our desalination revenue and this growth could further accelerate in the latter half of the decade. In our opinion, it is only a matter of time, until regions outside of the Middle East and Asia begin to look at seawater desalination as a critical solution to their growing water needs.

We will remain diligent in our efforts to support the needs of this market growth. To protect our position in seawater desalination, we must invest in this business, and we are focused on three specific areas:

- First, R&D to continue advancing our PX technology to remain ahead of potential competition
- Second, growing our sales and service teams to be where our customers and products are
- Finally, expanding and modernizing our manufacturing, where needed, to address growing demand.

Industrial Wastewater

Our industrial wastewater business also addresses the world's water supply gap by reducing the electricity consumption needed to filter and reuse this water.

The industrial wastewater market is complex and touches many industries – everything from textiles to lithium-ion battery manufacturing. In processes where wastewater is filtered by passing through multiple reverse osmosis stages, we also have the potential to expand our Ultra PX sales alongside our PX and turbochargers.

There are a variety of estimates as to the total amount of annual industrial wastewater discharged today. The UN, for example, cites estimates as high as 620 billion cubic meters per year, and one can find estimates a fraction of that number. What is more settled is that roughly 80% of this wastewater is discharged into local water sources without treatment. This untreated water then pollutes other water sources, further reducing access to clean freshwater.

To address their own water issues, the governments of China and India have taken the lead in mandating advanced water treatment and recycling technologies be applied to industrial wastewater. China discharges more than 20 billion cubic meters of industrial wastewater annually and has committed to invest \$50 billion into wastewater treatment in its most recent 5-year plan.

We conservatively estimate worldwide industrial wastewater discharge to be between 100-150 billion cubic meters annually, under the assumption that China constitutes approximately 20% of global wastewater discharge. Using this flow, we can roughly estimate a current one-time TAM of between \$4-\$5 billion across all our products if 100% of wastewater was treated using advanced RO technologies. Today, only 20% of water is properly filtered which would imply a TAM closer to \$1 billion. The United Nations has a Sustainable Development Goal, which we align to, to triple the amount of filtered industrial wastewater to 60% by

2030, tripling our estimated addressable market over the next 10 years to closer to \$3 billion.

While we believe we can address a significant portion of this market today, we will need to advance our product line to address the challenges that exist to unlocking this additional TAM over the next 2-3 years. The market is made up of a variety of wastewater types, with an array of viscosities, thickness, size differences, volumes of solids, biofouling potential, and diverse contaminants. Additionally, there is a strong push towards utilizing reverse osmosis to recover precious minerals captured during desalination. Our product roadmap envisions multiple Ultra PX, and potential PX derivatives, none of which are expected to incur significant research and development timelines or cost expectations, but each addressing its own portion of the market.

To accelerate the unlocking of this TAM, and to further penetrate these industries, we must commission and present actual data supporting the value of our technology to better educate the industries that would benefit. We should commission our first two to three plants over the next three to four months, with data points available shortly thereafter.

Investment will be required to grow our position in these markets, as well to further build partnerships not only in China and India, but globally.

- First, as I mentioned earlier, we will invest in R&D to increase the portion of the market that we are able to address.

- Second, we intend to build out our sales teams and marketing efforts in China, India and eventually other regions to educate the market as interest in our products grows.

With that, let's turn to refrigeration.

Refrigeration – The Next Generation CO2 Refrigeration System

I have previously referred to our PX G1300 as a transformative technology that could help accelerate the global transition from climate-damaging HFCs to natural refrigerants, such as CO2. We are convinced that our PX G can become the foundation of the next generation of CO2 refrigeration systems. As deadlines to transition away from HFCs continue to approach in Europe and now the US, the 55 billion dollar global refrigeration industry, including end-users such as supermarkets, are under increased pressure to identify technologies to reduce the higher operating cost of CO2 refrigeration systems. Our PX G does just that.

Our momentum is accelerating as we move to achieve our internal target of commercializing any new product by the end of the second year. We are in discussions with a number of grocery chains in Europe and in North America for potential first PX G deployment. In fact, we just received our first order from Vallarta Supermarkets in southern California. Our PX G will not only help Vallarta reduce the cost of complying with California's requirements on refrigerants, which are more stringent than the proposed EPA rules, but will also help Vallarta lower their emissions via reduced energy consumption. We target commissioning the unit during the first quarter next year.

As you can see, neither Energy Recovery nor the refrigeration industry's end customers are waiting for the industry to realize the importance of reducing the cost impact of these next-generation systems. Grocery store owners, in particular, are anxious to ease the financial strain felt in providing more climate-friendly refrigeration systems. Our initial deployments are designed to show the industry the benefits the PX G provides compared to existing CO2 refrigeration technologies, which we believe will help drive the transition to a PX G-centric CO2 refrigeration model.

We will help educate the contractors how to design the PX G-centric systems, who in turn can present the designs to the OEMs for manufacturing. Meanwhile, we are also speaking with several refrigeration manufacturers in the U.S. and in Europe, who sense what an opportunity to partnership with us provides. By combining our PX G with the OEMs' refrigeration expertise, we could potentially maximize both OPEX and CAPEX savings delivered by the next generation CO2 system.

Last quarter, we discussed a potential billion-dollar annual TAM in this industry by 2030. We intend to achieve that TAM, and we are focused on investing in specific areas to be successful:

- First, we have developed a roadmap of our PX G development to address this total TAM, and beyond. This includes varying sizes of our PX G, which will allow us to deploy in different sized systems than we are targeting today. We will also invest in making our PX G even more efficient, and more cost effective, as we expand.

- Second, starting in 2022, we will build out our commercial team, starting with sales and technical support to work with our OEM partners, engineer contractors and end customers.
- Finally, we will continue to invest in our marketing outreach to educate the industry on the value of the PX G and drive industry interest.

We have made solid progress and look forward to updating you further next year. Now, onto VorTeq.

VorTeq

As we have stated over the last several quarters, while we have proven the VorTeq can effectively perform without interrupting or impeding normal frac operations, we must extend cartridge life to commercialize. We are actively testing potential solutions, but we have no progress updates at this time.

We will refrain from further comment until we are ready to definitively commercialize or halt investment in this product. In the meantime, while we have not ceased activities, we are further reducing investments, which Josh will address.

Conclusion

Climate disruption is an ongoing reality, it faces us in the news every day, and we are embracing the challenge this reality poses. Our technology is not tackling just one area, but now multiple aspects of the environmental impact the change is causing. What started as a means to help millions of people worldwide

access more affordable drinking water has evolved into removing toxins from industrial wastewater and now providing the world a more economical means to transition from harmful HFCs to more climate-friendly natural refrigerants.

Addressing these global environmental concerns head-on is driving our growth and is the backbone behind our updated revenue outlook. We are opening up new markets where the PX is delivering value similar to what we have done in desalination.

With that, I will turn the call over to Josh to discuss the financial section and our revenue targets for the next five years.

Financial Review and Update – Josh Ballard

Thank you, Bob.

I will start with this quarter's results. As expected, our barbell shaped revenue continued to play out this year with revenue of \$21 million during the third quarter, relatively flat against last quarter but more than \$6 million lower than the same quarter a year ago. We told you this would occur. I have mentioned previously that comparing our year-on-year quarterly revenue results does not point to future trends. This quarter's year-on-year decrease is simply due to a shift in the timing of mega project shipments compared to last year. Barring any unforeseen delays due to the ongoing supply chain crisis, we expect our fourth quarter revenue to exceed \$30 million, which would be our strongest quarter ever, and possibly allow us to exceed our roughly 10% guidance in desalination revenue. We are on track to achieve at least the 68% margin year-to-date.

In short, the year remains strong, as expected.

As we look to 2022, we still expect to achieve roughly \$127 million in desalination revenue, in line with the guidance Bob has been giving since this time last year. In addition, we anticipate industrial wastewater contributing as much as \$3 million in revenue, about three times what we expect in 2021, for total water revenue of approximately \$130 million. We should deliver this revenue at between 66-68% gross margins next year. We are seeing some potential weakness in margin as we deal with some labor inflation, an increased sales mix of lower margin non-PX products, and tariffs. However, we are still targeting the upper end of this range and will update you throughout next year.

While we have announced our first PX G1300 commercial order and expect others in 2022, we are not currently providing guidance at this nascent stage. We have structured our initial orders of our PX G as energy savings agreements, meaning we get paid based on the real energy savings our customers experience. Any revenues from these initial sales will be delayed as we commission, test, and finally go live throughout the year. We will then recognize revenue over an extended period of time. We generally expect we will sell in a more traditional manner as we ramp up sales in 2023 but we are working creatively with customers in these early installations as we introduce our new product to the market. Note that our final go-to-market sales strategy is still being worked on, so don't be surprised if we continue to evolve how we approach this market in the coming quarters.

Let's now discuss years three through five, 2023 – 2026. First, we are targeting desalination revenue growth of 15% in 2023, to over \$145 million. In

fact, we believe desalination revenue growth will average between 10-20% throughout this decade based on the strong global factors Bob mentioned earlier, which could more than double our desalination revenue by the end of 2026. To be clear, the desalination industry remains lumpy, and while the upward trends are strong, we cannot know exactly when we may experience a dip simply due to the timing of project shipments in a given year. But, we are confident in the long-term trend.

We continue to remain bullish on our new industrial wastewater business, which is an emerging but growing market. We see clear signs in Asia, and globally, that the world is beginning to focus on reusing industrial wastewater to help narrow the fast-growing freshwater gap. We see the potential to achieve high single digit to low double-digit millions by 2023 in this market. We are targeting a revenue range of \$30 - \$70 million by 2026. The extent to which this market grows in the long term will be driven by regulatory forces and/or investor and consumer pressure as the freshwater gap continues to worsen over this decade. Where we sit today, we believe we can achieve this overall water revenue while maintaining a gross margin percentage in the high 60s.

As for refrigeration, once we clearly establish our product's value in reducing energy consumption, we believe we will see demand increase swiftly from end customers. We are already seeing that strong interest as supermarkets experience the pain from the increased operating costs of CO2 refrigeration systems today. This is evident in our first contract here in California. The refrigeration industry must address this pain point, and we believe we are well placed to do so.

We are targeting a scaling up of the refrigeration business to between \$100 - \$300 million in revenue by the end of 2026. The speed at which we scale this business will largely depend on a few factors, all of which we are actively working on: (1) educating and proving actual cost savings to the end customers in stores, (2) educating the engineering contractors that define the systems that are installed in most supermarkets, and (3) potentially partnering with one or several OEMs. While any final pricing and margin are still to be determined, we are initially targeting in excess of a 50% margin.

To summarize – we are targeting revenue growth by end of 2026 of roughly \$200 million in desalination, \$30-70 million in industrial wastewater, and \$100-\$300 million in refrigeration. These three sustainability-focused businesses reflect a projected spread of \$330 to \$570 million in revenue by end of 2026, or roughly, 25-40% compounded annual growth as compared to our expected 2021 results. Our goal is to achieve a 60-70% gross margin as we grow, starting with somewhat lower margin as we launch, and but building up to our target as soon as possible following launch.

Let's now turn to our operating spend. We will likely end this year at somewhat less than 55% OPEX as a percent of product revenue. This is compared to approximately 65% in 2020, and over 75% in 2018 and 2019. In fact, excluding our one-time impairment charge last year, we should end flat to somewhat below 2020 in recurring OPEX spend. Healthy increases in sales and marketing spend are being offset by reductions in R&D, as expected, as we reduce our investments in the VorTeq, and G&A spend has remained relatively flat for the year.

I have stated in the past that I believe, over time, that it is important we reduce our OPEX as a percent of revenue to more normalized levels, likely between 30-40%, through prudent management of our organization as we grow. However, to support our revenue growth expectations, we will clearly need to invest in the organization, at times before we have realized associated revenue, especially in the early stages of launching these new businesses.

For 2022, we are targeting OPEX as a percent of revenue to decline to roughly 50% of the \$130 million revenue guidance I provided a moment ago. As you can see, we are intentionally and gradually right sizing our spend while supporting the organization as we push for substantial growth.

The immediate pace of our OPEX reduction will be slower than we envisioned a year ago, largely for three reasons: (1) we are maintaining reasonable levels of R&D, targeting roughly 15% of sales in 2022, to both continue to make progress in the refrigeration and industrial wastewater markets, as well as to strengthen our products in desalination; (2) we are investing in additional sales & marketing resources to ramp up our industrial wastewater and refrigeration businesses next year; and (3) we are not immune from the inflationary effects the country is experiencing currently.

With regards to the VorTeq, note that one of three scenarios will occur: the first is that we could achieve success in the short-term with the extension of cartridge life and move to commercialize, at which time we would maintain our current spend and factor in a revenue forecast for 2022. Or, in the second scenario, we would be reducing our spend on VorTeq to, at most, the low single digit millions next year assuming material progress is made. Or, in the final

scenario, we would stop investing entirely. This is a decision that we will make in the short-term, but know that no matter the decision our investments in support of VorTeq development are fairly small today.

As we look to 2026, we maintain our longer-term target to reduce OPEX as a percent of revenue to below 40%, as the initial push into these businesses begins to realize greater revenue streams.

Our Capex needs remain fairly stable in 2022. We are adding a new kiln early next year to support capacity, but do not foresee the need to significantly increase further additional capacity at this time. If refrigeration were to accelerate faster than currently expected, we will have time to increase ceramics capacity in the latter half of next year, or by the first half of 2023 as demand picks up. Clearly, if we are successful in our 5-year targets, we will need to substantially increase capacity in the future, and potentially re-look at how we manufacture to produce more efficiently at higher volumes. These are determinations we will begin to make next year and in early 2023, which will influence any decisions on capital needs over the long-term.

Our current cash and security balances remain healthy at \$108 million. As of October 31st, we had cumulatively repurchased over \$21 million in shares at an average price of \$18.28. Prior to any further stock repurchases in the fourth quarter, we would expect to end the year at a roughly similar cash balance. Therefore, any material deviations will depend on stock repurchases in the last couple of months of this year.

I would also like to comment briefly on the dual global pressures of inflation and supply chain constraints. Last year we made the decision to invest our cash to build inventory, both in raw materials and finished goods, to mitigate any effects from Covid related disruptions and expected inflation. You will see that as of the end of the third quarter, we had nearly doubled our inventory value since the start of the year. This approach has allowed us to avoid any disruptions to manufacturing and to delay effects of raw material inflation until at least the second half of 2022 or even 2023.

Our increased finished good inventory levels are helping to mitigate two risks:

- First, we can provide more flexibility in shipping to our customers to manage delays that could be caused by port congestion or lack of containers.
- Second, we are better protected against disruption in the event of a Covid outbreak at one of our plants. To be clear, we have not experienced a Covid outbreak at any of our facilities due to strong safety protocols, a generally well-spaced manufacturing facility, and high vaccination rates.

I should note that we are experiencing labor and energy-related inflation like everyone else, and that is having some downward effects on our margin, which you are seeing reflected in our guidance. We are actively working today to mitigate future inflationary effects as we look out to 2023 and will continue to update you.

With that, we can move to Q&A. Thank you.