ENERGY RECOVERY

First Quarter 2022

Earnings Call

May 4, 2022

Opening Remarks – James Siccardi

Hello everyone, and welcome to Energy Recovery's 2022 first-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, 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, May 4, 2022 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.

Strategic and Commercial Update – Bob Mao

Introduction

Thank you, Jim, and thank you everyone for joining us.

We delivered a strong first quarter, with revenue of 32.5 million dollars, a 12% increase over the first quarter 2021. Importantly, we also delivered over $8 million in operating income, a 34% increase over Q1 last year. The fact that our operating income grew almost three times our revenue underlines our continued focus on profitability as we grow.

Today, I am going to focus our discussion on the industrial wastewater and CO2 businesses. Our core desalination business remains strong, and we are maintaining our outlook for this year and next of 25% and 15% growth, respectively.

Industrial Wastewater

Let's start with our Industrial Wastewater business, where we achieved revenues in the first quarter equal to nearly 50% of 2021's full-year industrial wastewater revenue. The growth we are seeing in our backlog and sales pipeline is encouraging, providing us confidence in the $3 million top-line guidance we set for industrial wastewater in 2022.

Our first Ultra PXs were commissioned at a lithium battery manufacturing facility in China in Q1 and have been running for more than a month now. We are collecting performance data which we will use to further educate and penetrate this market.

In our third quarter earnings call last year, we talked about the overall potential of this market, with a current one-time TAM of roughly $1 billion today based on industrial water treatment statistics. This market has the potential to grow up to $4-5 billion depending on how the regulatory environment develops during this decade. We have already identified specific TAMs of $300-400 million in just a few industries, such as the lithium battery market.

In preparation to seize this opportunity, we have increased our boots on the ground in China and India, where regulations pushing towards minimal or zero liquid discharge provide potential tailwinds. We have also added technical personnel here in California to help drive business and applications development within the various market verticals.

To ensure product leadership with the PX and Turbochargers as the energy recovery devices of choice, just as they are in desalination, we have also partnered with two major equipment suppliers, and are in discussions with several process innovators, to joint-market to the industry. Our teams are actively engaging with government-run industrial design institutes in China, who define the technologies that can be used in various industrial processes, OEMs, system integrators, and the end-users themselves to educate them on the value proposition of our solutions. Finally, we are now looking at how we can expand our focus in the industries we know, such as the lithium battery market, to further drive sales outside of Asia.

In short, as a first mover, we are positioning ourselves to capitalize on an industry poised for significant expansion in the near-term, with regulatory tailwinds helping to drive that expansion, and a great need for quality, proven, reliable energy recovery devices. During our next Earnings call on August 3rd, we will provide further clarity on additional industrial wastewater markets where we will initially focus.

CO2

Now let me turn now to the developments in our CO2 refrigeration business, where we have made significant progress on our initial PXG deployments with our Partners, and therefore our first steps to eventual volume sales.

The installation and commissioning of the industry's first CO2 refrigeration unit with an integrated PXG in Europe is scheduled to occur early this summer. We have already shipped our PXG to Europe and will soon be on site with our Partner to help with installation.

The deployment of our bolt-on PXG to Vallarta's Indio, CA grocery store was pushed out a few weeks due to delays in construction. Installation will now occur during the second quarter. We will then begin testing and fully-commission the PXG alongside Vallarta's existing CO2 refrigeration rack this summer and begin compiling the energy savings data the PXG offers. We will give further updates on both deployments during our second quarter Earnings call in early August.

We continue to engage with and find interest from other refrigeration manufacturers as we look to expand our commercial relationships to build our volume business. We are actively working with two additional refrigeration manufacturers who have met with our engineers, performed tests on our refrigeration test loop, studied our PXG and the data compiled, and understand the benefit of the PX-centric design for optimal energy savings.

In short, the industry is taking notice of us.

Let's take a moment to remind ourselves as to the regulatory forces driving the industry to adopt CO2 refrigerants and thereby for the need for our energy saving PX.

The Kigali Amendment to the Montreal Protocol requires accelerated reductions in the production and consumption of HFCs and was committed to by over 130 countries, including, The European Union, China and India. While the US has not yet officially ratified the Kigali Amendment, the US has already begun implementing the HFC phasedown under the American Innovation and Manufacturing Act enacted last year. Some jurisdictions are accelerating these reductions, such as the EU's F-Gas regulation which moved up the timeline by 6 years. Europe is also imposing outright bans on new HFC systems as well as on servicing existing HFC systems in the coming years. In addition, here in the US, California has adopted the Snap Plus to achieve similar timelines as to Europe.

The world is already reducing HFC supplies. Today, the EU has already reduced HFCs by 60% from their 2015 baseline. In 2022, the US is implementing its first phasedown of 10% of its baseline.

This reduction in supplies of HFC also affects existing systems. Refrigeration systems lose a significant amount of refrigerant each year. Central supermarket refrigeration systems, for which the PX G is currently being developed, leak an average of 17% of their HFC each year. Limits to HFC production and the ultimate ban of production and the trade in future, will mean supply will no longer be enough to refill even existing HFC systems in the coming years. Other industries yet to be affected by this protocol, such as data centers, will put further pressure on dwindling supplies.

While some HFC refrigerant can be recycled from retired systems to help alleviate reductions in new production, we believe there will be a 20% deficit in available HFCs to satisfy demand within roughly the first half of the transition period.

Here in the US, based on the typical life of 10-15 years for a refrigeration system, this translates to a 9% average annual replacement rate of the total installation over 40,000 supermarket and grocery stores. However, this replacement rate will likely accelerate in future years as HFC supplies continue to tighten and costs to run these systems increase.

The key takeaway here is that these regulatory limits and bans of HFC refrigerants will equally affect all countries, including those in Europe and all 50 US states, there by accelerating the conversion from HFC-based systems to CO_2-based systems. This regulatory pressure, and the evolution of the European market, is why we believe we can achieve the \$100-\$300 million targets by 2026, which we outlined late last year.

As you can see, momentum continues to build both in our own business, as well as in the overall regulatory environment globally. This year we will deploy PX-centric systems, gather proof points and prove the reliability of the PX G in the real world. These are the next steps to creating a volume business and achieving our breakeven milestone by the first half of 2023.

Transformation & Conclusion

I'd like to take a few moments to talk about the change occurring inside ERI. Energy Recovery itself will have to continue to mature its operations to maintain our position in desalination and achieve the growth we have targeted in industrial wastewater and CO_2 refrigeration. Growing up to \$550 million in revenue means not only approaching our markets in new ways, which I have described at length during these calls, but will also mean adding complexity to our operations as we add substantially to our workforce and expand capacity, potentially in new locations, to handle the increased volume.

This growth will put new pressures on our leadership, employees and systems to manage this more complex business. One of the pillars of our commitment to achieving sustainable growth is our commitment to our ESG program. The employee aspect of ESG is growing in importance as we look at hiring and retaining the best talent, as well as developing our employees and leaders within as we seek to scale.

While we are establishing new teams to address our new markets, we are also actively building out and developing our internal capabilities to prepare for this growth in a multi-year effort to ensure we can meet increasing demand in a disciplined, focused and accountable manner.

We believe we are off to a good start. Our ESG efforts have been noticed by others and our second annual ESG report was recognized with the IR Magazine Award for "Best ESG reporting" for a Small to Mid-Cap company in March and, just last week, MSCI upgraded our ESG rating from a single-A rating to double-A. This represents an ESG rating increase by MSCI two years in a row. We are proud of these acknowledgements of our commitment to ESG principles.

In addition to these recognitions, we also recently earned certification as a Great Place to Work, an early step in our commitment to our employees as we grow.

With that, I will turn the call over to Josh.

Financial Results – Josh Ballard

Thank you, Bob.

Our 12% year-over-year revenue growth this quarter was largely driven by our OEM and aftermarket channels, both of which exceeded Q1 2021 by 67%, while our mega project channel remained flat against last year. However, as we have discussed before, a quarter-on-quarter comparison does not point to a trend for the year. The first quarter of 2021 was still affected by Covid slowdowns, however we saw growth in both the OEM and aftermarket channels throughout the final three quarters of the year. In particular, if you look closer at OEM sales, you can see that revenue this quarter is very much in line with the past three quarters. While aftermarket is high compared to any quarter last year, I do not expect it to remain this elevated throughout 2022.

While we are maintaining our guidance of roughly $130 million for the fiscal year, we have seen some shifting between quarters. We originally expected our quarterly revenue to be fairly evenly distributed in 2022. It now appears our second and third quarters will be lighter than our first and fourth again this year. Our second quarter will be our lightest quarter, likely around $20 million. Fourth quarter revenue is shaping up to land in the low to mid $40 million range, and Q3 will make up the balance.

We generated a 71% product gross margin during the quarter but anticipate this range to moderate as the year progresses. We are benefiting from our inventory build during 2021 but will begin to experience some effects from inflation and tariffs in the latter half of this year which will moderate our margin to bring it within our guidance of 66-68%.

Our OPEX grew about 3% over our average 2021 quarterly rate. Our R&D spend should remain fairly stable for the remainder of the year, averaging between $4 - $5 million per quarter. You can expect significant increases in sales & marketing as the year progresses, and moderate 8-12% growth to G&A. We are still targeting OPEX of roughly 50% of revenue this year.

In order to provide you with a bit more clarity as to the nature of our OPEX, we included non-GAAP measures in our earnings press release to exclude share-based compensation, non-recurring and extraordinary items if they occur. Due to our slightly higher gross margin and decreasing OPEX as a percent of revenue, we saw healthy growth in our operating income to $8.2 million, or 34% year-on-year growth, and we achieved adjusted EBITDA of $11 million, or 23% growth year-on-year and 34% of revenue.

We have also offered greater insight to our tax rate, which has bounced around quite a bit the last couple of years, from a 10% tax benefit in Q1 last year to a 5% effective tax rate this quarter. This change is reflective of two events: First, last year's rapid share price advance led to the exercising of options, resulting in high deductions in the first half of the year, which provided a tax benefit. Exercises have moderated to more typical levels this quarter.

Second, we will have access to the new Foreign Derived Intangible Income deduction, or FDII, for the first time this year. FDII is not an allowable deduction while a company is utilizing accrued net operating losses to offset taxable income, but we should use up all of our net operating losses in 2022. Based on what we know today, we believe this new FDII benefit could reduce our tax rate by up to 7% this year. This expected deduction, together with the significant R&D tax credits we receive, should keep our effective tax rate, adjusted for share-based compensation, at roughly 10% as reported this quarter.

We closed the quarter with a cash and securities balance of $97 million, somewhat below our end of year balances largely due to share repurchases totaling $8 million in the quarter as well as somewhat negative operating cash flow. As of the end of April, we had repurchased 1.9 million shares for a cumulative $35 million at an average share price of $18.77. That leaves us with about $15 million remaining in the current repurchase program as of last Friday.

With regards to our operating cash flow, increased inventory and receivables levels compared to year end drove this dip. Accounts receivable continued to grow in the first quarter due to record high sales but remain strong and we have seen no indication of weakness in the ability of our customers to pay on time.

Inventories rose mostly due to the timing of the receipt of raw materials. Despite the continued negative news regarding the global supply chain, we remain in a fairly strong position from a manufacturing perspective. First, our suppliers have largely avoided port shutdowns. Second, due to our inventory program in 2021, we have a healthy buffer of finished goods and materials which, if the world were to shut down today, would provide us with up to 8 months of pressure exchangers for our customers.

Note that you should expect inventory levels to continue to rise in the second and third quarters as sales moderate mid-year. We have level loaded production of pressure exchangers this year to cover shipments for this year as well as to prepare us for continued growth in 2023. Because of the very large level of shipments anticipated in the fourth quarter, by end of year our finished goods inventory should be more in line with what we saw at the end of 2021.

We often get questions on capacity and our ability to satisfy not only growth in demand from our desal customers, but also incremental new demand from industrial wastewater and CO_2 in the next couple of years. We are comfortable that we can handle any new production volumes over the next couple of years. We have the footprint to incrementally add new capacity at our existing facilities if needed at fairly low cost to support the initial growth of these businesses.

We are, however, actively reviewing our manufacturing options for 2024 and beyond, which will largely be driven by our CO_2 business, and we will keep you updated. Any investment in expanding our existing facilities, or building a new one, would likely not begin until 2023 at the earliest, unless CO_2 demand upticks much faster than currently expected.

Finally, let me briefly update you on VorTeq. We continue to discuss options with potential parties and expect to finalize our plans in the coming weeks one way or another. As I mentioned last quarter, our spend on VorTeq is fairly minimal at this time. We are not testing at this time, and are mainly focused on supporting employees that we would need within any potential partnership. We should be prepared to discuss our final plans for the VorTeq at the next earnings call, but either way you should not expect much change to our recurring OPEX.

With that, we can now move to Q&A.