

ENERGY RECOVERY, INC.

Second Quarter 2021

Earnings Call

Opening Remarks – James Siccardi

Good afternoon everyone, and welcome to Energy Recovery's 2021 second 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, 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, August 5, 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

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

During the second quarter, our evolution as a PX-based platform company continued to gain steam. We are seeing momentum for our new water solutions outside of seawater desalination, and we made progress with VorTeq and substantial strides in refrigeration.

Today I will describe to you in greater detail our activities in each of our new lines of business, including technical challenges as well as new insights into our go-to-market strategies. Each new industry will present its own unique challenges, but we are ready.

Let me start with desalination.

Desalination

Our desalination business is performing in-line with expectations. The dumbbell shape of our water revenue that Josh mentioned last quarter is playing out as expected. While our second quarter revenue of \$21 million was lower than the first quarter, we expect strong annual product revenue results. Our backlog is strong, and our growth outlook remains robust at 10% this year and 25% in 2022.

The Middle East remains our most active region, and we do not foresee that changing in the near-term. However, we are encouraged by other regions that are appearing in our pipeline, most notably Asia where we have been generating only nominal revenue the past few years. China's recent "Action Plan", which calls for a 75% increase in desalination capacity, could lead to desalination on a far greater scale in the region. We remain very bullish on the potential of desalination not only for the next two years, but for many years to come.

Industrial Wastewater

Let's now turn to our growing industrial wastewater business.

As we announced earlier this week, we recently secured an additional three awards, all in China, related to the landfill, chemical and lithium battery industries. Over the past nine months, we have secured five awards in four industries, including those just mentioned as well as natural gas.

These initial awards will allow us to accumulate the real-life data we need to show the benefits reverse osmosis (RO) methods provide together with our PX and Ultra PX, as we have shown in seawater desalination. Our next focus will be to expand our brand recognition within these new markets. We will work with our reverse osmosis partners to educate these markets as to why our pressure

exchanger together with other RO technologies is the most cost-effective, sustainable solution to meet growing industrial wastewater treatment requirements.

I would like to take a little time to dive into one of these markets today – lithium batteries. In 2020, there was roughly 450 GWh of global lithium battery capacity, with 60% of this in China, which is expected to grow to nearly 2,500 GWh by 2030. If we conservatively assume the average battery capacity of a vehicle is 90 KWh, which is the capacity of a Tesla Model S, then this overall market capacity equates to roughly 5 million electric vehicles growing to nearly 30 million vehicles over that period. While we cannot yet know the exact size of this market, based on these capacity assumptions, we estimate up to a \$20 million one-time TAM for our PXs in the lithium battery market today. We expect this market to grow, on average, by at least \$10m per year through the next decade for a total TAM of up to \$120 million. This is in addition to each of the \$100 million one-time TAMs we previously mentioned in both China and India.

This is an example of the potential of a single industry, but the concept can be extended to other industries as well. We may not know exactly when an industry may shift to more sustainable methods of wastewater treatment. However, judging by the increasingly dire freshwater concerns we have cited many times in our calls, we believe that this will become an issue outside of just China and India sooner rather than later.

We are now digging deeper into these new verticals to increase our knowledge of the best strategy to expand sales in China, India, and the rest of the world. However, not all industrial wastewater is the same. It can vary by amount

and types of solids, viscosity, and other parameters that need to be addressed by our technology. Therefore, we are also laying out a product roadmap to approach the wider industrial wastewater market.

Next quarter, we plan to share our thoughts on how industrial wastewater could potentially impact our revenue outlook over the next 5 years.

VorTeq

At our annual shareholders meeting in June, we highlighted the progress made during multiple live-well field trials where the VorTeq was deployed. Year-to-date, we have participated in four field trials and completed 40 frac stages. These trials clearly demonstrated that the VorTeq can perform as envisioned, without interrupting or impeding normal frac operations. In addition, we are encouraged by the positive feedback we received from Liberty Oilfield Services and their customer.

We have repeatedly stated that the key to achieving profitable commercialization is cartridge life extension. Today, I will describe in a little more detail what we are trying to achieve.

Our cartridges are made from the second hardest material known to man – tungsten carbide. But even tungsten carbide wears under the abrasiveness of sand at pressures as high as 10,000 PSI, and over time we must refurbish the cartridges as this occurs. To extend cartridge life in between refurbishments, we designed and are testing solutions to protect portions of our cartridge with industrial diamonds.

We are looking at a variety of production methods to apply diamond to our tungsten carbide cartridges that we believe hold great promise. Our challenge is to attach the diamond to the tungsten to withstand high pressures and at the size we need. This has not previously been done at such extremes. The process is iterative and entails work at both our supplier's facilities and our own. We then test, analyze and identify new issues, and again work with our suppliers on a new iteration of the PX.

While we await results of our cartridge life enhancement efforts, we continue to move forward on our "go-to-market" strategy. To maximize its potential, it is critical that the VorTeq becomes a standard piece of equipment on a frac site, and that our customers take ownership and ultimately operate the VorTeq themselves. Therefore, we are prepared to offer the design of the skid to our customers, without charge, to build themselves, while we provide and maintain the cartridges needed to run the VorTeq. In essence, we are providing them a reference design of our system. This will ease our supply chain, create ownership over the system with our customers, and ultimately enable us to focus on what we do best: design and manufacture pressure exchanger cartridges.

We will continue to update you on this front.

Refrigeration

Now let's turn to our new product, the PX G1300 energy recovery device for refrigeration, or PXG.

Global regulations are accelerating a shift away from refrigerants such hydrofluorocarbons, or HFCs, to more natural ones such as CO₂. Most developed

countries are making this transition within the next 15 years. Phasing out HFCs has the potential to help avoid a half degree Celsius increase in temperature globally. This is significant. For Energy Recovery, this transition could translate into a roughly \$1 billion annual TAM by the end of the decade in commercial and industrial refrigeration alone.

Current CO₂ systems operate at pressures 4-5x higher than the more efficient HFC-based ones. This means that a CO₂ system without an energy recovery device is much more expensive to operate. Existing energy recovery technologies for CO₂ systems can recover only 10% of wasted pressure energy and, importantly, only operate efficiently in a narrow range of temperatures that cap out at roughly 75 degrees Fahrenheit. Moreover, the efficiency of these technologies actually degrades as temperatures increase!

Our PXG is designed to solve these challenges – the warmer it gets, the better it performs. In fact, the PXG can potentially increase the breadth of market for CO₂ systems globally by approaching hotter regions that have been an economically insurmountable hurdle for the industry to date.

Owing to the rapid transition happening within the refrigeration industry, and the weakness of existing energy recovery technologies, we feel a real sense of urgency to bring our product to market as quickly as possible. Our strategy for this involves a two-pronged approach:

First, we will offer a system that can “bolt on” to existing CO₂ systems, allowing customers to begin to achieve real energy savings with our PXG. This approach will allow our system to be decoupled from operations. In the event of

failure, the system would simply bypass our PXG automatically and operate as if it was not present. This is a streamlined approach for customers with existing CO2 systems already installed, providing them assurance that our new technology will not melt their ice cream while giving them first-hand evidence of the benefits it can offer.

While this retrofit approach will allow customers to achieve material cost savings, it will not show the full potential of our technology. To achieve this, our second approach is to provide a PXG-centric reference design to the industry at no cost to accelerate the adoption of our technology. This PXG-centric system will fully leverage the power of our PXG, with the goal of dramatically decreasing energy consumption and operating costs for our customers, thereby making their shift to sustainable CO2 systems as financially painless as possible.

Refrigeration technologies have changed little over the past 100 years. We believe the PXG has the potential to disrupt the global refrigeration industry much as the PX did in desalination. And, if successful, we could not only accelerate the sales of our PXGs, but also may help accelerate the adoption of CO2 systems and significantly contribute to the reduction of global warming gases. To achieve this, we must educate the refrigeration market on our PXG and make it as easy as possible for customers to try, and ultimately adopt, our technology.

We have come far with the PXG over the past 15 months. We have tested it across a range of temperatures in our full refrigeration test loop in California, built a control system to manage it in operations, and are building our first commercial ready system as we speak. We truly believe this could be a game changer for the refrigeration industry.

Wrap-Up

As you can see, we continue to make solid progress in each of our verticals of focus and are adjusting our go-to-market strategy based on the needs of the specific industry we approach. As we look to next quarter's update, we plan to provide deeper insight into how we view the economics of these initiatives playing out through the first half of this decade, as well as how we intend to support the expected growth from these activities. We know that it is important for our investors to understand the growth we anticipate and how we plan to realize that growth.

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

Financial Update – Josh

Thank you, Bob.

Product revenue slowed to 7% growth in the second quarter, as expected, but our outlook remains intact. As a reminder, our revenue this year is dumbbell shaped, with our first and fourth quarters being the highest revenue quarters, and the second and third being the lowest. You should expect a similar level of revenue in Q3 as in Q2, between \$19-\$21 million. Given that last year's third quarter was our largest, the year-over-year comparison will show a decrease in Q3. However, barring any unforeseen circumstances, our fourth quarter should be the largest one this year, allowing us to achieve our 10% guided growth.

You should also note that we are beginning to experience growth in OEM sales. The second quarter in 2020 was the first fully impacted Covid-19 quarter

and the 6% growth in OEM reflects our first increase since the onset of the pandemic. We are currently seeing a rebound in OEM activity across most territories and industry sectors, including hospitality.

While aftermarket sales fell this quarter, the overall trend for the year is beginning to feel positive. We feel a similar optimism about our OEM sales, which may lead to upside to our 10% guidance for this year. However, we are hesitant to change our outlook at this time until we have a better sense of where Covid-19 is headed.

As a final note to revenue, this is the last quarter we will show year-on-year quarterly comparisons that include GAAP recognized revenue from the old Schlumberger contract which terminated in June 2020. In Q2 2020 we recognized the remaining revenue associated with that contract which created a large bump of non-cash revenue. On a quarterly basis, this will no longer be a factor.

Our gross margin came in lower than our annual guidance this quarter. This is a temporary phenomenon largely driven by increased sales of lower margin non-PX products, such as pumps and turbochargers, as OEM sales rebounded. This has happened from time-to-time in previous years as well.

As of today, we still expect to achieve roughly 68% gross margin for the year. It is important to note that this dip is not due to any permanent changes in our economics – i.e., our ASPs are holding strong. While we are watching inflationary pressures, we are not experiencing significant inflation today. If we were to slip below 68% gross margin this year, this would be owing to higher than expected OEM revenue and, therefore, gross profit.

Our OPEX remains much in line with the past few quarters as we continue to prudently manage our spend as we grow. Even if you exclude the one-time impairment charge from Q2 last year, our OPEX still came in 2% below our recurring spend in Q2 2020. We experienced growth in G&A and S&M, however these increases were offset by decreased R&D spend on VorTeq as communicated previously.

Growth in our G&A spend is largely due to normal inflation and the return of some expenses as employees returned to the office, travel picked up, etc. The fairly large percentage increase in sales and marketing spend this quarter is for two reasons: first, we are seeing a rebound in trade marketing and commissions as our base desal business begins to see renewed life in marketing activities and OEM sales. Second, we are investing in building our teams in support of industrial wastewater and refrigeration. We anticipate continuing to invest in sales & marketing well into 2022, as we add further resources to ensure success in these two markets.

Now let's turn to cash. Operating cash flow grew substantially, driven by strong customer receipts following very strong sales in Q1. Note that we expect moderately negative operating cash flow in the third and fourth quarters due to the lower sales in Q2 and Q3, and therefore decreased customer receipts that will follow. However, our large projected Q4 revenue should lead to a corresponding increase in Q1 22 cash flow.

Capex is roughly half of what it was this time last year. For the full year, we expect Capex to be more or less in line with last year's at between \$6 to \$7 million. Our investments to date this year have largely been in our corporate

offices as we expand and build out for future growth as well as to create a safer and socially distanced office during this pandemic. During the second half of this year, we are adding a kiln to expand production and create some redundancy, as well as upgrading aging equipment.

Our cash and securities balance increased to \$121 million despite nearly \$12 million in share buybacks. We repurchased 657k shares on the open market at an average price of \$17.60 per share. We will continue to execute our buyback program in a disciplined manner as opportunities arise to maximize the number of shares we repurchase.

Finally, a quick comment about the organization. Overall, our team continues to execute admirably despite the ups and downs of Covid. Today, roughly 25% of our staff continues to work offsite. While we have opened the office back up to those who wish to return, we have not mandated a full return as of today. We continue to prepare for the growth that is coming and are excited by the potential that we can all see in our existing and new businesses.

Thank you. I will now hand it back to our moderator for Q&A.