ENERGY RECOVERY, INC.

Fourth Quarter 2020

Earnings Call

Opening Remarks – James Siccardi

Good afternoon everyone, and welcome to Energy Recovery's 2020 fourth quarter and full year 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, March 11, 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. I want to start today's call as I did last quarter, and every quarter since the pandemic started, with the sincere hope that everyone listening, and your families, are safe and healthy.

Although the past year has been challenging for everyone, I am happy to report that the Energy Recovery team, and our business, remains healthy and strong. Our goal has always been to protect the lives and livelihoods of our team. We have robust testing and monitoring protocols in place for all our manufacturing sites. To our knowledge, there has been no spread of COVID-19 at our facilities. It is a testament to our team that we have been able to keep everyone safe even while producing and selling a record number of PXs.

Beyond these achievements, our continued evolution as a company is exciting. We have settled into our long-term strategy – expanding the operating range of our pressure exchanger technology and introducing it to new industries outside of desalination. As an example, we diversified our water product offering with the introduction of our Ultra PX energy recovery device for use in industrial wastewater treatment. We are now partnering with a leading global membrane manufacturer, DuPont Water Solutions, to market our products in this space.

We also issued our first ESG report, formalizing the focus we have always had on environmental sustainability, and our efforts along this path have led to an A rating by MSCI. We know there is more we can do to be a good global corporate citizen and will continue to update you on our ESG efforts in 2021.

Finally, in recognition of our achievements, Forbes named Energy Recovery as number 16 in its list of top 100 small cap companies and IR Magazine shortlisted us for Top Investor Relations Department for Small Cap Companies.

I am proud of how this team responded to 2020's challenges, but I am not surprised. The evolution underway at Energy Recovery is what I envisioned when I accepted the permanent role of President and CEO. We are now building off our momentum in 2020 and are positioned to deliver another great year in 2021, and beyond.

In today's call, I will update you on our base desalination business, industrial wastewater, VorTeq, and our emerging incubation projects. With that, let us begin with desalination where we once again generated a record year of revenue despite the global pandemic.

Desalination

Our mega project channel remained strong throughout the year. Mega projects were the main driver of our 27% water product revenue growth in 2020, beating the 25% outlook we had maintained throughout the year. We anticipate this segment to lead the way again in 2021 and 2022, as large-scale projects are built to meet the needs of a thirsty world. We are also seeing concrete proof of the technology shift from thermal to reverse osmosis in our revenue and backlog, which should drive further growth. Thus, we affirm the outlook we offered during our third quarter call of 10% growth in 2021 and up to 25% growth in 2022.

Over the past year, we have repeatedly spoken of the secular shift in global water demand. Water scarcity is growing in communities across the globe and Seawater Reverse Osmosis Desalination is a drought proof option to deliver water in water-scarce locations. Governments around the world are seeking solutions to the water needs of their people, which is leading to further growth in SWRO.

As countries evaluate their path forward, many are prioritizing sustainable solutions. This is where our PX can add significant value. The PX generates no emissions when operating and reduces the energy intensity of SWRO. It decreases energy use by up to 60%, making SWRO far more cost-efficient and environmentally sustainable.

Importantly, our customers don't have to compromise on quality for sustainability. Our reputation in SWRO of reliability, efficiency and lifetime value proposition in desalination supports our strategy to apply the PX to other verticals to improve efficiency and environmental sustainability. I'll now move to talk in more detail about our new product applications, starting with industrial wastewater.

Industrial Wastewater

Since we announced the Ultra PX energy recovery device late last year, we have received two orders. The first has already shipped to India and is expected to be commissioned by mid-year, and the second is scheduled to ship to China by the second quarter. We also hosted a webinar yesterday with DuPont as part of our partnership agreement to drive market acceptance of Ultra High-Pressure Reverses Osmosis, or, for the sake of this discussion, RO for short.

To refresh our comments last quarter, Zero and Minimal Liquid Discharge systems, what we refer to as ZLD and MLD systems, seek to eliminate or minimize wastewater discharge, by purifying and recycling concentrated industrial wastewater. In traditional ZLD and MLD systems, up to fifty percent of costs come from energy-intensive thermal treatments. However, ZLD and MLD systems that adopt RO can lower energy intensity and potentially generate significant cost savings, by replacing most of the thermal treatment with RO.

When our Ultra PX, which can achieve an industry-leading 93% efficiency today, is added to the process, RO becomes even an even more attractive option.

For this reason, we believe our Ultra PX has the potential to make RO the preferred treatment option to achieve ZLD and MLD treatment requirements, just as our PX helped RO become the leading method for seawater desalination.

Where we sit today, RO adoption in industrial wastewater treatment is in the early stages. However, environmental regulations are beginning to drive growth, and we believe regulatory changes plus companies' own ESG commitments will push this new segment forward. Sectors such as metals and mining, tanning, chemicals, pulp and paper, pharmaceuticals, textiles and others could potentially all benefit from RO as a means to remove toxins from their industrial wastewater. As this demand increases, we would like the Ultra PX to have the same impact on this industry as the PX had in seawater desalination.

We are now actively building our team and pipeline in Asia and increasing our marketing efforts. We are excited by this new business line and see it as another opportunity to demonstrate how our solutions can make industrial processes more efficient and environmentally sustainable.

VorTeq

Over the past few quarters, we have repeatedly stated the hurdles we must achieve in order to turn the VorTeq into a commercial product - we must successfully complete 2-3 live well fracs, validate our value proposition, and maximize the life of the cartridge. As a reminder, if we do not pass **any** one of these hurdles, we do not have a commercial product.

Let's begin with the live well fracs. We are pleased to announce that we have completed our first live well in Texas and are currently taking part in a frac operation for a multi-well pad field trial in New Mexico. Our first trial was at a small refrac on a vertical well. This job was like a dress rehearsal for the multi-well pad and large frac stages.

Since March 1st, we have been onsite at a multi-well pad owned by one of the largest independent oil producers in the U.S. We have experienced challenges which represent valuable learnings for us as we work to fine tune the technology. By end of day on Sunday March 7th, VorTeq was utilized in 10 frac stages. We expect to continue for an additional 50 to 100 stages. Through these stages, we will accumulate data to further validate our work on all three hurdles. You can expect a more fulsome report at the next earnings call in eight weeks as the frac concludes and we are able to fully evaluate the data.

As a reminder, cartridge life remains the key hurdle to success. Cartridges, and the maintenance of them, are the main cost driver for the VorTeq. We consider R&D to now be complete on the VorTeq, however manufacturing of the cartridge remains a real challenge for commercialization. We still have work to do to prove we can produce cartridges profitably. In addition, field engineering will continue as we work to improve the VorTeq in the field.

If you remember, we committed to commercialize by mid-year this year or cease investing. We remain on this schedule and the coming weeks will prove pivotal to define our next steps. Let's now move on to our future PX applications.

Future Applications

Last quarter I explained how Energy Recovery is transitioning into a growth company built on our versatile pressure exchanger. As a reminder, this technology can handle relatively clean to dirty liquids at pressures from 1,000 to over 10,000 PSI.

Today, I would like to talk about the work our team has done to expand the sandbox within which the pressure exchanger operates. Specifically, we have now demonstrated that the PX can also expand and compress gas, therefore widening the parameters of our sandbox.

This technical achievement opens up potential applications and industries where our technology could provide significant energy savings, such as refrigeration, HVAC, power generation, and liquid natural gas.

Our first target is to address the challenges faced in industrial and commercial refrigeration. The refrigeration industry is facing a shift in technology as regulation phases out incumbent refrigerants like hydrofluorocarbons, known as HFCs, and replaces them with natural refrigerants, such as carbon dioxide.

We started working on this project a year ago, and during these 12 months we have technically proven that the PX is capable of processing gas as needed in the refrigeration cycle. We are, of course, mindful of the two-year deadline to commercialize new products that I previously laid out for new technology projects, and therefore over the next 12 months we will provide a deeper discussion on this topic as we continue our efforts.

Wrap-Up

In summary, the momentum with which we ended 2020 has carried into the new year. Our desalination business continues to ride the secular wave of demand. We are excited to join with DuPont in marketing the benefits of RO as a means to gain acceptance for industrial wastewater solutions. At long last, we have the VorTeq on-site and operating at a live well. And, we have expanded the operational sandbox of our PX to handle gases, opening up new potential solutions to advance the environmental sustainability of new markets. I look forward to providing further updates on our progress when I speak to you in eight weeks' time.

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

Financial Update – Josh

Thank you, Bob.

The dynamics in our revenue that I described last quarter, with mega projects leading growth and OEM and aftermarket showing weakness, played out through the end of the year as expected. Mega project sales grew 75% in 2020, while OEM and Aftermarket ended the year having decreased 31% and 18% respectively. As I mentioned last quarter, the weakness in the OEM and aftermarket channels was entirely due to the impacts of COVID-19, which especially affected our travel and hospitality markets.

As we look forward to this fiscal year's revenue, we expect a different set of dynamics in 2021. We expect MPD will continue to grow but the growth will likely be more tempered this year, in the range of 6-12%, before likely accelerating in 2022. Due to the ongoing pandemic, it is unclear whether our OEM and aftermarket channels will return to their highs in 2019, but we do not expect them to continue to decline.

Our revenue will also likely be recognized in a different quarterly cadence this year. Whereas in 2020 revenue was more heavily weighted to the final two quarters, in 2021 we expect more of a dumbbell result – Q1 and Q4 should be very strong, accounting for as much as 60-65% of revenue, while the remaining 35-40% of revenue will be split between two considerably smaller second and third quarters. This cadence is entirely being driven by the timing of mega project shipments and is another example of the lack of seasonality in our business.

We are pleased that we ended 2020 at 69% gross margin, which is in the middle of the guidance we provided for the year. Despite losses due to manufacturing slowdowns early in the pandemic, we were able to claw back a good portion of the lost manufacturing and ended the year in a good place. As I mentioned last quarter, we expect gross margin of between 68-70% this year.

Our operating expenditures grew at a much slower pace in 2020. While overall OPEX grew 6%, once you factor out the $2.3 million impairment charge related to the termination of the Schlumberger agreement, our recurring OPEX grew less than 2%. Some of that lower growth was due to reduced spend related to COVID-19, such as the 14% reduction in sales & marketing spend from less travel, trade shows and other marketing events. However, a significant portion also came from a decrease in R&D activities related to VorTeq. Looking at the quarterly trend of Oil & Gas R&D spend, you will see that we peaked in the first half of 2020, and our R&D spend in the second half of the year was nearly half that of the first. I provided guidance on our OPEX in the last earnings call and have no changes to that guidance as of today.

We closed the year with an increased cash and securities balance of $115 million. Our cash for 2021 is expected to stay roughly level but, depending on Q4 collections, could increase as high as to $120 to $125 million. Because of our increasing cash balances, we have made the decision to begin a share buyback program. The total program will be for $50 million, beginning over the next week, with no specific term in place. The buybacks will be done in the market, and we will seek to maximize the number of shares that we purchase.

I would also like to give you a heads-up as to some changes coming to how we present information in our filings. Beginning in the first quarter, we will transition our oil & gas business unit into a new category that we are calling Emerging Technologies. This business unit will include not only our VorTeq activities, but also our incubation efforts in refrigeration, new enabling technologies, as well as other new products that have not yet been fully realized in the markets. We believe this will better highlight to our shareholders how we are investing into new products, and how we will create value over the long-term on these investments. Our new Ultra PX product line will be rolled up into our water business unit for reporting purposes. You will note changes in our 10k to be filed tomorrow in our business section outlining this new structure, but new financial reporting will start only in the first quarter. We have also begun to include sales channel information in both our press release and financial filings, in light of the importance of these channels and how they affect our growth and profitability.

My final comments relate to our team. Although everyone is a bit tired, as I am sure you are as well, our team has held up admirably. Roughly three-fourths of our employees are regularly working onsite today. We have been actively preparing our offices in California to allow the remaining members to return as restrictions are eased in the coming months, including an upgrade to our HVAC system for better air flow, increased office space to allow for easier social distancing, temperature testing, weekly testing of all onsite employees, and strict adherence to CDC guidelines. We look forward to getting everyone back on site in the coming weeks and months.

Thank you.