

Energy Recovery
Q1 Earnings Call
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Presenters

James Siccardi, Vice President of Investor Relations
Bob Mao, Chairman, President, CEO
Josh Ballard, CFO

Q&A Participants

Jason Bandel – Evercore ISI
Pavel Molchanov – Raymond James
Wally Walker – Hana Road

Operator

Greetings and welcome to Energy Recovery's First Quarters 2021 Earnings Conference Call. At this time all participants are in a listen only mode. A question and answer session will follow the formal presentation. If anyone should require operator assistance during the conference, please press star, zero, on your telephone keypad. As a reminder, this conference is being recorded.

I would now like to turn the conference over to your host James Siccardi, with Vice President of industrial relations.

James Siccardi

Good afternoon, everyone, and welcome to Energy Recovery's 2021 First Quarter Conference Call. My name is Jim Siccardi, Vice President of Investor Relations at Energy Recovery. And I'm 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 Vortec, growth expectations, new products and their performance, cost, structure and business strategy. Forward looking statements are based on information currently available to us and our 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 10K and form 10Q. 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 6th, 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.

Bob Mao

Thank you, Jim. And thank you everyone for joining us today. Once again, I want to start today's call was the sincere hope that everyone listening, and your families are safe and healthy. Although there has only been eight weeks since our last earnings call, the momentum we spoke about has continued to build. We completed the two life wealth (INAUDIBLE) trials in Texas and New Mexico, announced in our last call.

We are currently at another and have two more planned. We held another successful joined marketing webinar (INAUDIBLE) this time hosted in Mandarin and the focus on the Chinese market. Our R&D testing has delivered compelling data on our co2 refrigeration PX. And we are finalizing design and testing new preparation for beta testing. And of course, our core desalination business continue to surge forward, delivering a new record high first quarter product revenue.

In addition, we are proud to say that we have been shortlisted for the best first time sustainability report, with the Corporate Register reporting award. Corporate Register is the world's largest corporate responsibility and ESG report directory. In today's call, I will update you our desalination business, industrial wastewater, work Pac and our refrigeration efforts.

With that, let us start with our record setting desalination business. Our desalination business started a year of robust fashion, with record setting quarterly product revenue. The \$28.9 million we posted is 52% higher than a year ago and was once again led by our mega projects segment. Demand for these large scale projects stands from the world's need for more water and is why our desalination business has averaged solid double line growth since 2015. Our growth outlook remains strong at 10% this year and up to 25% in 2022. While desalination is one tool to address the world's water needs, how we manage existing water resources is another.

Which brings us to our outdoor PX energy recovery device and industrial wastewater. Over the last eight weeks, we have focused on building our pipeline for potential projects. The sales cycle for these projects are typically between 12 to 18 months long. Most projects in the pipeline this year, had already been designed with thermal or a RO process using a competitor's ERD. Therefore, we must work hard to ensure the ultra PX in the bidding process.

The fact that we have landed two projects so soon after launching, shows the focus of our sales team and the strength of our technology. As we further educate the marketplace, together with partners, such as DuPont, we should make deeper inroads, as customers begin to spec in ultra-high pressure RO and our ultra PX into future designs. We will have more updates on industrial wastewater in the coming quarters, as we further define the market and making growth on sales.

Our initial ultra PX sales will help reduce energy consumption while removing toxins from the industrial wastewater of a natural gas plant in China and the chemical manufacturing plant in India. The first two sales demonstrate the broad applicability of the ultra PX to different industry. In the near term, were focused on further expanding the breadth of industries able to benefit from the use of reverse osmosis and our ultra PX in addressing their wastewater treatment needs.

Let me now turn to Vortec. During our last quarter recall, we highlighted the two life world field trials where the Vortec was deployed. We participated in more than 25 grant stages and demonstrated that the Vortec can effectively perform without interrupting or impeding normal frac operations. We integrated successfully with Liberty System and prove that the Vortec can withstand (INAUDIBLE) conditions and unplanned events, such as (INAUDIBLE) pressure fluctuations, and other issues commonly occur during a frac job. We thank Liberty and their end customer for accommodating us onsite.

Following the success of those field trials, we have joined Liberty and the same end customer at a new world site in Worth, Texas, where we are currently operating. We're using this field trial to test changes that we made to the Vortec based on the learnings from the first two field trials. And to gather more data to validate our customer value proposition. We're planning to additional field trials in May. Again, with liberty and the same large independent producer.

The main gating item to finalize our decision on commercialization remains extending the service life of work Pac efforts. Without this, we cannot achieve profitable commercialization. We have made important progress toward gathering the information needed to make a final decision which we promise by the end of June. But because that timing is mid-cycle, we have decided to give shareholders our decision at our annual shareholders meeting on June 10th. With our decision they nearing we are evaluating multiple options to generate a return on Vortec investment, which is why these additional field trials are important.

Some of the choices were considering include commercialization on our own or with a partner, a joint venture, selling or licensing the IP, or seeking other users, so the Vortec outside of fracking. Above all, we're focused on monetizing our hard work and investment in the Vortec and the efficiency this technology can deliver. We look forward to updating you our plans on June 10th. For those who are unable to join us for that meeting, we plan to publish the transcript in our Investor Relations website.

Now, I turned to refrigeration. Last quarter, we announced the EPX capability to expand and compress gas. We also identified commercial refrigeration, which includes the stores such as supermarkets and mega markets, as our first target market. I will now explain why this capability is so important to the commercial refrigeration industry.

In short, we believe our company's ERI can play a key role in supporting and accelerating the transition from extremely environmentally harmful greenhouse refrigerants, CFCs and HFCs to environmentally neutral, natural refrigerants, the most promising of which is carbon dioxide, or Co2. More than 100 countries have signed on to the (INAUDIBLE) amendment, an amendment to the Montreal Protocol. And this year the United States and China have publicly committed to signing.

While the Montreal Protocol successfully reduced (INAUDIBLE) layer harming CFCs, the (INAUDIBLE) is aiming at phasing out HFC. HFC's our greenhouse gas refrigerants that can contribute thousands of times more to global warming than Co2. According to the National Academy of Science, eliminating HFCs alone could potentially reduce global warming by up to half a degree centigrade. I'm sorry, half a degree Celsius.

The goal of the (INAUDIBLE) amendment is an 80% reduction of HFC use by 2047. With certain countries and regions are already accelerating the pace by implementing strict targets for the 2020s in order to reach the 2047 goal. European Union is leading the way and has banned sales of many types of HFC usage by 2022. California is seeking to reduce HFC usage by 40% by 2030.

The transition away from HFC and to Co2 refrigerant system is accelerating. For the \$55 billion refrigeration and air conditioning industry, moving away from HFC means moving to natural refrigerants, such as ammonia, or Co2. Ammonia is potentially flammable and explosive. Therefore, it has been limited to large industrial systems away from dense populations and requires 24/7 outside technical maintenance. Co2 is stable, more benign, and therefore the safe choice.

Over 35,000 Co2 units have already been deployed, primarily concentrated in northern parts of Europe, where the ambient temperatures are mild. This regional choice is likely due to the added costs of running Co2 systems, compared to the traditional HFC system as the cost premium for Co2 systems increases with warmer ambient temperatures. Energy Recovery Devices, ERDs, have been incorporated into Co2 systems to mitigate some of the cost premium. Of the energy recovery devices on the market, we believe our PX alone may be able to reduce the operating costs enough for Co2 systems to compete outside of mild climate.

Refrigeration systems work via cycle where refrigerant is pressurized, then the pressurized to carry heat away from objects such as food, in the case of the supermarket. That heat is then this carbon into the atmosphere, which is at a lower temperature. And the refrigerant is recycled through the system to again carry away more heat. At an (INAUDIBLE) temperature of 90 to 95 degrees Fahrenheit or 35 degrees Celsius, Co2 refrigerant must be pressurized to 1,300

pounds per square inch, psi, to achieve this cycle. Whereas the HFC only needs to be pressurized to around 300 psi to achieve the same result.

To reach the higher psi pressure needed for Co2 systems, more electricity must be consumed. The higher pressure and the corresponding increase in electricity needed for Co2 systems have led to the use of energy recovery devices. Without energy recovery device, the additional operating cost of a Co2 system in warmer climates could be prohibitive. And the transition to Co2 would likely not occur without the draconian push of environmental regulations.

Current Co2 systems in the market utilize an energy recovered device called an ejector. However, the efficiency limitations of the ejector mean that the economics of Co2 systems outside of mild Northern Europe region are not very good. ERIs PX offers a potential solution to this higher temperature hurdle. Rigorous testing our labs have shown that our PX may reduce the existing operating cost disadvantage of co2 refrigeration systems today in warmer climates, thereby allowing the systems to better compete on cost.

In fact, our test results show that the performance of the PX actually improved relatively as the ambient temperature gets hotter. This relative improvement occurs because as temperatures rise, the pressure differential needed to create a refrigeration cycle also increased. While the injector can only manage a 200 psi differential boost, and therefore work within a limited temperature range, our PX ability to manage this differential boost is unlimited, meaning we improve as temperatures increase. We're now finalizing our product development.

In addition, we will begin engagement with global commercial refrigeration companies and original equipment manufacturers to prove our product in system level beta tests and to establish future sales distribution. If you would like further details on this technology, we have published a new page on our corporate website.

In summary, we carried our last year's strong momentum to this year, starting 2021 off in record fashion. Our core desalination business remains strong. We are building momentum in our efforts to educate the industrial wastewater industry. On the benefits of reverse osmosis and our ultra PX, we are at our third Vortec field trial of the year and have two more planned as we near our water commercialization decision.

Finally, our PX refrigeration have shown very compelling test results. And we are actively seeking beta test partners. Our disciplined, diversified growth is emerging and opening up new potential solutions to accelerate the environmental sustainability of new markets. And with that, I will hand it over to Josh.

Josh Ballard

Thank you, Bob. We achieved extraordinary 52% growth in water product revenue in the first quarter as compared to last year. However let's remember that this year, unlike in 2020, our quarterly results should be more of a dumbbell shape, meaning we expect to report higher Q1

and Q4 revenues in lower Q2 and Q3 revenues, whereas in 2020, Q1 was our lowest quarter for water. We achieved these sales with a gross margin of 69% in Q1, right in the middle of our guidance of 68% to 70% for the year.

We realized the decrease of 12% operating expenditures against Q1 last year. However, if you compare opex to the latter half of 2020, you'll see that we're right in line with expenditures in Q3 and Q4. The latter half of 2020 is a better comparison to our trend this year for three reasons. First, many expenditures fell after Q1 due to the pandemic, especially those related to travel, employee related office expenses and tradeshow marketing, for example. Second, we had a somewhat elevated G&A expense in Q1 2020 related to the CEO search, which ended in the second quarter.

And third and most importantly, Vortec spend remained elevated in the first half of last year during a heavy testing period, which has since tempered. Total Vortec spend was \$3.5 million dollars in comparison with \$6.6 million in Q1 last year, which is also comparable to the past two quarters. We expect roughly to spend on Vortec in Q2 and spend in the second half of the year will depend on our decision in June.

Overall, we expect our optics to grow in mid-single digits 5% to 7% for the year, once you exclude the one time impairment charge related to the termination of the Schlumberger Agreement in Q2 last year. 2021 R&D spend should remain lower than 2020, despite our investments and refrigeration. As a reminder, we guided 15% to 20% R&D spend as a percentage of revenue for 2021.

We close the quarter with an increase in our cash and securities balance from \$115 million in December to \$120 million at the end of Q1. Notably, unlike the past few years, we posted positive operating cash flow in the first quarter. Historically, we've generally reported negative cash as high as \$5 million to \$6 million in the first quarter, driven by annual bonus and insurance payments, etcetera.

The increased cash flow this quarter reflects our growing sales, and importantly, our strong cash collections which our team has remained focused on throughout the pandemic. I received many questions related to our capital needs as we look to grow our industrial wastewater business and to invest in our new refrigeration product. Unlike Vortec, which if we commercialize, could demand significant working capital and sixth asset investments launch, our ultra PX and refrigeration product will both leverage our ceramics manufacturing capabilities, thus lowering any capex needs. Significant investments to expand manufacturing capacity would only be made to support growth and demand.

As it relates to our refrigeration product, it's a little too early to say what investments may be needed to enter this market. Although as we proceed this year and identify partners, we'll provide more clarity. However, just this past Monday, the U.S. Environmental Protection Agency announced that the U.S. intends to phase down the use of damaging

hydrofluorocarbons 85% by 2036. That's 11 years before the date set in the Kigali Amendment that Bob referenced just a moment ago. Typical commercial and industrial systems have a roughly 15 year life and very few Co2 systems have been installed the date here in the U.S. However, with this announcement, and the capability and intention of the EPA to monitor this phase down, it means that the sale of Co2 systems should pick up significantly in the U.S. in the near future. That's another way of saying that our entry into this market has been very well timed. We'll clearly need to invest to keep up with this anticipated spike in demand, as we have no intention of missing this critical transitional moment to a more sustainable refrigeration ecosystem in our home country.

With regards to our industrial wastewater business, we plan to invest all of our gross profit generated from sales back into developing this business as we start out, because we expect gross margin to ultimately be similar to our desalination business, we should have ample cash to invest in the business development sales and marketing teams that will ultimately be needed to make the ultra PX success. As this business takes hold, we'll provide further insight into our investments.

Our share buyback program was launched as announced following our earnings call. However, we purchased less than 2,000 shares in these initial weeks due to continual increases in our share price. We do expect these purchases to grow and remain committed to utilizing the entire \$50 million for repurchases at this time, absent any unforeseen circumstances. We plan to execute our buyback program in a disciplined manner as the opportunity arises to maximize the number of shares we repurchase.

Finally, as I discussed last quarter, we adjusted the presentation of our financials to combine low or non-revenue generating products into our emerging technology segment. In addition, we have taken a close look at how our corporate spend aligns with our water segment and reallocated some expenses from the corporate to the water segment to give shareholders a better sense of how we are using our opex resources. For ease of comparison, we have also included recast the prior year numbers.

As a reminder, the goal of this change to our emerging technology segment is the better highlight to shareholders how we are investing in the new products, and how we we will create value over the long term on these investments. As this issue has become more independent and substantial in terms of revenue, we will break them out in the future as appropriate. However, I have committed to ensuring that we continue to highlight our allocations within the Vortec within our notes to provide you appropriate context as we progress. Our new ultra PX product line is being rolled up into our water business unit for reporting purposes and we will likely break this out into a new channel in the future as it grows more substantial.

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

Operator

At this time, we will be conducting a question and answer session. If you would like to ask a question, please press star, one, on your telephone keypad. A confirmation tone will indicate that your line is in the question queue. You may press star, two, if you would like to remove your question from the queue. For participants using speaker equipment, it may be necessary to pick up your handset before pressing the star keys. One moment please while we pull for questions.

Our first question is with Jason Bandel with Evercore ISI. Please proceed with your question.

Jason Bandel

Hi, good afternoon, Bob, Josh and Jim.

Josh Ballard

Hi, Jason.

James Siccardi

Hi, Jason.

Jason Bandel

First question. In your earnings release, you talk about sustainable discipline and diversified growth and how the company is at a key inflection point here. It's more of a high level. As you look out a few years, can you discuss your vision, what the company looks like and how you achieve diversification while also protecting your strong position in DSL and create value?

Bob Mao

Josh, you want to take that?

Josh Ballard

Sure. We have a strong DSL base, which we plan on protecting and we have dedicated teams to that desalination business that we invest into. And we're also investing into the technology in order to stay ahead of any potential competitive threats and so forth in the future. So, we're actively investing and protecting that base business. But our margins financials do allow us to invest in other areas.

And so as we look forward, we would like to diversify and de risk our revenue. We're very concentrated, obviously, in one industry today. And by expanding and diversifying outside of these industries, we can de risk that revenue, create much more growth, as well as create a more stable growth, if you will, right?

In addition, we're looking at really building--we're focused on our PX platform technology, which is focused almost entirely on sustainability, right? I mean, we started out our business, reducing energy costs and VSL. We're looking at how we can reduce waste in oil and gas with

the Vortec. But the other things that we're working on currently today are very much sustainably focused very much focused on reducing energy costs in other industries, so we're expanding on that story with our technology as we look forward, and then hope to really do that in a diversified manner here in the coming years.

Does that answer your question, Jason?

Jason Bandel

It does. No, thanks for that. Now, turning to your water business, obviously, you reiterated your 2021 and 2022 growth rates. Can you talk about opportunities that you're seeing to further grow your projects backlog? And also just noticing aftermarket revenue was also a strong and in the first quarter. Are you seeing opportunities in aftermarkets and is that strength already included in your current guidance?

Bob Mao

Josh?

Josh Ballard

Sure. Let me start with aftermarket. We are seeing a return to our aftermarket business. We did assume that in our guidance, so that has been included. This first quarter is definitely evidence of that. And if I understood your megaproject question correctly, we are very focused on building up that backlog in the mega project space, as early as we can, as you know, we typically sign contracts about 12 to 18 months out. And sometimes a little bit shorter, but on average, 12 to 18 months. We're off to a very strong start with that this year, for not only 2021, but also 2022.

And in terms of growing that, I mean, we haven't lost a project in about seven years. And so, we're sort of capturing that market and growing with it as it expands globally, whether it's in the Middle East or in Asia, where we're seeing lots of growth as well.

Jason Bandel

Perfect.

Bob Mao

(INAUDIBLE) confirm that the aftermarket has fully bounced back from the COVID.

Jason Bandel

Understood, thanks for that clarification. Then the last one for me, just touching on ultra PX capabilities. How do you guys, can you talk more about your education process to the marketplace? Does it require some results when the products you have in the first two contracts in the field itself? Or it can marketing education and partnerships kind of be enough to get the potential customers to understand what you're trying to do with it?

Bob Mao

One part is, indeed, these webinars and other marketing communications we do. But secondly, Jason, is that, as we said this a few minutes ago, we will attend to secure initial projects, commercial projects, in different industry verticals, and thereby with wizard deployment and actual field results, that will educate the market, what are the real efficiencies, and the value that our ultra PX brings. So, you will see that in the coming months, that we expect to penetrate into additional verticals. And that is, I think, that's the most effective or potent way of educating the market.

Jason Bandel

Makes sense. Great. Thanks for the time. I'll turn it back.

Operator

Our next question is with Pavel Molchanov with Raymond James. Please proceed with your question.

Pavel Molchanov

(INAUDIBLE) questions. All of your testing has been in one basin, the Permian. And obviously, an important oil producing area, but by no means the only one. Has your ENP company partner, or Liberty suggested that it might make sense to do some field tests outside the Permian, maybe in another shale play or even in a different geography altogether?

Bob Mao

Eventually, we will do that. However, the Permian is a pretty large place. And it just so happened, this particular and customer has a lot of wells in that region. And we are getting, including the two addition, the one we're doing now, and the two additional ones we plan you May, we should have sufficient data for not only the customer value proposition, verification, but as well as our own Vortec coverage life light tests. So, for the coming couple of months or for the coming 45, 60 days, until we make the report to you on June 10th, the premium serves the total purpose that we need.

Pavel Molchanov

And just to clarify, on June the 10th, you will announce whether Vortec will be commercialized. And if you commercialize it, in which manner or using what strategy, like the GV, both parts of that decision at the same time, right?

Bob Mao

Correct. Yes.

Pavel Molchanov

Okay. My follow up question is on your water kind of capabilities broadly. Obviously, in the last several months, a lot of discussion in Washington about infrastructure, including, \$100 billion dollars proposed water infrastructure spending in Biden's proposal. Do you anticipate any

desalination projects being incremental in the United States in the context of that infrastructure program?

Bob Mao

We hope so. But as you know, Washington push is one thing, respective state level requirements to verify the the, for lack of better term, attractiveness of DSL to the environment. For example, California, that will continue to play a very important role. So, we're hopeful that this bush will result in more initiatives of DSL in the United States.

Pavel Molchanov

Okay. Well, the point about slowness in Washington is well taken. So, thank you very much, guys.

Bob Mao

Thank you.

Josh Ballard

Thank you, Pavel.

Operator

As a reminder, if you would like to ask a question, please press star, one, on your telephone keypad. Ladies and gentlemen, we have reached the end of the question and answer session. And I would like to turn the call back over to Bob Mao for closing remarks. Oh, excuse me, actually, we do have.

Bob Mao

Oh, okay. Go ahead. One more.

Operator

We do have one more question. It's from Wally Walker with Hana Road. Please proceed with your question.

Wally Walker

Yeah. Good afternoon. So, the gross margin percent continues to be extremely high, extraordinary, really for a manufacturing business. Assuming that your customers can also read the financial statements, can you elaborate a little bit on what the value proposition they see, makes them willing to accept that kind of pricing to drive a 70% gross margin?

Bob Mao

Josh?

Josh Ballard

Sure. Hey, Wally.

Wally Walker

Hey.

Josh Ballard

Our product delivers incredible savings to our customers, right? So, if you look at DSL, and this will apply also in industrial wastewater, and we believe in refrigeration. But if you take DSL as our concrete example, we deliver 60% energy savings within the RO process for our customers, which is pretty tremendous. And electricity, energy costs are one of the highest costs, if not the highest costs of an operating DSL plant.

In addition, our product, we like to say, is near perfect. Or I personally like to because we sell them our product, they put it in their plant, it basically lasts for 25 years or so, basically the life of the plant. They don't have to touch it, they don't have to maintain it, they don't want to clean it, right? It just runs and runs and runs. So, the lifecycle value, or lifecycle cost is the lowest in the industry, over the life of our product. And that's why it's so valuable to our customers and why we can get the margins that we can. It's just tremendous value for customers. And there's no competitor out there right now, who can deliver that kind of low lifecycle cost, that kind of life value that we do to our customers.

Wally Walker

And to follow up, as you grow your volume and move into adjacent markets, do you think you can sustain anything close to the current margins?

Josh Ballard

Absolutely, if we can continue to create this kind of value for our customers, I see no reason why we can't have great margins in the other industries we're looking at. We believe we'll achieve similar margins and industrial wastewater. Refrigeration, we'll see, but certainly we're gonna have great margins in refrigeration as well if we're successful with that product.

Wally Walker

Yeah. Okay. Good. Thanks, Josh. Congratulations, guys. Great quarter.

Josh Ballard

Thanks, Wally.

Operator

And now we've reached the end of our question and answer session. I would like to turn the call back over to Bob Mao for closing remarks.

Bob Mao

Well, again, thank you for joining us today. And we're happy that we're able to report not only great DSL performance, but all the exciting new things we are doing, which we'll come back to

those further, the value of our company to view as investors. And we look forward to talking with you again in late July or early August at our next earnings call. Thank you.

Unknown Speaker

Goodbye.

Operator

This concludes tonight's conference. You may disconnect your lines at this time. Thank you for your participation.