ENERGY RECOVERY, INC.

Second Quarter 2020

Earnings Call

Opening Remarks - James Siccardi

Good afternoon everyone, and welcome to Energy Recovery's 2020 second 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, 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, July 30, 2020, 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.

In addition, we may make some references to non-GAAP financial measures during this call. You will find supplemental data in the Company's earnings press release, which was released to newswires and furnished to the SEC earlier today. The press release includes reconciliations of the non-GAAP measures to the comparable GAAP results.

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, with the sincere hope that everyone listening, and your families, are safe and healthy. I am happy to report that the Energy Recovery team, and our business, remains healthy, well and strong.

The COVID-19 pandemic has not abated as hoped, and it has changed how the world and we at Energy Recovery must operate. To date, both the water industry as a whole and Energy Recovery have managed well through this pandemic. We are optimistic on the future. We remain focused on balancing first the health and safety of all our employees, but also on protecting our employees' livelihoods, and shareholders' investments.

Energy Recovery is at a key inflection point. First, like everyone, we are working through the challenges of our new normal during this pandemic and adjusting accordingly. Second, our base water business continues to grow and show long-term resilience, and we continue to support the industry and the millions of people who rely on the fresh water created with the help of our technology. Third, the VorTeq is at a point where we must, in the near term, deliver value to our shareholders, either by monetizing the technology or by bringing an end to our spend.

Finally, in addition to those clear challenges before us, we must think about the future. When I look at Energy Recovery, I do not see a water company, nor do I see an oil & gas company. What I see is a PX company. In fact, Energy Recovery is

the PX company. Over the years, including the time spent on VorTeq, significant investment has been made to build our PX technology platform.

Water

Let's turn to our Water business, which remains strong and dynamic despite the economic and operational challenges presented by the Coronavirus. As evidenced by our recent water awards, our mega project channel continues to show strength and has been largely unaffected by events to date. We are seeing a secular shift in desalination demand as water needs continue to grow globally owing to climate change, population growth and industrialization. The need for more fresh water has not weakened during these tough times. That shows not only in our results this year to date, but also in our backlog and pipeline. It is for this reason that we, again, affirm our guidance of 20-25% growth for the year.

COVID-19 continues to create uncertainty for our 2021 forecast. While we are confident that our mega project business will remain strong, the OEM channel has been more affected by the global economic downturn. Our current overall water backlog and pipeline support a flat 2021 up to modest growth of 5%.

The relative near-term stability we are seeing underscores the strength of the overall water market. The fact is, despite economic uncertainties, access to fresh water is a real and pressing need all around the world. Our pipeline and industry forecasts suggest that over the longer-term, the secular shift in desalination demand remains intact, and we expect a rebound once the economic risks that exist today pass.

Additionally, we continue to see proof of the thermal to SWRO technology conversion occurring in the industry, recently evidenced by our Al Jubail II announcement. This project is a thermal replacement and one of the largest projects in our company's history. As a reminder, from 1980-2018, thermal plant capacity of roughly 23 million cubic meters of produced water per day was commissioned. These plants will eventually transition to SWRO, either as plants approach the end of their useful lives or beforehand owing to the significant efficiencies and cost savings offered by reverse osmosis operations. This translates into approximately half a billion dollars in additional addressable market to Energy Recovery, just to maintain existing capacity.

Oil and Gas

As I turn to our Oil and Gas business, I would like to repeat what I said at our Annual General Shareholders meeting two weeks ago. The VorTeq is in a fundamentally stronger position than it was when I was named interim CEO in November. We have cleared every technical hurdle we have faced. Our late June simulated frac test with Liberty has proved to others what we have long believed - we are ready for live well testing.

Let me restate exactly why that test was important. We did not look at this test as indication that the VorTeq worked because we had long ago proven this fact. This test:

1. Proved to us that the VorTeq should not impede frac operations nor cause failure to a job, which will satisfy end customer safety and quality concerns.
2. Proved to us that the VorTeq can integrate with another team's software, equipment and frac crews.

These are important accomplishments when introducing a new technology to a vastly competitive, mature industry. We are proud of our successes during this test.

The VorTeq skid we tested with Liberty will be our production model 1.0. It is an elegant, simple single PX skid solution which takes advantage of the higher sand concentrations we can now handle. This more compact solution is less costly to produce with greatly reduced lead times and has a smaller footprint making it less intrusive to frac operations. In addition, this model allows operators the freedom to scale the VorTeq up or down to configure their jobs depending on their flow rate, pressure and overall job configuration needs.

The key question for all our shareholders now is: what's next? As we mentioned at the Annual General Meeting, three hurdles remain. We must pass each hurdle, or we will cease investment in VorTeq.

First, we must successfully complete at least 2-3 live well fracs. As we have mentioned, we are working actively with Liberty together to do so. I think all of us understand the current challenges in North American pressure pumping. Our preference is to achieve this with our partner Liberty. However, now that we are free to approach the market, we will also explore opportunities with other operators to expand our search if needed. We cannot wait for the frac market to return to accomplish these live well beta tests.

Second, and related, is that we must prove our customer value proposition with data from the live well fracs. We must validate whether we can achieve our calculated savings of up to $6 million per frac fleet per year. While we have

vetted this data with industry experts, live data will validate our assumptions and calculations.

We should note that the value to our customers extends beyond the direct opex savings on a frac site that we have calculated, but also encompasses areas more difficult to quantify but nonetheless extremely valuable to a customer. For example, significant operational and organizational efficiencies could be obtained as maintenance and logistics challenges become more manageable and breakdowns become more predictable. In addition, with the potential reduced downtime for a frac fleet using the VorTeq, the number of frac stages a fleet could complete each day may increase, which in turn would further lower costs and increase revenue over time. Also, by minimizing pump redundancy and increasing equipment lifespan, the VorTeq can lower costs and reduce the resources required for well completion operations. This in turn can indirectly lower emissions associated with oil & gas production, as longer-lasting equipment means fewer truck trips to replace broken pumps and less energy expended on manufacturing redundant equipment. Increasing equipment lifespan can also help to promote safety on a job site by reducing the exposure of repair personnel.

The third and final hurdle relates to the pressure exchangers themselves. We must maximize the amount of sand that can be processed through the cartridges before wear requires repair or replacement. These cartridges are the single largest cost driver for the VorTeq. Increasing the amount of sand processed by each pressure exchanger will both reduce the frequency of resurfacings needed and the number of cartridges a single frac fleet would use per year. This is critical to meeting our own profit targets and we are not there yet.

I want to be very clear – if we do not pass any one of these hurdles, we do not have a commercial product. We also do not have much time. While it's not possible to give an exact timeline to each of these activities, I can tell you that all of this must happen in less than a year, and we must show significant progress in the life of the cartridges before the end of this year. We are in a good place, but we are not at the finish line yet. We will only commercialize if we have a product that is technically ready and will achieve our profit and ROI targets in a reasonable amount of time.

I would also like to discuss our go-to market strategy now that we have the entire frac market as our potential addressable market. We are in the early days of this analysis, and do not expect to make any firm decisions on potential partnerships or licensing arrangements until we have sufficiently achieved our remaining hurdles. However, we will be approaching the larger, well established pressure pumping companies in the coming months. The basic economics of our go-to-market strategy will not change - we are planning a leasing model as we launch, much as we have described previously, centered around our new single PX system.

Incubation

Now, to turn my discussion to the future. What does it mean to be a PX company and how will we grow and diversify? The truth is, we know the PX better than anyone in the world. The underlying strength of our business, and by extension our financials, stems from this unique technological platform. Because our technology is so focused on delivering tangible value to our customers in the

form of reduced waste and tremendous savings, it in turn creates tangible value in our financials in the form of a growing top line and high margins.

We believe we have the potential to achieve additional high-margin growth, by focusing our incubation efforts on applications of our PX technology platform. For over two decades, the Pressure Exchanger has proven the ability to effortlessly handle pressure of roughly one thousand PSI and relatively clean sea water. We have pushed the envelope of the PX with our work on the VorTeq and we are now able to handle harsh hydraulic fluid at pressures of ten thousand PSI or more. There are many applications, in many industries, within this sandbox that we can explore.

This year we began work on three projects at pressures under 3,000 psi. Two of these projects address new industrial applications of the PX, and at least one of these will not only allow us to expand our water business into new channels but will also be an enabling technology for a variety of other potential adjacent industries. The third project aims to further expand the aperture of the PX technology platform itself. This in turn will allow us to tackle more applications within our PX sandbox. You can see in our financials that these projects require modest investment, but they can create the value that our investors have come to expect. We plan to confirm technical feasibility over the next several months and hope to explicitly discuss our first commercial launch during the third quarter call in late October.

We must be disciplined in our investments, maintaining a focus on increasing shareholder value, and delivering within reasonable time frames. This includes taking a rigorous approach to new product introduction that begins and

ends with direct commercial involvement to ensure we keep our eye on costs and ROI. Incubation efforts must be challenged, and we will not hesitate to shelve or stop spending on efforts that do not meet the cost objectives and return profiles that we have set.

We are also focused on delivering commercial results quickly. This means proving out technical and commercial feasibility within twelve months and achieving the first commercial order within twenty-four. If we do not believe we can achieve that as we begin a new project, we will shelve it. So, we will not pursue another VorTeq in terms of expected timing. We do not believe that limits the potential – and some of the applications we pursue could be transformative to both ERI and to the industries they serve.

At the end of each incubation project, four possible outcomes will be achieved:

1) The products will move into an existing business unit
2) The products will move into a newly formed business unit
3) We will form a joint venture or other partnership
4) Or, we cease investing and close down the project.

We will continue to keep you updated as we launch these future products in the coming quarters.

Before I hand off to Josh, I wanted to discuss one last item. For more than 20 years, we have sought to help our customers achieve more efficient, sustainable operations. Our flagship PX Pressure Exchanger delivers up to 60% energy savings in SWRO. We have played a major part in transforming

desalination from an historically energy-intensive industry into one more sustainable and energy efficient. While water scarcity remains a significant global concern, we take pride providing a solution that reduces both costs and carbon emissions. Our new incubation efforts are finding new ways to continue this good work.

In addition to focusing on how our products can help the world, we also need to look at how we can build a better Energy Recovery for our shareholders, our employees, and the world. Given our focus on growing our business, now seemed an ideal time to provide our first ESG report, which we will issue in the third quarter. Taking this step reflects our commitment towards continuous improvement as we strive to become a more sustainable and resilient business. We look forward to your input once our report is public.

With a stable and growing water business during this economic turmoil, real proof points with the VorTeq, exciting incubation projects, and embarking on our new ESG journey, it could not be a more interesting time at Energy Recovery.

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

Financial Update – Josh

Thank you, Bob.

You know, not many companies can say that they maintained steady revenues during arguably the worst quarter economically since the Great Depression. But that is exactly what we did. We are in a fortunate position, and I

couldn't be prouder of not only our sales team, but also our manufacturing and support teams that delivered this product during such challenging times.

We do see differing dynamics within each of our channels given the recent economic uncertainty. Mega projects continue to show strength with revenue growing 19% year on year. The global economy, however, is affecting our OEM channel, which was down 38% for the quarter and 31% for the first half of 2020 as compared to the same periods last year. We expect this weakness in our OEM channel to continue with near-term project delays in industries we serve, owing to the current economic challenges. For example, a portion of our OEM revenue historically has come from the travel and hospitality industries which we do not expect to recover in the near term. Other industries are also affected. Overall, we expect our OEM channel to be down between 25-35% this year. However, despite the softening in our OEM channel, we believe we will reach our water revenue guidance of 20-25% growth for the year.

As we look to 2021, the basis of our flatter outlook is specifically due to this weakness in the OEM market. Unlike in our mega project channel where we typically close projects 12-18 months out and have visibility up to 36 months out, our smaller OEM channel is less clear with visibility only six months out on average. Now, if the global economy recovers, it's possible that we will see some upside to that forecast due to a strengthening in these smaller projects, and we will advise accordingly in the coming months.

Our base product gross margin, which today is entirely driven by the water segment, decreased 5½% for the quarter year on year. This is largely due to Covid-19. First, reduced production levels due to the coronavirus in the second

quarter decreased our margin by 3.7%. However, we returned to full operating capacity in mid-May. Second, we experienced some pandemic-related delays in commissioning our new Tracy facility late in the quarter while still assuming the burden of the new overhead costs associated with that facility. We were pleased to announce this week that we commissioned our new Tracy location in July. Although we will see a small negative effect on margins in Q3 due to the delayed commissioning, we do not anticipate this pandemic-related downward pressure to otherwise continue unless the Covid situation worsens significantly. However, you may remember that we guided a gross margin in the range of 68-70% this fiscal year due to lower ASPs in our mega project channel and tariff expenses. These pressures have not gone away. We expect gross margin for second half of the year to average at the low end of that range we provided.

We understand the importance of continuing to manufacture and support our customers, as long as we can do so while protecting our employees. We have implemented strict protocols for the safety of our employees who must work on site, including masks, regular disinfections of the facility throughout the day and between shifts, as well as weekly COVID testing. The nature of our manufacturing and the size of our facilities allow our employees to largely maintain proper social distancing while they work. Our office staff continue to work at home. Overall, our employees have adapted well to our new normal. They remain focused on the tasks at hand, and we could not be prouder of the work they are doing.

You will see the recent Schlumberger separation reflected in two areas of our income statement. First, we recognized $24 million of license development revenue this quarter which is the full remaining amount of the original $75

million. This is the final quarter that we will recognize license and development revenue associated with this contract. Second, we recognized an impairment of $2.3 million on assets that we considered directly related to this contract. Specifically, we wrote off assets related to our large and modular VorTeqs, both of which were built with this contract in mind. We have moved fully into launching the single PX Vorteq, and these larger iterations are no longer relevant to commercialization today.

With regards to the single PX VorTeq, note that beyond its technical advantages, it provides us both cost… and operational advantages as well. First, a single PX skid costs roughly 10% of our original VorTeq. With our ability to process higher concentrations of sand, this means that the overall Capex involved for a single frac fleet could be roughly one-third of the original VorTeq, which is a significant reduction in upfront investment for us. In addition, it will be easier to source our skid from more suppliers and our lead times will fall from up to 6 months for the original VorTeq, down to at least 6-8 weeks for the single skids. And we will work on improving that even further.

Let's now turn to our operating expenditures. Overall OPEX excluding the one-time impairment associated with the Schlumberger agreement was $13.5 million, reflecting a 1% increase in the second quarter when compared to Q2 last year, but a 14% decrease from last quarter. This decrease is very much related to our new normal, owing to reduced travel and other employee costs, and a delay in marketing expenses that we would have more typically incurred. In addition, we saw a reduction in R&D spend of about 5% which was entirely driven by reduced spending in our Oil & Gas business. I would also note that although we

do show an increase in our incubation R&D spend, it remains nominal at this time which supports Bob's earlier commentary with regards to our focus on disciplined investment.

I also want to take a couple moments to talk about the future of our R&D spend so you can better understand what is happening underneath the hood. In the first half of this year, we averaged a $6.5 million R&D expense each quarter, with close to $5 million attributable to Oil & Gas.

In the second half of this year, we will be able to reduce our R&D spend on VorTeq without slowing progress to our goals. In fact, we have already realized some reductions from last year. For example, we decreased the number of R&D engineers working on the VorTeq by half – this is a natural transition as the R&D challenges grow smaller. As a result, our R&D spend on VorTeq specifically should decline at least 25% in the second half of the year vs. the first half. This will be offset slightly by some increased spend on incubation efforts in this period, but overall, in the remaining two quarters of the fiscal year, we are expecting to realize an 8-10% reduction in total R&D spend compare to the first half.

And as we look to 2021, you can expect Oil & Gas R&D to fall even further. While we can't define exact numbers today, as it depends on the timing of our final R&D push to commercialization, we can say with certainty that either one of two scenarios will play out in 2021: 1) if we do not pass each of the hurdles in front of us, we will stop investing in VorTeq and that portion of our R&D expense will go to zero. Or (2) If we are successful with commercialization, then at some point in the year our Oil & Gas R&D expense run rate will fall to somewhere between 20-30% of where it is today. Today, all of our expenditures in Texas are

considered R&D, including the manufacturing facility and our field staff. As we move into a commercialized product, almost all of this expense will move into cost of goods sold. So, next year, if we're successful, we will be talking about how our revenues will offset these expenditures and what breakeven and final profitability looks like.

My point of all this is that there is a finite period during which we will continue to spend at the levels you will see this year. As VorTeq R&D winds down, we will settle on a more normalized level of R&D spend as a % of revenue which will naturally control the size of our investments in individual projects, and how we approach them. We will better define 2021 for you in the Q3 call, but I wanted to be clear that we are not on a never-ending VorTeq R&D expense cycle.

In addition, I wanted to further expand on Bob's comments regarding project returns. We have defined very specific financial metrics as we look at new projects. First, a project must have the ability to generate an ROI that exceeds 20% on a conservative basis. Second, any new internal product development must have a potential gross margin that exceeds 50%. This means if we were to fall short of this initial target we would still expect to generate healthy margins north of 40%. In short, we are not a low margin company nor do we seek to be. Third, any project must be able to achieve a cash flow neutral run rate by its third year. This means time to market and ramp up to profitability are both key KPIs.

It is part of my job to ensure we remain focused on the commercial aspects of our new product development. We are serious about these KPIs and are continually reviewing our existing projects through this lens.

Finally, a few words on our cash position. We have seen little, if any, effect of this crisis on our cash flows to date. We remain in a good position from a cash and liquidity perspective. As our investment portfolio in corporate bonds has matured, we have shifted a significant portion of these investments into cash for the time being. Only 6% of our cash and investments are in long-term investments today. We have ample liquidity to support the company while we all find our way during these uncertain times.

With that, let's move to the question and answer portion of our call. Thank you.

FINAL WORDS (BOB)

Thank you for joining us this afternoon. We look forward to speaking with you in October. In the meantime, please keep yourselves and your families safe. With that, we will now take your questions.