

Energy Recovery
Q2 2020 Earnings Call
October 29, 2020

Presenters

Bob Mao, Chairman, President, and Chief Executive Officer
Josh Ballard, Chief Financial Officer
James Siccardi, Vice President of Investor Relations

Q&A Participants

Pavel Molchanov - Raymond James
Ryan Pfingst - B. Riley Securities

Operator

Good afternoon ladies and gentlemen and thank you for standing by. Welcome to the Energy Recovery third quarter 2020 earnings call. At this time all participants are in a listen only mode. A question and answer session will follow the formal presentation. Should you require operator assistance during the conference, please press star zero to signal an operator. Please note, this conference is being recorded.

I will now turn the conference over to your host James Siccardi, Vice President of Investor Relations for Energy Recovery. Thank you. You may begin.

James Siccardi

Good afternoon, everyone. And welcome to Energy Recovery's 2020 third 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 and 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 commercial VorTek, 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, October 29th, 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. 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. I want to start today's call as I did last quarter, with sincere hope that everyone listening and your families are safe and healthy. Once again, I am happy to report that the Energy Recovery team and our business remain healthy, well, and strong. Energy Recovery is evolving well into a COVID inspired new normal.

Where (INAUDIBLE) continue to steadily achieve growth both in our base business as well as in our new business initiatives. The disciplined financial and time bounded approach to our new initiatives as reported in our last earning call is being strictly executed which should translate to greater bottom line results and increased return for our investors.

Following in the format of my previous earning call report, I will provide you updates to our water business and forecast development in our oil and gas business. In addition, in our last earning call we committed to provide more details on our incubation effort for the PX technology platform since we started at the end of the first quarter of this year.

Today we are happy to report one of the efforts, ZLD, zero liquid discharge, which has just graduated into commercialization was receipt of the first purchase order. Let's begin with our water business which country needs to be healthy and strong. Riding our incredibly strong global desalination growth even amidst the COVID pandemic. This third quarter was ERI's biggest water revenue generating quarter ever, eclipsing last year's higher quarter record by 26%.

At this time we feel confident increasing our previously projected 20 to 25% water revenue growth for Fiscal Year 2020 up to 25%. We also feel confident increasing our 2021 gross outlook to 10% from the flat to five percent gross rate we communicated last quarter. Finally and just when desalination industry trends allows us to optimistically anticipate water revenue growth in 2022 similar to what we are achieving in 2020.

Despite global seawater reverse osmosis desalination growth trend, it is anchored in the equipment we need to provide access to clean water in many parts of the world. In addition to the basic need, three other trends are helping to growth in seawater reverse osmosis.

First, the technological shift from inefficient thermal desalination plants to reverse osmosis is becoming a growing portion of our pipeline. Second, acceptance of private financing into desalination construction in places like Saudi Arabia, Dubai, Egypt, and India is increasingly decoupling desalination capital projects from national fiscal budgets, which may be susceptible to overpriced needs and COVID-19. And finally geopolitical issues are creating an urgent strategic need for desalination in countries like Egypt along the construction of the Nile River dam in Ethiopia threatens Egypt's water independence.

In addition to our fundamentally strong baseline seawater reverse osmosis outlook our first incubation initiative, zero liquid discharge, or ZLD, is focused on our water business. Specifically the wastewater industry. In fact, we are excited to announce that we received our first commercial purchase order for our new wastewater production from a customer in India just this last week. Which is very encouraging.

A global regulatory push is currently being lead by China and India to implement more environmentally friendly practices in industrial wastewater treatment. Most countries are struggling with maintaining clean water sources and they are seeking to maximize the recovery of clean water and minimize the impact of wastewater disposal polluting their waterways. ZLD allows for this by fully removing the harmful industrial waste from the water and reintroducing or recycling only clean water.

The ZLD market is in its nascent stages. It is a fragmented market and multiple competing technologies none of which has emerged as a dominant technology. Much like the desalination market. We believe our reverse osmosis is the optimal solution. However, unlike desalination the pressure is needed to achieve zero or minimum liquid discharge are nearly \$200, I'm sorry, 2,000 PSI. Or roughly double that of seawater desalination.

To address this we are using our PX technology platform to build a high pressure PX application which we call the ultra PX. We believe our technology has the potential to become the dominant solution in ZLD wastewater just like our legendary PX has dominated the seawater reverse osmosis market. Our preliminary ZLD market research identified existing wastewater application both our ultra PX with the potential for the addressable market in China as high as \$100 million U.S. dollars which would not include further annual growth as the market expands.

We see a similar opportunity in India where we recently received our first purchase order. And we believe that markets globally will move further toward both zero and minimal discharge technology over time as clean water becomes a more critical research. Now that it has achieved commercialization, ZLD will move out of incubation and into our water business unit. We're proud of our R&D and commercial teams and their ability to commercialize our new ultra PX using (INAUDIBLE) from initial incubation. Well below our two year project commitment.

ZLD should achieve a return on investment far exceed 20%. And we anticipate ultimately achieving margins at levels comparable to our base water business. Finally, we anticipate positive operating cashflow from the onset with our first purchase order in hand. We are truly confident in the potential of our water business as we look forward. Our baseline seawater desalination business continues to enjoy a (INAUDIBLE) upswing with no end in sight over the next few years. And we are excited about the potential of our new wastewater business efforts. We look forward to update you on both in the future.

Next we turn to our oil and gas business and VorTeq. Where I continue to view the progress we made with great pride. We have developed our production model 1.0 which was utilized during our previously reported fuel simulation frack with Liberty Oilfield Services. However the three hurdles we outline must still be clear before we commercialize.

One, successfully compete three industry live fracks. Two, validate our customer value proposition. And three, maximize the amount of sand that can be pushed through the cartridges before repair or replacement. As I said at the beginning of these live fracks and by extension our value proposition we are aggressively seeking to get out and live frack before year end. As live frack verification is critical to establishing the VorTeq value proposition for our customers and to verify our VorTeq cartridge serve spec.

In addition to our ongoing dialogue with Liberty, we have taken calls from and hosted in Katy additional oilfield service companies interested in the potential use of VorTeq. We are pleased with the response companies are giving us and the willingness in which they have introduced VorTeq to their own customers. We remain confident in our ability to achieve the live well requirements as outlined last quarter. And quantifying our value proposition. As soon as we have achieved our first live drill, we will let you know.

With regard to the final hurdle, we're making solid progress in cartridge life extension. And manufacturing and financing. We believe we identified a solution to achieve our cartridge life or at a minimum a solution that will give us a material step forward to this end goal. And we'll be testing the solution at the end of the year.

We continue to remind ourselves we need to commercialize VorTeq by midyear 2021 or else stop investing. Our committed timeline has not changed.

Next we report on the incubation. I discussed earlier our ZLD initiative. The first incubation effort to graduate to an exciting business unit. In addition to the ZLD market there are a multitude of potential applications for our ultra high pressure PX in a variety of industries both in and outside of water. We see significant future potential for our ultra high pressure PX technology and believe it could become a significant percentage of our revenue in the coming years.

We are also making progress on our second PX incubation initiative, targeted at a very large global industry currently undergoing regulatory driven transformation. While this product had the potential of being transformative in much the same manner that PX transformed the desalination industry we are at the technology feasibility stage. And so we'll forgo deeper discussion at this point. We expect a report on the progress of the incubation effort when we speak to you again in March. At which time we will have either proved our technical feasibility or ceased investing.

Finally, we mentioned last quarter that we're working on a project that will expand the aperture of our PX technology platform thereby creating new PX applications in new industries. This project is a zero mix PX. Zero mixing simply means that there is no comingling of fluids as columns of fluid transfer their pressure within the PX. That direction does occur in our current applications in desalination and in oil and gas. But mixing however slight can exclude the PX from being applied to many applications such as gas processing or chemicals among others. Where our technology could potentially help reduce energy consumption and thereby cost in existing systems.

We have already proven the technical feasibility of this extension of our technology and that we are now working on longer life and reliability. As we begin to apply this technology to new applications we will update you on our progress and the potential of these new markets.

(INAUDIBLE) let's turn to ESG. As you know, we released our inaugural ESG report in September. Where our business has always been aligned with sustainability issues such as addressing global water scarcity and improved access to affordable and clean energy. Our ESG report reflects our commitment to become a more sustainable and (INAUDIBLE) business.

The initial drive to build out our ESG program is based on our business skills as well as inputs from our key stakeholders. The pursuit of more efficient sustainable customer solutions has been the core of our DNA since our founding more than 20 years ago. We're proud of the impact our technology has in making desalination more efficient and sustainable. Particularly as our world confronts growing water scarcity.

Our new ventures will continue to focus our energy efficiency and the pandemic. As we use our own pressure change technology to drive new growth opportunities we desire to do so while providing you efficient and sustainable solutions to industrial needs. This is an exciting time at Energy Recovery. Our water chain is focused on maintaining the momentum of our desalination business as well as expanding our reach with the launch of the new GID(PH) product. Our oil and gas team is focused on finding and on climate rising and commercializing VorTeq.

And finally our incubation efforts are focused on achieving technical verification on one product that could prove transformative and another that could further expand the aperture of our PX for (INAUDIBLE). We are transitioning Energy Recovery into a growth company on the basis of

our very versatile pressure exchanger. We are giving you an inside seat to this transition by reporting our progress, our wins, and our failures.

We are investing our hard earned cash and you should know how and why we are investing it. We will continue to tell you what to expect, give you updates on our coverage, and provide details on the outcomes. If we fail you will know why, but when we succeed you should not be surprised. In short, you will see every punch we land and every hit we take. And we do not plan to take any hits.

With that I will hand it over to Josh.

Josh Ballard

Thank you, Bob. As we saw last quarter, each channel in the water business continues to experience differing dynamics. Mega projects remain dominant growing 70% year on year in the quarter and an impressive 48% year to date. As expected both the OEM and after market channels remain weak as compared to 2019, falling 22 and 47% respectively in the quarter from a year ago.

Based on Bob's affirmation of at least 25% growth in our water business this year we should expect a very strong fourth quarter. I've mentioned in the past calls that it's hard to pinpoint quarterly trends in our business. In both 2018 and 19 we experienced a drop off in sales in the fourth quarter. However, this year our fourth quarter sales should be comparable to that of the third quarter.

As we look to 21 and 22 we do expect to see our OEM and after market channels recover. However, the extent of that recovery will largely depend on the global effects of COVID over this winter and next spring. While some industries will remain weak within these channels regardless, most notably travel and hospitality, at this time we believe pent up demand in other industries may help return the OEM and after market channels to more normalized levels which is lending to our increased confidence in projections for next year.

I should also note that revenue from our new ZLD market is not yet included in these projections. As we build our pipeline and grow more comfortable we will provide more clarity. That being said it's probably fair to assume that our initial revenue will be in the single digit million the first couple of years with considerably more growth in the future. Also note that these projects will be of a different nature than the large mega project desalination plants driving our water growth today.

A typical ZLD project will be in the range of \$50 to \$150,000 in revenue but there are potentially a much larger number of these projects than we have seen in desalination. For example, if we assume \$100 million market in China as Bob outlined this will imply roughly 100 projects whereas in desalination it could be as low as 10.

Our product gross margin decreased by 360 basis points as compared to Q3 2019. We showed a healthy 550 basis point increase from our low mark in the second quarter of this year. And somewhat exceeded our expectations this quarter. Our margin's strengthening over last quarter's largely due to our return to normal production levels at the end of Q2. While we did have a small effect from COVID due to the delay in the commissioning of our new ceramics plant in Tracy, California that affect was muted compared to prior quarters.

We are pleased with how well our manufacturing team is operating within the restrictions of COVID, and we continue to work on the strict protocols to ensure the safety of our employees as well as the continuity of our business.

In addition, our decreased OEM sales lead to lower than expected sales of turbo chargers and pumps which proved accrete at the margins as these products are less profitable than our PX sales in this channel. Last year we mentioned some margin pressure owing to lower ASPs as a result of bigger order sizes as we serve ever larger desalination projects. We expect this trend to continue in Q4 and to round out the fiscal year with roughly 68 to 69% gross margin despite a reduced effect from COVID.

As we look to 2021 the fundamentals of our gross margin will remain largely the same excluding the potential of any temporary COVID-19 related effects. At this time we don't expect to see a shift in our water business outside of this 68 to 70% range.

Let's now turn to our operating expenditures where we have reported a decrease of nine percent compared to Q3 2019. While our opex is somewhat lower than planned today due to COVID, the real story is in R&D where you will see a 23% decrease compared to Q3 last year and a similar decrease as compared to the first half of 2020.

While our R&D expense may increase somewhat in Q4 we expect it to remain roughly 15 to 20% lower than the first half of 2020. If there is a single theme that Bob and I want you to hear it is that of discipline. Discipline in our R&D efforts as well as our operations and by extension our expenses. For example this year we terminated some projects altogether that would not have achieved our commercial KPIs and the expenses from these projects ceased.

And as we look at our opex going forward, while we expect opex to grow we are focused on reducing our spend as a percentage of revenue over the next two to three years to a more normalized level as related to our peers in the market. Over the past decade we have reported annual opex higher than 60 to 65% of revenue every year and would have been in a similar range this year if not for the second quarter termination of the Schlumberger contract and subsequent GAAP recognition of the remaining license and development revenue.

We are targeting our opex to drop to a range of 35 to 40% of revenue by 2022 and subsequently to reduce it to the low 30s which will be more in line with our peers in the

market. This taming of opex will be done in two ways. First, we will be capping our R&D as a percent of revenue in our baseline budgets. Our R&D expenses averaged over 20% of revenue the past few years due to our elevated spend on the VorTeq.

In 2021 we will be targeting a range closer to 15 to 20% with the goal in lowering it further in 2022 towards the 10 to 15% range. Keep in mind that this percentage will be decreasing despite the fact that we are guiding total revenues lower next year due to this year's increase in revenue from the termination of the Schlumberger contract. You can expect a clear reduction in R&D by the second half of next year as we reduce spend on the VorTeq and wind down those R&D activities.

In addition, base R&D spend on our incubation projects is expected to remain in the single digit millions, a far cry from the level of spend we saw with the VorTeq. Second, we will continue to leverage our existing infrastructure which will slow G&A growth in the coming years. We have invested significantly in the new system the past 18 months to better modernize our operations and leverage our back office as we grow. And we should see the fruits of this labor as we expect G&A spending growth to continue to lag that of revenue.

This year G&A spend is somewhat lower than planned due to COVID-19. Next year we expect more normalized G&A spend and growth will generally occur from inflation and a reversion to the norm rather than increasing resources. I expect total G&A to grow no more than 10% in 2021 and further decrease in growth in subsequent years as like R&D we aim to reduce G&A as a percent of revenue to the mid to high teens over the medium to long term. Scale to marketing spend is expected to stay roughly where it is today, around 10 to 12% of revenue.

Lastly as it concerns opex please keep in mind that our current level of spend assumes success with the VorTeq. If the VorTeq does not commercialize in 2021 our overall opex spend would decline considerably as we reduce activities in our oil and gas business unit and cease R&D. If in modeling you keep similar levels of opex you should then assume revenue from the commercialization of the VorTeq.

If we commercialize the VorTeq we expect up to a 40 to 50% reduction in oil and gas opex spend overall with about half of that reduction due to shifting of spend and the cost of goods sold once we begin to generate revenue. And the other half due to decreased R&D. All told this will result in an overall reduction in total R&D spend of at least 20 to 25% next year. Total reductions will depend on how quickly we commercialize or cease operations.

Finally a few words on our cash and investments position which ended at \$106 million for the quarter. We continue to see no effect on cash from the global economic uncertainty. In fact our accounts receivable is the cleanest it has ever been which is reflective of the strong position the desalination industry finds itself in despite these strange times. For now we continue to shift our corporate bond portfolio into cash as securities mature. As the future becomes more certain we will revisit our longer term plans.

CapEx investments look to finish the year in the mid to lower end of the eight to \$10 million I guided this time last year. Our baseline CapEx for 2021 is planned at five to seven million dollars. Now this baseline excludes any CapEx related to the potential commercialization of the VorTeq which will become clearer if and when we commercialize and we will provide more clarity at that time.

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

Operator

Thank you. 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 your line is in the question queue. If at any time you wish to remove your question from the queue please press star two. For participants using speaker equipment it may be necessary to pick up your handset before pressing the star keys.

One moment please while we poll for questions.

Our first question is from Pavel Molchanov with Raymond James.

Pavel Molchanov

Thanks for taking the question. I want to just review the guidance targets that you gave, make sure we all heard them right. Following 25% water revenue growth this year it should slow to 10% growth next year but then reaccelerate to 25% in 22. Is that correct?

Josh Ballard

Correct.

James Siccardi

Yes. That's what we said, yes.

Pavel Molchanov

So what gives you the confidence that 22 will see this acceleration in the growth rate? Is it specific projects, specific geographies, specific customers?

Bob Mao

Actually all of the above. Specific projects, specific (INAUDIBLE), specific geographies, and in fact we already have some back log going into 2022. So it's not depending on macro market trends only. It is on the ground actually project by project customer by customer.

Pavel Molchanov

Okay. And does it include retrofits of legacy plants? Or are you only looking at green field new builds?

Bob Mao

Both.

Pavel Molchanov

Okay. My final question was about your comment about an industry that is being transformed by government regulation. And I'm sorry if this is a silly question but are you referring to the oil and gas industry or something else?

Bob Mao

We will clarify that next call as we are in the technical feasibility phase.

Pavel Molchanov

Okay. Fair enough. We'll look forward to that. Thank you guys.

Bob Mao

Thank you.

Operator

Our next question is from Ryan Pfingst with B. Riley Securities.

Ryan Pfingst

Hey, good evening guys.

Josh Ballard

Evening.

James Siccardi

Hey, Ryan.

Ryan Pfingst

In terms of your inventory of VorTeq equipment for the new single cartridge skid design if the opportunity presented itself could you simultaneously execute one well with Liberty and another with a different pressure pumper? If not then are you prioritizing the first attempted well with Liberty above all other options or if another interested party wanted to conduct a live well test before a Liberty customer is ready would you move forward with that opportunity?

Bob Mao

We have enough inventories to do both should that pleasant opportunity arise.

Ryan Pfingst

Okay. That's helpful. And then for hurdle number three on the path to commercialization, the volume of fracked sand that the cartridge can process before it needs to be repaired or

replaced how far along are you now towards your target? I know that by year end you aim to be at 50% with clear visibility on reaching 100%. Could you give some insight on maybe what percentage you're at now or where you exited the third quarter?

Bob Mao

We are on track to reach those targets.

Ryan Pfingst

Okay. So on track for, you know, 100% visibility by year end?

Bob Mao

Yes.

Ryan Pfingst

Great. And then turning to the new PX derivative product developments could you give some other examples of potential end users that you're investigating now?

Bob Mao

We should particularly with zero mixing. And that will open up additional end user in the chemical industry where no mixing is allowed at all.

Ryan Pfingst

Alright. Thank you. And then maybe just one last one for Josh. Could you please provide the third quarter breakdown for water revenue by segment?

Josh Ballard

Sure. It's 76% for the mega projects, 15% for OEM, and about 10% for after market.

Ryan Pfingst

Alright guys. I appreciate the responses.

Josh Ballard

You bet.

Operator

As a reminder, hit star one to enter the question queue. Our next question is from Ken Hershberg(PH), private investor.

Ken Hershberg

Congratulations on the excellent quarter and all the progress you're making. Could you please give us an update on the commercialization of the IsoGen and IsoBoost? Thank you.

Bob Mao

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On that one we are in discussion with potential customers to deploy our standard product. And of course you know our source project is truly new operation and very happily accepted by our customer. So what we look for here is for a standard product applicable to a larger base of customers rather doing individual almost custom made projects. So we're making progress. We expect to report more at the next earning call.

Ken Hershberg

Thank you. That's for IsoGen and IsoBoost?

Bob Mao

Yes, both IsoGen and IsoBoost. Did I answer your question?

Ken Hershberg

Yes you did. Thank you very much. I appreciate that.

Bob Mao

Thank you.

Operator

Ladies and gentlemen we have reached the end of the question and answer session and I'd like to turn the call back to James Siccardi for closing remarks.

James Siccardi

I wanna thank everyone for joining us today. For your convenience we've decided to put our prepared remarks up on our website. You can access that at any chance that you have. Again, thank you very much for joining us and we look forward to speaking with you again in March. Please be safe.

Operator

This concludes today's conference. Energy Recovery thanks you for your participation. You may disconnect your lines at this time.