Energy Recovery
Second Quarter 2021 Earnings Call
August 5th, 2021

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

Q&A Participants
Pavel Molchanov - Raymond James
Nils Thommesen - Fearnley Securities

Operator
Greetings and welcome to Energy Recovery Second Quarter 2021 Earnings 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 today, James Siccardi, Vice-President of Investor Relations. Please proceed.

James Siccardi
Good afternoon everyone and welcome to Energy Recovery's 2021 Second Quarter conference call. My name is Jim Siccardi, Vice-President of Investor Relations at Energy Recovery 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 VorTeq, growth expectations, new products' net 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 government'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 today, August 5th,

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'd 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. During the second quarter, our evolution as a PX based platform company continued to gain steam. We're seeing momentum for our new water solutions outside of seawater desalination, and we made progress with VorTeq and substantial strides in refrigeration. Today, I will describe to you in greater detail our activities in each of our new lines of business, including technical challenges as well as new insights into our go-to market strategies. Each new industry will present its own unique challenges, but we're ready. Let me start with desalination. Our desalination business is performing in line with expectations.

The dumbbell shape of our water revenue that Josh mentioned last quarter, is playing out as expected, while our second quarter revenue of $21 million was lower than the first quarter, we expect strong annual product revenue results. Our backlog is strong, our growth outlook remains robust at 10% this year, and 25% in 2022. The Middle East remains our most active region, and we do not foresee that changing in the near term. However, we are encouraged by other regions that are appearing in our pipeline, most notably Asian, where we had been generating only nominal revenues the past few years. China's recent Action Plan, which calls for a 75% increase in desalination capacity, could lead to desalination on a far greater scale in the region. We remain very bullish on the potential of desalination not only for the next two years, but for many years to come.

Let's now turn to our growing industrial wastewater business. As we announced earlier this week, we recently secured additional three awards, all in China, related to landfill chemical, and lithium battery industries. Over the past nine months, we have secured five awards in four industries, including those just mentioned, as well as natural gas. These initial awards will allow us to accumulate the real-life data we need, to show the benefits reverse osmosis methods provide, together with our PX and ultra-PX as we have shown in seawater desalination.

Our next focus will be to expand our brand recognition within these new markets. We will work with our reverse osmosis partners to educate these markets as to why our pressure exchanger together with other RO technologies is the most cost effective, sustainable solution to meet growing industrial wastewater treatment requirements. I would like to take a little time to dive into one of these markets today; lithium batteries.

In 2020, there were roughly 450 gigawatt hours of global lithium battery capacity with 60% of this in China, which is expected to grow to nearly 2,500-gigawatt hour by 2030. If we conservatively assume the average battery capacity of a vehicle is 90-kilowatt hour, which is the

capacity of a Tesla Model S, then this overall market capacity equates to roughly 5 million electric vehicles growing to nearly 30 million vehicles, over that period.
While we cannot yet know the exact size of this market, based on these capacity assumptions we estimate up to a 20 milloin one-time total addressable market TAM for our PXs in the lithium battery market today. We expect this market to grow on average by at least $10 million dollars per year through the next decade, for a total TAM of up to $120 million dollars. This is in addition to each of the $100 million dollars one-time TAMs, we previously mentioned in both China and India. This is an example of the potential of a single industry. But the concept can be extended to other industries as well. We may not know exactly when an industry may shift to more sustainable method of wastewater treatment.

However, judging by the increasingly dire freshwater concerns we have cited many times in our calls, we believe that this will become an issue outside of just China and India sooner rather than later. We're now digging deeper into these new verticals, to increase our knowledge of the best strategy to expand sales in China, India and the rest of the world. However, not all industrial water is the same. It can vary by amounts and types of solids, viscosity and other parameters that need to be addressed by our technology. Therefore, we are also laying out a product roadmap to approach this wider industrial wastewater market. Next quarter, we plan to share our thoughts on how industrial wastewater could potentially impact our revenue outlook, over the next five years.

Now we turn to VorTeq. At our Annual Shareholders Meeting in June, we highlighted the progress made during multiple live well (PH) field trials, where the VorTeq was deployed. Year to date, we have participated in four field trials and completed 40 frack stages. These trials clearly demonstrated that the VorTeq can perform as envisioned without interrupting or impeding normal frack operations. In addition, we're encouraged by the positive feedback we received from Liberty Oil Services and their customer. We have repeatedly stated that the key to achieve profitable commercialization is cartridge life extension. Today, I will describe a little more detail what we are trying to achieve.

Our cartridges are made from the second hardest material known to man, tungsten carbide, but even tungsten carbide wears, under the abrasiveness of sand, at pressures as high as 10,000 pounds per square inch, and over time, we must refurbish the cartridges as this occurs. To extend cartridge life in between refurbishments, we designed and are testing solutions to protect portions of our cartridge with industrial diamonds. We're looking at a variety of production methods to apply diamond to our tungsten carbide cartridges that we believe hold great promise. Our challenge is to attach a diamond to the tungsten to withstand high pressures, and at the size we need.

This has not previously been done at such extremes. The process is iterative and entails work at both our supplier’s facilities and our own. We then test, analyze, identify new issues again work with our suppliers on a new iteration of the PX. While we await results over cartridge life enhancement efforts, we continue to move forward on our go-to market strategy. To maximize

its potential, it is critical that the VorTeq becomes a standard piece of equipment on our frack site that our customers take ownership, and ultimately operate the VorTeq themselves. Therefore, we are prepared to offer the design of our skid to our customers, without charge to build themselves while we provide and maintain the cartridges needed to run the VorTeq. In essence, we are providing them with a reference design of our system. This will ease our supply chain, creating ownership over the system with our customers, and ultimately, enable us to focus on what we do best; design and manufacture pressure exchanger cartridges. We will continue to update you on this front.

Now let us turn to our new product: the PX G1300 Energy Recovery Device for refrigeration or PXG. Global regulations are accelerating a shift away from refrigerants, such as hydrofluorocarbons or HFC to more natural ones such as co2. Most developed countries are making this transition within the next 15 years. Phasing out HFCs has the potential to help avoid a half a degree Celsius increase in temperature globally. This is significant.

For Energy Recovery, this transition could translate into a roughly $1 billion-dollar annual TAM by the end of this decade, in commercial and industrial refrigeration alone. The current co2 systems operate at pressures four to five times higher than the more efficient HFC based ones. This means that a co2 system without energy recovery device is much more expensive to operate. Existing energy recovery technologies for co2 systems can recover only about 10% of wasted pressure energy, and importantly, only operate efficiently in a narrow range of temperatures that cap out at roughly 75 degrees Fahrenheit.

Moreover, the efficiency of these technologies actually degrades as temperatures increase. Our PXG is designed to resolve these challenges. The warmer it gets, the better PXG performs. In fact, the PXG can potentially increase the breadth of the market for co2 systems globally, by approaching hotter regions that have been an economically insurmountable hurdle for the industry today. Going to the rapid transition happening within the refrigeration industry and the weakness of existing energy recovery technologies, we feel a real sense of urgency to bring our product to market, as quickly as possible. Our strategy for this involves a two-pronged approach. First, we offer a system that can bolt on to existing co2 systems, allowing customers to begin to achieve real energy savings with our PXG. This approach will allow our system to be decoupled from operations.

In the event of failure, the system will simply bypass our PXG automatically and operate as if it was not present. This is a streamlined approach for customers with existing co2 systems already installed, providing them assurance that our new technology will not melt their ice cream, while giving them the firsthand evidence of the benefits it can offer. While this retrofit approach will allow customers to achieve material cost savings, it will not show the full potential of our technology. To achieve this, our second approach is to provide a PXG-centric reference design to the industry, at no cost, to accelerate the adoption of our technology.

This PXG centric system will fully leverage the power of our PXG with the goal of dramatically decreasing energy consumption and operating costs for our customers, thereby making their shift to a sustainable co2 system as financially painless as possible.
Refrigeration technologies have changed very little over the past 100 years. We believe that PXG has the potential to disrupt the global refrigeration industry, much as the PX did in desalination and if this is successful, we could not only accelerate the sale of our PXGs but also help accelerate the adoption of co2 systems, and significantly contribute to the reduction of global warming gases. To achieve this, we must educate the refrigeration market, on our PXG and make it as easy as possible for customer to try and ultimately, adopt our technology. We have come far with the PXG over the past 15 months, we have tested it across a range of temperatures in our full refrigeration test loop in California, built a control system to manage it in operations, and are building our first commercial ready system, as we speak. We truly believe this could be a game changer for the refrigeration industry.

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

Joshua Ballard
Thank you, Bob. Product revenues slowed to 7% growth in the second quarter as expected, but our outlook remains intact. As a reminder, our revenue this year is dumbbell shaped, with our first and fourth quarters being the highest revenue quarters, and the second and third being the lowest. You should expect a similar level of revenue in Q3 as in Q2, roughly between $19 and $21 million dollars. Given that last year's third quarter was our largest the year over year comparison will show a decrease in Q3. However, barring any unforeseen circumstances, our fourth quarter should be the largest one this year, allowing us to achieve our 10% guided growth. You should also note that we are beginning to experience growth in OEM sales. The second quarter and 2020 was the first fully impacted COVID-19 quarter, and the 6% growth in OEM reflects our first increase, since the onset of the pandemic.

We are currently seeing a rebound in OEM activity across most territories and industry sectors including hospitality. While aftermarket sales fell this quarter, the overall trend for the year is beginning to feel positive. We feel a similar optimism about our OEM sales, which may lead to upside to our 10% guidance for this year. However, we are hesitant to change our outlook at this time until we have a better sense of where COVID-19 is headed. As a final note to revenue, this is the last quarter we will show year on year quarterly comparison that includes GAAP revenue recognized revenue from the old Schlumberger contract, which terminated in June 2020. In Q2 2020, we recognized the remaining revenue associated with that contract, which created a large bump of non-cash revenue. On a quarterly basis, this will no longer be a factor.

Our gross margin came in lower than our annual guidance of this quarter. This is a temporary phenomenon largely driven by increased sales of lower margin non-PX products such as pumps and turbochargers, as OEM sales rebounded. This has happened from time to time in previous years as well. As of today, we still expect to achieve roughly 68% gross margin for the year. It is important to note that this dip is not due to any permanent changes in our economics i.e. our ASPs are holding strong. While we're watching inflationary pressures, we are not experiencing significant inflation today. If we were to slip below 60% gross margin this year, this would be owing to higher-than-expected OEM revenue and therefore, gross profit.

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

Growth in our DNA spend is largely due to normal inflation and the return of some expenses as employees returned to the office, travel picked up that kind of thing. The fairly large percentage increase in sales and marketing spend this quarter is for two reasons. First, we are seeing a rebound in trade and marketing and commissions as our base desal business begins to see renewed life in marketing activities and OEM sales. And second, we are investing in building our teams in support of industrial wastewater and refrigeration. We anticipate continuing to invest in sales and marketing well into 2022, as we add further resources to ensure success in these two markets. Now let's turn to cash. Operating cashflow grew substantially driven by strong customer receipts following very strong sales in Q1. Note that we expect moderately negative operating cashflow in the third and fourth quarters, due to the lower sales in Q2, Q3 and therefore, decreased customer receipts that will follow.

However, our large projected Q4 revenue should lead to a corresponding increase in Q1 ‘22 cashflow. CapEx is roughly half of it was this time last year, for the full year we expect CapEx to be more or less in line with last year's at between $6 to $7 million dollars. Our investments to date this year have largely been in our corporate offices as we expand and build out for future growth, as well as to create a safer and socially distanced office, during this pandemic. During the second half of this year, we are adding a kiln (PH) to expand production and to create some redundancy, as well as upgrading and adding to aging equipment.

Our cash and securities balance increased to $121 million dollars, despite nearly $12 million dollars in share buybacks, we repurchased 657,000 shares on the open market at an average price of $17.60 per share. We will continue to execute our buyback program in a disciplined manner, as opportunities arise to maximize the number of shares we repurchase. Finally, a quick comment about the organization. Overall, our team continues to execute admirably despite the ups and downs of COVID.

Today, roughly 25% of our staff continues to work offsite. While we have opened the office back up to those who wish to return, we have not mandated a full return as of today. We continue to prepare for the growth that is coming and are excited by the potential that we can all see in our existing and new businesses. Thank you, and I will now hand it back to our moderator for Q&A.

Operator
Thank you. At this time, we will conduct 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 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. Once again that's star one to ask a question at this time. One moment while we poll for our first question. Our first question comes from Pavel Molchanov with Raymond James, please proceed.

Pavel Molchanov
Thanks for taking the question and appreciate the technical update on VorTeq and the cartridges. Going forward should we assume that you will be providing these technical update, essentially every three months on a recurring basis--you know, as you continue to move along the development process?

James Siccardi
The simple answer is yes, to varying degrees of depth, yes.

Pavel Molchanov
Okay. And is there--I suppose, when you give the plans, the blueprint, so to speak to your prospective customers, will you be selling them? Is there going to be a cost associated with that, that you will generate revenue from? Or is that on a pre-purchase basis? How's that going to work for them to get the information?

Bob Mao
Well, as I said, we provide this information free of charge, you can think a comparable situation in another industry, for years, when Intel comes out with a new generation of CPU, they give every PC manufacturer a reference design, and they can simply use that and produce the next generation PCs. They could also of course, for--optimize even more. Since very analogous to the Intel CPUs, since we are the central part of this energy saving construct, but we do not produce the total system whether (PH) it is in VorTeq, and also in refrigeration, we give the reference design free of charge. And when they deploy the reference design, of course, they buy the most important central part from us, which is the PX. Intel never charged anybody for reference design. Neither does Qualcomm.

Pavel Molchanov

Okay, good comparison. And then finally, do you see any reason at this stage, to be testing VorTeq outside the Permian Basin, perhaps in other shale production areas like the Balkan or even outside the United States, maybe in Argentina?

Bob Mao
We do not see a need because there is no difference; a fracking site is a fracking site, and there's no substantial difference that we can discern that will make one site so uniquely different that will affect our equipment design. No.

Pavel Molchanov
Okay, thank you very much, guys.

Operator
Once again, ladies and gentlemen, to ask a question, please press star one on your telephone keypad. Our next question comes from Nils Thommesen with Fearnley Securities, please proceed.

Nils Thommesen
Good afternoon, gentlemen. Can you hear me?

Bob Mao
Yes, good evening.

Nils Thommesen
Good evening. Good evening, Bob. Just to clarify, in your statements regarding the expected revenues for 2022 is it--did I hear it correctly to say that you are now expecting revenue growth in 2022 to come into the higher end of the range? At 25%?

Bob Mao
Yes, correct.

Nils Thommesen
Great, and then I have a question on the PX G1300. Because it seems like within the industrial wastewater industries, you have a bit of a need to have some commercial beta tests in different industries, within the broader industrial wastewaters here, but is that less of an issue or is there less of that need when it comes to commercial refrigeration? So I guess, are these systems much more standardized, so that you're able to test this on your own? And then you can go to market with a bit more of a finished product, or at least have that data more comparable to what your clients are experiencing?

Bob Mao
Refrigerating is more of a standard design. We will--of course, our initial deployments, you could also look at it as testing out the system. We think as we have demonstrated in the

industrial wastewater case, that there is a pent-up market demand for what we can offer, so that the customer and us actually is shrinking the time that traditionally you will go for a beta tests and you announce a product.
So we will be repeating pretty much what we are doing in industrial wastewater, as the refrigeration in our initial deployments, as a commercial deployment, but at the same time, accumulate even more data, to refine our product and our system. This is a continued iterative process.

Joshua Ballard
Neil, I would add, we also have a full refrigeration test loop downstairs, so we're doing full testing here in San Leandro, as well.

Nils Thommesen
Yeah, cause that was my thought that those refrigeration systems are more easy to build on your own, rather than having to go out in the field for protesting within different wastewater industries. But I think that answered my question. So thank you.

James Siccardi
Thank you, Neil

Operator
Thank you, ladies and gentlemen, at this time, there are no further questions in queue. I would like to turn the call back over to management for closing comments.

Joshua Ballard
Well, thanks, everybody, for coming. We look forward to talking to you next quarter at the end of October. And our prepared remarks will be published on our website or already are in case you want to grab them here early. So appreciate everybody coming.

James Siccardi
Thank you everyone.

Operator
Thank you, ladies and gentlemen, you may disconnect your lines at this time, and thank you for your participation and have a great day.