ENERGY RECOVERY
Full Year and Fourth Quarter 2022
Earnings Call
February 22, 2023

Opening Remarks – James Siccardi

Hello everyone, and welcome to Energy Recovery's 2022 full-year and fourth-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, 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, February 22, 2023, 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 will turn the call over to our Chairman, President and Chief Executive Officer, Bob Mao.

Strategic and Commercial Update – Bob Mao

Introduction

Thank you, Jim. And thank you everyone for joining us.

We had one of the best years in Energy Recovery's history in 2022. Let's recap for a moment:

- 21% organic topline growth, while winning 100% of the mega projects tendered and awarded in 2022. Industrial wastewater exceeded guidance and almost quadrupled 2021 revenue.
- We generated some of the best profit metrics in Energy Recovery's history:
  - Gross margin, of 69.6%, exceeded 2021 full year by 100 basis points
  - OPEX as a percentage of revenue, when adjusted for one-time costs, was 48% - its lowest level in nearly 14 years. During the past three years, this adjusted OPEX has grown only 8% despite revenue growing 73% in the same period.
  - Our adjusted EBITDA exceeded $30 million for the first time and we increased earnings per share by 75%.

We also positioned each of our businesses for future growth:

- We launched the Q400 for seawater desalination, a low pressure PX for brackish and wastewater applications, along with new industrial wastewater products.
- We commissioned our first PX G1300s in Europe and the US and have generated field performance that has surprised even our partners.

In short, I couldn't be more pleased with our progress in 2022.

As we all look to 2023, there remains macroeconomic uncertainty, and this is nothing particular to Energy Recovery. We will have to navigate these short-term uncertainties together in the coming months, and we will continue to keep you informed. But what I will say is that here, at the start of 2023, we are cautiously optimistic about the current year, seeing solid single-digit revenue growth, and remain bullish on our long-term prospects.

Water

As usual, I'll start with our Water business where we are actively investing to both strengthen our position in the desalination market, as well as to seek out new avenues of growth. We know we cannot sit still and must continue to innovate and grow in new ways despite our commanding position in the market.

Last quarter we announced the new Q400, our most efficient and highest-capacity PX available to date. We have found strong customer interest in our new high-efficiency PX. The first of these orders will begin to ship in the second half of this year. And we expect that the Q400 will make up a material portion of our mega project sales by 2024.

In addition, we launched our low-pressure PX for varying flow rates as we seek to unlock portions of the brackish water and various segments of wastewater markets with our PX. Brackish is very common in the United States and Europe but has remained out of the reach of the PX until now. We believe we can potentially capture material incremental revenue from this market as we seek to achieve our $230 to $270 million target in total Water revenue by 2026.

We will also continue to invest in core engineering research in 2023. This is not an easy task when we are already producing a product with efficiencies near the limit of physics. However, we must think about how to further evolve the PX, to expand our opportunity set, in desalination, industrial wastewater, and water reuse, in the coming years.

Now let's turn to wastewater where we have had a few notable developments.

We generated nearly $4 million in wastewater revenue in 2022, nearly 30% over our target for the year. Importantly, we have now increased our gross margin to one much more akin to our desalination business. The Ultra PX continues to prove its value to customers in the field.

The recent introduction of our low-pressure product line also expands our reach into wastewater. We are now positioned to actively address some of the largest municipal wastewater projects in the world, including initial projects in the Middle East, on the basis of this line. Municipal wastewater, in particular potable reuse, is a natural extension of our Water business. Many regions are beginning to turn to potable reuse to help address their growing water shortages, including the Middle East and here in the U.S. As we learn more about this potential market, we will keep you updated.

Overall, wastewater is already generating a clear profit and paying for itself. This year, we are adding to our sales teams in China and India while also continuing investments to improve and expand our line of products. Wastewater is a clear example of how we can successfully apply our existing PX technologies swiftly to new and adjacent industries with minimal investments.

CO2 Refrigeration

Now let's turn to our CO_2 business.

We have now shipped PX G1300s to six separate OEMs and are soon shipping to a seventh.

During our third quarter call, we spoke about the sale of multiple PX Gs to an industrial refrigeration manufacturer in Europe. This manufacturer, Fieuw Koeltechniiek, is a leading refrigeration components and service provider for the Benelux region of Belgium, Netherlands, and Luxembourg. Fieuw expects to commission the first installation with two PXG units at a Carrefour store in Benelux. Carrefour is one the largest supermarkets in Europe and in the world.

Following a visit in January, Fieuw placed a second order for six additional units to be deployed this year. And, we are currently negotiating a distribution agreement with Fieuw for the PX G in the Benelux region.

This relationship is the first formal step in building a broader pipeline and backlog, and a critical achievement for Energy Recovery in the refrigeration space. As we progress through this year, we will look for more regional distribution agreements like what we are discussing with Fieuw for the Benelux region.

Even more importantly, in 2023, we look to continue initial PXG installation breakthroughs into end-user supermarket chains to verify potential sales pipelines. Our potential pipelines already include Vallarta stores in California, Carrefour stores, and the large Southern Europe chain, in which Epta commissioned a PXG last summer.

In 2023 our priority is to turn as many of the European and US supermarket chains into what we call the confirmed addressable markets, which will build confidence in growing our refrigeration business and hitting our revenue targets of $100M-$300M by 2026. In support of these actions, we are hiring additional sales account managers for Europe and North America. Our first European sales account manager started in January and we will also be hiring field technicians to assist our partners as we rollout in the coming months.

Additionally, we commissioned our PX G at NTNU, the Norwegian University of Science and Technology. NTNU is considered the critical research facility to confirm performance data on new technologies in the refrigeration space in Europe. We have been very pleased with our performance on NTNUs refrigeration rack the past few months and will be presenting this data at EuroShop in Germany next week. This performance data should provide objective third-party verification of the strength of our technology.

In addition to exploring additional regional distribution agreements for the PX G at EuroShop 2023, we will be joining Epta Group, our European joint development partner, at this event. Epta is a leading player in the refrigeration market in Europe and in the United States through their subsidiary, Kysor Warren.

Together with Epta, we will be showcasing to end users the impressive results of our first deployment in Southern Europe, during last summer's record high temperatures, as part of Epta's push into new and sustainable products.

We have previously discussed how the PX G can help alleviate the stress of ever-increasing temperature highs on refrigeration systems. Today, supermarkets build-in extra refrigeration capacity to handle the hottest days of the year. The historic high temperatures we experienced last year, in many parts of the world, exceeded the design maximum capacity of many refrigeration systems. This caused some supermarket chains to shut down their stores to avoid losing refrigerated inventory. This is a significant loss of revenue and profit.

Our PX G's unique ability to provide additional capacity as temperatures rise means you no longer need to over-build the system, if our PX G is installed. In fact, our technology can help handle these unexpected spikes in temperatures when it is needed most at a significantly lower cost than existing technologies, protecting their operating margins.

We still have much to do to achieve our $100 to $300 million targeted revenue for 2026, but momentum is clearly building. Market interest is strong, and the demand for a solution such as our PX G is there. As we continue to demonstrate the reliability of our PX G, our confidence in hitting our targets will further solidify. I look forward to providing further updates during our next call, in early May.

With that, I will turn the call over to Josh.

Financial Update – Joshua Ballard

Good afternoon, everyone.

We'll start with revenue. We generated $121.6 million in desalination revenue, and nearly $4 million in industrial wastewater in 2022, for a combined total growth of 21% for the year. Mega projects continued to pick up pace as expected, growing nearly 9% in 2022, and OEM and Aftermarket achieved 64%

and 36% growth respectively. Desalination OEM revenue, excluding industrial wastewater, grew nearly 50% to $25 million, exceeding our previous annual high in desalination OEM sales by 9%.

The geographic dynamics of our 2022 revenue are also important. We continued to see steady growth in the Middle East and Africa of 10% for the year, an acceleration from 2021's increase of only 6%. However, Asia is where the real story lies. We achieved over 30% growth in 2022 on the heels of over 150% growth in 2021. This rapid increase over the past few years highlights major freshwater issues in Asia. Countries such as China and India are turning to desalination and filtration of wastewater to help alleviate their water problems. In addition, we are beginning to see sales in other countries outside of China and India, which made up 16% of industrial wastewater sales last year.

Finally, last quarter I had referenced $4M of at-risk backlog in Egypt that was delayed due to local hard currency capital controls. We were able to realize about half of that at-risk backlog, with the balance expected to be shipped this year.

We will retain our desalination revenue growth guidance for 2023 of 3-7%, or $125 to $130 million. We continue to expect desalination revenue to be heavily weighted to the third and fourth quarters, with up to 70% to 80% of revenue occurring in the second half of the year. We are currently anticipating revenue within the lower to mid-range of our $10-$15 million guidance for the first quarter. Our range remains the same at $20-$25 million in the second quarter, with the balance occurring in Q3 and Q4. We are also maintaining our industrial wastewater target of $6-$8 million in revenue in 2023, for a combined Water revenue of $131 to $138 million.

Last quarter I mentioned three risks to growth that we are closely monitoring this year: inflation, the strengthening dollar, and the potential for a global economic downturn. Although these risks remain, two of the three risks have alleviated somewhat over the past few months. The rapid strengthening of the US dollar against many of the local currencies in the countries into which we sell has softened. And we have seen that inflation is beginning to be addressed in many of these same countries. We are continuing to monitor if these risks could affect revenue or our pipeline, this year and next, and will keep you apprised.

Now let's turn to gross margin where we significantly exceeded the upper end of our target for 2022. Our overall gross margin performance for the year was driven by three factors: (1) the success of our sales team in increasing pricing in response to inflation; (2) a product mix that shifted heavily to the PX in the fourth quarter; and (3) our outperformance in industrial wastewater, and improved pricing in those markets, which helped increase our overall margin by about half a percent for the year.

We are maintaining our 2023 outlook of 64-66% average gross margin for the year for Water. However, our first, and potentially second quarter, margin may come in lower than this average because of our shift in product mix in favor of the PX in the fourth quarter last year. We are currently projecting 60 to 64% gross margin in the first quarter, largely dependent on the final product mix of sales. Note that we have seen lower margins in prior years in quarters more weighted to OEM and Aftermarket sales, so this is not a new phenomenon. The second half of 2023 will likely be heavily weighted to mega project PX shipments, where margins will improve and balance out the year.

Let's now turn to operating expenses. We ended the year with OPEX slightly less than 50% of revenue, or 48% when adjusted for one-time non-recurring expenses, compared to 55% in 2021. While sales & marketing increased by 1% in 2022 to 13% of revenue, we saw declines in G&A from 24% to 22%, and R&D from 19% to 13% excluding any on-time non-recurring expenses.

Our OPEX guidance for 2023 remains unchanged at 52-53% of revenue this year, excluding any potential upside from CO2 refrigeration revenue.

I mentioned during the last call that sales and marketing would increase 30-40% this year, pushing this spend to 17-18% of revenue. However, I expect G&A to grow only in the low to mid-single digits, largely driven by inflation. R&D spend will likely remain flat in 2023. Therefore, both G&A and R&D should flatten or fall somewhat as a percentage of revenue this year, which is in line with our longer-term targets.

With regards to Net Income, note that our first and second quarters will show negative income. Keep in mind that sales are significantly lower in the first two quarters, but our OPEX is relatively fixed and growing. This is simply because of the lumpy nature of our quarterly sales due to the timing of mega project shipments and has happened in past quarters as well. We will see a significant uptick in profitability from our larger sales in Q3 and Q4 which will balance out the year.

We ended the year with $93 million in cash and securities, falling within our target, despite returning $26 million to shareholders last year as we wrapped up our $50 million share buyback program. Our overall operating cashflow was $12.6 million, slightly below 2021's level.

Operating cash was driven by two main factors in 2022. First, inventory grew by $8 million for the year. Second, because revenue was heavily weighted to the fourth quarter last year, our accounts receivable balance is significantly higher than in previous years. This increase in receivables is simply due to the timing of these late year sales. We have seen no delays in collections, nor any increase in doubtful accounts. We expect to collect the majority of this receivables balance in the first quarter.

As we look forward to 2023, it's important I comment on inventory. As I stated earlier, we expect to ship only 20-30% of our 2023 revenue in the first half of this year, with 70-80% of revenue to ship in Q3 and Q4.

In order to meet this high demand in the second half of the year, we must continue to build product in the first two quarters. Therefore, you should expect substantial growth in finished goods inventory in Q1 and Q2. By the end of the second quarter, we could see an inventory balance as high as $40 million. This balance should subsequently fall in the second half of the year. By the end of the year, based on Water demand, we expect inventory levels to end the year roughly in line with 2022. Any additional increase would be driven by our CO2 business, which we will communicate as the year plays out.

In addition, based on our first and second quarter shipment expectations, we should see lower than normal cash and investment balances by the end of the second quarter, possibly falling to a range of $70 to $80 million, which should subsequently rebound in the second half of the year. Depending on the timing of shipments in the fourth quarter, we should end the year with between $110 to $120 million in cash and securities, driven by growing operating cash flow.

Let's move into Q&A.