ENERGY RECOVERY
Third Quarter 2023
Earnings Call
November 1, 2023

Opening Remarks – James Siccardi

Hello everyone, and welcome to Energy Recovery's 2023 third quarter earnings conference call. My name is Jim Siccardi, Vice President of Investor Relations at Energy Recovery. I am here today with our Chairperson of the Board Pamela Tondreau, Interim President and Chief Executive Officer David Moon, 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, November 1st, 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 Chairperson Pamela Tondreau.

Chairperson Update – Pamela Tondreau

Thank you, Jim. And thank you, everyone, for joining us today. Last Tuesday, October 24, my fellow directors and I appointed David Moon as Interim Chief Executive Officer of Energy Recovery. Bob Mao will remain a member of the Board, and I want to thank him for his many contributions advancing our business.

Over the last several years, we have introduced our PX G and created a tremendous opportunity in CO_2, built an established and growing business in wastewater and launched a family of new products to grow that business. We continued to innovate within the desalination industry with our Q400, the highest efficiency energy recovery device in the world. The Board and I understand, and clearly see, the opportunity to not only accelerate growth in our existing three markets, but also to expand the PX beyond these markets in the coming years.

We are pleased that David agreed to join management as interim President and CEO during this time. David is a seasoned leader and both his previous experience as President of Carrier Commercial Refrigeration, a division of Carrier Global Corporation, as well as his history developing and commercializing technological capabilities will provide important insight and perspective while in this role. Our goal is to ensure that this transition period is not only smooth and without operational disruption but will allow us to continue along our growth path.

I want to be clear that there are no underlying concerns about the business or its strategy.

As mentioned in the press release, we had already begun the CEO search process and hope to fill the role permanently in the near term. The search committee includes two of Energy Recovery's newest members who bring a key operational focus to the business, and we are even now speaking with a number of qualified candidates.

With that, it is my pleasure to turn the call over to David Moon.

Strategic and Commercial Update – David Moon

Thank you, Pam.

Before I start, I want to emphasize that Energy Recovery's fundamentals remain strong. Neither I, nor the Board, are seeking any major changes in our strategy or in our executive team at this time. I am coming in as interim CEO to do the following: maintain stability, keep us moving towards our long-term goals for our Water and CO_2 businesses, and to ensure we continue to further build and grow the relationships we have with our shareholders, whom I look forward to meeting.

Every quarter, management intentionally speaks with shareholders to ensure not only that our strategy and its execution is well understood but that we are also hearing your questions and concerns. Normally, the majority speak with either the CEO or CFO, as well as our investor relations team. However, owing to the recent unique events, I intend to participate in every one of these meetings this quarter. I look forward to speaking with each of you directly.

I have spent almost three decades in the cooling and heating industry in the US, Europe, Asia, and Australia, most recently with Carrier. I understand what it takes to commercialize and to introduce a highly engineered product to a mature market and, more importantly, how to penetrate that market. This is what Energy Recovery did in desalination and wastewater and is now what we will do in refrigeration. I'm excited to contribute to our CO_2 journey as well as ensure our Water momentum continues. I hope to share my experience with this great team as we aggressively embark on the next chapter for Energy Recovery.

Most importantly, I want to reiterate that we remain confident in our long-term strategy, which we are not deviating from, and in our financial performance in 2023 and in the coming years. I am excited to lead this charge and have hit the ground running.

Today, while I will briefly touch upon Water, the focus of my commentary will be on our CO_2 strategy and our progress in turning valuable pilot locations into an improved product offering while continuing to cement our value proposition, thus getting us ever closer to widespread commercialization. Josh will discuss our desalination and wastewater businesses. And, of course, he will update you on our 2023 and 2024 guidance.

Water

Let me start briefly with our Water business.

As you have likely seen from our press release, despite a few tactical challenges we faced in the third quarter, our team was able to deliver a great quarter. This performance points to the strength of our Water and operational teams.

Overall, I, and the rest of the Board are extremely bullish on our base water markets. The long-term secular story in desalination, and our broader water strategy, remains as strong as ever. Global freshwater use is trending to increase as much as 30% by 2050, while water scarcity remains a growing and critical issue in just about every region of the world. Our advanced solutions help bridge the gap between the divergence of the world's fresh water supplies with increasing demand by addressing the energy component of water treatment technologies. Desalination and water reuse will remain a critical part of the solution to supporting the world's freshwater needs. Our Water business will continue to grow in 2024, and we remain well positioned at the core of a significant secular shift in water demand.

I will let Josh give you a more in-depth update on water in a minute, but let's talk about our CO_2 business first.

CO_2

The PX G is one of the first truly innovative products that I have seen in quite some time in the commercial and industrial refrigeration market. I believe we have the potential to disrupt this market. I also firmly believe that this market is simply the foundation from which our CO_2 business will grow. Again, that's why I am here and why I have been so pleased I could help as interim CEO during this period.

The CO_2 strategy roadmap that Bob and the CO_2 team have executed thus far has been highly effective. The team is making tremendous progress in a mature, competitive industry and have made a name for ourselves in the market within a very short period. We have done the following: established strong relationships with major OEMs in Europe and the US, executed on installations with great OEM and grocery partners on both continents, and we've won two industry awards, the latest being the RAC "Innovation of the Year" award together with our good partner Epta Group in September of this year. One key player in this industry said recently, "You are everywhere, and everyone is talking about you."

It is important that we understand this market from different perspectives. First, the U.S. and European markets are in very different phases of the transition from HFCs. In the U.S., we have a market that is just getting started. The regulatory tailwinds are in place and only growing stronger, evidenced by the EPA's final "Technology Transitions" ruling that was issued October 6th, just a few weeks ago. This new ruling adheres closer to California's own tight HFC restrictions and expands these restrictions to many other refrigeration uses. In short, while the CO_2 refrigeration market is still fairly nascent in the U.S., the regulatory momentum is strong, which means that we should see considerable uptick in the U.S. greenfield market in the coming years.

The U.S. market is also simpler than its European counterpart. First, it's largely served by only a small number of large OEMs and contractors, which simplifies our distribution channels. Because we are getting known early in the U.S.'s evolution into alternative refrigerants, it means that as CO_2 is further adopted, we should be well placed to be specced into new greenfield projects from the ground up, which is an efficient way for us to enter the market.

However, it also means that true volume sales in the U.S. is still a few years away, even as we begin to make real progress today. According to the North American Sustainable Refrigeration Council, the US has only roughly 1,500 CO_2-based refrigeration systems as of 2023 and is expected to increase this number to over 5,000 by 2027. Luckily, the European market provides us with a strong understanding of how the US market is likely to evolve.

Contrary to the U.S., the transition to natural refrigerants in the European market is more advanced, with over 60,000 CO_2 installations already in place throughout the continent, and north of 10,000 installations occurring annually in recent years. Thus, we have a large established potential brownfield market in Europe, and a strong base of annual greenfield installations we can tackle. However, this is a more complicated market with a variety of regional players, some multi-national, with a variety of local norms to understand. This means we need to determine the resources necessary to address this market, and the most efficient means to obtain them, to accelerate our growth in Europe. Ultimately, this should be a low hanging growth opportunity if correctly approached.

Underlying both markets is a mature, conservative industry that is typically cautious to adopt new technologies. The most critical element of a refrigeration system is that it must reliably deliver cold within the parameters it has been built. Any deviation or shutdown in a refrigeration system can generate large losses for end users, like supermarkets and cold storage facilities, and the rest of the value chain. Therefore, we are doing the necessary upfront work to ensure that when end users press the “go” button, the PX G will be a seamless introduction into new and existing CO_2 refrigeration systems in the US and Europe. This is where we are at in our CO_2 strategy.

Therefore, to unlock the potential in this market, our strategy is to begin with pilot installations in a given Food Retail chain or Cold Storage facility to build confidence in the operational and economic benefits of our PX G. Once that confidence has been built, we can then expand our footprint within that chain, by obtaining repeat orders. This is how we confirm our addressable market and move towards the volumetric orders we believe to be ultimately within our reach.

We are already seeing this play out. In North America, we will soon be commissioning our second installation with Vallarta in California, and we are in discussions for multiple deployments with them in 2024. We should commission our initial PX G with our first Canadian supermarket partner, a chain with over 1,000 locations, in the fourth quarter of this year. In addition, we are in advanced discussions with several well-known national chains in the United States for potential deployments in 2024. This is the groundwork that is absolutely required for us to be successful.

In Europe, our partner in the Benelux region, Fieuw Koeltechnik, is planning three more installations in Q4, including two at Delhaize, a large European and US chain with over 800 locations, as well as at a pancake factory in Belgium, which we had previously announced. Fieuw is also in discussions with the large European chain, Carrefour, on our first repeat installation with them. And, finally, we are working actively on our second deployment with Epta Group, for a supermarket chain of over 2,000 locations. And, of course, we are in conversations with other large chains throughout the continent. From my perspective, this is impressive progress for a new technology in this industry.

As these chains continue to see the benefits of our PX G in their operations, we can then expand in greenfield and brownfield installations. The greenfield market will take up to a couple years to show substantial volume simply due to the 12- to 24-month lead time in designing and installing new systems. Therefore, the greenfield market is our long-term potential, but not our substantial near-term volume opportunity.

The key to near term volume growth is the brownfield market, but it is also the most complicated. While our PX G will likely add only minimal costs to a greenfield operation, in the brownfield market there are extra costs and equipment to build and install. To be successful in this market, we must be able to, first, deliver a standard product that is plug-and-play, meaning that the installation, commissioning, maintenance and install must be efficient and without risk, and we need to commit limited time to design and deliver. Second, we must deliver a PX G with meaningful payback to the end users. And third, of course, our PX G must deliver the performance needed to generate that meaningful payback. These are the focus of our entire CO_2 and engineering teams in 2024.

In prior quarters, we spoke about our intentions to provide more explicit guidance for 2024. During the short time I have been in this seat, I have gained belief that we can achieve a substantial first step along this path in 2024. We are targeting at least 50 locations for next year. I'm still in the early days of doing my deep dive into our CO_2 strategy. However, what I can say is 50 PX G locations for next year would create a substantial foundation, while growing a pipeline for future expansion. As our strategy unfolds, and we begin to penetrate the market in a more significant manner, we will provide a clearer sense of our CO_2 revenue objectives.

It is clear that we are growing at a slower pace than originally envisioned. However, we are encouraged by the achievements we have made thus far and our prospects for additional locations in 2024. More to come.

Our planned performance in 2024 will create more clarity as to how fast we can grow from our initial installations this year. We will update you on our 2026 targets as I gain comfort operationally on our status, and we will update you throughout the year on our 2024 forecast as needed.

Wrap-Up

With that, let me hand the call over to Josh to talk in more detail about our Water business, and to update you on our financials.

Financial and Water Update – Joshua Ballard

Thanks, David, and good afternoon, everyone.

Before I get started, I want to be clear – in my opinion, we remain a fundamentally solid company with a clear growth strategy and a base, cash generating water business that remains strong. As David described, we are achieving real progress in CO_2, our secular story has not changed in desalination, and we are seeing tremendous success in our wastewater business. Therefore, I remain as bullish as ever in Energy Recovery's prospects.

We had a great third quarter, beating expectations across the board. We achieved $37 million in revenue, exceeding the upper end of our guidance by almost 6%, with a nearly 70% gross margin and over 32% adjusted EBITDA margin. Specifically, in desalination, sales increased over $15 million compared to the previous quarter, while our wastewater sales more than doubled. Moreover, our emphasis on expanding our market presence in CO_2 led to $100K in Q3 revenue, with the rest of our emerging technology segment revenues attributed to oil & gas sales for aftermarket parts.

We are beginning to see our predicted uptick in revenue after our lighter first two quarters, as previously communicated. We successfully shipped one of the two projects that were at risk for the third quarter, and we were able to recognize revenue from our existing pipeline to make up the difference. Our Water and operations teams did a tremendous job executing.

For fiscal year 2023, we now expect to land in the mid-range of our $131 to $138 million overall revenue guidance, with roughly $7 million of that coming from wastewater and the balance from desalination. This means that we again anticipate record-breaking desalination revenues in what will be nearly a decade of consecutive growth. However, we do have a few specific risks in the fourth quarter which I would like to address.

First, $5 million of our 2023 backlog is shipping to Israel. As of today, we are on track to ship in November, but we are closely monitoring the situation in the region.

Second, we have significant levels of revenue shipping to emerging markets in North Africa and Southeast Asia. As smaller emerging market countries make up a larger portion of our sales, such as those we have described in recent calls, our short-term execution risk within a given quarter also increases due to the complexity of managing and shipping to these countries. In the fourth quarter, we have an $8 million shipment scheduled for India in the last few weeks of the year and $11 million to Algeria in November. While we have no reason to believe these will not go out as scheduled, due to the late timing of these shipments and a history of delays in these regions, we are watching and managing them closely. To be clear, any 2023 delays, if they were to occur, would simply increase our guidance for 2024 revenue. Meaning, it should have no real effect on our business. Therefore, we will return to revenue guidance at our next call once this year's results are in.

Let's pivot to gross margin. Year-to-date, we've beaten our guidance of 64-66% with a gross margin just shy of 67%. Our focus on cost reduction initiatives in 2023 is showing some success. We are currently expecting to finish the year somewhat higher than our previous guidance of 65-67% for the year. It's important to note that our end-of-year gross margin is contingent upon our final product mix, which is heavily weighted to our PX, and our ability to execute on our remaining sales as planned in Q4.

We now expect OPEX to end the year at roughly $68-$69 million. There are no real surprises here year-to-date, and we remain focused on prudently managing our expenses as we grow.

Our current cash and investments balance grew to $106 million primarily owing to robust customer collections. As we concentrate on enhancing our inventory turns and supporting business critical capital investments, we anticipate concluding the year with a cash and investments balance ranging between $110-$120 million. Where we land within this range largely hinges on the timing of customer receipts in the fourth quarter.

Now that we've established that 2023 is going well and as planned, let's move to 2024 and beyond in our Water business.

As of today, we already have line of sight to roughly 80% of our $200 million desalination target for 2026. In addition, our wastewater business, owing to our expanded product line and sales team, continues to surprise to the upside as our pipeline strengthens and evolves, the interest and participation in our webinars grow, and early-stage signs in regions outside of Asia, and in industries such as municipal wastewater, begin to show promise. This gives us confidence that we can achieve at least the lower end of our $30-70 million target for 2026.

Clearly, a pipeline three years out has inherent risk but, as we have discussed in prior earnings calls, our visibility into our mega project space, as well as the overall water scarcity story, is what drives our long-term confidence in this business despite short-term fluctuations due to the day-to-day challenges of operating in emerging markets, or the nearer-term trends in the macro-economic environment.

The inflationary pressures of the past couple of years, coupled with a relatively strong dollar, and higher interest rates, are beginning to increase the cost of producing water. We are seeing cost increases per cubic meter of water as high as 40%, and interest rates have increased from 1-2% in 2020 to 4-6% today for a high-quality developer.

If we look back, costs to desalinate water have fallen dramatically in the past decade or so, from a few dollars per cubic meter to under 50 cents in some regions of the world, such as in the Middle East. The mindset of the industry has been to continually drive down costs, construct larger and larger desalination plants, making desalination more affordable each year. As you well know, this is one reason why our pressure exchanger solution is so strong in this market.

However, this shift in costs has created a new dynamic in the industry. We are now seeing some projects being delayed due to the rising costs to produce water, as well as the challenges of end users reaching financial closure in a higher interest rate environment. In today's macro environment, water tariff expectations between large scale developers, EPCs, and end users are misaligned.

While we do not believe these dynamics will permanently alter the trajectory of the desalination market, they will likely slow our rate of growth in the near term, especially in more susceptible emerging markets. For 2024, we now expect modest revenue growth for desalination in the range of $128 to $135 million, implying flat desalination revenue to 5% for next year based on this year's expectations. This slowdown is entirely due to our mega project space, which we now expect will flatten next year, and possibly even fall by a few percentage points, compared to 2023. While we see shifts every year in projects, we are now seeing significant projects shifting out from 2024 to 2025 or beyond in countries such as Egypt and India, which have been hard hit by inflation, growing interest rates and weakened currencies. We are also seeing delays in the release of tenders of over $7 million in Saudi Arabia. These shifts alone account for more than 15% growth in 2024.

One very positive development in desalination comes from our new PX Q400, which is the highest performing energy recovery device available on the market. The Q400 could exceed 20%, or more, of our sales in 2024. The Q400's increased efficiency and capacity is resonating with customers, and we believe it could make up the majority of our mega project desalination sales by 2025, essentially supplanting the PX Q300 in large-scale desalination projects. This adoption further strengthens our position in the market vis-à-vis our competitors.

Where we sit today, we believe the market has the potential to regain its double-digit growth trajectory in 2025, where we could return to growth in the low to mid-teens, with further accelerated growth by 2026 to the high teens or even up to 20%.   As 2024 progresses, we will get more clarity on where 2025 could head and will update you accordingly.

Our wastewater business continues to show real strength and we are guiding $12-$15 million in revenue in 2024, which will mean we have the potential to once again roughly double our revenue in this segment from this year. Our greatest opportunity, and risk, next year are two mega-sized municipal wastewater projects that total roughly $4 million. These two projects show that our strategy to diversify into the broader water treatment space is working, but any delays could have an outsized effect on next year's wastewater performance. If we can achieve this growth next year, we will be well on our path to achieving our targeted range for 2026.

So, you can see, regardless of the short-term headwinds we see in desalination, our Water business remains robust. Overall, we expect to achieve $140 - $150 million in Water revenue next year. Although we have short-term challenges in our desalination mega project channel, we believe we remain on the path to achieve at least the lower end of our $230-$270 million targets for our Water business by end of 2026. We are looking at how we can invest in wastewater to potentially accelerate areas of the world outside of China and India. In addition, we are examining our desalination OEM and aftermarket channels for opportunities to increase sales and reduce our reliance on mega projects to achieve these growth targets.

Where we sit today, we believe our Water gross margin for 2024 should fall within the range of 64-67%. We will tighten this up early next year. Our CO_2 gross margin will largely depend on how we achieve sales, meaning whether by direct PX G1300 sales or by a skid solution, and could show losses in 2024 as we grow into the profitability of our brownfield market product. I will have to advise you on this further as our sales mix becomes clearer.

I am currently forecasting OPEX to remain at 50-54% of revenue in 2024, excluding any one-time effects of the CEO transition. Most investments will occur in sales and marketing, and any other growth to G&A and R&D would be largely inflation related. I will be in a better position to detail our OPEX at our year-end call in February after David has had a chance to dig in.

Note that, due to slowing growth in revenue, somewhat weaker water gross margin and growing sales and marketing spend, we could see a softening of operating margin next year. We are currently anticipating an acceleration of growth again in 2025, and therefore believe this softening will be temporary. Our goal to fall below 40% of revenue by 2026 remains achievable.

To summarize, I believe, despite what our share price may be saying, the sky is not falling at Energy Recovery. We see some headwinds in desalination in the short term, but nothing we haven't seen before, and our overall water business remains robust. While our acceleration in CO_2 has started slower than we would like, we are making real and tangible progress which should put us on our growth curve by 2025 if we successfully deliver on next year's installations.

With that, let's move to Q&A.