ENERGY RECOVERY
Fourth Quarter 2023
Earnings Call
February 21, 2024

Opening Remarks – James Siccardi

Hello everyone, and welcome to Energy Recovery's 2023 fourth quarter and full-year earnings conference call. My name is Jim Siccardi, Vice President of Investor Relations at Energy Recovery. I am here today with our 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, February 21st, 2024, 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 President and Chief Executive Officer, David Moon.

Strategic and Commercial Update – David Moon

Thank you, Jim.

First off, I want to thank my fellow Board members for appointing me the permanent CEO. I look forward to working with our shareholders, the Board, my leadership team, and our employees as we enter this next phase of Energy Recovery's growth.

I also want to thank Bob Mao for his grace, assistance, and advice these past four months.

As we announced today, Josh Ballard has decided to step down at the end of June as our CFO. He and I are working together with Korn Ferry to conduct our CFO search. I want to thank him for his commitment to an orderly CFO transition and for his continued leadership throughout this transition.

He and the Energy Recovery leadership team have given me a great foundation to build on, which is:

- a healthy business with nine years of consecutive revenue growth,
- a strong balance sheet, and
- a technology that is showing promise outside of our core desalination business.

I'm excited to be here, and I look forward to our future at Energy Recovery.

I have now been in the seat for approximately four months. Over this period, I have taken a deeper dive into our:

- technology and products,

- our diversification strategy around our pressure exchanger and wastewater technology, and
- where we are executing that strategy.

I have a better understanding of our markets and customers, where we sit in the product development cycle and commercialization of these new products, as well as the challenges ahead of us.

I would like to start with a few observations and how I will approach this role.

First, to be clear, my number one focus is to rebuild the shareholder value that we have seen decline in recent months, and then to grow it further. There is nothing more important than:

- creating stability,

- rebuilding trust with shareholders, and

- showing you that we can deliver on the full potential of our pressure exchanger technology.

We start with delivering on an orderly CFO transition. We must also execute, and therefore deliver on our 2024 financial targets, or "walk the talk" as I like to say. We have challenges, but I believe we can create true value for our shareholders in the coming years.

Second, I have had extensive discussions with many of you and heard your opinions regarding the CEO transition. I assure you that your voices have been heard loud and clear, and your concerns have been communicated directly to the Board.

Third, this is a strong team, and I could not be more excited to lead it. Everyone has rolled up their sleeves and jumped in to:

- make the transition as smooth as possible,
- have been consummate professionals throughout,

- kept the company moving forward,
- signed Water customer contracts,
- continued to produce industry-leading products, and
- showed what the good teams do during moments of transition - adapt and come together.

Fourth, the company's strategy of PX diversification and growth is the right strategy in my and the Board's opinion. It is critical to Energy Recovery's future, as well as to our ability to rebuild and grow shareholder value, that we continue to grow and diversify our business around our incredible pressure exchanger Intellectual Property that creates value for our customers by recovering otherwise wasted energy in desalination, wastewater, and now CO2 refrigeration.

However, we must now do the deep work to develop our 2025-2029 strategic plan, or what I call our Playbook. With this Playbook, I will be able to clearly communicate what and where our growth targets will be in the desal, wastewater and CO_2 verticals, as well as the critical actions and milestones needed to achieve these targets. This Playbook will also clearly identify what our cash requirements will be to fund our growth. Rest assured, we will continue to spend wisely and be mindful of the need to generate strong returns on investments.

Our Playbook will focus on maintaining our market leadership in desalination, as well as on executing in the wastewater verticals where we see the most potential growth, including wastewater treatment for lithium battery manufacturing, chemicals and municipal water, as well as CO_2 commercial refrigeration. I also see derivative verticals where I believe our wastewater and CO2 refrigeration products could be applicable, however, more work needs to be done here to understand and prioritize these other verticals.

Fifth, I remain committed to sustainability in the products we develop and produce as well as in our own internal operations and how we produce. Sustainability is a critical piece of our DNA and will remain part of our strategy going forward.

Finally, Energy Recovery remains in an enviable position financially. We continue to generate cash, and we expect to see our cash position grow in 2024, even while we invest in growth, which Josh will describe to you. We will need to make decisions about how to deploy this growing cash position with the same financial and commercial focus that we have instilled in Energy Recovery for the past few years. Rest assured that I share Josh's vision of expanding our EBITDA margin as we grow in these new verticals.

Where I sit today, I believe the fundamental pieces of Energy Recovery's overall vision and diversification strategy will remain in place.

1. We must continue to defend and strengthen our position in desalination.
2. We must accelerate growth in wastewater.
3. Where my experience and strengths come to bear, we must define in more detail what the best market and distribution strategy is to deliver our PX G to supermarkets. Successful execution here has the potential to open doors to other vertical opportunities in the coming years, but we must first be laser focused on the task at hand.

In short, I think you can see that while we will certainly see changes at Energy Recovery, the fundamental principles that have attracted so many of you to our company remain in place.

With that, let's get into our update. As usual, we will start with Water.

Water

We delivered growth in our desalination business for the 9th consecutive year in 2023. This growth was slower than we would have liked due to a delay in a single $8 million project in India, which Josh highlighted as a specific risk last quarter. That project is now slated to ship in 2024. Due to this slippage, we came in at approximately $128M in revenue.

Despite this shipment moving into this year, we are holding our overall Water guidance of $140 - $150 million for 2024. While this India project will increase our revenue for the year, since our last earnings call, we have had two projects in Saudi Arabia shift to 2025 that together offset this increase by India.

In addition, we have several large projects shipping in December that, based on our experience in 2023, pose some timing risk. Although my team has identified some potential mitigation approaches for this risk, I am still getting my hands around our project-based Water business and prefer to remain conservative. We will tighten up this guidance throughout the year as more is known.

Note that our wastewater guidance of $12-$15 million remains unchanged, which means our overall guidance points to between roughly 10-17% growth for the whole of our water business this year.

We also have some great things happening underneath the hood.

First:

- roughly 50% of our desal mega project revenue will come from our Q400, our newest and most efficient energy recovery device.
- We are extremely proud of this fact as our initial projections were to achieve only 25% of revenue this year from the Q400.
- Not only should we achieve 50% this year, but we believe the Q400 could be as much as 75% of our revenue in 2025.
- The resounding success of the Q400, which we only introduced to the market in late 2022, is proof that we are continuing to innovate and show leadership in the desal space.

Second:

- if we hit our guidance in wastewater, this implies wastewater could double in 2024 and be up to 10% of our overall water revenue after only our third-year pursuing diversification into wastewater.
- To date, we have generated revenue from 16 different industry verticals in wastewater.

- We have 12 industries in our pipeline exceeding $1 million each in potential revenue.
- We are tracking projects in over 30 countries. And, importantly, more than a quarter of our pipeline is in the municipal sector, a market that we thought was still a few years away.
- We consider our wastewater business a resounding success that highlights the versatility of the PX as well as the acceptance of our value proposition outside of desalination.

As you might expect, to tackle 16 different wastewater industry verticals takes resources and products that potentially can be unique to each vertical. Our Playbook will prioritize those verticals to ensure greater probabilities of success, financial return and customer satisfaction. More to come here.

Our water business remains firmly entrenched in a global secular upward trend in water demand, and our confidence in this business has not changed. We continue to innovate and to provide a compelling argument for our product offering in the marketplace.

As you all know, there is simply not enough freshwater in the world today. The world is beginning to understand that to address these freshwater challenges, we must

- reuse the water that we have, which our wastewater products address and
- that desalination is critical to providing new freshwater capacity at scale, which our desal products address.

Now let's move to our CO2 business.

CO_2

This year, our focus for the CO2 business unit is to gain market penetration in OEM's and supermarkets through increased site validations. This will allow us to continue stress testing a greater number of PX Gs in the field in varied climates and operating conditions while validating and fine tuning our value proposition.

One thing we learned during PX G field testing in 2023 was that we were seeing some operating issues that needed to be addressed. I temporarily slowed the PX G rollout in late Q4 2023 to allow our engineering team sufficient time to apply these learnings to upgrade the PX G to address these issues.

Our 2nd generation PX G is now being tested in our lab with very positive results and will be deployed to field validation sites in Europe and the U.S. in the 2nd quarter.

This 2nd generation PX G is a drop-in replacement for the 1st generation and also makes for a more reliable and quieter PX G. In addition, we have designed a more streamlined and cost-effective skid for retrofits in the field.

We have two critical milestones to achieve in 2024 with this 2nd generation PX G to move forward with a broader commercialization in 2025.

- The 1st milestone is the successful completion of testing in our internal labs in Q2 2024. We are encouraged by the results thus far.
- The 2nd milestone is successful installation, operations and 3rd party validation of at least 30 – 50 additional field validation sites by Q4 2024.

As a reminder, supermarkets are very conservative when it comes to adopting disruptive technology, especially large chains with billions of dollars of existing refrigeration infrastructure. We must take the time and pay our dues to perform extensive field validation while continuing to work with end users, OEM's and engineering firms.

However, we have several things on our side:

1. Growing relationships with new influential supermarkets customers in the US and Europe, who are marquee national and international chains.
2. Repeat orders with existing supermarkets, such as Vallarta and Carrefour.
3. Recent EPA legislation in the US, the AIM Act, and EU F-Gas Regulations, have accelerated the phase-out of HFC's thereby putting the pressure on supermarkets to

begin serious planning to convert refrigeration infrastructure to natural refrigerants like CO_2.

4. A historical track record of successful supermarket industry adoption of past disruptive technologies such as aluminum coils, ejectors and others.
5. Two years of PX G field testing in extreme operating conditions, which has led to the 2nd generation PX G and provided a prioritized list of upgrades and improvements for future generation PX Gs.

My experience in this industry has taught me that when introducing a disruptive technology like the PX G into this market on a broader scale, reliability is of the utmost importance to end users.

And that's why we must be more deliberate and conservative, spending the necessary time to validate the product in the lab and the field while developing relationships with the industry stakeholders such as supermarkets, OEM's, major contractors and influential engineering firms.

A new product introduction must provide a seamless installation experience, be operationally reliable and repeatable across varied regions and contractors. If we have done our job successfully, we will be invisible to the supermarket site manager, especially in the summer months.

As part of our Playbook development, we are moving towards a more standardized PX G that will allow future generation PX Gs to be a "drop in" or "plug and play" element of the refrigeration rack. We believe this more standardized version, which is closer to what supermarkets and OEM's are more comfortable with, will provide a more seamless option to further accelerate the rate at which we can penetrate the market. Our initial step to this plug-and-play element is with the 2nd generation PX G.

Looking forward, our focus for 2024 is to deploy at least 30 – 50 PX Gs between North America and Europe.

However, because I intentionally slowed our PX G progress to allow for the 2nd generation PX G to be launched, we are more likely to be closer to 30 validations sites. When it comes to selecting validation sites, we are focusing on quality versus quantity.

This will provide us the critical mass we need for validation purposes and puts us in a good position to achieve the 2nd critical milestone in Q4.

By the time we get to the first quarter earnings call, I will be able to better define the number of validation sites for 2024.

Wrap-Up

To sum up, the operational deliverables that I have put in place for 2024 are as follows:

- maintain and grow our dominant position in desalination;
- grow our wastewater business to $12-15 million in revenue;
- install at least 30 PX G units across North America and Europe; and,
- to deliver on our full-year revenue guidance of $140-150 million.

With that, let me hand the call over to Josh to update you on our financials.

Financial Update – Joshua Ballard

Thanks, David, and good afternoon, everyone.

I want to start off by saying how much I have enjoyed my nearly six years here at Energy Recovery. As I will get into shortly, Energy Recovery is financially in very good shape, and I feel really positive about the company's future.

Before I get to that, I want to make clear that I have been in full support of David since he made the decision to put his hat in the ring for CEO, and I'm pleased the Board thought the same. David has done a great job right out the gate and it's frankly been really enjoyable working with him. This is a decision I personally came to some time ago, which was unrelated to who our future CEO would be. Now that we have our CEO, I decided it was the right time to formalize my plans. It is important to both David and I that we have a smooth transition, and I look forward to fully supporting David with the CFO search process and with the upcoming transition.

Now, I'll turn to our financial results and, as usual, we'll start with revenue.

First, I'd like to close the loop on some of my commentary from last quarter. We mentioned three risks to revenue from projects shipping to Israel, Algeria and India. We were able to ship off all projects to Israel and Algeria successfully within the quarter, and of the highlighted risks only the India project of $8 million was delayed to this year.

Despite achieving slightly lower revenue than projected in 2023, we had a great fourth quarter, a record one as a matter of fact. We recognized 35% more revenue than our previous highest quarter in Q4 2022. The team continues to prove that we can operationally handle higher and higher volumes and I'm confident that they can handle our substantial volume in the second half of this year as well.

Notably, our Middle East and Africa revenue fell for the first time in 2023 from $86 to $77 million. This reduction was driven by our Middle East business, which fell to 37% of revenue in 2023, down from 56% in 2022, driven from temporary declines in sales to Saudi Arabia. Although Middle East sales are rebounding to similar levels this year as we saw in 2022, growth in the region will likely slow in the coming years, and other regions of the world will continue to show strength.

Algeria is the real story of 2023, increasing from $4.4 million in 2022 to over $23 million last year. Although in 2024 we forecast less activity in Algeria, as we have mentioned North Africa is expected to remain a strong source of revenue in the upcoming years. This year we are expecting substantial revenue from Morocco, and we currently see potentially strong revenues in Algeria and Egypt in 2025.

Both our Asia and Americas businesses also continued to expand in 2023 as well. Asia grew 23%, also reaching over 24% of revenue from 20% in 2022. This was driven by growth of over 100% in China and a substantial bump from South Korea. India, another growth country for us, ended weaker due to the shifting of that project in the fourth quarter. Had our planned India project shipped, Asia would have almost reached 30% of revenue last year. The Americas grew 77% from $8.6 million to over $15 million in 2023, driven by strength in Chile in particular, as well as some Caribbean Island nations such as the Bahamas and the Dominican Republic.

This growth in regions outside of the Middle East continues to hit home the underlying shift occurring in our revenues that I have mentioned in the past. Middle East sales fell to 37% of revenue in 2023, from 56% in 2022. We expect the Middle East to remain strong in the coming years and, for example, it is rebounding back to similar levels this year as we saw in 2022. However, growth in the Middle East will likely slow in the coming years, and other regions of the world will continue to show strength. This dynamic creates two risks for us that we must watch as we look forward in our water forecasts, in particular in desalination. I have touched upon these themes separately in prior quarters but want to summarize here for clarity.

First, any slowdown in our Middle East business should be offset by growth in other regions. We could see an imbalance during this shift in growth from the Middle East to other regions that could cause a slowdown in growth or a temporary dip even despite long-term trends remaining firmly in place. In our opinion this dynamic would not be a sign of any change in the long-term strength of our water business.

Second, some of these new and upcoming regions may pose short-term risk to our forecasts, especially with regards to project timing and potential delays, such as we experienced last year. We will need to factor this risk into our projections and guidance and one reason why you see us taking some caution in our forecast this year. Our sales are once again heavily weighted to the second half of the year, and 40% of our mega projects in Q3 and Q4 are shipping out to emerging markets such as Morocco and India that pose a higher risk to timing than do those countries more established in desalination in the Middle East.

Finally, our projections for the first half of this year remain the same as I mentioned last quarter – $10-$15 million in the first quarter, and $20-$25 million in the second. We will be better prepared to tighten up the second half of the year in either our Q1 or Q2 call.

With regards to gross margin, we ended the year beating our guidance by about 80 basis points. Our gross margin forecast for Water remains unchanged for 2024, at 64-67%. The cause of our wider forecast range is related to the launch of our new Q400. We are moving into volume production and will be dialing in our material and labor costs as we do so. Therefore, we are being cautiously conservative in our forecast as we start the year. I believe there is potential upside here, which is reflected in the higher end of our range.

While we are seeing another year of margin decline regardless of the Q400, as I've mentioned before, this is due to inflation catching up to us which we've been predicting for some time. As long as we can reasonably grow ASPs in line with normalized inflation in the coming years, and we keep a firm focus on managing growing manufacturing costs, my full expectation is that we should see our Water gross margin begin to move back up to the 68-70% range over the next couple of years.

Our OPEX came in at the lower end of our guidance at $68 million, or 53% of revenue, which includes nearly $1 million of one-time expenses related to the recruiting of Board members and the transition to the new CEO. Excluding those one-time expenses, our base recurring operating expense grew about 7.5% despite fairly high labor inflation last year.

Our goal this year is to increase our base recurring OPEX by 7-10%, which excludes any one-time transition costs that are not entirely known related to our announced changes to the executive team. Most of this increase will be driven by three factors: first, we project growing sales & marketing spend by 20-25%; second, G&A will grow 3-5% largely driven by increased spend related to CEO compensation, the CFO transition, and other executive related costs; third, roughly half the growth in OPEX will come from share-based compensation.

If we take the mid-point of our revenue guidance for the year, these assumptions would put us at 50-52% of revenue for the year, and at the high end of our growth we could fall below 50%.

If we look one layer down, I'm very comfortable on the trajectory of our spend vs. where we want to be in the next three years. First, again taking the mid-point of our guidance, if we look at our expense components as a percentage of revenue, we continue to see progress. We are seeing a reduction of G&A from 22% of revenue in 2023 to under 21% in 2024. We see a similar trend in R&D with a reduction from 13% to 12%. With the faster growth in sales and Marketing spend, we see that increase from 17% to between 18-19% of revenue this year.

In short, excluding any one-time transition costs this year, we continue to see reductions in spend as a percentage of revenue in G&A and R&D, and a temporary increase in sales and marketing as compared to revenue, which should be lowered as we either begin to hit our revenue growth stride in the next 1-2 years, or we begin to lower spend because we have not. This is what I have expected and previously described.

Finally, I want to comment on our cash position. We increased our cash and investments by roughly $30 million in 2023, ending the year at $122 million. We currently expect to end this year at between $140-150 million in cash and investments and, depending on collections from Q4, we could exceed $175 million by the end of the first quarter 2025. Note that we will see cash dip somewhat during the year, especially in Q2, as revenues decrease in these initial quarters. In addition, as we saw last year, we will be building inventory throughout the year to support shipments in Q3 and Q4. Therefore, we could see inventory levels increase to as high as $35-40 million again this year, to again decrease and settle out likely 10-15% higher than the end of 2023.

As we stand today, David will be assessing our go-forward strategy to execute in our various business units, and more concrete decisions around capital allocation will occur later this year or early next. This growing cash position is a clear indicator of how closely we have managed our spending in recent years, and the immense value this company can create as we grow. As a part of our Playbook from this year, we will need to make specific decisions around the utilization of this cash, and whether to invest in new paths to accelerate growth, or to return capital to shareholders.

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