ENERGY RECOVERY
Third Quarter 2022
Earnings Call
November 2, 2022

Opening Remarks – James Siccardi

Hello everyone, and welcome to Energy Recovery's 2022 third-quarter earnings conference call. My name is Jim Siccardi, Vice President of Investor Relations at Energy Recovery. I am here today with our Chairman, President and Chief Executive Officer, Bob Mao and our Chief Financial Officer, Joshua Ballard.

During today's call, we may make projections and other forward-looking statements under the Safe Harbor provisions contained in the Private Securities 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 2, 2022 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 recognize today's challenging economic environment with a potential global recession, rising interest rates, inflation, a strengthening dollar, and lingering supply chain issues. We are not immune to these macro events. However, by the nature of our business and the strength of our balance sheet, we are in a better position to navigate these headwinds. Despite these macro-economic headwinds, we achieved our second-highest revenue quarter to date of $30.5 million dollars in the third quarter. We continue to anticipate a record Q4, which would mark our sixth consecutive record revenue year. While we anticipate signing roughly $130 million in contracts to ship this year, we are experiencing some mega project customer related delays, which could result in revenue landing between $121 and $125 million for 2022. Meanwhile, we are on track to exceed our industrial wastewater guidance of $3 million for this year.

We will discuss these risks, as well as our successes, today. Josh will then also take you through our guidance for next year and outlook for 2024. The takeaway is that we believe we are well positioned with the right technology and strategy even for this environment, despite any headwinds globally, and feel confident about our long-term prospects.

Desalination & Industrial Wastewater

As usual, we will start with our water business.

In 2022, it seems that water scarcity issues are increasing at a heightened pace across the globe. This is evident with news headlines highlighting record low water levels in places as disparate as the Western United States, along the Mississippi in the US, the Rhine in Europe, the Thames in England, throughout Italy, and around the world.

Growing water scarcity highlights the need for solutions that create more sustainable and stable sources of freshwater. Our water businesses, including both Desalination and Industrial Wastewater, are a part of that solution. For this reason, and to remain the dominant market leader in these growing markets, we continue to invest in innovative new products to remain at the forefront of these industries.

In October, we launched our newest pressure exchanger: the PX Q400. The Q400 is our most efficient and highest-capacity PX available and has generated substantial industry interest, including our first purchase orders. The Q400 is targeted at larger scale desalination plants as well as potential industrial wastewater applications. The Q400 can handle 33% more water flow than the Q300 model, it offers an industry-leading mixing rate of less than 3%, and provides a nearly 1% increase in efficiency at maximum PX flow capacity, which translates into significant additional dollar savings for our customers over the Q300.

We also recently announced a new pressure exchanger for lower pressure water applications. One example of this is brackish water desalination, such as underground aquifers, which typically requires much lower pressures than seawater desalination. Our new lower-pressure PX should help us expand our presence in brackish desalination. We are also innovating in industrial wastewater. Our team has worked with our customers to develop new PX products that address the industry's specific needs, such as our new U-250 PX. This PX increases the flow capacity of our Ultra PX line by six times, allowing larger industrial wastewater plants to implement this technology. We are seeing demand for such devices in industries like the lithium battery market, and brine mining in desalination. We are working on additional products to offer additional flow capacities that can process other types of wastewater to continue expanding into potential industrial wastewater verticals.

Results from the field continue to show that our Ultra PX is achieving efficiencies of at least 93% while generating significant savings for our customers, as we described last quarter. The proof-points collected from these initial deployments are proving instrumental in helping us to grow our product leadership position, and our backlog, in these key verticals, while highlighting our value proposition through efficiency gains and market-leading reliability.

We continue to see the results of these efforts in the lithium market, where we have secured 15 separate contracts, from lithium refining, recycling, and mining markets in China. According to Benchmark Mineral Intelligence, current global lithium volumes will need to increase by twentyfold to meet demand by the middle of this century. By 2040, nearly 20% of lithium will be sourced from recycled batteries.

The lithium market is an important segment of our growing industrial wastewater backlog. With our more customer-focused marketing approach, we are seeking to extract additional market share in this market. We are also actively investing into developing our brand name and building a market leadership role within the Asian industrial wastewater industry in verticals such as textiles where we expect to see significant growth in the coming years. We are committed to building the teams and presence we need to be successful in this market. We have set aggressive targets for our team and we will hold ourselves responsible for delivering on these targets.

To sum up, we will continue to strengthen our competitive position in desalination throughout 2023 and beyond to meet our 2026 target of $200 million in revenue. In addition, we will continue to invest in our industrial wastewater business to build our volume sales by investing in new product innovation, personnel in the key markets, including China and India, and increased local marketing efforts. To stay on track of our $30-$70 million revenue goal for 2026, we must significantly grow industrial wastewater revenue in 2023 and 2024. Given our backlog, we feel comfortable in our ability to double our revenue in 2023. For 2024, we are targeting a range of $12-$20M.

CO2 Refrigeration

Now let’s turn to our CO_2 business.

As we have previously stated, we are focused on achieving volume sales in 2023. We are comfortable with the technology and results seen in the field, continue to see growing interest from the refrigeration market, as evidenced by new sales orders, and increased activity by our OEM partners and others. It's an exciting time for Energy Recovery.

I'll start with an update of our partner related activities.

First, we successfully commissioned our PX G at Vallarta Supermarkets here in California. The unit has been performing reliably and as expected these first few weeks, but it is too early to provide data. Because we are now entering the cooler months, we expect efficiency gains will be less than those we initially experienced at our first installation in Europe. As a reminder, our technology improves in efficiency as outside temperatures rise. Continuing the momentum from the successful commissioning, we are working with Vallarta on potential future deployments of PX-enabled systems in 2023.

Our PX G installation in Southern Europe continues to perform optimally, which have frankly exceeded expectations. However, we have not incurred as much experience in these early weeks as we would have liked due to commissioning issues related to ancillary equipment, which resulted in some delays in running the PX G. When running, the PX G has delivered efficiency gains up to 25% during the hottest days of the summer. We are also in discussions with our partner on potential deployments for next year. We hope to have more of an update on those locations in early 2023.

Our US-based partner, whom we announced on our call in August, has been working with our technical team to optimize their system architecture with the intention of deploying their first PX G enabled CO_2 system at a supermarket here in the US, which will likely occur in early 2023.

In addition, we expect to ship multiple units to other customers through the end of this year and early 2023. In fact, we will recognize our first revenue in the fourth quarter this year. While this revenue will not be very material, it marks a major milestone on our path to volume sales. Importantly, these sales also include our first four units to an industrial partner in Europe for two locations in Europe. These sites will be the first locations to utilize multiple PX Gs, and we are already discussing future installations for 2023. We will be able to update you on these upcoming shipments on our year-end earnings call in February.

Finally, we have begun to see an uptick of interest from European heat pump manufacturers. This is, in part, a response to our recently published heat pump reference design, but also follows our participation in the largest refrigeration and heating technology trade show held annually in Germany. We were one of the only disruptive technologies at the conference and interest in our capabilities was high from both refrigeration and heat pump OEMS at the conference and these discussions have led to increased activities in the weeks since.

Our early partner successes are significant milestones for our burgeoning business. We are showing that (1) the refrigeration and heating industries are hungry for new technologies to help address their challenges with CO_2 systems, (2) that CO_2 is the future for both refrigeration and heat pump applications, and (3) that our products can provide concrete value by reducing energy consumption, just as we have consistently done for over 20 years in desalination.

As we look forward to 2023, we must begin to deliver on volume sales. Our CO_2 business is a startup, and just beginning to enter the market, therefore it is too early to provide explicit guidance. However, what I can tell you is that any volume sales in 2023 would be weighted to the second half of the year, and likely remain in the single digit millions. My goal is to exit 2023 with a backlog and/or pipeline that points to double-digit millions in sales in 2024 and show that we are on our way to our $100 to $300 million targeted revenue for 2026. We clearly have a lot of work to do to achieve these targets. However, we believe market interest is strong, and that the potential pipeline volume is there as we further gain acceptance of our technology in the industry.

In 2023, we will be increasing investments in sales and account management talent, as well as technical service resources to provide after sales commissioning and product support as we launch and expand marketing to further build our brand name in the industry and drive demand from the end customer of our technology – supermarkets and industrial users. We will continue to invest in engineering and technology to (1) partner closely with OEMs and supermarkets on the most efficient architectures using our PX G, (2) provide future improvements to our technology, and (3) further our heat pump applications.

We believe we are proving the versatile nature of our PX technology platform, while meeting the targets required by the disciplined growth strategy metrics we have put in place. We continue to execute on the strategy we have laid out for you over the last several quarters. And, despite the global economic headwinds this year has brought, we are making significant progress and continue to grow our business.

With that, let me hand the call over to Josh.

Financial Update – Joshua Ballard

Good afternoon, everyone.

I'll start first with providing a few more details on our top-line growth.

Revenue grew 47% in the third quarter year-on-year and has grown 18% year-to-date. The real story within these results is the strength in OEM and aftermarket sales, which have finally broken through our Covid lows in 2020 and 2021. OEM sales, excluding industrial wastewater, have grown over 60% year-to-date, and aftermarket has exceeded 30%. These strong results reflect, in part, a backlog of projects that were delayed the past couple of years. It is likely that 2022 will be our largest year ever in both OEM and aftermarket sales.

As I mentioned in prior calls, our mega project revenue started out slower the first half of the year but is picking up in the second half as expected. While Q3 was a strong quarter, our fourth quarter should be our strongest ever led by mega project shipments.

However, as Bob mentioned, there is some risk in our fourth quarter. I want to be clear that this risk is simply due to temporary project-specific delays. While we are seeing some changes in the timing of a few individual projects, we are not yet seeing a shift in our longer-term outlook related to global economic events. There were two key project related shifts this year:

- First, about $4 million of our 2022 backlog is shipping to Egypt where local capital controls have been put in place to slow hard currency payments due to a weakening Egyptian pound. This has slowed our ability to ship and recognize this revenue. While the timing is in flux, as of today we are confident these projects will ship either this year or next.

- Second, another $6 million project in the UAE was delayed due to the replacement of the EPC itself. This project is being rebid and revenue is likely delayed until 2024.

We are working hard to solve these challenges, but there does seem to be more risk to the timing of our 2022 revenue, which is why we have adjusted to a range.

In 2023, the dynamics of our desalination revenue will likely change somewhat. First, after a covid rebound in OEM and aftermarket sales, we expect these channels to remain relatively flat to slightly down in 2023. However, our mega project channel should exhibit growth of 6-12%, which shows continued strength in our most important channel for desalination growth.

Therefore, in 2023, we are currently projecting overall desalination revenue growth of between 3-7%. However, the actual growth rate in 2023 will much depend on our final 2022 results, and so I will update you again at the next earnings call.

This may be slower growth than 2022, however we often talk about the lumpy nature of our desalination revenue as a slight shift in the timing of one or two mega projects can have an outsized effect on growth in a given year. This is, in part, what we are seeing in 2023. You should also note that this growth is over weighted to the latter half of next year due to the timing of mega project shipments. Our first quarter will likely be our lowest quarter of the year, at between $10 and $15 million in revenue, and our second quarter could fall to between $20-$25 million, with the remaining balance split between Q3 and Q4.

We anticipate 2024 to be another strong year for desalination, where revenue growth could again exceed 20%. This growth in 2024 would put us back on an average 15% growth trend and put us well on the path to achieving our $200 million target in desalination revenue by 2026. We believe the secular strength of desalination remains strong.

In industrial wastewater, we are targeting $6-$8 million in revenue in 2023, which would mean doubling from this year. At least a doubling again of revenue in industrial wastewater in 2024 will keep us on track to hit our target of $30-$70 million in 2026.

Despite our bullishness, we are watching global events and, in particular, three main risks in the short to medium term: inflation, the strengthening dollar, and a potential global economic downturn. The biggest risk to our outlook is in our desalination OEM and aftermarket channels where we have visibility on average of only about six months. These two channels could be more negatively affected by a strengthening dollar or a potential global economic slowdown because 40-50% of their revenue is made up of a variety of industries in as many countries. We are already experiencing a negative effect related to the dollar with our sales to Egypt as I described earlier. While 60-70% of our revenue is currently in the Middle East, where there is little fear of the rising dollar or an economic downturn, it could affect customers in other parts of the world, such as North Africa, Asia, and Latin America.

We are less concerned as to how these economic events could affect our launch in the CO_2 business. This is a new business, and whether there is a slowdown in the overall industry is largely irrelevant to us, as the transition to CO_2

means that the CO_2 market will continue to grow at a very fast clip regardless. In addition, our product helps supermarkets save money, which only becomes more valuable in a challenging inflationary environment.

Now let's turn to gross margin. We remain on target to achieve our guided 66-68% gross margin in 2022 and will likely end the year at the higher end of this range. We still expect to see some softening of our water margin in 2023 as we experience growing wages, possible increased tariffs, and other inflationary pressures. In addition, we are expecting a growing shift in product mix whereas we are providing more integrated packages including racks and manifolds, which have grown to as high as 4% of revenue this past year. Racks and manifolds are an added service to our customers, but largely a pass-through cost for us at a much-reduced margin.

Of course, as every company is today, we are looking at pricing and methods to increase manufacturing efficiencies to mitigate the effect of increasing costs. Altogether, we are currently estimating a water gross margin of between 64-66% in 2023.

Our blended top line gross margin will depend on the level of CO_2 sales next year. As the nature of our volume sales in this startup business begins to take shape in 2023, I will be sure to update you.

Let's now turn to operating expenses. Our OPEX, excluding the one-time expenses associated with ceasing VorTeq operations, continues to evolve in line with what I have described in past calls. This year, we are trending to roughly 48-49% of revenue based on our original revenue guidance, or approximately $63-64 million in OPEX when excluding those one-time expenses. This OPEX range translates into 50-52% of revenue based on our adjusted guidance for this year. You will note that sales and marketing spend represents up to 80% of growth in recurring OPEX in 2022 as we ramp up our CO_2 and industrial wastewater teams; also included is a post-Covid bounce in spend as our desalination sales team returned to traveling, trade shows picked up, and so forth.

We expect this dynamic will remain much the same in 2023, with slower single digit growth in G&A spend, largely driven by wage inflation and headcount added in 2022, along with inflationary increases in insurance and professional services spend such as audit. We expect growth as high as 30-40% in sales and marketing spend as we accelerate investments in CO_2 and industrial wastewater, and flat to a possible slight decrease in R&D spend due to the lack of VorTeq investments in 2023. Overall, we expect OPEX as a percent of revenue to come in at 52-53% next year. This will be a slight increase over 2022, but we remain steadfast in maintaining our disciplined approach to spend as we grow. Inflation and our need to invest in sales and marketing ahead of future sales, has simply caused a bit of a bump.

However, I remain confident that by 2026 we can still reduce our operating spend to a lower percent of revenue, likely in the 30-35% range. In 2024, assuming we achieve the growth we are targeting, we will see the trend of OPEX decreasing as a percent of revenue begin to accelerate. As we look forward to 2024-2026, G&A spend should continue to grow at a much slower pace than revenue, and therefore normalize over this period. Sales and marketing spend will likely remain elevated over the next year or two but should begin to fall to a more normalized range of 5-10% of revenue as we realize revenue from our new business lines. Finally, based on our current strategy, R&D spend should continue to grow slowly and therefore fall below 10% of revenue in the coming years.

So, what does all this mean for our bottom-line profitability? In 2023, we are currently projecting a somewhat weaker operating margin compared to 2022 of between 10-14%, and adjusted EBITDA margin of 19-23%.

We should see our operating margin begin to grow again in 2024 through 2026. The simple math is this: if we assume an average blended gross margin of 60% by 2026 within our three business lines and reduce our OPEX to 30-35%, this implies an operating margin over the long run of 25-30%, and therefore an adjusted EBITDA margin of 35-40%.

In our projections of net profit, we are assuming a 15-20% tax range, which I would use for projections going forward.

Let's now turn to cash.

Our current cash and security balance remained at a healthy $87 million in Q3, and we believe we will end the year between $90 and $100 million. Where we end on that range depends solely on the timing of customer receipts at this point. We have clearly made a significant investment in inventory this year; however, this pace will not continue. First, we will ship out a lot of pressure exchangers in the fourth quarter. Second, while you will continue to see growth in our raw material inventory levels that will begin to reduce by early 2023. We had two goals this year: We have targeted to end the year with 4-5 months of pressure exchanger inventory, which is roughly what we ended last year with. Also, we continued to build up raw material inventory in light of production and supply chain issues in both China and Europe, which we believe we can begin to moderate as we head into 2023.

As we look forward, we should begin to see a reduction in inventory levels in Q4, which will likely continue throughout the first half of 2023. We will need to be careful to balance our finished good inventory levels with a changing product mix, which includes our new Q400, our industrial wastewater products, and PX G. In addition, we must keep an eye on our capacity needs as we gauge how quickly the CO_2 business will ramp up in the latter half of 2023 and into 2024. Increased finished good levels of our stable water products, for example, could help to free up capacity in 2024 if it is needed for CO_2.

In short, we will keep you updated as these businesses evolve next year.

We are expecting to invest $4-$4.5 million in total capex by the end of this year, and likely a similar level in 2023 as we continue to upgrade our manufacturing equipment in San Leandro and in the overall facilities. We do not expect a large increase in capex to occur until we begin to see growth in CO_2, at which time we will need to invest in new capacity to manage future growth. At this time, there is no plan for additional share buybacks.

With that, we can move into Q&A.