

ENERGY RECOVERY
Second Quarter 2023
Earnings Call
August 2, 2023

Opening Remarks – James Siccardi

Hello everyone, and welcome to Energy Recovery's 2023 second-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, August 2nd, 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

Thank you, Jim and thank you everyone for joining us today.

Water

First, as usual, let me start with our core Water business. Within desalination, we have now signed all mega projects that we targeted to ship this year and are now filling out our OEM and aftermarket channels, which happen closer to their shipment date. We are well positioned for the remainder of the year, and Josh will give you more specifics on these numbers.

In wastewater, our overall signed contracts and pipeline remain robust, and we now believe we should land at the mid to high end of our \$6 to \$8 million guidance by the end of the year. The team is most importantly focused on where we need to invest to deliver another doubling of revenue in 2024. We have discussed our intent to build out this team in the regions in which we operate, and this effort continues at a quickening pace as we enter the second half of 2023.

In June, we announced our expanded Ultra PX product series in a broad range from smaller flows as low as 10 gallons per minute, up to 250 gallons per minute under operating pressures as high as 120 bar, or 1740 PSI. Additionally, our Low Pressure PX enables us to provide pressure exchanger technologies in all trains of a plant – from low pressures to ultra-high pressures.

We will update you more on our plans for wastewater at our next earnings call in November, but our progress continues to yield confidence in not only achieving our 2023 wastewater guidance, but also our 2026 revenue targets in this segment.

As we look further out, we continue to pay attention to specific regions globally that may have potential for Energy Recovery in the coming years. Last quarter, we spoke about the potential for our business in North Africa, in particular the strength we see in Morocco, Algeria and Egypt. We have also identified potential growth markets in South America, which is also experiencing severe water stress and turning to desalination, water reuse, and wastewater treatment for relief.

Chile, which has been dealing with record drought conditions, continues to be a leader in the Latin American desalination market. In the second quarter, we announced contracts totaling over \$8 million for projects in the country, all of which are scheduled for delivery later this year.

Chile is projected to see growing water stress in the coming decades, which is already affecting their water supplies. According to the World Resources Institute, during the 2010s, Chile experienced only “low to medium” water stress,

based on the ratio of local water withdrawals to their renewable supply. This decade, they are already in the “high stress” category and are expected to be classified as “most extreme” by the 2030s and 2040s. The rise in temperatures will likely further accelerate; particularly in the Andes Mountains, which is the source of most of the country’s water supply. In addition, Central Chile, where 70% of the population lives, is expected to see significant reductions in rainfall.

This water stress is playing out today in the mining industry – a critical industry for Chile’s economy, which supplies nearly a quarter of the world’s copper supply. As of a year ago, Chile was expected to nearly triple its use of desalination in mining from eight desalination plants to 23 by 2028. Annually, the mining industry uses enough water to supply 75% of Chile’s population and by 2028, it is expected that over 50% of the water used in mining will be desalinated.

This need for water in Chile is appearing in our pipeline today, with sales expected to nearly double by 2026. Water reuse and recycling is another option for Chile, which could potentially generate material increases in our wastewater business as the decade plays out.

Mexico, ranked 24th in the world for water stress, is another country experiencing significant drought and recurring heat waves in recent years. The current water crisis began in 2022 and up to 60% of the country could be under severe water stress in the coming decades. In fact, earlier this year, Mexico City itself announced it would reduce water pressure as reserves in its main reservoir fell below 50%.

We believe desalination and wastewater reuse will be critical components of Mexico's water strategy in the coming years. Although we have not seen significant revenues from Mexico in recent years, our pipeline is growing, and we are nearly doubling our business there in 2023. However, the future of desalination or water reuse in Mexico will depend on their ability to build sufficient water distribution networks.

Argentina, despite it not being a material revenue generator for Energy Recovery, is another South American country experiencing significant water stress. The country's worst drought in 60 years led to Argentina reporting significantly lower crop yields for 2023, which is a strain for an economy heavily dependent on agricultural exports.

These three countries have a combined population of roughly 200 million, which is more than twice that of the Middle Eastern countries that have been driving large scale desalination growth in recent years. In 2023, revenues in Central and South America are potentially nearly doubling from single digit millions to the mid-teens.

As with North Africa, how and when water stress finally pushes these countries into a considerable ramp up in alternative sources or recycling of water is not known, but that there is a growing need is clear. We have already recently deployed additional resources to continue to serve this market and will continue to invest in its future in the coming years as needed.

CO2 Refrigeration

Now let's turn to CO₂, where we continue to receive both market validation that our technology is being accepted, as well as concrete proof points with customers.

In a clear signal that our PX G is beginning to truly resonate with the refrigeration market, we were recognized in two significant ways in the second quarter. First, the PX G was awarded the Refrigeration Innovation of the Year at the ATMO America Summit in Washington DC in June. This award was chosen by a vote of industry players globally, and Energy Recovery's PX G was selected over nominations of other leaders in the industry.

Additionally, the PX G, as well as Epta's XTE refrigeration system, have been separately selected as finalists in multiple award categories, for the annual RAC Cooling Industry Awards - including, the "Refrigeration Innovation of the Year Award". This award is granted to a product that provides existing refrigeration systems with "definitive and impactful change". As a reminder, the core innovation of Epta's XTE refrigeration system is the incorporation of our PX G.

We are proud of both the ATMO award and, win or lose, these latest nominations are encouraging signs that our innovative technology is becoming increasingly accepted by a conservative and mature industry. However, validation must become pipeline, and pipeline orders, and those orders must become profitable revenue for Energy Recovery for us to achieve our target. In that regard, a few concrete actions have taken place this quarter.

First, we have begun to see repeat orders from our partners as they build their own pipelines of PX G demand. Both European partners, Fieuw Koeltechnik

and Epta Group, have identified their next installations in major chains in Eastern and Western Europe. We will keep you updated on their progress as they are commissioned.

Second, our PX G is scheduled to be installed in a Canadian supermarket chain this quarter to help support refrigeration systems under stress from the historic temperature spikes happening today. Food loss due to refrigeration is a major problem in the supermarket industry costing millions of dollars annually and affecting the bottom lines of both supermarkets and the OEMs themselves.

Our PX G has shown it can allow existing CO2 refrigeration systems to operate at temperatures up to 10 degrees Fahrenheit over their current capabilities. With average global temperatures reaching their highest on record, we are well positioned to help solve a growing challenge as supermarkets move to CO2 refrigeration.

Third, our US partner, Vallarta Supermarkets, has ordered a PX G for installation at a second store in California. We recently presented the results of our PX G at their supermarket in Indio, California at the ATMO conference in June together with Vallarta. We showcased an independent assessor's finding that shows, under certain conditions, our PX G helped Vallarta achieve a significant reduction in its CO2 refrigeration system's energy consumption. Specifically, the study showed that, at temperatures of 95-105 degrees Fahrenheit, the PX G reduced the system's total energy workload by approximately 30%. These tremendous savings are comparable with those that we saw earlier this year with Epta.

And lastly, as previously discussed, regional distributors in Europe are an integral part of our strategy to approach the market in the region. As such, we continue to move forward in discussions with additional distributors with the hope of signing more of them in the coming months. Such agreements are important in helping us penetrate markets in an expeditious manner.

Last quarter, we announced our plans to hire and train the field engineering and technical staff we need to support our roll out. This quarter, we are taking this a step further and will be soon announcing a partnership with a major U.S. OEM to open a new training facility here in the U.S. This new facility will incorporate our PX G technology and help familiarize external service technicians with the operations of the PX G. We have already begun inviting industry participants to the opening and look forward to formally announcing it in the coming weeks. Our hope is to replicate such facilities elsewhere with other partners to ensure that demand for the PX G is not only met with the product, but with the technical support needed as well.

Wrap-Up

As you can see, we have had an eventful quarter, and first half of the year. And, I am also pleased to report that, in the second quarter, MSCI assigned Energy Recovery its highest ESG rating of AAA. In fact, we actually earned the top rating within our industry sector. This is quite an accomplishment for a company that only commenced on its ESG journey four short years ago and is a testimony not only to our strategy and products, but also to the hard work and dedication of our ESG team and that of our entire company.

Next quarter, we will talk about our plans and projections for 2024 in both the CO2 and Water businesses as we continue to push towards our 2026 targets.

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

Financial Update – Joshua Ballard

Good afternoon, everyone. Achieve

We generated revenue of \$20.7 million this quarter, which was within our guidance of \$20 - \$25 million. Note that we actually shipped out over \$26 million in product during the quarter, but due to GAAP revenue recognition rules nearly \$6 million of revenue of a specific mega project shipment will be recognized early in the third quarter. Therefore, we had a strong quarter based on our expectations, which helps provide confidence that we will continue to meet our revenue targets this year. However, this delay in recognizing that mega project did cause an operating loss in the second quarter of \$2.5 million. We are confident that our overall profitability will remain in line for the year as we begin to realize a larger number of mega project shipments in the third and fourth quarters.

We recognized \$600k in wastewater revenue, for a total of \$2 million year to date. While we have only achieved a portion of our target for the year, between signed contracts and our pipeline we are comfortable that we will achieve our wastewater targets this year as Bob described.

In addition, we recognized roughly \$100k in CO2 revenue this quarter. Although we are showing a negative margin in our emerging technology segment,

this is related to the timing of the GAAP recognition of expenses related to this revenue, and we should see this normalize in the third quarter. The balance of revenue in the emerging technology segment was in oil & gas, largely related to replacement parts of projects already in operation from several years ago.

As we look towards the third quarter, you can expect to see growth continue to rise but with some short-term risk. Our current revenue target range for the third quarter is quite wide, between \$25 - \$35 million. The reason for this wide range is related to a few specific mega projects. We are uncertain as to whether we will be able to ship these orders before the end of the quarter, however we are confident these projects will ship before the end of the year.

Therefore, the risk to these projects is very short-term, but should not affect our overall 2023 results. However, note that if we only achieve the low end of our range in the third quarter, we would be close to a breakeven operating profit, or possibly show a small loss in Q3.

Both our second and third quarter swings again highlight the lumpy nature of our revenue in desalination, and how a small number of mega projects can swing a quarter one way or another. However, this in no way reflects the strength of our pipeline. This strength, along with the purchase orders we have in hand already, gives us confidence in our ability to achieve our targets this year.

As we look to the second half of the year, we now anticipate achieving desalination revenues in the lower half of our guidance, or roughly 3-5%. Note that, based on our guidance for the third quarter, this year is now heavily weighted to Q4, which could exceed \$60 million. Such a large quarter, of course,

increases risk when so much is dependent on the final few months of the year. Of course, we have been building for this heavy second half all year, which is the main driver of the increase in inventory year-to-date. Therefore, we are ready to deliver the product, and if we experience any delays, they will likely be customer-related ones. We'll know more in November and will update you on our progress in the fourth quarter then.

Our gross margin was comfortably within the upper end of our guidance. Our product mix was a more typically balanced one, although somewhat light on pressure exchangers, but overall putting positive pressure on margins. You should expect to see gross margin inch upward to between 65-67% in the third and fourth quarters as this trend continues. The range we are providing is reflective of a little uncertainty in the final mix of pumps and turbochargers, which is contingent on our OEM and aftermarket sales. However, this forecast means that we should end the year within our 64-66% guidance.

Our operating expenditures continue to trend within the guidance we laid out last October. G&A spend is growing in the single digits, and largely driven by inflation and a small increase in headcount. Most growth can be seen in sales and marketing spend, which has grown 38% year-to-date. This growth is right in line with expectations as we continue to ramp up investments to support growth in both wastewater and CO2.

You will note a 22% decrease in research and development spend year to date. While we do expect R&D spending to fall somewhat this year due to the cessation of VorTeq activities, most of this quarter's drop is simply due to the

timing of some of our project spend. By the end of the year, as we stand today, we anticipate R&D spend falling year-over-year roughly between 4-8%.

Therefore, our overall target to spend between 52-53% OPEX as a percentage of revenue, based on our current revenue projections for the year, remains on track and unchanged from our projections in October last year.

Unsurprisingly, following a very low revenue quarter in Q1, we showed negative operating cash flow in the second quarter. This is entirely due to lower collections from a much-reduced accounts receivable balance at the end of the 1st quarter.

However, our overall cash balances actually remain higher than planned due to better than expected collections in the second quarter, as well as inventory levels that remain below forecast. At the last call, I stated that inventory levels could exceed \$40 million this quarter. We have continued to proactively manage our raw material inventory levels down, which is the main reason for this reduction from forecast. This is a positive result as we seek to reduce the number of days we hold raw material inventories from our highs during the supply chain crisis over the past couple of years.

While we think it is still possible to see raw materials fall further this year, how far they fall is entirely dependent on our CO2 buildup in the coming months. We'll have a better idea in October. Where we stand today, we see our inventory levels settling out at between \$25 -\$30 million by the end of the year.

Overall, it was another financially sound quarter, and our team remains confident in achieving our range of guidance for the year.

Let's move to Q&A.