ENERGY RECOVERY
First Quarter 2024
Earnings Call
May 1, 2024

Opening Remarks – James Siccardi

Hello everyone, and welcome to Energy Recovery's 2024 first quarter 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, May 1st, 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 and thank you all for joining us today. The first quarter was a busy one for us and played out as anticipated. Revenue, at $12.1 million, was in-line with our guidance for the quarter of $10-13 million.

With regards to the CFO transition – we have been actively interviewing some promising candidates and are making progress. We believe we will have our candidate in place prior to Josh's last date of June 30th.

I stated on our last call that I, as well as the Board, strongly believe Energy Recovery's strategy of PX diversification to drive growth is the right strategy and is critical to our future. While continuing to recognize the importance of maintaining our foundational market leadership in desalination, it is critical that we also continue to look for ways to accelerate our penetration into the wastewater and the CO_2 refrigeration markets, as this is from where the lion share of potential revenue growth will originate. We anticipate our strategic future will build off this perspective.

We have now formally kicked off work on our strategic planning cycle and have enlisted the assistance of industry experts to provide us additional guidance, specifically in Wastewater and refrigeration. These industry experts will play integral roles in providing intelligence and hard data, while challenging us on our product development and market strategy and contributing to the development of our strategic Playbook. This will add significant expense in the second quarter especially, but I believe it is critically important work to establish a strong strategic foundation from which to grow in the coming years.

Now let's get into our update, starting with Water.

Water

First, we are maintaining our revenue guidance of $140-150 million for the year. Our current 2024 contracted projects, including the revenue recognized in the first quarter, totals roughly $87 million, or 60% of the mid-point of our guided range for the year. This compares to $69 million, or 50% of the guided range, at the same time in 2023. This reflects a 26% increase year over year and underpins our confidence in our guidance for the year.

In addition, we also just signed our first mega project deal in Brazil for shipment in 2025. In our second quarter call last August, we discussed in some detail the growing water challenges in South America. This project is a clear example of how growing water challenges outside of the Middle East, desal's historic growth area, are being reflected in our pipeline in new ways.

The cadence of this year's revenue guidance is unchanged. We remain heavily weighted towards the second half of the year. We are seeing real strength in both our desal OEM and Aftermarket sales as we start the year and have signed most of the mega project deals for the year. Our focus today in Water is to close the handful of mega project deals remaining in the coming months, as well as maintaining our momentum in our OEM and Aftermarket channels to end the year as strongly as possible.

Our wastewater business is also developing well this year, and we remain confident in our range of $12 - $15 million for the year. Our pipeline continues to grow, and we have increased our signed wastewater contracts by almost 40% as compared to last year at this time.

We have also seen positive news here locally in the United States as it relates to the municipal wastewater market. The United States government on April 10th announced newly adopted rules to address PFAS contamination, or forever chemicals, in our drinking water. The Biden Administration has allocated $9 billion to help communities with drinking water impacted by PFAS. One valuable tool for filtering out existing PFAS from drinking water is reverse osmosis filtration. While it's not the only solution to this problem, we believe reverse osmosis can play a key role in the coming years as the world tackles this growing challenge and we will be exploring these opportunities and the timing of them in our Playbook. The global attention on PFAS continues to underscore the growing focus on water quality and scarcity that is happening around the world today.

Now let's move to our CO2 business.

CO_2

The past few months, the most important activity I engaged in was to meet with the major OEMs in the US and Europe. I have a few key takeaways from these meetings, all of which support the approach we are taking this year.

First and foremost, the interest in and feedback on the PX G was positive. OEMs can see the potential value of the PX G in their systems and remain very interested in our success.

Second, OEMs are looking for more quality, uninterrupted runtime data during the summer months, which is the goal of our activities this year. This data will (1) provide reliable performance data in the field which is critical to OEMs and end customers to fully accept our product in the marketplace, (2) fine-tune our value proposition, and (3) be a catalyst to allow Energy Recovery to take a substantial step forward to building commercial relationships with the OEMs.

Third, once the OEMs have comfort in our data, it is clear that our best path forward will be to integrate the PX G directly into the rack architecture of the OEMs CO_2 systems. This will mean that OEMs will need to commit engineering resources to adjust their existing architectures to incorporate the PX G. This is a commitment of time and money and therefore another reason why field data is so key to creating broader market acceptance for the PX G.

At the last earnings call, we discussed two gates to better position ourselves for future market penetration and revenue growth. These gates directly support the feedback we received from the OEMs in the first quarter.

The first gate is the successful completion of testing of our second generation PX G in our internal labs by the end of Q2 2024. I am pleased to announce that we have achieved this milestone. Lab performance has shown an order of magnitude increase in reliability and performance, which is critical to providing the uninterrupted runtime data we need this year. This second generation PX G has now been installed as part of a beta test in supermarkets in California and Belgium. Both installations have been operating successfully since the beginning of March.

The second gate is the successful installation, operations, and 3rd party validation of 30 – 50 additional field validation sites by the end of Q4 2024. Our first step is to install roughly 10 sites this summer, which are the most critical sites for this year and will provide the key performance data that we need. As of today, we have three sites currently running. We expect four additional sites to be commissioned by the end of June in Canada, Belgium, Hungary, and the US. The remaining three sites are scheduled for Europe and the US by the end of August.

I will continue to update you on our progress in August, but we are off to a strong start to the year.

Outside of these critical activities, I have two other updates from the market. First, our PX G was awarded the "Refrigeration Product of the Year" by ACR News London. This Award is a recognition of excellence and innovation from across the air-conditioning and refrigeration sector. The PX G was selected for its ability to improve year-round trans critical CO_2 system performance by reducing energy costs, which is perhaps the single biggest hurdle faced by grocery stores in adjusting to the stringent global requirements. This is the third award we have received since the start of 2023 as the PX G continues to gain attention across the globe and should serve as further proof that technology is catching up to the changing regulatory environment.

Second, I have a quick update on the regulatory environment. The EU came out with new, more stringent regulations on the reduction in HFCs that became effective March 11th. Whereas previous regulations reduced HFC usage from 31% of their 2015 baseline in 2024 to 21% by 2030, the EU has now accelerated this reduction. As of March 11th, the EU must reduce usage to 24% of their baseline by 2025, 12% in 2027, to 5% in 2030. This is good news for CO_2.

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 30-50 sites in North America and Europe by the end of the year, and
- Deliver our full-year revenue guidance of $140-150 million.

The work we do over the next several months will position us to deliver on our future in Water and CO_2 growth. In the interim, we remain one of the purest means to invest in the growing global water scarcity story.

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

Financial Update – Joshua Ballard

Good afternoon, everyone.

First quarter revenue fell comfortably within expectations, with no real surprises and within the midpoint of our guidance from our last earnings call. Unlike the first quarter last year, our Water channel mix was more balanced; with roughly half our revenue coming from mega projects, and the remaining split between OEM and aftermarket sales. Although our OEM channel shows a significant decline as compared to Q1 last year, this is simply due to the timing of projects shipping. We currently expect to show healthy double-digit growth in our OEM channel in 2024.

We are reporting no material Emerging Technology revenue this quarter, which is in line with David's comments in February with regards to our short pause to make and test the enhancements to the PX G, and now launch the second generation here in the second quarter.

We are maintaining our estimated range for Water revenue in the second quarter at $20-$25 million. This means that we are still heavily weighted to the second half of the year. Where we sit today, we are assuming that the last two quarters will show 40% of the second half revenue falling into Q3, and 60% in Q4. However, we will be better prepared to update you more precisely in our August call as the third quarter comes into focus. Note that our target Water revenue range of $140 - $150 million this year includes a buffer against possible movements of up to a couple of mega projects.

David mentioned the status of our signed and shipped contracts year to date. We have been getting a lot of questions on the status of our pipeline from all of you to get a sense as to how the year is progressing. Our plan is to continue to update you on this cumulative number as we move forward through the year to give you a sense as to how we are tracking to the current full-year guidance. We will then reset in Q1 next year for 2025. Therefore, note that the $87 million cited for this year is explicitly for signed Water projects, in both our desalination and wastewater markets, forecasted to ship out in 2024 inclusive of those shipped in the first quarter.

Our gross margin in the first quarter was 59%. Much like last year, we are seeing a product mix more heavily weighted to pumps and turbochargers in a low revenue quarter, which is lowering our margin on a blended basis. You will also note that our margin is 190 basis points below Q1 2023, despite a similar product mix. This is because of the inflation and growing manufacturing costs that we have been describing over the past year. We also experienced slightly higher scrap in the first quarter which, combined with a lower revenue denominator, had an outsized effect on margin but will not be material for the full year. We fully expect to recover to our guided range as the year progresses and pressure exchangers take a larger percentage of sales. For now, we have no change to our guided range of 64-67%, and the year-on-year variance from Q1 2023 roughly falls in line with our expectations for 2024.

Let's now turn to operating expenses. Our OPEX grew 11% over the first quarter of last year, however we are reporting a decrease of 4% against Q4 2023, which is a more relevant comparison. There are two things at play here. First, Q1

OPEX is inclusive of nearly $500k of, what we call, one-time executive transition costs, which you will note in our non-GAAP calculations in our press release. In addition, this quarter includes another $300k of short-term retention grants provided to some executives at the end of last year. Adjusted for these temporary charges of roughly $800k, our base recurring OPEX grew closer to 7% year on year.

Second, our investments in people and the organization grew throughout the year in 2023 as we increased our sales and marketing spend and added headcount in support of both our Water and CO_2 businesses. Therefore, what we are seeing now is the effect of increased headcount and other spend in the first quarter for investments made in 2023.

Now that we are further into the year, and our one-time costs related to the ongoing transition are becoming clearer, I wanted to go a little deeper into our OPEX forecast to provide some additional clarity.

In the second quarter, we expect our base recurring OPEX to remain fairly flat. However, we will have material one-time expenses related to executive transition, and a significant portion associated with work in support of our long-term growth strategy as mentioned by David in his opening remarks. These overall costs, which will include a mix of cash and non-cash items, could be as high as $5 million in Q2, meaning our OPEX will likely land between $22-$23 million. We are expecting an additional roughly $1.5 million of these one-time expenses by the end of the year. When you add in the $800k of one-time expenses described earlier, this brings these charges to a total of about $7 million for 2024.

In light of some of these one-time expenses, we have made the decision to reduce our base recurring OPEX to around $71-$73 million vs. my guidance from last quarter of $73-$75 million. Note that these reductions are in softer non-personnel discretionary spend and will not be in areas that could get in the way of our growth plans. If you add our estimated $7 million of one-time costs, this puts our total forecasted OPEX for the year at roughly $78 to $80 million.

I realize that 2024 is a bit of an anomaly compared to prior years, but we should normalize again in 2025. We will be sure to clearly outline this one-time spend each quarter so you can differentiate between our recurring operating spend and any one-time charges that we do not expect to repeat next year.

Now let's turn to our bottom line. We experienced a loss in Q1, as forecasted, and largely in line with public estimates. Like the first quarter last year, this should be expected based on our level of revenue and fixed OPEX. We expect our second quarter to remain negative, moving back into positive territory in the third and fourth quarters to end the year strong.

We continued to grow cash in the first quarter, increasing our cash and investments from $122 to $129 million. We expect these balances to pause at this level in the second quarter as we continue to build inventory levels to support planned shipments in Q3 and Q4. We are already seeing an uptick in inventory levels driven by WIP and finished goods. Like last year, inventory will continue to build until dipping back down to normalized levels in the third and fourth quarters as I've described in previous calls.

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