ENERGY RECOVERY
Second Quarter 2024
Earnings Call
July 31, 2024

Opening Remarks – James Siccardi

Hello everyone, and welcome to Energy Recovery's 2024 second 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 Brandon Young, our Controller and Interim Chief Accounting Officer.

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, July 31st, 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

Thanks Jim and thank you all for joining us today.

I am joined today by Brandon Young, our Controller, and interim Chief Accounting Officer. Brandon has been an integral part of our financial leadership team for many years.

Before I get into the second quarter results, I want to update you on our CFO search and strategic planning process, or Playbook process as we call it.

First, I want to call your attention to the press release that went out earlier today regarding our new Chief Financial Officer.

I am pleased to announce that Michael Mancini will become our new CFO effective August 5th. Michael brings experience leading high-growth, engineering and technology-focused startup companies, two of which he served as CFO. He has extensive financial, operational and capital markets experience from a diverse career including banking, private equity and hedge funds. Michael's experience will serve us well as we expand into new Wastewater and CO2 markets and work to further strengthen our relationships with shareholders.

Regarding our Playbook process, we have moved from the "Where to Play' phase to the "How to Play" phase. This "How to Play" phase will include critical milestones and financial targets that will form the foundation for how we communicate our progress with all of you in the years to come.

While we still intend to share a high-level summary of our Playbook during the third quarter earnings call, I have decided that a more appropriate forum would be to host a webinar in the 4th quarter to share the details. We will be providing the details for this webinar by the end of the third quarter.

Now let us move to the second quarter update.

Water

Beginning with Water, we are maintaining revenue guidance of $140 to $150 million for the year. There are four reasons why I remain confident in this guidance.

First, we achieved second-quarter Water revenue of $26.9 million, which was $6.4 million better than the same quarter last year thanks in large part to strong Megaproject and OEM performance in MEA and Europe. There were several shipments worth noting that we have discussed in previous calls.

- We are pleased to report that we have completed shipment of the Perur project In Chennai, India. As a reminder, this was the project that slipped out of December last year. As is the case with all large-scale infrastructure projects, there are execution risks that are out of our control that can cause delays. It is important to note that while our position remains strong in the mega project space, we are not immune to these risks. We delivered the first shipment in Q2 worth $4.2 million and the second shipment this month worth $4.1 million. Once constructed, this will be the largest Desalination plant in India delivering 400,000 cubic meters per day.

- We also shipped the first phase of a three phase Hassyan IPP project in Dubai, UAE worth $5.2 million. Once constructed, this 820,000 cubic meters per day plant will be the largest Desalination plant in Dubai. This serves as another example of large-scale project slippage. In this case the project was retendered, and timing was adjusted but our position to execute this project remained strong throughout the process. We expect the remaining two phases to ship within this calendar year.

Second, we announced in July the signing of $15 million in contracts to supply Pressure Exchangers to several SWRO desalination plants in India, which included the Perur project. The remaining four projects are expected to ship in 2024. All together, these plants will provide over 670,000 cubic meters of clean drinking water to communities in India each day. As one of the most water stressed countries in the world, India continues to invest in desalination projects to supplement its freshwater supply. We continue to observe a growing divergence between the world's freshwater supply and demand and this trend can be observed in countries like India where it is home to 18% of the world's population but has only 4% of the world's freshwater resources.

Third, our current 2024 total Water revenue which includes revenue recognized in the first half of the year, and signed projects under contract yet to be delivered, totals approximately $107 million or 74% of the midpoint of our guided range for the year. This compares to roughly $118M, or 89% of the guided range, at the same time in 2023. This reflects a 9% decrease year over year. The decrease is driven by the timing of the closure of several large-scale project contracts. We currently have approximately $25 million of mega project draft contracts that we are anticipating finalizing over the next several weeks that we plan to deliver this year. Our strong performance of contracted activity and the draft contracts under finalization underpins our confidence in reaffirming our guidance for the year.

And fourth, our Wastewater pipeline continues to grow, and we have increased our signed wastewater contracts by almost 5% as compared to last year at this time. As predicted, we had a slow start to the year primarily driven by the economic conditions in China. We are monitoring the situation closely but have already seen an uptick in bid activity and plan to have a very active second half of the year in this sector.

Based on current project delivery schedules, we expect that 35% of the second half Water revenue will fall into Q3, and 65% in Q4. This would put the third quarter Water revenue at $35 to $39 million and the fourth quarter at $66 to $72 million.

Now let's move to our CO2 business.

CO2

As I stated during our last call, after the successful completion of lab testing our second generation PX G in the second quarter, our first gate for 2024, we have now moved towards our second gate, which is the installation of 30 to 50 sites by the end of Q4 2024.

We had planned to have ten of these sites installed by the end of August to capture critical summer data that would then form the foundation for a white paper we will publish in the fourth quarter. I am pleased to report that we now have nine second generation PX

G sites operating in the US and Europe as of July 15, with the tenth site to start up in August.

Additionally, we have contracted with a highly respected third-party engineering firm, DC Engineering, to measure and verify (M&V) energy savings provided by our second generation PX G at six of the ten sites. They will also assist us in the white paper development. These six sites are in California (Vallarta & Grocery Outlet), Ohio (Kroger), Belgium (Delhaize) and Spain (ELDA Foods). The site in Spain will be a large food processing plant.

DC Engineering is an industry leader in commercial/industrial refrigeration design, management, and compliance services. In fact, many of their engineers have worked for large retailers.

In such a conservative industry as food retail, third party verification of a new technology is paramount. In fact, if you have faith in your technology as we do, you will proactively engage a respected third party or university to independently verify your claims in a field setting. This is exactly what we are doing with DC Engineering.

The last time I worked with them was on a new ammonia carbon dioxide cascade refrigeration system for a supermarket chain in the southeast. In fact, our results were so well received, we and our supermarket customer were awarded the EPA's Greenchill Platinum certification for environmentally advanced refrigeration systems.

Such an exercise becomes table stakes when sitting in front of end users.

With DC Engineering's assistance, our white paper will become the catalyst for our OEM partners and us to accelerate PX G adoption with end users.

DC Engineering is currently in the "measuring" phase.

Additionally, our OEM partners, Hillphoenix and Epta, will be collecting data on our behalf at two of the ten sites located in Canada (Loblaws) and Hungary (Auchan) respectively. We will be collecting data at the remaining two sites.

And finally, we currently have forty sites in our pipeline for 2024 including the nine sites already operating.

Financial Update

Our Gross Margin rebounded from the first quarter of the year with the second quarter coming in at approximately 65%.

Our Gross Margin expectation for the third quarter is 62% to 64% as we continue to manage Q400 ramp up production challenges. We are confident we will have most of these challenges, which are largely material handling, behind us by the end of the third quarter, including adding Q400 capacity by the end of the year.

We had expected the Q400 would only comprise 25% of our Water PX demand for 2024 but have been pleasantly surprised that it is trending towards 50%.

Our full year Gross Margin guidance remains at 64% to 67%.

Our Operating Expenses increased 21% over the second quarter of last year, primarily due to one-time expenses. As mentioned last quarter and as expected, we continued to experience one-time costs associated with the work in support of our long-term growth strategy as well as some executive transition costs. The combined impact of these one-time expenses totaled approximately $4 million in the second quarter.

To recap one-time costs in Operating Expense to date, we incurred $0.8 million in the first quarter and $4.0 million in the second quarter. The second quarter breakdown is as follows:

- $2.6 million for Playbook consulting,
- $1.4 million for recruiting and Executive transition costs.

We are maintaining our Operating Expense guidance for the year of $78 to $80 million, which includes the estimated $7 million in one-time costs. We expect Operating Expense to come in at $21 to $22 million for the third quarter.

Of the remaining approximately $2.2 million of one-time costs, we expect 75% to be spent in the third quarter and 25% in the fourth quarter.

As a result of these one-time items, we experienced a small Net Income loss in the quarter, though with a large sequential improvement from the previous quarter and putting us very close to break even. We are on track to moving to positive operating income as the remainder of the year progresses.

Lastly, we continued to grow cash in the second quarter, increasing our cash and investments position in the second quarter from $129 million to $138 million. We currently expect to end the year at between $140 to $150 million.

Wrap-Up

To sum up:

- We delivered a strong quarter supported by a growing backlog, which gives us confidence in our full year revenue guidance of $140 to $150 million,
- We anticipate our wastewater business to generate $12 to $15 million in revenue,
- We expect to have 30 to 50 sites with our second generation PX G installed by the end of the year, and
- We are maintaining our Gross Margin guidance of 64% to 67% and Operating Expense guidance of $78 to $80 million.

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