

ENERGY RECOVERY
Second Quarter 2022
Earnings Call
August 3, 2022

Opening Remarks – James Siccardi

Hello everyone, and welcome to Energy Recovery's 2022 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 3, 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 are all hearing a lot of negative global and domestic economic news. Inflation is high, there is war in Europe, and we may already be in a recession. Equity markets, though a little better recently, have fallen swifter than any time in decades. Yet, here at Energy Recovery, we continue to make substantial progress in all three of our business markets, despite this noise around us. Our growth targets remain intact and our optimism resilient.

I will remind you that, regardless of the domestic economic headwinds, more than 98% of our business is overseas. Despite high inflation, our profitability remains robust owing to the strength of our margins, reflected by the reputation and value creation of our PX technology. Despite supply chain disruptions, we continue manufacturing without pause because of our team's

forethought to build inventories well before supply chains were an issue. Despite turmoil in the financial markets, we maintain ample cash reserves. And, despite the rise in interest rates, our business, which currently has no reliance on debt, has not been directly impacted.

In our core market of desalination, we help provide water to millions of people worldwide. We believe this basic human need will largely weather current global economic uncertainty as it has in past years. The need for water in an increasingly water scarce world remains a strong motivator for investments in this sector.

As of today, we believe we remain on track in our desalination and industrial wastewater markets to meet our guidance of 25% revenue growth for 2022. Our mega project channel remains strong, and we are seeing a resurgence in our smaller OEM desalination projects from the Covid-related pent-up demand. In addition, increased global water scarcity is leading to a regulatory environment that is pushing filtration requirements of industrial wastewater.

In short, we feel we are well positioned today and are poised to execute on the strategy we have laid out ahead of us. Today, I will focus our discussion on industrial wastewater and CO₂, and Josh will provide you some more specific updates about how the desalination business is evolving this year.

Industrial Wastewater

With that let me move on to industrial wastewater. As of the end of the second quarter, we have already exceeded 2021 revenue by 60% and are well on

our way to meeting our forecast of three million dollars in industrial wastewater revenue for fiscal year 2022.

I mentioned on our last call that we were collecting performance data from our first commissioned industrial wastewater plants. Results from the field show that our new Ultra PX is achieving efficiencies of at least 93% and we are generating the savings for our customers that we promised.

For example, at one lithium battery plant, our technology is saving the facility roughly \$150 thousand in electricity costs per year, based on 2021 electricity cost levels, with an estimated one-year payback. At a textile plant in India, a \$500 thousand investment in our technologies is netting an estimated \$500 thousand per year in savings, again based on 2021 electricity costs. This translates into value creation of 10-15x the initial investment over the life of these wastewater plants. We expect to see similar savings results in other wastewater verticals as well. With rising energy costs, we expect these savings to increase and accelerate in the coming years. We believe these real-world savings will help further prove the value proposition of reverse osmosis processes in industrial wastewater, which of course are driven by the energy savings provided by our products.

We are now able to use this data to educate and further penetrate the markets where we have a presence. For example, we received our first award within the lithium battery recycling market in China during the second quarter. This installation will give us our first reference site in this lithium sub-vertical. We have now penetrated three sub-verticals of the lithium-ion battery value chain – namely: lithium mining, battery manufacturing, and now recycling. This is a

significant milestone for us as we continue to build volume in this space, especially given the significant position China plays in this global market.

We have previously spoken about the potential of the overall lithium market and our estimated TAM of likely more than \$200 million this decade. Because of the global urgency to expand lithium capacity, our teams will continue to prioritize this market; and have already identified numerous projects in various stages of planning, between now and 2030.

Another industry where we have had early success is Textiles. Water is used in multiple stages of the textile manufacturing process and the industry overall generates nearly 5 billion tons of wastewater per year. Textiles is one of the top three water-wasting industries in both China and India. Combined, the two countries discharge over 2.5 billion tons of wastewater every year.

Today, the Textile industry is looking for ways to reduce waste effluent and to re-use as much wastewater as possible for a variety of reasons including regulatory pressures, rising costs and limited availability of fresh water in an increasingly more water scarce world, and the fact that many chemicals in the textiles process can be recycled and re-used or sold.

We have had initial success in textiles, with approximately 15% of our early sales occurring within this industry. We currently estimate a potential TAM, in China and India alone, of about \$75 million today, growing to over \$100 million by 2026 and \$140 million by the end of the decade. Importantly, India has announced intentions to double the size of their textile output by 2026 and is investing in textile hubs with centralized wastewater treatment centers. This

centralized treatment model, which will likely process larger flows of wastewater, should provide an exciting opportunity for Energy Recovery.

All told, the lithium battery and textile markets could reach a total TAM for this decade of more than \$340 million. In summary, we believe that these two verticals represent critical market opportunities to serve as the core revenue generating focus for our industrial wastewater unit.

We will keep you updated on our progress within these two verticals in the coming quarters as we continue to drill down within them and will highlight additional wastewater verticals in future calls as we continue to push for increased volume sales in this business.

CO2 Refrigeration

Now let's discuss our CO2 business, where again, global regulations are forcing a transition from HFC refrigerants to more climate friendly natural refrigerants due to global warming, providing the tailwinds that drive future potential growth in CO2. While this transition will occur with or without us, the response we have received thus far seems to indicate the industry's desire to ease the OPEX challenge natural refrigerants pose.

First, we are pleased to announce that our first PX G was commissioned in a new grocery store in southern Europe and the initial results are exceeding expectations. Installation and commissioning went smoothly, and we have been consistently reducing the energy load of the rack by over 20% during days where temperatures ranged from 30 – 35 degrees Celsius, or 86 – 95 degrees Fahrenheit.

It is important to note that this first unit was not a PXG-centric system. The unit was fully integrated into the rack's control systems, but mechanically separated, almost like the bolt-on we will be deploying at Vallarta in California. Our European partner's initial priority was the reliability of our technology in the field and this architecture provides our partner with the ability to isolate the PXG should any issues arise. Therefore, in this first installation energy efficiency was actually a secondary consideration. However, despite these less-than-optimal architectural conditions, the PXG's efficiency has provided pleasantly surprising upside to our partner.

We believe that with a fully integrated PXG-centric build, we can achieve even greater efficiencies for our customers. Our initial success with this customer has already led to preliminary discussions for additional PXG-centric deployments at new sites possibly later this year.

In addition to our successful commissioning, I am pleased to announce we entered into a second joint development agreement with a large US-based refrigeration manufacturer. Our new partner has indicated they intend to deploy our PXG late this year or early next year. We are also engaged in advanced discussions with additional refrigeration rack manufacturers and hope to sign and deploy our technology with them in the coming months.

We have also received a strong response from the PXG reference designs we published on our website this summer. These reference designs provide manufacturers a number of PXG architectures to consider as they design their own next generation PXG-centric CO2 refrigeration rack. This move has further

aided market acceptance and expedited relationships with additional OEMs. We hope to see further deployments with these OEMs as well.

Finally, an update on our installation at Vallarta supermarkets. While we had hoped to have commissioned our unit during the second quarter, we are now on track to commission in September. Much of the construction work has been completed and our testing of the skid has been ongoing. Vallarta remains excited about the technology and has begun preliminary discussions about additional future PXG-centric deployments.

In summary, we made material progress this quarter. We believe that our technology is being viewed by the refrigeration industry as the sought-after solution to the OPEX challenge of transitioning away from climate harmful HFCs and towards more climate friendly natural refrigerants. Our strategy to leverage distribution networks established by existing manufacturers is beginning to show promise. Now, we are gathering data from field installations that is proving to the industry the value of our technology in real world situations while more and more industry participants are taking notice.

We expect to begin in earnest, discussions with our partners regarding volumetric orders, so that we can commence the necessary planning needed to meet their delivery requirements for 2023 and beyond. We will provide further updates on our progress in CO2 at our next earnings call in November, including how we foresee volumes ramping up in 2023.

With that, I will hand it over to Josh.

Financial Update – Josh Ballard

Good afternoon, everyone.

We generated \$20 million in revenue this quarter, as guided during the Q1 call, relatively flat against Q2 2021. Results for this quarter's revenue were driven by the timing of mega project shipments, which this year are weighted to the third and fourth quarters as communicated in May. For example, while year-to-date, mega project revenues are down 9%, based on our contracted backlog we are anticipating a strong second half highlighted by a very robust fourth quarter. By year-end, we expect full-year mega project growth in the 10-15% range.

Notably, OEM revenues are up 75% year-to-date. Total OEM revenue for the year includes \$1.6 million in industrial wastewater sales, which as Bob mentioned is on pace to achieve our full-year guidance. OEM desalination revenue has grown closer to 50% year to date, which we currently expect to hold through the end of the fiscal year.

Overall, we continue to finally see our post Covid return of desalination OEM and aftermarket revenues due to pent up demand, which, as of today, is expected to continue through the end of the year. We have no change to our revenue forecast for the year, although we continue to keep an eye on end of year shipments in our very large 4th quarter.

As I mentioned last quarter, we expect gross margin to moderate this year, and we have begun to see this in the second quarter. There are two things at play here: First, our product mix changed in the second quarter reflecting an increase

in sales of non-PX products, which naturally puts pressure on our top line blended margin. We have seen this occur several times over the years. Second, while we are not yet reflecting inflationary increases in our pressure exchanger costs this year, we are experiencing some inflationary pressure on raw materials for pumps and turbochargers, which has weighed on margins. While we are working to mitigate these increases, we do not expect to see our margin improve considerably in 2022. Again, we maintain our guidance of 66-68% gross margin for the year.

Note that we do expect to see additional increases in costs in 2022, particularly for labor and other inputs such as energy and shipping. The majority of these increases will not be reflected in 2022 margins, in part owing to our overall inventory build that has already occurred, but we cannot delay inflation forever. We do not anticipate that the overall effect of these increases will be large, however, and we will be prepared to discuss them in more detail during our Q3 call.

Our OPEX grew about 24% year over year in the quarter. However, keep in mind that this includes a \$1.3 million one-time expense due to the cessation of our VorTeq activities. About \$1 million of this is reflected in R&D spend and the remaining \$300 thousand in G&A. Therefore, on an adjusted and recurring basis, OPEX grew 15% year on year, largely driven by sales and marketing as we naturally grow spend from our covid lows and focus on building our industrial wastewater and CO2 businesses. For example, we have greatly increased the number and frequency of trade shows and conferences as we work to re-engage with customers in desalination after Covid as well as to expand our messaging in

industrial wastewater and refrigeration. R&D remained relatively flat year over year, and G&A grew about 8%.

Importantly, overall adjusted operated expenses showed a nominal increase of only 1% over first quarter this year. We are still targeting around 50% OPEX as a percent of revenue by year end, excluding these one-time VorTeq related expenses, as increased revenues in the second half of the year should begin to balance out our spend.

We closed the quarter with a cash and securities balance of \$87 million. This \$10 million reduction from last quarter is entirely due to the share repurchase program. Our free cash flows actually increased by \$12 million for the quarter due mostly to increased collections, but were offset by nearly \$19 million in buybacks.

We completed the repurchase program on July 1st. All told, we repurchased \$50 million of stock at an average price of \$18.57, for a total of 2.7 million shares. As of today, we have not put a new buyback program in place but, of course, we will let you know if that changes.

With regards to our operating cash flow, as I discussed last quarter, we continued to see increased inventory levels due to the lower shipments this quarter. Despite those lower shipments, we continued to produce at a level loaded pace to satisfy demand for the much larger planned third and fourth quarters, which increased inventory levels up to \$28 million.

Finally, I will give you a brief update on VorTeq. We have not been successful in finding a partner to date. Although we continue discussions with a

couple potential interested parties, activities had been reduced to the point where we made the decision to shut down operations. This resulted in a \$1.3 million one-time expense driven by severance and accelerated depreciation. All told, the cash component of this one-time expense was only about \$200 thousand.

With that, we can now move to Q&A.