

FIRST QUARTER 2023 CONFERENCE CALL

Jess Jankowski, President & CEO

Thank you, Lateef.

Good morning to all of those listening live, and we also welcome those who choose to listen later online. Thanks for joining us today for a discussion of our 1st quarter 2023 results, the state of the business, and our outlook for the balance of the year. Kevin Cureton, our Chief Operating Officer, will be joining me on the call today.

The first quarter was bumpier than we'd hoped, however, it ended with a good deal of positivity, as we saw some of our improvements begin to take shape. As we discussed recently, January was a tough month, with a few weeks being devoted more to locking down inventory, rather than building and shipping product. Examining the trend throughout the quarter, revenue was back-loaded, we had roughly 20%, 30%, then 50% of our quarterly revenue shipped during January, February, and March, respectively. With January being a \$2M month, the entire quarter skewed toward a poorer gross profit, and to a negative bottom line. The better news, is that February was stronger, and March was stronger yet, exceeding \$4M. For the entire 1st quarter of 2023, even given a weak January, we still saw a 2% gross margin pickup in direct labor utilization over 2022.

We'll cover more of this when we talk about the specific numbers, but margin improvement and profitability are a major focus for us, from top-to-bottom, and you'll be hearing a lot more about it through 2023. Now, I wanted to spend a little time talking about our Operations function, particularly Supply Chain and Manufacturing. We've been working to fix this part of our organization over the past few years. Through these efforts, we achieved many incremental improvements, with a lot of hard work by the members of our Operations team, but without enough day-to-day attention at the senior level.

The litigation that we're involved in with BASF, which began in August 2022, has been a major distraction for our Company. It certainly impeded our progress in implementing the changes to our Operations functions that are necessary for us to both continue to grow and, more importantly now than ever, to do so with greater profitability, and cash flow. The time and money spent on this litigation, were we able to invest it in addressing our Operations issues instead, would surely have had a significant positive impact on our gross margin, and our bottom line. Speaking for the two of us on this call, attending to the needs of a rapidly-growing, rapidly-scaling company, while being chronically short on infrastructure, was a necessary step in developing the business, and something we've been committed to doing,but we weren't able to achieve it quickly enough. The distraction of litigation certainly didn't help us in moving these changes along.

Looking forward, the best news here, the news that is keeping all of us at Nanophase and Solésence enthusiastic, is that we are finishing up the process, of a major overhaul of our manufacturing organization.

Last year, we added a seasoned director of Supply Chain, and we believe our inventory issues are behind us. We are now focused on improving our purchasing function. We believe there are significant opportunities to take greater advantage of our increased buying leverage, which has been created by virtue of our rapid volume growth. Finally, we concluded our search for a highly experienced VP of Manufacturing this week, with an expected start date in early June. We found a professional whom we

believe will be an immediate contributor, and our expectations for them, and their impact on our manufacturing function, and the Company as a whole, are very high.

In 2022, we built-out the R&D and Sales functions, adding experienced leadership, and support staff, to handle our increased transaction volume. These areas have been functioning well, and are well-aligned to support our growth plans.

We also added a senior financial leader in the 2nd half of 2022, which will allow us to spend more time on identifying and addressing opportunities for cost reduction, while remaining compliant with the regulatory load that comes with being a public company.

We expect this to allow us more freedom to operate and, critically, to enhance the enterprise value of our Company.

Before we continue, let's walk through the numbers.

Unless identified otherwise, all numbers will be stated in approximate terms.

Our Q12023 revenue was \$9.5M, versus \$8.2M for the same period last year, so we were up 16%.

At \$9.5M, Q1 of 2023 also represents the highest revenue we've ever recorded in a first quarter.

Q12023 revenue also exceeded Q42022 revenue by 14%.

For the first quarter of 2023, we had a net loss of just under \$1.2M, or \$0.02/share, compared to earnings of less than a penny a share in Q12022.

The Q12023 loss had several drivers that I'd like to cover in more detail before moving on:

I'll address it in two parts:

1st) In terms of gross profit impact, which is where we've struggled the most, and where we expect to see the greatest improvement this year; and

2nd) In operating expenses, where we've made some significant investments in infrastructure, but also got hit by a few notable expenses that were difficult to anticipate or control.

For gross profit, we put ourselves in a hole during January, by missing too much production time while locking down year-end inventory. We shipped just under \$2M in January, resulting in too little variable margin being generated to cover our fixed costs. We believe we've addressed this appropriately, and don't expect to lose more than a day or two during 2023's year-end process. While that doesn't help now, it's indicative of our getting a better handle on materials flow. Ultimately, this will be a critical driver of both throughput, and margin increases.

As I mentioned during our year-end call, we are now operating three production facilities. All in Illinois. We have one in Burr Ridge, one in Romeoville, and our newest and largest facility in Bolingbrook. All-in, this represents approximately 320,000 s.f. of space, the largest being the 260,000 s.f. facility in Bolingbrook. On average, our facilities costs are up about \$250K per quarter, representing a gross margin hit of about 3%. To reduce the near-term burden, we've been subletting about a third of the Bolingbrook space. Our schedule for upfitting the building was some months behind last year, and we were only able to begin moving production, in Q4 of 2022.

Today, we have substantially all of our filling and packaging operations running out of Bolingbrook. We also have a much greater capacity, to generate more revenue volume, with greater efficiency. We expect our new facility to be a net contributor to margins in 2024.

Given the headwinds we've had, it's important to remember that we continue to produce at record levels. This alone makes this the area that will yield the most immediate, and greatest return, in terms of our profitability, then our valuation, which is why we're all here.

For Q1 of '23, the fact that we saw a 2% increase, as a percentage of sales, in direct labor utilization, even after our January struggles, shows the initial return we're getting on the investments we've made in Q1 to streamline operations. In terms of twenty-twenty-two volume, this modest gain alone would have added \$750K to our bottom line. We are going to grow in 2023, so the benefits will multiply.

Given the addition of our new manufacturing leader, on top of the installation of new automation that we began in Q1, we expect to be able to add at least two more percent, more likely four percent or more, to our gross margin as we continue to improve our process during 2023.

Another major opportunity for margin improvement, which I alluded to earlier, will be better management of our monthly volumes. Volatility of both monthly customer demand, and our own production, has eaten in to profits significantly over the past 18 – 24 months. The past two Q1 reports underscore this.

With the higher functioning Supply Chain team in place, and now the addition of a seasoned VP of Manufacturing, we're expecting to smooth out some of the monthly production and shipping volatility that has been a problem since the Solésence business really took off in 2021.

The ability to match production and sales to fixed costs is a practice that we expect will have a marked impact on our bottom line, and we are pursuing this aggressively. Also, another margin contributor that's coming on line is the benefit from a series of price increases we put into place, that were generally effective beginning some time in Q1. This will help to enhance our margins, and offset cost increases, as we continue through 2023.

Speaking of cost increases, the last focused area of improvement we're counting on, will be the impact of a stronger purchasing function. As the other changes we've made, including the June start of our VP of Manufacturing, metabolize through the organization, we'll apply greater focus to purchasing, and should see some relatively immediate benefits.

As you can see, we're going at margin improvement from every angle that we can, and I think this will play out well for the Company, and all of its stakeholders. There will definitely be more to follow on this.

Looking now at Operating Expenses, we saw R&D expense, which includes our engineering group, up by 50% YOY. About half of that increase was related to compensation expense, and part of that, related to the addition of engineering staff in 2022 to help us with the upfitting and optimization of our new facility in Bolingbrook. We expect these engineering adds to pay for themselves in 2023. Another 25% of the variance in R&D expense was from increases to legal spending relating to securing our intellectual property. These legal expenses help us to actively protect our existing products, and our position in the marketplace, by deepening the moat around our technology. We're also continuing to develop and protect new technology. This is the technology that will drive the next generation of product offerings.

Although we've won many awards, coveted awards, for our Solésence products over the past few years, this is an area that requires continued investment to keep us in the premium end of the markets we serve, and to continue to drive growth.

Moving to SG&A Expenses, these were up \$750K, to a little over \$2M, for the first quarter of 2023. Of this increase, 65%, or almost \$500K, related to increased legal fees incurred due to the BASF litigation. The bulk of the remaining increases related to compensation, primarily due to the 2022 additions of senior leadership in our Sales, Marketing and Business Development team, and the addition of our Controller. We also saw interest expense more than triple, a \$110K increase from the same period in 2022, primarily due to rapid increases in the Prime Lending Rate in the last twelve months.

Having much of this organizational work completed, or near completion, we're now in a better position to increase our focus on capturing the bottom-line benefits that these changes were designed to deliver. We expect this to allow us more freedom to operate and, critically, to enhance the enterprise value of our Company. Now I'd like to introduce Kevin Cureton, our Chief Operating Officer, to discuss progress in these strategic areas, and their drivers, in greater detail. Kevin?

Kevin Cureton, Chief Operating Officer

Thanks, Jess.

As always, I would like to begin by thanking our team for their efforts in helping fulfill our mission in enhancing people's lives through the world's best skin care products as we also work tirelessly toward creating a more valuable company for our shareholders. I will also add a thank you to all of our investors who remain steadfast in their support of our company. As Jess has already mentioned our primary focus is on returning to profitability. We know that until the bottom-line results are seen, these are empty words given what has been 4 consecutive quarters of results that are not reflective of our standards and expectations. To this end, I will keep my prepared remarks very brief, but certainly look forward to answering questions that our investors may have. Over the past two months, we have spent an incredible amount of time identifying and recruiting the operational leaders that will further our profit objectives, while empowering key engineering personnel to drive changes that have had a significant impact in uptime and throughput. We are further supporting this investment by taking advantage of the strength of our pipeline and our solid backlog to redirect a portion of our investments in business development toward improving operations. This does not mean we have stopped innovating and creating the best products in the industry, in fact we hope to have several more exciting announcements in this area in the next couple of quarters, but that we are fully embracing the need and our ability to drive cash positive growth. We remain complete confident and certain in our ability to achieve

profitable performance in the very near term. I'll now turn it back over to Jess for some closing comments. Jess?

Jess Jankowski, President & CEO

Thanks Kevin!

Man, I hate to follow that with the "L" word! I talked a bit about litigation earlier, and wanted to quickly cover our commercial relationship with BASF, and to discuss the ways we're managing the litigation, to keep it segregated from our day-to-day business activities. The management of both companies, Nanophase and BASF, have remained committed to keeping our respective commercial teams as far away from the demands of the litigation as possible. Both of our goals are to continue to support the API market that our products serve through BASF, and we're still looking for potential ways to expand our shared reach there.

Through all of this, demand remains strong from BASF. Purchase orders keep coming in, and we keep shipping world-class product. BASF volume was up by 40% in 2021 from 2020, then it was up more than another 40% between 2021 and 2022. For the first quarter, volume is up by almost 50% over the same period last year. We're not sure about their demand through 2023 yet, but it is our view, that their orders for Nanophase ingredients, will follow the demands of the markets they serve, and we continue to believe, that our products are among the best.

Regarding the litigation, as I said during our year-end call, we continue to feel that our case is a good one, but we will also pursue a negotiated settlement, with the goal of resolving this issue as quickly as is practical and beneficial to our Company. I'm sure it's frustrating that we can't share more at this point about the litigation, but things are moving along, and we're working to minimize the impact of it, both financially, and in terms of management distraction.

Now, let's get into the part of the call that Kevin and I appreciate the most. Although we know that most of our investors listen to the webcast, or review the transcript, after the live call, we'd like to invite those participating in today's call to ask any questions you may have, or to share your comments.

Lateef, Would you please begin the Q&A session?

10:15 AM

Q&A SESSION PLACEHOLDER

10:45 AM

Thank you, Lateef.

There's really not much more to add at this point. We're focused on building a stronger, bigger, more profitable company.

Enhancing profitability is highest on our list, with maintaining growth a close second. Our products continue to be in demand, and we're working hard to shorten the time and expense that it takes to get them to our brand partners, and ultimately, the consumers.

The consumers' preference for our products continues to move Solésence forward, regardless of the ups-and-downs in our economy. That's another great facet of this business.

Thank you, again, for attending our call today. We're looking forward to sharing better results with you in a few months. We remain excited about our prospects, and hope that you feel the same way.

Have a great day everybody!