

Energy Recovery, Inc.
Form 10-Q
August 06, 2015

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2015

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission File Number: 001-34112

Energy Recovery, Inc.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of incorporation)

01-0616867

(IRS Employer Identification No.)

1717 Doolittle Drive, San Leandro, CA

(Address of Principal Executive Offices)

94577

(Zip Code)

(510) 483-7370

(Registrant's Telephone Number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer
Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Exchange Act Rule 12b-2). Yes No

As of August 3, 2015, there were 52,231,186 shares of the registrant's common stock outstanding.

ENERGY RECOVERY, INC.

QUARTERLY REPORT ON FORM 10-Q FOR THE PERIOD ENDED JUNE 30, 2015

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PART I — FINANCIAL INFORMATION**Item 1. Financial Statements (unaudited)****ENERGY RECOVERY, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS****(in thousands, except share data and par value)****(unaudited)**

| | June 30, | December |
|---|-----------------|-----------------|
| | 2015 | 31, |
| | | 2014 |
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 18,107 | \$ 15,501 |
| Restricted cash | 1,347 | 2,623 |
| Short-term investments | 4,713 | 13,072 |
| Accounts receivable, net of allowance for doubtful accounts of \$162 and \$155 at June 30, 2015 and December 31, 2014, respectively | 7,429 | 10,941 |
| Unbilled receivables, current | 1,193 | 1,343 |
| Inventories | 9,703 | 8,204 |
| Deferred tax assets, net | 240 | 240 |
| Prepaid expenses and other current assets | 1,080 | 1,317 |
| Total current assets | 43,812 | 53,241 |
| Restricted cash, non-current | 1,704 | 2,850 |
| Unbilled receivables, non-current | 504 | 414 |
| Long-term investments | 262 | 267 |
| Property and equipment, net of accumulated depreciation of \$16,777 and \$15,143 at June 30, 2015 and December 31, 2014, respectively | 12,085 | 13,211 |
| Goodwill | 12,790 | 12,790 |
| Other intangible assets, net | 2,849 | 3,166 |
| Other assets, non-current | 2 | 2 |
| Total assets | \$ 74,008 | \$ 85,941 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 2,366 | \$ 1,817 |
| Accrued expenses and other current liabilities | 4,886 | 8,427 |

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| | | |
|--|-----------|-----------|
| Income taxes payable | 8 | 4 |
| Accrued warranty reserve | 747 | 755 |
| Deferred revenue | 1,224 | 519 |
| Current portion of long-term debt | 11 | — |
| Total current liabilities | 9,242 | 11,522 |
| Long-term debt, net of current portion | 42 | — |
| Deferred tax liabilities, non-current, net | 2,119 | 1,989 |
| Deferred revenue, non-current | 68 | 59 |
| Other non-current liabilities | 839 | 2,453 |
| Total liabilities | 12,310 | 16,023 |
| Commitments and Contingencies (Note 9) | | |
| Stockholders' equity: | | |
| Preferred stock, \$0.001 par value; 10,000,000 shares authorized; no shares issued or outstanding | — | — |
| Common stock, \$0.001 par value; 200,000,000 shares authorized; 54,510,642 shares issued and 52,031,186 shares outstanding at June 30, 2015, and 54,398,421 shares issued and 51,918,965 shares outstanding at December 31, 2014 | 55 | 54 |
| Additional paid-in capital | 127,803 | 124,440 |
| Accumulated other comprehensive loss | (47) | (73) |
| Treasury stock, at cost 2,479,456 shares repurchased at both June 30, 2015 and December 31, 2014 | (6,835) | (6,835) |
| Accumulated deficit | (59,278) | (47,668) |
| Total stockholders' equity | 61,698 | 69,918 |
| Total liabilities and stockholders' equity | \$74,008 | \$ 85,941 |

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements

ENERGY RECOVERY, INC.**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****(in thousands, except per share data)****(unaudited)**

| | Three Months Ended | | Six Months Ended | |
|--|---------------------------|-------------|-------------------------|-------------|
| | June 30, | | June 30, | |
| | 2015 | 2014 | 2015 | 2014 |
| Net revenue | \$10,484 | \$6,407 | \$16,348 | \$10,304 |
| Cost of revenue | 4,836 | 3,332 | 7,367 | 4,984 |
| Gross profit | 5,648 | 3,075 | 8,981 | 5,320 |
| Operating expenses: | | | | |
| General and administrative | 5,362 | 2,995 | 11,640 | 5,034 |
| Sales and marketing | 1,994 | 2,702 | 4,427 | 5,197 |
| Research and development | 1,410 | 1,724 | 3,943 | 2,958 |
| Amortization of intangible assets | 158 | 215 | 317 | 430 |
| Total operating expenses | 8,924 | 7,636 | 20,327 | 13,619 |
| Loss from operations | (3,276) | (4,561) | (11,346) | (8,299) |
| Interest expense | — | — | (40) | — |
| Other non-operating (expense) income | 20 | 8 | (82) | 129 |
| Loss before income taxes | (3,256) | (4,553) | (11,468) | (8,170) |
| Provision for income taxes | 71 | 58 | 142 | 124 |
| Net loss | \$(3,327) | \$(4,611) | \$(11,610) | \$(8,294) |
| Basic and diluted net loss per share | \$(0.06) | \$(0.09) | \$(0.22) | \$(0.16) |
| Shares used in basic and diluted per share calculation | 52,026 | 51,566 | 51,987 | 51,506 |

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements

ENERGY RECOVERY, INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS

(in thousands)

(unaudited)

| | Three Months Ended | | Six Months Ended | |
|--|-------------------------------|-------------|-----------------------------|-------------|
| | June 30, | | June 30, | |
| | 2015 | 2014 | 2015 | 2014 |
| Net loss | \$ (3,327) | \$ (4,611) | \$ (11,610) | \$ (8,294) |
| Other comprehensive (loss) income, net of tax: | | | | |
| Foreign currency translation adjustments | (6) | 3 | 25 | 46 |
| Unrealized (loss) gain on investments | (2) | 16 | 1 | 18 |
| Other comprehensive (loss) income | (8) | 19 | 26 | 64 |
| Comprehensive loss | \$ (3,335) | \$ (4,592) | \$ (11,584) | \$ (8,230) |

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements

ENERGY RECOVERY, INC.**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(in thousands)

(unaudited)

| | Six Months Ended | |
|---|-------------------------|---------------|
| | June 30 | |
| | 2015 | 2014 |
| Cash Flows From Operating Activities | | |
| Net loss | \$(11,610) | \$(8,294) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Share-based compensation | 3,053 | 1,215 |
| Depreciation and amortization | 1,959 | 1,998 |
| Deferred income taxes | 131 | 111 |
| Amortization of premiums/discounts on investments | 130 | 239 |
| Other non-cash adjustments | 86 | (153) |
| Provision for doubtful accounts | 59 | 126 |
| Valuation adjustments for excess or obsolete inventory | 21 | 43 |
| Unrealized loss on foreign currency transactions | 21 | 41 |
| Provision for warranty claims | 15 | 48 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | 3,472 | 5,724 |
| Deferred revenue | 714 | 153 |
| Accounts payable | 549 | 610 |
| Prepaid and other assets | 239 | (213) |
| Unbilled receivables | 60 | 5,281 |
| Income taxes payable | 4 | 4 |
| Inventories | (1,520) | (4,683) |
| Litigation settlement | (1,700) | — |
| Accrued expenses and other liabilities | (3,633) | (2,443) |
| Net cash used in operating activities | (7,950) | (193) |
| Cash Flows From Investing Activities | | |
| Maturities of marketable securities | 8,235 | 4,065 |
| Restricted cash | 2,422 | (192) |
| Capital expenditures | (429) | (2,140) |
| Net cash provided by investing activities | 10,228 | 1,733 |
| Cash Flows From Financing Activities | | |
| Net proceeds from issuance of common stock | 293 | 1,138 |
| Proceeds from borrowings | 55 | — |
| Repayment of long-term debt | (2) | — |
| Repurchase of common stock for treasury | — | (633) |
| Net cash provided by financing activities | 346 | 505 |

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| | | |
|---|----------|----------|
| Effect of exchange rate differences on cash and cash equivalents | (18) | 31 |
| Net change in cash and cash equivalents | 2,606 | 2,076 |
| Cash and cash equivalents, beginning of period | 15,501 | 14,371 |
| Cash and cash equivalents, end of period | \$18,107 | \$16,447 |

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements

ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

Note 1 — The Company and Summary of Significant Accounting Policies

The Company

Energy Recovery, Inc. (the “Company”, “Energy Recovery”, “we”, “our”, or “us”) is an energy solutions provider. We convert wasted pressure energy into a reusable asset and preserve or eliminate pumping technology in hostile processing environments. Our core competencies are fluid dynamics and advanced material science. Our products are marketed and sold in fluid flow markets, such as desalination and oil & gas, under the trademarks ERI[®], PX[®], Pressure Exchanger[®], PX Pressure Exchanger[®], IsoBoost[®], IsoGen[®], and VorTeq[®]. Our products are developed and manufactured in the United States of America (“U.S.”) at our headquarters in San Leandro, California, and we have five wholly-owned subsidiaries: Energy Recovery Iberia, S.L., Energy Recovery Canada Corp., ERI Energy Recovery Ireland Ltd., Energy Recovery (Cayman) Ltd., and ERI Energy Recovery Holdings Ireland Limited. We also have sales offices in Dubai, United Arab Emirates and Shanghai, Peoples Republic of China.

Use of Estimates

The preparation of condensed consolidated financial statements in conformity with U.S. generally accepted accounting principles (“U.S. GAAP”) requires our management to make judgments, assumptions, and estimates that affect the amounts reported in the condensed consolidated financial statements and accompanying notes. Our more significant estimates and judgments that we believe are the most critical to aid in fully understanding and evaluating our reported financial results are revenue recognition; allowance for doubtful accounts; allowance for product warranty; valuation of stock options; valuation and impairment of goodwill, long-lived assets, and acquired intangible assets; useful lives for depreciation and amortization; valuation adjustments for excess and obsolete inventory; and deferred taxes and valuation allowances on deferred tax assets. Actual results could differ materially from those estimates.

Basis of Presentation

The condensed consolidated financial statements include the accounts of Energy Recovery, Inc. and its wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated.

The accompanying condensed consolidated financial statements have been prepared by us, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"). Certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. GAAP have been condensed or omitted pursuant to such rules and regulations. The December 31, 2014 condensed consolidated balance sheet was derived from audited financial statements, and may not include all disclosures required by U.S. GAAP; however, we believe that the disclosures are adequate to make the information presented not misleading. These unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the notes thereto for the fiscal year ended December 31, 2014 included in our Annual Report on Form 10-K filed with the SEC on March 6, 2015.

In the opinion of management, all adjustments, consisting of only normal recurring adjustments that are necessary to present fairly the financial position, results of operations, and cash flows for the interim periods, have been made. The results of operations for the interim periods are not necessarily indicative of the operating results for the full fiscal year or any future periods.

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-09, *Revenue from Contracts with Customers*. The amendment requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. ASU 2014-09 will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective. ASU 2014-09 is effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. We expect to adopt this guidance as of January 1, 2017. Early application is not permitted. ASU 2014-09 permits the use of either the retrospective or cumulative effect transition method. We are currently evaluating the effect that ASU 2014-09 will have on our financial statements and related disclosures. We have not yet selected a transition method nor have we determined the effect of the standard on our ongoing financial reporting.

On July 9, 2015, the FASB voted to approve a one-year deferral of the effective date of ASU 2014-09. Based on the FASB's decision, ASU 2014-09 will apply to us for annual reporting periods beginning after December 15, 2017, including interim reporting periods within annual reporting periods beginning after December 15, 2017. Additionally, the FASB decided to permit early adoption, but not before the original effective date (that is, annual periods beginning after December 15, 2016). The FASB expects to issue its final update formally amending the effective date by the end of the third quarter of 2015.

In January 2015, the FASB issued ASU 2015-01, *Income Statement – Extraordinary and Unusual Items*. ASU 2015-01 eliminates from GAAP the concept of extraordinary items. As a result, an entity will no longer be required to separately present an extraordinary item on its statement of operations, net of tax, after income from continuing operations, or disclose income taxes and net income per share data applicable to an extraordinary item. However, ASU 2015-01 will still retain the presentation and disclosure guidance for items that are unusual in nature and occur infrequently. ASU 2015-01 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. Early adoption is permitted provided the guidance is applied from the beginning of the fiscal year of adoption. We do not expect the adoption of this standard to have a material impact on our financial statements, absent any material transactions in future periods that would qualify for extraordinary item presentation under the prior guidance.

In April 2015, the FASB issued ASU 2015-03, *Interest – Imputation of Interest*. ASU 2015-03 require that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. The recognition and measurement guidance for debt issuance costs are not affected by the amendments in this update. For public entities, ASU 2015-03 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. We do not expect the adoption of this standard to have a material impact on our financial statements.

Also in April 2015, the FASB issued ASU 2015-05, *Intangibles – Goodwill and Other- Internal-Use Software*. ASU 2015-05 provides guidance to customers about whether a cloud computing arrangement includes a software license. If a cloud computing arrangement includes a software license, then the customer should account for the software license element of the arrangement consistent with the acquisition of other software licenses. If a cloud computing arrangement does not include a software license, the customer should account for the arrangement as a service contract. ASU 2015-05 does not change GAAP for customer's accounting for service contracts. For public entities, ASU 2015-05 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. We do not expect the adoption of this standard to have a material impact on our financial statements.

In July 2015, the FASB issued ASU 2015-11, *Inventory – Simplifying the Measurement of Inventory*. ASU 2015-11 does not apply only to inventory that is measured using last-in, first-out (“LIFO”) or to the retail inventory method. ASU 2015-11 applies to all other inventory, which includes inventory that is measured using first-in, first-out (“FIFO”) or average cost. ASU 2015-11 provides that inventory be measured at the lower of cost and net realizable value. Net realizable value is the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. For public entities, ASU 2015-11 is effective for fiscal years beginning after

December 15, 2016 and interim periods within those fiscal years. Early application is permitted as of the beginning of an interim or annual reporting period. We do not expect the adoption of this standard to have a material impact on our financial statements.

Note 2 — Goodwill and Other Intangible Assets

Goodwill as of June 30, 2015 and December 31, 2014 of \$12.8 million was the result of our acquisition of Pump Engineering, LLC in December 2009. During the three and six months ended June 30, 2015, there were no changes in the recognized amount of goodwill, and there has been no impairment of goodwill to date.

The components of identifiable other intangible assets, all of which are finite-lived, as of the dates indicated were as follows (in thousands):

| | June 30, 2015 | | | |
|------------------------|----------------------|---------------------|--------------------|-----------------|
| | Gross | | Accumulated | Net |
| | Carrying | Accumulated | Impairment | Carrying |
| | Amount | Amortization | Losses | Amount |
| Developed technology | \$ 6,100 | \$ (3,405) | \$ — | \$ 2,695 |
| Non-compete agreements | 1,310 | (1,310) | — | — |
| Backlog | 1,300 | (1,300) | — | — |
| Trademarks | 1,200 | (180) | (1,020) | — |
| Customer relationships | 990 | (990) | — | — |
| Patents | 585 | (389) | (42) | 154 |
| Total | \$ 11,485 | \$ (7,574) | \$ (1,062) | \$ 2,849 |

| | December 31, 2014 | | | |
|------------------------|--------------------------|---------------------|--------------------|-----------------|
| | Gross | | Accumulated | Net |
| | Carrying | Accumulated | Impairment | Carrying |
| | Amount | Amortization | Losses | Amount |
| Developed technology | \$ 6,100 | \$ (3,101) | \$ — | \$ 2,999 |
| Non-compete agreements | 1,310 | (1,310) | — | — |
| Backlog | 1,300 | (1,300) | — | — |
| Trademarks | 1,200 | (180) | (1,020) | — |
| Customer relationships | 990 | (990) | — | — |
| Patents | 585 | (376) | (42) | 167 |
| Total | \$ 11,485 | \$ (7,257) | \$ (1,062) | \$ 3,166 |

Accumulated impairment losses at June 30, 2015 and December 31, 2014, include a \$1.0 million impairment loss from 2012 for trademarks, a \$31,000 loss for patents from 2007, and an \$11,000 loss for patents from 2010.

Note 3 — Loss per Share

Basic and diluted net loss per share is based on the weighted average number of common shares outstanding during the period. Potential dilutive securities are excluded from the calculation of loss per share, as their inclusion would be anti-dilutive.

The following table shows the computation of basic and diluted loss per share (in thousands, except per share data):

| | Three Months Ended | | Six Months Ended | |
|--|---------------------------|-------------|-------------------------|-------------|
| | June 30, 2015 | 2014 | June 30, 2015 | 2014 |
| Numerator: | | | | |
| Net loss | \$(3,327) | \$(4,611) | \$(11,610) | \$(8,294) |
| Denominator: | | | | |
| Basic and diluted weighted average common shares outstanding | 52,026 | 51,566 | 51,987 | 51,506 |
| Basic and diluted net loss per share | \$(0.06) | \$(0.09) | \$(0.22) | \$(0.16) |

The following potential common shares were not considered in the computation of diluted loss per share because their effect would have been anti-dilutive (in thousands):

| | Three and Six Months Ended | |
|---------------|-----------------------------------|-------------|
| | June 30, 2015 | 2014 |
| Stock options | 8,267 | 7,573 |
| Warrants | 200 | 600 |

Note 4 — Other Financial Information***Restricted Cash***

We have pledged cash in connection with stand-by letters of credit. We have deposited a corresponding amount into a non-interest bearing account at one financial institution for these items as follows (in thousands):

| | June 30, 2015 | December 31, 2014 |
|---|------------------------------|------------------------------|
| Collateral for stand-by letters of credit | \$1,347 | \$ 2,623 |
| Current restricted cash | \$1,347 | \$ 2,623 |
| Collateral for stand-by letters of credit | \$1,704 | \$ 2,850 |
| Non-current restricted cash | \$1,704 | \$ 2,850 |
| Total restricted cash | \$3,051 | \$ 5,473 |

Inventories

Our inventories are stated at the lower of cost (using the first-in, first out “FIFO” method) or market and consisted of the following (in thousands):

| | June 30, 2015 | December 31, 2014 |
|-----------------|------------------------------|------------------------------|
| Raw materials | \$2,743 | \$ 2,903 |
| Work in process | 2,331 | 1,915 |
| Finished goods | 4,629 | 3,386 |
| Inventories | \$9,703 | \$ 8,204 |

Prepaid and Other Current Assets

Prepaid expenses and other current assets consisted of the following (in thousands):

| | June 30, 2015 | December 31, 2014 |
|---|------------------------------|------------------------------|
| Interest receivable | \$52 | \$ 112 |
| Supplier advances | 159 | 107 |
| Other prepaid expenses and current assets | 869 | 1,098 |
| Total prepaid and other current assets | \$ 1,080 | \$ 1,317 |

Accrued Expenses and Other Current Liabilities

Accrued expenses and other current liabilities consisted of the following (in thousands):

| | June 30, 2015 | December 31, 2014 |
|--|------------------------------|------------------------------|
| Accrued legal expenses | \$188 | \$ 1,734 |
| Payroll and commissions payable | 2,368 | 3,116 |
| Other accrued expenses and current liabilities | 2,330 | 3,577 |
| Accrued expenses and other current liabilities | \$4,886 | \$ 8,427 |

Other Non- Current Liabilities

Other non- current liabilities consisted of the following (in thousands):

| | June 30, 2015 | December 31, 2014 |
|--|------------------------------|------------------------------|
| Deferred rent expense, non-current | \$ 796 | \$ 866 |
| Accrued legal expenses, non-current | 43 | 1,587 |
| Accrued expenses and other current liabilities | \$ 839 | \$ 2,453 |

Accumulated Other Comprehensive Loss

Changes in accumulated other comprehensive loss by component for the six months ended June 30, 2015 were as follows (in thousands):

| | Foreign Currency Translation Adjustments Net of Tax Benefit | | Unrealized Gains (Losses) on Investments | | Total Accumulated Other Comprehensive Loss |
|--------------------------------|--|--|---|--|---|
| Balance, December 31, 2014 | \$ (67) | | \$ (6) | | \$ (73) |
| Net other comprehensive income | 25 | | 1 | | 26 |
| Balance, June 30, 2015 | \$ (42) | | \$ (5) | | \$ (47) |

There were no reclassifications of amounts out of accumulated other comprehensive loss, as there have been no sales of securities or translation adjustments that impacted other comprehensive loss during the quarter. The tax impact of the changes in accumulated other comprehensive loss were not material.

Note 5 — Investments

Our short-term and long-term investments are all classified as available-for-sale. There were no sales of available-for-sale securities during the quarter ended June 30, 2015.

Available-for-sale securities as of the dates indicated consisted of the following (in thousands):

| | June 30, 2015 | | | |
|------------------------------|---------------------------|---|--|-----------------------|
| | Amortized Cost | Gross Unrealized Holding Gains | Gross Unrealized Holding Losses | Fair Value |
| Short-term investments: | | | | |
| Corporate notes and bonds | \$4,717 | \$ — | \$ (4) | \$4,713 |
| Total short-term investments | \$4,717 | \$ — | \$ (4) | \$4,713 |

Long-term investments:

| | | | | | | | |
|-------------------------------------|---------|----|---|----|----|---|---------|
| Corporate notes and bonds | \$263 | \$ | — | \$ | (1 |) | \$262 |
| Total long-term investments | \$263 | \$ | — | \$ | (1 |) | \$262 |
| Total available-for-sale securities | \$4,980 | \$ | — | \$ | (5 |) | \$4,975 |

| | December 31, 2014 | | | |
|--|--------------------------|-------------------|-------------------|------------------|
| | Amortized | Gross | Gross | Fair |
| | Cost | Unrealized | Unrealized | Value |
| | | Holding | Holding | |
| | | Gains | Losses | |
| Short-term investments | | | | |
| State and local government obligations | \$225 | \$ | — | \$ 225 |
| Corporate notes and bonds | 12,851 | | 4 | (8) 12,847 |
| Total short-term investments | \$13,076 | \$ | 4 | \$ (8) \$13,072 |
| Long-term investments | | | | |
| Corporate notes and bonds | 268 | | — | (1) 267 |
| Total long-term investments | \$268 | \$ | — | \$ (1) \$267 |
| Total investments | \$13,344 | \$ | 4 | \$ (9) \$13,339 |

Gross unrealized losses and fair values of our investments in an unrealized loss position as of the dates indicated, aggregated by investment category and length of time that the security has been in a continuous loss position, were as follows (in thousands):

| | June 30, 2015 | | | | | |
|---------------------------|----------------------------|--------------------------------|-----------------------------|--------------------------------|-------------------|--------------------------------|
| | Less than 12 months | | 12 months or greater | | Total | |
| | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| Corporate notes and bonds | \$262 | \$ (1) | \$3,380 | \$ (4) | \$3,642 | \$ (5) |
| Total | \$262 | \$ (1) | \$3,380 | \$ (4) | \$3,642 | \$ (5) |

| | December 31, 2014 | | | | | |
|---------------------------|----------------------------|--------------------------------|-----------------------------|--------------------------------|-------------------|--------------------------------|
| | Less than 12 months | | 12 months or greater | | Total | |
| | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| Corporate notes and bonds | \$5,085 | \$ (6) | \$1,205 | \$ (3) | \$6,290 | \$ (9) |
| Total | \$5,085 | \$ (6) | \$1,205 | \$ (3) | \$6,290 | \$ (9) |

Expected maturities can differ from contractual maturities because borrowers may have the right to prepay obligations without prepayment penalties. The amortized cost and fair value of available-for-sale securities that had stated maturities as of June 30, 2015 are shown below by contractual maturity (in thousands):

| | June 30, 2015 | |
|--|-----------------------|-------------------|
| | Amortized Cost | Fair Value |
| Due after one year through three years | \$4,980 | \$4,975 |
| Total available-for-sale securities | \$4,980 | \$4,975 |

Note 6 — Long-Term Debt and Lines of Credit

Debt

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In March 2015, we entered into a loan agreement with a financial institution for a \$55,000 fixed-rate installment loan with an annual interest rate of 6.35%. The loan is payable in equal monthly installments and matures on April 2, 2020. The note is secured by the asset purchased.

Long-term debt consisted of the following (in thousands)

| | June 30, 2015 | December 31, 2014 |
|-----------------------|------------------------------|------------------------------|
| Loan payable | \$ 53 | \$ — |
| Less: current portion | (11) | — |
| Total long-term debt | \$ 42 | \$ — |

Future minimum principal payments due under long-term debt arrangements consist of the following (in thousands):

| | June 30, 2015 |
|---------------------------|------------------------------|
| 2015 (remaining 6 months) | \$ 5 |
| 2016 | 11 |
| 2017 | 11 |
| 2018 | 11 |
| 2019 | 11 |
| Thereafter | 4 |
| Total debt | \$ 53 |

Lines of Credit

In June 2012, we entered into a loan agreement (the “2012 Agreement”) with a financial institution. The 2012 Agreement matured in June 2015 and was amended in June 2015. The 2012 Agreement, as amended, provides for a total available credit line of \$16.0 million. Under the 2012 Agreement, we are allowed to draw advances not to exceed, at any time, \$10.0 million as revolving loans. The total stand-by letters of credit issued under the 2012 Agreement may not exceed the lesser of the \$16.0 million credit line or the credit line minus all outstanding revolving loans. At no time may the aggregate of the revolving loans and stand-by letters of credit exceed the total available credit line of \$16.0 million. Revolving loans may be in the form of a base rate loan that bears interest equal to the prime rate plus 0% or a Eurodollar loan that bears interest equal to the adjusted LIBOR rate plus 1.25%. Stand-by letters of credit are subject to customary fees and expenses for issuance or renewal. The unused portion of the credit facility is subject to a facility fee in an amount equal to 0.25% per annum of the average unused portion of the revolving line. The 2012 Agreement, as amended, also requires us to maintain a cash collateral balance equal to 101% of all outstanding advances and all outstanding stand-by letters of credit collateralized by the line of credit. The 2012 Agreement, as amended, matures in June 2018 and is collateralized by substantially all of our assets. As of June 30,

2015 and December 31, 2014, there were no advances drawn under the 2012 Agreement, as amended. Remaining stand-by letters of credit collateralized under the 2012 Agreement, as amended, totaled \$3.0 million and \$3.1 million as of June 30, 2015 and December 31, 2014, respectively. Total cash restricted related to these stand-by letters of credit totaled \$3.1 million as of June 30, 2015 and December 31, 2014.

We are subject to certain financial and administrative covenants under the 2012 Agreement, as amended. As of June 30, 2015, we were in compliance with these covenants.

In 2009, we entered into a loan and security agreement (the “2009 Agreement”) with another financial institution. The 2009 Agreement, as amended, provided a total available credit line of \$16.0 million. Under the 2009 Agreement, we were allowed to draw advances of up to \$10.0 million on a revolving line of credit or utilize up to \$15.9 million as collateral for stand-by letters of credit, provided that the aggregate of the outstanding advances and collateral did not exceed the total available credit line of \$16.0 million. Advances under the revolving line of credit incurred interest based on a prime rate index or LIBOR plus 1.375%. The 2009 Agreement, as amended, also required us to maintain cash collateral balances equal to at least 101% of the face amount of all outstanding stand-by letters of credit collateralized by the line of credit and 100% of the amount of all outstanding advances. The amended 2009 Agreement expired in May 2012, at which time we became required to maintain a cash collateral balance equal to at least 105% of the face amount of all outstanding stand-by letters of credit collateralized by the line of credit. There were no advances drawn under the 2009 Agreement’s credit line at the time it expired. Remaining stand-by letters of credit issued under the 2009 Agreement totaled zero and \$2.3 million as of June 30, 2015 and December 31, 2014, respectively. Total cash restricted related to these stand-by letters of credit totaled zero and \$2.4 million as of June 30, 2015 and December 31, 2014, respectively.

Note 7 — Equity

Share-Based Compensation Expense

For the three and six months ended June 30, 2015 and 2014, we recognized share-based compensation expense related to employees and consultants as follows (in thousands):

| | Three Months Ended | | Six Months Ended | |
|--|-----------------------------------|-------------|-----------------------------|-------------|
| | June 30, | | June 30, | |
| | 2015 | 2014 | 2015 | 2014 |
| Cost of revenue | \$37 | \$26 | \$72 | \$48 |
| General and administrative | 1,679 | 365 | 2,576 | 694 |
| Sales and marketing | 106 | 155 | 207 | 308 |
| Research and development | 91 | 88 | 198 | 165 |
| Total share-based compensation expense | \$1,913 | \$634 | \$3,053 | \$1,215 |

As of June 30, 2015, total unrecognized compensation cost related to non-vested share-based awards, net of estimated forfeitures, was \$3.9 million, which is expected to be recognized as expense over a weighted average period of approximately 2.77 years.

In February 2015, we granted 344,090 stock options to our non-employee directors. The vesting start date for options granted to incumbent non-employee directors was June 20, 2014, the date of our last annual meeting. The vesting start date for options granted to newly appointed non-employee directors was the date of grant. The options became fully vested on June 19, 2015, the date of our annual meeting; had an exercise price of \$3.53 per share, as determined on the date of grant; and expire 10 years from the grant date. The total compensation cost associated with these option grants was recognized over the period from the grant date in February 2015 (which was determined to be the service inception date) to the vesting end date in June 2015. Accordingly, the six months ended June 30, 2015 includes compensation expense from the service inception date through the vesting end date of June 19, 2015.

In March 2015, we granted 1,415,739 stock options to certain officers and other employees. The options vest over a four-year period, have an exercise price of \$2.75 per share, and expire 10 years from the grant date.

In connection with the resignation of Mr. Thomas S. Rooney, Jr. as President and Chief Executive Officer, additional stock based compensation of approximately \$170,000 was recorded in the first quarter of 2015 related to the accelerated vesting of options previously granted to Mr. Rooney.

In June 2015, we entered into a consulting agreement with Mr. Rooney, under which his unvested options outstanding on the first day of consultancy continue to vest for the period of consultancy and all vested options continue to be exercisable through the 90 day period following the last day of the consultancy. In connection with this modification, we recorded additional stock based compensation of approximately \$1.1 million related to the additional vesting and extended exercise period in the three months ended June 30, 2015.

In April 2015, Ms. Audrey Bold resigned as our Chief Marketing Officer. In connection with her resignation and the providing of a general release, the Company agreed to provide her with continued vesting of granted options during the six month period following her termination and the ability to exercise the vested options through the 90 days following this six month period. In connection with this modification, we recorded additional stock based compensation of approximately \$43,000 related to the additional vesting and extended exercise period in the three months ended June 30, 2015.

In June 2015, we granted 300,000 stock options to our new Chief Financial Officer and Vice President of Strategy. These options vest over a four year period, have an exercise price of \$2.61 per share, and expire 10 years from the grant date.

In June 2015, we granted 16,000 stock options to an employee. The options vest over a four year period, have an exercise price of \$2.60 per share, and expire 10 years from the grant date.

In June 2015, we granted 373,744 stock options to our non-employee directors. The vesting start date was June 23, 2015, the date of grant. The options will become fully vested on June 17, 2016, the anticipated date of our next annual meeting. The options have an exercise price of \$2.92 per share, as determined on the date of grant, and expire 10 years from the grant date.

Note 8 — Income Taxes

The effective tax rate for the six months ended June 30, 2015 and 2014 was (1.23%) and (1.5%), respectively. As of December 31, 2014, a full valuation allowance of approximately \$20.4 million had been established to reduce our deferred income tax assets to the amount expected to be realized. As such, no tax benefit related to our pre-tax loss was recognized for the six months ended June 30, 2015, as there was no change in our assessment of the amount of deferred income tax assets expected to be realized.

Note 9 — Commitments and Contingencies

Operating Lease Obligations

We lease facilities under fixed non-cancellable operating leases that expire on various dates through November 2019. Future minimum lease payments consist of the following (in thousands):

| | June 30, 2015 |
|-------------------------------------|--------------------------|
| 2015 (remaining six months) | \$ 805 |
| 2016 | 1,576 |
| 2017 | 1,567 |
| 2018 | 1,591 |
| 2019 | 1,398 |
| Total future minimum lease payments | \$ 6,937 |

Product Warranty

The following table summarizes the activity related to the product warranty liability during the three months ended June 30, 2015 and 2014 (in thousands):

| | Three Months Ended | | Six Months Ended | |
|---|-----------------------------------|-------------|-----------------------------|-------------|
| | June 30, | | June 30, | |
| | 2015 | 2014 | 2015 | 2014 |
| Balance, beginning of period | \$756 | \$705 | \$755 | \$709 |
| Warranty costs charged to cost of revenue | (6) | 50 | 15 | 53 |
| Utilization of warranty | (3) | (50) | (23) | (57) |
| Balance, end of period | \$747 | \$705 | \$747 | \$705 |

Purchase Obligations

We enter into purchase order arrangements with our vendors. As of June 30, 2015, there were open purchase orders for which we had not yet received the related goods or services. These arrangements are subject to change based on our sales demand forecasts, and we have the right to cancel the arrangements prior to the date of delivery. As of June 30, 2015, we had approximately \$1.6 million of cancellable open purchase order arrangements related primarily to materials and parts.

Guarantees

We enter into indemnification provisions under our agreements with other companies in the ordinary course of business, typically with customers. Under these provisions, we generally indemnify and hold harmless the indemnified party for losses suffered or incurred by the indemnified party as a result of our activities, generally limited to personal injury and property damage caused by our employees at a customer's desalination plant in proportion to the employee's percentage of fault for the accident. Damages incurred for these indemnifications would be covered by our general liability insurance to the extent provided by the policy limitations. We have not incurred material costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, the estimated fair value of these agreements is not material. Accordingly, we have no liabilities recorded for these agreements as of June 30, 2015 and December 31, 2014.

In certain cases, we issue warranty and product performance guarantees to our customers for amounts ranging from 5% to 10% of the total sales agreement to endorse the execution of product delivery and the warranty of design work, fabrication, and operating performance. These guarantees, generally in the form of stand-by letters of credit or bank guarantees secured by stand-by letters of credit, typically remain in place for periods ranging up to 24 months and in some cases up to 65 months, and relate to the underlying product warranty period. The stand-by letters of credit are collateralized by restricted cash and our credit facility. All of the \$3.0 million in outstanding stand-by letters of credit at June 30, 2015 was issued under the 2012 Agreement. The stand-by letters of credit outstanding at June 30, 2015 were collateralized by restricted cash of \$3.1 million.

Litigation

On September 10, 2014, the Company terminated the employment of its Senior Vice President, Sales, Borja Blanco, on the basis of breach of duty of trust and conduct leading to conflict of interest. On October 3, 2014, Mr. Blanco filed a labor claim against ERI Iberia in Madrid, Spain alleging breach of contract and termination without cause. The claim seeks wages (salary and bonus) of €567,000 and alleged stock option gains of €630,000. The matter has been delayed until November 2015. At this time, the Company has not determined that an award to Mr. Blanco is probable.

In January 2015, two stockholder class action complaints were filed against the Company in the Northern District of California, on behalf of Energy Recovery stockholders under the captions, *Joseph Sabatino v. Energy Recovery, Inc. et al.* and *Thomas C. Mowdy v. Energy Recovery, Inc. et al.* The complaints have now been consolidated under the caption *In Re Energy Recovery Inc. Securities Litigation*. The complaint alleges violations of Section 10(b), Rule 10b-5, and Section 20(a) of the Securities Exchange Act of 1934 and seeks the recovery of unspecified monetary damages. We are not able to estimate the possible loss, if any, due to the early state of this matter.

On May 8, 2015, we entered into a post-judgment settlement and mutual general release agreement (the “Agreement”) in the matter entitled “Morgan Technical Ceramics, Inc v. Energy Recovery, Inc” in the County of Alameda, State of California. Under the Agreement, the Company in exchange for a general release paid \$1.7 million to the plaintiffs. The Company had reserved the full amount of the judgment entered against it in the amount of approximately \$1.9 million and consequently released \$0.2 million from its legal reserve.

Note 10 — Business Segment and Geographic Information

We manufacture and sell high-efficiency energy recovery devices and pumps as well as related services under one reportable segment. Our chief operating decision-maker is the chief executive officer (“CEO”). The CEO reviews financial information presented on a consolidated basis for purposes of making operating decisions and assessing financial performance. Accordingly, we have concluded that we have one reportable segment.

The following geographic information includes net revenue to our domestic and international customers based on the customers' requested delivery locations, except for certain cases in which the customer directed us to deliver our products to a location that differs from the known ultimate location of use. In such cases, the ultimate location of use, rather than the delivery location, is reflected in the table below (in thousands, except percentages):

| | Three Months Ended | | Six Months Ended | | | |
|-----------------------|---------------------------|-------------|-------------------------|-------------|---|---|
| | June 30, | | June 30, | | | |
| | 2015 | 2014 | 2015 | 2014 | | |
| Domestic revenue | \$922 | \$235 | \$1,186 | \$584 | | |
| International revenue | 9,562 | 6,172 | 15,162 | 9,720 | | |
| Total revenue | \$10,484 | \$6,407 | \$16,348 | \$10,304 | | |
| Revenue by country: | | | | | | |
| United Arab Emirates | 35 | % 2 | % 23 | % 3 | % | |
| United States | 9 | 4 | 7 | 6 | | |
| Bahamas | * | 14 | * | 10 | | |
| China | 4 | 11 | 4 | 8 | | |
| Israel | 2 | 9 | 1 | 10 | | |
| Others ** | 50 | 60 | 65 | 63 | | |
| Total | 100 | % 100 | % 100 | % 100 | % | % |

* Less than 1%.

** Includes remaining countries not separately disclosed. No country in this line item accounted for more than 10% of our net revenue during the periods presented.

All of our long-lived assets were located in the United States at June 30, 2015 and December 31, 2014.

Note 11 — Concentrations

Customers accounting for 10% or more of our accounts receivable and unbilled receivables were as follows:

| June | December |
|-------------|-----------------|
| 30, | 31, |

| | 2015 | 2014 | | |
|------------|-------------|-------------|---|--|
| Customer A | 31 % | — | | |
| Customer B | 15 % | — | | |
| Customer C | 10 % | 32 | % | |
| Customer D | 8 % | 11 | % | |

Revenue from customers representing 10% or more of net revenue varies from period to period. For the periods indicated, customers representing 10% or more of net revenue were:

| | Three Months Ended | | Six Months Ended | |
|------------|-----------------------------------|-------------|---------------------------------|-------------|
| | June 30, 2015 | 2014 | June 30, 2015 | 2014 |
| Customer A | 30 % | — | 22 % | — |
| Customer B | 9 % | * | 10 % | 1 % |
| Customer E | 2 % | 14 % | 2 % | 9 % |

*Less than 1%

Note 12 — Fair Value Measurements

The authoritative guidance for measuring fair value provides a hierarchy that prioritizes the inputs to valuation techniques used in measuring fair value as follows:

Level 1 — Quoted prices (unadjusted) in active markets for identical assets or liabilities;

Level 2 — Inputs other than quoted prices included within Level 1 that are either directly or indirectly observable; and

Level 3 — Unobservable inputs in which little or no market activity exists, therefore requiring an entity to develop its own assumptions that market participants would use in pricing.

The carrying values of cash and cash equivalents, restricted cash, accounts receivable, unbilled receivables, accounts payable, and other accrued expenses approximate fair value due to the short-term maturity of those instruments. For our investments in available-for-sale securities, if quoted prices in active markets for identical investments are not available to determine fair value (Level 1), then we use quoted prices for similar assets or inputs other than quoted prices that are observable either directly or indirectly (Level 2). The investments included in Level 2 consist primarily of corporate, and agency obligations.

The fair value of financial assets and liabilities measured on a recurring basis for the indicated periods was as follows (in thousands):

| | June 30, 2015 | Level 1 Inputs | Level 2 Inputs | Level 3 Inputs |
|--|------------------------------|-------------------------------|-------------------------------|-------------------------------|
| Assets: | | | | |
| Short-term available-for-sale securities | \$4,713 | \$ — | \$4,713 | \$ — |
| Long-term available-for-sale securities | 262 | — | 262 | — |
| Total assets | \$4,975 | \$ — | \$4,975 | \$ — |

| | December 31, 2014 | Level 1 Inputs | Level 2 Inputs | Level 3 Inputs |
|--|----------------------------------|-------------------------------|---------------------------|-------------------------------|
| Assets: | | | | |
| Short-term available-for-sale securities | \$ 13,072 | \$ — | \$13,072 | \$ — |
| Long-term available-for-sale securities | 267 | — | 267 | — |
| Total assets | \$ 13,339 | \$ — | \$13,339 | \$ — |

Note 13 — Subsequent Events

On July 1, 2015, warrants to purchase 200,000 shares of our common stock were exercised for cash at a price of \$1.00 per share. The proceeds from this exercise totaled \$200,000. This exercise represents the last outstanding warrant issued in 2005.

Subsequent to June 30, 2015, the Company adopted a new organizational structure based on the operating segments Water and Oil & Gas. In accordance with GAAP, segment information on this basis will be presented commencing in the period of change and will be included for the quarter ended September 30, 2015.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The discussion in this item and in other items of this Form 10-Q contains forward-looking statements within the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements in this report include, but are not limited to, statements about our expectations, objectives, anticipations, plans, hopes, beliefs, intentions, or strategies regarding the future.

Forward-looking statements that represent our current expectations about future events are based on assumptions and involve risks and uncertainties. If the risks or uncertainties occur or the assumptions prove incorrect, then our results may differ materially from those set forth or implied by the forward-looking statements. Our forward-looking statements are not guarantees of future performance or events.

Words such as "expects," "anticipates," "believes," "estimates," variations of such words, and similar expressions are also intended to identify such forward-looking statements. These forward-looking statements are subject to risks, uncertainties, and assumptions that are difficult to predict; therefore, actual results may differ materially and adversely from those expressed in any forward-looking statements. Forward-looking statements in this report include, without limitation, statements about the following:

our belief that levels of gross profit margin are sustainable to the extent that volume grows, we experience a favorable product mix, pricing remains stable, and we continue to realize cost savings through production efficiencies and enhanced yields;

our expectation that our expenses for research and development and sales and marketing may increase as a result of the diversification into markets outside of desalination;

our expectation that sales outside of the United States will remain a significant portion of our net revenue;

our belief that our existing cash balances and cash generated from our operations will be sufficient to meet our anticipated liquidity needs for the foreseeable future, with the exception of a decision to enter into an acquisition and/or fund investments in newly developed technology arising from rapid market adoption that could require us to seek additional equity or debt financing; and

our expectation that, as we expand our international sales, a portion of our revenue could continue to be denominated in foreign currencies.

You should not place undue reliance on these forward-looking statements, which reflect management's opinions only as of the date of the filing of this Quarterly Report on Form 10-Q. All forward-looking statements included in this document are subject to certain risks and uncertainties, which could cause actual results to differ materially from those projected in the forward-looking statements, as disclosed from time to time in our reports on Forms 10-K, 10-Q, and 8-K as well as in our Annual Reports to Stockholders and, if necessary, updated in "Part II, Item 1A: Risk Factors." We assume no obligation to update any such forward-looking statements. It is important to note that our actual results could differ materially from the results set forth or implied by our forward-looking statements.

Overview

We are an energy solutions provider. We convert wasted pressure energy into a reusable asset and preserve or eliminate pumping technology in hostile processing environments. Our core competencies are fluid dynamics and advanced material science. Our company was founded in 1992, and we introduced the initial version of our Pressure Exchanger[®] energy recovery device in early 1997. In December 2009, we acquired Pump Engineering, LLC, which manufactured centrifugal energy recovery devices known as turbochargers as well as high-pressure pumps.

Our energy recovery devices are primarily used in seawater reverse osmosis desalination. In the past several years, we have invested significant research and development costs to expand into other pressurized fluid flow industries such as oil & gas. In 2014, we introduced a new product for the fracking industry, the VorTeq[™] hydraulic pumping solution.

Our revenue is principally derived from the sale of our energy recovery devices. We also derive revenue from the sale of our high-pressure and circulation pumps which we manufacture and sell in connection with our energy recovery devices for use in desalination plants. Additionally, we receive revenue from the sale of spare parts and services, including start-up and commissioning services that we provide to our customers. In 2014, we recognized oil & gas revenue of \$784,000 from the operating lease and lease buy-out of an IsoGen[®] system. In the first quarter of 2015, we recognized oil & gas revenue of \$60,000 from commissioning services and \$81,000 from fees related to the cancellation of a ConocoPhillips sales order.

A significant portion of our net revenue typically has been generated from sales to a limited number of large engineering, procurement, and construction, or EPC, firms that are involved with the design and construction of large desalination plants. Sales to these firms often involve a long sales cycle that can range from 6 to 16 months, and in some cases, up to 24 months. A single large desalination project can generate an order for numerous energy recovery devices and generally represents a significant revenue opportunity. We also sell our devices to many small- to medium-sized original equipment manufacturers, or OEMs, which commission smaller desalination plants, order fewer energy recovery devices per plant, and have shorter sales cycles.

We often experience substantial fluctuations in net revenue from quarter to quarter and from year to year because a single order for our energy recovery devices by a large EPC firm for a particular plant may represent significant revenue. In addition, historically our EPC customers tend to order a significant amount of equipment for delivery in the fourth quarter, and as a consequence, a significant portion of our annual sales typically occurs during that quarter. This historical trend was reflected in the fourth quarter of the last several years. Normal seasonality trends also generally show our lowest revenue in the first quarter of the year.

A limited number of our customers account for a substantial portion of our net revenue and of our accounts receivable and unbilled receivables. Revenue from customers representing 10% or more of net revenue varies from period to period. For the three months ended June 30, 2015, one customer accounted for 30% of our net revenue. For the three months ended June 30, 2014, one customer accounted for 14% of our net revenue. For the six months ended June 30, 2015, two customers accounted for 22% and 10%, respectively, of our net revenue. For the six months ended June 30, 2014, no customer accounted for 10% or more of our net revenue. No other customer accounted for more than 10% of our net revenue during any of these periods. At June 30, 2015, three customers accounted for 31%, 15%, and 10%, respectively, of our accounts receivable and unbilled receivable balance. At December 31, 2014, two customers accounted for 32% and 11%, respectively, of our accounts receivable and unbilled receivable balance.

During the three and six months ended June 30, 2015 and 2014, most of our net revenue was attributable to sales outside of the United States. We expect sales outside of the United States to remain a significant portion of our net revenue for the next few years.

Our condensed consolidated financial statements are prepared in accordance with generally accepted accounting principles in the United States, or GAAP. These accounting principles require us to make estimates and judgments that can affect the reported amounts of assets and liabilities as of the date of the condensed consolidated financial statements as well as the reported amounts of revenue and expense during the periods presented. We believe that the estimates and judgments upon which we rely are reasonable based upon information available to us at the time that we make these estimates and judgments. To the extent that there are material differences between these estimates and actual results, our consolidated financial results will be affected. The accounting policies that reflect our more significant estimates and judgments and which we believe are the most critical to aid in fully understanding and evaluating our reported financial results are revenue recognition; allowance for doubtful accounts; allowance for product warranty; valuation of stock options; valuation and impairment of goodwill, long-lived assets, and acquired intangible assets; useful lives for depreciation and amortization; valuation adjustments for excess and obsolete inventory; and deferred taxes and valuation allowances on deferred tax assets.

On January 12, 2015, Mr. Thomas S. Rooney, Jr., President, Chief Executive Officer, and Director, announced his intent to resign to allow the Company to facilitate a transition during which the Company would identify and appoint a successor. To facilitate this transition the Company entered into an amendment to Mr. Rooney's offer letter dated February 14, 2011 (the "Amendment"). Under the terms of the Amendment, Mr. Rooney resigned as a member of the Board of Directors and its subsidiaries effective January 13, 2015. Mr. Rooney continued to serve as Chief Executive Officer until the appointment of Mr. Gay as Chief Executive Officer on April 24, 2015.

On February 6, 2015, the Board of Directors appointed Mr. Ole Peter Lorentzen and Mr. Alexander J. Buehler as directors. The addition increased the number of directors on the Board to nine, following the resignation of Mr. Rooney on January 13, 2015.

On April 24, 2015, the Board of Directors appointed Mr. Joel Gay as President and Chief Executive Officer and as a member of the Board of Directors effective immediately. Mr. Gay served as the Company's Chief Financial Officer from June 2014 until his appointment as President.

In June 2015, the Board of Directors appointed Mr. Chris Gannon as Chief Financial Officer.

At the annual meeting of stockholders, our stockholders elected Mr. Olav Fjell, Mr. Lorentzen, and Mr. Gay as Class I directors. Incumbent Class I directors, Mr. Johannessen, Mr. Cook, and Ms. Pate-Cornell, decided not to stand for re-election.

*Second Quarter of 2015 Compared to Second Quarter of 2014***Results of Operations**

The following table sets forth certain data from our operating results as a percentage of net revenue for the periods indicated (in thousands, except percentages):

| | Three Months Ended June 30, | | | | | | Change | |
|--------------------------------------|------------------------------------|-------|-------------|-------|-------------------|-------|-------------------|--|
| | 2015 | | 2014 | | Increase / | | (Decrease) | |
| Results of Operations:* | | | | | | | | |
| Net revenue | \$10,484 | 100 % | \$6,407 | 100 % | \$4,077 | 64 % | | |
| Cost of revenue | 4,836 | 46 % | 3,332 | 52 % | 1,504 | 45 % | | |
| Gross profit | 5,648 | 54 % | 3,075 | 48 % | 2,573 | 84 % | | |
| Operating expenses: | | | | | | | | |
| General and administrative | 5,362 | 51 % | 2,995 | 47 % | 2,367 | 79 % | | |
| Sales and marketing | 1,994 | 19 % | 2,702 | 42 % | (708) | (26%) | | |
| Research and development | 1,410 | 13 % | 1,724 | 27 % | (314) | (18%) | | |
| Amortization of intangible assets | 158 | 2 % | 215 | 3 % | (57) | (27%) | | |
| Total operating expenses | 8,924 | 85 % | 7,636 | 119 % | 1,288 | 17 % | | |
| Loss from operations | (3,276) | (31%) | (4,561) | (71%) | 1,285 | 28 % | | |
| Other non-operating (expense) income | 20 | 0 % | 8 | 0 % | 12 | 150 % | | |
| Loss before income taxes | (3,256) | (31%) | (4,553) | (71%) | 1,297 | 28 % | | |
| Provision for income taxes | 71 | 1 % | 58 | 1 % | 13 | 22 % | | |
| Net loss | \$(3,327) | (32%) | \$(4,611) | (72%) | \$1,284 | 28 % | | |

* Percentages may not add up to 100% due to rounding

Net Revenue

Our net revenue increased by \$4.1 million, or 64%, to \$10.5 million for the three months ended June 30, 2015 from \$6.4 million for the three months ended June 30, 2014. The increase was primarily due to increased mega project shipments of \$3.8 million, higher OEM shipments of \$0.2 million, and higher aftermarket shipments of \$0.3 million. The increases were offset by lower oil & gas revenue of \$0.2 million.

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Although we operate under one segment, we categorize revenue based on the type of energy recovery device and its related products and services. The following table reflects revenue by product category and as a percentage of total net revenue (in thousands, except percentages):

| | Three Months Ended June 30, | | | |
|---|------------------------------------|------|-------------|------|
| | 2015 | | 2014 | |
| PX devices and related products and services | \$7,429 | 71 % | \$4,053 | 63 % |
| Turbochargers, pumps, and related products and services | 3,055 | 29 % | 2,149 | 34 % |
| Oil & gas product lease and related services | — | — | 205 | 3 % |
| Net revenue | \$10,484 | 100% | \$6,407 | 100% |

During the three months ended June 30, 2015 and 2014, a significant portion of our net revenue was attributable to sales outside of the United States. Revenue attributable to domestic and international sales as a percentage of net revenue was as follows:

| | Three Months Ended | |
|-----------------------|---------------------------|-------------|
| | June 30, | |
| | 2015 | 2014 |
| Domestic revenue | 9 % | 4 % |
| International revenue | 91 % | 96 % |
| Net revenue | 100 % | 100 % |

Gross Profit

Gross profit represents our net revenue less our cost of revenue. Our cost of revenue consists primarily of raw materials, personnel costs (including share-based compensation), manufacturing overhead, warranty costs, depreciation expense, and manufactured components. For the three months ended June 30, 2015, gross profit as a percentage of net revenue was 54%. For the three months ended June 30, 2014, gross profit as a percentage of net revenue was 48%. The increase was attributable to a favorable shift in product mix.

Future gross profit is highly dependent on the product and customer mix of our net revenues, overall market demand and competition, and the volume of production in our manufacturing plant that determines our operating leverage. Accordingly, we are not able to predict our future gross profit levels with certainty. We believe that the current levels of gross profit margin are sustainable to the extent that volume remains healthy, our product mix favors PX devices, and we continue to realize cost savings through production efficiencies and enhanced yields.

Manufacturing headcount decreased to 36 at the end of the second quarter of 2015 from 37 at the end of the second quarter of 2014.

Share-based compensation expense included in cost of revenue was \$37,000 and \$26,000 for the three months ended June 30, 2015 and 2014, respectively.

General and Administrative Expense

General and administrative expense increased by \$2.4 million, or 79%, to \$5.4 million for the three months ended June 30, 2015 from \$3.0 million for the three months ended June 30, 2014. As a percentage of net revenue, general and administrative expense increased to 51% for the three months ended June 30, 2015 from 47% for the three months ended June 30, 2014.

General and administrative headcount decreased to 24 at the end of the second quarter of 2015 from 28 at the end of the second quarter of 2014.

Of the \$2.4 million increase in general and administrative expense for the three months ended June 30, 2015 compared to the same quarter of 2014, \$1.3 million related to stock based compensation expense primarily associated

with the resignation of the Chief Executive Officer and the modification of his vested options, \$1.0 million related to professional and legal costs, and \$0.3 million related to occupancy costs, compensation and employee related benefits, other taxes, and bad debt expense. These changes were offset by a decrease of approximately \$0.2 million primarily in other administrative costs.

Share-based compensation expense included in general and administrative expense was \$1.7 million and \$365,000 for the three months ended June 30, 2015 and 2014, respectively. The increase in share-based compensation is primarily related to the modification of vested options associated with the resignation of the Chief Executive Officer.

Sales and Marketing Expense

Sales and marketing expense decreased by \$0.7 million, or 26%, to \$2.0 million for the three months ended June 30, 2015 from \$2.7 million for the three months ended June 30, 2014. As a percentage of net revenue, sales and marketing expense decreased to 19% for the three months ended June 30, 2015 from 42% for the three months ended June 30, 2014.

Sales and marketing headcount decreased to 29 at the end of the second quarter of 2015 from 35 at the end of the second quarter of 2014.

Of the \$0.7 million decrease in sales and marketing expense for the three months ended June 30, 2015 compared to the same quarter of 2014, \$0.4 million related to compensation and employee related benefits associated with decreased stock-based compensation expense and lower annual incentive bonus accruals, \$0.2 million related to marketing costs, and \$0.1 million related to professional and other sales and marketing services.

Share-based compensation expense included in sales and marketing expense was \$106,000 and \$155,000 for the three months ended June 30, 2015 and 2014, respectively.

Research and Development Expense

Research and development expense decreased by \$0.3 million, or 18%, to \$1.4 million for the three months ended June 30, 2015 from \$1.7 million for the three months ended June 30, 2014. As a percentage of net revenue, research and development expense decreased to 13% for the three months ended June 30, 2015 from 27% for the three months ended June 30, 2014.

Research and development headcount decreased to 16 at the end of the second quarter of 2015 from 19 at the end of the second quarter of 2014.

Of the \$0.3 million decrease in research and development expense for the three months ended June 30, 2015 compared to the same quarter of 2014, \$0.2 million related to costs associated with the Company's investment in product development for oil & gas applications, and \$0.1 million related to outside consulting and professional fees.

Share-based compensation expense included in research and development expense was \$91,000 and \$88,000 for the three months ended June 30, 2015 and 2014, respectively.

As we continue to advance our existing technologies and develop new energy recovery and efficiency-enhancing solutions for markets outside of seawater desalination, we anticipate that our research and development expenses may increase in the future.

Amortization of Intangible Assets

Amortization of intangible assets is primarily related to finite-lived intangible assets acquired as a result of our purchase of Pump Engineering, LLC in December 2009. Amortization expense decreased by \$57,000, or 27%, to \$158,000 for the three months ended June 30, 2015 from \$215,000 for the three months ended June 30, 2014. The decrease was due to the full amortization of all intangibles, except developed technology, in the fourth quarter of 2014.

Non-Operating Income (Expense), Net

Non-operating income (expense), net, including interest expense, increased by \$12,000 to income of \$20,000 in the three months ended June 30, 2015 from income of \$8,000 in the three months ended June 30, 2014. The increase was primarily due to \$28,000 higher net foreign currency gains offset by a \$16,000 decrease in interest income related to interest receivable on investments.

Income Taxes

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The income tax provision was \$71,000 in the three months ended June 30, 2015 compared to \$58,000 in the three months ended June 30, 2014. The tax expense for the three months ended June 30, 2015 and June 30, 2014 primarily relate to the tax basis amortization of goodwill and state and other taxes. The three months ended June 30, 2015 also includes a tax true-up of approximately \$3,000.

*Six Months Ended June 30, 2015 Compared to Six Months Ended June 30, 2014***Results of Operations**

The following table sets forth certain data from our operating results as a percentage of net revenue for the periods indicated (in thousands, except percentages):

| | Six Months Ended June 30, | | | | Change Increase / | | | |
|--------------------------------------|----------------------------------|-------|-------------|-------|--------------------------|--------|--|--|
| | 2015 | | 2014 | | (Decrease) | | | |
| Results of Operations:* | | | | | | | | |
| Net revenue | \$16,348 | 100 % | \$10,304 | 100 % | \$6,044 | 59 % | | |
| Cost of revenue | 7,367 | 45 % | 4,984 | 48 % | 2,383 | 48 % | | |
| Gross profit | 8,981 | 55 % | 5,320 | 52 % | 3,661 | 69 % | | |
| Operating expenses: | | | | | | | | |
| General and administrative | 11,640 | 71 % | 5,034 | 49 % | 6,606 | 131 % | | |
| Sales and marketing | 4,427 | 27 % | 5,197 | 50 % | (770) | (15%) | | |
| Research and development | 3,943 | 24 % | 2,958 | 29 % | 985 | 33 % | | |
| Amortization of intangible assets | 317 | 2 % | 430 | 4 % | (113) | (26%) | | |
| Total operating expenses | 20,327 | 124 % | 13,619 | 132 % | 6,708 | 49 % | | |
| Loss from operations | (11,346) | (69%) | (8,299) | (81%) | (3,047) | (37%) | | |
| Interest expense | 40 | ** | — | — | (40) | ** | | |
| Other non-operating (expense) income | (82) | (1%) | 129 | 1 % | (211) | (164%) | | |
| Loss before income taxes | (11,468) | (70%) | (8,170) | (79%) | (3,298) | (40%) | | |
| Provision for income taxes | 142 | 1 % | 124 | 1 % | 18 | 15 % | | |
| Net loss | \$(11,610) | (71%) | \$(8,294) | (80%) | \$(3,316) | (40%) | | |

* Percentages may not add up to 100% due to rounding

** Not meaningful

Net Revenue

Our net revenue increased by \$6.0 million, or 59%, to \$16.3 million for the six months ended June 30, 2015 from \$10.3 million for the six months ended June 30, 2014. The increase was primarily due to increased mega project shipments of \$3.8 million, increased OEM shipments of \$2.1 million, and higher aftermarket shipments of \$0.3 million. The increases were offset by a decrease in oil & gas revenue of \$0.2 million.

Although we operate under one segment, we categorize revenue based on the type of energy recovery device and its related products and services. The following table reflects revenue by product category and as a percentage of total net revenue (in thousands, except percentages):

| | Six Months Ended June 30, | | | |
|---|----------------------------------|------|-------------|------|
| | 2015 | | 2014 | |
| PX devices and related products and services | \$11,505 | 70 % | \$6,439 | 63 % |
| Turbochargers, pumps, and related products and services | 4,702 | 29 % | 3,523 | 34 % |
| Oil & gas product lease and related services | 141 | 1 % | 342 | 3 % |
| Net revenue | \$16,348 | 100% | \$10,304 | 100% |

During the six months ended June 30, 2015 and 2014, a significant portion of our net revenue was attributable to sales outside of the United States. Revenue attributable to domestic and international sales as a percentage of net revenue was as follows:

| | Six Months Ended | |
|-----------------------|-------------------------|-------------|
| | June 30, | |
| | 2015 | 2014 |
| Domestic revenue | 7 % | 6 % |
| International revenue | 93 % | 94 % |
| Net revenue | 100% | 100 % |

Gross Profit

Gross profit represents our net revenue less our cost of revenue. Our cost of revenue consists primarily of raw materials, personnel costs (including share-based compensation), manufacturing overhead, warranty costs, depreciation expense, and manufactured components. For the six months ended June 30, 2015, gross profit as a percentage of net revenue was 55%. For the six months ended June 30, 2014, gross profit as a percentage of net revenue was 52%. The increase was attributable to a favorable shift in product mix.

Future gross profit is highly dependent on the product and customer mix of our net revenues, overall market demand and competition, and the volume of production in our manufacturing plant that determines our operating leverage. Accordingly, we are not able to predict our future gross profit levels with certainty. We believe that the current levels of gross profit margin are sustainable to the extent that volume remains healthy, our product mix favors PX devices, and we continue to realize cost savings through production efficiencies and enhanced yields.

Manufacturing headcount decreased to 36 at June 30, 2015 from 37 at June 30, 2014.

Share-based compensation expense included in cost of revenue was \$72,000 and \$48,000 for the six months ended June 30, 2015 and 2014, respectively.

General and Administrative Expense

General and administrative expense increased by \$6.6 million, or 131%, to \$11.6 million for the six months ended June 30, 2015 from \$5.0 million for the six months ended June 30, 2014. As a percentage of net revenue, general and administrative expense increased to 71% for the six months ended June 30, 2015 from 49% for the six months ended June 30, 2014.

General and administrative headcount decreased to 24 at June 30, 2015 from 28 at June 30, 2014.

Of the \$6.6 million increase in general and administrative expense for the six months ended June 30, 2015 compared to the same period of 2014, \$2.9 million related to professional, legal and other administrative costs, including that related to the termination of the former Senior Vice President of Sales in 2014, \$1.9 million related to increased stock based compensation expense, \$850,000 related to the reversal of VAT in the first quarter of 2014 that was expensed in

2011 and in prior years, \$0.7 million related to compensation and employee related benefits primarily associated with the resignation of the Chief Executive Officer and termination benefits associated with a reduction in force in the first quarter of 2015, and \$0.3 million related to other administrative costs.

Share-based compensation expense included in general and administrative expense was \$2.6 million and \$694,000 for the six months ended June 30, 2015 and 2014, respectively. The increase in share-based compensation is related to increased value of options granted to non-employee directors in February 2015 (see Note 7 – Equity), the full vesting of restricted shares granted to a non-employee director on December 31, 2014, and the accelerated vesting and modification of options associated with the resignation of the Chief Executive Officer.

Sales and Marketing Expense

Sales and marketing expense decreased by \$0.8 million, or 15%, to \$4.4 million for the six months ended June 30, 2015 from \$5.2 million for the six months ended June 30, 2014. As a percentage of net revenue, sales and marketing expense decreased to 27% for the six months ended June 30, 2015 from 50% for the six months ended June 30, 2014.

Sales and marketing headcount decreased to 29 at June 30, 2015 from 35 at June 30, 2014.

Of the \$0.8 million decrease in sales and marketing expense for the six months ended June 30, 2015 compared to the same period of 2014, \$0.5 million related to compensation and employee related benefits associated with decreased stock-based compensation expense and lower annual incentive bonus accruals, \$0.4 million related to marketing costs, and \$0.1 million related to professional and other sales and marketing services. The decreases were offset by increases of \$0.2 million primarily related to commissions to certain sales representatives accrued at premium rates and occupancy costs and \$0.1 million in termination benefits associated with a reduction in force in the first quarter of 2015.

Share-based compensation expense included in sales and marketing expense was \$207,000 and \$308,000 for the six months ended June 30, 2015 and 2014, respectively.

Research and Development Expense

Research and development expense increased by \$0.9 million, or 33%, to \$3.9 million for the six months ended June 30, 2015 from \$3.0 million for the six months ended June 30, 2014. As a percentage of net revenue, research and development expense decreased to 24% for the six months ended June 30, 2015 from 29% for the six months ended June 30, 2014.

Research and development headcount decreased to 16 at June 30, 2015 from 19 at June 30, 2014.

Of the \$0.9 million increase in research and development expense for the six months ended June 30, 2015 compared to the same period of 2014, \$0.7 million related to costs associated with the Company's investment in product development for oil & gas applications, \$0.5 million related to compensation and employee-related benefits, including \$81,000 in termination benefits associated with a reduction in force in the first quarter of 2015, and \$22,000 primarily related to occupancy cost. The increases were offset by a decrease of \$0.2 million related to outside consulting and professional fees.

Share-based compensation expense included in research and development expense was \$198,000 and \$165,000 for the six months ended June 30, 2015 and 2014, respectively.

As we continue to advance our existing technologies and develop new energy recovery and efficiency enhancing solutions for markets outside of seawater desalination, we anticipate that our research and development expenses may increase in the future.

Amortization of Intangible Assets

Amortization of intangible assets is primarily related to finite-lived intangible assets acquired as a result of our purchase of Pump Engineering, LLC in December 2009. Amortization expense decreased by \$113,000, or 26%, to \$317,000 for the six months ended June 30, 2015 from \$430,000 for the six months ended June 30, 2014. The decrease was due to the full amortization of all intangibles, except developed technology, in the fourth quarter of 2014.

Non-Operating Income (Expense), Net

Non-operating income (expense), net, including interest expense, decreased by \$251,000 to an expense of (\$122,000) in the six months ended June 30, 2015 from income of \$129,000 in the six months ended June 30, 2014. The decrease was primarily due to a \$148,000 decrease in interest income related to interest receivable on investments, \$63,000 higher net foreign currency losses recorded during the first six months of 2015 compared to the same period last year, and an increase in interest expense of \$40,000.

Income Taxes

The income tax provision was \$142,000 the six months ended June 30, 2015 compared to \$124,000 in the six months ended June 30, 2014. The tax expense for the six months ended June 30, 2015 and June 30, 2014 primarily relate to the tax basis amortization of goodwill and state and other taxes. The six months ended June 30, 2015 also includes a tax true-up of approximately \$3,000.

Supplemental Information

With the appointment of a new CEO in April 2015, new internal reporting is being developed for making operating decisions and assessing financial performance. We report segment information based on the “management approach” designated by the internal reporting used by management. Accordingly, beginning with the third quarter ending September 30, 2015, with a new internal organizational structure we will begin reporting segment information on a basis reflecting this new structure. At that time, the composition of our reporting units will be reassessed and the impairment analysis of goodwill and long-lived assets will be performed based on the new structure.

Our reportable operating segments will be based on the type of energy recovery device and its related products and services and will consist of the Water Segment and the Oil & Gas Segment.

The Water Segment will consist of products sold for use in desalination or water processing and the related identifiable expenses. The Oil & Gas Segment will consist of products sold for use in gas processing, chemical processing, and hydraulic fracturing and the related identifiable expenses. Operating income for each segment will exclude other income and expenses and certain expenses managed outside the operating segment. Cost excluded from operating income include various corporate expenses such as certain share-based compensation expenses, income taxes, and other separately managed general and administrative expenses not related to the identified segments.

Information for the period ended June 30, 2015 based on the new reportable segments is presented below.

| | Three Months Ended June 30, 2015 | | | Six Months Ended June 30, 2015 | | |
|-----------------------------------|---|-------------------------|--------------|---|-------------------------|--------------|
| | Water | Oil &Gas | Total | Water | Oil &Gas | Total |
| Net revenue | \$10,484 | \$— | \$10,484 | \$16,206 | \$142 | \$16,348 |
| Cost of revenue | 4,836 | — | 4,836 | 7,338 | 29 | 7,367 |
| Gross profit | 5,648 | — | 5,648 | 8,868 | 113 | 8,981 |
| Operating expenses: | | | | | | |
| General and administrative | (17) | 391 | 374 | 587 | 723 | 1,310 |
| Sales and marketing | 931 | 949 | 1,880 | 2,101 | 2,069 | 4,170 |
| Research and development | 201 | 1,299 | 1,500 | 546 | 3,459 | 4,005 |
| Amortization of intangible assets | 143 | 15 | 158 | 285 | 32 | 317 |
| Total operating expenses | 1,258 | 2,654 | 3,912 | 3,519 | 6,283 | 9,802 |
| Operating income (loss) | \$4,390 | \$(2,654) | \$1,736 | \$5,349 | \$(6,170) | \$(821) |

Negative general and administrative expenses in the Water Segment for the three months ended June 30, 2015, are reflective of the reversal of previously accrued expenses associated with a litigation case that was settled for less during the quarter.

Operating expenses in the Oil & Gas Segment reflect our investment to develop new markets and verticals, such as gas processing, ammonia, and pipelines, as well as hydraulic fracturing. The majority of our sales and marketing expenses in this segment relate to gas processing, ammonia, and pipelines. Conversely, research and development expenses are primarily related to the development and commercialization of our hydraulic fracturing solution, the VorTeq.

The following is a reconciliation of segment operating income (loss) to the Condensed Consolidated Statements of Operations for the three and six months ended June 30, 2015.

| | Ended June 30, 2015 | |
|---------------------------------|--------------------------------|-----------------------|
| | Three Months | Six Months |
| Segment operating income (loss) | \$1,736 | \$(821) |
| Corporate expenses | 5,012 | 10,525 |
| Operating loss | \$(3,276) | \$(11,346) |

Year over Year Comparison***Segment Revenue***

| <u>Segment</u> | Three Months Ended | | |
|-----------------------|---------------------------|-------------|---------------|
| | June 30, | | |
| | 2015 | 2014 | Change |
| Water | \$ 10,484 | \$ 6,202 | 69 % |
| Oil & Gas | — | 205 | (100%) |
| Net Revenue | \$ 10,484 | \$ 6,407 | 64 % |

Net revenue in the Water Segment increased by \$4.3 million, or 69%, to \$10.5 million for the three months ended June 30, 2015 from \$6.2 million for the three months ended June 30, 2014. The increase was primarily due to increased mega project shipments of \$3.8 million, higher OEM shipments of \$0.2 million, and higher aftermarket shipments of \$0.3 million.

Net revenue in the Oil & Gas Segment decreased by \$0.2 million, or 100%, to zero for the three months ended June 30, 2015 from \$0.2 million for the three months ended June 30, 2014. The decrease was due to the lease buy-out of an IsoGen™ system at the end of 2014 and therefore there was no lease revenue in 2015.

| <u>Segment</u> | Six Months Ended June | | |
|-----------------------|------------------------------|-------------|---------------|
| | 30, | | |
| | 2015 | 2014 | Change |
| Water | \$ 16,206 | \$ 9,962 | 63 % |
| Oil & Gas | 142 | 342 | (58 %) |
| Net Revenue | \$ 16,348 | \$ 10,304 | 59 % |

Net revenue in the Water Segment increased by \$6.2 million, or 63%, to \$16.2 million for the six months ended June 30, 2015 from \$10.0 million for the six months ended June 30, 2014. The increase was primarily due to increased mega project shipments of \$3.8 million, higher OEM shipments of \$2.1 million, and higher aftermarket shipments of \$0.3 million.

Net revenue in the Oil & Gas Segment decreased by \$0.2 million, or 58%, to \$0.1million for the six months ended June 30, 2015 from \$0.3 million for the six months ended June 30, 2014. The decrease was due to the lease buy-out of an IsoGen® system at the end of 2014 and therefore there was no lease revenue in 2015.

Segment Gross Profit

| | Three Months Ended June 30, 2015 | | | Six Months Ended June 30, 2015 | | |
|--------------|-------------------------------------|-------------|-------|-----------------------------------|-------------|-------|
| | Water | Oil &Gas | Total | Water | Oil &Gas | Total |
| Gross profit | 5,648 | — | 5,648 | 8,868 | 113 | 8,981 |
| Gross margin | 54 % | — | 54 % | 55 % | 80 % | 55 % |

| | Three Months Ended June 30, 2014 | | | Six Months Ended June 30, 2014 | | |
|--------------|-------------------------------------|-------------|-------|-----------------------------------|-------------|-------|
| | Water | Oil &Gas | Total | Water | Oil &Gas | Total |
| Gross profit | 2,870 | 205 | 3,075 | 4,978 | 342 | 5,320 |
| Gross margin | 46 % | 100 % | 48 % | 50 % | 100 % | 52 % |

Segment Operating Expenses

On a segment basis, we are unable to compare our operating expenses for the three and six months ending June 30, 2015 to the same period last year as comparative information is unavailable at this time.

Liquidity and Capital Resources

Overview

Our primary source of cash historically has been proceeds from the issuance of common stock and customer payments for our products and services. In March 2015, we entered into a loan agreement with a financial institution for a \$55,000 fixed-rate installment loan carrying an annual interest rate of 6.35%. The loan is payable in monthly

installments and matures on April 2, 2020. From January 1, 2005 through June 30, 2015, we issued common stock for aggregate net proceeds of \$87.4 million, excluding common stock issued in exchange for promissory notes. The proceeds from the sales of common stock have been used to fund our operations and capital expenditures.

As of June 30, 2015, our principal sources of liquidity consisted of unrestricted cash and cash equivalents of \$18.1 million that are invested primarily in money market funds; short-term and long-term investments of \$5.0 million that are primarily invested in marketable debt securities; and accounts receivable of \$7.4 million. We invest cash not needed for current operations predominantly in high-quality, investment-grade, and marketable debt instruments with the intent to make such funds available for operating purposes as needed.

We currently have unbilled receivables pertaining to customer contractual holdback provisions, whereby we will invoice the final installment due under a sales contract six to 24 months after the product has been shipped to the customer and revenue has been recognized. The customer holdbacks represent amounts intended to provide a form of security to the customer during the warranty period; accordingly, these receivables have not been discounted to present value. At June 30, 2015 we had \$1.7 million of short- and long-term unbilled receivables.

In 2009, we entered into a loan and security agreement (the "2009 Agreement") with a financial institution. The 2009 Agreement, as amended, provided a total available credit line of \$16.0 million. Under the 2009 Agreement, we were allowed to draw advances of up to \$10.0 million on a revolving line of credit or utilize up to \$15.9 million as collateral for stand-by letters of credit, provided that the aggregate of the outstanding advances and collateral did not exceed the total available credit line of \$16.0 million. Advances under the revolving line of credit incurred interest based on a prime rate index or on LIBOR plus 1.375%. The amended 2009 Agreement also required us to maintain a cash collateral balance equal to at least 101% of the face amount of all outstanding stand-by letters of credit collateralized by the line of credit and 100% of the amount of all outstanding advances.

During the periods presented, we provided certain customers with stand-by letters of credit to secure our obligations for the delivery and performance of products in accordance with sales arrangements. Some of these stand-by letters of credit were issued under our 2009 Agreement. The stand-by letters of credit remain in place generally for periods ranging up to 24 months and in some cases up to 65 months. As of June 30, 2015, there were no outstanding stand-by letters of credit collateralized under our 2009 Agreement and no cash was restricted related to the stand-by letters of credit issued under the 2009 Agreement. There were no advances drawn on the line of credit under the 2009 Agreement at the time of its expiration.

In June 2012, we entered into a loan agreement (the “2012 Agreement”) with another financial institution. The 2012 Agreement, as amended, provides for a total available credit line of \$16.0 million. Under the 2012 Agreement, as amended, we are allowed to draw advances not to exceed, at any time, \$10.0 million as revolving loans. The total stand-by letters of credit issued under the 2012 Agreement, as amended, may not exceed the lesser of the \$16.0 million credit line or the credit line minus all outstanding revolving loans. At no time may the aggregate of the revolving loans and stand-by letters of credit exceed the total available credit line of \$16.0 million. Revolving loans may be in the form of a base rate loan that bears interest equal to the prime rate plus 0% or a Eurodollar loan that bears interest equal to the adjusted LIBO rate plus 1.25%. Stand-by letters of credit are subject to customary fees and expenses for issuance or renewal. The unused portion of the credit facility is subject to a fee in an amount equal to 0.25% per annum of the average unused portion of the revolving line.

We are subject to certain financial and administrative covenants under the 2012 Agreement, as amended. As of June 30, 2015, we were in compliance with these covenants.

The 2012 Agreement, as amended, also requires us to maintain a cash collateral balance equal to 101% of all outstanding advances and all outstanding stand-by letters of credit collateralized by the line of credit. The 2012 Agreement, as amended, matures on June 5, 2018 and is collateralized by substantially all of our assets. As of June 30, 2015 there were no advances drawn under the 2012 Agreement’s line of credit. The amounts outstanding on stand-by letters of credit collateralized under the 2012 Agreement, as amended, totaled approximately \$3.0 million, and restricted cash related to these stand-by letters of credit issued under the 2012 Agreement, as amended, was approximately \$3.1 million as of June 30, 2015. Of this \$3.1 million of restricted cash, \$1.4 million was classified as current and \$1.7 million was classified as non-current.

Cash Flows from Operating Activities

Net cash used in operating activities was \$(8.0) million and \$(193,000) for the six months ended June 30, 2015 and 2014, respectively. For the six months ended June 30, 2015, a net loss of \$(11.6) million was adjusted to \$(6.1) million by non-cash items totaling \$5.5 million. For the six months ended June 30, 2014, a net loss of \$(8.3) million was adjusted to \$(4.6) million by non-cash items totaling \$3.7 million. Non-cash adjustments during the six months ended June 30, 2015, primarily include share-based compensation of \$3.1 million; depreciation and amortization of \$2.0 million; and unrealized losses on foreign currency transactions, amortization of premiums/discounts on investments, deferred income taxes, and other non-cash items of \$0.4 million.

Non-cash adjustments during the six months ended June 30, 2014, primarily include depreciation and amortization of \$2.0 million, share-based compensation of \$1.2 million, and provision for doubtful accounts and amortization of premiums/discounts on investments of \$0.3 million.

The net cash impact from changes in assets and liabilities was approximately \$(1.9) million and \$4.4 million for the six months ended June 30, 2015 and 2014, respectively. Net changes in assets and liabilities during the six months ended June 30, 2015 are primarily attributable to a decrease of \$3.5 million in accounts receivable and unbilled receivables as a result of the collections and the timing of invoices for projects shipped previously, an increase of \$0.7 million in deferred revenue due to the timing of invoices, an increase in accounts payable of \$0.5 million due to timing of payments to vendors, and a decrease in prepaid and other assets and unbilled receivables of \$0.3 million. These changes were offset by an increase of \$3.6 million in accrued expense, and other liabilities due to the timing of payments to other third parties; the settlement of a litigation case for \$1.7 million; and an increase of \$1.5 million in inventories due to the delay in a shipments.

Net changes in assets and liabilities during the six months ended June 30, 2014 were primarily attributable to a decrease of \$11.0 million in accounts receivable and unbilled receivables as a result of the timing of invoices and collections for large projects that were shipped in the fourth quarter of 2013 and a \$0.6 million increase in accounts payable. These changes were offset by an increase in inventory of \$4.7 million as a result of inventory buildup for future shipments, a decrease in accrued expenses and other liabilities of \$2.4 million as a result of a VAT settlement in Spain and the timing of payments to employees, vendors, and other third parties, and an increase of \$0.2 million in prepaid expenses.

Cash Flows from Investing Activities

Cash flows provided by investing activities primarily relate to maturities of investments in marketable securities and the release of restricted cash used to collateralize our stand-by letters of credit offset by capital expenditures to support our growth and additional investments in marketable securities.

Net cash provided by investing activities was \$10.2 million and \$1.7 million for the six months ended June 30, 2015 and 2014, respectively. Cash flows provided by investing activities for the six months ended June 30, 2015 were primarily due to the maturity of marketable securities of \$8.2 million and a decrease of \$2.4million in restricted cash to collateralize stand-by letters of credit. These sources of cash were offset by the use of \$0.4 million to purchase fixed assets.

Cash flows provided by investing activities for the six months ended June 30, 2014 was primarily due to the maturity of marketable securities of \$4.0 million. This source of cash provided by investing activities was offset by \$2.1 million of additions to property and equipment and the restriction of \$0.2 million in cash to collateralize stand-by letters of credit.

Cash Flows from Financing Activities

Net cash provided by financing activities was \$346,000 and \$505,000 for the six months ended June 30, 2015 and 2014, respectively. Net cash provided during the six months ended June 30, 2015 consisted of \$293,000 received for the issuance of common stock due to option exercises and \$55,000 of borrowings offset by the use of \$2,000 for repayment of borrowings.

Net cash provided during the six months ended June 30, 2014, was the result of \$1.1 million received for the issuance of common stock due to option and warrant exercises offset by the use of \$633,000 to repurchase common stock.

Liquidity and Capital Resource Requirements

We believe that our existing cash balances and cash generated from operations will be sufficient to meet our anticipated capital requirements for at least the next twelve months. However, we may need to raise additional capital or incur additional indebtedness to continue to fund our operations or to support acquisitions in the future. Our future capital requirements will depend on many factors, including our rate of revenue growth, if any, the expansion of our sales and marketing and research and development activities, the amount and timing of cash used for stock repurchases, the timing and extent of our expansion into new geographic territories, the timing of new product introductions, and the continuing market acceptance of our products. We may enter into potential material investments in, or acquisitions of, complementary businesses, services, or technologies in the future, which could also require us to seek additional equity or debt financing. Additional funds may not be available on terms favorable to us or at all.

Contractual Obligations

In March 2015, we entered into a loan agreement that matures in April 2020. The total of future minimum installment payment under this agreement as of June 30, 2015 was \$55,000. For additional information, see Note 6 — “Long-Term Debt and Lines of Credit” to the unaudited condensed consolidated financial statements in this quarterly report on Form 10-Q.

We lease facilities under fixed non-cancellable operating leases that expire on various dates through 2019. The total of the future minimum lease payments under these leases as of June 30, 2015 was \$6.9 million. For additional information, see Note 9 — “Commitments and Contingencies” to the unaudited condensed consolidated financial statements in this quarterly report on Form 10-Q.

In the course of our normal operations, we also enter into purchase commitments with our suppliers for various raw materials and components parts. The purchase commitments covered by these arrangements are subject to change based on sales forecasts for future deliveries. As of June 30, 2015, we had approximately \$1.6 million of cancellable open purchase order arrangements related primarily to materials and parts.

We have agreements with guarantees or indemnity provisions that we have entered into with customers and others in the ordinary course of business. Based on our historical experience and information known to us as of June 30, 2015, we believe that our exposure related to these guarantees and indemnities was not material.

The following is a summary of our contractual obligations as of June 30, 2015 (in thousands):

| Payments Due During Year Ending December 31, | Operating Leases | Payments Due by Period | | |
|--|---------------------|---------------------------|-------|----------|
| | | Purchase Obligations | Loan | Total |
| 2015 (remaining 6 months) | \$ 805 | \$ 1,626 | \$ 5 | \$ 2,436 |
| 2016 | 1,576 | — | 11 | 1,587 |
| 2017 | 1,567 | — | 11 | 1,578 |
| 2018 | 1,591 | — | 11 | 1,602 |
| 2019 | 1,398 | — | 11 | 1,409 |
| Thereafter | — | — | 4 | 4 |
| | \$ 6,937 | \$ 1,626 | \$ 53 | \$ 8,616 |

Off-Balance Sheet Arrangements

During the periods presented, we did not have any relationships with unconsolidated entities or financial partnerships such as entities often referred to as structured finance or special purpose entities that would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

Recent Accounting Pronouncements

See Note 1 — “The Company and Summary of Significant Accounting Policies” to the condensed consolidated financial statements regarding the impact of certain recent accounting pronouncements on our condensed consolidated financial statements.

Item 3. Quantitative and Qualitative Disclosure About Market Risk

The information in this section should be read in connection with the information on financial market risk related to changes in currency exchange rates and interest rates in Part II, Item 7A, “Quantitative and Qualitative Disclosure About Market Risk,” in our Annual Report on Form 10-K for the year ended December 31, 2014.

Foreign Currency Risk

The majority of our revenue contracts have been denominated in United States Dollars. In some circumstances, we have priced certain international sales in Euros.

As we expand our international sales, we expect that a portion of our net revenue could continue to be denominated in foreign currencies. As a result, our cash and cash equivalents and operating results could be increasingly affected by changes in exchange rates. Our international sales and marketing operations incur expenses that are denominated in foreign currencies. These expenses could be materially affected by currency fluctuations. Our exposures are to fluctuations in exchange rates for the United States Dollar versus the Euro, AED, CNY, and CAD. Changes in currency exchange rates could adversely affect our consolidated operating results or financial position. Additionally, our international sales and marketing operations maintain cash balances denominated in foreign currencies. To decrease the inherent risk associated with translation of foreign cash balances into our reporting currency, we have not maintained excess cash balances in foreign currencies. We have not hedged our exposure to changes in foreign currency exchange rates because expenses and cash balances in foreign currencies have been insignificant to date and exchange rate fluctuations have had little impact on our operating results and cash flows.

Interest Rate Risk

We have an investment portfolio of fixed income marketable debt securities, including amounts classified as cash equivalents, short-term investments, and long-term investments. At June 30, 2015, our short- and long-term investments totaled \$5.0 million. The primary objective of our investment activities is to preserve principal and liquidity while at the same time maximizing yields without significantly increasing risk. Our current investments are primarily in high-quality, short-term and long-term debt instruments of high-quality corporate issuers. These investments are subject to interest rate fluctuations and will decrease in market value if interest rates increase. To minimize the exposure due to adverse shifts in interest rates, we maintain investments with an average maturity of less than eighteen months. A hypothetical 1% increase in interest rates would have resulted in an approximately \$10,000 decrease in the fair value of our fixed-income debt securities as of June 30, 2015.

Concentration of Credit Rate Risk

Our investments in marketable debt securities are subject to potential loss of value due to counterparty credit risk. To minimize this risk, we invest pursuant to a Board-approved investment policy. The policy mandates high-credit-rating requirements and restricts our exposure to any single corporate issuer or sector by imposing concentration limits.

Item 4. Controls and Procedures.

(a) *Evaluation of disclosure controls and procedures.* Under the supervision and with the participation of our management, including the President and Chief Executive Officer and the Principal Financial Officer, we have evaluated the effectiveness of our disclosure controls and procedures as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934 as of the end of the period covered by this report.

Based on that evaluation, the Chief Executive Officer and the Principal Financial Officer have concluded that these disclosure controls and procedures are effective.

(b) *Changes in internal controls.* There were no changes in our internal control over financial reporting during the quarter ended June 30, 2015 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II — OTHER INFORMATION

Item 1. Legal Proceedings

Note 9 – “Commitments and Contingencies”, under the caption “Litigation” of our Annual Report on Form 10-K filed with the SEC on March 6, 2015, provides information on certain litigation in which we are involved.

For an update on the litigation matters previously disclosed in our Form 10-K, see the discussion in Note 9 – “Commitments and Contingencies”, under the caption “Litigation” of this quarterly report on Form 10-Q, which discussion is incorporated by reference into this Item 1.

Item 1A. Risk Factors

There has been no material changes in our risk factors from those disclosed in Part I, Item 1A, in our Annual Report on Form 10-K filed on March 6, 2015.

Item 6. Exhibits

| <u>Exhibit No.</u> | <u>Description</u> |
|---------------------------|---|
| 10.1 | Resignation, Transition, and Separation Agreement with Ms. Audrey Bold, incorporated by reference to Exhibit 99.1 in the Company’s Form 8-K filed on April 16, 2015 |
| 10.2 | Energy Recovery 2015 Annual Incentive Plan, incorporated by reference to Exhibit 10.1 in the Company’s Form 8-K filed on April 29, 2015 |
| 10.3 | Offer Letter to Mr. Joel Gay, incorporated by reference to Exhibit 99.2 in the Company’s Form 8-K filed on April 29, 2015 |
| 10.4 | Promotion Letter for Ms. Sharon Smith-Lenox, incorporated by reference to Exhibit 99.1 in the Company’s Form 8-K filed on May 1, 2015 |
| 10.5 | Settlement and Mutual Release, incorporated by reference to Exhibit 99.1 in the Company’s Form 8-K filed May 13, 2015 |
| 10.6 | Offer Letter to Mr. Chris Gannon, incorporated by reference to Exhibit 99.1 in the Company’s Form 8-K filed on May 15, 2015 |

- 10.7 Second Amendment to Loan Agreement with HSBC Bank USA, National Association
- 31.1 Certification of Principal Executive Officer Pursuant to Exchange Act Rule 13a-14(a) or 15d-14(a), as Adopted Pursuant to Section 302 of The Sarbanes Oxley Act of 2002
- 31.2 Certification of Principal Financial Officer Pursuant to Exchange Act Rule 13a-14(a) or 15d-14(a), as Adopted Pursuant to Section 302 of The Sarbanes Oxley Act of 2002
- 32.1 Certifications of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 101.INS XBRL Instance Document

- 101.SCH XBRL Taxonomy Extension Schema Document
- 101.CAL XBRL Taxonomy Extension Calculation Linkbase Document
- 101.DEF XBRL Taxonomy Extension Definition Linkbase Document
- 101.LAB XBRL Taxonomy Extension Label Linkbase Document
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Registrant: Energy Recovery, Inc.

By: /s/ JOEL GAY President and Chief Executive Officer August 6, 2015
 Joel Gay (Principal Executive Officer)

/s/ CHRIS GANNON Chief Financial Officer
Chris Gannon (Principal Financial Officer)

August 6, 2015

Exhibit List

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