

Energy Recovery, Inc.  
Form 10-Q  
May 05, 2016

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**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 March 31, 2016**

**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**



**ENERGY RECOVERY, INC.**

**QUARTERLY REPORT ON FORM 10-Q FOR THE PERIOD ENDED MARCH 31, 2016**

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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)**

	<b>March 31, 2016</b>	<b>December 31, 2015</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$96,527	\$ 99,931
Restricted cash	1,232	1,490
Short-term investments	255	257
Accounts receivable, net of allowance for doubtful accounts of \$156 and \$166 at March 31, 2016 and December 31, 2015, respectively	7,683	11,590
Unbilled receivables, current	1,804	1,879
Inventories	6,725	6,503
Income tax receivable	2	—
Deferred tax assets, net	1,145	938
Prepaid expenses and other current assets	1,299	943
Total current assets	116,672	123,531
Restricted cash, non-current	2,911	2,317
Unbilled receivables, non-current	—	6
Property and equipment, net of accumulated depreciation of \$19,113 and \$18,338 at March 31, 2016 and December 31, 2015, respectively	9,956	10,622
Goodwill	12,790	12,790
Other intangible assets, net	2,374	2,531
Other assets, non-current	2	2
Total assets	\$144,705	\$ 151,799
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$2,592	\$ 1,865
Accrued expenses and other current liabilities	4,984	7,808

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Income taxes payable	—	2
Accrued warranty reserve	428	461
Deferred revenue	5,619	5,878
Current portion of long-term debt	10	10
Total current liabilities	13,633	16,024
Long-term debt, net of current portion	36	38
Deferred tax liabilities, non-current, net	2,360	2,360
Deferred revenue, non-current	67,766	69,000
Other non-current liabilities	674	718
Total liabilities	84,469	88,140
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; 55,368,637 shares issued and 52,215,481 shares outstanding at March 31, 2016, and 54,948,235 shares issued and 52,468,779 shares outstanding at December 31, 2015	55	55
Additional paid-in capital	132,469	129,809
Accumulated other comprehensive loss	(75 )	(64 )
Treasury stock at cost, 3,153,156 and 2,479,456 shares repurchased at March 31, 2016 and December 31, 2015, respectively	(10,941 )	(6,835 )
Accumulated deficit	(61,272 )	(59,306 )
Total stockholders' equity	60,236	63,659
Total liabilities and stockholders' equity	\$144,705	\$151,799

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements

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

	<b>Three Months Ended</b>	
	<b>March 31,</b>	
	<b>2016</b>	<b>2015</b>
Product revenue	\$ 10,051	\$ 5,864
Product cost of revenue	3,674	2,531
Product gross profit	6,377	3,333
License and development revenue	1,250	—
Operating expenses:		
General and administrative	4,884	6,278
Sales and marketing	2,070	2,433
Research and development	2,665	2,533
Amortization of intangible assets	157	159
Total operating expenses	9,776	11,403
Loss from operations	(2,149 )	(8,070 )
Other expense:		
Interest expense	(1 )	(40 )
Other non-operating expense	(21 )	(102 )
Loss before income taxes	(2,171 )	(8,212 )
(Benefit) provision for income taxes	(205 )	71
Net loss	\$(1,966 )	\$(8,283 )
Basic and diluted net loss per share	\$(0.04 )	\$(0.16 )
Shares used in basic and diluted per share calculation	52,207	51,948

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements

**ENERGY RECOVERY, INC.**

**CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS**

**(in thousands)**

**(unaudited)**

	<b>Three Months Ended</b>	
	<b>March 31, 2016</b>	<b>2015</b>
Net loss	\$(1,966)	\$(8,283)
Other comprehensive (loss) income, net of tax:		
Foreign currency translation adjustments	(12 )	31
Unrealized gain on investments	1	3
Other comprehensive (loss) income	(11 )	34
Comprehensive loss	\$(1,977)	\$(8,249)

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements

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

(in thousands)

(unaudited)

	<b>Three Months Ended</b>	
	<b>March 31, 2016      2015</b>	
<b>Cash Flows From Operating Activities</b>		
Net loss	\$(1,966 )	\$(8,283 )
Adjustments to reconcile net loss to net cash used in operating activities:		
Share-based compensation	1,188	1,140
Depreciation and amortization	932	979
Unrealized loss on foreign currency transactions	53	124
Change in fair value of put options	29	—
Valuation adjustments for excess or obsolete inventory	12	(10 )
Provision for doubtful accounts	4	2
Amortization of premiums on investments	3	79
Provision for warranty claims	—	21
Deferred income taxes	(207 )	65
Reversal of accruals related to expired warranties	(33 )	—
Other non-cash adjustments	(44 )	428
Changes in operating assets and liabilities:		
Accounts receivable	3,904	5,524
Accounts payable	727	215
Unbilled receivables	81	314
Income taxes payable	(4 )	2
Inventories	(234 )	(1,120 )
Deferred revenue, product	(245 )	574
Prepaid and other assets	(385 )	154
Deferred revenue, SLB license	(1,250 )	—
Accrued expenses and other liabilities	(2,825 )	(1,192 )
<b>Net cash used in operating activities</b>	<b>(260 )</b>	<b>(984 )</b>
<b>Cash Flows From Investing Activities</b>		
Maturities of marketable securities	—	4,675
Capital expenditures	(152 )	(179 )
Restricted cash	(335 )	1,084
<b>Net cash (used in) provided by investing activities</b>	<b>(487 )</b>	<b>5,580</b>
<b>Cash Flows From Financing Activities</b>		



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Net proceeds from issuance of common stock	1,515	250
Proceeds from long-term debt	—	55
Repayment of long-term debt	(2 )	—
Repurchase of common stock	(4,106 )	—
<b>Net cash (used in) provided by financing activities</b>	<b>(2,593 )</b>	<b>305</b>
<b>Effect of exchange rate differences on cash and cash equivalents</b>	<b>(64 )</b>	<b>(11 )</b>
<b>Net change in cash and cash equivalents</b>	<b>(3,404 )</b>	<b>4,890</b>
<b>Cash and cash equivalents, beginning of period</b>	<b>99,931</b>	<b>15,501</b>
<b>Cash and cash equivalents, end of period</b>	<b>\$96,527</b>	<b>\$20,391</b>

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”, “our”, “us”, or “we”) 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 solutions are marketed and sold in fluid flow markets, such as water and oil & gas.

*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. The accounting policies that reflect our more significant estimates and judgments and 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, 2015 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, 2015 included in our Annual Report on Form 10-K filed with the SEC on March 3, 2016.

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”) No. 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. 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 issued ASU 2015-14 in August 2015, formally deferring the effective date of ASU 2014-09 by one year. We expect to adopt this guidance as of January 1, 2018. 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.

In January 2016, the FASB issued ASU No. 2016-01 *Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*. ASU 2016-01 modifies certain aspects of the recognition, measurement, presentation, and disclosure of financial instruments. For public entities, ASU 2016-01 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2017, and early adoption is permitted. We do not expect the adoption of this standard to have a material impact on our financial statements.

In February 2016, the FASB issued ASU No. 2016-02 *Leases (Topic 842)*. ASU 2016-02 impacts any entity that enters into a lease with some specified scope exceptions. The guidance updates and supersedes Topic 840, Leases. For public entities, ASU 2016-02 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2018, and early adoption is permitted. We have not evaluated the impact of this guidance, but do not expect the adoption of this standard to have a material impact on our financial statements.

In March and April 2016, the FASB issued ASU No. 2016-08 and ASU No. 2016-10, respectively, *Revenue from Contracts with Customers (Topic 606)*. The amendments in the Updates are intended to improve the operability and understandability of the implementation guidance on principal versus agent considerations and to clarify two aspects of Topic 606: identifying performance obligations and the licensing implementation guidance, while retaining the related principles for those areas. The effective date and transition requirements for both ASU 2016-08 and ASU 2016-10 are the same as those for ASU 2014-09 as deferred by ASU 2015-14.

In March 2016, the FASB issued ASU No. 2016-09 *Compensation – Stock Compensation (Topic 718)*. ASU 2016-09 affects any entity that issues share-based payment awards to their employees and is intended to simplify several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. For public entities, ASU 2016-09 is effective for annual periods beginning after December 15, 2016, and interim periods with those annual periods. Early adoption is permitted. We have not evaluated the impact of this guidance, but 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 March 31, 2016 and December 31, 2015 of \$12.8 million was the result of our acquisition of Pump Engineering, LLC in December 2009. During the three months ended March 31, 2016, there were no changes in the recognized amount of goodwill, and there has been no impairment of goodwill to date.

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

	<b>March 31, 2016</b>			
	<b>Gross</b>		<b>Accumulated</b>	<b>Net</b>
	<b>Carrying</b>	<b>Accumulated</b>	<b>Impairment</b>	<b>Carrying</b>
	<b>Amount</b>	<b>Amortization</b>	<b>Losses</b>	<b>Amount</b>
Developed technology	\$6,100	\$(3,863)	) \$—	\$2,237
Non-compete agreements	1,310	(1,310)	) —	—
Backlog	1,300	(1,300)	) —	—
Trademarks	1,200	(180)	) (1,020)	) —
Customer relationships	990	(990)	) —	—
Patents	585	(406)	) (42)	) 137
Total	\$11,485	\$(8,049)	) \$(1,062)	) \$2,374

**December 31, 2015**

	<b>Gross</b>		<b>Accumulated</b>	<b>Net</b>
	<b>Carrying</b>	<b>Accumulated</b>	<b>Impairment</b>	<b>Carrying</b>
	<b>Amount</b>	<b>Amortization</b>	<b>Losses</b>	<b>Amount</b>
Developed technology	\$6,100	\$ (3,711)	) \$ —	\$ 2,389
Non-compete agreements	1,310	(1,310)	) —	—
Backlog	1,300	(1,300)	) —	—
Trademarks	1,200	(180)	) (1,020)	) —
Customer relationships	990	(990)	) —	—
Patents	585	(401)	) (42)	) 142
Total	\$11,485	\$ (7,892)	) \$ (1,062)	) \$ 2,531

Accumulated impairment losses at March 31, 2016 include impairment charges for trademarks in 2012 and impairment charges for patents in 2007 and 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):

	<b>Three Months Ended</b>	
	<b>March 31,</b>	
	<b>2016</b>	<b>2015</b>
Numerator:		
Net loss	\$(1,966 )	\$(8,283 )
Denominator:		
Basic and diluted weighted average common shares outstanding	52,207	51,948
Basic and diluted net loss per share	\$(0.04 )	\$(0.16 )

The following potential common shares were excluded from the computation of diluted loss per share because their effect would have been anti-dilutive (in thousands):

	<b>Three months Ended</b>	
	<b>March 31,</b>	
	<b>2016</b>	<b>2015</b>
Stock options	7,432	7,864
Warrants	—	200
Restricted awards	205	—

**Note 4 — Other Financial Information**

***Restricted Cash***

We have pledged cash in connection with stand-by letters of credit. We have deposited corresponding amounts into a money market account at a financial institution for these items as follows (in thousands):

	<b>March 31,</b>	<b>December 31,</b>
	<b>2016</b>	<b>2015</b>
Current collateral for stand-by letters of credit	\$1,232	\$ 1,490
Non-current collateral for stand-by letters of credit	2,911	2,317
Total restricted cash	\$4,143	\$ 3,807

***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):

	<b>March 31,</b>	<b>December 31,</b>
	<b>2016</b>	<b>2015</b>
Raw materials	\$2,380	\$ 2,590
Work in process	1,990	1,689
Finished goods	2,355	2,224
Inventories	\$6,725	\$ 6,503

***Prepaid and Other Current Assets***

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

	<b>March 31,</b>	<b>December 31,</b>
	<b>2016</b>	<b>2015</b>
Foreign currency put option	\$4	\$ 33
Interest receivable	15	4
Supplier advances	106	171
Prepaid rent	142	7
Other prepaid expenses and current assets	1,032	728
Total prepaid and other current assets	\$ 1,299	\$ 943

***Accrued Expenses and Other Current Liabilities***

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

	<b>March 31,</b>	<b>December 31,</b>
	<b>2016</b>	<b>2015</b>
Payroll and commissions payable	\$2,194	\$ 5,086
Accrued legal expenses	306	217
Other accrued expenses and current liabilities	2,484	2,505
Accrued expenses and other current liabilities	\$4,984	\$ 7,808

***Accumulated Other Comprehensive Loss***

Changes in accumulated other comprehensive loss by component for the quarter ended March 31, 2016, were as follows (in thousands):



	<b>Foreign</b>		<b>Total</b>	
	<b>Currency</b>	<b>Unrealized</b>	<b>Accumulated</b>	
	<b>Translation</b>	<b>Gains</b>	<b>Other</b>	
	<b>Adjustments</b>	<b>(Losses)</b>	<b>Comprehensive</b>	
	<b>Net of Tax</b>	<b>on</b>	<b>Investments</b>	
	<b>Benefit</b>	<b>Loss</b>	<b>Loss</b>	
Balance, December 31, 2015	\$ (63 )	\$ (1 )	\$ (64 )	
Net other comprehensive (loss) income	(12 )	1	(11 )	
Balance, March 31, 2016	\$ (75 )	\$ —	\$ (75 )	

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 investments are all classified as available-for-sale. There were no sales of available-for-sale securities during the quarter ended March 31, 2016.

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

	<b>March 31, 2016</b>			
	<b>Amortized</b>	<b>Gross</b>	<b>Gross</b>	<b>Fair</b>
	<b>Cost</b>	<b>Unrealized</b>	<b>Unrealized</b>	<b>Value</b>
		<b>Holding</b>	<b>Holding</b>	
		<b>Gains</b>	<b>Losses</b>	
Corporate notes and bonds	\$256	\$ —	\$ (1 )	\$ 255
Total short-term investments	\$256	\$ —	\$ (1 )	\$ 255



**December 31, 2015**

	<b>Amortized Cost</b>	<b>Gross Unrealized Holding Gains</b>	<b>Gross Unrealized Holding Losses</b>	<b>Fair Value</b>
Corporate notes and bonds	\$258	\$ —	\$ (1)	) \$ 257
Total short-term investments	\$258	\$ —	\$ (1)	) \$ 257

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):

**March 31, 2016**

	<b>Less than 12 months</b>		<b>12 months or greater</b>		<b>Total</b>	
	<b>Gross Fair Value</b>	<b>Unrealized Losses</b>	<b>Gross Fair Value</b>	<b>Unrealized Losses</b>	<b>Gross Fair Value</b>	<b>Unrealized Losses</b>
Corporate notes and bonds	\$—	\$ —	\$255	\$ (1)	) \$255	\$ (1)
Total	\$—	\$ —	\$255	\$ (1)	) \$255	\$ (1)

**December 31, 2015**

	<b>Less than 12 months</b>		<b>12 months or greater</b>		<b>Total</b>	
	<b>Gross Fair Value</b>	<b>Unrealized Losses</b>	<b>Gross Fair Value</b>	<b>Unrealized Losses</b>	<b>Gross Fair Value</b>	<b>Unrealized Losses</b>
Corporate notes and bonds	\$—	\$ —	\$257	\$ (1)	) \$257	\$ (1)
Total	\$—	\$ —	\$257	\$ (1)	) \$257	\$ (1)

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 March 31, 2016 are shown below by contractual maturity (in thousands):

	<b>March 31, 2016</b>	
	<b>Amortized Cost</b>	<b>Fair Value</b>
Due in one year or less	\$256	\$ 255
Total available-for-sale securities	\$256	\$ 255

**Note 6 — Long-Term Debt and Line of Credit***Debt*

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 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)

	<b>March 31, 2016</b>	<b>December 31, 2015</b>
Loan payable	\$ 46	\$ 48
Less: current portion	(10 )	(10 )
Total long-term debt	\$ 36	\$ 38

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

	<b>March 31,</b>
	<b>2016</b>
2016 (remaining 9 months)	\$ 8
2017	11
2018	11
2019	12
2020	4
Total debt	\$ 46

### *Line of Credit*

In June 2012, we entered into a loan agreement (the “2012 Agreement”) with a financial institution. The 2012 Agreement matured in 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 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 March 31, 2016 and December 31, 2015, there were no advances drawn under the 2012 Agreement. Stand-by letters of credit collateralized under the 2012 Agreement, as amended, totaled \$4.1 million and \$3.8 million as of March 31, 2016 and December 31, 2015, respectively. Total cash restricted related to these stand-by letters of credit totaled \$4.1 million and \$3.8 million as of March 31, 2016 and December 31, 2015, respectively.

We are subject to certain financial and administrative covenants under the 2012 Agreement, as amended. As of March 31, 2016, we were in compliance with these covenants.

**Note 7 — Equity*****Stock Repurchase Program***

In January 2016, the Board of Directors authorized a stock repurchase program under which shares, not to exceed \$6.0 million in aggregate cost, of our outstanding common stock can be repurchased through June 30, 2016 at the discretion of management. We account for stock repurchases using the cost method. Cost includes fees charged in connection with acquiring the treasury stock. As of March 31, 2016, 673,700 shares, at an aggregate cost of \$4.1 million, had been repurchased under this authorization.

***Share-Based Compensation Expense***

For the three months ended March 31, 2016 and 2015, we recognized share-based compensation expense related to employees and consultants as follows (in thousands):

	<b>Three Months Ended</b>	
	<b>March 31,</b>	
	<b>2016</b>	<b>2015</b>
Cost of revenue	\$38	\$35
General and administrative	884	897
Sales and marketing	159	101
Research and development	107	107
Total share-based compensation expense	\$1,188	\$1,140

As of March 31, 2016, total unrecognized compensation cost related to non-vested share-based awards, net of estimated forfeitures, was \$6.2 million, which is expected to be recognized as expense over a weighted average period of approximately 3.35 years.

In February 2016, we granted 20,678 options to purchase stock to a new employee. The options vest over a four-year period, have an exercise price of \$6.00 per share, and expire 10 years from the grant date.

In February 2016, we also granted 32,000 options to purchase stock to another new employee. The options vest over a four-year period, have an exercise price of \$7.26 per share, and expire 10 years from the grant date.

In March 2016, we granted 650,301 options to purchase stock to officers and other employees. The options vest over a four-year period, have an exercise price of \$8.52 per share, and expire 10 years from the grant date.

In March 2016, we also granted 204,514 restricted stock units to officers and other employees. The restricted units vest over a four-year period, have a grant price of \$8.52 per share, and expire 10 years from the grant date.

In connection with the resignation of Mr. Juan Otero, as General Counsel, Chief Compliance Officer, and Secretary, additional stock based compensation of approximately \$0.5 million was recorded in the first quarter of 2016 related to the continued vesting of awards granted to Mr. Otero prior to his resignation.

## **Note 8 — Income Taxes**

The effective tax rate for the three months ended March 31, 2016 and 2015 was 9.4% and (1.0%), respectively. As of December 31, 2015, a valuation allowance of approximately \$21.4 million had been established to reduce our deferred income tax assets to the amount expected to be realized. The tax benefit recognized for the three months ended March 31, 2016, was primarily related to losses in our Ireland subsidiary.

**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):

	<b>March 31, 2016</b>
2016 (remaining nine months)	1,206
2017	1,577
2018	1,600
2019	1,402
Total future minimum lease payments	\$5,785

*Product Warranty*

The following table summarizes the activity related to the product warranty liability during the three months ended March 31, 2016 and 2015 (in thousands):

	<b>Three Months Ended</b>	
	<b>March 31,</b>	
	<b>2016</b>	<b>2015</b>
Balance, beginning of period	\$461	\$755
Warranty costs charged to cost of revenue	—	21
Release of accrual for expired warranties	(33 )	—
Utilization of warranty	—	(20 )
Balance, end of period	\$428	\$756



### ***Purchase Obligations***

We enter into purchase order arrangements with our vendors. As of March 31, 2016, 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 March 31, 2016, we had approximately \$2.0 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 March 31, 2016 and December 31, 2015.

In certain cases, we issue warranty and product performance guarantees to our customers for amounts ranging from 5% to 15% 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 68 months, and relate to the underlying product warranty period. The stand-by letters of credit are collateralized by restricted cash and our credit facility. The \$4.1 million in stand-by letters of credit outstanding at March 31, 2016 were collateralized by restricted cash of \$4.1 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 24, 2014, Mr. Blanco filed a labor claim against ERI Iberia in Madrid, Spain challenging the fairness of his dismissal and seeking compensation ("Case 1"). A hearing was held on November 13, 2015 after which the labor court ruled that it did not have jurisdiction over the matter. Mr. Blanco has appealed. At this time, the Company has not determined that an award to Mr. Blanco is probable.

On November 24, 2014, Mr. Blanco filed a second action based on breach of contract theories in the same court as Case 1, but the cases are separate. In Case 2, Mr. Blanco seeks payment of unpaid bonus, stock options, and non-compete compensation. The court ruled that this case is stayed until a final ruling is issued in Case 1. At this time, the Company has not determined that an award to Mr. Blanco is probable.

On January 20 and 27, 2015, two stockholder class action complaints were filed against the Company in the United States District Court of the Northern District of California, on behalf of Energy Recovery stockholders under the captions, *Joseph Sabatino v. Energy Recovery, Inc. et al.*, Case No. 3:15-cv-00265 EMC, and *Thomas C. Mowdy v. Energy Recovery, Inc. et al.*, Case No. 3:15-cv-00374 EMC. The complaints have now been consolidated under the caption, *In Re Energy Recovery Inc. Securities Litigation*, Case No. 3:15-cv-00265 EMC. The complaint alleges violations of Section 10(b), Rule 10b-5, and Section 20(a) of the Securities Exchange Act of 1934 based upon alleged public misrepresentations and seeks the recovery of unspecified monetary damages. The Company is not able to estimate the possible loss, if any, due to the early stage of this matter.

On January 27, 2016, a complaint was filed by the Company's Former Chief Sales Officer, Mr. David Barnes, in the United States District Court for the Northern District of California under the caption, *David Barnes v. Energy Recovery, Inc.*, et al. Case No. 3:16-cv-00477 EMC, related to his separation from the Company and alleging numerous legal claims including, but not limited to, wrongful termination, breach of contracts and negligent and/or intentional misrepresentations to induce Mr. Barnes to join the Company. Mr. Barnes is seeking to recover, among other things, relocation and business expenses, back pay, front pay, lost equity, contractual severance, emotional distress damages, punitive damages, damages under the California Private Attorneys General Act, attorneys' fees, costs and interest. At this time, the Company is not able to estimate a potential loss, if any, due to the early stage of the matter.

On February 18, 2016, a complaint captioned *Goldberg v. Rooney, et al.*, HG 16804359, was filed in the Superior Court for the State of California, County of Alameda, naming as defendants Thomas Rooney, Alexander J. Buehler, Joel Gay, Ole Peter Lorentzen, Audrey Bold, Arve Hanstveit, Fred Olav Johannessen, Robert Yu Lang Mao, Hans Peter Michelet, Maria Elisabeth Pate-Cornell, Paul Cook, Olav Fjell, and Dominique Trempont (“Individual Defendants”) and naming the Company as a nominal defendant. The complaint is styled as a derivative action being brought on behalf of the Company and generally alleges breach of fiduciary duty, abuse of control, gross mismanagement and unjust enrichment causes of action against the Individual Defendants. At this time, the Company is not able to estimate a potential loss, if any, due to the early stage of the matter.

#### **Note 10 — Business Segment and Geographic Information**

We manufacture and sell high-efficiency energy recovery devices and pumps as well as related products and services. Our chief operating decision-maker (“CODM”) is the chief executive officer (“CEO”).

Following the appointment of a new CEO in April 2015, new internal reporting was developed for making operating decisions and assessing financial performance. Beginning July 1, 2015, a new internal organizational and reporting structure was implemented and we began reporting segment information on a basis reflecting this new structure. Prior period amounts have been adjusted retrospectively to reflect this new internal reporting structure.

Our reportable operating segments consist of the Water Segment and the Oil & Gas Segment. These segments are based on the industries in which the products are sold, the type of energy recovery device sold, and the related products and services. The Water Segment consists of revenue associated with products sold for use in reverse osmosis water desalination, as well as the related identifiable expenses. The Oil & Gas Segment consists of product revenue associated with products sold for use in gas processing, chemical processing, and hydraulic fracturing and license and development revenue associated with hydraulic fracturing, as well as related identifiable expenses. Operating income for each segment excludes other income and expenses and certain expenses managed outside the operating segment. Costs 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. Assets and liabilities are reviewed at the consolidated level by the CODM and are not accounted for by segment. The CODM allocates resources to and assesses the performance of each operating segment using information about its revenue and operating income (loss).

The following summarizes financial information by segment for the periods presented (in thousands):

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	Three Months Ended March 31, 2016			Three Months Ended March 31, 2015		
	Water	Oil & Gas	Total	Water	Oil & Gas	Total
Product revenue	\$10,051	\$—	\$10,051	\$5,723	\$141	\$5,864
Product cost of revenue	3,674	—	3,674	2,503	25	2,531
Product gross profit	6,377	—	6,377	3,220	113	3,333
License and development revenue	—	1,250	1,250	—	—	—
Operating expenses:						
General and administrative	219	188	407	604	332	936
Sales and marketing	1,129	807	1,936	1,170	1,120	2,290
Research and development	359	2,297	2,656	345	2,160	2,505
Amortization of intangibles	157	—	157	159	—	159
Operating expenses	1,864	3,292	5,156	2,278	3,612	5,890
Operating income (loss)	\$4,513	\$(2,042)	2,471	\$942	\$(3,499)	(2,557)
Less:						
Corporate operating expenses			4,620			5,513
Consolidated operating loss			(2,149)			(8,070)
Non-operating expenses			(22)			(142)
Loss before income taxes			\$(2,171)			\$(8,212)

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):

	<b>Three Months Ended</b>	
	<b>March 31,</b>	
	<b>2016</b>	<b>2015</b>
Domestic product revenue	\$185	\$264
International product revenue	9,866	5,600
Total product revenue	\$10,051	\$5,864

Product revenue by country:

Qatar	39	%	*	%
Spain	11	%	13	%
United States	2	%	5	%
Egypt	1	%	22	%
Others **	47	%	60	%
Total	100	%	100	%

\* Less than 1% or none.

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

All of our long-lived assets were located in the United States at March 31, 2016 and December 31, 2015.

**Note 11 — Concentrations**

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

<b>March 31,</b>	<b>December 31,</b>
----------------------	-------------------------

	<b>2016</b>		<b>2015</b>	
Customer A	48	%	18	%
Customer B	5	%	26	%

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

**Three  
Months  
Ended**

**March 31,  
2016 2015**

Customer A	41	%	*	%
Customer C	*	%	12	%
Customer D	3	%	12	%

\*

Less  
than  
1% or  
none.

A single customer, Customer E, represents 100% of our license and development revenue for the three months ended March 31, 2016. There was no license and development revenue recognized for the three months ended March 31, 2015.

Vendors accounting for 10% or more of our accounts payable were as follows:

	<b>March 31, 2016</b>		<b>December 31, 2015</b>	
Vendor A	14	%	0	%

**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 of corporate agency obligations and the premium paid for foreign currency put options.

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

	<b>March 31, 2016</b>	<b>Level 1 Inputs</b>	<b>Level 2 Inputs</b>	<b>Level 3 Inputs</b>
Assets:				
Available-for-sale securities	\$ 255	\$ —	\$ 255	\$ —
Foreign currency put option	4	—	4	—
Total assets	\$ 259	\$ —	\$ 259	\$ —

	<b>December 31, 2015</b>	<b>Level 1 Inputs</b>	<b>Level 2 Inputs</b>	<b>Level 3 Inputs</b>
Assets:				
Available-for-sale securities	\$ 257	\$ —	\$ 257	\$ —

Foreign currency put options	33	—	33	—
Total assets	\$ 290	\$ —	\$ 290	\$ —

**Note 13 — Related Party Transactions**

In January 2016, the Company entered into a lease agreement with EMS USA, Inc. for the use of office space. The President and Chief Executive Officer of EMS USA, Inc. is also a member of the Board of Directors of the Company. The lease is for a term of ninety (90) days with continuation on a month-to-month basis thereafter, with each month being an “Additional Term.” Additional Terms are not to exceed a total of three. The Company paid EMS USA, Inc. \$1,668 related to this agreement during the three months ended March 31, 2016.

In March 2016, the Company extended an employee loan to one of its employees for \$21,786. The loan is repayable to the Company monthly over six months and is non-interest bearing.

**Note 14 - Subsequent Events**

On April 20, 2016, the Company announced the receipt of a Letter of Award to provide our IsoBoost™ technology for integration into a major gas processing plant to be constructed in the Middle East. The award value is approximately \$7 million worth of equipment and services with a potential to supply an additional \$4 million worth of equipment and services. The total potential value could be worth approximately \$11 million; however the optional supply may not be confirmed by our client until the latter portion of 2017.



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

*• our expectation that we will meet the two key milestones associated with our VorTeq™ licensing agreement with Schlumberger Technology Corporation and will receive annual royalties under said agreement;*

*• our expectation that oil price fluctuations may impact the acceptance or rate of adoption of our oil & gas and hydraulic fracturing products;*

*• our belief that levels of gross profit margin for our Water Segment 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, as we expand our international sales, a portion of our revenue could continue to be denominated in foreign currencies;*

*•*

*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 water and hydraulic fracturing; and*

*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 technologies or product offerings arising from rapid market adoption that could require us to seek additional equity or debt financing.*

*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 to industrial fluid flow markets worldwide. We make industrial processes more operating and capital expenditure efficient. Our solutions 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<sup>®</sup> energy recovery device in early 1997 for sea water reverse osmosis desalination. In December 2009, we acquired Pump Engineering, LLC, which manufactured centrifugal energy recovery devices known as turbochargers as well as high-pressure pumps. In 2012, we introduced the IsoBoost and IsoGen branded products for use in the oil & gas industry. In 2015, we conducted field trials for the VorTeq hydraulic pumping solution also for use in the oil & gas industry for oil field hydraulic fracturing operations and entered into a fifteen year license agreement with Schlumberger Technology Corporation.

Following the appointment of a new Chief Executive Officer in April 2015, new internal reporting was developed for making operating decisions and assessing financial performance. Beginning July 1, 2015, a new internal organizational and reporting structure was implemented and we began reporting segment information on a basis reflecting this new structure. Prior period segment results have been adjusted retrospectively to reflect this new internal reporting structure.

Our reportable operating segments consist of the Water Segment and the Oil & Gas Segment. These segments are based on the industries in which the products are sold, the type of energy recovery device sold, and the related solution and services.

### *Water Segment*

The Water Segment consists of revenue associated with products sold for use in reverse osmosis water desalination, as well as the related identifiable expenses. Our Water Segment revenue is principally derived from the sale of our energy recovery devices for use in water desalination plants worldwide. We also derive product revenue from the sale of our high-pressure and circulation pumps which we manufacture and sell both separately and in connection with our energy recovery devices for use in water desalination plants. Additionally, we receive product revenue from the sale of spare parts and services, including start-up and commissioning services that we provide to our customers.

With respect to product revenue from our energy recovery devices in our Water Segment, a significant portion of our 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 16 to 36 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 our Water Segment 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 product revenue and of our accounts receivable and unbilled receivables. Product revenue from customers representing 10% or more of product revenue varies from period to period. For the three months ended March 31, 2016, one customer accounted for 41% of our product revenue. For the three months ended March 31, 2015, two customers accounted for 12% each of our product revenue. No other customer accounted for more than 10% of our product revenue during any of these periods.

At March 31, 2016, one customer accounted for 48% of our accounts receivable and unbilled receivables balance. At December 31, 2015, two customers accounted for 26% and 18%, respectively, of our accounts receivable and unbilled receivables balance.

At March 31, 2016, one vendor accounted for 14% of our accounts payable balance. At December 31, 2015, no customer accounted for more than 10% of our accounts payable balance.

During the three months ended March 31, 2016 and 2015, most of our product revenue and accounts receivable were attributable to sales outside of the United States. We expect sales and accounts receivable outside of the United States to remain a significant portion of our Water Segment product revenue and accounts receivable for the next few years.

### *Oil & Gas Segment*

The Oil & Gas Segment consists of revenue associated with products sold or licensed for use in gas processing, chemical processing, and hydraulic fracturing, as well as related identifiable expenses. In the past several years, we have invested significant research and development costs to expand our business into pressurized fluid flow industries within the oil & gas industry. In 2014, we announced a new product for the hydraulic fracturing industry, the VorTeq hydraulic fracturing system. Field trials were initiated for the VorTeq in the second quarter of 2015 and successfully completed in December 2015.

No oil & gas product revenue was recognized during the three months ended March 31, 2016. In the first quarter of 2015, we recognized oil & gas product revenue of \$0.1 million from oil & gas commissioning services and fees related to the cancellation of a ConocoPhillips sales order.

On October 14, 2015, the Company, through our subsidiary ERI Energy Recovery Ireland Ltd., entered into a Licensing Agreement (the "Agreement") with Schlumberger Technology Corporation, a subsidiary of Schlumberger Limited (NYSE:SLB). The Agreement has a term of fifteen (15) years for the exclusive right to use certain intellectual property related to our VorTeq Hydraulic Fracturing System technology. The Agreement provided for a \$75 million exclusivity payment in connection with the execution of the Agreement, two separate \$25 million payments upon the meeting of two milestones, and recurring royalty payments throughout the term of the Agreement. License and development revenue related to the exclusivity payment is recognized over the term of the agreement with \$1.3 million of license and development revenue recognized in the three months ended March 31, 2016.

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.

### *First Quarter of 2016 Compared to First Quarter of 2015*

**Results of Operations*****Total Revenue***

	<b>Three Months Ended March 31,</b>					
	<b>2016</b>		<b>2015</b>		<b>Change</b>	
					<b>Increase /</b>	<b>(Decrease)</b>
Product revenue	\$ 10,051	89 %	\$ 5,864	100 %	\$ 4,187	71 %
License and development revenue	1,250	11 %	—	—	1,250	100 %
Total revenue	\$ 11,301	100 %	\$ 5,864	100 %	\$ 5,437	93 %

***Product Revenue***

<b>Segment</b>	<b>Three Months Ended</b>				
	<b>March 31,</b>				
	<b>2016</b>	<b>2015</b>	<b>\$</b>	<b>%</b>	
			<b>Change</b>	<b>Change</b>	
Water	\$ 10,051	\$ 5,723	\$ 4,328	76	%
Oil & Gas	—	141	(141)	(100)	(%)
Product revenue	\$ 10,051	\$ 5,864	\$ 4,187	71	%

Product revenue in the Water Segment increased by \$4.3 million, or 76%, to \$10.1 million for the three months ended March 31, 2016 from \$5.7 million for the three months ended March 31, 2015. The increase was primarily due to increased mega project (“MPD”) shipments of \$3.9 million compared to no MPD shipments in the three months ended March 31, 2015. Also contributing to the increase were higher OEM shipments of \$0.3 million and higher aftermarket shipments of \$0.1 million.

Product revenue in the Oil & Gas Segment decreased by \$0.1 million, or 100%, to zero for the three months ended March 31, 2016 from \$0.1 million for the three months ended March 31, 2015.

The following table reflects product revenue by category and as a percentage of total product revenue (in thousands, except percentages):

	<b>Three Months Ended March 31,</b>			
	<b>2016</b>		<b>2015</b>	
PX devices and related products	\$7,987	80 %	\$4,076	70 %
Turbochargers, pumps, and related products	2,064	20 %	1,647	28 %
Oil & gas product operating lease	—	—	141	2 %
Product revenue	\$10,051	100 %	\$5,864	100 %

During the three months ended March 31, 2016 and 2015, a significant portion of our product revenue was attributable to sales outside of the United States. Product revenue attributable to domestic and international sales as a percentage of product revenue was as follows:

	<b>Three Months Ended</b>			
	<b>March 31, 2016</b>		<b>2015</b>	
Domestic revenue	2 %	5 %		
International revenue	98 %	95 %		
Product revenue	100 %	100 %		

***License and Development Revenue***

<b>Segment</b>	<b>Three Months Ended</b>			
	<b>March 31,</b>		<b>\$</b>	<b>%</b>
	<b>2016</b>	<b>2015</b>	<b>Change</b>	<b>Change</b>

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Water	\$—	\$ —	—	
Oil & Gas	1,250	—	1,250	100 %
License and development revenue	\$ 1,250	\$ —	\$ 1,250	100 %

The increase in license and development revenue during the three months ended March 31, 2016 was due to the recognition of \$1.3 million in revenue associated with the licensing agreement with Schlumberger. The \$1.3 million is representative of the straight-line basis of revenue recognition of the \$75 million initial payment over the fifteen-year term of the agreement.

License and development revenue attributable to domestic and international sales as a percentage of license and development revenue was as follows:

	<b>Three Months Ended</b>	
	<b>March 31, 2016 2015</b>	
Domestic revenue	—	—
International revenue	100 %	—
License and development revenue	100 %	—

***Product Gross Profit***

	<b>Three Months Ended March 31, 2016</b>			<b>Three months Ended March 31, 2015</b>		
	<b>Water</b>	<b>Oil &amp;Gas</b>	<b>Total</b>	<b>Water</b>	<b>Oil &amp;Gas</b>	<b>Total</b>
Product gross profit	\$6,377	\$ —	\$6,377	\$3,220	\$ 113	\$3,333
Product gross margin	63 %	—	63 %	56 %	80 %	57 %

Product gross profit represents our product revenue less our product cost of revenue. Our product 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 March 31, 2016, product gross profit as a percentage of product revenue was 63% compared to 57% for the three months ended March 31, 2015.





The increase in product gross profit as a percentage of product revenue in the three months ended March 31, 2016 compared to the three months ended March 31, 2015 was primarily due to a shift in product mix toward PX devices, increased sales volume, and pricing.

Future product gross profit is highly dependent on the product and customer mix of our product revenue, 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 product gross profit levels with certainty. We believe that the current levels of product 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 increased to 42 in the first quarter of 2016 from 37 in the first quarter of 2015.

Share-based compensation expense included in cost of revenue was \$38,000 and \$35,000 for the three months ended March 31, 2016 and 2015, respectively.

*Operating Expenses*

**Three  
Months  
Ended  
March  
31,  
2016**