WELLS FARGO & COMPANY/MN
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**The information in this preliminary pricing supplement is not complete and may be changed. This preliminary pricing supplement and the accompanying product supplement, market measure supplement, prospectus supplement and prospectus are not an offer to sell these securities and we are not soliciting an offer to buy these securities in any jurisdiction where the offer or sale is not permitted.**

Subject To Completion, dated January 5, 2017

PRICING SUPPLEMENT No. 798 dated January , 2017

(To Product Supplement No. 3 dated March 18, 2015,

Market Measure Supplement dated March 18, 2015,

Prospectus Supplement dated March 18, 2015

and Prospectus dated March 18, 2015)

**Wells Fargo & Company**

**Medium-Term Notes, Series K**

**Equity Index Linked Securities**

**Market Linked Securities Leveraged Upside Participation**

**and Contingent Downside**

**Principal at Risk Securities Linked to the EURO STOXX 50® Index due February 7, 2020**

Linked to the EURO STOXX 50® Index

Unlike ordinary debt securities, the securities do not pay interest or repay a fixed amount of principal at maturity. Instead, the securities provide for a payment at maturity that may be greater than, equal to or less than the original offering price of the securities, depending on the performance of the Index from its starting level to its ending level. The payment at maturity will reflect the following terms:

If the level of the Index increases, you will receive the original offering price plus 125% to 135% (to be determined on the pricing date) participation in the upside performance of the Index

If the level of the Index decreases but the decrease is not more than 30%, you will be repaid the original offering price

If the level of the Index decreases by more than 30%, you will have full downside exposure to the decrease in the level of the Index from the starting level, and you will lose more than 30%, and possibly all, of the original offering price of your securities

Investors may lose some, or all, of the original offering price

All payments on the securities are subject to the credit risk of Wells Fargo & Company, and you will have no ability to pursue any securities included in the Index for payment; if Wells Fargo & Company defaults on its obligations, you could lose some or all of your investment

No periodic interest payments or dividends

No exchange listing; designed to be held to maturity

**On the date of this preliminary pricing supplement, the estimated value of the securities is approximately $946.32 per security. While the estimated value of the securities on the pricing date may differ from the estimated value set forth above, we do not expect it to differ significantly absent a material change in market conditions or other relevant factors. In no event will the estimated value of the securities on the pricing date be less than $931.32 per security. The estimated value of the securities was determined for us by Wells Fargo Securities, LLC using its proprietary pricing models. It is not an indication of actual profit to us or to Wells Fargo Securities, LLC or any of our other affiliates, nor is it an indication of the price, if any, at which Wells Fargo Securities, LLC or any other person may be willing to buy the securities from you at any time after issuance. See Investment Description in this pricing supplement.**

**The securities have complex features and investing in the securities involves risks not associated with an investment in conventional debt securities. See Selected Risk Considerations herein on page PRS-9 and Risk Factors in the accompanying product supplement.**

**The securities are unsecured obligations of Wells Fargo & Company and all payments on the securities are subject to the credit risk of Wells Fargo & Company. The securities are not deposits or other obligations of a depository institution and are not insured by the Federal Deposit Insurance Corporation, the Deposit Insurance Fund or any other governmental agency of the United States or any other jurisdiction.**

**Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this pricing supplement or the accompanying product supplement, market measure supplement, prospectus supplement and prospectus is truthful or complete. Any**

**representation to the contrary is a criminal offense.**

| | Original Offering Price | Agent Discount[(1)] | Proceeds to Wells Fargo |
|---|---|---|---|
| **Per Security** | $1,000.00 | $20.75 | $979.25 |
| **Total** | | | |

(1) Wells Fargo Securities, LLC, a wholly owned subsidiary of Wells Fargo & Company, is the agent for the distribution of the securities and is acting as principal. See Investment Description in this pricing supplement for further information.

**Wells Fargo Securities**

**Market Linked Securities  Leveraged Upside Participation and Contingent Downside**

**Principal at Risk Securities Linked to the EURO STOXX 50® Index due February 7, 2020**

## Investment Description

The Principal at Risk Securities Linked to the EURO STOXX 50® Index due February 7, 2020 are senior unsecured debt securities of Wells Fargo & Company that do not pay interest or repay a fixed amount of principal at maturity. Instead, the securities provide for a payment at maturity that may be greater than, equal to or less than the original offering price of the securities depending on the performance of the EURO STOXX 50® Index (the  Index ) from its starting level to its ending level. The securities provide:

(i) the possibility of a leveraged return at maturity if the level of the Index increases from its starting level to its ending level;

(ii) repayment of principal if, **and only if**, the ending level of the Index is not less than the starting level by more than 30%; and

(iii) full exposure to the decrease in the level of the Index from the starting level if the ending level is less than the starting level by more than 30%.

**If the ending level is less than the starting level by more than 30%, you will lose more than 30%, and possibly all, of the original offering price of your securities at maturity.** All payments on the securities are subject to the credit risk of Wells Fargo.

The Index is an equity index that is composed of 50 component stocks of sector leaders in 12 Eurozone countries and is intended to provide an indication of the pattern of common stock price movement in the Eurozone.

You should read this pricing supplement together with product supplement no. 3 dated March 18, 2015, the market measure supplement dated March 18, 2015, the prospectus supplement dated March 18, 2015 and the prospectus dated March 18, 2015 for additional information about the securities. Information included in this pricing supplement supersedes information in the product supplement, market measure supplement, prospectus supplement and prospectus to the extent it is different from that information. Certain defined terms used but not defined herein have the meanings set forth in the product supplement.

You may access the product supplement, market measure supplement, prospectus supplement and prospectus on the SEC website www.sec.gov as follows (or if such address has changed, by reviewing our filing for the relevant date on the SEC website):

Product Supplement No. 3 dated March 18, 2015 filed with the SEC on March 18, 2015:
http://www.sec.gov/Archives/edgar/data/72971/000119312515096520/d890775d424b2.htm

Market Measure Supplement dated March 18, 2015 filed with the SEC on March 18, 2015:
http://www.sec.gov/Archives/edgar/data/72971/000119312515096591/d890724d424b2.htm

Prospectus Supplement dated March 18, 2015 and Prospectus dated March 18, 2015 filed with the SEC on March 18, 2015:
http://www.sec.gov/Archives/edgar/data/72971/000119312515096449/d890684d424b2.htm

The EURO STOXX 50® is the intellectual property (including registered trademarks) of STOXX Limited ( STOXX ), Zurich, Switzerland and/or its licensors ( Licensors ), which is used under license.

**Market Linked Securities Leveraged Upside Participation and Contingent Downside**

**Principal at Risk Securities Linked to the EURO STOXX 50® Index due February 7, 2020**

**Investment Description (Continued)**

The original offering price of each security of $1,000 includes certain costs that are borne by you. Because of these costs, the estimated value of the securities on the pricing date will be less than the original offering price. The costs included in the original offering price relate to selling, structuring, hedging and issuing the securities, as well as to our funding considerations for debt of this type.

The costs related to selling, structuring, hedging and issuing the securities include (i) the agent discount, (ii) the projected profit that our hedge counterparty (which may be one of our affiliates) expects to realize for assuming risks inherent in hedging our obligations under the securities and (iii) hedging and other costs relating to the offering of the securities.

Our funding considerations take into account the higher issuance, operational and ongoing management costs of market-linked debt such as the securities as compared to our conventional debt of the same maturity, as well as our liquidity needs and preferences. Our funding considerations are reflected in the fact that we determine the economic terms of the securities based on an assumed funding rate that is generally lower than the interest rates implied by secondary market prices for our debt obligations and/or by other traded instruments referencing our debt obligations, which we refer to as our secondary market rates. As discussed below, our secondary market rates are used in determining the estimated value of the securities.

If the costs relating to selling, structuring, hedging and issuing the securities were lower, or if the assumed funding rate we use to determine the economic terms of the securities were higher, the economic terms of the securities would be more favorable to you and the estimated value would be higher. The estimated value of the securities as of the pricing date will be set forth in the final pricing supplement.

*Determining the estimated value*

Our affiliate, Wells Fargo Securities, LLC (WFS), calculated the estimated value of the securities set forth on the cover page of this pricing supplement based on its proprietary pricing models. Based on these pricing models and related market inputs and assumptions referred to in this section below, WFS determined an estimated value for the securities by estimating the value of the combination of hypothetical financial instruments that would replicate the payout on the securities, which combination consists of a non-interest bearing, fixed-income bond (the debt component) and one or more derivative instruments underlying the economic terms of the securities (the derivative component).

The estimated value of the debt component is based on a reference interest rate, determined by WFS as of a recent date, that generally tracks our secondary market rates. Because WFS does not continuously calculate our reference interest rate, the reference interest rate used in the calculation of the estimated value of the debt component may be higher or lower than our secondary market rates at the time of that calculation. As noted above, we determine the economic terms of the securities based upon an assumed funding rate that is generally lower than our secondary market rates. In contrast, in determining the estimated value of the securities, we value the debt component using a reference interest rate that generally tracks our secondary market rates. Because the reference interest rate is generally higher than the assumed funding rate, using the reference interest rate to value the debt component generally results in a lower estimated value for the debt component, which we believe more closely approximates a market valuation of the debt component than if we had used the assumed funding rate.

WFS calculated the estimated value of the derivative component based on a proprietary derivative-pricing model, which generated a theoretical price for the derivative instruments that constitute the derivative component based on various inputs, including the derivative component factors identified in Selected Risk Considerations The Value Of The Securities Prior To Stated Maturity Will Be Affected By Numerous Factors, Some Of Which Are Related In Complex Ways. These inputs may be market-observable or may be based on assumptions made by WFS in its discretion.

The estimated value of the securities determined by WFS is subject to important limitations. See Selected Risk Considerations The Estimated Value Of The Securities Is Determined By Our Affiliate s Pricing Models, Which May Differ From Those Of Other Dealers and Our Economic Interests And Those Of Any Dealer Participating In The Offering Are Potentially Adverse To Your Interests.

**Market Linked Securities Leveraged Upside Participation and Contingent Downside**

**Principal at Risk Securities Linked to the EURO STOXX 50® Index due February 7, 2020**

## Investment Description (Continued)

*Valuation of the securities after issuance*

The estimated value of the securities is not an indication of the price, if any, at which WFS or any other person may be willing to buy the securities from you in the secondary market. The price, if any, at which WFS or any of its affiliates may purchase the securities in the secondary market will be based upon WFS s proprietary pricing models and will fluctuate over the term of the securities due to changes in market conditions and other relevant factors. However, absent changes in these market conditions and other relevant factors, except as otherwise described in the following paragraph, any secondary market price will be lower than the estimated value on the pricing date because the secondary market price will be reduced by a bid-offer spread, which may vary depending on the aggregate face amount of the securities to be purchased in the secondary market transaction, and the expected cost of unwinding any related hedging transactions. Accordingly, unless market conditions and other relevant factors change significantly in your favor, any secondary market price for the securities is likely to be less than the original offering price.

If WFS or any of its affiliates makes a secondary market in the securities at any time up to the issue date or during the 3-month period following the issue date, the secondary market price offered by WFS or any of its affiliates will be increased by an amount reflecting a portion of the costs associated with selling, structuring, hedging and issuing the securities that are included in the original offering price. Because this portion of the costs is not fully deducted upon issuance, any secondary market price offered by WFS or any of its affiliates during this period will be higher than it would be if it were based solely on WFS s proprietary pricing models less the bid-offer spread and hedging unwind costs described above. The amount of this increase in the secondary market price will decline steadily to zero over this 3-month period. If you hold the securities through an account at WFS or any of its affiliates, we expect that this increase will also be reflected in the value indicated for the securities on your brokerage account statement.

If WFS or any of its affiliates makes a secondary market in the securities, WFS expects to provide those secondary market prices to any unaffiliated broker-dealers through which the securities are held and to commercial pricing vendors. If you hold your securities through an account at a broker-dealer other than WFS or any of its affiliates, that broker-dealer may obtain market prices for the securities from WFS (directly or indirectly), but could also obtain such market prices from other sources, and may be willing to purchase the securities at any given time at a price that differs from the price at which WFS or any of its affiliates is willing to purchase the securities. As a result, if you hold your securities through an account at a broker-dealer other than WFS or any of its affiliates, the value of the securities on your brokerage account statement may be different than if you held your securities at WFS or any of its affiliates.

The securities will not be listed or displayed on any securities exchange or any automated quotation system. Although WFS and/or its affiliates may buy the securities from investors, they are not obligated to do so and are not required to make a market for the securities. There can be no assurance that a secondary market will develop.

**Market Linked Securities Leveraged Upside Participation and Contingent Downside**

**Principal at Risk Securities Linked to the EURO STOXX 50® Index due February 7, 2020**

## Investor Considerations

We have designed the securities for investors who:

- seek 125% to 135% (to be determined on the pricing date) exposure to the upside performance of the Index if the ending level is greater than the starting level;
- desire repayment of the original offering price at maturity so long as the ending level is not less than the starting level by more than 30%;
- understand that if the ending level is less than the starting level by more than 30%, they will be fully exposed to the decrease in the Index from the starting level, and will lose more than 30%, and possibly all, of the original offering price per security at maturity;
- are willing to forgo interest payments on the securities and dividends on securities included in the Index; and
- are willing to hold the securities until maturity.

The securities are not designed for, and may not be a suitable investment for, investors who:

- seek a liquid investment or are unable or unwilling to hold the securities to maturity;
- are unwilling to accept the risk that the ending level of the Index may decrease by more than 30% from the starting level;
- are unwilling to purchase securities with an estimated value as of the pricing date that is lower than the original offering price and that may be as low as the lower estimated value set forth on the cover page;
- seek full return of the original offering price of the securities at stated maturity;
- seek current income;
- are unwilling to accept the risk of exposure to the Eurozone equity market;

seek exposure to the Index but are unwilling to accept the risk/return trade-offs inherent in the payment at stated maturity for the securities;

are unwilling to accept the credit risk of Wells Fargo to obtain exposure to the Index generally, or to the exposure to the Index that the securities provide specifically; or

prefer the lower risk of fixed income investments with comparable maturities issued by companies with comparable credit ratings.

**Market Linked Securities Leveraged Upside Participation and Contingent Downside**

**Principal at Risk Securities Linked to the EURO STOXX 50® Index due February 7, 2020**

## Terms of the Securities

| | |
|---|---|
| **Market Measure:** | EURO STOXX 50® Index |
| **Pricing Date:** | January 31, 2017* |
| **Issue Date:** | February 7, 2017* (T+5) |
| **Original Offering Price:** | $1,000 per security. References in this pricing supplement to a security are to a security with a face amount of $1,000. |
| **Redemption Amount:** | The redemption amount per security will equal:<br><br>if the ending level is greater than or equal to the starting level: $1,000 *plus:*<br><br>$\$1{,}000 \times \frac{\text{ending level} - \text{starting level}}{\text{starting level}} \times \text{participation rate}$ ;<br><br>if the ending level is less than the starting level, but greater than or equal to the threshold level: $1,000; or<br><br>if the ending level is less than the threshold level: $1,000 *minus*:<br><br>$\$1{,}000 \times \frac{\text{starting level} - \text{ending level}}{\text{starting level}}$<br><br>**If the ending level is less than the threshold level, you will lose more than 30%, and possibly all, of the original offering price of your securities at maturity.** |
| **Stated Maturity Date:** | February 7, 2020*. If the calculation day is postponed, the stated maturity date will be postponed to the later of (i) February 7, 2020* and (ii) the third business day after the calculation day as postponed. |
| **Starting Level:** | , the closing level of the Index on the pricing date. |
| **Ending Level:** | The ending level will be the closing level of the Index on the calculation day. |
| **Threshold Level:** | , which is equal to 70% of the starting level. |
| **Participation Rate:** | The participation rate will be determined on the pricing date and will be within the range of 125% to 135%. |
| **Calculation Day:** | January 31, 2020.* If such day is not a trading day, the calculation day will be postponed to the next succeeding trading day. The calculation day is also subject to postponement due to the occurrence of a market disruption event. |
| **Calculation Agent:** | Wells Fargo Securities, LLC |
| **Material Tax** | |

| | |
|---|---|
| **Consequences:** | For a discussion of the material U.S. federal income tax consequences of the ownership and disposition of the securities, see United States Federal Tax Considerations. |
| **Agent:** | Wells Fargo Securities, LLC, a wholly owned subsidiary of Wells Fargo & Company. The agent may resell the securities to other securities dealers at the original offering price of the securities less a concession not in excess of $20.00 per security. Such securities dealers may include Wells Fargo Advisors ( WFA ) (the trade name of the retail brokerage business of our affiliates, Wells Fargo Clearing Services, LLC and Wells Fargo Advisors Financial Network, LLC). In addition to the concession allowed to WFA, WFS will pay $0.75 per security of the agent s discount to WFA as a distribution expense fee for each security sold by WFA.<br><br>The agent or another affiliate of ours expects to realize hedging profits projected by its proprietary pricing models to the extent it assumes the risks inherent in hedging our obligations under the securities. If any dealer participating in the distribution of the securities or any of its affiliates conducts hedging activities for us in connection with the securities, that dealer or its affiliate will expect to realize a profit projected by its proprietary pricing models from such hedging activities. Any such projected profit will be in addition to the discount, concession or distribution expense fee received in connection with the sale of the securities to you. |
| **Denominations:** | $1,000 and any integral multiple of $1,000. |
| **CUSIP:** | 94986R3F6 |

* To the extent that we make any change to the expected pricing date or expected issue date, the calculation day and stated maturity date may also be changed in our discretion to ensure that the term of the securities remains the same.

**Market Linked Securities Leveraged Upside Participation and Contingent Downside**

**Principal at Risk Securities Linked to the EURO STOXX 50® Index due February 7, 2020**

## Determining Payment at Stated Maturity

On the stated maturity date, you will receive a cash payment per security (the redemption amount) calculated as follows:

**Market Linked Securities Leveraged Upside Participation and Contingent Downside**

**Principal at Risk Securities Linked to the EURO STOXX 50® Index due February 7, 2020**

## Hypothetical Payout Profile

The following profile is based on a hypothetical participation rate of 130% (the midpoint of the specified range for the participation rate) and a threshold level equal to 70% of the starting level. This graph has been prepared for purposes of illustration only. Your actual return will depend on the actual ending level, the actual participation rate and whether you hold your securities to maturity.

**Market Linked Securities Leveraged Upside Participation and Contingent Downside**

**Principal at Risk Securities Linked to the EURO STOXX 50® Index due February 7, 2020**

## Selected Risk Considerations

The securities have complex features and investing in the securities will involve risks not associated with an investment in conventional debt securities. These risks are explained in more detail in the Risk Factors section in the product supplement. You should reach an investment decision only after you have carefully considered with your advisors the suitability of an investment in the securities in light of your particular circumstances.

**If The Ending Level Is Less Than The Threshold Level, You Will Lose More Than 30%, And Possibly All, Of The Original Offering Price Of Your Securities At Stated Maturity.** If the ending level is less than the threshold level, the redemption amount that you receive at stated maturity will be reduced by an amount equal to the decline in the level of the Index to the extent it is below the starting level (expressed as a percentage of the starting level). The threshold level is 70% of the starting level. For example, if the Index has declined by 30.1% from the starting level to the ending level, you will not receive any benefit of the contingent downside feature and you will lose 30.1% of the original offering price per security. As a result, you will not receive any protection if the level of the Index declines significantly and you may lose more than 30%, and possibly all, of the original offering price per security at stated maturity, even if the level of the Index is greater than or equal to the starting level or the threshold level at certain times during the term of the securities.

**No Periodic Interest Will Be Paid On The Securities.** No periodic payments of interest will be made on the securities. However, if the agreed-upon tax treatment is successfully challenged by the Internal Revenue Service (the IRS ), you may be required to recognize taxable income over the term of the securities. You should review the sections of this pricing supplement and the accompanying product supplement entitled United States Federal Tax Considerations.

**The Securities Are Subject To The Credit Risk Of Wells Fargo.** The securities are our obligations and are not, either directly or indirectly, an obligation of any third party. Any amounts payable under the securities are subject to our creditworthiness, and you will have no ability to pursue any securities included in the Index for payment. As a result, our actual and perceived creditworthiness may affect the value of the securities and, in the event we were to default on our obligations, you may not receive any amounts owed to you under the terms of the securities.

**The Estimated Value Of The Securities On The Pricing Date, Based On WFS s Proprietary Pricing Models, Will Be Less Than The Original Offering Price.** The original offering price of the securities includes certain costs that are borne by you. Because of these costs, the estimated value of the securities on the pricing date will be less than the original offering price. The costs included in the original offering price relate to selling, structuring, hedging and issuing the securities, as well as to our funding considerations for debt of this type. The costs related to selling, structuring, hedging and issuing the securities include (i) the agent discount, (ii) the projected profit that our hedge counterparty (which may be one of our affiliates) expects to realize for assuming risks inherent in hedging our obligations under the securities and (iii) hedging and other costs relating to the offering of the securities. Our funding considerations are reflected in the fact that we determine the economic terms of the securities based on an assumed funding rate that is generally lower than our secondary market rates. If the costs relating to selling, structuring, hedging and issuing the securities were lower, or if the assumed funding rate we use to determine the economic terms of the securities were higher, the economic terms of the securities would be more favorable to you and the estimated value would be higher.

**The Estimated Value Of The Securities Is Determined By Our Affiliate s Pricing Models, Which May Differ From Those Of Other Dealers.** The estimated value of the securities was determined for us by WFS using its proprietary pricing models and related market inputs and assumptions referred to above under Investment Description Determining the estimated value. Certain inputs to these models may be determined by WFS in its discretion. WFS s views on these inputs may differ from other dealers views, and WFS s estimated value of the securities may be higher, and perhaps materially higher, than the estimated value of the securities that would be determined by other dealers in the market. WFS s models and its inputs and related assumptions may prove to be wrong and therefore not an accurate reflection of the value of the securities.

**The Estimated Value Of The Securities Is Not An Indication Of The Price, If Any, At Which WFS Or Any Other Person May Be Willing To Buy The Securities From You In The Secondary Market.** The price, if any, at which WFS or any of its affiliates may purchase the securities in the secondary market will be based on WFS s proprietary pricing models and will fluctuate over the term of the securities as a result of changes in the market and other factors described in the next risk consideration. Any such secondary market price for the securities will also be reduced by a bid-offer spread, which may vary depending on the aggregate face amount of the securities to be purchased in the secondary market transaction, and the expected cost of unwinding any related hedging transactions. Unless the factors described in the next risk consideration change significantly in your favor, any such secondary market price for the securities is likely to be less than the original offering price.

**Market Linked Securities Leveraged Upside Participation and Contingent Downside**

**Principal at Risk Securities Linked to the EURO STOXX 50® Index due February 7, 2020**

## Selected Risk Considerations (Continued)

If WFS or any of its affiliates makes a secondary market in the securities at any time up to the issue date or during the 3-month period following the issue date, the secondary market price offered by WFS or any of its affiliates will be increased by an amount reflecting a portion of the costs associated with selling, structuring, hedging and issuing the securities that are included in the original offering price. Because this portion of the costs is not fully deducted upon issuance, any secondary market price offered by WFS or any of its affiliates during this period will be higher than it would be if it were based solely on WFS s proprietary pricing models less the bid-offer spread and hedging unwind costs described above. The amount of this increase in the secondary market price will decline steadily to zero over this 3-month period. If you hold the securities through an account at WFS or any of its affiliates, we expect that this increase will also be reflected in the value indicated for the securities on your brokerage account statement. If you hold your securities through an account at a broker-dealer other than WFS or any of its affiliates, the value of the securities on your brokerage account statement may be different than if you held your securities at WFS or any of its affiliates, as discussed above under Investment Description.

**The Value Of The Securities Prior To Stated Maturity Will Be Affected By Numerous Factors, Some Of Which Are Related In Complex Ways.** The value of the securities prior to stated maturity will be affected by the level of the Index at that time, interest rates at that time and a number of other factors, some of which are interrelated in complex ways. The effect of any one factor may be offset or magnified by the effect of another factor. The following factors, which we refer to as the derivative component factors, are expected to affect the value of the securities: Index performance; interest rates; volatility of the Index; time remaining to maturity; dividend yields on the securities included in the Index; volatility of currency exchange rates; and correlation between currency exchange rates and the Index. In addition to the derivative component factors, the value of the securities will be affected by actual or anticipated changes in our creditworthiness, as reflected in our secondary market rates. Because numerous factors are expected to affect the value of the securities, changes in the level of the Index may not result in a comparable change in the value of the securities.

**The Securities Will Not Be Listed On Any Securities Exchange And We Do Not Expect A Trading Market For The Securities To Develop.** The securities will not be listed or displayed on any securities exchange or any automated quotation system. Although the agent and/or its affiliates may purchase the securities from holders, they are not obligated to do so and are not required to make a market for the securities. There can be no assurance that a secondary market will develop. Because we do not expect that any market makers will participate in a secondary market for the securities, the price at which you may be able to sell your securities is likely to depend on the price, if any, at which the agent is willing to buy your securities. If a secondary market does exist, it may be limited. Accordingly, there may be a limited number of buyers if you decide to sell your securities prior to stated maturity. This may affect the price you receive upon such sale. Consequently, you should be willing to hold the securities to stated maturity.

**The Amount You Receive On The Securities Will Depend Upon The Performance Of The Index And Therefore The Securities Are Subject To The Following Risks, As Discussed In More Detail In The Product**

**Supplement:**

*Your Return On The Securities Could Be Less Than If You Owned Securities Included In The Index.* Your return on the securities will not reflect the return you would realize if you actually owned the securities included in the Index because, among other reasons, the redemption amount will be determined by reference to the ending level of the Index, which will be calculated by reference to the prices of the securities in the Index without taking into consideration the value of dividends paid on those securities.

*Historical Levels Of The Index Should Not Be Taken As An Indication Of The Future Performance Of The Index During The Term Of The Securities.*

*Changes That Affect The Index May Adversely Affect The Value Of The Securities And The Amount You Will Receive At Stated Maturity.*

*We Cannot Control Actions By Any Of The Unaffiliated Companies Whose Securities Are Included In The Index.*

*We And Our Affiliates Have No Affiliation With The Index Sponsor And Have Not Independently Verified Its Public Disclosure Of Information.*

**An Investment In The Securities Is Subject To Risks Associated With Foreign Securities Markets.** The Index includes the stocks of foreign companies and you should be aware that investments in securities linked to the value of foreign equity securities involve particular risks. Foreign securities markets may have less liquidity and may be more volatile than the U.S. securities markets, and market developments may affect foreign markets differently than U.S. securities markets. Direct or indirect government intervention to stabilize a foreign securities market, as well as cross-shareholdings in foreign companies, may affect trading prices and volumes in those markets. Also, there is generally less publicly available information about non-U.S. companies that are not subject to the reporting requirements of the Securities and Exchange Commission, and non-U.S. companies are subject

**Market Linked Securities Leveraged Upside Participation and Contingent**

**Downside**

**Principal at Risk Securities Linked to the EURO STOXX 50® Index due February 7, 2020**

**Selected Risk Considerations (Continued)**

to accounting, auditing and financial reporting standards and requirements that differ from those applicable to U.S. reporting companies.

The prices and performance of securities of non-U.S. companies are subject to political, economic, financial, military and social factors which could negatively affect foreign securities markets, including the possibility of recent or future changes in a foreign government s economic, monetary and fiscal policies, the possible imposition of, or changes in, currency exchange laws or other laws or restrictions applicable to foreign companies or investments in foreign equity securities, the possibility of imposition of withholding taxes on dividend income, the possibility of fluctuations in the rate of exchange between currencies, the possibility of outbreaks of hostility or political instability and the possibility of natural disaster or adverse public health developments. Moreover, the relevant non-U.S. economies may differ favorably or unfavorably from the U.S. economy in important respects, such as growth of gross national product, rate of inflation, trade surpluses or deficits, capital reinvestment, resources and self-sufficiency.

The stocks included in the Index may be listed on a foreign stock exchange. A foreign stock exchange may impose trading limitations intended to prevent extreme fluctuations in individual security prices and may suspend trading in certain circumstances. These actions could limit variations in the closing level of the Index which could, in turn, adversely affect the value of the securities.

**The Stated Maturity Date May Be Postponed If The Calculation Day Is Postponed.** The calculation day will be postponed if the originally scheduled calculation day is not a trading day or if the calculation agent determines that a market disruption event has occurred or is continuing on the calculation day. If such a postponement occurs, the stated maturity date will be the later of (i) the initial stated maturity date and (ii) three business days after the postponed calculation day.

**Our Economic Interests And Those Of Any Dealer Participating In The Offering Are Potentially Adverse To Your Interests.** You should be aware of the following ways in which our economic interests and those of any dealer participating in the distribution of the securities, which we refer to as a participating dealer, are potentially adverse to your interests as an investor in the securities. In engaging in certain of the activities described below, our affiliates or any participating dealer or its affiliates may take actions that may adversely affect the value of and your return on the securities, and in so doing they will have no obligation to consider your interests as an investor in the securities. Our affiliates or any participating dealer or its affiliates may realize a profit from these activities even if investors do not receive a favorable investment return on the securities.

***The calculation agent is our affiliate and may be required to make discretionary judgments that affect the return you receive on the securities.*** WFS, which is our affiliate, will be the calculation agent for the securities. As calculation agent, WFS will determine the ending level of the Index and may be required to make other determinations that affect the return you receive on the securities at maturity. In making these determinations, the calculation agent may be required to make discretionary judgments, including determining whether a market disruption event has occurred on the scheduled calculation day, which may result in postponement of the calculation day; determining the ending level of the Index if the calculation day is postponed to the last day to which it may be postponed and a market disruption event occurs on that day; if the Index is discontinued, selecting a successor index or, if no successor index is available, determining the ending level of the Index; and determining whether to adjust the ending level of the Index on the calculation day in the event of certain changes in or modifications to the Index. In making these discretionary judgments, the fact that WFS is our affiliate may cause it to have economic interests that are adverse to your interests as an investor in the securities, and WFS s determinations as calculation agent may adversely affect your return on the securities.

***The estimated value of the securities was calculated by our affiliate and is therefore not an independent third-party valuation.*** WFS calculated the estimated value of the securities set forth on the cover page of this pricing supplement, which involved discretionary judgments by WFS, as described under Selected Risk Considerations The Estimated Value Of The Securities Is Determined By Our Affiliate s Pricing Models, Which May Differ From Those Of Other Dealers above. Accordingly, the estimated value of the securities set forth on the cover page of this pricing supplement is not an independent third-party valuation.

***Research reports by our affiliates or any participating dealer or its affiliates may be inconsistent with an investment in the securities and may adversely affect the level of the Index.*** Our affiliates or any dealer participating in the offering of the securities or its affiliates may, at present or in the future, publish research reports on the Index or the companies whose securities are included in the Index. This research is modified from time to time without notice and may, at present or in the future, express opinions or provide recommendations that are inconsistent with purchasing or holding the securities. Any research reports on the Index or the companies whose securities are included in the Index could adversely affect the level of the Index and, therefore, adversely affect the value of and your return on the securities. You are encouraged to derive information concerning the Index from multiple sources and should not rely on the views expressed by us or our affiliates or

**Market Linked Securities  Leveraged Upside Participation and Contingent**

**Downside**

**Principal at Risk Securities Linked to the EURO STOXX 50® Index due February 7, 2020**

## Selected Risk Considerations (Continued)

any participating dealer or its affiliates. In addition, any research reports on the Index or the companies whose securities are included in the Index published on or prior to the pricing date could result in an increase in the level of the Index on the pricing date, which would adversely affect investors in the securities by increasing the level at which the Index must close on the calculation day in order for investors in the securities to receive a favorable return.

***Business activities of our affiliates or any participating dealer or its affiliates with the companies whose securities are included in the Index may adversely affect the level of the Index.*** Our affiliates or any participating dealer or its affiliates may, at present or in the future, engage in business with the companies whose securities are included in the Index, including making loans to those companies (including exercising creditors remedies with respect to such loans), making equity investments in those companies or providing investment banking, asset management or other advisory services to those companies. These business activities could adversely affect the level of the Index and, therefore, adversely affect the value of and your return on the securities. In addition, in the course of these business activities, our affiliates or any participating dealer or its affiliates may acquire non-public information about one or more of the companies whose securities are included in the Index. If our affiliates or any participating dealer or its affiliates do acquire such non-public information, we and they are not obligated to disclose such non-public information to you.

***Hedging activities by our affiliates or any participating dealer or its affiliates may adversely affect the level of the Index.*** We expect to hedge our obligations under the securities through one or more hedge counterparties, which may include our affiliates or any participating dealer or its affiliates. Pursuant to such hedging activities, our hedge counterparties may acquire securities included in the Index or listed or over-the-counter derivative or synthetic instruments related to the Index or such securities. Depending on, among other things, future market conditions, the aggregate amount and the composition of such positions are likely to vary over time. To the extent that our hedge counterparties have a long hedge position in any of the securities included in the Index, or derivative or synthetic instruments related to the Index or such securities, they may liquidate a portion of such holdings at or about the time of the calculation day or at or about the time of a change in the securities included in the Index. These hedging activities could potentially adversely affect the level of the Index and, therefore, adversely affect the value of and your return on the securities.

***Trading activities by our affiliates or any participating dealer or its affiliates may adversely affect the level of the Index.*** Our affiliates or any participating dealer or its affiliates may engage in trading in the securities included in the Index and other instruments relating to the Index or such securities on a regular basis as part of their general broker-dealer and other businesses. Any of these trading activities could potentially adversely affect the level of the Index and, therefore, adversely affect the value of and your return on the securities.

***A participating dealer or its affiliates may realize hedging profits projected by its proprietary pricing models in addition to any selling concession and/or distribution expense fee, creating a further incentive for the participating dealer to sell the securities to you.*** If any participating dealer or any of its affiliates conducts hedging activities for us in connection with the securities, that participating dealer or its affiliates will expect to realize a projected profit from such hedging activities and this projected profit will be in addition to the concession and/or distribution expense fee that the participating dealer realizes for the sale of the securities to you. This additional projected profit may create a further incentive for the participating dealer to sell the securities to you.

**The U.S. Federal Tax Consequences Of An Investment In The Securities Are Unclear.** There is no direct legal authority regarding the proper U.S. federal tax treatment of the securities, and we do not plan to request a ruling from the IRS. Consequently, significant aspects of the tax treatment of the securities are uncertain, and the IRS or a court might not agree with the treatment of the securities as prepaid derivative contracts that are open transactions for U.S. federal income tax purposes. If the IRS were successful in asserting an alternative treatment of the securities, the tax consequences of ownership and disposition of the securities might be materially and adversely affected. In addition, in 2007 the U.S. Treasury Department and the IRS released a notice requesting comments on various issues regarding the U.S. federal income tax treatment of prepaid forward contracts and similar instruments. Any Treasury regulations or other guidance promulgated after consideration of these issues could materially and adversely affect the tax consequences of an investment in the securities, including the character and timing of income or loss and the degree, if any, to which income realized by non-U.S. persons should be subject to withholding tax, possibly with retroactive effect.

In addition, Section 871(m) of the Internal Revenue Code of 1986, as amended (the Code ), imposes a withholding tax of up to 30% on dividend equivalents paid or deemed paid to non-U.S. investors in respect of certain financial instruments linked to U.S. equities. In light of an IRS notice providing a general exemption for non-delta-one financial instruments issued in 2017, as of the date of this preliminary pricing supplement the securities should not be subject to withholding under Section 871(m). However, information about the application of Section 871(m) to the securities will be updated in the final pricing supplement. Moreover, the

**Market Linked Securities Leveraged Upside Participation and Contingent Downside**

**Principal at Risk Securities Linked to the EURO STOXX 50® Index due February 7, 2020**

**Selected Risk Considerations (Continued)**

IRS could challenge a conclusion that the securities should not be subject to withholding under Section 871(m). If withholding applies to the securities, we will not be required to pay any additional amounts with respect to amounts withheld.

You should read carefully the sections of this pricing supplement and the accompanying product supplement entitled United States Federal Tax Considerations. You should also consult your tax adviser regarding the U.S. federal tax consequences of an investment in the securities, as well as tax consequences arising under the laws of any state, local or non-U.S. taxing jurisdiction.

**Market Linked Securities  Leveraged Upside Participation and Contingent Downside**

**Principal at Risk Securities Linked to the EURO STOXX 50® Index due February 7, 2020**

## Hypothetical Returns

The following table illustrates, for a hypothetical participation rate of 130% (the midpoint of the specified range for the participation rate) and a range of hypothetical ending levels of the Index:

the hypothetical percentage change from the hypothetical starting level to the hypothetical ending level;

the hypothetical redemption amount payable at stated maturity per security;

| | | | | |
|---|---|---|---|---|
| | | (357 | ) | |
| Net income (loss) | $ 2,654 | | $ | (726 | ) |
| Income (loss) per share: | | | | |
| Basic | $ 0.05 | | $ | (0.01 ) |
| Diluted | $ 0.05 | | $ | (0.01 ) |
| Number of shares used in per share calculations: | | | | |
| Basic | 54,116 | | 53,987 | |
| Diluted | 55,368 | | 53,987 | |

See Accompanying Notes to Condensed Consolidated Financial Statements

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ENERGY RECOVERY, INC.
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

| | Three Months Ended March 31, | |
|---|---|---|
| | 2019 | 2018 |
| | (In thousands) | |
| Net income (loss) | $2,654 | $(726) |
| Other comprehensive income (loss), net of tax: | | |
| Foreign currency translation adjustments | (24) | 21 |
| Unrealized gain (loss) on investments | 84 | (64) |
| Other comprehensive income (loss), net of tax | 60 | (43) |
| Comprehensive income (loss) | $2,714 | $(769) |

See Accompanying Notes to Condensed Consolidated Financial Statements

ENERGY RECOVERY, INC.

CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

| | Common Stock | | Treasury Stock | | Additional Paid-in Capital | Accumulated Other Comprehensive (Loss) | Accumulated Deficit | Total Stockholders' Equity |
|---|---|---|---|---|---|---|---|---|
| | Shares | Amount | Shares | Amount | | | | |
| | (In thousands) | | | | | | | |
| Balance at December 31, 2018 | 59,396 | $ 59 | (5,456) | $(30,486) | $158,404 | $ (133) | $(14,466) | $113,378 |
| Net income | — | — | — | — | — | — | 2,654 | 2,654 |
| Unrealized gain on investments | — | — | — | — | — | 84 | — | 84 |
| Foreign currency translation adjustments | — | — | — | — | — | (24) | — | (24) |
| Issuance of common stock | 523 | 1 | — | — | 2,156 | — | — | 2,157 |
| Employee stock-based compensation | — | — | — | — | 1,671 | — | — | 1,671 |
| Balance at March 31, 2019 | 59,919 | $ 60 | (5,456) | $(30,486) | $162,231 | $ (73) | $(11,812) | $119,920 |

| | Common Stock | | Treasury Stock | | Additional Paid-in Capital | Accumulated Other Comprehensive Income (Loss) | Accumulated Deficit | Total Stockholders' Equity |
|---|---|---|---|---|---|---|---|---|
| | Shares | Amount | Shares | Amount | | | | |
| | (In thousands) | | | | | | | |
| Balance at December 31, 2017 | 58,168 | $ 58 | (4,263) | $(20,486) | $149,006 | $ (125) | $(36,559) | $91,894 |
| Net income | — | — | — | — | — | — | (726) | (726) |
| Unrealized loss on investments | — | — | — | — | — | (64) | — | (64) |
| Foreign currency translation adjustments | — | — | — | — | — | 21 | — | 21 |
| Issuance of common stock | 532 | 1 | — | — | 1,598 | — | — | 1,599 |
| Repurchase of common stock for treasury * | — | — | (410) | (3,495) | — | — | — | (3,495) |
| Stock-based compensation | — | — | — | — | 2,246 | — | — | 2,246 |
| Balance at March 31, 2018 | 58,700 | $ 59 | (4,673) | $(23,981) | $152,850 | $ (168) | $(37,286) | $91,474 |

* The March 2018 stock repurchase authorization expired in September 2018.

See Accompanying Notes to Condensed Consolidated Financial Statements

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ENERGY RECOVERY, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

| | Three Months Ended March 31, | |
|---|---|---|
| | 2019 | 2018 |
| | (In thousands) | |
| Cash Flows From Operating Activities: | | |
| Net income (loss) | $2,654 | $(726) |
| Adjustments to reconcile net income (loss) to net cash used in operating activities: | | |
| Stock-based compensation | 1,678 | 2,242 |
| Depreciation and amortization | 900 | 1,124 |
| Amortization of premiums on investments | (26) | 90 |
| Provision for warranty claims | 152 | 48 |
| Reversal of accruals related to expired warranties | (47) | (50) |
| Unrealized (gain) loss on foreign currency translation | (56) | 113 |
| Provision for doubtful accounts | (34) | 8 |
| Adjustments for excess or obsolete inventory | 38 | 4 |
| Deferred income taxes | 549 | (376) |
| Loss on disposal of fixed assets | — | 21 |
| Other non-cash adjustments | 31 | 3 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (7,162) | (297) |
| Contract assets | 2,977 | 1,330 |
| Inventories | (218) | (1,824) |
| Prepaid and other assets | (140) | (127) |
| Accounts payable | 18 | (1,467) |
| Accrued expenses and other liabilities | (3,353) | (4,092) |
| Income taxes | 10 | (3) |
| Contract liabilities | (3,922) | (2,354) |
| Net cash used in operating activities | (5,951) | (6,333) |
| Cash Flows From Investing Activities: | | |
| Maturities of marketable securities | 19,599 | 25,623 |
| Purchases of marketable securities | (19,198) | (13,935) |
| Capital expenditures | (1,566) | (626) |
| Net cash (used in) provided by investing activities | (1,165) | 11,062 |
| Cash Flows From Financing Activities: | | |
| Net proceeds from issuance of common stock | 2,191 | 1,636 |
| Tax payment for employee shares withheld | (34) | (37) |
| Repayment of long-term debt | — | (2) |
| Repurchase of common stock | — | (3,495) |
| Net cash provided by (used in) financing activities | 2,157 | (1,898) |
| Effect of exchange rate differences on cash and cash equivalents | (4) | (14) |
| Net change in cash, cash equivalents and restricted cash | (4,963) | 2,817 |
| Cash, cash equivalents and restricted cash, beginning of year | 22,138 | 30,626 |
| Cash, cash equivalents and restricted cash, end of period | $17,175 | $33,443 |

See Accompanying Notes to Condensed Consolidated Financial Statements

ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1 — Description of Business and Significant Accounting Policies

Energy Recovery, Inc. and its wholly-owned subsidiaries (the "Company," "Energy Recovery," "our," "us," or "we") is an energy solutions provider to industrial fluid flow markets worldwide. The Company's core competencies are fluid dynamics and advanced material science. The Company's products make industrial processes more operationally and capital expenditure efficient. The Company's solutions convert wasted pressure energy into a reusable asset and preserve or eliminate pumping technology in hostile processing environments. The Company's solutions are marketed and sold in fluid flow markets, such as water, oil & gas, and chemical processing, under the trademarks ERI®, PX®, Pressure Exchanger®, PX Pressure Exchanger®, VorTeq™, MTeq™, IsoBoost®, IsoGen®, AT™, and AquaBold™. The Company owns, manufactures, and/or develops its solutions, in whole or in part, in the United States of America, ("U.S.").

Basis of Presentation

The Company's Condensed Consolidated Financial Statements include the accounts of Energy Recovery, Inc. and its wholly-owned subsidiaries. All significant inter-company accounts and transactions have been eliminated in consolidation.

The accompanying Condensed Consolidated Financial Statements have been prepared by the Company, pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"). Certain information and footnote disclosures normally included in the financial statements prepared in accordance with U.S. generally accepted accounting principles ("GAAP") have been condensed or omitted pursuant to such rules and regulations. The December 31, 2018 Condensed Consolidated Balance Sheet was derived from audited financial statements, and may not include all disclosures required by GAAP; however, the Company believes that the disclosures are adequate to make the information presented not misleading. The March 31, 2019 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, 2018 included in the Company's Annual Report on Form 10-K filed with the SEC on March 7, 2019, as amended on March 12, 2019.

In the opinion of management, all adjustments, consisting of 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.

Use of Estimates

The preparation of Condensed Consolidated Financial Statements in conformity with U.S. GAAP requires the Company's management to make judgments, assumptions, and estimates that affect the amounts reported in the Condensed Consolidated Financial Statements and accompanying Notes to Condensed Consolidated Financial Statements.

The accounting policies that reflect the Company's more significant estimates and judgments and that the Company believes are the most critical to aid in fully understanding and evaluating its reported financial results are revenue recognition; capitalization of research and development assets; valuation of stock options; valuation and impairment of goodwill and acquired intangible assets; valuation adjustments for excess and obsolete inventory; deferred taxes and valuation allowances on deferred tax assets; and evaluation and measurement of contingencies. Those estimates could change, and as a result, actual results could differ materially from those estimates.

Recent Accounting Pronouncements

Recently Adopted Accounting Pronouncements

There were no material accounting pronouncements adopted during the quarter ended March 31, 2019.

ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Recently issued accounting pronouncements not yet adopted

In August 2018, the Financial Accounting Standards board ("FASB") issued Accounting Standards Update ("ASU") 2018-15 ("ASU 2018-15"), Intangibles - Goodwill and Other - Internal-Use Software (Topic 350-40): Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract. ASU 2018-15 aligns the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software. The updated guidance is effective for annual periods beginning after December 15, 2019, and interim periods within those fiscal years, and early adoption is permitted. At this time, we are still evaluating the impact of adopting this standard on our financial statements.

ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 2 — Revenues

Our 2018 Annual Report on Form 10-K includes a description of certain significant accounting policies, including those with respect to revenue recognition. There have been no material changes to our significant accounting policies described in our 2018 Annual Report on Form 10-K.

Disaggregation of Revenue

The following table presents the Company's revenues disaggregated by geography, based on the "shipped to" addresses of the Company's customers and major product/service lines. Sales and usage-based taxes are excluded from revenues.

| | Three Months Ended March 31, 2019 | | | Three Months Ended March 31, 2018 | | |
|---|---|---|---|---|---|---|
| | Water | Oil and Gas | Total | Water | Oil and Gas | Total |
| | (In thousands) | | | | | |
| Primary geographical market | | | | | | |
| Middle East and Africa | $8,698 | $104 | $8,802 | $6,102 | $10 | $6,112 |
| Americas | 4,023 | 3,723 | 7,746 | 1,101 | 2,749 | 3,850 |
| Asia | 2,134 | — | 2,134 | 2,673 | — | 2,673 |
| Europe | 1,113 | — | 1,113 | 1,172 | — | 1,172 |
| Total | $15,968 | $3,827 | $19,795 | $11,048 | $2,759 | $13,807 |
| | | | | | | |
| Major product/service line | | | | | | |
| PX, pumps and turbo devices | $15,968 | $— | $15,968 | $11,048 | $— | $11,048 |
| License and development | — | 3,723 | 3,723 | — | 2,749 | 2,749 |
| Oil & gas products | — | 104 | 104 | — | 10 | 10 |
| Total | $15,968 | $3,827 | $19,795 | $11,048 | $2,759 | $13,807 |

The Company records unbilled receivables as contract assets. Significant changes in contract assets during the period were as follows.

| | March 31, 2019 | December 31, 2018 |
|---|---|---|
| | (In thousands) | |
| Balance, beginning of year | $4,083 | $ 6,278 |
| Transferred to receivables | (3,598 ) | (8,865 ) |
| Additional unbilled receivables | 622 | 6,670 |
| Balance, end of period | $1,107 | $ 4,083 |

The Company records contract liabilities when cash payments are received in advance of the Company's performance. Significant changes in contract liabilities during the period were as follows.

| | March 31, 2019 | December 31, 2018 |
|---|---|---|
| | (In thousands) | |
| Balance, beginning of year | $42,809 | $ 56,426 |

| | | |
|---|---|---|
| Revenue recognized | (3,736 ) | (13,493 ) |
| Cash received | (186 ) | (124 ) |
| Balance, end of period | $38,887 | $ 42,809 |

ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Transaction Price Allocated to the Remaining Performance Obligation

The following table includes estimated revenue expected to be recognized in the future related to performance obligations that are unsatisfied or partially unsatisfied.

| | March 31, 2019 (In thousands) |
|---|---|
| Year: | |
| 2019 (remaining nine months) | $ 10,821 |
| 2020 | 14,119 |
| 2021 | 6,794 |
| 2022 | 661 |
| 2023 and thereafter | 5,031 |
| Total | $ 37,426 |

ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 3 — Income (Loss) Per Share

Net income (loss) is divided by the weighted average number of common shares outstanding during the year to calculate basic net income (loss) per common share. Basic earnings per share exclude any dilutive effects of stock options and restricted stock units (“RSUs”).

Diluted net income (loss) per common share reflects the potential dilution that would occur if outstanding stock options to purchase common stock were exercised for shares of common stock, using the treasury stock method, and the shares of common stock underlying each outstanding RSU were issued. Diluted earnings per share for the three months ended March 31, 2019 and 2018, includes the dilutive effects of stock options and RSUs. Certain shares of common stock issuable under stock options and RSUs have been omitted from the three months ended March 31, 2019 and 2018 diluted net income per share calculations because their inclusion is considered anti-dilutive.

The computation of basic and diluted net income (loss) per share is presented in the following table.

| | Three Months Ended March 31, | |
|---|---|---|
| | 2019 | 2018 |
| | (In thousands, except per share amounts) | |
| Numerator: | | |
| Net income (loss) | $2,654 | $(726) |
| Denominator: | | |
| Basic weighted average common shares outstanding | 54,116 | 53,987 |
| Weighted average effect of dilutive stock awards | 1,252 | — |
| Diluted weighted average common shares outstanding | 55,368 | 53,987 |
| Net income (loss) per share: | | |
| Basic | $0.05 | $(0.01) |
| Diluted | $0.05 | $(0.01) |

The potential common shares that were excluded from the computation of diluted net income (loss) per share as their effect would have been anti-dilutive are presented in the following table.

| | Three Months Ended March 31, | |
|---|---|---|
| | 2019 | 2018 |
| | (In thousands) | |
| Anti-dilutive shares excluded from net income (loss) per share calculation | 2,461 | 5,414 |

ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 4 — Other Financial Information

Cash, Cash Equivalents and Restricted Cash

The Company's Condensed Consolidated Statement of Cash Flows explains the change in the total of cash, cash equivalents, and restricted cash. The following table provides a reconciliation of cash and cash equivalents, and restricted cash reported within the Condensed Consolidated Balance Sheets that sum to the total of such amounts in the Condensed Consolidated Statements of Cash Flows.

| | March 31, 2019 | December 31, 2018 |
|---|---|---|
| | (In thousands) | |
| Cash and cash equivalents | $16,992 | $ 21,955 |
| Restricted cash | 183 | 183 |
| Total cash, cash equivalents, and restricted cash | $17,175 | $ 22,138 |

The Company pledged cash in connection with certain stand-by letters of credit and company credit cards. The Company deposited corresponding amounts into accounts at several financial institutions.

Inventories

Inventories are stated at the lower of cost (using the first-in, first-out method) or net realizable value and are presented by category in the following table.

| | March 31, 2019 | December 31, 2018 |
|---|---|---|
| | (In thousands) | |
| Raw materials | $2,387 | $ 2,238 |
| Work in process | 2,139 | 2,689 |
| Finished goods | 2,781 | 2,211 |
| Inventories, net | $7,307 | $ 7,138 |

Valuation adjustments for excess and obsolete inventory, reflected as a reduction of inventory at March 31, 2019 and December 31, 2018 were $0.7 million.

Accrued Expenses and Other Current Liabilities

Accrued expenses and other current liabilities by category are presented in the following table.

| | March 31, 2019 | December 31, 2018 |
|---|---|---|
| | (In thousands) | |
| Payroll and commissions payable | $3,315 | $ 5,843 |
| Other accrued expenses and current liabilities | 1,797 | 2,176 |
| Total accrued expenses and other current liabilities | $5,112 | $ 8,019 |

ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Accumulated Other Comprehensive Loss

Changes in accumulated other comprehensive loss by component are presented in the following table.

| | Foreign Currency Translation Adjustments | Unrealized Gains (Losses) on Investments | Total Accumulated Other Comprehensive Gain (Loss) |
|---|---|---|---|
| | (In thousands) | | |
| Balance, December 31, 2018 | $(45) | $ (88) | $ (133) |
| Other comprehensive gain (loss), net | (24) | 84 | 60 |
| Balance, March 31, 2019 | $(69) | $ (4) | $ (73) |

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 period presented. The tax impact of the changes in accumulated other comprehensive loss was not material.

ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 5 — Investments and Fair Value Measurements

The Company's cash, cash equivalents, short-term and long-term investments are presented in the following table.

| | March 31, 2019 | December 31, 2018 |
|---|---|---|
| | (In thousands) | |
| Cash and cash equivalents | $16,992 | $ 21,955 |
| Short-term investments | 71,771 | 73,338 |
| Long-term investments | 2,548 | 1,269 |
| Total cash, cash equivalents and marketable securities | $91,311 | $ 96,562 |

As of March 31, 2019, there were no available-for-sale investments reported in cash and cash equivalents on the Condensed Consolidated Balance Sheets.

Available-for-Sale Investments

The Company's investments are all classified as available-for-sale. As of March 31, 2019 and December 31, 2018, all available-for-sale investments were classified as short-term, with maturities less than 12 months, and long-term with maturities over 12 months. There were no sales of available-for-sale investments during the three months ended March 31, 2019 and 2018.

ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Available-for-sale investments as of March 31, 2019 and December 31, 2018 are presented in the following tables.

| | March 31, 2019 | | | |
|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Holding Gains | Gross Unrealized Holding Losses | Fair Value |
| | (In thousands) | | | |
| Short-term investments | | | | |
| U.S. Treasury securities | $5,126 | $ 3 | $ — | $5,129 |
| Corporate notes and bonds | 66,645 | 19 | (22 ) | 66,642 |
| Total short-term investments | 71,771 | 22 | (22 ) | 71,771 |
| Long-term investments | | | | |
| Corporate notes and bonds | 2,549 | — | (1 ) | 2,548 |
| Total long-term investments | 2,549 | — | (1 ) | 2,548 |
| Total available-for-sale investments | $74,320 | $ 22 | $ (23 ) | $74,319 |

| | December 31, 2018 | | | |
|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Holding Gains | Gross Unrealized Holding Losses | Fair Value |
| | (In thousands) | | | |
| Short-term investments | | | | |
| U.S. Treasury securities | $8,102 | $ 1 | $ (2 ) | $8,101 |
| Corporate notes and bonds | 65,324 | 1 | (88 ) | 65,237 |
| Total short-term investments | 73,426 | 2 | (90 ) | 73,338 |
| Long-term investments | | | | |
| Corporate notes and bonds | 1,269 | — | — | 1,269 |
| Total long-term investments | 1,269 | — | — | 1,269 |
| Total available-for-sale investments | $74,695 | $ 2 | $ (90 ) | $74,607 |

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 are shown by contractual maturity in the following table.

| | March 31, 2019 | |
|---|---|---|
| | Amortized Cost | Fair Value |
| | (In thousands) | |
| Due in one year or less | $71,771 | $71,771 |
| Due in greater than one year | $2,549 | $2,548 |

Fair Value of Financial Instruments

Financial assets and liabilities that are remeasured and reported at fair value at each reporting period are classified and disclosed in one of the following three levels:

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.

ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

For the Company's 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 the Company uses 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 notes and bonds, and U.S. Treasury securities.

The fair value of financial assets and liabilities measured on a recurring basis is presented in the following tables.

| | March 31, 2019 | | | |
|---|---|---|---|---|
| | Total | Level 1 Inputs | Level 2 Inputs | Level 3 Inputs |
| | (In thousands) | | | |
| Assets: | | | | |
| Cash equivalents | | | | |
| Money market securities | $7,533 | $7,533 | $— | $ — |
| Total cash equivalents | $7,533 | $7,533 | $— | $ — |
| Short-term investments | | | | |
| U.S. Treasury securities | 5,129 | — | 5,129 | — |
| Corporate notes and bonds | 66,642 | — | 66,642 | — |
| Total short-term investments | 71,771 | — | 71,771 | — |
| Long-term investments | | | | |
| Corporate notes and bonds | $2,548 | $— | $2,548 | $ — |
| Total long-term investments | 2,548 | — | 2,548 | — |
| Total | $81,852 | $7,533 | $74,319 | $ — |

| | December 31, 2018 | | | |
|---|---|---|---|---|
| | Total | Level 1 Inputs | Level 2 Inputs | Level 3 Inputs |
| | (In thousands) | | | |
| Assets: | | | | |
| Cash equivalents | | | | |
| Money market securities | $6,661 | $6,661 | $— | $ — |
| Total cash equivalents | $6,661 | $6,661 | $— | $ — |
| Short-term investments | | | | |
| U.S. Treasury securities | 8,101 | — | 8,101 | — |
| Corporate notes and bonds | 65,237 | — | 65,237 | — |
| Total short-term investments | 73,338 | — | 73,338 | — |
| Long-term investments | | | | |
| Corporate notes and bonds | $1,269 | — | 1,269 | — |
| Total long-term investments | 1,269 | — | 1,269 | — |
| Total | $81,268 | $6,661 | $74,607 | $ — |

During the three months ended March 31, 2019, the Company had no transfers of financial assets and liabilities between Level 1 and Level 2.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

The fair value and gross unrealized losses on the available-for-sale securities that have been in a continuous unrealized loss position, aggregated by type of investment instrument as of March 31, 2019 and December 31, 2018 are summarized in the following table. The Company's available-for-sale investments consist of short-term with maturities less than 12 months and long-term with maturities over 12 months. Available-for-sale investments that were in an unrealized gain position have been excluded from the following table.

| | March 31, 2019 | | December 31, 2018 | |
|---|---|---|---|---|
| | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| U.S. Treasury securities | $349 | $ — | $8,101 | $ (2 ) |
| Corporate notes and bonds | 41,215 | (23 ) | 61,809 | (88 ) |
| Total available-for-sale investments | $41,564 | $ (23 ) | $69,910 | $ (90 ) |

ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 6 — Goodwill and Intangible Assets

Goodwill

The net carrying amount of goodwill as of March 31, 2019 and December 31, 2018 was $12.8 million. As of March 31, 2019 and December 31, 2018, no impairment of goodwill was recorded in the accompanying Condensed Consolidated Financial Statements.

Other Intangible Assets

Identifiable intangible assets, all of which are finite-lived, as of the date indicated were as follows in the table below. All intangible assets are amortized on a straight-line basis over their useful life.

| | March 31, 2019 | December 31, 2018 |
|---|---|---|
| | (In thousands) | |
| Finite-lived intangible assets | $6,643 | $ 6,643 |
| Accumulated amortization | (6,159 ) | (6,003 ) |
| Intangible assets, net | $484 | $ 640 |

ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 7 — Lines of Credit

Loan and Pledge Agreement

On January 27, 2017, the Company entered into a loan and pledge agreement (the “Loan and Pledge Agreement”) with a financial institution. The Loan and Pledge Agreement provides for a committed revolving credit line of $16.0 million and an uncommitted revolving credit line of $4.0 million. The Loan and Pledge Agreement was amended on March 30, 2018 to extend the termination date of the Loan and Pledge Agreement from March 31, 2018 to March 31, 2020, in connection with which the Company paid closing fees of $16 thousand. The Loan and Pledge Agreement was further amended on August 24, 2018 to permit the Company to incur indebtedness owed to a foreign subsidiary in an aggregate amount not to exceed $66.0 million, which amount is subordinated to any amounts outstanding under the Loan and Pledge Agreement. The Loan and Pledge Agreement was subsequently amended on April 8, 2019 to clarify definitions of certain terms and to allow the term of any Letter of Credit to not exceed two years instead of 364 days from the date of issuance, and in addition to permit the Company to issue Standby Letters of Credit (“SBLCs”) up to one year past the expiration date of the loan agreement. On April 23, 2019, the Loan and Pledge Agreement was amended further to clarify definition of certain additional terms. As of March 31, 2019, no debt was outstanding under the Loan and Pledge Agreement, however, the standby letters of credit are deducted from the total revolving credit line.

Stand-by Letters of Credit

The outstanding amounts of stand-by letters of credit are $10.7 million at March 31, 2019.

ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 8 — Commitments and Contingencies

Operating Lease Obligations

The Company leases office facilities and equipment under operating leases that expire on various dates through 2029.

On January 10, 2019, the Company entered into an industrial lease agreement (the lease was executed but has not commenced as of March 31, 2019) pursuant to which the Company has leased approximately 25,200 square feet to be constructed office and warehouse space and approximately 4.5 acres of yard space in Katy, Texas, for a new commercial development center for oil & gas field testing and training. The Company's monthly base rent obligation is approximately $26,000 for the first year of the lease and increases three percent annually thereafter. The future lease payments are approximately $26,000 for the remainder of 2019, $317,000 for year two, $326,000 for year three, $336,000 for year four, $347,000 for year five and $2,204,000 for all years thereafter. In addition, the Company will pay its share of operating expenses, which is currently estimated to be approximately $12,000 per month. The initial term of the Lease is one hundred twenty (120) months after the commencement date (expected to be in the second half of the year), and the Company has two options to extend the Lease by an additional five-year term, which must be exercised by written notice at least six months prior to the end of the relevant term. Maturities of the lease liabilities as of March 31, 2019 (excluding the new lease referenced above that is executed but will not commence until the second half of the year), are presented in the following table.

| | Lease Amounts (In thousands) |
|---|---|
| Year: | |
| 2019 (remaining nine months) | $ 1,377 |
| 2020 | 1,855 |
| 2021 | 1,653 |
| 2022 | 1,812 |
| 2023 | 1,714 |
| Thereafter | 10,044 |
| Total | 18,455 |
| Less imputed lease interest | (5,190) |
| Total lease liabilities | $ 13,265 |

Warranty

Changes in the Company's accrued product warranty reserve are presented in the following table.

| | Three Months Ended March 31, | |
|---|---|---|
| | 2019 | 2018 |
| | (In thousands) | |
| Balance, beginning of period | $478 | $366 |
| Warranty costs charged to cost of revenue | 152 | 48 |

| | | |
|---|---|---|
| Utilization charges against reserve | (12 ) | (50 ) |
| Release of accrual related to expired warranties | (47 ) | (5 ) |
| Balance, end of period | $571 | $359 |

Purchase Obligations

The Company has purchase order arrangements with its vendors for which the Company has not received the related goods or services as of March 31, 2019. These arrangements are subject to change based on the Company's sales demand forecasts, and the Company has the right to cancel the arrangements prior to the date of delivery. The majority of these purchase order arrangements were related to various raw materials and components parts. As of March 31, 2019, the Company had approximately $8.4 million of open cancellable purchase order arrangements related primarily to materials and parts.

ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Guarantees

The Company enters into indemnification provisions under its agreements with other companies in the ordinary course of business, typically with customers. Under these provisions, the Company generally indemnifies and holds harmless the indemnified party for losses suffered or incurred by the indemnified party as a result of the Company’s activities, generally limited to personal injury and property damage caused by the Company’s 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 the Company’s general liability insurance to the extent provided by the policy limitations. The Company has 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, the Company had no liabilities recorded for these agreements as of March 31, 2019 and December 31, 2018.

In certain cases, the Company issues warranty and product performance guarantees to its customers for amounts generally equal to 10% or less of the total sales agreement to endorse the execution of product delivery and the warranty of design work, fabrication, and operating performance of our devices. These guarantees are generally stand-by letters of credit that typically remain in place in general for periods of 24 to 36 months. All stand-by letters of credit at March 31, 2019 and December 31, 2018, were in the aggregate for amounts of $10.7 million and $8.8 million, respectively.

ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Litigation

The Company is named in and subject to various proceedings and claims in connection with our business. The outcome of matters the Company has been, and currently are, involved in cannot be determined at this time, and the results cannot be predicted with certainty. There can be no assurance that these matters will not have a material adverse effect on our results of operations in any future period and a significant judgment could have a material impact on the Company's financial condition, results of operations and cash flows. The Company may in the future become involved in additional litigation in the ordinary course of its business, including litigation that could be material to its business.

The Company considers all claims on a quarterly basis and based on known facts assesses whether potential losses are considered reasonably possible, probable and estimable. Based upon this assessment, the Company then evaluates disclosure requirements and whether to accrue for such claims in its consolidated financial statements. The Company records a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, settlements, rulings, advice of legal counsel and other information and events pertaining to a particular case.

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. 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 appealed and the appeals court reversed the labor court's finding and instructed the labor court to make a ruling on the merits on November 21, 2017. On February 14, 2018, the Company received notice that the labor court issued a ruling in favor of Mr. Blanco and ordered the Company to pay to Mr. Blanco a severance amount. The Company appealed and on March 18, 2019, the Company received notice that the appeals court had partially reversed the labor court's order and significantly reduced the severance amount. The Company again appealed the decision on April 24, 2019. The Company denies any allegations of wrongdoing and intends to continue to vigorously defend against this lawsuit. Based on currently available information and review with outside counsel, the Company had previously estimated and accrued for a potential loss. The Company does not believe that it is reasonably possible that a material loss in excess of amounts accrued will occur.

ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 9 — Income Taxes

The effective tax rate for the three months ended March 31, 2019 and 2018 was 17.3% on pretax book income of $3.2 million and 33.0% on pretax book loss of $1.1 million, respectively. Excluding stock option related discrete tax income tax benefits of $0.1 million in the current period and $0.4 million in the prior year period, the effective tax rate for the three months ended March 31, 2019 and 2018 was 21.3% and (3.5)%, respectively. The tax rate in the three months ending March 31, 2019 is lower than the tax rate in the three months ending March 31, 2018 as a result of the Company reporting losses of $1.3 million in the prior year period in a jurisdiction for which the Company could not recognize a tax benefit due to a full valuation allowance in this jurisdiction.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 10 — Stock-based Compensation

Stock-based Compensation Expense

Stock-based compensation expense related to the fair value measurement of awards granted to employees by financial line and by type of award is presented in the following table.

| | Three Months Ended March 31, | |
|---|---|---|
| | 2019 | 2018 |
| | (In thousands) | |
| Stock-based compensation expense by financial line: | | |
| Cost of revenue | $34 | $24 |
| General and administrative [(1)] | 959 | 1,676 |
| Sales and marketing | 203 | 262 |
| Research and development | 482 | 281 |
| Total stock-based compensation expense | $1,678 | $2,243 |
| | | |
| Stock-based compensation expense by type of award: | | |
| Options [(1)] | $1,133 | $1,664 |
| RSUs [(1)] | 545 | 579 |
| Total stock-based compensation expense | $1,678 | $2,243 |

[(1)] 2018 Amounts include modifications of equity awards held by the Company's former Chief Executive Officer.

The Company estimates forfeitures at the time of grant and revises those estimates periodically in subsequent periods if actual forfeitures differ from those estimates. The Company uses historical data to estimate pre-vesting option forfeitures and record stock-based compensation expense only for those awards that are expected to vest. All stock-based payment awards are amortized on a straight-line basis over the requisite service periods of the awards, which are generally the vesting periods. If the Company's actual forfeiture rate is materially different from its estimate, the stock-based compensation expense could be significantly different from what the Company has recorded in the current period.

Modifications of Equity Awards

In the first quarter of 2018, the Company recorded additional stock-based compensation expense of $0.9 million due to an equity award modification charge chiefly related to the modification of certain equity awards held by the Company's former President and Chief Executive Officer, who resigned on February 24, 2018, in consideration for his entering into a Settlement Agreement and Release.

Unamortized Stock-based Compensation Costs

Stock-based compensation cost related to unvested stock options and RSUs will generally be amortized on a straight-line basis over the remaining average service period of each award. The following table presents the unamortized compensation cost and weighted average service period of all unvested outstanding awards as of March 31, 2019.

Weighted Average Service Period

| | Unamortized Compensation Costs | |
|---|---|---|
| | (In thousands) | (In years) |
| Stock options | $ 6,798 | 2.81 |
| RSUs | 4,823 | 3.1 |
| Total | $ 11,621 | |

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ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Vested Stock Options and RSUs

The total grant date fair value of stock options and RSUs vested during the period are presented in the following table.

| | Three Months Ended March 31, | | | |
|---|---|---|---|---|
| | 2019 | | 2018 | |
| | (In thousands) | | | |
| Stock options | $ | 1,367 | $ | 1,261 |
| RSUs | 924 | | 509 | |
| Total grant date fair value of stock options and RSUs vested during the period | $ | 2,291 | $ | 1,770 |

Stock Option Activities

The following table summarizes the stock option activities under the Company's 2016 Incentive Plan ("2016 Plan") and Amended and Restated 2008 Equity Incentive Plan.

| | Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Life (in Years) | Aggregate Intrinsic Value [(1)] |
|---|---|---|---|---|
| | (In thousands, except for weighted average exercise price and weighted average remaining contractual life) | | | |
| Balance, December 31, 2018 | 4,982 | $ 6.36 | 6.56 | $ 6,572 |
| Granted | 416 | $ 7.66 | | |
| Exercised | (420 ) | $ 5.21 | | $ 1,396 |
| Forfeited | (308 ) | $ 8.48 | | |
| Balance, March 31, 2019 | 4,670 | $ 6.44 | 6.68 | $ 11,442 |
| Vested and exercisable as of March 31, 2019 | 3,057 | $ 5.53 | 5.51 | $ 10,156 |
| Vested and exercisable as of March 31, 2019 and expected to vest thereafter | 4,441 | $ 6.35 | 6.55 | $ 11,255 |

(1) The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying options and the fair value of the Company's common stock at the time of exercise. The aggregate intrinsic value at March 31, 2019 is calculated as the difference between the exercise price of the underlying options and the fair value of the Company's common stock as of March 31, 2019 or the last trading day prior to March 31, 2019. The aggregate intrinsic value at December 31, 2018 is calculated as the difference between the exercise price of the underlying options and the fair value of the Company's common stock as of December 31, 2018 or the last trading day prior to December 31, 2018.

Restricted Stock Unit Activities

The following table summarizes the RSU activities under the 2016 Plan.

| | Shares | Weighted Average Grant-Date Fair Value |
|---|---|---|
| | (In thousands, except for weighted average grant-date fair value) | |
| Balance, December 31, 2018 | 463 | $ 8.49 |
| Awarded | 390 | $ 7.69 |
| Vested | (107) | $ 8.62 |
| Forfeited | (71 ) | $ 8.37 |
| Balance, March 31, 2019 | 675 | $ 8.02 |

ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 11 — Business Segment and Geographic Information

The Company is an energy solutions provider to industrial fluid flow markets worldwide. The Company manufactures and sells high-efficiency energy recovery devices (“ERDs”) and pumps as well as related products and services. The Company’s chief operating decision-maker (“CODM”) is the chief executive officer.
The Company’s reportable 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 products sold, and the related products and services. The Water segment consists of revenue associated with products sold for use in reverse osmosis desalination, as well as the related identifiable expenses. The Oil & Gas segment consists of product primarily in seawater revenue associated with products sold for use in gas processing, chemical processing, and hydraulic fracturing, as well as license and development revenue associated with hydraulic fracturing, as well as related identifiable expenses. Operating income (loss) for each segment excludes other income and expenses and certain corporate expenses managed outside the operating segment, such as 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 summary of financial information by segment is presented in the following tables.

| | Three Months Ended March 31, 2019 | | | Three Months Ended March 31, 2018 | | |
|---|---|---|---|---|---|---|
| | Water | Oil & Gas | Total | Water | Oil & Gas | Total |
| | (In thousands) | | | | | |
| Product revenue | $15,968 | $104 | $16,072 | $11,048 | $ 10 | $11,058 |
| Product cost of revenue | 4,747 | 188 | 4,935 | 3,228 | 86 | 3,314 |
| Product gross profit | 11,221 | (84) | 11,137 | 7,820 | (76) | 7,744 |
| License and development revenue | — | 3,723 | 3,723 | — | 2,749 | 2,749 |
| Operating expenses: | | | | | | |
| General and administrative | 535 | 364 | 899 | 305 | 651 | 956 |
| Sales and marketing | 1,649 | 263 | 1,912 | 1,445 | 344 | 1,789 |
| Research and development | 804 | 3,363 | 4,167 | 244 | 3,665 | 3,909 |
| Amortization of intangibles | 156 | — | 156 | 158 | — | 158 |
| Operating expenses | 3,144 | 3,990 | 7,134 | 2,152 | 4,660 | 6,812 |
| Operating income (loss) | $8,077 | $(351) | 7,726 | 5,668 | (1,987) | 3,681 |
| Less: Corporate operating expenses | | | 5,017 | | | 5,012 |
| Consolidated operating income (loss) | | | 2,709 | | | (1,331) |
| Non-operating income | | | 499 | | | 248 |
| Income (loss) before income taxes | | | $3,208 | | | (1,083) |

The following geographic information includes net revenue from 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 percentages):

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ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

| | Three months Ended March 31, | |
|---|---|---|
| | 2019 | 2018 |
| | (In thousands, except for percentages) | |
| Product revenue by geographic location: | | |
| United States | 2 % | 4 % |
| International | 98 % | 96 % |
| Total product revenue | 100% | 100% |
| | | |
| Product revenue by country: | | |
| United Arab Emirates | 30 % | --- |
| Chile | 22 % | --- |
| Saudi Arabia | 12 % | 13 % |
| Egypt | --- | 30 % |
| China | --- | 14 % |
| Others[(1)] | 36 % | 43 % |
| Total | 100% | 100% |

(1) Includes remaining countries not separately disclosed. No country in this line item accounted for more than 10% of our product revenue during the period presented.

All of our long-lived assets were located in the United States at March 31, 2019 and December 31, 2018.

ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 12 — Concentrations

Customers accounting for 10% or more of the Company's product revenue by segment are presented in the following table.

Product Revenue

| | | Three Months Ended March 31, | |
|---|---|---|---|
| | Segment | 2019 | 2018 |
| Customer A | Water | 10 % | 34 % |
| Customer B | Water | ** | 12 % |
| Customer C | Water | 29 % | ** |
| Customer D | Water | 14 % | ** |
| Customer H | Water | 12 % | ** |

** Less than 10%

One international Oil and Gas segment customer accounts for 100% of the Company's license and development revenue for the quarters ended March 31, 2019 and 2018.

Customers accounting for 10% or more of the Company's combined accounts receivable and contract assets by segment are presented in the following table.

| | Segment | March 31, 2019 | December 31, 2018 |
|---|---|---|---|
| Customer C | Water | 21% | ** |
| Customer E | Water | 12% | 20% |
| Customer F | Water | ** | 11% |
| Customer G | Oil & Gas | 17% | 26% |
| Customer I | Water | 16% | ** |

** Less than 10%

Vendor Concentration

Vendors accounting for 10% or more of the Company's combined accounts payable by segment are presented in the following table.

| | Segment | March 31, 2019 | December 31, 2018 |
|---|---|---|---|
| Vendor A | Oil & Gas | 16 % | ** |
| Vendor B | Oil & Gas | ** | 10 % |
| Vendor C | Oil & Gas | 11 % | ** |
| Vendor D | Water | 11 % | ** |

** Less than 10%

Item 2 — Management's Discussion and Analysis of Financial Condition and Results of Operations

This Quarterly Report on Form 10-Q for the three months ended March 31, 2019, including "Part I, Item 2 – Management's Discussion and Analysis of Financial Condition and Results of Operations" (the "MD&A") and certain information incorporated by reference, contain 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 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," "aims," "projects," "intends," "plans," "believes," "estimates," "seeks," variations of s 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. Readers are directed to risks and uncertainties identified under "Part II, Item 1A – Risk Factors" and elsewhere in this report for factors that may cause actual results to be different from those expressed in these forward-looking statements. Except as required by law, we undertake no obligation to revise or update publicly any forward-looking statements for any reason.

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 plan to improve our existing energy recovery devices and to develop and manufacture new and enhanced versions of these devices;
- our belief that our PX® energy recovery devices are the most cost-effective energy recovery devices over time and will result in low life-cycle costs;
- our belief that our turbocharger devices have long operating lives;
- our objective of finding new applications for our technology and developing new products for use outside of desalination, including oil & gas applications;
- our expectation that our expenses for research and development and sales and marketing may increase as a result of diversification into markets outside of desalination;
- our expectation that we will continue to rely on sales of our energy recovery devices in the desalination market for a substantial portion of our revenue and that new desalination markets, including the United States ("U.S."), will provide revenue opportunities to us;
- our ability to meet projected new product development dates, anticipated cost reduction targets, or revenue growth objectives for new products;
- our belief that we can commercialize the VorTeq™ hydraulic fracturing system;
- our belief that the VorTeq enables oilfield services ("OFS") companies to migrate to more efficient pumping technology;
- our belief that we will be able to enter into a long-term licensing agreement to bring the MTeq™ solution to market;
- our belief that customers will accept and adopt our new products;
- our belief that our current facilities will be adequate for the foreseeable future;
- our expectation that sales outside of the U.S. will remain a significant portion of our revenue;

- the timing of our receipt of payment for products or services from our customers;
- 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 our latest technology arising from rapid market adoption that could require us to seek additional equity or debt financing;
- our expectation that, as we expand our international sales, a portion of our revenue could be denominated in foreign currencies and the impact of changes in exchange rates on our cash and cash equivalents and operating results;

- our expectations of the impact of the U.S. Tax Cuts and Jobs Act (“Tax Act”);
- our belief that new markets will grow in the water desalination market;
- our expectation that we will be able to enforce our intellectual property rights;
- our expectation that the adoption of new accounting standards will not have a material impact on our financial position or results of operations;
- the outcome of proceedings, lawsuits, disputes, and claim;
- the impact of losses due to indemnification obligations; and
- the impact of changes in internal control over financial reporting.

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 Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K, as well as in our Annual Reports to Stockholders and, if necessary, updated in “Part II, Item 1A – Risk Factors.” In preparing the MD&A below, we presume the readers have access to and have read the MD&A in our Annual Report on Form 10-K, pursuant to Instruction 2 to paragraph (b) of Item 303 of Regulation S-K. 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.

We provide our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, Proxy Statements, Forms 3, 4 and 5 filed by or on behalf of directors, executive officers and certain large shareholders, and any amendments to those documents filed or furnished pursuant to the Securities Exchange Act of 1934, free of charge on the Investor Relations section of our website, www.energyrecovery.com. These filings will become available as soon as reasonably practicable after such material is electronically filed with or furnished to the SEC. From time to time, we may use our website as a channel of distribution of material company information.

We also make available in the Investor Relations section of our website our corporate governance documents, including our code of business conduct and ethics and the charters of the audit, compensation, and nominating and governance committees. These documents, as well as the information on the website, are not intended to be part of this Quarterly Report on Form 10-Q. We use the Investor Relations section of our website as a means of complying with our disclosure obligations under Regulation FD. Accordingly, you should monitor the Investor Relations section of our website in addition to following our press releases, SEC filings, and public conference calls and webcasts.

Overview

Energy Recovery, Inc. (the "Company", "Energy Recovery", "we", "our" and "us") (NASDAQ: ERII) is an engineering-driven technology company that engineers, designs, manufactures and supplies solutions for industrial fluid flow processes. The Company offers technologies which can drive meaningful, immediate cost savings and operational efficiencies for our customers. Currently, we operate in two markets - water and oil & gas, and our products are utilized in these markets to either recycle and convert wasted pressure energy into a usable asset or preserve pumps that are subject to hostile processing environments.

Energy Recovery was incorporated in Virginia in 1992 and reincorporated in Delaware in 2001. Our headquarters and principal research, development, and manufacturing facility is located in California. We are also constructing a new facility in Texas, which we hope to complete in 2019, for a new commercial development center for Oil & Gas field testing and training. We maintain direct sales offices and technical support centers in Europe, the Middle East and Asia.

Our reportable operating segments consist of the Water and the Oil & Gas segments. These segments are based on the industries in which the technology solutions are sold, the type of energy recovery device or other technology sold, and the related solution and service.

Water Segment

Our Water segment consists of revenues and expenses associated with solutions sold for use in seawater, brackish, and wastewater reverse osmosis desalination. Our Water segment revenue is principally derived from the sale of energy recovery devices ("ERDs") and high-pressure and circulation pumps to our mega-project ("MPD"), original equipment manufacturer ("OEM"), and After-Market ("AM") channels. MPD sales are typically made to global Engineering, Procurement and Construction ("EPC") firms to build very large desalination plants worldwide. Our typical MPD sale consists of our PX Pressure Exchangers, and each MPD represents revenue opportunities generally ranging from $1 million to $10 million. Our packaged solutions to OEMs include PXs, turbochargers, high-pressure pumps, and circulation "booster" pumps for integration and use in small- to medium-sized desalination plants. OEM projects typically represent revenue opportunities of up to $1 million. Our existing and expanding installed base of ERD and pump products in water plants has created a growing customer base comprised of plant operators and service providers who purchase spare parts, replacement parts, and service contracts through our AM channel.

Oil & Gas Segment

Our Oil & Gas segment consists of revenues and expenses associated with solutions sold or licensed for use in hydraulic fracturing, gas processing, and chemical processing. In the past several years, we have invested significant research and development, and sales and marketing costs to expand our business into pressurized fluid flow industries within the oil & gas industry. Our revenue in the first quarter of 2019 is primarily from license and development revenue.

Results of Operations

Three Months Ended March 31, 2019 Compared to Three Months Ended March 31, 2018

Total Revenue

| | Three Months Ended March 31, | | | | | |
|---|---|---|---|---|---|---|
| | 2019 | | 2018 | | Change | |
| | $ | % of Total Revenue | $ | % of Total Revenue | $ | % |
| | (In thousands, except for percentages) | | | | | |
| Water | $15,968 | 81 % | $11,048 | 80 % | $4,920 | 45 % |
| Oil & Gas | 104 | — % | 10 | — | 94 | 940% |
| Product revenue | $16,072 | 81 % | $11,058 | 80 % | $5,014 | 45 % |
| License and development revenue | 3,723 | 19 % | 2,749 | 20 % | 974 | 35 % |
| Total revenue | $19,795 | 100 % | $13,807 | 100 % | $5,988 | 43 % |

Product Revenue by Segment

Total product revenue increased by $5.0 million, or 45%, to $16.1 million for the three months ended March 31, 2019 from $11.1 million for the three months ended March 31, 2018. Of the $5.0 million increase, $4.9 million was attributable to the Water Segment and $0.1 million was attributable to the Oil & Gas Segment.

During the three months ended March 31, 2019, compared to the three months ended March 31, 2018, Water segment product revenue increased by $4.9 million, or 45%, due primarily to an increase of $6.4 million of MPD shipments, offset by $0.9 million of lower OEM shipments and $0.6 million of lower AM shipments. Revenues in the first three months were significantly higher than in 2018 due to the timing of MPD shipments. Significant variability quarter to quarter is typical, and year on year quarterly comparisons are not necessarily indicative of the trend for the year due to these variations.

During the three months ended March 31, 2019, compared to the three months ended March 31, 2018, Oil & Gas segment product revenue increased by $0.1 million.

License and Development Revenue

License and development revenue increased by $1.0 million, or 35%, in the three months ended March 31, 2019, compared to the three months ended March 31, 2018, due primarily to higher costs incurred based on input measure of progress.

Product Gross Profit and Margin

| | Three Months Ended March 31, 2019 | | | Three Months Ended March 31, 2018 | | |
|---|---|---|---|---|---|---|
| | Water | Oil & Gas | Total | Water | Oil & Gas | Total |
| | (In thousands, except for percentages) | | | | | |
| Product gross profit | $11,221 | $(84) | $11,137 | $7,820 | $(76) | $7,744 |
| Product gross margin | 70.3% | (80.8%) | 69.3% | 70.8% | (760.0%) | 70.0% |

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 stock-based compensation), manufacturing overhead, warranty costs, depreciation expense, and manufactured components.

In the three months ended March 31, 2019, compared to the three months ended March 31, 2018, product gross profit increased $3.4 million, or 44%, due primarily to a favorable $4.8 million impact from higher MPD volume, offset somewhat by unfavorable impacts of $0.5 million from lower OEM volume, a $0.5 million impact from lower AM volume, and an unfavorable price and mix impact of $0.5 million.

Product gross margin was 69% in the three months ended March 31, 2019, compared to the product gross margin of 70% in the three months ended March 31, 2018.

Operating Income (Loss)

| | Three Months Ended March 31, 2019 | | | Three Months Ended March 31, 2018 | | |
|---|---|---|---|---|---|---|
| | Water | Oil & Gas | Total | Water | Oil & Gas | Total |
| | (In thousands) | | | | | |
| Product revenue | $15,968 | $104 | $16,072 | $11,048 | $ 10 | $11,058 |
| Product cost of revenue | 4,747 | 188 | 4,935 | 3,228 | 86 | 3,314 |
| Product gross profit | 11,221 | (84 ) | 11,137 | 7,820 | (76 ) | 7,744 |
| License and development revenue | — | 3,723 | 3,723 | — | 2,749 | 2,749 |
| Operating expenses: | | | | | | |
| General and administrative | 535 | 364 | 899 | 305 | 651 | 956 |
| Sales and marketing | 1,649 | 263 | 1,912 | 1,445 | 344 | 1,789 |
| Research and development | 804 | 3,363 | 4,167 | 244 | 3,665 | 3,909 |
| Amortization of intangibles | 156 | — | 156 | 158 | — | 158 |
| Operating expenses | 3,144 | 3,990 | 7,134 | 2,152 | 4,660 | 6,812 |
| Operating income (loss) | $8,077 | $(351) | 7,726 | 5,668 | (1,987) | 3,681 |
| Less: Corporate operating expenses | | | 5,017 | | | 5,012 |
| Consolidated operating income (loss) | | | 2,709 | | | (1,331 ) |

Operating income was $7.7 million for the three months ended March 31, 2019 compared to $3.7 million for the three months ended March 31, 2018, an increase of $4.0 million, due primarily to an increase of total product revenue of $5.0 million (attributable to the Water Segment) and an increase of $1.0 million in license and development revenue.

Operating Expenses

General and Administrative

General and administrative expense decreased $0.3 million, or (4%), in the three months ended March 31, 2019, compared to the three months ended March 31, 2018, due primarily to a decrease in total employee-related compensation and benefits of $0.3 million. The net decrease in employee-related compensation and benefits of $0.3 million is due to a $0.4 million increase in compensation generally and a $0.7 million reduction in stock based compensation costs in the current period resulting mostly from a non-recurring charge related to the modification of certain equity awards held by the Company’s former President and Chief Executive Officer in the three months ended March 31, 2018, who resigned on February 24, 2018 and entered into a Settlement Agreement and Release.

Sales and Marketing

For the three months ended March 31, 2019, compared to the three months ended March 31, 2018, sales and marketing expense increased by $0.2 million, or 13%, due primarily to higher sales incentive expenses in the water segment.

Research and Development

For the three months ended March 31, 2019, compared to the three months ended March 31, 2018, research and development expense increased by $0.3 million, or 9%, due primarily to higher employee related expenses of $0.4 million from increased investment in water growth initiatives, slightly offset by the timing of VorTeq R&D testing expenses.

Amortization of Intangible Assets

Amortization of intangible assets is related to finite-lived intangible assets acquired as a result of our purchase of Pump Engineering, LLC in December 2009. There was no material change in our amortization amounts in the three months ended March 31, 2019, compared to the three months ended March 31, 2018.

Other Income (Expense), net

| | Three Months Ended March 31, | | | | | |
|---|---|---|---|---|---|---|
| | 2019 | | 2018 | | Change | |
| | $ | % of Total Revenue | $ | % of Total Revenue | $ | % |
| | (In thousands, except for percentages) | | | | | |
| Total revenue | $19,795 | 100 % | $13,807 | 100 % | $5,988 | 43 % |
| Other income (expense): | | | | | | |
| Interest income | $523 | 3 % | $301 | 2 % | $222 | 74 % |
| Interest expense | — | — % | — | — % | — | |
| Other non-operating expense, net | (24) | — % | (53) | — % | 29 | (55 %) |
| Total other income, net | $499 | 3 % | $248 | 2 % | $251 | 101 % |

Total other income (expense), net, increased in the three months ended March 31, 2019, compared to the three months ended March 31, 2018, due primarily to interest income on higher investment balances.

Income Taxes

The effective tax rate for the three months ended March 31, 2019 and 2018 was 17.3% on pretax book income of $3.2 million and 33.0% on pretax book loss of $1.1 million, respectively. Excluding stock option related discrete tax income tax benefits of $0.1 million in the current period and $0.4 million in the prior year period, the effective tax rate for the three months ended March 31, 2019 and 2018 was 21.3% and (3.5%), respectively. The tax rate in the three months ending March 31, 2019 is lower than the tax rate in the three months ending March 31, 2018 as a result of the Company reporting losses of $1.3 million in the prior year period in a jurisdiction for which the Company could not recognize a tax benefit due to a full valuation allowance in this jurisdiction.

Liquidity and Capital Resources

Overview

Our primary source of cash to fund our operations and capital expenditures has been proceeds from customer payments for our products and services and the issuance of common stock.

As of March 31, 2019, our principal sources of liquidity consisted of : (i) unrestricted cash and cash equivalents of $17.0 million that are primarily invested in money market funds, (ii) short-term investments of $71.8 million that are primarily invested in marketable debt instruments, such as corporate notes and bonds, and U.S. Treasury securities, and (iii) accounts receivable, net of allowances of $17.4 million. We invest cash not needed for current operations predominantly in high-quality, investment-grade, marketable debt instruments with the intent to make such funds available for operating purposes as needed.

At March 31, 2019 and December 31, 2018, we had $1.1 million and $4.1 million, respectively, of short-term contract assets which represents unbilled receivables. In the Water segment, we had contract assets of $1.1 million pertaining to customer contractual holdback provisions, whereby we will invoice the final retention payment(s) due under certain sales contracts in the next 12 months. The customer holdbacks represent amounts intended to provide a form of security for the customer; accordingly, these contract assets have not been discounted to present value. In the Oil & Gas segment, there were no unbilled project costs at March 31, 2019.

Loan Agreements

On January 27, 2017, we entered into a loan and pledge agreement (the “Loan and Pledge Agreement”) with a financial institution. The Loan and Pledge Agreement provides for a committed revolving credit line of $16.0 million and an uncommitted revolving credit line of $4.0 million. Under the Loan and Pledge Agreement, we are allowed to borrow and request letters of credit against the eligible assets held from time to time in the pledged account maintained with the financial institution.

The Loan and Pledge Agreement was amended on March 30, 2018 to extend the termination date of the Loan and Pledge Agreement from March 31, 2018 to March 31, 2020. The Loan and Pledge Agreement was further amended on August 24, 2018 to permit the Company to incur indebtedness owed to a foreign subsidiary in an aggregate amount not to exceed $66.0 million, which amount is subordinated to any amounts outstanding under the Loan and Pledge Agreement. The Loan and Pledge Agreement was subsequently amended on April 8, 2019 to clarify definitions of certain terms and to allow the term of any Letter of Credit to not exceed two years instead of 364 days from the date of issuance, and in addition to permit the Company to issue Standy Letter of Credit (“SBLCs”) up to one year past the expiration date of the loan agreement. On April 23, 2019, the Loan and Pledge Agreement was amended further to clarify definition of certain additional terms.

As of March 31, 2019, no debt was outstanding under the Loan and Pledge Agreement, however, the SBLCs outstanding are deducted from the total revolving credit line. See our 2018 Annual Report on Form 10-K. As of March 31, 2019, we were in compliance with the loan covenants.

Stand-by Letters of Credit

As of March 31, 2019, we had SBLCs with various financial institutions totaling $10.7 million whereby we are required to maintain a U.S. investment balance of $10.6 million. SBLCs are subject to fees based on the amount of the letter of credit that are payable quarterly and are non-refundable.

Share Repurchase Programs

Our Board of Directors has authorized various share repurchase programs since 2012. On March 7, 2018, our Board of Directors authorized a share repurchase program (the "March 2018 Authorization") under which the Company, at the discretion of management, may repurchase up to $10.0 million in aggregate cost of our outstanding common stock through September 30, 2018. As of March 31, 2019, we have repurchased 1,193,102 shares for $10.0 million under the March 2018 Authorization. Since the initial authorization of the share repurchase programs, we have spent an aggregate $30.4 million, excluding commissions, to repurchase 5.5 million shares. The March 2018 Authorization expired in September 2018 and no other authorization is in place today.

Cash Flows

Our cash flows are presented in the following table.

| | Three Months Ended March 31, | |
|---|---|---|
| | 2019 | 2018 |
| | (In thousands) | |
| Net cash used in operating activities | $(5,951) | $(6,333) |
| Net cash (used in) provided by investing activities | (1,165) | 11,062 |
| Net cash provided by (used in) financing activities | 2,157 | (1,898) |
| Effect of exchange rate differences on cash and cash equivalents | (4) | (14) |
| Net change in cash, cash equivalents and restricted cash | $(4,963) | $2,817 |

Cash Flows from Operating Activities

Cash used in operating activities is generated by net income (loss) adjusted for certain non-cash items and changes in assets and liabilities.

Cash used in operating activities was lower in the three months ended March 31, 2019, compared to the cash used in three months ended March 31, 2018, by $0.4 million, primarily due to the increase in income net, as adjusted for some non-cash items, timing of collection, billing and shipment.

Due to the project driven, non-cyclical nature of our business, operating cash flow can fluctuate significantly from quarter to quarter due to the timing of receipts of large project orders. Operating cash flow may be negative in one quarter, and significantly positive in the next, and year-on-year quarterly comparisons are difficult to compare. Therefore, it may be difficult to derive meaning directly from quarterly comparisons of cash flow.

Cash Flows from Investing Activities

Cash flows from investing activities primarily relate to maturities and purchases of marketable securities to preserve principal and liquidity while at the same time maximizing yields without significantly increasing risk, capital expenditures to support our growth, and changes in our restricted cash used to collateralize our stand-by letters of credit and other contingent considerations.

Cash used in investing activities of $1.2 million during the three months ended March 31, 2019 was primarily due to $19.2 million used to purchase investments and $1.6 million for capital expenditures partially offset by $19.6 million in maturities of marketable security investments.

Cash provided by investing activities of $11.1 million during the three months ended March 31, 2018 was primarily due to $13.9 million used to purchase investments and $0.6 million for capital expenditures, partially offset by $25.6 million in maturities of marketable security investments.

Cash Flows from Financing Activities

Cash provided by financing activities of $2.2 million during the three months ended March 31, 2019 was primarily due to $2.2 million received from the purchase of common stock through stock option exercises.

Cash used in financing activities of $1.9 million during the three months ended March 31, 2018 was primarily due to $3.5 million used to repurchase our common stock, partially offset by $1.6 million received from the purchase of common stock through stock option exercises.

Liquidity and Capital Resource Requirements

We believe that our existing resources and cash generated from our operations will be sufficient to meet our anticipated capital requirements for at least the next 12 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 and/or fund investments in our latest technology arising from rapid market adoption that could require us to seek additional equity or debt financing. Our future capital requirements will depend on many factors, including the continuing market acceptance of our products, our rate of revenue growth, the timing of new product introductions, the expansion of our research and development, manufacturing, and sales and marketing activities, the timing and extent of our expansion into new geographic territories, and the amount and timing of cash used for stock repurchases. In addition, 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. Should we need additional liquidity or capital funds, these funds may not be available to us on favorable terms, or at all.

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, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

Recent Accounting Pronouncements

There were no material accounting pronouncements adopted during the quarter ended March 31, 2019.

Item 3 — Quantitative and Qualitative Disclosures About Market Risk

Foreign Currency Risk

Our exposures are due to fluctuations in exchange rates for USD versus the British Pound, Saudi Riyal, United Arab Emirates Dirham, Euro, Chinese Yuan, Indian Rupee and Canadian Dollar. Changes in currency exchange rates could adversely affect our consolidated operating results or financial position.

Our revenue contracts have been denominated in U.S. Dollars (“USD”). At times our international customers may have difficulty in obtaining USD to pay our receivables, thus increasing collection risk and potential doubtful account expense. As we expand our international sales, a portion of our revenue could 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.

In addition, we pay many vendors in foreign currency and therefore, are subject to changes in foreign currency exchange rates.

Our international sales and service operations incur expense that is denominated in foreign currencies. This expense could be materially affected by currency fluctuations. Our international sales and services operations also maintain cash balances denominated in foreign currencies. To decrease the inherent risk associated with translation of foreign cash balances into our reporting currency, we do not maintain excess cash balances in foreign currencies.

We have not hedged our exposure to changes in foreign currency exchange rates because expenses 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 and Credit Risk

We have an investment portfolio of fixed-income marketable debt securities, including amounts classified as cash equivalents and short-term investments. The primary objective of our investment activities is to preserve principal and liquidity while at the same time maximizing yields without significantly increasing risk. We invest primarily in investment-grade short-term debt instruments of high-quality corporate issuers and the U.S. government and its agencies. These investments are subject 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 by imposing concentration limits.

At March 31, 2019, all of our investments totaled approximately $74.3 million. These investments were presented in short-term investments and long-term investments on our Condensed Consolidated Balance Sheets as of March 31, 2019. 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 seven months. A hypothetical 1% increase in interest rates would have resulted in an approximately $0.3 million decrease in the fair value of our fixed-income debt securities as of March 31, 2019.

Item 4. — Controls and Procedures

(a) Evaluation of disclosure controls and procedures. Our management, with the participation of our President and Chief Executive Officer, and our Chief Financial Officer, 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, our President and Chief Executive Officer and our Chief Financial Officer have concluded that, as of the end of the period covered by this report, our disclosure controls and procedures are effective.

(b) Changes in internal controls. There were no changes in our internal control over financial reporting during the period covered by this report 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 16, “Litigation,” of our Annual Report on Form 10-K filed with the SEC on March 7, 2019, as amended on March 12, 2019, 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 8, “Commitments and Contingencies – Litigation,” of the Notes to Condensed Consolidated Financial Statements of this quarterly report on Form 10-Q, which discussion is incorporated by reference into this Item 1.

### Item 1A. — Risk Factors

There have 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 7, 2019.

### Item 2. — Unregistered Sales of Equity Securities and Use of Proceeds

Purchases of Equity Securities by the Issuer and Affiliated Purchasers

There has been no activity with respect to the program to repurchase outstanding units during the three months ended March 31, 2019.

Pursuant to the March 2018 Authorization, the Company, at the discretion of management, could repurchase up to $10.0 million in aggregate cost of our outstanding common stock. As of March 31, 2019, 1,193,102 shares at an aggregate cost of $10.0 million had been repurchased under the March 2018 Authorization. The aggregate cost includes fees charged in connection with acquiring the outstanding common stock.

### Item 3. — Defaults Upon Senior Securities

None.

### Item 4. — Mine Safety Disclosures

Not applicable.

### Item 5. — Other Information

None.

### Item 6. — Exhibits

See the Exhibit Index following the Signature page to this Quarterly Report on Form 10-Q for a list of exhibits filed or furnished with this report, which Exhibit Index is incorporated herein by reference.

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.

| | | |
|---|---|---|
| | | ENERGY RECOVERY, INC. |
| Dated: | May 2, 2019 | By: /s/ CHRIS GANNON<br>Chris Gannon<br>President and Chief Executive Officer |
| Dated: | May 2, 2019 | By: /s/ JOSHUA BALLARD<br>Joshua Ballard<br>Chief Financial Officer |

EXHIBIT LIST

| Exhibit Number | Exhibit Description | Incorporated by Reference | | | | Filed Herewith |
|---|---|---|---|---|---|---|
| | | Form | File No. | Exhibit | Filing Date | |
| 10.1 | Fourth Amendment to Loan and Pledge Agreement by and between Energy Recovery, Inc. and Citibank N.A. | | | | | X |
| 10.2 | Fifth Amendment to Loan and Pledge Agreement by and between Energy Recovery, Inc. and Citibank N.A. | | | | | X |
| 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. | | | | | X |
| 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. | | | | | X |
| 32.1 | Certification of Principal Executive Officer and Principal Financial Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. | | | | | X |
| 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 | | | | | |

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