

ENERGY FOCUS, INC/DE
Form 10-Q
May 05, 2015

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

Form 10-Q

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

For the quarterly period ended March 31, 2015

OR

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

For the transition period from _____ to _____

Commission file number 0-24230

ENERGY FOCUS, INC.

(Exact name of registrant as specified in its charter)

Delaware

94-3021850

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(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

32000 Aurora Road, Suite B, Solon, OH

(Address of principal executive offices)

44139

(Zip Code)

(Registrant's telephone number, including area code): **(440) 715-1300**

None

(Former Name, Former Address and Former Fiscal Year, If Changed Since Last Report)

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer", "accelerated filer", and "smaller reporting company" in

Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer (do not check if a smaller reporting company) Smaller reporting company

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

The number of outstanding shares of the registrant's Common Stock, \$0.0001 par value, as of May 1, 2015 was 10,014,766.

TABLE OF CONTENTS

PART I – FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

| | |
|---|---|
| a. Condensed Consolidated Balance Sheet as of March 31, 2015 and December 31, 2014 (Unaudited) | 3 |
| b. Condensed Consolidated Statement of Operations for the three months ended March 31, 2015 and 2014 (Unaudited) | 4 |
| c. Condensed Consolidated Statement of Comprehensive Income (Loss) for the three months ended March 31, 2015 and 2014 (Unaudited) | 5 |
| d. Condensed Consolidated Statement of Stockholders' Equity for the three months ended March 31, 2015 (Unaudited) | 6 |
| e. Condensed Consolidated Statement of Cash Flows for the three months ended March 31, 2015 and 2014 (Unaudited) | 7 |
| f. Notes to the Condensed Consolidated Financial Statements (Unaudited) | 8 |

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS 17

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK 21

ITEM 4. CONTROLS AND PROCEDURES 21

PART II – OTHER INFORMATION

ITEM 1A. RISK FACTORS 23

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS 23

ITEM 5. OTHER INFORMATION 23

ITEM 6. EXHIBITS 23

SIGNATURES 23

EXHIBIT INDEX 24

PART I – FINANCIAL INFORMATION

Forward-looking statements

Unless the context otherwise requires, all references to “Energy Focus,” “we,” “us,” “our,” “our company,” or “the Company” refer to Energy Focus, Inc., a Delaware corporation, and its subsidiaries, and their respective predecessor entities for the applicable periods, considered as a single enterprise.

This Quarterly Report on Form 10-Q (“Quarterly Report”) includes statements that express our opinions, expectations, beliefs, plans, objectives, assumptions or projections regarding future events or future results and therefore are, or may be deemed to be, “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These forward-looking statements can generally be identified by the use of forward-looking terminology, including the terms “believes,” “estimates,” “anticipates,” “expects,” “feels,” “seeks,” “forecasts,” “projects,” “intends,” “plans,” “may,” “will,” “should,” “could” or “would” or, in each case, their negative or other variations or comparable terminology. These forward-looking statements include all matters that are not historical facts. They appear in a number of places throughout this Quarterly Report and include statements regarding our intentions, beliefs, or current expectations concerning, among other things, our results of operations, financial condition, liquidity, prospects, growth, strategies, capital expenditures, and the industry in which we operate.

By their nature, forward-looking statements involve risks and uncertainties because they relate to events and depend on circumstances that may or may not occur in the future. Although we base these forward-looking statements on assumptions that we believe are reasonable when made, we caution you that forward-looking statements are not guarantees of future performance and that our actual results of operations, financial condition and liquidity, and industry developments may differ materially from statements made in or suggested by the forward-looking statements contained in this Quarterly Report. In addition, even if our results of operations, financial condition and liquidity, and industry developments are consistent with the forward-looking statements contained in this Quarterly Report, those results or developments may not be indicative of results or developments in subsequent periods.

We believe that important factors that could cause our actual results to differ materially from forward-looking statements include, but are not limited to, the risks and uncertainties outlined under “Risk Factors” under Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2014 (“2014 Annual Report”) and other matters described in this Quarterly Report generally. Some of these factors include:

our history of operating losses and our ability to generate sufficient cash from operations or receive sufficient financing, on acceptable terms, to continue our operations,

general economic conditions in the United States and in other markets in which we operate, our dependence on government customers, in particular the U.S. Navy, and on the levels of funding available to such customers and our ability to satisfactorily fulfill our contractual obligations to such customers, our ability to implement and manage our growth plans and control expenses to increase sales and improve margins, market acceptance of LED lighting technology, our ability to respond to new lighting technologies and market trends with safe and reliable products, our ability to compete effectively against companies with greater resources, our ability to protect our intellectual property rights and the impact of any type of legal claim or dispute, our reliance on a limited number of customers for a significant portion of our revenue, our ability to obtain critical components and finished products from third-party suppliers on acceptable terms, risks inherent in international markets, such as economic and political uncertainty, changing regulatory and tax requirements and currency fluctuations, our ability to maintain effective internal controls, and our ability to meet the continued listing standards of the NASDAQ Capital Market.

In light of the foregoing, we caution you not to place undue reliance on our forward-looking statements. Any forward-looking statement that we make in this Quarterly Report speaks only as of the date of such statement, and we undertake no obligation to update any forward-looking statement or to publicly announce the results of any revision to any of those statements to reflect future events or developments. Comparisons of results for current and any prior periods are not intended to express any future trends or indications of future performance, unless specifically expressed as such, and should only be viewed as historical data.

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ITEM 1. FINANCIAL STATEMENTS**ENERGY FOCUS, INC.****CONDENSED CONSOLIDATED BALANCE SHEET***(in thousands, except share and per share amounts)***(Unaudited)**

| | March 31, 2015 | December 31, 2014 |
|---|-------------------------------|----------------------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$8,869 | \$ 7,531 |
| Trade accounts receivable less allowances of \$296 and \$323, respectively | 3,126 | 3,113 |
| Inventories, net | 10,826 | 7,283 |
| Prepaid and other current assets | 991 | 1,002 |
| Total current assets | 23,812 | 18,929 |
| Property and equipment, net | 539 | 479 |
| Other assets | 86 | 88 |
| Total assets | \$24,437 | \$ 19,496 |
| LIABILITIES | | |
| Current liabilities: | | |
| Accounts payable | \$7,061 | \$ 7,601 |
| Accrued liabilities | 1,215 | 1,209 |
| Accrued warranty reserve | 503 | 188 |
| Deferred revenue | 236 | 133 |
| Billings in excess of costs and estimated earnings on uncompleted contracts | - | 23 |
| Credit line borrowings | 1,726 | 453 |
| Total current liabilities | 10,741 | 9,607 |
| Other liabilities | 89 | 46 |
| Long-term debt | 70 | 70 |
| Total liabilities | 10,900 | 9,723 |
| STOCKHOLDERS' EQUITY | | |
| <i>Preferred stock, par value \$0.0001 per share:</i> | | |
| Authorized: 2,000,000 shares in 2015 and 2014 | | |
| Issued and outstanding: no shares in 2015 and 2014 | | |
| | - | - |
| <i>Common stock, par value \$0.0001 per share:</i> | | |

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Authorized: 15,000,000 shares in 2015 and 2014

Issued and outstanding: 10,013,169 at March 31, 2015 and

9,423,975 at December 31, 2014

Additional paid-in capital

1 1
100,741 98,133

Accumulated other comprehensive income

496 469

Accumulated deficit

(87,701) (88,830)

Total stockholders' equity

13,537 9,773

Total liabilities and stockholders' equity

\$24,437 \$ 19,496

The accompanying notes are an integral part of these condensed consolidated financial statements.

ENERGY FOCUS, INC.**CONDENSED CONSOLIDATED STATEMENT OF OPERATIONS***(in thousands, except per share amounts)***(Unaudited)**

| | Three months ended March 31, 2015 2014 | |
|---|--|-----------|
| Net sales | \$13,145 | \$4,919 |
| Cost of sales | 7,743 | 3,497 |
| Gross profit | 5,402 | 1,422 |
| Operating expenses: | | |
| Product development | 543 | 191 |
| Selling, general, and administrative | 3,624 | 2,304 |
| Total operating expenses | 4,167 | 2,495 |
| Income (loss) from operations | 1,235 | (1,073) |
| Other expenses: | | |
| Interest expense | 23 | 2,618 |
| Other expenses | 57 | 360 |
| Income (loss) from continuing operations before income taxes | 1,155 | (4,051) |
| Benefit from income taxes | 10 | 1 |
| Income (loss) from continuing operations | 1,165 | (4,050) |
| Discontinued operations: | | |
| Loss from discontinued operations | - | (20) |
| Loss on sale of discontinued operations | (36) | - |
| Loss from discontinued operations | (36) | (20) |
| Net income (loss) | \$1,129 | \$(4,070) |
| Net income (loss) per share - basic: | | |
| Income (loss) from continuing operations | \$0.12 | \$(0.79) |
| Loss from discontinued operations | - | - |
| Net income (loss) per share - basic | \$0.12 | \$(0.79) |
| Net income (loss) per share -diluted: | | |
| Income (loss) from continuing operations | \$0.11 | \$(0.79) |
| Loss from discontinued operations | - | - |

| | | |
|--|--------|-----------|
| Net income (loss) per share - diluted | \$0.11 | \$(0.79) |
|--|--------|-----------|

Weighted average shares used in computing net income (loss) per share:

| | | |
|---------|-------|-------|
| Basic | 9,671 | 5,172 |
| Diluted | 9,993 | 5,172 |

The accompanying notes are an integral part of these condensed consolidated financial statements.

ENERGY FOCUS, INC.

CONDENSED CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME (LOSS)

(in thousands)

(Unaudited)

| | Three months ended March 31, 2015 2014 | |
|--|---|------------|
| Net income (loss) | \$ 1,129 | \$ (4,070) |
| Other comprehensive income: | | |
| Foreign currency translation adjustments | 27 | 2 |
| Comprehensive income (loss) | \$ 1,156 | \$ (4,068) |

The accompanying notes are an integral part of these condensed consolidated financial statements.

ENERGY FOCUS, INC.

CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

*(in thousands)***(Unaudited)**

| | Common Stock Shares | Amount | Additional Paid-in Capital | Accumulated Other Comprehensive Income | Accumulated Deficit | Total Stockholders' Equity |
|---|------------------------------------|---------------|---|---|--------------------------------|---|
| Balance at December 31, 2014 | 9,424 | \$ 1 | \$98,133 | \$ 469 | \$ (88,830) | \$ 9,773 |
| Issuance of common stock under employee stock option and stock purchase plans | 9 | | 2 | | | 2 |
| Stock-based compensation - options and restricted stock units | | | 112 | | | 112 |
| Issuance of common stock upon the exercise of warrants | 580 | | 2,494 | | | 2,494 |
| Foreign currency translation adjustment | | | | 27 | | 27 |
| Net income | | | | | 1,129 | 1,129 |
| Balance at March 31, 2015 | 10,013 | \$ 1 | \$ 100,741 | \$ 496 | \$ (87,701) | \$ 13,537 |

The accompanying notes are an integral part of these condensed consolidated financial statements.

ENERGY FOCUS, INC.

CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS

*(in thousands)***(Unaudited)**

| | Three months ended March 31, 2015 2014 | |
|---|--|----------------|
| Cash flows from operating activities: | | |
| Net income (loss) | \$1,129 | \$(4,070) |
| Adjustments to reconcile net income (loss) to net cash used in operating activities: | | |
| Depreciation | 52 | 57 |
| Stock-based compensation | 112 | 123 |
| Provision for doubtful accounts receivable | 99 | (6) |
| Amortization of intangible assets | - | 14 |
| Amortization of discounts on long-term borrowings and acquisition related liabilities | - | 2,815 |
| Amortization of loan origination fees | 11 | 55 |
| Changes in operating assets and liabilities: | | |
| Trade accounts receivable, inventories, and other assets | (3,677) | 1,017 |
| Accounts payable, accrued liabilities, and accrued warranty reserve | (124) | (1,685) |
| Deferred revenue | 81 | (410) |
| Total adjustments | (3,446) | 1,980 |
| Net cash used in operating activities | (2,317) | (2,090) |
| Cash flows from investing activities: | | |
| Proceeds from the sale of property and equipment | - | 130 |
| Acquisitions of property and equipment | (112) | (37) |
| Net cash (used in) provided by investing activities | (112) | 93 |
| Cash flows from financing activities: | | |
| Proceeds from warrants exercised | 2,494 | - |
| Proceeds from exercise of stock options and purchases through employee stock purchase plan | 2 | 1 |
| Payments on other borrowings | - | (14) |
| Net proceeds on credit line borrowings | 1,273 | 1,109 |
| Net cash provided by financing activities | 3,769 | 1,096 |
| Effect of exchange rate changes on cash | (2) | 1 |
| Net increase (decrease) in cash and cash equivalents | 1,338 | (900) |
| Cash and cash equivalents, beginning of period | 7,531 | 2,860 |
| Cash and cash equivalents, end of period | \$8,869 | \$1,960 |

Classification of cash and cash equivalents:

| | | |
|--|---------|---------|
| Cash and cash equivalents | \$8,472 | \$1,497 |
| Restricted cash held | 97 | 63 |
| Cash held in escrow | 300 | 400 |
| Cash and cash equivalents, end of period | \$8,869 | \$1,960 |

Supplemental information - non-cash financing activities:

| | | |
|---|-----|---------|
| Conversion of subordinated convertible debt to equity, net of discount amortization | \$- | \$3,858 |
|---|-----|---------|

The accompanying notes are an integral part of these condensed consolidated financial statements.

ENERGY FOCUS, INC.

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2015

(Unaudited)

NOTE 1. NATURE OF OPERATIONS

Energy Focus, Inc. and its subsidiaries engage in the design, development, manufacturing, marketing, and installation of energy-efficient lighting systems. Prior to 2015, we provided turnkey, high-quality, energy-efficient lighting application alternatives, primarily to the existing public-sector building market, and reported this business as a separate “solutions” segment. However, in the third quarter of 2014, we began shifting our focus away from the turnkey solutions business to align our resources with developing and selling our energy-efficient LED products into the commercial and government markets. During the first quarter of 2015, we completed all outstanding solutions-based jobs and are no longer accepting new solutions-based jobs. As such, our management has determined that the Company operates in a single industry segment.

Additionally, product development remains a key focus for us. Our product development team is dedicated to developing and designing leading-edge technology LED lighting products, and we have curtailed our efforts on bidding on research contracts and grants.

NOTE 2. BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of presentation

The condensed consolidated financial statements (“financial statements”) include the accounts of the Company and its subsidiaries, Energy Focus LED Solutions, LLC (“EFLS”) in Solon, Ohio, and Crescent Lighting Limited (“CLL”), and its subsidiary, Energy Focus Europe, Ltd, each located in the United Kingdom. All significant inter-company balances and transactions have been eliminated.

We have prepared the accompanying financial data for the three months ended March 31, 2015 and 2014 pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”). Certain information and footnote

disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States (“U.S. GAAP”) have been condensed or omitted pursuant to such rules and regulations. The accompanying financial data and information should be read in conjunction with our 2014 Annual Report.

In the opinion of management, the accompanying financial statements contain all normal and recurring adjustments necessary to present fairly our Condensed Consolidated Balance Sheet as of March 31, 2015 and December 31, 2014, Condensed Consolidated Statement of Operations for the three months ended March 31, 2015 and 2014, Condensed Consolidated Statement of Comprehensive Income (Loss) for the three months ended March 31, 2015 and 2014, Condensed Consolidated Statement of Stockholders’ Equity for the three months ended March 31, 2015, and Condensed Consolidated Statement of Cash Flows for the three months ended March 31, 2015 and 2014.

Use of estimates

The preparation of financial statements in accordance with U.S. GAAP requires management to make estimates and assumptions that affect the amounts reported in our financial statements and accompanying notes. Management bases its estimates on historical experience and various other assumptions believed to be reasonable. Although these estimates are based on management’s best knowledge of current events and actions that may impact us in the future, actual results may vary from the estimates. Estimates include, but are not limited to, the establishment of reserves for accounts receivable, sales returns, inventory obsolescence and warranty claims; the useful lives of property and equipment; revenues recognized on a percentage-of-completion basis; and stock-based compensation. In addition, estimates and assumptions associated with the determination of the fair value of financial instruments and evaluation of long-lived assets for impairment requires considerable judgment. Actual results could differ from those estimates and such differences could be material.

Reclassifications

Certain prior period amounts have been reclassified within the financial statements, and related notes thereto, to be consistent with current period presentation.

ENERGY FOCUS, INC.

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2015

(Unaudited)

Certain risks and concentrations

We had certain customers whose net sales individually represented 10 percent or more of our total net sales, or whose net trade accounts receivable balance individually represented 10 percent or more of our total net trade accounts receivable, as follows:

For the three months ended March 31, 2015 and 2014, one customer accounted for approximately 82 percent and two customers accounted for approximately 34 percent of net sales, respectively.

At March 31, 2015, one customer accounted for approximately 78 percent of net trade accounts receivable. At December 31, 2014, three customers accounted for approximately 79 percent of net trade accounts receivable.

Recent accounting pronouncements

In January 2015, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2015-01, *Income Statement—Extraordinary and Unusual Items (Subtopic 225-20): Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items*, which provides guidance on simplifying income statement presentation by eliminating the concept of extraordinary items from U.S. GAAP. The amendments in this update are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. A reporting entity may apply the amendments prospectively and retrospectively to all periods presented in the financial statements. Early adoption is permitted provided that the guidance is applied from the beginning of the fiscal year of adoption. We have evaluated the accounting guidance and determined that there is no impact of this update to our consolidated financial statements.

In May 2014, the FASB issued ASU No. 2014-09, *Revenue Recognition - Revenue from Contracts with Customers*, which is a comprehensive revenue recognition standard that will supersede nearly all existing revenue recognition

guidance under U.S. GAAP. The standard is effective for interim and annual periods beginning after December 15, 2016, however, the FASB has proposed a one-year deferral. Either full retrospective adoption or modified retrospective adoption is permitted. We are in the process of evaluating the impact of the standard.

In April 2014, the FASB issued ASU No. 2014-08, *Presentation of Financial Statements (Topic 205) and Property, Plant, and Equipment (Topic 360): Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity*, which changes the criteria for reporting discontinued operations while enhancing disclosures in this area. Under the new guidance, only disposals representing a strategic shift in operations should be presented as discontinued operations. Those strategic shifts should have a major effect on the organization's operations and financial results. Examples include a disposal of a major geographic area, a major line of business, or a major equity method investment. Additionally, the new guidance requires expanded disclosures about discontinued operations that will provide financial statement users with more information about the assets, liabilities, income, expenses of discontinued operations and of the pretax income attributable to a disposal of a significant part of an organization that does not qualify for discontinued operations reporting. The new standard is effective for interim and annual periods beginning after December 15, 2014. We have evaluated the accounting guidance and determined that this update will have no effect on our consolidated financial statements.

Update to significant accounting policies

There have been no material changes to our significant accounting policies, as compared to those described in our 2014 Annual Report.

ENERGY FOCUS, INC.**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****MARCH 31, 2015****(Unaudited)****Net income (loss) per share**

Basic earnings (loss) per share is computed by dividing net income (loss) available to common stockholders by the weighted average number of common shares outstanding during the period, excluding the effects of any potentially dilutive securities. Diluted earnings (loss) per share gives effect to all dilutive potential common shares outstanding during the period. Dilutive potential common shares consist of incremental shares upon the exercise of stock options and warrants, unless the effect would be anti-dilutive.

The following is a reconciliation of the numerator and denominator of the basic and diluted net income (loss) per share computations for the periods presented below (in thousands):

| | Three months ended March 31, 2015 2014 | |
|---|--|------------------|
| Numerator: | | |
| Income (loss) from continuing operations | \$1,165 | \$(4,050) |
| Loss from discontinued operations | (36) | (20) |
| Net income (loss) | \$1,129 | \$(4,070) |
| Denominator: | | |
| Basic weighted average common shares outstanding | 9,671 | 5,172 |
| Potential common shares from options and warrants | 322 | - |
| Diluted weighted average shares | 9,993 | 5,172 |

As a result of the net loss we incurred for the three months ended March 31, 2014, approximately 3.0 million options, warrants, and convertible securities were excluded from the loss per share calculation, as their inclusion would have been anti-dilutive.

Product warranties

We warrant finished goods against defects in material and workmanship under normal use and service for periods generally between one and five years. Settlement costs consist of actual amounts expensed for warranty which are largely a result of the cost of replacement products. A liability for the estimated future costs under product warranties is maintained for products and services outstanding under warranty. The following table summarizes warranty activity for the periods indicated (in thousands):

| | Three months ended March 31, 2015 2014 | |
|---|---|--------------|
| Balance at beginning of period | \$ 188 | \$ 75 |
| Accruals for warranties issued | 352 | 16 |
| Settlements made during the period (in cash or in kind) | (37) | (16) |
| Accrued warranty reserve | \$ 503 | \$ 75 |

NOTE 3. DISCONTINUED OPERATIONS

In November 2013, we sold our pool products business for a cash purchase price of \$5.2 million. The Purchase Agreement provided for an escrow of \$500 thousand of the purchase price to secure customary indemnification obligations with respect to our representations, warranties, covenants and other obligations under the Purchase Agreement. At March 31, 2015, \$300 thousand remained in escrow subject to the resolution of outstanding buyer claims. For more information on the cash remaining in escrow, please refer to Note 17. Legal matters, included under Item 8 of our 2014 Annual Report.

ENERGY FOCUS, INC.**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****MARCH 31, 2015****(Unaudited)****NOTE 4. INVENTORIES**

Inventories are stated at the lower of standard cost (which approximates actual cost determined using the first-in, first-out cost method) or market and consists of the following, net of reserves (in thousands):

| | March 31, 2015 | December 31, 2014 |
|-------------------------|-------------------------------|----------------------------------|
| Raw materials | \$4,149 | \$ 3,183 |
| Finished goods | 6,677 | 4,100 |
| Inventories, net | \$10,826 | \$ 7,283 |

NOTE 5. PROPERTY AND EQUIPMENT

Property and equipment are stated at cost and depreciated using the straight-line method over the estimated useful lives of the related assets and consist of the following (in thousands):

| | March 31, 2015 | December 31, 2014 |
|---|-------------------------------|----------------------------------|
| Equipment (useful life 3 - 15 years) | \$1,529 | \$ 1,495 |
| Tooling (useful life 2 - 5 years) | 864 | 865 |
| Furniture and fixtures (useful life 5 years) | 92 | 92 |
| Computer software (useful life 3 years) | 448 | 452 |
| Leasehold improvements (the shorter of useful life or lease life) | 569 | 572 |

| | | |
|---------------------------------------|---------|----------|
| Construction in progress | 85 | 18 |
| Property and equipment at cost | 3,587 | 3,494 |
| Less: accumulated depreciation | (3,048) | (3,015) |
| Property and equipment, net | \$539 | \$ 479 |

Depreciation expense was \$52 thousand and \$57 thousand for the three months ended March 31, 2015 and 2014, respectively.

NOTE 6. CONTRACTS IN PROGRESS

Costs and estimated earnings on contracts in progress as of the periods indicated are summarized in the following table (in thousands):

| | March 31, 2015 | December 31, 2014 |
|---|-------------------------------|----------------------------------|
| Costs incurred on uncompleted contracts | \$2,704 | \$ 6,707 |
| Estimated earnings | 763 | 1,507 |
| Total revenues | 3,467 | 8,214 |
| Less: billings to date | 3,467 | 8,237 |
| Total | \$- | \$ (23) |

Balance sheet classification:

| | | |
|---|-----|-------|
| Billings in excess of costs and estimated earnings on uncompleted contracts | \$- | \$ 23 |
|---|-----|-------|

ENERGY FOCUS, INC.

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2015

(Unaudited)

NOTE 7. DEBT

Credit facilities

On December 22, 2011, we entered into a \$4.5 million revolving line of credit (“credit facility”) with Rosenthal & Rosenthal. The total loan amount available to us under the line of credit is equal to 85 percent of our net, eligible receivables, plus available inventory (50 percent of the lower of cost or market value of eligible inventory, or \$250 thousand, whichever is less). The credit facility is secured by a lien on our domestic assets. The interest rate for borrowing on accounts receivable is 8.5 percent, on inventories 10 percent, and on overdrafts 13 percent. Additionally, there is an annual 1 percent facility fee on the entire \$4.5 million amount of the credit facility payable at the beginning of the year. The agreement automatically renews from year to year after December 31, 2014, unless we provide the requisite notice to Rosenthal. Additionally, Rosenthal has the right to terminate the agreement by providing 60 days written notice to us. We have not received such notice from Rosenthal. We are required to comply with certain financial covenants, measured quarterly, including, as defined in the agreement: a tangible net worth amount and a working capital amount. We were in compliance with the financial covenants as of March 31, 2015. Borrowings under the revolving line of credit were \$1.7 million and \$453 thousand at March 31, 2015 and December 31, 2014, respectively, and were recorded in the Condensed Consolidated Balance Sheet as a current liability under the caption “Credit line borrowings.” At March 31, 2015, there was approximately \$708 thousand available for us to borrow under this line of credit.

In January 2015, the invoice discounting arrangement we had in place for our subsidiary in the United Kingdom was terminated. As of March 31, 2015, we had not entered into any new financing arrangements for the subsidiary. Under the terms of the old arrangement, the amount available for borrowing was based at 80 percent of their eligible sales ledger. The interest rate for borrowing under the arrangement was 3.02 percent. While the arrangement was still in effect as of December 31, 2014; there were no borrowings outstanding.

Borrowings

The components of our debt at March 31, 2015 and December 31, 2014 were as follows (in thousands):

| | March 31, 2015 | December 31, 2014 |
|---|-------------------------------|----------------------------------|
| Unsecured promissory note - Quercus Trust (1) | \$ 70 | \$ 70 |
| Long-term debt | \$ 70 | \$ 70 |

(1) Note matures on June 1, 2109 and bears interest at 1 percent.

For a full description of our debt financing, please refer to Note 9, Debt, included under Item 8 of our 2014 Annual Report.

NOTE 8. GEOGRAPHIC INFORMATION

The following provides a geographic summary of our net sales for the periods indicated (in thousands):

| | Three months ended March 31, 2015 2014 | |
|------------------|--|----------------|
| United States | \$12,603 | \$4,283 |
| International | 542 | 636 |
| Net sales | \$13,145 | \$4,919 |

ENERGY FOCUS, INC.**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****MARCH 31, 2015****(Unaudited)**

A geographic summary of long-lived fixed assets is as follows (in thousands):

| | March 31, 2015 | December 31, 2014 |
|-------------------------------|-------------------------------|----------------------------------|
| United States | \$ 520 | \$ 456 |
| International | 19 | 23 |
| Long-lived assets, net | \$ 539 | \$ 479 |

NOTE 9. INCOME TAXES

Benefit from income taxes for the three months ended March 31, 2015 was a result of CLL, our United Kingdom subsidiary, receiving refundable research and development tax credits.

At March 31, 2015, we had a full valuation allowance recorded against our deferred tax assets. The valuation allowance was recorded due to uncertainties related to our ability to utilize the deferred tax assets; primarily consisting of certain net operating losses carried forward. The valuation allowance is based upon management's estimates of taxable income by jurisdiction and the periods over which the deferred tax assets will be recoverable.

At December 31, 2014, we had a net operating loss carry-forward of approximately \$75.4 million for U.S. federal, state, and local income tax purposes. However, due to changes in our capital structure, approximately \$23.9 million of this amount is available after the application of Internal Revenue Code Section 382 limitations. If not utilized, these carry-forwards will begin to expire in 2021 for federal purposes and have already started expiring for state and local purposes. At December 31, 2014, we had a foreign net operating loss carry-forward of approximately \$1.6 million, denominated in British pounds and based on the exchange rate at that date, related to our operations in the United Kingdom. Based on current tax law in the United Kingdom, net operating losses may be carried forward to offset

future profits of the same trade for an indefinite period of time until fully utilized. For a full discussion of the estimated restrictions on our utilization of net operating loss carry-forwards, please refer to Note 14, Income taxes, included under Item 8 of our 2014 Annual Report.

NOTE 10. STOCKHOLDERS' EQUITY

Warrants

A summary of warrant activity for the three months ended March 31, 2015 is shown as follows:

| | Warrants Outstanding | Weighted Average Exercise Price During Period |
|---|---------------------------------|--|
| Outstanding at December 31, 2014 | 969,549 | \$ 4.61 |
| Exercised | (580,000) | 4.30 |
| Cancelled/forfeited | (55,000) | 4.30 |
| Expired | (240,000) | 5.34 |
| Outstanding at March 31, 2015 | 94,549 | \$ 4.82 |

ENERGY FOCUS, INC.**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****MARCH 31, 2015****(Unaudited)****Stock-based compensation**

On May 6, 2014, our Board of Directors approved the Energy Focus, Inc. 2014 Stock Incentive Plan (the “2014 Plan”). The 2014 Plan was approved by the stockholders at our annual meeting on July 15, 2014, after which no further awards could be issued under the Energy Focus, Inc. 2008 Incentive Stock Plan (the “2008 Plan”). The 2014 Plan allows for awards up to 600,000 shares of common stock and expires on July 15, 2024. The 2014 Plan is described in further detail in our 2014 Annual Report.

Stock-based compensation expense is attributable to stock options and restricted stock unit awards. For all stock-based awards, we recognize expense using a straight-line amortization method.

The following table summarizes stock-based compensation expense and the impact it had on operations for the periods indicated (in thousands):

| | Three months ended March 31, 2015 2014 | |
|---------------------------------------|---|--------------|
| Cost of sales | \$3 | \$2 |
| Product development | 3 | (1) |
| Selling, general, and administrative | 106 | 122 |
| Total stock-based compensation | \$112 | \$123 |

Total unearned stock-based compensation was \$1.1 million at March 31, 2015, compared to \$601 thousand at March 31, 2014. These costs will be charged to expense and amortized on a straight line basis in subsequent periods. The

weighted average period over which the unearned compensation at March 31, 2015 is expected to be recognized is approximately 2.6 years.

Stock options

The fair value of each stock option is estimated on the date of grant using the Black-Scholes option pricing model. Estimates utilized in the calculation include the expected life of the option, risk-free interest rate, and expected volatility, and are further comparatively detailed as follows:

| | Three months ended March 31, 2015 2014 | |
|------------------------------------|--|--------|
| Fair value of options issued | \$4.07 | \$3.25 |
| Exercise price | \$5.47 | \$4.23 |
| Expected life of option (in years) | 5.9 | 5.6 |
| Risk-free interest rate | 1.7 % | 1.8 % |
| Expected volatility | 91.3% | 98.0% |
| Dividend yield | 0 % | 0 % |

ENERGY FOCUS, INC.**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****MARCH 31, 2015****(Unaudited)**

A summary of option activity under all plans for the three months ended March 31, 2015 is shown as follows:

| | Number of Options | Weighted Average Exercise Price Per Share | Weighted Average Remaining Contractual Life (in years) |
|---|----------------------------------|--|---|
| Outstanding at December 31, 2014 | 459,271 | \$ 8.95 | |
| Granted | 208,500 | 5.47 | |
| Exercised | (321) | 2.30 | |
| Cancelled/forfeited | (47,947) | 6.35 | |
| Outstanding at March 31, 2015 | 619,503 | \$ 7.98 | 8.5 |
| Vested and expected to vest at March 31, 2015 | 545,159 | \$ 7.35 | 8.4 |
| Exercisable at March 31, 2015 | 304,654 | \$ 10.71 | 7.5 |

Restricted stock units

A summary of restricted stock unit activity under all plans for the three months ended March 31, 2015 is shown as follows:

| Restricted Stock Units | Weighted Average Grant Date Fair Value | Weighted Average Remaining Contractual Life (in |
|---------------------------------------|---|--|
|---------------------------------------|---|--|

years)

| | | | |
|----------------------------------|--------|---------|-----|
| Outstanding at December 31, 2014 | - | \$ - | |
| Granted | 60,750 | 5.47 | |
| Outstanding at March 31, 2015 | 60,750 | \$ 5.47 | 2.0 |

NOTE 11. RELATED PARTY TRANSACTIONS

On December 12, 2012, our Board of Directors appointed James Tu to serve as our non-executive Chairman. On April 30, 2013, Mr. Tu became the Executive Chairman assuming the duties of the Principal Executive Officer. On October 30, 2013 Mr. Tu was appointed Executive Chairman and Chief Executive Officer by the Board of Directors. Mr. Tu is also the Founder, Chief Executive Officer and Chief Investment Officer of 5 Elements Global Advisors, an investment advisory and management company managing the holdings of 5 Elements Global Fund LP, which was a beneficial owner of more than 5 percent of our common stock prior to the August 2014 registered offering. 5 Elements Global Advisors focuses on investing in clean energy companies with breakthrough, commercialized technologies, and near-term profitability potential. Mr. Tu is also Co-Founder and Managing Partner of Communal International Ltd. (“Communal”), a British Virgin Islands company dedicated to assisting clean energy, solutions-based companies, maximizing technology and product potential and gaining them access to global marketing, distribution licensing, manufacturing and financing resources. Communal has a 50 percent ownership interest in 5 Elements Energy Efficiencies (BVI) Ltd., a beneficial owner of more than 5 percent of our common stock. Yeh-Mei Cheng controls 5 Elements Energy Efficiencies (BVI) Ltd. and owns the other 50 percent. She is Co-Founder of Communal International Ltd. with Mr. Tu and the mother of Simon Cheng, a current member of our Board of Directors and an employee of the Company.

On February 27, 2012, we entered into an Asian Business Development/Collaboration Agreement with Communal. The agreement has a 60 month term. Additionally, during the term of the agreement, we will pay Communal a 5 percent commission on the net sales that occur within the territory, as defined by the agreement. We have incurred no commissions due under this agreement through March 31, 2015.

ENERGY FOCUS, INC.

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2015

(Unaudited)

Effective January 1, 2013, the Asian Business Development/Collaboration Agreement with Communal was amended to reflect the extension of the terms of the Agreement for an additional twelve months, and the addition of certain services and countries in the territory covered by the Agreement. In connection with the amended and restated Agreement, nothing was paid during the first quarter of 2015 or 2014, respectively. We recorded expense of \$56 thousand under this agreement during the first quarter of 2015 and 2014, respectively. At March 31, 2015, we had \$170 thousand relating to this agreement included under the caption, "Prepaid and other current assets" in the Condensed Consolidated Balance Sheet.

NOTE 12. COMMITMENTS AND CONTINGENCIES

On December 22, 2014, a former employee filed a lawsuit against us in the Superior Court of the State of California, County of San Diego, known as Merl Toyer v. Energy Focus, Inc., et al., alleging wrongful termination and other claims related to his employment with us. We subsequently removed the case to the United States District Court for the Southern District of California. On May 1, 2015, we entered into a settlement agreement with the plaintiff, which assigns no culpability to any party and provides for a payment by us in exchange for full settlement and release of his claims. At March 31, 2015, we had approximately \$240 thousand recorded in Selling, general, and administrative expenses for the amount we expect to pay in May 2015.

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

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with the financial statements and related notes thereto, included under Item 1 of this Quarterly Report, as well as the section entitled “Management’s Discussion and Analysis of Financial Condition and Results of Operations” included under Item 7 of our 2014 Annual Report.

Overview

Energy Focus, Inc. and its subsidiaries engage in the design, development, manufacturing, marketing, and installation of energy-efficient lighting systems. Prior to 2015, we provided turnkey, high-quality, energy-efficient lighting application alternatives, primarily to the existing public-sector building market, and reported this business as a separate “solutions” segment. However, in the third quarter of 2014, we began shifting our focus away from the turnkey solutions business to align our resources with developing and selling our energy-efficient LED products into the commercial and government markets. During the first quarter of 2015, we completed all outstanding solutions-based jobs and are no longer accepting new solutions-based jobs. As such, our management has determined that the Company operates in a single industry segment.

Additionally, product development remains a key focus for us. Our product development team is dedicated to developing and designing leading-edge technology LED lighting products, and we have curtailed our efforts on bidding on research contracts and grants.

Results of operations

The following table sets forth items in our Condensed Consolidated Statement of Operations as a percentage of net sales for the periods indicated:

| | Three months ended March 31, 2015 2014 | |
|------------------|--|--------|
| Net sales | 100.0% | 100.0% |

| | | |
|---|--------|----------|
| Cost of sales | 58.9 | 71.1 |
| Gross profit | 41.1 | 28.9 |
| Operating expenses: | | |
| Product development | 4.1 | 3.9 |
| Selling, general, and administrative | 27.6 | 46.8 |
| Total operating expenses | 31.7 | 50.7 |
| Income (loss) from operations | 9.4 | (21.8) |
| Other expenses: | | |
| Interest expense | 0.2 | 53.2 |
| Other expenses | 0.4 | 7.3 |
| Income (loss) from continuing operations before income taxes | 8.8 | (82.3) |
| Benefit from income taxes | 0.1 | - |
| Income (loss) from continuing operations | 8.9 | (82.3) |
| Discontinued operations: | | |
| Income (loss) from continuing operations | - | (0.4) |
| Loss on sale of discontinued operations | (0.3) | - |
| Loss from discontinued operations | (0.3) | (0.4) |
| Net income (loss) | 8.6 % | (82.7)% |

A further breakdown of our net sales is shown as follows (in thousands):

| | Three months ended March 31, 2015 2014 | |
|--|--|---------|
| Turnkey solutions (formerly our "Solutions" segment) | \$23 | \$2,188 |
| Commercial products | 2,303 | 1,230 |
| Government products | 10,802 | 1,478 |
| R&D services | 17 | 23 |
| Total net sales | \$13,145 | |