Energy Recovery, Inc.
Form 10-Q
November 05, 2015

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2015
OR
TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from ____________ to __________

Commission File Number: 001-34112

Energy Recovery, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**01-0616867**
(State or other jurisdiction of incorporation)	(IRS Employer Identification No.)
1717 Doolittle Drive, San Leandro, CA	**94577**
(Address of Principal Executive Offices)	(Zip Code)

(510) 483-7370

(Registrant's Telephone Number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Exchange Act Rule 12b-2).

Yes No

As of November 2, 2015, there were 54,838,283 shares of the registrant's common stock outstanding.

ENERGY RECOVERY, INC.

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

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PART I — FINANCIAL INFORMATION

Item 1. Financial Statements (unaudited)

ENERGY RECOVERY, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except share data and par value)

(unaudited)

	September 30, 2015	**Dececmber 31, 2014**
ASSETS		
Current assets:		
Cash and cash equivalents	$ 21,498	$ 15,501
Restricted cash	1,385	2,623
Short-term investments	1,344	13,072
Accounts receivable, net of allowance for doubtful accounts of $164 and $155 at September 30, 2015 and December 31, 2014, respectively	8,060	10,941
Unbilled receivables, current	828	1,343
Inventories	8,893	8,204
Income taxes receivable	5	—
Deferred tax assets, net	240	240
Prepaid expenses and other current assets	1,506	1,317
Total current assets	43,759	53,241
Restricted cash, non-current	2,232	2,850
Unbilled receivables, non-current	420	414
Long-term investments	—	267
Property and equipment, net of accumulated depreciation of $17,556 and $15,143 at September 30, 2015 and December 31, 2014, respectively	11,346	13,211
Goodwill	12,790	12,790
Other intangible assets, net	2,690	3,166
Other assets, non-current	2	2
Total assets	$ 73,239	$ 85,941
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		

Accounts payable	$ 1,683	$ 1,817
Accrued expenses and other current liabilities	4,835	8,427
Income taxes payable	—	4
Accrued warranty reserve	600	755
Deferred revenue	948	519
Current portion of long-term debt	11	—
Total current liabilities	8,077	11,522
Long-term debt, net of current portion	39	—
Deferred tax liabilities, non-current, net	2,160	1,989
Deferred revenue, non-current	79	59
Other non-current liabilities	764	2,453
Total liabilities	11,119	16,023
Commitments and Contingencies (Note 9)		
Stockholders' equity:		
Preferred stock, $0.001 par value; 10,000,000 shares authorized; no shares issued or outstanding	—	—
Common stock, $0.001 par value; 200,000,000 shares authorized; 54,736,742 shares issued and 52,257,286 shares outstanding at September 30, 2015, and 54,398,421 shares issued and 51,918,965 shares outstanding at December 31, 2014	55	54
Additional paid-in capital	128,566	124,440
Accumulated other comprehensive loss	(48)	(73)
Treasury stock, at cost 2,479,456 shares repurchased at both September 30, 2015 and December 31, 2014	(6,835)	(6,835)
Accumulated deficit	(59,618)	(47,668)
Total stockholders' equity	62,120	69,918
Total liabilities and stockholders' equity	$ 73,239	$ 85,941

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements

ENERGY RECOVERY, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

(unaudited)

	Three Months Ended		**Nine Months Ended**	
	September 30,		**September 30,**	
	2015	**2014**	**2015**	**2014**
Net revenue	$12,112	$5,342	$28,460	$15,646
Cost of revenue	4,948	3,007	12,315	7,991
Gross profit	7,164	2,335	16,145	7,655
Operating expenses:				
General and administrative	3,590	3,078	15,230	8,112
Sales and marketing	2,195	2,351	6,622	7,548
Research and development	1,474	2,131	5,417	5,089
Amortization of intangible assets	159	216	476	646
Total operating expenses	7,418	7,776	27,745	21,395
Loss from operations	(254)	(5,441)	(11,600)	(13,740)
Interest expense	—	—	(40)	—
Other non-operating (expense) income	(48)	(2)	(130)	127
Loss before income taxes	(302)	(5,443)	(11,770)	(13,613)
Provision for income taxes	38	63	180	187
Net loss	$(340)	$(5,506)	$(11,950)	$(13,800)
Basic and diluted net loss per share	$(0.01)	$(0.11)	$(0.23)	$(0.27)
Shares used in basic and diluted per share calculation	52,237	51,861	52,071	51,626

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements

ENERGY RECOVERY, INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS

(in thousands)

(unaudited)

	Three Months Ended		**Nine Months Ended**	
	September 30,		**September 30,**	
	2015	**2014**	**2015**	**2014**
Net loss	$(340)	$(5,506)	$(11,950)	$(13,800)
Other comprehensive (loss) income, net of tax:				
Foreign currency translation adjustments	(4)	22	21	68
Unrealized gain (loss) on investments	3	(6)	4	12
Other comprehensive (loss) income	(1)	16	25	80
Comprehensive loss	$(341)	$(5,490)	$(11,925)	$(13,720)

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements

ENERGY RECOVERY, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

	Nine Months Ended September 30	
	2015	**2014**
Cash Flows From Operating Activities		
Net loss	$(11,950)	$(13,800)
Adjustments to reconcile net loss to net cash used in operating activities:		
Share-based compensation	3,549	1,628
Depreciation and amortization	2,897	3,025
Deferred income taxes	172	169
Amortization of premiums/discounts on investments	154	348
Provision for warranty claims	91	87
Provision for doubtful accounts	88	293
Loss on fair value remeasurement of put options	55	—
Loss on foreign currency transactions	54	(10)
Other non-cash adjustments	11	(179)
Valuation adjustments for excess or obsolete inventory	(126)	212
Reversal of accruals related to expired warranties	(213)	—
Gain on fair value remeasurement of contingent consideration	—	(149)
Changes in operating assets and liabilities:		
Accounts receivable	2,810	10,935
Unbilled receivables	509	5,698
Deferred revenue	449	203
Income taxes payable	(10)	(7)
Accounts payable	(134)	64
Prepaid and other assets	(242)	(1,045)
Inventories	(563)	(5,484)
Litigation settlement	(1,700)	—
Accrued expenses and other liabilities	(3,602)	(2,256)
Net cash used in operating activities	**(7,701)**	**(268)**
Cash Flows From Investing Activities		
Maturities of marketable securities	11,845	4,355
Restricted cash	1,856	3,338
Purchase of marketable securities	—	(273)
Capital expenditures	(557)	(2,301)
Net cash provided by investing activities	**13,144**	**5,119**
Cash Flows From Financing Activities		

Net proceeds from issuance of common stock	558	1,165
Proceeds from borrowings	55	—
Repayment of long-term debt	(5)	—
Payment of contingent consideration	—	(1,375)
Repurchase of common stock for treasury	—	(1,633)
Net cash provided by (used in) financing activities	**608**	**(1,843)**
Effect of exchange rate differences on cash and cash equivalents	**(54)**	**44**
Net change in cash and cash equivalents	**5,997**	**3,052**
Cash and cash equivalents, beginning of period	**15,501**	**14,371**
Cash and cash equivalents, end of period	**$21,498**	**$17,423**

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements

ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

Note 1 — The Company and Summary of Significant Accounting Policies

The Company

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

Use of Estimates

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

Basis of Presentation

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

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

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

Reclassification

During the fourth quarter of 2014, we changed the classification of the payment of contingent consideration of $1.4 million made during the third quarter of 2014 from operating to financing in the Consolidated Statements of Cash Flows at December 31, 2014. This change is reflected in the Condensed Consolidated Cash Flows in this filing on Form 10-Q for the nine months ended September 30, 2014. The $1.4 million impact of the change was not considered material to the Condensed Consolidated Statement of Cash Flows for the nine months ended September 30, 2014.

Change in Accounting Principle for Goodwill Impairment Testing

Prior to July 1, 2015, we evaluated our goodwill for impairment at the reporting unit level annually during the fourth quarter or when indicators for potential impairment were present. At that time we operated under a single reporting unit.

Subsequent to July 1, 2015, we adopted a new organizational and reporting structure based on the operating segments, Water and Oil & Gas. We have reassessed our reporting units and the impairment analysis of goodwill and long-lived assets, and performed our analysis based on the new structure. During the third quarter of 2015, we changed the measurement date of our annual goodwill impairment test from the fourth quarter to July 1. This change was not material to our consolidated financial statements as it did not result in the delay, acceleration, or avoidance of an impairment charge. We believe this timing better aligns the goodwill impairment test with our strategic business planning process, which is a key component of the goodwill impairment test. We have completed the required annual testing of goodwill for impairment for all reporting units as of July 1, 2015 and have determined that goodwill is no impaired.

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-09, *Revenue from Contracts with Customers.* The amendment requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. ASU 2014-09 will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective. ASU 2014-09 is effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period.

On July 9, 2015, the FASB voted to approve a one-year deferral of the effective date of ASU 2014-09. Based on the FASB's decision, ASU 2014-09 will apply to us for annual reporting periods beginning after December 15, 2017, including interim reporting periods within annual reporting periods beginning after December 15, 2017. Additionally, the FASB decided to permit early adoption, but not before the original effective date (that is, annual periods beginning after December 15, 2016). The FASB issued ASU 2015-14 in August 2015, formally deferring the effective date of ASU 2014-09 by one year. We expect to adopt this guidance as of January 1, 2018. ASU 2014-09 permits the use of either the retrospective or cumulative effect transition method. We are currently evaluating the effect that ASU 2014-09 will have on our financial statements and related disclosures. We have not yet selected a transition method nor have we determined the effect of the standard on our ongoing financial reporting.

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

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

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

In July 2015, the FASB issued ASU 2015-11, *Inventory – Simplifying the Measurement of Inventory.* ASU 2015-11 does not apply only to inventory that is measured using last-in, first-our ("LIFO") or to the retail inventory method. ASU 2015-11 applies to all other inventory, which includes inventory that is measured using first-in, first-out ("FIFO") or average cost. ASU 2015-11 provides that inventory be measured at the lower of cost and net realizable value. Net realizable value is the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. For public entities, ASU 2015-11 is effective for fiscal years beginning after December 15, 2016 and interim periods within those fiscal years. Early application is permitted as of the beginning of an interim or annual reporting period. We do not expect the adoption of this standard to have a material impact on our financial statements.

Note 2 — Goodwill and Other Intangible Assets

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

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

	September 30, 2015			
	Gross Carrying Amount	Accumulated Amortization	Accumulated Impairment Losses	Net Carrying Amount
Developed technology	$6,100	$ (3,558)	$ —	$ 2,542
Non-compete agreements	1,310	(1,310)	—	—
Backlog	1,300	(1,300)	—	—
Trademarks	1,200	(180)	(1,020)	—
Customer relationships	990	(990)	—	—
Patents	585	(395)	(42)	148
Total	$11,485	$ (7,733)	$ (1,062)	$ 2,690

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