

Energy Recovery, Inc.
Form 10-Q
November 03, 2016

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, 2016

or

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

For the transition period from _____ to _____

Commission File Number: 001-34112

Energy Recovery, Inc.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of incorporation or organization)

01-0616867

(IRS Employer Identification No.)

1717 Doolittle Drive, San Leandro, CA

(Address of Principal Executive Offices)

94577

(Zip Code)

(510) 483-7370

(Registrant's Telephone Number, including area code)

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

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

Yes No

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

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

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

As of October 31, 2016, there were 52,351,885 shares of the registrant's common stock outstanding.

ENERGY RECOVERY, INC.

QUARTERLY REPORT ON FORM 10-Q FOR THE PERIOD ENDED SEPTEMBER 30, 2016

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

| | September 30, 2016 | December 31, 2015 |
|--|-------------------------------|----------------------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 80,691 | \$ 99,931 |
| Restricted cash | 521 | 1,490 |
| Short-term investments | 15,049 | 257 |
| Accounts receivable, net of allowance for doubtful accounts of \$189 and \$166 at September 30, 2016 and December 31, 2015, respectively | 8,193 | 11,590 |
| Unbilled receivables, current | 914 | 1,879 |
| Cost and estimated earnings in excess of billings | 440 | — |
| Inventories | 5,839 | 6,503 |
| Deferred tax assets, net | — | 938 |
| Prepaid expenses and other current assets | 1,507 | 943 |
| Total current assets | 113,154 | 123,531 |
| Restricted cash, non-current | 3,301 | 2,317 |
| Unbilled receivables, non-current | — | 6 |
| Deferred tax assets, non-current | 1,021 | — |
| Property and equipment, net of accumulated depreciation of \$20,634 and \$18,338 at September 30, 2016 and December 31, 2015, respectively | 9,182 | 10,622 |
| Goodwill | 12,790 | 12,790 |
| Other intangible assets, net | 2,058 | 2,531 |
| Other assets, non-current | 4 | 2 |
| Total assets | \$ 141,510 | \$ 151,799 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 1,796 | \$ 1,865 |

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| | | |
|---|------------|-------------|
| Accrued expenses and other current liabilities | 6,272 | 7,808 |
| Income taxes payable | 137 | 2 |
| Accrued warranty reserve | 394 | 461 |
| Deferred revenue | 6,455 | 5,878 |
| Current portion of long-term debt | 11 | 10 |
| Total current liabilities | 15,065 | 16,024 |
| Long-term debt, net of current portion | 30 | 38 |
| Deferred tax liabilities, non-current | 2,173 | 2,360 |
| Deferred revenue, non-current | 65,231 | 69,000 |
| Other non-current liabilities | 598 | 718 |
| Total liabilities | 83,097 | 88,140 |
| Commitments and Contingencies (Note 9) | | |
| Stockholders' equity: | | |
| Preferred stock, \$0.001 par value; 10,000,000 shares authorized; no shares issued or outstanding | — | — |
| Common stock, \$0.001 par value; 200,000,000 shares authorized; 56,023,054 shares issued and 52,301,398 shares outstanding at September 30, 2016, and 54,948,235 shares issued and 52,468,779 shares outstanding at December 31, 2015 | 56 | 55 |
| Additional paid-in capital | 136,053 | 129,809 |
| Accumulated other comprehensive loss | (91 |) (64) |
| Treasury stock at cost, 3,721,656 and 2,479,456 shares repurchased at September 30, 2016 and December 31, 2015, respectively | (16,210 |) (6,835) |
| Accumulated deficit | (61,395 |) (59,306) |
| Total stockholders' equity | 58,413 | 63,659 |
| Total liabilities and stockholders' equity | \$ 141,510 | \$ 151,799 |

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements

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

| | Three Months Ended | | Nine Months Ended | |
|---|-------------------------------|-------------|------------------------------|-------------|
| | September 30, | | September 30, | |
| | 2016 | 2015 | 2016 | 2015 |
| Product revenue | \$11,024 | \$12,112 | \$33,048 | \$28,460 |
| Product cost of revenue | 3,968 | 4,948 | 11,878 | 12,315 |
| Product gross profit | 7,056 | 7,164 | 21,170 | 16,145 |
| License and development revenue | 1,250 | — | 3,750 | — |
| Operating expenses: | | | | |
| General and administrative | 3,971 | 3,590 | 12,847 | 15,230 |
| Sales and marketing | 2,512 | 2,195 | 6,517 | 6,622 |
| Research and development | 2,319 | 1,474 | 7,406 | 5,417 |
| Amortization of intangible assets | 158 | 159 | 473 | 476 |
| Total operating expenses | 8,960 | 7,418 | 27,243 | 27,745 |
| Loss from operations | (654) | (254) | (2,323) | (11,600) |
| Other expense: | | | | |
| Interest expense | (1) | — | (2) | (40) |
| Other non-operating income (expense) | 79 | (48) | 137 | (130) |
| Loss before income taxes | (576) | (302) | (2,188) | (11,770) |
| Provision (benefit) for income taxes | 3 | 38 | (99) | 180 |
| Net loss | \$(579) | \$(340) | \$(2,089) | \$(11,950) |
| Net loss per share – basic and diluted | \$(0.01) | \$(0.01) | \$(0.04) | \$(0.23) |
| Weighted average shares outstanding – basic and diluted | 52,106 | 52,237 | 52,227 | 52,071 |

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, 2016 | | September 30, 2015 | |
| | 2016 | 2015 | 2016 | 2015 |
| Net loss | \$ (579) | \$ (340) | \$ (2,089) | \$ (11,950) |
| Other comprehensive income (loss), net of tax: | | | | |
| Foreign currency translation adjustments | 5 | (4) | (1) | 21 |
| Unrealized gain (loss) on investments | 5 | 3 | (26) | 4 |
| Other comprehensive income (loss) | 10 | (1) | (27) | 25 |
| Comprehensive loss | \$ (569) | \$ (341) | \$ (2,116) | \$ (11,925) |

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, | |
| | 2016 | 2015 |
| Cash Flows From Operating Activities | | |
| Net loss | \$(2,089) | \$(11,950) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Depreciation and amortization | 2,771 | 2,897 |
| Stock-based compensation | 2,640 | 3,549 |
| Provision for warranty claims | 134 | 91 |
| Amortization of premiums on investments | 94 | 154 |
| Provision for doubtful accounts | 68 | 88 |
| Unrealized loss on foreign currency transactions | 65 | 54 |
| Change in fair value of put options | 33 | 55 |
| Other non-cash adjustments | (120) | 11 |
| Valuation adjustments for excess or obsolete inventory | (175) | (126) |
| Reversal of accruals related to expired warranties | (201) | (213) |
| Deferred income taxes | (270) | 172 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | 3,330 | 2,810 |
| Unbilled receivables | 971 | 509 |
| Inventories | 839 | (563) |
| Deferred revenue, product | 557 | 449 |
| Income taxes payable | 135 | (10) |
| Litigation settlement | — | (1,700) |
| Accounts payable | (69) | (134) |
| Costs and estimated earnings in excess of billings | (440) | — |
| Prepaid and other assets | (598) | (242) |
| Accrued expenses and other liabilities | (1,598) | (3,602) |
| Deferred revenue, SLB license | (3,750) | — |
| Net cash provided by (used in) operating activities | 2,327 | (7,701) |
| Cash Flows From Investing Activities | | |
| Maturities of marketable securities | 1,000 | 11,845 |
| Change in restricted cash | (15) | 1,856 |
| Capital expenditures | (900) | (557) |
| Purchases of marketable securities | (15,912) | — |
| Net cash (used in) provided by investing activities | (15,827) | 13,144 |

Cash Flows From Financing Activities

| | | |
|---|-----------------|-----------------|
| Net proceeds from issuance of common stock | 3,708 | 558 |
| Proceeds from long-term debt | — | 55 |
| Repayment of long-term debt | (7) | (5) |
| Repurchase of common stock | (9,375) | — |
| Net cash (used in) provided by financing activities | (5,674) | 608 |
| Effect of exchange rate differences on cash and cash equivalents | (66) | (54) |
| Net change in cash and cash equivalents | (19,240) | 5,997 |
| Cash and cash equivalents, beginning of period | 99,931 | 15,501 |
| Cash and cash equivalents, end of period | \$80,691 | \$21,498 |

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements

ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

Note 1 — The Company and Summary of Significant Accounting Policies

The Company

Energy Recovery, Inc. (the “Company,” “Energy Recovery,” “our,” “us,” and “we”) is an energy solutions provider to industrial fluid flow markets worldwide. Our core competencies are fluid dynamics and advanced material science. Our products make industrial processes more operating and capital expenditure efficient. Our solutions convert wasted pressure energy into a reusable asset and preserve or eliminate pumping technology in hostile processing environments. Our 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[®], AT[™], AquaBold[™], VorTeq[™], IsoBoost[®], and IsoGen[®]. Our solutions are owned, manufactured, and/or developed, in whole or in part, in the United States of America (“U.S.”) and the Republic of Ireland.

Use of Estimates

The preparation of condensed consolidated financial statements in conformity with U.S. generally accepted accounting principles (“U.S. GAAP”) requires our management to make judgments, assumptions, and estimates that affect the amounts reported in the condensed consolidated financial statements and accompanying notes. The accounting policies that reflect our more significant estimates and judgments and that we believe are the most critical to aid in fully understanding and evaluating our reported financial results are revenue recognition - completed contract and percentage-of-completion; 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 and its wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated.

The accompanying condensed consolidated financial statements have been prepared by us, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"). Certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. GAAP have been condensed or omitted pursuant to such rules and regulations. The December 31, 2015 condensed consolidated balance sheet was derived from audited financial statements, and may not include all disclosures required by U.S. GAAP; however, we believe that the disclosures are adequate to make the information presented not misleading. These unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the notes thereto for the fiscal year ended December 31, 2015 included in our Annual Report on Form 10-K filed with the SEC on March 3, 2016.

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

Addition of New Revenue Stream to Revenue Recognition Policy - IsoBoost and IsoGen

In July 2016 we finalized a purchase order associated with a previously announced letter of award to provide multiple units of our IsoBoost technology for integration into a major gas processing plant to be constructed in the Middle East. The contract is for approximately \$7 million worth of equipment and services, with an option for an additional \$4 million to be determined at a later date. The optional supply may not be confirmed by the customer until the latter portion of 2017. This contract is comprised of fixed prices, with customer specific specifications, and will take over one year to complete.

IsoBoost and IsoGen systems are highly engineered, customized solutions that are designed and manufactured over an extended period of time and are built specifically to meet a customer's specifications. It is the Company's position that percentage-of-completion method of accounting is appropriate for IsoBoost and IsoGen systems given the facts and circumstances of these projects. In the event that a purchase order for an IsoBoost or IsoGen does not meet these facts and circumstances then percentage-of-completion method of accounting does not apply.

Revenue from fixed price contracts is recognized using the percentage-of-completion method of accounting in the ratio of costs incurred to estimated final costs. Contract costs include all direct material and labor costs and those indirect costs related to contract performance. Pre-contract costs with no future benefit are expensed in the period in which they are incurred. Since the financial reporting of these contracts depends on estimates, which are assessed continually during the term of the contract, recognized revenues and profit are subject to revisions as the contract progresses to completion. Revisions in profit estimates are reflected in the period in which the facts that give rise to the revisions become known. If material, the effects of any changes in estimates are disclosed in the notes to the consolidated financial statements. When estimates indicate that a loss will be incurred on a contract, a provision for the expected loss is recorded in the period in which the loss becomes evident. Revenue is recognized only to the extent costs have been recognized in the same period.

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2014-09, *Revenue from Contracts with Customers*. The amendment requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. ASU 2014-09 will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective. ASU 2014-09 is effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. On July 9, 2015, the FASB voted to approve a one-year deferral of the effective date of ASU 2014-09. Based on the FASB’s decision, ASU 2014-09 will apply to us for annual reporting periods beginning after December 15, 2017, including interim reporting periods within annual reporting periods beginning after December 15, 2017. Additionally, the FASB decided to permit early adoption, but not before the original effective date (that is, annual periods beginning after December 15, 2016). The FASB issued ASU 2015-14 in August 2015, formally deferring the effective date of ASU 2014-09 by one year. We expect to adopt this guidance as of January 1, 2018. ASU 2014-09 permits the use of either the retrospective or cumulative effect transition method. We are currently evaluating the effect that ASU 2014-09 will have on our financial statements and related disclosures. We have not yet selected a transition method nor have we determined the effect of the standard on our ongoing financial reporting.

In November 2015, the FASB issued ASU No. 2015-17, *Income Taxes (Topic 740) - Balance Sheet Classification of Deferred Taxes*. ASU 2015-17 eliminates the current requirement to present deferred tax assets and liabilities as current and noncurrent in a classified statement of financial position. Instead, ASU 2015-17 requires that deferred tax assets and liabilities be classified as noncurrent in a classified statement of financial position. We adopted this accounting standard update early, on a prospective basis, at the beginning of the second quarter of 2016 to simplify presentation of deferred taxes. The adoption at the beginning of the second quarter of 2016 resulted in a \$1.1 million decrease in current deferred tax assets, a \$0.8 million increase in non-current deferred tax assets, and a \$0.3 million decrease in non-current deferred tax liabilities. No prior periods were retrospectively adjusted.

In January 2016, the FASB issued ASU No. 2016-01 *Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*. ASU 2016-01 modifies certain aspects of the recognition, measurement, presentation, and disclosure of financial instruments. For public entities, ASU 2016-01 is

effective for fiscal years, and interim periods within those years, beginning after December 15, 2017, and early adoption is permitted. We do not expect the adoption of this standard to have a material impact on our financial statements.

In February 2016, the FASB issued ASU No. 2016-02 *Leases (Topic 842)*. ASU 2016-02 impacts any entity that enters into a lease with some specified scope exceptions. The guidance updates and supersedes Topic 840, *Leases*. For public entities, ASU 2016-02 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2018, and early adoption is permitted. We are currently evaluating the impact of this guidance on our ongoing financial reporting.

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

In March 2016, the FASB issued ASU No. 2016-09 *Compensation – Stock Compensation (Topic 718)*. ASU 2016-09 affects any entity that issues stock-based payment awards to their employees and is intended to simplify several aspects of the accounting for stock-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. For public entities, ASU 2016-09 is effective for annual periods beginning after December 15, 2016, and interim periods with those annual periods. Early adoption is permitted. We are currently evaluating the impact of this guidance, but do not expect the adoption of this standard to have a material impact on our financial statements.

In August 2016, the FASB issued ASU No. 2016-15 *Statement of Cash Flows (Topic 230) – Classification of Certain Cash Receipts and Cash Payments*. ASU 2016-15 impacts all entities that are required to present a statement of cash flows under Topic 230. The amendment provides guidance on eight specific cash flow issues. For public entities, ASU 2016-15 is effective for fiscal periods beginning after December 15, 2017 and interim periods within those years. Early adoption is permitted and should be applied using a retrospective transition method to each period presented. 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, 2016 and December 31, 2015 of \$12.8 million and \$12.8 million, respectively, was the result of our acquisition of Pump Engineering, LLC in December 2009. In July 2015 with the adoption of a new organizational and reporting structure based on our operating segments, Water and Oil & Gas, we changed the measurement date of our annual goodwill impairment test from December to July. Consequently, we completed the required annual testing of goodwill for impairment for all reporting units as of July 1, 2016 and determined that goodwill was not impaired.

During the three and nine months ended September 30, 2016, 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, 2016 | | | |
|---------------------------|---------------------|--------------------|-----------------|
| Gross | Accumulated | Accumulated | Net |
| Carrying | Amortization | Impairment | Carrying |

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| | Amount | | Losses | | Amount |
|------------------------|---------------|-----------|---------------|-----------|---------------|
| Developed technology | \$6,100 | \$ (4,168 |) | \$ — | \$ 1,932 |
| Non-compete agreements | 1,310 | (1,310 |) | — | — |
| Backlog | 1,300 | (1,300 |) | — | — |
| Trademarks | 1,200 | (180 |) | (1,020 |) — |
| Customer relationships | 990 | (990 |) | — | — |
| Patents | 585 | (417 |) | (42 |) 126 |
| Total | \$11,485 | \$ (8,365 |) | \$ (1,062 |) \$ 2,058 |

December 31, 2015

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

Accumulated impairment losses at September 30, 2016 and December 31, 2015, include impairment charges for trademarks in 2012 and impairment charges for patents in 2007 and 2010.

Note 3 — Loss per Share

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

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

| | Three Months Ended | | Nine Months Ended | |
|--|-------------------------------|-------------|-------------------------------|-------------|
| | September 30, 2016 | 2015 | September 30, 2016 | 2015 |
| Numerator: | | | | |
| Net loss | \$(579) | \$(340) | \$(2,089) | \$(11,950) |
| Denominator: | | | | |
| Basic & diluted weighted average common shares outstanding | 52,106 | 52,237 | 52,227 | 52,071 |
| Net loss per share – basic and diluted | \$(0.01) | \$(0.01) | \$(0.04) | \$(0.23) |

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

| | Three Months Ended | | Nine Months Ended | |
|------------------------|-----------------------------------|-------------|-----------------------------------|-------------|
| | September 30, 2016 | 2015 | September 30, 2016 | 2015 |
| Stock options | 6,938 | 7,550 | 6,938 | 7,550 |
| Restricted stock units | 214 | — | 214 | — |

Note 4 — Other Financial Information

Restricted Cash

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

| | September 30, | December 31, |
|---|--------------------------|-------------------------|
| | 2016 | 2015 |
| Current collateral for stand-by letters of credit | \$ 521 | \$ 1,490 |
| Non-current collateral for stand-by letters of credit | 3,301 | 2,317 |
| Total restricted cash | \$ 3,822 | \$ 3,807 |

Inventories

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

| | September 30, | December 31, |
|-----------------|--------------------------|-------------------------|
| | 2016 | 2015 |
| Raw materials | \$ 2,059 | \$ 2,590 |
| Work in process | 1,661 | 1,689 |
| Finished goods | 2,119 | 2,224 |
| Inventories | \$ 5,839 | \$ 6,503 |

Prepaid and Other Current Assets

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

| | September 30, | December 31, |
|---|--------------------------|-------------------------|
| | 2016 | 2015 |
| Foreign currency put option | \$ — | \$ 33 |
| Interest receivable | 81 | 4 |
| Supplier advances | 54 | 171 |
| Prepaid rent | 153 | 7 |
| Other prepaid expenses and current assets | 1,219 | 728 |
| Total prepaid and other current assets | \$ 1,507 | \$ 943 |

Accrued Expenses and Other Current Liabilities

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

| | September 30, | December 31, |
|--|--------------------------|-------------------------|
| | 2016 | 2015 |
| Payroll and commissions payable | \$ 3,838 | \$ 5,086 |
| Accrued project costs | 220 | — |
| Accrued legal expenses | 303 | 217 |
| Other accrued expenses and current liabilities | 1,911 | 2,505 |
| Accrued expenses and other current liabilities | \$ 6,272 | \$ 7,808 |

Accumulated Other Comprehensive Loss

Changes in accumulated other comprehensive loss by component for the nine months ended September 30, 2016, were as follows (in thousands):

| | Foreign Currency Translation Adjustments Net of Tax Benefit | Unrealized Losses on Investments | Total Accumulated Other Comprehensive Loss |
|------------------------------|--|---|---|
| Balance, December 31, 2015 | \$ (63) | \$ (1) | \$ (64) |
| Net other comprehensive loss | (1) | (26) | (27) |
| Balance, September 30, 2016 | \$ (64) | \$ (27) | \$ (91) |

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

Note 5 — Investments

Our short-term investments are all classified as available-for-sale. There were no sales of available-for-sale securities during the nine months ended September 30, 2016.

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

| | September 30, 2016 | | | |
|------------------------------|---------------------------|---|--|-----------------------|
| | Amortized Cost | Gross Unrealized Holding Gains | Gross Unrealized Holding Losses | Fair Value |
| Corporate notes and bonds | \$ 15,076 | \$ — | \$ (27) | \$ 15,049 |
| Total short-term investments | \$ 15,076 | \$ — | \$ (27) | \$ 15,049 |

| | December 31, 2015 | | | |
|--|---------------------------|-----------------------------|-----------------------------|-----------------------|
| | Amortized Cost | Gross Unrealized | Gross Unrealized | Fair Value |

| | | Holding Gains | | Holding Losses | |
|------------------------------|-------|--------------------------|---|---------------------------|----------|
| Corporate notes and bonds | \$258 | \$ | — | \$ (1 |) \$ 257 |
| Total short-term investments | \$258 | \$ | — | \$ (1 |) \$ 257 |

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

| September 30, 2016 | | | | | | |
|---------------------------|----------------------------|--------------------------|-----------------------------|--------------------------|-------------------|--------------------------|
| | Less than 12 Months | | 12 Months or greater | | Total | |
| | Gross | | Gross | | Gross | |
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| Corporate notes and bonds | \$15,049 | \$ (27) | \$ — | \$ — | \$15,049 | \$ (27) |
| Total | \$15,049 | \$ (27) | \$ — | \$ — | \$15,049 | \$ (27) |

| December 31, 2015 | | | | | | |
|---------------------------|----------------------------|--------------------------|-----------------------------|--------------------------|-------------------|--------------------------|
| | Less than 12 Months | | 12 Months or greater | | Total | |
| | Gross | | Gross | | Gross | |
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| Corporate notes and bonds | \$— | \$ — | \$257 | \$ (1) | \$257 | \$ (1) |
| Total | \$— | \$ — | \$257 | \$ (1) | \$257 | \$ (1) |

Expected maturities can differ from contractual maturities because borrowers may have the right to prepay obligations without prepayment penalties. The amortized cost and fair value of available-for-sale securities that had stated maturities as of September 30, 2016 are shown below by contractual maturity (in thousands):

| | September 30, 2016 | |
|-------------------------------------|---------------------------|-------------------|
| | Amortized Cost | Fair Value |
| Due in one year or less | \$15,076 | \$15,049 |
| Total available-for-sale securities | \$15,076 | \$15,049 |

Note 6 — Long-Term Debt and Line of Credit

Debt

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

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

| | September 30, | December 31, |
|-----------------------|--------------------------|-------------------------|
| | 2016 | 2015 |
| Loan payable | \$ 41 | \$ 48 |
| Less: current portion | (11) | (10) |
| Total long-term debt | \$ 30 | \$ 38 |

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

| | September 30, |
|-------------------------------|--------------------------|
| | 2016 |
| 2016 (remaining three months) | \$ 3 |
| 2017 | 11 |
| 2018 | 11 |
| 2019 | 12 |
| 2020 | 4 |
| Total debt | \$ 41 |

Line of Credit

In June 2012, we entered into a loan agreement with a financial institution. The loan agreement was amended in June 2015, (as amended, the “Loan Agreement”). The Loan Agreement provides for a total available credit line of \$16.0 million. Under the Loan Agreement, we are allowed to draw advances not to exceed, at any time, \$10.0 million as revolving loans. The total stand-by letters of credit issued under the Loan Agreement may not exceed the lesser of the \$16.0 million credit line or the credit line minus all outstanding revolving loans. Revolving loans may be in the form of a base rate loan that bears interest equal to the prime rate or a Eurodollar loan that bears interest equal to the adjusted LIBOR rate plus 1.25%. Stand-by letters of credit are subject to customary fees and expenses for issuance or renewal. The unused portion of the credit facility is subject to a facility fee in an amount equal to 0.25% per annum of the average unused portion of the revolving line. The Loan Agreement also requires us to maintain a cash collateral balance equal to 101% of all outstanding advances and all outstanding stand-by letters of credit collateralized by the line of credit. The Loan Agreement matures in June 2018 and is collateralized by substantially all of our assets.

As of September 30, 2016 and December 31, 2015, there were no revolving loans drawn under the Loan Agreement. Stand-by letters of credit collateralized under the Loan Agreement totaled \$3.6 million and \$3.8 million as of September 30, 2016 and December 31, 2015, respectively. Total cash restricted related to these stand-by letters of credit totaled \$3.6 million and \$3.8 million as of September 30, 2016 and December 31, 2015, respectively.

We are subject to certain financial and administrative covenants under the Loan Agreement. As of September 30, 2016, we were in compliance with these covenants.

As of September 30, 2016, we also had a stand-by letter of credit at another financial institution for \$0.2 million. Restricted cash related to this stand-by letter of credit totaled \$0.2 million as of September 30, 2016.

Note 7 — Equity

Stock Repurchase Program

In January 2016, our Board of Directors authorized a stock repurchase program under which the Company, at the discretion of management, could repurchase up to \$6.0 million in aggregate cost of our outstanding common stock through June 30, 2016 (the “January Authorization”). In May 2016, our Board of Directors rescinded the January

Authorization and authorized a new stock repurchase program under which the Company, at the discretion of management, could repurchase up to \$10.0 million in aggregate cost of our outstanding common stock through October 31, 2016 (the “May Authorization”). We account for stock repurchases using the cost method. Cost includes fees charged in connection with acquiring the outstanding common stock. As of September 30, 2016, 673,700 shares, at an aggregate cost of \$4.1 million, had been repurchased under the January Authorization and 568,500 shares, at an aggregate cost of \$5.3 million, had been repurchased under the May Authorization.

Stock-Based Compensation Expense

For the three and nine months ended September 30, 2016 and 2015, we recognized stock-based compensation expense related to employees and consultants as follows (in thousands):

| | Three Months Ended | | Nine Months Ended | |
|--|-----------------------------------|-------------|------------------------------|-------------|
| | September 30, | | September 30, | |
| | 2016 | 2015 | 2016 | 2015 |
| Cost of revenue | \$16 | \$32 | \$78 | \$104 |
| General and administrative | 378 | 280 | 1,635 | 2,856 |
| Sales and marketing | 218 | 114 | 502 | 321 |
| Research and development | 163 | 70 | 425 | 268 |
| Total stock-based compensation expense | \$775 | \$496 | \$2,640 | \$3,549 |

Stock-based compensation in the three and nine months ended September 30, 2016 included expenses related to 31,659 options granted in the three months ended September 30, 2016 to new employees and a new member of the Board of Directors.

Stock-based compensation for the nine months ended September 30, 2015 included option modification expenses in connection with the resignation of the former Chief Executive Officer related to the accelerated vesting, extended vesting, and extended exercise period of options previously granted of approximately \$1.3 million.

Stock-based compensation for the nine months ended September 30, 2016 included additional stock-based compensation expense of approximately \$0.5 million in connection with the resignation of the former General Counsel related to the continued vesting of awards granted prior to his resignation.

Stock Option Plan

On June 23, 2016, our stockholders approved the 2016 Incentive Plan (the “Plan”). Prior to June 23, 2016, we maintained the Amended and Restated 2008 Equity Incentive Plan (the “Prior Plan”). Stock-based awards granted under the Plan and Prior Plan generally vest over four years and expire no more than ten years after the date of grant. Subject to adjustments as provided in the Plan, the number of shares of common stock initially authorized for issuance under the Plan is 4,441,083 (which consist of 3,830,000 new shares plus 611,083 shares that were authorized and unissued under the Prior Plan) plus up to 7,635,410 shares that were set aside for option awards granted under the Prior Plan that are subsequently forfeited. On July 27, 2016, we filed with the U.S. Securities and Exchange Commission a registration statement on Form S-8 with respect to the 4,441,083 shares issuable under the Plan. The Plan supersedes all previously issued stock incentive plans (including the Prior Plan) and will be the only available plan from which stock related awards may be granted.

Stock Option Activity

The following table summarizes the stock option activity under the Plan and includes options granted under all previous plans:

| | Options Outstanding | Weighted | Weighted | Aggregate |
|--|----------------------------|--------------------|------------------|------------------|
| | Options | Average | Remaining | Intrinsic |
| | Exercise | Contractual | Value | Value |
| | Price | Life (in | Years) | (2) |
| Balance December 31, 2015 | 7,198,479 | \$ 3.97 | 7.0 | \$22,875,000 |
| Granted | 903,676 | \$ 8.63 | — | — |
| Exercised | (1,074,819) | \$ 3.45 | — | — |
| Forfeited | (89,054) | \$ 5.39 | — | — |
| Balance September 30, 2016 | 6,938,282 | \$ 4.64 | 7.0 | \$78,694,000 |
| Vested and exercisable as of September 30, 2016 | 4,361,961 | \$ 4.18 | 5.9 | \$51,462,000 |
| Vested and exercisable as of September 30, 2016 and expected to vest thereafter ⁽¹⁾ | 6,557,108 | \$ 4.59 | 6.8 | \$74,718,000 |

(1) Options that are expected to vest are net of estimated future option forfeitures in accordance with the provisions of ASC 718, “*Compensation — Stock Compensation.*”

(2) The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying options and the fair value of our common stock as of September 30, 2016 of \$15.98 per share

As of September 30, 2016, total unrecognized compensation cost related to non-vested options, net of estimated forfeitures, was \$6.9 million, which is expected to be recognized as an expense over a weighted average period of approximately 2.5 years.

Restricted Stock Unit Activity

The following table summarizes the restricted stock unit activity under the Plan and includes restricted stock units granted under all previous plans:

| | Units | Weighted Average Grant-Date Fair Value (Per unit) |
|--------------------------------|--------------|--|
| Unvested at December 31, 2015 | — | \$ — |
| Awarded | 213,514 | \$ 8.65 |
| Vested | — | \$ — |
| Forfeited | — | \$ — |
| Unvested at September 30, 2016 | 213,514 | \$ 8.65 |

As of September 30, 2016, total unrecognized compensation cost related to non-vested restricted stock units, net of estimated forfeitures, was \$1.3 million, which is expected to be recognized as an expense over a weighted average period of approximately 3.4 years.

Note 8 — Income Taxes

The effective tax rate for the nine months ended September 30, 2016 and 2015 was 4.5% and (1.53%), respectively. As of December 31, 2015, a valuation allowance of approximately \$21.4 million reduced our deferred income tax assets to the amount expected to be realized. The tax expense recognized for the nine months ended September 30, 2016, was primarily related to the tax basis amortization of goodwill and federal, state, and other taxes. The tax expenses were offset by a tax benefit related to losses in our Ireland subsidiary.

Note 9 — Commitments and Contingencies***Operating Lease Obligations***

We lease facilities under fixed non-cancellable operating leases that expire on various dates through July 2021. Future minimum lease payments consist of the following (in thousands):

| | September 30, |
|-------------------------------------|--------------------------|
| | 2016 |
| 2016 (remaining three months) | \$ 428 |
| 2017 | 1,691 |
| 2018 | 1,662 |
| 2019 | 1,460 |
| 2020 | 59 |
| 2021 | 34 |
| Total future minimum lease payments | \$ 5,334 |

Product Warranty

The following table summarizes the activity related to the product warranty liability during the three and nine months ended September 30, 2016 and 2015 (in thousands):

| | Three Months Ended | | Nine Months Ended | |
|---|--|-------|--|-------|
| | September 30, 2016 2015 | | September 30, 2016 2015 | |
| Balance, beginning of period | \$411 | \$756 | \$461 | \$755 |
| Warranty costs charged to cost of revenue | 38 | (6) | 134 | 15 |
| Release of accrual for expired warranties | (55) | — | (201) | — |
| Utilization of warranty | — | (3) | — | (23) |
| Balance, end of period | \$394 | \$747 | \$394 | \$747 |

Purchase Obligations

We enter into purchase order arrangements with our vendors. As of September 30, 2016, there were open purchase orders for which we had not yet received the related goods or services. These arrangements are subject to change based on our sales demand forecasts, and we have the right to cancel the arrangements prior to the date of delivery. As of September 30, 2016, we had approximately \$1.2 million of cancellable open purchase order arrangements related primarily to materials and parts.

Additionally, we have entered into sale of goods agreements with two vendors for which the purchase orders have not yet been issued, but the Company has made a purchase obligation. The sale of goods agreements total \$3.2 million.

Guarantees

We enter into indemnification provisions under our agreements with other companies in the ordinary course of business, typically with customers. Under these provisions, we generally indemnify and hold harmless the indemnified party for losses suffered or incurred by the indemnified party as a result of our activities, generally limited to personal injury and property damage caused by our employees at a customer's desalination plant in proportion to the employee's percentage of fault for the accident. Damages incurred for such indemnifications would be covered by our general liability insurance to the extent of the policy limitations. We have not incurred material costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, the estimated fair value of these agreements is not material. Accordingly, we have no liabilities recorded for these agreements as of September 30, 2016 and December 31, 2015.

In certain cases, we issue warranty and product performance guarantees to our customers for amounts generally no more than 10% of the total sales agreement to provide a form of security to the customer during the warranty period. These guarantees, generally in the form of stand-by letters of credit or bank guarantees secured by stand-by letters of credit, typically remain in place for periods ranging up to 24 months and in some cases up to 68 months, and relate to the underlying product warranty period. The stand-by letters of credit are collateralized by restricted cash. The \$3.8 million in stand-by letters of credit outstanding at September 30, 2016 were collateralized by restricted cash of \$3.8 million.

Litigation

The Company is named in and subject to various proceedings and claims in connection with our business. We are contesting the allegations in these claims, and we believe that there are meritorious defenses in each of these matters. The outcome of matters we have 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 adverse impact on our financial condition, results of operations and cash flows. We may in the future become involved in additional litigation in the ordinary course of our business, including litigation that could be material to our business. Based on currently available information and review with outside counsel, management does not believe that the currently known actions or threats against the Company will result in any material adverse effect on our financial condition, results of operations, or cash flows.

On September 10, 2014, the Company terminated the employment of its Senior Vice President, Sales, Borja Blanco, on the basis of breach of duty of trust and conduct leading to conflict of interest. On October 24, 2014, Mr. Blanco filed a labor claim against ERI Iberia in Madrid, Spain, challenging the fairness of his dismissal and seeking compensation (“Case 1”). A hearing was held on November 13, 2015, after which the labor court ruled that it did not have jurisdiction over the matter. Mr. Blanco has appealed. Based on currently available information and review with outside counsel, at this time, the Company has not determined that an award to Mr. Blanco is probable.

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

On January 20 and 27, 2015, two stockholder class action complaints were filed against the Company in the United States District Court of the Northern District of California, on behalf of Energy Recovery stockholders under the captions, *Joseph Sabatino v. Energy Recovery, Inc. et al.*, Case No. 3:15-cv-00265 EMC, and *Thomas C. Mowdy v. Energy Recovery, Inc. et al.*, Case No. 3:15-cv-00374 EMC. The complaints have now been consolidated under the

caption, *In Re Energy Recovery Inc. Securities Litigation*, Case No. 3:15-cv-00265 EMC. The consolidated complaint alleges violations of Section 10(b), Rule 10b-5, and Section 20(a) of the Securities Exchange Act of 1934 based upon alleged public misrepresentations and seeks the recovery of unspecified monetary damages. On October 12, 2016, the Company and the attorneys representing the class reached an agreement in principle to settle all outstanding claims in the case. As part of the settlement agreement, the Company has agreed to pay the class an undisclosed sum, the entirety of which will be borne by the Company's insurer. The settlement agreement is subject to approval by the United States District Court of the Northern District of California.

On January 27, 2016, a complaint was filed by the Company's Former Chief Sales Officer, David Barnes, in the United States District Court for the Northern District of California under the caption, *David Barnes v. Energy Recovery, Inc.*, et al. Case No. 3:16-cv-00477 EMC ("Barnes Lawsuit"), related to his separation from the Company and alleging numerous legal claims including, but not limited to, wrongful termination, breach of contracts, and negligent and/or intentional misrepresentations to induce Mr. Barnes to join the Company. Mr. Barnes is seeking to recover, among other things, relocation and business expenses, back pay, front pay, lost equity, contractual severance, emotional distress damages, punitive damages, damages under the California Private Attorneys General Act, attorneys' fees, costs, and interest. The Company and Mr. Barnes have reached an agreement to settle all outstanding claims between the named parties to the Barnes Lawsuit. The United States District Court for the Northern District of California, in an Order, approved the Stipulation, Settlement and Order for Dismissal ("Stipulation for Dismissal") proposed by the named parties, and both the Order and Stipulation for Dismissal are publicly available. Thus, the Barnes Lawsuit is now resolved and has been dismissed as set forth in the Order entered by the Court. Pursuant to the settlement, further details are confidential.

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

On July 27, 2016, a complaint captioned *Gerald McManiman v. Gay, et al.*, RG 16824960, was filed in the Superior Court for the State of California, County of Alameda, naming as defendants Joel Gay, Chris Gannon, Hans Peter Michelet, Alexander Buehler, Arve Hanstveit, Dominique Trempont, Robert Yu Lang Mao, Thomas S. Rooney, Jr., Borja Sanchez-Blanco, Audrey Bold, Paul M. Cook, Marie-Elisabeth Pate -Cornell, Fred Olav Johannessen (“Individual Defendants”) and naming the Company as a nominal defendant. The complaint is styled as a derivative action being brought on behalf of the Company and generally alleges breach of fiduciary duties and violations of laws against the Individual Defendants. Based on currently available information and review with outside counsel, the Company is not able to estimate a potential loss, if any, due to the early stage of the matter.

Note 10 — Business Segment and Geographic Information

We are an energy solutions provider to industrial fluid flow markets worldwide. We make industrial processes more operating and capital expenditure efficient. Our chief operating decision-maker (“CODM”) is the chief executive officer (“CEO”).

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

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

| | Three Months Ended September 30, 2016 | | | Three Months Ended September 30, 2015 | | |
|---------------------------------|--|--------------|----------|--|--------------|----------|
| | Water | Oil & Gas | Total | Water | Oil & Gas | Total |
| Product revenue | \$10,568 | \$456 | \$11,024 | \$12,112 | \$— | \$12,112 |
| Product cost of revenue | 3,647 | 321 | 3,968 | 4,948 | — | 4,948 |
| Product gross profit | 6,921 | 135 | 7,056 | 7,164 | — | 7,164 |
| License and development revenue | — | 1,250 | 1,250 | — | — | — |
| Operating expenses: | | | | | | |
| General and administrative | 346 | 278 | 624 | 158 | 255 | 413 |
| Sales and marketing | 1,434 | 750 | 2,184 | 1,121 | 1,061 | 2,182 |
| Research and development | 262 | 2,023 | 2,285 | 293 | 1,184 | 1,477 |
| Amortization of intangibles | 158 | — | 158 | 159 | — | 159 |
| Operating expenses | 2,200 | 3,051 | 5,251 | 1,731 | 2,500 | 4,231 |
| Operating income (loss) | \$4,721 | \$(1,666) | 3,055 | \$5,433 | \$(2,500) | 2,933 |
| Less: | | | | | | |
| Corporate operating expenses | | | 3,709 | | | 3,187 |
| Consolidated operating loss | | | (654) | | | (254) |
| Non-operating income (expense) | | | 78 | | | (48) |
| Loss before income taxes | | | \$(576) | | | \$(302) |

| | Nine Months Ended September 30, 2016 | | | Nine Months Ended September 30, 2015 | | |
|---------------------------------|---|-------------|-----------|---|-------------|------------|
| | Water | Oil &Gas | Total | Water | Oil &Gas | Total |
| Product revenue | \$32,592 | \$456 | \$33,048 | \$28,319 | \$141 | \$28,460 |
| Product cost of revenue | 11,557 | 321 | 11,878 | 12,287 | 28 | 12,315 |
| Product gross profit | 21,035 | 135 | 21,170 | 16,032 | 113 | 16,145 |
| License and development revenue | — | 3,750 | 3,750 | — | — | — |
| Operating expenses: | | | | | | |
| General and administrative | 828 | 650 | 1,478 | 745 | 978 | 1,723 |
| Sales and marketing | 3,663 | 2,133 | 5,796 | 3,222 | 3,130 | 6,352 |
| Research and development | 954 | 6,394 | 7,348 | 839 | 4,643 | 5,482 |
| Amortization of intangibles | 473 | — | 473 | 476 | — | 476 |
| Operating expenses | 5,918 | 9,177 | 15,095 | 5,282 | 8,751 | 14,033 |
| Operating income (loss) | \$15,117 | \$(5,292) | 9,825 | \$10,750 | \$(8,638) | 2,112 |
| Less: | | | | | | |
| Corporate operating expenses | | | 12,148 | | | 13,712 |
| Consolidated operating loss | | | (2,323) | | | (11,600) |
| Non-operating income (expense) | | | 135 | | | (170) |
| Loss before income taxes | | | \$(2,188) | | | \$(11,770) |

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

| | Three Months Ended | | Nine Months Ended | |
|-------------------------------|-----------------------|-----------------------|-----------------------|-----------------------|
| | September 30, 2016 | September 30, 2015 | September 30, 2016 | September 30, 2015 |
| Domestic product revenue | \$268 | \$355 | \$672 | \$1,439 |
| International product revenue | 10,756 | 11,757 | 32,376 | 27,021 |
| Total product revenue | \$11,024 | \$12,112 | \$33,048 | \$28,460 |
| Product revenue by country: | | | | |
| Saudi Arabia | 24 | % 1 | % 10 | % 3 |
| Singapore | 22 | % 1 | % 8 | % 2 |
| United Arab Emirates | 5 | % 2 | % 3 | % 14 |
| China | 4 | % 2 | % 11 | % 3 |
| United States | 2 | % 3 | % 2 | % 5 |
| Qatar | * | % 31 | % 12 | % 13 |

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| | | | | | | | | |
|-----------|-----|---|-----|---|-----|---|-----|---|
| Others ** | 43 | % | 60 | % | 54 | % | 60 | % |
| Total | 100 | % | 100 | % | 100 | % | 100 | % |

*Less than 1%.

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

All of our long-lived assets were located in the United States at September 30, 2016 and December 31, 2015.

Note 11 — Concentrations

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

| | September 30, | | December 31, | |
|------------|--------------------------|---|-------------------------|---|
| | 2016 | | 2015 | |
| Customer A | 23 | % | 0 | % |
| Customer B | 16 | % | 2 | % |
| Customer C | 5 | % | 26 | % |
| Customer D | 5 | % | 18 | % |

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

| | Three Months Ended | | | Nine Months Ended | | |
|------------|-----------------------------------|---|--------------------------|----------------------------------|-------------|---|
| | September 30, | | September 30, | | | |
| | 2016 | | 2016 | | 2015 | |
| Customer A | 23 | % | 0 | % | 9 | % |
| Customer E | 15 | % | 0 | % | 5 | % |
| Customer D | 1 | % | 32 | % | 13 | % |
| Customer F | 0 | % | * | % | 0 | % |
| | | | 13 | % | 14 | % |

*Less than 1%.

A single customer, Customer G, represents 100% of our license and development revenue for the three and nine months ended September 30, 2016. There was no license and development revenue recognized for the three or nine months ended September 30, 2015.

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

| | September 30, | | December 31, | |
|----------|--------------------------|---|-------------------------|---|
| | 2016 | | 2015 | |
| Vendor A | 19 | % | 0 | % |

Note 12 — Fair Value Measurements

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

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

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

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

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

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

| | September 30, | | Level 1 | Level 2 | Level 3 |
|-------------------------------|--------------------------|----|--------------------|----------------|--------------------|
| | 2016 | | Inputs | Inputs | Inputs |
| Assets: | | | | | |
| Available-for-sale securities | \$ 15,049 | \$ | — | \$15,049 | \$ — |
| Total assets | \$ 15,049 | \$ | — | \$15,049 | \$ — |

| | December 31, 2015 | Level 1 Inputs | Level 2 Inputs | Level 3 Inputs |
|-------------------------------|----------------------------------|-------------------------------|-------------------------------|-------------------------------|
| Assets: | | | | |
| Available-for-sale securities | \$ 257 | \$ — | \$ 257 | \$ — |
| Foreign currency put options | 33 | — | 33 | — |
| Total assets | \$ 290 | \$ — | \$ 290 | \$ — |

Note 13 — Related Party Transactions

In January 2016, the Company entered into a lease agreement with EMS USA, Inc. for the use of office space. The President and Chief Executive Officer of EMS USA, Inc. is also a member of the Board of Directors of the Company. The lease is for a term of ninety (90) days with continuation on a month-to-month basis thereafter, with each month being an “Additional Term.” The Company paid EMS USA, Inc. \$1,098 and \$5,268, respectively, related to this agreement during the three and nine months ended September 30, 2016. The lease was terminated as of July 2016.

In March 2016, the Company extended an employee loan to one of its employees for \$21,786. The loan was repayable to the Company monthly over six months and was non-interest bearing. At September 30, 2016, the loan was fully paid and another employee loan was extended to this employee for \$21,786. The new loan is repayable to the Company monthly over six months and is non-interest bearing.

Note 14 - Subsequent Events

See Note 9 – “Commitments and Contingencies”, under the caption “Litigation” for a discussion of litigation developments in October 2016.

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

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

Forward-looking statements that represent our current expectations about future events are based on assumptions and involve risks and uncertainties. If the risks or uncertainties occur or the assumptions prove incorrect, then our results may differ materially from those set forth or implied by the forward-looking statements. Our forward-looking statements are not guarantees of future performance or events. These forward-looking statements are based on information currently available to us and on management's beliefs, assumptions, estimates, or projections and are not guarantees of future events or results. We may not actually achieve the plans, intentions, or expectations disclosed in our forward-looking statements and you should not place undue reliance on our forward-looking statements.

Words such as "expects," "anticipates," "believes," "estimates," "assumes," "intends," "projects," "predicts," "plans," "forecasts," "outlook," "sustain," "could," "may," "strategy," "will," "would be," "seek," "target," variations of such words, and similar expressions are also intended to identify such forward-looking statements. These forward-looking statements are subject to risks, uncertainties, and assumptions that are difficult to predict; therefore, actual results may differ materially and adversely from those expressed in any forward-looking statements.

Forward-looking statements in this report include, without limitation, statements about the following:

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

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

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

- *our belief that levels of gross profit margin for our Water Segment are likely 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;*

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our expectation that our expenses for research and development may increase as a result of our continuing to advance our existing technologies and develop new energy recovery and efficiency-enhancing solutions for existing and new products; and

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

You should not place undue reliance on these forward-looking statements, which reflect management's opinions only as of the date of the filing of this Quarterly Report on Form 10-Q. All forward-looking statements included in this document are subject to certain risks and uncertainties, which could cause actual results to differ materially from those projected in the forward-looking statements, including those risks and uncertainties, as disclosed from time to time in our reports on Forms 10-K under Part I, Item 1A, Risk Factors, as may be updated from time to time in our Forms 10-Q, and/or 8-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.

Overview

Energy Recovery, Inc. (the “Company,” “Energy Recovery,” “our,” “us,” and “we”) is an energy solutions provider to industrial fluid flow markets worldwide. Our core competencies are fluid dynamics and advanced material science. Our products make industrial processes more operating and capital expenditure efficient. Our solutions convert wasted pressure energy into a reusable asset and preserve or eliminate pumping technology in hostile processing environments. Our 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[®], AT[™], AquaBold[™], VorTeq[™], IsoBoost[®], and IsoGen[®]. Our solutions are owned, manufactured, and/or developed, in whole or in part, in the United States of America (“U.S.”) and the Republic of Ireland.

Our company was founded in 1992, and we introduced the initial version of our Pressure Exchanger energy recovery device in early 1997 for sea water reverse osmosis desalination. Shares of our common stock began trading publicly in July 2008. In December 2009, we acquired Pump Engineering, LLC, which manufactured centrifugal energy recovery devices known as turbochargers as well as high-pressure pumps. In 2012, we introduced the IsoBoost and IsoGen branded products for use in the oil & gas industry. In 2015, we conducted field trials for the VorTeq hydraulic fracturing system, also for use in the oil & gas industry for oil field hydraulic fracturing operations and entered into a fifteen-year license agreement with Schlumberger Technology Corporation. In 2016, we received our first major purchase order for multiple units of our IsoBoost technology for integration into a major gas processing plant to be constructed in the Middle East. The contract is for approximately \$7 million worth of equipment and services with an option for an additional \$4 million to be determined at a later date. The optional supply may not be confirmed by the customer until the latter portion of 2017.

Our reportable operating segments consist of the Water Segment and the Oil & Gas Segment. These segments are based on the industries in which the products are sold and the related solutions and services.

Water Segment

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

With respect to product revenue from our energy recovery devices in our Water Segment, a significant portion of our revenue typically has been generated from sales to a limited number of large engineering, procurement, and construction, or EPC, firms that are involved with the design and construction of large desalination plants. Sales to these firms often involve a long sales cycle that can range from 16 to 36 months. A single large desalination project can generate an order for numerous energy recovery devices and generally represents a significant revenue opportunity. We also sell our devices to many small- to medium-sized original equipment manufacturers, or OEMs, which commission smaller desalination plants, order fewer energy recovery devices per plant, and have shorter sales cycles.

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

A limited number of our customers in our Water Segment account for a substantial portion of our product revenue and of our accounts receivable and unbilled receivables. Product revenue from these customers representing 10% or more of product revenue varies from period to period. For the three months ended September 30, 2016, two customers accounted for 23% and 15%, respectively, of our Water Segment product revenue. For the three months ended September 30, 2015, one customer accounted for 32% of our Water Segment product revenue. For the nine months ended September 30, 2016, one customer accounted for 13% of our Water Segment product revenue. For the nine months ended September 30, 2015, two customers accounted for 14% and 13%, respectively, of our Water Segment product revenue. No other customer accounted for 10% or more of our Water Segment product revenue during any of these periods.

At September 30, 2016, two customers accounted for 23% and 16%, respectively, of our Water Segment accounts receivable and unbilled receivables balance. At December 31, 2015, two customers accounted for 26% and 18%, respectively, of our Water Segment accounts receivable and unbilled receivables balance. For additional information, see Note 11—“Concentrations” in the accompanying Condensed Consolidated Financial Statements.

During the three and nine months ended September 30, 2016 and 2015, most of our Water Segment product revenue and accounts receivable were attributable to sales outside of the United States. We expect sales and accounts receivable outside of the United States to remain a significant portion of our Water Segment product revenue and accounts receivable for the next few years.

Oil & Gas Segment

The Oil & Gas Segment consists of revenue associated with products sold or licensed for use in gas processing, chemical processing, and hydraulic fracturing, as well as related identifiable expenses. In the past several years, we have invested significant research and development costs to expand our business into pressurized fluid flow industries within the oil & gas industry. In 2012, we introduced the IsoBoost and IsoGen branded products for use in the oil & gas industry. In 2014, we announced a new product for the hydraulic fracturing industry, the VorTeq hydraulic fracturing system. Field trials were initiated for the VorTeq in the second quarter of 2015 and successfully completed in December 2015. In 2016, we received our first major purchase order for multiple units of our IsoBoost technology for integration into a major gas processing plant to be constructed in the Middle East. The contract is for approximately \$7 million worth of equipment and services with an option for an additional \$4 million to be determined at a later date. The optional supply may not be confirmed by the customer until the latter portion of 2017.

Oil & gas product revenue recognized during the three and nine months ended September 30, 2016 relates to a purchase order for multiple units of our IsoBoost technology. The design, procurement, and manufacturing of this project began in July 2016. The project is expected to be completed in August 2017. IsoBoost and IsoGen systems are highly engineered, customized solutions that are designed and manufactured over an extended period of time and are built specifically to meet a customer's specifications. It is the Company's position that percentage-of-completion method of accounting is appropriate for IsoBoost and IsoGen systems given the facts and circumstances of these projects. Accordingly, we recognized \$0.5 million in the three and nine months ended September 30, 2016 under this revenue recognition policy. All of this product revenue is attributable to this purchase order.

In the first quarter of 2015, we recognized oil & gas product revenue of \$0.1 million from oil & gas commissioning services and fees related to the cancellation of a sales order.

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

three months ended September 30, 2016 and \$3.8 million recognized in the nine months ended September 30, 2016. As of September 30, 2016, the Company had not met the milestones.

During the three and nine months ended September 30, 2016 all of our license and development revenue is attributable to the Licensing Agreement. There was no license and development revenue in the three and nine months ended September 30, 2015.

At September 30, 2016 and December 31, 2015, there were no accounts receivable associated with our Oil & Gas Segment. At September 30, 2016, there was \$0.4 million in cost and estimated earnings in excess of billings related to the percentage-of-completion method of accounting for the purchase order for multiple units of our IsoBoost technology.

Results of Operations

Our condensed consolidated financial statements are prepared in accordance with generally accepted accounting principles in the United States, or U.S. GAAP. These accounting principles require us to make estimates and judgments that can affect the reported amounts of assets and liabilities as of the date of the condensed consolidated financial statements as well as the reported amounts of revenue and expense during the periods presented. We believe that the estimates and judgments upon which we rely are reasonable based upon information available to us at the time that we make these estimates and judgments. To the extent that there are material differences between these estimates and actual results, our consolidated financial results will be affected. The accounting policies that reflect our more significant estimates and judgments and which we believe are the most critical to aid in fully understanding and evaluating our reported financial results are revenue recognition - completed contract and percentage-of-completion; 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.

Three Months Ended September 30, 2016 Compared to Three Months Ended September 30, 2015**Total Revenue**

| | Three Months Ended September 30, | | Change | |
|---------------------------------|----------------------------------|----------------|--------------------------|-----------------|
| | 2016 | 2015 | Increase / (Decrease) | |
| Product revenue | \$ 11,024 | 90 % \$ 12,112 | 100% | \$(1,088) (9 %) |
| License and development revenue | 1,250 | 10 % — | — | 1,250 100% |
| Total revenue | \$ 12,274 | 100% \$ 12,112 | 100% | \$ 162 1 % |

Product Revenue

| Segment | Three Months Ended | | \$ Change | % Change |
|-----------------|--------------------|-----------|--------------|-------------|
| | 2016 | 2015 | | |
| Water | \$ 10,568 | \$ 12,112 | \$(1,544) | (13 %) |
| Oil & Gas | 456 | — | 456 | 100 % |
| Product revenue | \$ 11,024 | \$ 12,112 | \$(1,088) | (9 %) |

Product revenue in the Water Segment decreased by \$1.5 million, or 13%, to \$10.6 million for the three months ended September 30, 2016 from \$12.1 million for the three months ended September 30, 2015. The decrease was primarily due to lower aftermarket shipments of \$1.4 million and lower OEM shipments of \$0.3 million. These decreases were offset by higher mega project (“MPD”) shipments of \$0.2 million.

Product revenue in the Oil & Gas Segment increased by \$0.5 million, or 100%, to \$0.5 million for the three months ended September 30, 2016 from zero for the three months ended September 30, 2015. The increase was due to a percentage-of-completion revenue recognition associated with the sale of multiple IsoBoost systems.

During the three months ended September 30, 2016 and 2015, a significant portion of our product revenue was attributable to sales outside of the United States. Product revenue attributable to domestic and international sales as a percentage of product revenue was as follows:

**Three
Months
Ended****September
30,****2016 2015**

| | | |
|-----------------------|------|-------|
| Domestic revenue | 2 % | 3 % |
| International revenue | 98 % | 97 % |
| Product revenue | 100% | 100 % |

License and Development Revenue**Three Months Ended****September 30,**

| Segment | 2016 | 2015 | \$ Change | % Change |
|---------------------------------|-------------|-------------|----------------------|---------------------|
| Water | \$— | \$ — | \$ — | — |
| Oil & Gas | 1,250 | — | 1,250 | 100 % |
| License and development revenue | \$ 1,250 | \$ — | \$ 1,250 | 100 % |

License and development revenue during the three months ended September 30, 2016 was \$1.3 million associated with the Schlumberger Licensing Agreement. The \$1.3 million is representative of the straight-line basis of revenue recognition of the \$75 million exclusivity payment over the fifteen-year term of the Licensing Agreement.

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

| | Three Months Ended | |
|---------------------------------|---------------------------|-------------|
| | September 30, 2016 | 2015 |
| Domestic revenue | — | — |
| International revenue | 100 % | — |
| License and development revenue | 100 % | — |

Product Gross Profit

| | Three Months Ended September 30, 2016 | | | Three Months Ended September 30, 2015 | | |
|----------------------|--|----------------------|--------------|--|----------------------|--------------|
| | Water | Oil & Gas | Total | Water | Oil & Gas | Total |
| Product gross profit | \$6,921 | \$ 135 | \$7,056 | \$7,164 | \$ — | \$7,164 |
| Product gross margin | 65 % | 30 % | 64 % | 59 % | — | 59 % |

Product gross profit represents our product revenue less our product cost of revenue. Our product cost of revenue consists primarily of raw materials, manufactured components, personnel costs (including stock-based compensation), and manufacturing overhead. For the three months ended September 30, 2016, total product gross profit as a percentage of total product revenue was 64% compared to 59% for the three months ended September 30, 2015.

The increase in total product gross profit as a percentage of total product revenue in the three months ended September 30, 2016 compared to the three months ended September 30, 2015 was primarily due to a favorable shift in product channel from OEM and aftermarket to MPD, and to product mix and pricing in the Water Segment, as well as, increased revenue in the Oil & Gas Segment.

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

production efficiencies and enhanced yields.

Manufacturing headcount increased to 41 at September 30, 2016 from 40 at September 30, 2015.

Stock-based compensation expense included in product cost of revenue was \$16,000 and \$32,000 for the three months ended September 30, 2016 and 2015, respectively.

Operating Expenses

| | Three Months Ended September 30, | | | | | |
|-----------------------------------|----------------------------------|------|----------|------|------------|------------|
| | 2016 | | 2015 | | Change | |
| | | | | | Increase / | (Decrease) |
| Total revenue | \$12,274 | 100% | \$12,112 | 100% | \$162 | 1 % |
| Operating expenses: | | | | | | |
| General and administrative | 3,971 | 32 % | 3,590 | 30 % | 381 | 11 % |
| Sales and marketing | 2,512 | 20 % | 2,195 | 18 % | 317 | 14 % |
| Research and development | 2,319 | 19 % | 1,474 | 12 % | 845 | 57 % |
| Amortization of intangible assets | 158 | 1 % | 159 | 1 % | (1) | (1 %) |
| Total operating expenses | \$8,960 | 73 % | \$7,418 | 61 % | \$1,542 | 21 % |

General and Administrative Expense

General and administrative expense increased by \$0.4 million, or 11%, to \$4.0 million for the three months ended September 30, 2016 from \$3.6 million for the three months ended September 30, 2015. As a percentage of total revenue, general and administrative expense increased to 32% for the three months ended September 30, 2016 from 30% for the three months ended September 30, 2015.

General and administrative headcount increased to 31 at September 30, 2016 from 27 at September 30, 2015.

Of the \$0.4 million increase in general and administrative expense for the three months ended September 30, 2016 compared to the same quarter of 2015, \$0.4 million related to compensation and employee related benefits and \$0.1 million related to stock based compensation. These increases were offset by a decrease of \$0.1 million related to professional, legal and other administrative costs.

Stock-based compensation expense included in general and administrative expense was \$0.4 million and \$0.3 million for the three months ended September 30, 2016 and 2015, respectively.

Sales and Marketing Expense

Sales and marketing expense increased by \$0.3 million, or 14%, to \$2.5 million for the three months ended September 30, 2016 from \$2.2 million for the three months ended September 30, 2015. As a percentage of total revenue, sales and marketing expense increased to 20% for the three months ended September 30, 2016 from 18% for the three months ended September 30, 2015.

Sales and marketing headcount increased to 30 at September 30, 2016 from 28 at September 30, 2015.

The \$0.3 million increase in sales and marketing expense for the three months ended September 30, 2016 compared to the same quarter of 2015 was due to a \$0.2 million increase related to commissions and incentive bonus accruals and a \$0.1 million increase related to other marketing costs.

Stock-based compensation expense included in sales and marketing expense was \$0.2 million and \$0.1 million for the three months ended September 30, 2016 and 2015, respectively.

Research and Development Expense

Research and development expense increased by \$0.8 million, or 57%, to \$2.3 million for the three months ended September 30, 2016 from \$1.5 million for the three months ended September 30, 2015. As a percentage of total revenue, research and development expense increased to 19% for the three months ended September 30, 2016 from 12% for the three months ended September 30, 2015.

Research and development headcount increased to 23 at September 30, 2016 from 18 at September 30, 2015.

Of the \$0.8 million increase in research and development expense for the three months ended September 30, 2016 compared to the same quarter of 2015, \$0.7 million related to compensation and employee-related benefits, including

stock-based compensation costs and \$0.1 million related to costs associated with the Company's investment in product development for oil & gas applications.

Stock-based compensation expense included in research and development expense was \$0.2 million and \$0.1 million for the three months ended September 30, 2016 and 2015, respectively.

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

Amortization of Intangible Assets

Amortization of intangible assets is primarily related to finite-lived intangible assets acquired as a result of our purchase of Pump Engineering, LLC in December 2009. Amortization expense was \$0.2 million for both the three months ended September 30, 2016 and 2015. As a percentage of total revenue, amortization of intangible assets remained the same at 1% for both the three months ended September 30, 2016 and 2015.

Other income and expenses

| | Three Months Ended September 30, | | | | | |
|--------------------------------------|----------------------------------|------|----------|------|------------|------------|
| | 2016 | | 2015 | | Change | |
| | | | | | Increase / | (Decrease) |
| Total revenue | \$12,274 | 100% | \$12,112 | 100% | \$162 | 1% |
| Interest expense | (1) |)* | — |)* | (1) | (100%) |
| Other non-operating income (expense) | 79 | 1% | (48) |)* | 127 | 265% |
| Total other income (expenses) | \$78 | 1% | \$(48) |)* | \$126 | 263% |

*Less than 1%

Other non-operating income, increased by \$0.1 million to income of \$0.1 million in the three months ended September 30, 2016 from expense of (\$0.05) million in the three months ended September 30, 2015. The increase was primarily due to an increase in interest income related to interest receivable on investments recorded during the quarter in 2016 compared to the same period in 2015.

Income Taxes

The income tax provision was \$3,000 in the three months ended September 30, 2016 compared to a tax provision of \$38,000 in the three months ended September 30, 2015. The tax provision for the three months ended September 30, 2016 was primarily related to the tax basis amortization of goodwill and federal, state, and other taxes. The tax expenses were offset by a tax benefit related to losses in our Ireland subsidiary.

The tax expense for the three months ended September 30, 2015 primarily related to the tax basis amortization of goodwill and state and other taxes. The tax expense for the three months ended September 30, 2015 also includes a state tax benefit of approximately \$6,000.

Nine Months Ended September 30, 2016 Compared to Nine Months Ended September 30, 2015**Total Revenue**

| | Nine Months Ended September 30, | | Change | |
|---------------------------------|---------------------------------|----------------|--------------------------|-------------|
| | 2016 | 2015 | Increase / (Decrease) | |
| Product revenue | \$33,048 | 90 % \$28,460 | 100 % \$4,588 | 16 % |
| License and development revenue | 3,750 | 10 % — | — | 3,750 100 % |
| Total revenue | \$36,798 | 100 % \$28,460 | 100 % \$8,338 | 29 % |

Product Revenue

| Segment | Nine Months Ended | | | |
|-----------|-------------------|----------|---------|--------|
| | September 30, | | \$ | % |
| | 2016 | 2015 | Change | Change |
| Water | \$32,592 | \$28,319 | \$4,273 | 15 % |
| Oil & Gas | 456 | 141 | 315 | 223 % |

Product revenue \$33,048 \$28,460 \$4,588 16 %

Product revenue in the Water Segment increased by \$4.3 million, or 15%, to \$32.6 million for the nine months ended September 30, 2016 from \$28.3 million for the nine months ended September 30, 2015. The increase was primarily due to increased MPD shipments of \$2.5 million and higher OEM shipments of \$2.0 million. These increases were offset by lower aftermarket shipments of \$0.2 million.

Product revenue in the Oil & Gas Segment increased by \$0.3 million, or 223%, to \$0.5 million for the nine months ended September 30, 2016 from \$0.1 million for the nine months ended September 30, 2015. The increase was due to a percentage-of-completion revenue recognition associated with the sale of multiple IsoBoost systems.

During the nine months ended September 30, 2016 and 2015, a significant portion of our product revenue was attributable to sales outside of the United States. Product revenue attributable to domestic and international sales as a percentage of product revenue was as follows:

| | Nine Months Ended | |
|-----------------------|----------------------------------|-------------|
| | September 30, | |
| | 2016 | 2015 |
| Domestic revenue | 2 % | 5 % |
| International revenue | 98 % | 95 % |
| Product revenue | 100 % | 100 % |

License and Development Revenue

| | Nine Months Ended | | | |
|---------------------------------|--------------------------|-------------|----------------------|---------------------|
| | September 30, | | | |
| Segment | 2016 | 2015 | \$ Change | % Change |
| Water | \$— | \$ — | \$ — | — |
| Oil & Gas | 3,750 | — | 3,750 | 100 % |
| License and development revenue | \$3,750 | \$ — | \$ 3,750 | 100 % |

License and development revenue during the nine months ended September 30, 2016 was \$3.8 million, which was a result of the recognition of \$3.8 million in revenue associated with the Schlumberger Licensing Agreement. The \$3.8 million is representative of the straight-line basis of revenue recognition of the \$75 million exclusivity payment over the fifteen-year term of the Licensing Agreement.

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

| | Nine Months Ended | |
|---------------------------------|---------------------------|-------------|
| | September 30, 2016 | 2015 |
| Domestic revenue | — | — |
| International revenue | 100 % | — |
| License and development revenue | 100 % | — |

Product Gross Profit

| | Nine Months Ended September 30, 2016 | | | Nine Months Ended September 30, 2015 | | |
|----------------------|---|----------------------|--------------|---|----------------------|--------------|
| | Water | Oil & Gas | Total | Water | Oil & Gas | Total |
| Product gross profit | \$21,035 | \$ 135 | \$21,170 | \$16,032 | \$ 113 | \$16,145 |
| Product gross margin | 65 % | 30 % | 64 % | 57 % | 80 % | 57 % |

Product gross profit represents our product revenue less our product cost of revenue. Our product cost of revenue consists primarily of raw materials, personnel costs (including stock-based compensation), manufacturing overhead, warranty costs, depreciation expense, and manufactured components. For the nine months ended September 30, 2016, product gross profit as a percentage of product revenue was 64% compared to 57% for the nine months ended September 30, 2015.

The increase in total product gross profit as a percentage of total product revenue in the nine months ended September 30, 2016 compared to the nine months ended September 30, 2015 was primarily due to increased sales volume, a shift in product mix, and pricing in the Water Segment, and increased revenue in the Oil & Gas Segment.

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

Stock-based compensation expense included in product cost of revenue was \$0.1 million and \$0.1million for the nine months ended September 30, 2016 and 2015, respectively.

Operating Expenses

| | Nine Months Ended September 30, | | | | | |
|-----------------------------------|--|-------|-------------|-------|----------------------------------|--------|
| | 2016 | | 2015 | | Change | |
| | | | | | Increase / (Decrease) | |
| Total revenue | \$36,798 | 100 % | \$28,460 | 100 % | \$8,338 | 29 % |
| Operating expenses: | | | | | | |
| General and administrative | 12,847 | 35 % | 15,230 | 54 % | (2,383) | (16 %) |
| Sales and marketing | 6,517 | 18 % | 6,622 | 23 % | (105) | (2 %) |
| Research and development | 7,406 | 20 % | 5,417 | 19 % | 1,989 | 37 % |
| Amortization of intangible assets | 473 | 1 % | 476 | 2 % | (3) | (1 %) |
| Total operating expenses | \$27,243 | 74 % | \$27,745 | 97 % | \$(502) | (2 %) |

General and Administrative Expense

General and administrative expense decreased by \$2.4 million, or 16%, to \$12.8 million for the nine months ended September 30, 2016 from \$15.2 million for the nine months ended September 30, 2015. As a percentage of total revenue, general and administrative expense decreased to 35% for the nine months ended September 30, 2016 from 54% for the nine months ended September 30, 2015.

Of the \$2.4 million decrease in general and administrative expense for the nine months ended September 30, 2016 compared to the same period of 2015, \$1.4 million related to professional, legal and other administrative costs and \$1.2 million related to stock based compensation. These decreases were offset by \$0.2 million related to compensation and employee related benefits.

Stock-based compensation expense included in general and administrative expense was \$1.6 million and \$2.9 million for the nine months ended September 30, 2016 and 2015, respectively. Stock-based compensation expense for the nine months ended September 30, 2015 included charges as a result of the modification of options associated with the resignation of the former Chief Executive Officer of \$1.3 million.

Sales and Marketing Expense

Sales and marketing expense decreased by \$0.1 million, or 2%, to \$6.5 million for the nine months ended September 30, 2016 from \$6.6 million for the nine months ended September 30, 2015. As a percentage of total revenue, sales and marketing expense decreased to 18% for the nine months ended September 30, 2016 from 23% for the nine months ended September 30, 2015.

The \$0.1 million decrease in sales and marketing expense for the nine months ended September 30, 2016 compared to the same period of 2015 was due to \$0.5 million related to compensation and employee related benefits. The decrease was offset by \$0.2 million related to commissions and bonuses and \$0.2 million related to stock-based compensation.

Stock-based compensation expense included in sales and marketing expense was \$0.5 million and \$0.3 million for the nine months ended September 30, 2016 and 2015, respectively.

Research and Development Expense

Research and development expense increased by \$2.0 million, or 37%, to \$7.4 million for the nine months ended September 30, 2016 from \$5.4 million for the nine months ended September 30, 2015. As a percentage of total revenue, research and development expense increased to 20% for the nine months ended September 30, 2016 from 19% for the nine months ended September 30, 2015.

Of the \$2.0 million increase in research and development expense for the nine months ended September 30, 2016 compared to the same period of 2015, \$1.0 million related to compensation and employee-related benefits, including stock-based compensation; \$0.7 million related to costs associated with the Company's investment in product development for oil & gas applications; \$0.2 million related to other administrative costs; and \$0.1 million related to professional and other services.

Stock-based compensation expense included in research and development expense was \$0.4 million and \$0.3 million for the nine months ended September 30, 2016 and 2015, respectively.

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

Amortization of Intangible Assets

Amortization expense was \$0.5 million for both the nine months ended September 30, 2016 and the nine months ended September 30, 2015. As a percentage of total revenue, amortization of intangible assets decreased to 1% for the nine months ended September 30, 2016 from 2% for the nine months ended September 30, 2015.

Other income and expenses

| | Nine Months Ended September 30, | | | | Change | |
|--------------------------------------|--|------|-------------|------|------------------------------|------|
| | 2016 | | 2015 | | Increase / (Decrease) | |
| Total revenue | \$36,798 | 100% | \$28,460 | 100% | \$8,338 | 29% |
| Interest expense | (2) * | | (40) * | | 38 | 95% |
| Other non-operating income (expense) | 137 | * | (130) * | | 267 | 205% |
| Total other income (expenses) | \$135 | * | \$(170) | 1 % | \$305 | 179% |

*Less than 1%

Total other income (expense), increased by \$0.3 million to income of \$0.1 million in the nine months ended September 30, 2016 from expense of (\$0.2) million in the nine months ended September 30, 2015. The increase was primarily due to an increase in interest income related to interest receivable on investments and lower interest expense.

Income Taxes

The income tax benefit was \$0.1 million in the nine months ended September 30, 2016 compared to a tax provision of \$0.2 million in the nine months ended September 30, 2015. The tax benefit for the nine months ended September 30, 2016 was primarily related to losses in our Ireland subsidiary offset by tax expense related to the tax basis amortization of goodwill and federal, state, and other taxes.

The tax provision for the nine months ended September 30, 2015 primarily related to the tax basis amortization of goodwill and state and other taxes.

Liquidity and Capital Resources

Overview

Our primary source of cash historically has been proceeds from customer payments for our products and services and the issuance of common stock. In October 2015, under the terms of the Licensing Agreement, we received a \$75 million exclusivity payment from Schlumberger. The Licensing Agreement with Schlumberger also provides for two separate \$25 million payments upon the meeting of two milestones, which we have not yet met, and recurring royalty payments throughout the term of the Licensing Agreement, once our VorTeq technology is commercialized.

As of September 30, 2016, we have issued common stock for aggregate net proceeds of \$91.9 million, excluding common stock issued in exchange for promissory notes. The proceeds from the issuance of common stock have been used to fund our operations and capital expenditures.

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

As of September 30, 2016, our principal sources of liquidity consisted of unrestricted cash and cash equivalents of \$80.7 million that are invested primarily in money market funds; short-term investments of \$15.0 million that are primarily invested in marketable debt securities; and net accounts receivable of \$8.2 million. We invest cash not

needed for current operations predominantly in high-quality, investment-grade, and marketable debt instruments with the intent to make such funds available for operating purposes as needed.

We currently have unbilled receivables pertaining to customer contractual holdback provisions, whereby we will invoice the final installment due under a sales contract 2 to 24 months after the product has been shipped to the customer and revenue has been recognized. The customer holdbacks represent amounts intended to provide a form of security to the customer during the warranty period; accordingly, these receivables have not been discounted to present value. At September 30, 2016 we had \$0.9 million of short-term unbilled receivables.

In June 2012, we entered into a loan agreement with a financial institution. The agreement was amended in June 2015 (as amended, the "Loan Agreement"). The Loan Agreement provides for a total available credit line of \$16.0 million. Under the Loan Agreement, we are allowed to draw advances not to exceed, at any time, \$10.0 million as revolving loans. The total stand-by letters of credit issued under the Loan Agreement may not exceed the lesser of the \$16.0 million credit line or the credit line minus all outstanding revolving loans. Revolving loans may be in the form of a base rate loan that bears interest equal to the prime rate or a Eurodollar loan that bears interest equal to the adjusted LIBOR rate plus 1.25%. Stand-by letters of credit are subject to customary fees and expenses for issuance or renewal. The unused portion of the credit facility is subject to a fee in an amount equal to 0.25% per annum of the average unused portion of the revolving line.

We are subject to certain financial and administrative covenants under the Loan Agreement. As of September 30, 2016, we were in compliance with these covenants.

The Loan Agreement also requires us to maintain a cash collateral balance equal to 101% of all outstanding advances and all outstanding stand-by letters of credit collateralized by the line of credit. The Loan Agreement matures in June 2018 and is collateralized by substantially all of our assets. As of September 30, 2016 there were revolving loans drawn under the Loan Agreement's line of credit. The amounts outstanding on stand-by letters of credit collateralized under the Loan Agreement totaled approximately \$3.6 million, and restricted cash related to these stand-by letters of credit issued under the Loan Agreement was approximately \$3.6 million as of September 30, 2016. Of this \$3.6 million of restricted cash, \$0.5 million was classified as current and \$3.1 million was classified as non-current.

As of September 30, 2016, we also had a stand-by letter of credit at another financial institution for \$0.2 million. All of this \$0.2 million restricted cash was classified as non-current.

Cash Flows from Operating Activities

Net cash provided by (used in) operating activities was \$2.3 million and (\$7.7) million for the nine months ended September 30, 2016 and 2015, respectively. For the nine months ended September 30, 2016, a net loss of (\$2.1) million was adjusted to \$3.0 by non-cash items totaling \$5.1 million. For the nine months ended September 30, 2015, a net loss of (\$11.9) million was adjusted to (\$5.2) million by non-cash items totaling \$6.7 million. Non-cash adjustments during the nine months ended September 30, 2016, primarily include depreciation and amortization of \$2.8 million and stock-based compensation of \$2.6 million.

Non-cash adjustments during the nine months ended September 30, 2015, primarily include stock-based compensation of \$3.5 million and depreciation and amortization of \$2.9 million.

The net cash impact from changes in assets and liabilities was approximately (\$0.6) million and (\$2.5) million for the nine months ended September 30, 2016 and 2015, respectively. Changes in assets and liabilities with a positive impact on cash flow during the nine months ended September 30, 2016 of \$5.8 million were primarily attributable to a \$4.3 million decrease in accounts receivable and unbilled receivables as a result of the collections and the timing of invoices for projects shipped previously; a \$0.8 million decrease in inventory; a \$0.6 million increase in deferred product revenue; and a \$0.1 million increase in income taxes payable. The positive impacts on cash flow were offset by negative impacts of \$(6.4) million primarily attributable to a (\$3.8) million decrease in non-current deferred revenue related to the recognition of revenue related to the Schlumberger exclusive license; a (\$1.6) million decrease in accrued expenses and other current liabilities due to the timing of payments to employees and other third parties; a (\$0.6) million increase in prepaid expenses and other current assets; and a (\$0.4) million change in costs and estimated earnings in excess of billings related to percentage-of-completion revenue recognition.

Changes in assets and liabilities with a positive impact on cash flow during the nine months ended September 30, 2015 of \$3.7 million were primarily attributable to a \$3.3 million decrease in accounts receivable and unbilled receivables as a result of the collections and the timing of invoices for projects shipped previously and a \$0.4 million increase in deferred revenue due to the timing of invoices. The positive impacts on cash flow were offset by negative impacts of (\$6.2) million primarily attributable to a (\$3.6) million decrease in accrued expense, and other liabilities due to the timing of payments to other third parties; the settlement of a litigation case for (\$1.7) million; a (\$0.6) million increase in inventories due to the timing of shipments; a (\$0.2) million increase in prepaid and other assets and unbilled receivables; and a (\$0.1) million decrease in accounts payable due to timing of payments to vendors.

Cash Flows from Investing Activities

Net cash (used in) provided by investing activities was (\$15.8) million and \$13.1 million for the nine months ended September 30, 2016 and 2015, respectively. Cash flows used in investing activities for the nine months ended September 30, 2016 included (\$15.9) million to purchase marketable securities and (\$0.9) million to purchase fixed assets. These uses were offset by \$1.0 million of cash received from the maturity of marketable securities.

Cash flows provided by investing activities for the nine months ended September 30, 2015 were primarily due to the maturity of marketable securities of \$11.8 million and the release of \$1.9 million of restricted cash used to collateralize stand-by letters of credit. These sources of cash were offset by the use of (\$0.6) million to purchase fixed assets.

Cash Flows from Financing Activities

Net cash (used in) provided by financing activities was (\$5.7) million and \$0.6 million for the nine months ended September 30, 2016 and 2015, respectively. Net cash used during the nine months ended September 30, 2016 consisted of (\$9.4) million used to repurchase our common stock related to repurchase programs. The use of cash was offset by \$3.7 million received for the issuance of common stock due to option exercises.

Net cash provided during the nine months ended September 30, 2015 consisted of \$0.6 million received for the issuance of common stock due to option and warrant exercises and \$55,000 of borrowings offset by the use of (\$5,000) for repayment of the borrowings.

Liquidity and Capital Resource Requirements

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

Contractual Obligations

In March 2015, we entered into a loan agreement that matures in April 2020. The total of future minimum installment payment under this agreement as of September 30, 2016 was \$41,000. For additional information, see Note 6 — “Long-Term Debt and Line of Credit” to the unaudited condensed consolidated financial statements.

We lease facilities and equipment under fixed non-cancellable operating leases that expire on various dates through 2021. The total of the future minimum lease payments under these leases as of September 30, 2016 was \$5.3 million. For additional information, see Note 9 — “Commitments and Contingencies” to the unaudited condensed consolidated financial statements.

In the course of our normal operations, we also enter into purchase commitments with our suppliers for various raw materials and components parts. The purchase commitments covered by these arrangements are subject to change based on sales forecasts for future deliveries. As of September 30, 2016, we had approximately \$1.2 million of cancellable open purchase order arrangements related primarily to materials and parts.

Additionally, we have entered into sale of goods agreements with two vendors for which the purchase orders have not yet been issued, but the Company has made a purchase obligation. The sale of goods agreements total \$3.2 million.

We have agreements with guarantees or indemnity provisions that we have entered into with customers and others in the ordinary course of business. Based on our historical experience and information known to us as of September 30, 2016, we believe that our exposure related to these guarantees and indemnities was not material.

The following is a summary of our contractual obligations as of September 30, 2016 (in thousands):

| Payments Due During Year Ending December 31, | Payments Due by Period | | | Loan | Total |
|--|------------------------|----------------------|--------------------------|------|---------|
| | Operating Leases | Purchase Obligations | Sale of Goods Agreements | | |
| 2016 (remaining three months) | \$428 | \$ 1,214 | \$ 849 | \$ 3 | \$2,494 |
| 2017 | 1,691 | — | 2,336 | 11 | 4,038 |
| 2018 | 1,662 | — | — | 11 | 1,673 |
| 2019 | 1,460 | — | — | 12 | 1,472 |

| | | | | | |
|------|---------|----------|----------|-------|---------|
| 2020 | 59 | — | — | 4 | 63 |
| 2021 | 34 | — | — | — | 34 |
| | \$5,334 | \$ 1,214 | \$ 3,185 | \$ 41 | \$9,774 |

Off-Balance Sheet Arrangements

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

Recent Accounting Pronouncements

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk

The information in this section should be read in connection with the information on financial market risk related to changes in currency exchange rates and interest rates in Part II, Item 7A, “Quantitative and Qualitative Disclosure About Market Risk,” in our Annual Report on Form 10-K for the year ended December 31, 2015.

Foreign Currency Risk

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

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

Interest Rate Risk and Credit Risk

We have an investment portfolio of fixed income marketable debt securities, including amounts classified as cash equivalents and short-term investments. At September 30, 2016, our short-term investments totaled \$15.0 million. The primary objective of our investment activities is to preserve principal and liquidity while at the same time maximizing yields without significantly increasing risk. Our current investments are primarily in high-quality, short-term and long-term debt instruments of high-quality corporate issuers. These investments are subject to interest rate fluctuations and will decrease in market value if interest rates increase. To minimize the exposure due to adverse shifts in interest rates, we maintain investments with an average maturity of less than eighteen months. A hypothetical 1% increase in interest rates would have resulted in a \$44,000 decrease in the fair value of our fixed-income debt securities as of September 30, 2016.

Concentration of Credit Rate Risk

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

Item 4. Controls and Procedures.

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

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

(b) *Changes in internal controls.* There were no changes in our internal control over financial reporting during the quarter ended September 30, 2016 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II — OTHER INFORMATION

Item 1. Legal Proceedings

Note 9 – “Commitments and Contingencies”, under the caption “Litigation” of our Annual Report on Form 10-K filed with the SEC on March 3, 2016, provides information on certain litigation in which we are involved.

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

Item 1A. Risk Factors

There has been no material changes in our risk factors from those disclosed in Part I, Item 1A, in our Annual Report on Form 10-K filed on March 3, 2016 except as noted below:

Our use of the percentage-of-completion method of accounting requires us to make estimates and judgments, which are subject to an inherent degree of uncertainty and which may differ from actual results

IsoBoost and IsoGen systems are highly engineered, customized solutions that are designed and manufactured over an extended period of time and are built specifically to meet a customer’s specifications. It is the Company’s position that percentage-of-completion method of accounting is appropriate for IsoBoost and IsoGen systems given the facts and circumstances of these projects. This methodology requires the application of significant judgment by management in selecting the appropriate assumptions for calculating revenue and costs. Revenue and profits are recognized over the life of a project based on costs incurred to date compared to total estimated project costs. Revisions to revenues and profits are made once amounts are known and can be reasonably estimated. Given the uncertainties in accurately estimating the costs of projects, as well as providing reliable estimates to completion, it is possible for actual amounts to vary significantly from estimates previously made, which may result in the reversal of revenues and gross profit previously recognized and publicly reported.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds*Purchases of Equity Securities by the Issuer and Affiliated Purchasers*

The following table summarizes the stock repurchase activity during the three months ended September 30, 2016:

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Program | Maximum Number of Shares or Approximate Dollar Value That May Yet be Purchased Under the Program |
|----------------------------------|---|---|---|---|
| July 1 – July 31, 2016 | 114,400 | \$ 8.710 | 568,500 | \$ 4,731,122 |
| August 1 – August 31, 2016 | — | — | 568,500 | \$ 4,731,122 |
| September 1 – September 30, 2016 | — | — | 568,500 | \$ 4,731,122 |
| Total | 114,400 | \$ 8.710 | 568,500 | \$ 4,731,122 |

In May 2016, the Board of Directors authorized a stock repurchase plan under which the Company, at the discretion of management, could repurchase up to \$10.0 million in aggregate cost, of our outstanding common stock through October 31, 2016 (the “May Authorization”). As of September 30, 2016, 568,500 shares, at an aggregate cost of \$5.3 million, had been repurchased under the May Authorization.

Item 6. Exhibits

See the Exhibit List 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.

Registrant: Energy Recovery, Inc.

/s/ JOEL GAY
By: **Joel Gay** President and Chief Executive Officer November 3, 2016
(Principal Executive Officer)

/s/ CHRIS GANNON Chief Financial Officer November 3, 2016
Chris Gannon (Principal Financial Officer)

Exhibit List

| <u>Exhibit No.</u> | <u>Description</u> |
|---------------------------|--|
| 31.1 | Certification of Principal Executive Officer Pursuant to Exchange Act Rule 13a-14(a) or 15d-14(a), as Adopted Pursuant to Section 302 of The Sarbanes Oxley Act of 2002 |
| 31.2 | Certification of Principal Financial Officer Pursuant to Exchange Act Rule 13a-14(a) or 15d-14(a), as Adopted Pursuant to Section 302 of The Sarbanes Oxley Act of 2002 |
| 32.1 | Certifications of 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 |
| 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 |