

Energy Recovery, Inc.
Form 10-Q
November 08, 2010

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q**

(Mark One)

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

For the quarterly period ended September 30, 2010

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 of Incorporation)**

**01-0616867
(IRS Employer Identification No.)**

**1717 Doolittle Drive
San Leandro, CA 94577
(Address of Principal Executive Offices)**

**94577
(Zip Code)**

**(510) 483-7370
(Telephone No.)**

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 Smaller reporting company

(Do not check if a smaller reporting company)

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

As of November 1, 2010, there were 52,481,109 shares of the registrant's common stock outstanding.

ENERGY RECOVERY, INC.
QUARTERLY REPORT ON FORM 10-Q FOR THE PERIOD ENDED SEPTEMBER 30, 2010
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Table of Contents**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, 2010	December 31, 2009
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 56,802	\$ 59,115
Restricted cash	5,650	5,271
Accounts receivable, net of allowance for doubtful accounts of \$26 and \$196 at September 30, 2010 and December 31, 2009, respectively	6,209	12,683
Unbilled receivables, current	1,868	5,544
Inventories	12,080	10,359
Deferred tax assets, net	1,416	1,466
Prepaid expenses and other current assets	4,234	1,741
Total current assets	88,259	96,179
Restricted cash, non-current	2,277	5,555
Property and equipment, net	22,866	16,958
Goodwill	12,790	12,790
Other intangible assets, net	8,937	10,987
Deferred tax assets, non-current, net	447	447
Other assets, non-current	41	53
Total assets	\$ 135,617	\$ 142,969
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	\$ 1,675	\$ 1,952
Accrued expenses and other current liabilities	7,168	9,492
Income taxes payable	38	350
Accrued warranty reserve	883	605
Deferred revenue	4,016	4,628
Current portion of long-term debt	128	265
Current portion of capital lease obligations	182	203
Total current liabilities	14,090	17,495
Long-term debt	117	246
Capital lease obligations, non-current	231	369
Other non-current liabilities	1,812	3,890
Total liabilities	16,250	22,000

Commitments and Contingencies (Note 8)

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; 52,479,358 and 51,215,653 shares issued and outstanding at September 30, 2010 and

December 31, 2009, respectively	52	51
Additional paid-in capital	111,084	108,626
Notes receivable from stockholders	(38)	(90)
Accumulated other comprehensive loss	(75)	(66)
Retained earnings	8,344	12,448

Total stockholders equity	119,367	120,969
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Total liabilities and stockholders equity	\$ 135,617	\$ 142,969
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See accompanying notes to unaudited Condensed Consolidated Financial Statements.

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

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2010	2009	2010	2009
Net revenue	\$ 6,921	\$ 9,545	\$ 32,840	\$ 31,280
Cost of revenue	4,537	3,387	16,470	11,251
Gross profit	2,384	6,158	16,370	20,029
Operating expenses:				
General and administrative	4,018	3,043	12,773	9,705
Sales and marketing	1,860	1,634	5,962	4,795
Research and development	1,252	779	2,943	2,409
Total operating expenses	7,130	5,456	21,678	16,909
Income (loss) from operations	(4,746)	702	(5,308)	3,120
Interest expense	(15)	(10)	(53)	(34)
Other non-operating income (expense), net	78	30	(21)	59
Income (loss) before provision for income taxes	(4,683)	722	(5,382)	3,145
Provision for (benefit from) income taxes	(833)	172	(1,278)	1,112
Net income (loss)	\$ (3,850)	\$ 550	\$ (4,104)	\$ 2,033
Earnings (loss) per share:				
Basic	\$ (0.07)	\$ 0.01	\$ (0.08)	\$ 0.04
Diluted	\$ (0.07)	\$ 0.01	\$ (0.08)	\$ 0.04
Number of shares used in per share calculations:				
Basic	52,447	50,160	51,923	50,120
Diluted	52,447	52,584	51,923	52,614

See accompanying notes to unaudited Condensed Consolidated Financial Statements.

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ENERGY RECOVERY, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	Nine Months Ended	
	September 30,	
	2010	2009
Cash Flows From Operating Activities		
Net income (loss)	\$ (4,104)	\$ 2,033
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	3,785	626
Interest accrued on notes receivables from stockholders	(2)	(4)
Share-based compensation	2,028	1,815
Net unrealized loss (gain) on foreign currency transactions	36	(458)
Excess tax benefit from share-based compensation arrangements	(31)	
Provision for doubtful accounts	(154)	(7)
Provision for warranty claims	447	55
Valuation adjustments for excess or obsolete inventory	216	59
Amortization of inventory acquisition valuation step-up	870	
Other non-cash adjustments	(112)	
Changes in operating assets and liabilities:		
Accounts receivable	6,672	10,765
Unbilled receivables	3,652	325
Inventories	(2,805)	(2,076)
Deferred tax assets, net	50	(182)
Prepaid and other assets	(2,484)	(1,280)
Accounts payable	53	(1,852)
Accrued expenses and other liabilities	(3,359)	(812)
Income taxes payable	(280)	(1,497)
Deferred revenue	(612)	(2,451)
Net cash provided by operating activities	3,866	5,059
Cash Flows From Investing Activities		
Capital expenditures	(9,097)	(4,635)
Restricted cash	2,899	(5,261)
Other		(7)
Net cash used in investing activities	(6,198)	(9,903)
Cash Flows From Financing Activities		
Repayment of long-term debt	(266)	(184)
Repayment of capital lease obligation	(159)	(28)
Net proceeds from issuance of common stock	392	297
Excess tax benefit from share-based compensation arrangements	31	
Repayment of notes receivables from stockholders	54	212
Net cash provided by financing activities	52	297

Effect of exchange rate differences on cash and cash equivalents	(33)	(15)
Net change in cash and cash equivalents	(2,313)	(4,562)
Cash and cash equivalents, beginning of period	59,115	79,287
Cash and cash equivalents, end of period	\$ 56,802	\$ 74,725
Supplemental disclosure of cash flow information		
Cash paid for interest	\$ 52	\$ 34
Cash paid for income taxes	\$ 1,646	\$ 3,545

See accompanying notes to unaudited Condensed Consolidated Financial Statements.

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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 , ERI , we or us) develops, manufactures and sells high-efficiency energy recovery devices for use in seawater desalination. Our products are sold under the trademarks ERI , PX , PEI , Pressure Exchanger , PX Pressure Exchanger , Pump Engineering and Quadribaric . Our energy recovery devices make desalination affordable by capturing and reusing the otherwise lost pressure energy from the concentrated seawater reject stream of the desalination process. We also manufacture and sell high pressure pumps and circulation pumps for use in desalination. Our products are developed and manufactured in the United States of America (U.S.) at our headquarters in San Leandro, California, and at a facility in New Boston, Michigan. Additionally, the Company has direct sales offices and technical support centers in Madrid, Dubai, and Shanghai.

The Company was incorporated in Virginia in April 1992 and reincorporated in Delaware in March 2001. Shares of the Company began trading publicly in July 2008. The Company has five wholly owned subsidiaries: Osmotic Power, Inc., Energy Recovery, Inc. International, Energy Recovery Iberia, S.L., ERI Energy Recovery Ireland Ltd. and Pump Engineering, Inc. (PEI).

Use of Estimates

The preparation of condensed consolidated financial statements in conformity with U.S. generally accepted accounting principles (U.S. GAAP) requires management to make judgments, estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. The Company s most significant estimates and judgments involve the determination of revenue recognition, allowance for doubtful accounts, allowance for product warranty, valuation of stock options, valuation of goodwill and acquired intangible assets, useful lives for depreciation and amortization, valuation adjustments for excess and obsolete inventory, deferred taxes and valuation allowances on deferred tax assets. Actual results could differ materially from those estimates.

Basis of Presentation

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All significant intercompany accounts and transactions have been eliminated.

The accompanying Condensed Consolidated Financial Statements have been prepared by the Company, 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, 2009 Condensed Consolidated Balance Sheet was derived from audited financial statements, but does not include all disclosures required by U.S. GAAP; however, the Company believes 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, 2009 included in the Company s Annual Report on Form 10-K filed with the SEC on March 15, 2010.

In the opinion of management, all adjustments, consisting of only normal recurring adjustments, which 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.

The significant accounting policies followed by the Company for interim financial reporting are consistent with the accounting policies followed for annual financial reporting as disclosed in the Company s Annual Report on Form 10-K for the year ended December 31, 2009.

In connection with preparing the unaudited condensed consolidated financial statements for the three and nine months ended September 30, 2010, we have evaluated subsequent events for potential recognition and disclosure through the date of this filing.

Table of Contents**Recent Accounting Pronouncements****Revenue Arrangements with Multiple Deliverables**

In October 2009, the FASB issued an amendment to its previously released guidance on revenue arrangements with multiple deliverables. This guidance addresses how to determine whether an arrangement involving multiple deliverables contains more than one unit of accounting and how to allocate consideration to each unit of accounting in the arrangement. Additionally, the guidance replaces all references to fair value as the measurement criteria with the term selling price and establishes a hierarchy for determining the selling price of a deliverable, eliminates the use of the residual value method for determining the allocation of arrangement consideration, and requires expanded disclosures. The guidance becomes effective for the Company for revenue arrangements entered into or materially modified on or after January 1, 2011. Earlier application is permitted with required transition disclosures based on the period of adoption. The Company is currently evaluating the application date and the impact of this standard on its consolidated financial statements.

No other new accounting pronouncement issued or effective during the period had or is expected to have a material impact on the consolidated financial statements.

Note 2 Goodwill and Other Intangible Assets

In December 2009, the Company acquired 100% of the equity interests of Pump Engineering, LLC, a private US company and supplier of energy recovery technology and pumps for use in the global desalination market. The purchase price was allocated to the tangible assets and intangible assets acquired and liabilities assumed based on their estimated fair values on the acquisition date, with the remaining unallocated purchase price recorded as goodwill. As of September 30, 2010, there were no changes in the recognized amounts of goodwill resulting from the acquisition of Pump Engineering, LLC.

The Company's intangible assets include intangible assets acquired in the acquisition of Pump Engineering, LLC and costs related to the Company's development of patents. The following is a summary of the Company's identifiable intangible assets as of September 30, 2010 and December 31, 2009, respectively (in thousands, except useful life data):

	September 30, 2010				
	Gross Carrying Amount	Accumulated Amortization	Accumulated Impairment Losses	Net Carrying Amount	Weighted Average Useful Life
	Amount	Amortization	Losses	Amount	
Developed Technology	\$ 6,100	\$ (508)	\$	\$ 5,592	10
Non-compete agreements	1,310	(355)		955	4
Backlog	1,300	(1,082)		218	1
Trademarks	1,200	(50)		1,150	20
Customer relationships	990	(252)		738	5
Patents	585	(270)	(31)	284	18
	\$ 11,485	\$ (2,517)	\$ (31)	\$ 8,937	9

	December 31, 2009				
	Gross Carrying Amount	Accumulated Amortization	Accumulated Impairment Losses	Net Carrying Amount	Weighted Average Useful Life
	Amount	Amortization	Losses	Amount	
Developed Technology	\$ 6,100	\$ (51)	\$	\$ 6,049	10
Non-compete agreements	1,310	(35)		1,275	4
Backlog	1,300	(108)		1,192	1

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Trademarks	1,200	(5)		1,195	20
Customer relationships	990	(17)		973	5
Patents	585	(251)	(31)	303	18
	\$ 11,485	\$ (467)	\$ (31)	\$ 10,987	9

Table of Contents**Note 3 Earnings (Loss) per Share**

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Numerator:				
Net income (loss)	\$ (3,850)	\$ 550	\$ (4,104)	\$ 2,033
Denominator:				
Weighted average common shares outstanding	52,447	50,160	51,923	50,120
Effect of dilutive securities:				
Stock options		528		582
Warrants		1,896		1,912
Total shares for purpose of calculating diluted earnings (loss) per share	52,447	52,584	51,923	52,614
Earnings (loss) per share:				
Basic	\$ (0.07)	\$ 0.01	\$ (0.08)	\$ 0.04
Diluted	\$ (0.07)	\$ 0.01	\$ (0.08)	\$ 0.04

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Restricted awards*	59	60	59	20
Stock options	4,054	2,877	4,054	2,196
Warrants	970		970	

* Includes restricted stock and restricted stock units.

Note 4 Supplemental Financial Information**Restricted Cash**

The Company has pledged cash in connection with irrevocable standby letters of credit, an equipment promissory note, and contingent payments resulting from a business acquisition. The Company has deposited corresponding amounts into money market and non-interest bearing accounts at two financial institutions for these items as follows (in thousands):

	September 30, 2010	December 31, 2009
	\$ 4,604	\$ 5,500

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Contingent and other consideration for acquisition of Pump Engineering, LLC		
Collateral for irrevocable standby letters of credit	3,066	4,968
Collateral for equipment promissory note	257	358
	\$ 7,927	\$ 10,826

As part of the acquisition of Pump Engineering, LLC in December 2009, the Company recognized a liability of \$5.5 million related to contingent and other consideration arrangements. During the third quarter of 2010, \$900,000 of \$2.0 million in contingent consideration attributable to general representations and warranties was released from escrowed funds for the settlement reached between the former owners of Pump Engineering, LLC and another party. Restricted cash in an amount equal to the remaining contingent and other consideration was reflected on the Company's consolidated balance sheet as of September 30, 2010.

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Inventories consisted of the following (in thousands):

	September 30, 2010	December 31, 2009
Raw materials	\$ 5,937	\$ 6,394
Work in process	3,186	1,848
Finished goods	2,957	2,117
	\$ 12,080	\$ 10,359

Property and Equipment

Property and equipment consisted of the following (in thousands):

	September 30, 2010	December 31, 2009
Machinery and equipment	\$ 12,542	\$ 4,508
Office equipment, furniture, and fixtures	2,124	1,943
Automobiles	40	40
Software	340	312
Leasehold improvements	9,198	4,754
Buildings	2,215	2,215
Land	210	210
Construction in progress	211	5,567
	26,880	19,549
Less:		