

---

**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 June 30, 2019**

**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™**

**Energy Recovery, Inc.**

*(Exact Name of Registrant as Specified in its Charter)*

**Delaware**

*(State or Other Jurisdiction of Incorporation)*

**01-0616867**

*(I.R.S. Employer Identification No.)*

**1717 Doolittle Drive, San Leandro, CA 94577**

*(Address of Principal Executive Offices) (Zip Code)*

**(510) 483-7370**

*(Registrant's Telephone Number, Including Area Code)*

Securities registered pursuant to Section 12(b) of the Act:

<u>Title of each class</u>	<u>Trading Symbol</u>	<u>Name of each exchange on which registered</u>
Common	ERII	The Nasdaq Stock Market LLC

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, every Interactive Data File required to be submitted 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, smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company  Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

As of July 26, 2019, there were 54,964,637 shares of the registrant's common stock outstanding.

---

---

ENERGY RECOVERY, INC.

TABLE OF CONTENTS

**PART I**  
**FINANCIAL INFORMATION**

Page No.

Item 1.	Financial Statements (Unaudited)	<a href="#">3</a>
	Condensed Consolidated Balance Sheets as of June 30, 2019 and December 31, 2018	<a href="#">3</a>
	Condensed Consolidated Statements of Operations for the Three and Six Months Ended June 30, 2019 and 2018	<a href="#">4</a>
	Condensed Consolidated Statements of Comprehensive Income for the Three and Six Months Ended June 30, 2019 and 2018	<a href="#">5</a>
	Condensed Consolidated Statements of Stockholders' Equity for the Three and Six Months Ended June 30, 2019 and 2018	<a href="#">6</a>
	Condensed Consolidated Statements of Cash Flows for the Six Months Ended June 30, 2019 and 2018	<a href="#">7</a>
	Notes to Condensed Consolidated Financial Statements	<a href="#">8</a>
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	<a href="#">25</a>
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	<a href="#">34</a>
Item 4.	Controls and Procedures	<a href="#">35</a>

**PART II**  
**OTHER INFORMATION**

Item 1.	Legal Proceedings	<a href="#">36</a>
Item 1A.	Risk Factors	<a href="#">36</a>
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	<a href="#">45</a>
Item 3.	Defaults Upon Senior Securities	<a href="#">45</a>
Item 4.	Mine Safety Disclosures	<a href="#">46</a>
Item 5.	Other Information	<a href="#">46</a>
Item 6.	Exhibits	<a href="#">46</a>
	Exhibit Index	<a href="#">47</a>
	Signatures	<a href="#">48</a>

PART I — FINANCIAL INFORMATION

Item 1 — Financial Statements (unaudited)

ENERGY RECOVERY, INC.  
CONDENSED CONSOLIDATED BALANCE SHEETS

	June 30, 2019	December 31, 2018
<i>(In thousands, except share data and par value)</i>		
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 23,331	\$ 21,955
Restricted cash	—	97
Short-term investments	71,854	73,338
Accounts receivable, net of allowance for doubtful accounts of \$397 and \$396 as of June 30, 2019 and December 31, 2018, respectively	15,197	10,212
Contract assets	1,936	4,083
Inventories, net	7,763	7,138
Income taxes receivable	—	15
Prepaid expenses and other current assets	2,247	2,810
<b>Total current assets</b>	<u>122,328</u>	<u>119,648</u>
Restricted cash, non-current	88	86
Long-term investments	1,507	1,269
Deferred tax assets, non-current	17,033	18,318
Property and equipment, net	17,384	14,619
Operating lease, right of use asset	11,700	12,189
Goodwill	12,790	12,790
Other intangible assets, net	327	640
Other assets, non-current	308	282
<b>Total assets</b>	<u>\$ 183,465</u>	<u>\$ 179,841</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 1,459	\$ 1,439
Accrued expenses and other current liabilities	5,525	8,019
Lease liabilities	983	926
Income taxes payable	32	—
Accrued warranty reserve	599	478
Contract liabilities	15,447	16,270
<b>Total current liabilities</b>	<u>24,045</u>	<u>27,132</u>
Lease liabilities, non-current	12,050	12,556
Contract liabilities, non-current	19,632	26,539
Other non-current liabilities	278	236
<b>Total liabilities</b>	<u>56,005</u>	<u>66,463</u>
Commitments and contingencies (Note 8)		
<b>Stockholders' equity:</b>		
Preferred stock, \$0.001 par value; 10,000,000 shares authorized; no shares issued or outstanding at June 30, 2019 and December 31, 2018	—	—
Common stock, \$0.001 par value; 200,000,000 shares authorized; 60,359,930 shares issued and 54,903,995 shares outstanding at June 30, 2019 and 59,396,020 shares issued and 53,940,085 shares outstanding at December 31, 2018	60	59
Additional paid-in capital	165,981	158,404
Accumulated other comprehensive loss	(2)	(133)
Treasury stock at cost, 5,455,935 shares repurchased at June 30, 2019 and December 31, 2018	(30,486)	(30,486)
Accumulated deficit	(8,093)	(14,466)
<b>Total stockholders' equity</b>	<u>127,460</u>	<u>113,378</u>
<b>Total liabilities and stockholders' equity</b>	<u>\$ 183,465</u>	<u>\$ 179,841</u>

See Accompanying Notes to Condensed Consolidated Financial Statements

**ENERGY RECOVERY, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

	Three Months Ended June 30,		Six Months Ended June 30,	
	2019	2018	2019	2018
	<i>(In thousands, except per share data)</i>			
Product revenue	\$ 19,226	\$ 17,406	\$ 35,298	\$ 28,464
Product cost of revenue	5,483	5,976	10,418	9,290
Product gross profit	13,743	11,430	24,880	19,174
License and development revenue	3,570	3,358	7,293	6,107
Operating expenses:				
General and administrative	5,500	4,927	11,079	10,764
Sales and marketing	2,181	1,858	4,343	3,770
Research and development	5,480	3,605	9,734	7,522
Amortization of intangible assets	157	158	313	316
Total operating expenses	13,318	10,548	25,469	22,372
Income from operations	3,995	4,240	6,704	2,909
Other income (expense):				
Interest income	528	373	1,051	674
Interest expense	—	(1)	—	(1)
Other non-operating (expense) income, net	(48)	9	(72)	(44)
Total other income, net	480	381	979	629
Income before income taxes	4,475	4,621	7,683	3,538
Provision for (benefit from) income taxes	756	(11,122)	1,310	(11,479)
Net income	\$ 3,719	\$ 15,743	\$ 6,373	\$ 15,017
Earnings per share:				
Basic	\$ 0.07	\$ 0.29	\$ 0.12	\$ 0.28
Diluted	\$ 0.07	\$ 0.28	\$ 0.11	\$ 0.27
Number of shares used in per share calculations:				
Basic	54,681	53,747	54,400	53,747
Diluted	56,110	55,406	55,764	55,437

See Accompanying Notes to Condensed Consolidated Financial Statements

**ENERGY RECOVERY, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

	Three Months Ended June 30,		Six Months Ended June 30,	
	2019	2018	2019	2018
	<i>(In thousands)</i>			
Net income	\$ 3,719	\$ 15,743	\$ 6,373	\$ 15,017
Other comprehensive income (loss), net of tax:				
Foreign currency translation adjustments	7	(33)	(1)	(12)
Unrealized gain (loss) on investments	64	7	132	(57)
Other comprehensive income (loss), net of tax	71	(26)	131	(69)
Comprehensive income	\$ 3,790	\$ 15,717	\$ 6,504	\$ 14,948

See Accompanying Notes to Condensed Consolidated Financial Statements

**ENERGY RECOVERY, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY**

	Three Months Ended June 30,		Six Months Ended June 30,	
	2019	2018	2019	2018
<i>(In thousands)</i>				
<b>Common stock</b>				
Beginning balance	\$ 60	\$ 59	\$ 59	\$ 58
Issuance of common stock, net <sup>1</sup>	—	—	1	1
Ending balance	60	59	60	59
<b>Additional paid-in capital</b>				
Beginning balance	162,231	152,850	158,404	149,006
Issuance of common stock, net	2,362	716	4,518	2,313
Stock-based compensation	1,388	958	3,059	3,205
Ending balance	165,981	154,524	165,981	154,524
<b>Accumulated other comprehensive loss</b>				
Beginning balance	(73)	(168)	(133)	(125)
Other comprehensive income (loss)	71	(26)	131	(69)
Ending balance	(2)	(194)	(2)	(194)
<b>Treasury stock</b>				
Beginning balance	(30,486)	(23,981)	(30,486)	(20,486)
Repurchase of common stock for treasury	—	(6,505)	—	(10,000)
Ending balance	(30,486)	(30,486)	(30,486)	(30,486)
<b>Accumulated deficit</b>				
Beginning balance	(11,812)	(37,285)	(14,466)	(36,559)
Net income	3,719	15,743	6,373	15,017
Ending balance	(8,093)	(21,542)	(8,093)	(21,542)
<b>Total stockholders' equity</b>	<b>\$ 127,460</b>	<b>\$ 102,361</b>	<b>\$ 127,460</b>	<b>\$ 102,361</b>
<b>Common stock issued (number of shares)</b>				
Beginning balance	59,919	58,700	59,396	58,168
Issuance of common stock, net	441	251	964	783
Ending balance	60,360	58,951	60,360	58,951
<b>Treasury stock (number of shares)</b>				
Beginning balance	(5,456)	(4,673)	(5,456)	(4,263)
Repurchase of common stock for treasury <sup>2</sup>	—	(783)	—	(1,193)
Ending balance	(5,456)	(5,456)	(5,456)	(5,456)

<sup>1</sup> Amounts less than \$500 rounded to zero

<sup>2</sup> The March 2018 stock repurchase authorization expired in September 2018

See Accompanying Notes to Condensed Consolidated Financial Statements

**ENERGY RECOVERY, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

	Six Months Ended June 30,	
	2019	2018
	<i>(In thousands)</i>	
Cash flows from operating activities:		
Net income	\$ 6,373	\$ 15,017
Adjustments to reconcile net income to cash provided by (used in) operating activities		
Stock-based compensation	3,071	3,184
Depreciation and amortization	1,952	2,040
(Accretion) amortization of premiums and discounts on investments	(30)	267
Provision for warranty claims	242	135
Unrealized gain on foreign currency translation	(48)	(51)
Reversal of accruals related to expired warranties	(83)	(84)
Provision for doubtful accounts	1	328
Adjustments for excess or obsolete inventory	62	17
Deferred income taxes	1,285	(11,512)
Loss on disposal of fixed assets	327	22
Other non-cash adjustments	—	2
Changes in operating assets and liabilities:		
Accounts receivable, net	(4,986)	833
Contract assets, costs and estimated earnings in excess of billings	2,147	186
Inventories, net	(725)	(907)
Prepaid and other assets	1,026	(10,477)
Accounts payable	14	(1,976)
Accrued expenses and other liabilities	(2,942)	7,532
Income taxes	47	(577)
Contract liabilities, cost in excess of billings	(7,730)	(5,649)
Net cash provided by (used in) operating activities	<u>3</u>	<u>(1,670)</u>
Cash flows from investing activities:		
Maturities of marketable securities	47,993	40,638
Purchases of marketable securities	(46,549)	(43,117)
Capital expenditures	(4,685)	(1,536)
Net cash used in investing activities	<u>(3,241)</u>	<u>(4,015)</u>
Cash flows from financing activities:		
Net proceeds from issuance of common stock	4,581	2,390
Tax payment for employee shares withheld	(62)	(76)
Repayment of long-term debt	—	(5)
Repurchase of common stock	—	(10,000)
Net cash provided by (used in) financing activities	<u>4,519</u>	<u>(7,691)</u>
Effect of exchange rate differences on cash and cash equivalents	—	22
Net change in cash, cash equivalents and restricted cash	1,281	(13,354)
Cash, cash equivalents and restricted cash, beginning of year	22,138	30,626
Cash, cash equivalents and restricted cash, end of period	<u>\$ 23,419</u>	<u>\$ 17,272</u>

See Accompanying Notes to Condensed Consolidated Financial Statements

**ENERGY RECOVERY, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Note 1 — Description of Business and Significant Accounting Policies**

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

**Basis of Presentation**

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

The accompanying Condensed Consolidated Financial Statements have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”). Certain information and footnote disclosures normally included in the financial statements prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) have been condensed or omitted pursuant to such rules and regulations. The December 31, 2018 Condensed Consolidated Balance Sheet was derived from audited financial statements and may not include all disclosures required by GAAP; however, the Company believes that the disclosures are adequate to make the information presented not misleading. The June 30, 2019 unaudited Condensed Consolidated Financial Statements should be read in conjunction with the audited Consolidated Financial Statements and the notes thereto for the fiscal year ended December 31, 2018 included in the Company’s Annual Report on Form 10-K filed with the SEC on March 7, 2019 as amended on March 12, 2019.

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

**Use of Estimates**

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

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

**Recent Accounting Pronouncements**

***Recently Adopted Accounting Pronouncements***

In August 2018, the Financial Accounting Standards board (“FASB”) issued Accounting Standards Update (“ASU”) 2018-15 (“ASU 2018-15”), *Intangibles - Goodwill and Other - Internal-Use Software (Topic 350-40): Customer’s Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract*. ASU 2018-15 aligns the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software. The updated guidance is effective for annual periods beginning after December 15, 2019 and interim periods within those fiscal years. Early adoption is permitted.

The Company has elected to early adopt ASU 2018-15 for the period beginning this second quarter of 2019, applying effects prospectively. The Company expects to defer related implementation costs of approximately \$0.6 million to \$0.9 million for the remainder of 2019.



**ENERGY RECOVERY, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Recently Issued Accounting Pronouncements Not Yet Adopted**

In the six months ended June 30, 2019, there were no accounting pronouncements issued which were not adopted by the Company that would have a material effect on the Company's reporting of results of operations.

**Note 2 — Revenue**

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

**Disaggregation of Revenue**

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

	Three Months Ended June 30, 2019			Six Months Ended June 30, 2019		
	Water	Oil and Gas	Total	Water	Oil and Gas	Total
<i>(In thousands)</i>						
<b>Primary geographical market</b>						
Middle East and Africa	\$ 10,805	\$ —	\$ 10,805	\$ 19,502	\$ 104	\$ 19,606
Americas	1,728	3,570	5,298	5,751	7,293	13,044
Asia	5,042	—	5,042	7,176	—	7,176
Europe	1,651	—	1,651	2,765	—	2,765
Total revenue	<u>\$ 19,226</u>	<u>\$ 3,570</u>	<u>\$ 22,796</u>	<u>\$ 35,194</u>	<u>\$ 7,397</u>	<u>\$ 42,591</u>

**Major product/service line**

PX, pumps and turbo devices	\$ 19,226	\$ —	\$ 19,226	\$ 35,194	\$ 104	\$ 35,298
License and development	—	3,570	3,570	—	7,293	7,293
Total revenue	<u>\$ 19,226</u>	<u>\$ 3,570</u>	<u>\$ 22,796</u>	<u>\$ 35,194</u>	<u>\$ 7,397</u>	<u>\$ 42,591</u>

	Three Months Ended June 30, 2018			Six Months Ended June 30, 2018		
	Water	Oil and Gas	Total	Water	Oil and Gas	Total
<i>(In thousands)</i>						
<b>Primary geographical market</b>						
Middle East and Africa	\$ 9,289	\$ 290	\$ 9,579	\$ 15,391	\$ 300	\$ 15,691
Americas	1,604	3,358	4,962	2,705	6,107	8,812
Asia	4,657	—	4,657	7,330	—	7,330
Europe	1,566	—	1,566	2,738	—	2,738
Total revenue	<u>\$ 17,116</u>	<u>\$ 3,648</u>	<u>\$ 20,764</u>	<u>\$ 28,164</u>	<u>\$ 6,407</u>	<u>\$ 34,571</u>

**Major product/service line**

PX, pumps and turbo devices	\$ 17,116	\$ —	\$ 17,116	\$ 28,164	\$ —	\$ 28,164
License and development	—	3,358	3,358	—	6,107	6,107
Oil & gas products	—	290	290	—	300	300
Total revenue	<u>\$ 17,116</u>	<u>\$ 3,648</u>	<u>\$ 20,764</u>	<u>\$ 28,164</u>	<u>\$ 6,407</u>	<u>\$ 34,571</u>

**ENERGY RECOVERY, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

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

	<u>June 30, 2019</u>	<u>December 31, 2018</u>
	<i>(In thousands)</i>	
Contract assets balance, beginning of year	\$ 4,083	\$ 6,278
Transferred to receivables	(3,598)	(8,865)
Additional unbilled receivables	1,451	6,670
Contract assets balance, end of period	<u>\$ 1,936</u>	<u>\$ 4,083</u>

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

	<u>June 30, 2019</u>	<u>December 31, 2018</u>
	<i>(In thousands)</i>	
Contract liabilities balance, beginning of year	\$ 42,809	\$ 56,426
Revenue recognized	(7,319)	(13,493)
Cash received	(411)	(124)
Contract liabilities balance, end of period	<u>\$ 35,079</u>	<u>\$ 42,809</u>

**Transaction Price Allocated to the Remaining Performance Obligation**

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

	<u>June 30, 2019</u>	
	<i>(In thousands)</i>	
Year:		
2019 (remaining six months)	\$ 7,304	
2020	14,558	
2021	6,770	
2022	661	
2023 and thereafter	5,031	
Total performance obligation	<u>\$ 34,324</u>	

**Note 3 — Earnings per Share**

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

Diluted earnings (loss) per common share reflects the potential dilution that would occur if outstanding stock options to purchase common stock were exercised for shares of common stock (using the treasury stock method) and the shares of common stock underlying each outstanding RSU were issued. Diluted earnings (loss) per share for the three and six months ended June 30, 2019 and 2018 includes the dilutive effects of stock options and RSUs. Certain shares of common stock issuable under stock options and RSUs have been omitted from the three and six months ended June 30, 2019 and 2018 diluted net earnings per share calculations because their inclusion is considered anti-dilutive.

**ENERGY RECOVERY, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

The computation of basic and diluted earnings per share is presented in the following table.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2019	2018	2019	2018
<i>(In thousands, except per share amounts)</i>				
<b>Numerator:</b>				
Net income	\$ 3,719	\$ 15,743	\$ 6,373	\$ 15,017
<b>Denominator:</b>				
Basic weighted average common shares outstanding	54,681	53,747	54,400	53,747
Weighted average effect of dilutive stock awards	1,429	1,659	1,364	1,690
Diluted weighted average common shares outstanding	56,110	55,406	55,764	55,437
<b>Earnings per share:</b>				
Basic	\$ 0.07	\$ 0.29	\$ 0.12	\$ 0.28
Diluted	\$ 0.07	\$ 0.28	\$ 0.11	\$ 0.27

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2019	2018	2019	2018
<i>(In thousands)</i>				
Anti-dilutive shares excluded from earnings per share calculation	1,650	1,990	2,197	2,015

**Note 4 — Balance Sheet Information**

**Inventories**

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

	June 30, 2019	December 31, 2018
<i>(In thousands)</i>		
Raw materials	\$ 3,175	\$ 2,238
Work in process	2,157	2,689
Finished goods	2,431	2,211
Inventories, net	\$ 7,763	\$ 7,138

Valuation adjustments for excess and obsolete inventory reflected as a reduction of inventory at June 30, 2019 and December 31, 2018 were \$0.7 million and \$0.7 million, respectively.

**Accrued Expenses and Other Current Liabilities**

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

	June 30, 2019	December 31, 2018
<i>(In thousands)</i>		
Payroll and commissions payable	\$ 4,000	\$ 5,843
Accrued legal expenses	142	574
Other accrued expenses and current liabilities	1,383	1,602
Total accrued expenses and other current liabilities	\$ 5,525	\$ 8,019

**ENERGY RECOVERY, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Note 5 — Investments and Fair Value Measurements**

The Company's cash and cash equivalents and marketable securities in the form of short-term investments and long-term investments are presented in the following table.

	June 30, 2019	December 31, 2018
<i>(In thousands)</i>		
Cash and cash equivalents	\$ 23,331	\$ 21,955
Short-term investments	71,854	73,338
Long-term investments	1,507	1,269
Total cash, cash equivalents and marketable securities	\$ 96,692	\$ 96,562

As of June 30, 2019 and December 31, 2018, there were no available-for-sale investments reported in cash and cash equivalents on the Condensed Consolidated Balance Sheets.

**Available-for-Sale Investments**

The Company's short-term and long-term investments are all classified as available-for-sale. As of June 30, 2019 and December 31, 2018, all available-for-sale investments were classified as short-term with maturities less than 12 months and long-term with maturities over 12 months. There were no sales of available-for-sale investments during the six months ended June 30, 2019 and 2018.

Available-for-sale investments as of June 30, 2019 and December 31, 2018 are presented in the following tables.

	June 30, 2019			Fair Value
	Amortized Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	
<i>(In thousands)</i>				
<b>Short-term investments</b>				
U.S. Treasury securities	\$ 8,829	\$ 9	\$ —	\$ 8,838
Corporate notes and bonds	62,949	73	(6)	63,016
Total short-term investments	71,778	82	(6)	71,854
<b>Long-term investments</b>				
Corporate notes and bonds	1,502	5	—	1,507
Total long-term investments	1,502	5	—	1,507
Total available-for-sale investments	\$ 73,280	\$ 87	\$ (6)	\$ 73,361

**ENERGY RECOVERY, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

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

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 with stated maturities are shown by contractual maturity in the following table.

	June 30, 2019		December 31, 2018	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
<i>(In thousands)</i>				
Due in one year or less	\$ 71,778	\$ 71,854	\$ 73,426	\$ 73,338
Due in greater than one year	1,502	1,507	1,269	1,269
Total available-for-sale investments	<u>\$ 73,280</u>	<u>\$ 73,361</u>	<u>\$ 74,695</u>	<u>\$ 74,607</u>

**Fair Value of Financial Instruments**

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

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

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

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

For the Company's investments in available-for-sale securities, if quoted prices in active markets for identical investments are not available to determine fair value (Level 1), then the Company uses quoted prices for similar assets or inputs other than quoted prices that are observable either directly or indirectly (Level 2). The investments included in Level 2 consist of corporate notes and bonds and U.S. Treasury securities.

**ENERGY RECOVERY, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

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

	June 30, 2019			
	Total	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs
<i>(In thousands)</i>				
<b>Cash equivalents</b>				
Money market securities	\$ 5,004	\$ 5,004	\$ —	\$ —
<b>Total cash equivalents</b>	<b>5,004</b>	<b>5,004</b>	<b>—</b>	<b>—</b>
<b>Short-term investments</b>				
U.S. Treasury securities	8,838	—	8,838	—
Corporate notes and bonds	63,016	—	63,016	—
<b>Total short-term investments</b>	<b>71,854</b>	<b>—</b>	<b>71,854</b>	<b>—</b>
<b>Long-term investments</b>				
Corporate notes and bonds	1,507	—	1,507	—
<b>Total long-term investments</b>	<b>1,507</b>	<b>—</b>	<b>1,507</b>	<b>—</b>
<b>Total fair value of financial assets</b>	<b>\$ 78,365</b>	<b>\$ 5,004</b>	<b>\$ 73,361</b>	<b>\$ —</b>

	December 31, 2018			
	Total	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs
<i>(In thousands)</i>				
<b>Cash equivalents</b>				
Money market securities	\$ 6,661	\$ 6,661	\$ —	\$ —
<b>Total cash equivalents</b>	<b>6,661</b>	<b>6,661</b>	<b>—</b>	<b>—</b>
<b>Short-term investments</b>				
U.S. Treasury securities	8,101	—	8,101	—
Corporate notes and bonds	65,237	—	65,237	—
<b>Total short-term investments</b>	<b>73,338</b>	<b>—</b>	<b>73,338</b>	<b>—</b>
<b>Long-term investments</b>				
Corporate notes and bonds	1,269	—	1,269	—
<b>Total long-term investments</b>	<b>1,269</b>	<b>—</b>	<b>1,269</b>	<b>—</b>
<b>Total fair value of financial assets</b>	<b>\$ 81,268</b>	<b>\$ 6,661</b>	<b>\$ 74,607</b>	<b>\$ —</b>

During the six months ended June 30, 2019 and 2018, the Company had no financial liabilities and had no transfers of financial assets between Level 1 and Level 2.

**ENERGY RECOVERY, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

The fair value and gross unrealized losses on the available-for-sale securities that have been in a continuous unrealized loss position, aggregated by type of investment instrument as of June 30, 2019 and December 31, 2018, are summarized in the following table. The Company's available-for-sale investments consist of short-term with maturities less than 12 months and long-term with maturities over 12 months. Available-for-sale for investments that were in an unrealized gain position have been excluded from the following table.

	June 30, 2019		December 31, 2018	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
	<i>(In thousands)</i>			
U.S. Treasury securities <sup>1</sup>	\$ 802	\$ —	\$ 8,101	\$ (2)
Corporate notes and bonds	10,213	(6)	61,809	(88)
Total available-for-sale investments with unrealized loss positions	\$ 11,015	\$ (6)	\$ 69,910	\$ (90)

<sup>1</sup> Amounts less than \$500 rounded to zero

**Note 6 — Goodwill and Intangible Assets**

**Goodwill**

The net carrying amount of goodwill as of June 30, 2019 and December 31, 2018 was \$12.8 million. As of June 30, 2019 and December 31, 2018, no impairment of goodwill was recorded in the accompanying Condensed Consolidated Financial Statements.

**Other Intangible Assets**

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

	June 30, 2019	December 31, 2018
		<i>(In thousands)</i>
Finite-lived intangible assets	\$ 6,643	\$ 6,643
Accumulated amortization	(6,316)	(6,003)
Intangible assets, net	\$ 327	\$ 640

**Note 7 — Lines of Credit**

**Loan and Pledge Agreement**

On January 27, 2017, the Company entered into a loan and pledge agreement (the "Loan and Pledge Agreement") with a financial institution. The Loan and Pledge Agreement provides for a committed revolving credit line of \$16.0 million and an uncommitted revolving credit line of \$4.0 million. Under the Loan and Pledge Agreement, the Company is allowed to borrow and request letters of credit against the eligible assets held from time to time in the pledged account maintained with the financial institution. Stand-by letters of credit ("SBLCs") are secured by pledged U.S. investments and there is no cash collateral balance required. SBLCs are subject to fees, in an amount equal to 0.7% per annum of the face amount of the letter of credit, that are payable quarterly and are non-refundable. Revolving loans incur interest per annum at a base rate equal to the LIBOR rate plus 1.5%. Any default bears the aforementioned interest rate plus an additional 2%. The unused portion of the credit line is subject to a fee equal to the product of 0.2% per annum multiplied by the difference, if positive, between \$16.0 million and the average daily balance of all advances under the committed facility plus aggregate average daily undrawn amounts of all letters of credit issued under the committed facility during the immediately preceding month or portion thereof.

The Loan and Pledge Agreement was amended on March 17, 2017 to increase the amount of allowable SBLCs held with other financial institutions from \$4.1 million to \$5.1 million.

The Loan and Pledge Agreement was further amended on March 30, 2018 to extend the termination date of the Loan and Pledge Agreement from March 31, 2018 to March 31, 2020. The covenants of the Loan and Pledge Agreement were further

**ENERGY RECOVERY, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

amended on August 24, 2018 to permit the Company to incur indebtedness owed to a foreign subsidiary in an aggregate amount not to exceed \$66.0 million, which amount is subordinated to any amounts outstanding under the Loan and Pledge Agreement.

The Loan and Pledge Agreement was subsequently amended on April 8, 2019 to extend the term of any Letter of Credit to not exceed two years and to permit the Company to issue SBLCs up to one year past the expiration date of the loan agreement. On April 8, 2019, and on April 23, 2019, the Loan and Pledge Agreement was amended to clarify certain additional terms.

The Loan and Pledge Agreement was again amended on June 17, 2019 to extend the termination date to June 30, 2022 and limit the term of any SBLC to three years. The Loan and Pledge Agreement was amended to clarify certain additional terms.

As of June 30, 2019 and December 31, 2018, no debt was outstanding under the Loan and Pledge Agreement, however, the SBLCs are deducted from the total revolving credit line.

**Stand-By Letters of Credit**

The outstanding amounts of stand-by letters of credit were \$9.2 million and \$8.8 million at June 30, 2019 and December 31, 2018, respectively.

**Note 8 — Commitments and Contingencies**

**Operating Lease Obligations**

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

On January 10, 2019, the Company entered into an industrial lease agreement (the lease was executed but has not commenced as of June 30, 2019) pursuant to which the Company has leased approximately 25,200 square feet of to be constructed office and warehouse space and approximately 4.5 acres of yard space in Katy, Texas (the "Texas Lease"), for a new commercial development center for oil and gas field testing and training. See Note 8, "Commitments and Contingencies" of the Company's Quarterly Report on Form 10-Q for the period ended March 31, 2019.

Maturities of the Company's lease liabilities as of June 30, 2019 are presented in the following table.

	<b>Lease Amounts</b>
	<i>(In thousands)</i>
Year:	
2019 (remaining six months)	\$ 918
2020	1,856
2021	1,653
2022	1,812
2023	1,714
2024 and thereafter	10,043
Total	17,996
Less imputed lease interest	(4,963)
Total lease liabilities	\$ 13,033

Excluded from the above table is the aforementioned executed Texas Lease that will commence when the Company takes possession in the second half of 2019.



**ENERGY RECOVERY, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Warranty**

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2019	2018	2019	2018
	<i>(In thousands)</i>			
Warranty reserve balance, beginning of period	\$ 571	\$ 359	\$ 478	\$ 366
Warranty costs charged to cost of revenue	89	87	242	135
Utilization charges against reserve	(25)	(23)	(38)	(28)
Release of accrual related to expired warranties	(36)	(34)	(83)	(84)
Warranty reserve balance, end of period	\$ 599	\$ 389	\$ 599	\$ 389

**Purchase Obligations**

The Company has purchase order arrangements with its vendors for which the Company has not received the related goods or services as of June 30, 2019. These arrangements are subject to change based on the Company's sales demand forecasts. The Company has the right to cancel the arrangements prior to the date of delivery. The majority of these purchase order arrangements were related to various raw materials and components parts. As of June 30, 2019, the Company had approximately \$8.6 million of such open cancellable purchase order arrangements.

**Guarantees**

The Company enters into indemnification provisions under its agreements with other companies in the ordinary course of business, typically with its customers. Under these provisions, the Company generally indemnifies and holds harmless the indemnified party for losses suffered or incurred by the indemnified party as a result of the Company's activities, generally limited to personal injury and property damage caused by the Company's employees at a customer's plant, and in proportion to the employee's percentage of fault for the accident. Damages incurred for these indemnifications would be covered by the Company's general liability insurance to the extent provided by the policy limitations. The Company has not incurred material costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, the estimated valuation of the potential liability arising from these agreements is not material. Accordingly, the Company recorded no liabilities for these agreements as of June 30, 2019 and December 31, 2018.

In certain cases, the Company issues warranty and product performance guarantees to its customers for amounts generally equal to 10% or less of the total sales agreement to endorse the execution of product delivery and to the warranty of design work, fabrication and operating performance of our devices. These guarantees are generally stand-by letters of credit that typically remain in place in general for periods of 24 to 36 months. Stand-by letters of credit at June 30, 2019 and December 31, 2018 totaled an aggregate of \$9.2 million and \$8.8 million, respectively.

**Litigation**

The Company is named in and subject to various proceedings and claims in connection with its business. The outcome of matters the Company has been, and currently is, 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 the Company's results of operations in any future period and a significant judgment could have a material impact on the Company's financial condition, results of operations and cash flows. The Company may in the future become involved in additional litigation in the ordinary course of business, including litigation that could be material to its business.

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

**ENERGY RECOVERY, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Note 9 — Income Taxes**

For the six months ended June 30, 2019, the Company recognized an income tax expense of \$1.3 million, which included a \$0.4 million discrete tax benefit related to tax deductions from stock-based compensation. For the six months ended June 30, 2018, the Company recognized an income tax benefit of \$11.5 million, which included a \$12.5 million discrete tax benefit. The year to date June 2018 discrete tax benefit includes an \$11.9 million tax benefit related to the tax effects of the Company electing in the second quarter of 2018 to change the tax status of its Irish subsidiaries as disregarded from a U.S. income tax perspective as part of the Company's international restructuring in the context of the 2017 U.S. Tax Cuts and Jobs Act regulations. This election resulted in the recognition of U.S. federal and state deferred tax assets related to existing Irish company book-tax temporary differences as a tax benefit in the second quarter of 2018. The \$11.5 million tax benefit for the six months ended June 30, 2018 also included a \$0.5 million discrete tax benefit related to tax deductions from stock-based compensation.

The effective tax rate for the six months ended June 30, 2019 and 2018 was 17.1% and (324.4)%, respectively. Excluding the discrete tax income tax items, the effective tax rate for the six months ended June 30, 2019 and 2018 was 21.6% and 27.8%, respectively. The effective tax rate for June 30, 2018 was adversely impacted by the full valuation allowance related to the losses in the Company's Irish operations.

**Note 10 — Stock-based Compensation**

**Stock-based Compensation Expense**

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2019	2018	2019	2018
	<i>(In thousands)</i>			
<b>Stock-based compensation expense charged to:</b>				
Cost of revenue	\$ 32	\$ 16	\$ 66	\$ 40
General and administrative <sup>1</sup>	815	455	1,774	2,131
Sales and marketing	174	157	377	419
Research and development	372	313	854	594
Total stock-based compensation expense	\$ 1,393	\$ 941	\$ 3,071	\$ 3,184
<b>Stock-based compensation expense by type of award:</b>				
Options <sup>1</sup>	\$ 1,003	\$ 680	\$ 2,136	\$ 2,344
RSUs <sup>1</sup>	390	261	935	840
Total stock-based compensation expense	\$ 1,393	\$ 941	\$ 3,071	\$ 3,184

<sup>1</sup> 2019 Amounts include modifications of equity awards held by the Company's former Chairman of the Board. 2018 Amounts include modifications of equity awards held by the Company's former Chief Executive Officer.

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

**Modifications of Equity Awards**

During the six months ended June 30, 2019, the Company recorded additional stock-based compensation expense of \$0.3 million related to the modification of certain equity awards resulting from the Company's former Chairman of the Board's retirement from service on June 13, 2019.

**ENERGY RECOVERY, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

During the six months ended June 30, 2018, the Company recorded additional stock-based compensation expense of \$0.9 million primarily related to the modification of certain equity awards resulting from the Company's former President and Chief Executive Officer's resignation on February 24, 2018 and in consideration for his entering into a Settlement Agreement and Release.

**Unamortized Stock-Based Compensation Costs**

Stock-based compensation cost related to unvested stock options and RSUs will generally be amortized on a straight-line basis over the remaining average service period of each award. The following table presents the unamortized compensation cost and weighted average service period of all unvested outstanding awards as of June 30, 2019.

	<b>Unamortized Compensation Costs</b>	<b>Weighted Average Service Period</b>
	<i>(In thousands)</i>	<i>(In years)</i>
Stock options	\$ 5,896	2.53
RSUs	3,733	2.92
Total unamortized compensation costs, net of adjusted forfeitures	<u>\$ 9,629</u>	

**Vested Stock Options and RSUs**

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

	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2019</b>	<b>2018</b>	<b>2019</b>	<b>2018</b>
	<i>(In thousands)</i>			
Stock options	\$ 1,126	\$ 1,256	\$ 2,493	\$ 2,517
RSUs	75	116	999	625
Total grant date fair value of stock options and RSUs vested during the period	<u>\$ 1,201</u>	<u>\$ 1,372</u>	<u>\$ 3,492</u>	<u>\$ 3,142</u>

**ENERGY RECOVERY, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Stock Option Activities**

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

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value <sup>1</sup>
	<i>(In thousands)</i>	<i>(Per share)</i>	<i>(In years)</i>	<i>(In thousands)</i>
Balance, December 31, 2018	4,982	\$6.36	6.56	\$ 6,572
Granted	551	\$8.24		
Exercised	(855)	\$5.36		\$ 3,548
Forfeited	(366)	\$8.63		
Balance, June 30, 2019	<u>4,312</u>	\$6.60	6.90	\$ 16,489
Vested and exercisable as of June 30, 2019	2,840	\$5.69	5.88	\$ 13,463
Vested and exercisable as of June 30, 2019 and expected to vest thereafter	4,110	\$6.53	6.79	\$ 16,037

<sup>1</sup> The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying options and the fair value of the Company's common stock at the time of exercise. The aggregate intrinsic value at June 30, 2019 is calculated as the difference between the exercise price of the underlying options and the fair value of the Company's common stock as of June 30, 2019 or the last trading day prior to June 30, 2019. The aggregate intrinsic value at December 31, 2018 is calculated as the difference between the exercise price of the underlying options and the fair value of the Company's common stock as of December 31, 2018 or the last trading day prior to December 31, 2018.

**Restricted Stock Unit Activities**

The following table summarizes the RSU activities under the 2016 Plan and includes the RSUs granted under previous plans.

	Number of Shares	Weighted Average Grant-Date Fair Value
	<i>(In thousands)</i>	<i>(Per share)</i>
Balance, December 31, 2018	463	\$8.49
Awarded	409	\$7.77
Vested	(116)	\$8.63
Forfeited	(88)	\$8.38
Balance, June 30, 2019	<u>668</u>	\$8.04

**Note 11 — Business Segment and Geographic Information**

**Business Segments**

The Company is an energy solutions provider to industrial fluid flow markets worldwide. The Company manufactures and sells high-efficiency energy recovery devices ("ERDs") and pumps as well as related products and services. The Company's chief operating decision-maker ("CODM") is the chief executive officer.

The Company's reportable segments consist of the Water Segment and the Oil & Gas Segment. These segments are based on the industries in which the products are sold, the type of products sold and the related products and services. The Water Segment consists of revenue associated with products sold for use in reverse osmosis desalination as well as the related identifiable expenses. The Oil & Gas Segment consists of revenue associated with products sold for use in gas processing, chemical processing and hydraulic fracturing as well as license and development revenue associated therewith. Operating

**ENERGY RECOVERY, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

income (loss) for each segment excludes other income and expenses and certain corporate expenses managed outside the operating segment such as income taxes and other separately managed general and administrative expenses not related to the identified segments. Assets and liabilities are reviewed at the consolidated level by the CODM and are not accounted for by segment. The CODM allocates resources to and assesses the performance of each operating segment using information about its revenue and operating income (loss).

The summary of financial information by segment is presented in the following tables.

	Three Months Ended June 30, 2019			Six Months Ended June 30, 2019		
	Water	Oil & Gas	Total	Water	Oil & Gas	Total
	<i>(In thousands)</i>					
Product revenue	\$ 19,226	\$ —	\$ 19,226	\$ 35,194	\$ 104	\$ 35,298
Product cost of revenue	5,483	—	5,483	10,230	188	10,418
Product gross profit (loss)	13,743	—	13,743	24,964	(84)	24,880
License and development revenue	—	3,570	3,570	—	7,293	7,293
<b>Operating expenses - segment</b>						
General and administrative	563	412	975	1,097	776	1,873
Sales and marketing	1,559	319	1,878	3,208	582	3,790
Research and development	1,103	4,305	5,408	1,908	7,668	9,576
Amortization of intangibles	157	—	157	313	—	313
Total operating expenses - segment	3,382	5,036	8,418	6,526	9,026	15,552
Operating income (loss) - segment	\$ 10,361	\$ (1,466)	8,895	\$ 18,438	\$ (1,817)	16,621
Less: Corporate operating expenses			4,900			9,917
Income from operations			3,995			6,704
Other income			480			979
Income before income taxes			\$ 4,475			\$ 7,683

**ENERGY RECOVERY, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Three Months Ended June 30, 2018**

**Six Months Ended June 30, 2018**

	Three Months Ended June 30, 2018			Six Months Ended June 30, 2018		
	Water	Oil & Gas	Total	Water	Oil & Gas	Total
	<i>(In thousands)</i>					
Product revenue	\$ 17,116	\$ 290	\$ 17,406	\$ 28,164	\$ 300	\$ 28,464
Product cost of revenue	5,640	336	5,976	8,868	422	9,290
Product gross profit (loss)	11,476	(46)	11,430	19,296	(122)	19,174
License and development revenue	—	3,358	3,358	—	6,107	6,107
Operating expenses - segment:						
General and administrative	666	371	1,037	971	1,022	1,993
Sales and marketing	1,363	318	1,681	2,808	662	3,470
Research and development	230	3,375	3,605	474	7,040	7,514
Amortization of intangibles	158	—	158	316	—	316
Total operating expenses - segment	2,417	4,064	6,481	4,569	8,724	13,293
Operating income (loss) - segment	\$ 9,059	\$ (752)	8,307	\$ 14,727	\$ (2,739)	11,988
Less: Corporate operating expenses			4,067			9,079
Income from operations			4,240			2,909
Other income			381			629
Income before income taxes			\$ 4,621			\$ 3,538

**ENERGY RECOVERY, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Geographic Segments**

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2019	2018	2019	2018
	<i>(In percent of total revenue)</i>			
<b>Product revenue by geographic location:</b>				
United States	2%	4%	2%	4%
International	98%	96%	98%	96%
Total product revenue	100%	100%	100%	100%
<b>Product revenue by country:<sup>1</sup></b>				
United Arab Emirates	—	—	15%	—
Chile	—	—	12%	—
Saudi Arabia	28%	39%	21%	29%
Egypt	—	—	—	17%
Oman	13%	—	—	—
Singapore	13%	14%	—	—
Others <sup>2</sup>	46%	47%	52%	54%
Total	100%	100%	100%	100%

<sup>1</sup> Countries representing more than 10% of total revenue

<sup>2</sup> Includes remaining countries not separately disclosed

— Less than 10%

All of the Company's long-lived assets were located in the United States at June 30, 2019 and December 31, 2018.

**ENERGY RECOVERY, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Note 12 — Concentrations**

**Product Revenue Concentration**

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

	Segment	Three Months Ended June 30,		Six Months Ended June 30,	
		2019	2018	2019	2018
<i>(In percent of total revenue)</i>					
Customer A	Water	27%	—	28%	—
Customer B	Water	13%	—	12%	—
Customer C	Water	12%	—	—	—
Customer D	Water	—	31%	—	19%
Customer E	Water	—	12%	—	—
Customer F	Water	—	12%	—	21%

— Less than 10%

One international Oil and Gas Segment customer accounts for 100% of the Company's license and development revenue for the six months ended June 30, 2019 and 2018.

**Accounts Receivable Concentration**

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

	Segment	June 30,	December 31,
		2019	2018
<i>(In percent of total accounts receivable)</i>			
Customer A	Water	33%	—
Customer G	Oil & Gas	17%	26%
Customer H	Water	14%	20%
Customer I	Water	—	11%

— Less than 10%

**Vendor Concentration**

No vendors accounted for 10% or more of the Company's combined purchases.



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

This Quarterly Report on Form 10-Q for the three and six months ended June 30, 2019 and 2018, including select information for the year ended December 31, 2018 and including “Part I, Item 2 – Management’s Discussion and Analysis of Financial Condition and Results of Operations” (the “MD&A”) and certain information incorporated by reference, contain forward-looking statements within the “safe harbor” provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements in this report include, but are not limited to, statements about our expectations, objectives, anticipations, plans, hopes, beliefs, intentions or strategies regarding the future.

Forward-looking statements represent our current expectations about future events, are based on assumptions, and involve risks and uncertainties. If the risks or uncertainties occur or the assumptions prove incorrect, then our results may differ materially from those set forth or implied by the forward-looking statements. Our forward-looking statements are not guarantees of future performance or events.

Words such as “expects,” “anticipates,” “aims,” “projects,” “intends,” “plans,” “believes,” “estimates,” “seeks,” variations of 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. Readers are directed to risks and uncertainties identified under “Part II, Item 1A – Risk Factors” and elsewhere in this report for factors that may cause actual results to be different from those expressed in these forward-looking statements. Except as required by law, we undertake no obligation to revise or update publicly any forward-looking statements for any reason.

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

- our belief that levels of gross profit margin are sustainable to the extent that volume grows, we experience a favorable product mix, pricing remains stable and we continue to realize cost savings through production efficiencies and enhanced yields;
- our plan to improve our existing energy recovery devices and to develop and manufacture new and enhanced versions of these devices;
- our belief that our PX<sup>®</sup> energy recovery devices are the most cost-effective energy recovery devices over time and will result in low life-cycle costs;
- our belief that our turbocharger devices have long operating lives;
- our objective of finding new applications for our technology and developing new products for use outside of desalination, including oil & gas applications;
- our expectation that our expenses for research and development and sales and marketing may increase as a result of diversification into markets outside of desalination;
- our expectation that we will continue to rely on sales of our energy recovery devices in the desalination market for a substantial portion of our revenue, and that new desalination markets, including the U.S., will provide revenue opportunities to us;
- our ability to meet projected new product development dates, anticipated cost reduction targets or revenue growth objectives for new products;
- our belief that we can commercialize the VorTeq<sup>™</sup> hydraulic fracturing system;
- our belief that the VorTeq enables oilfield services (“OFS”) companies to migrate to more efficient pumping technology;
- our belief that we will be able to enter into a long-term licensing agreement to bring the MTeq<sup>™</sup> solution to market;
- our belief that customers will accept and adopt our new products;
- our belief that our current facilities will be adequate for the foreseeable future;
- our expectation that sales outside of the U.S. will remain a significant portion of our revenue;
- the timing of our receipt of payment for products or services from our customers;
- our belief that our existing cash balances and cash generated from our operations will be sufficient to meet our anticipated liquidity needs for the foreseeable future, with the exception of a decision to enter into an acquisition and/or fund investments in our latest technology arising from rapid market adoption that could require us to seek additional equity or debt financing;
- our expectation that, as we expand our international sales, a portion of our revenue could be denominated in foreign currencies and the impact of changes in exchange rates on our cash and cash equivalents and operating results;
- our expectations of the impact of the U.S. Tax Cuts and Jobs Act (“Tax Act”);

- *our belief that new markets will grow in the water desalination market;*
- *our expectation that we will be able to enforce our intellectual property rights;*
- *our expectation that the adoption of new accounting standards will not have a material impact on our financial position or results of operations;*
- *the outcome of proceedings, lawsuits, disputes and claims;*
- *the impact of losses due to indemnification obligations;*  
*and*
- *the impact of changes in internal control over financial reporting.*

*You should not place undue reliance on these forward-looking statements, which reflect management's opinions only as of the date of the filing of this Quarterly Report on Form 10-Q. All forward-looking statements included in this document are subject to certain risks and uncertainties which could cause actual results to differ materially from those projected in the forward-looking statements, as disclosed from time to time in our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K, as well as in our Annual Reports to Stockholders and in "Part II, Item 1A – Risk Factors" within this Quarterly Report on Form 10-Q. In preparing the MD&A below, we presume the readers have access to and have read the MD&A in our Annual Report on Form 10-K for the year ended December 31, 2018, pursuant to Instruction 2 to paragraph (b) of Item 303 of Regulation S-K. We assume no obligation to update any such forward-looking statements. It is important to note that our actual results could differ materially from the results set forth or implied by our forward-looking statements.*

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

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

## Overview

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

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

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

### Water Segment

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

### Oil & Gas Segment

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

## Results of Operations

### Total Revenue

	Three Months Ended June 30,					
	2019		2018		Change	
	\$	% of Total Revenue	\$	% of Total Revenue	\$	%
	<i>(In thousands, except percentages)</i>					
Water	\$ 19,226	84%	\$ 17,116	83%	\$ 2,110	12 %
Oil & Gas	0	0%	290	1%	(290)	(100)%
Product revenue	19,226	84%	17,406	84%	1,820	10 %
License and development revenue	3,570	16%	3,358	16%	212	6 %
Total revenue	\$ 22,796	100%	\$ 20,764	100%	\$ 2,032	10 %

Total product revenue increased by \$1.8 million, or 10%, to \$19.2 million for the three months ended June 30, 2019 from \$17.4 million for the three months ended June 30, 2018. Of the \$1.8 million increase, a \$2.1 million increase was attributable to the Water Segment and a \$0.3 million decrease was attributable to the Oil & Gas Segment.

During the three months ended June 30, 2019 compared to the three months ended June 30, 2018, Water Segment product revenue increased by \$2.1 million, or 12%, due primarily to an increase of \$1.4 million of MPD shipments and \$1.7 million of OEM shipments and offset by \$1.0 million of lower AM shipments. Revenues in the second quarter of 2019 were significantly higher than the same period in 2018 due to the timing of MPD shipments. Significant variability quarter to quarter is typical, and year on year quarterly comparisons are not necessarily indicative of the trend for the year due to these variations.

During the three months ended June 30, 2019 compared to the three months ended June 30, 2018, Oil & Gas Segment product revenue decreased by \$0.3 million as there were no product sales in the second quarter. Our Oil & Gas Segment revenue is primarily comprised of license and development revenue which increased by \$0.2 million, or 6%, in the three months ended June 30, 2019 compared to the three months ended June 30, 2018, due primarily to higher costs incurred based on input measure of progress.

	Six Months Ended June 30,					
	2019		2018		Change	
	\$	% of Total Revenue	\$	% of Total Revenue	\$	%
	<i>(In thousands, except percentages)</i>					
Water	\$ 35,194	83%	\$ 28,164	81%	\$ 7,030	25 %
Oil & Gas	104	0%	300	1%	(196)	(65)%
Product revenue	35,298	83%	28,464	82%	6,834	24 %
License and development revenue	7,293	17%	6,107	18%	1,186	19 %
Total revenue	\$ 42,591	100%	\$ 34,571	100%	\$ 8,020	23 %

Total product revenue increased by \$6.8 million, or 24%, to \$35.3 million for the six months ended June 30, 2019 from \$28.5 million for the six months ended June 30, 2018. Of the \$6.8 million increase, a \$7.0 million increase was attributable to the Water Segment product revenue and a \$0.2 million decrease was attributable to the Oil & Gas Segment product revenue.

During the six months ended June 30, 2019 compared to the six months ended June 30, 2018, Water Segment product revenue increased by \$7.0 million, or 25%, due primarily to an increase of \$7.8 million of MPD shipments and an increase in OEM shipments of \$0.8 million, offset by \$1.6 million of lower AM shipments. Revenues in the six months were significantly higher than the same period in 2018 due to the timing of MPD shipments.

During the six months ended June 30, 2019 compared to the six months ended June 30, 2018, Oil & Gas Segment product revenue decreased by \$0.2 million. Our Oil & Gas Segment revenue is primarily comprised of license and development revenue which increased by \$1.2 million, or 19%, in the six months ended June 30, 2019 compared to the six months ended June 30, 2018, due primarily to higher costs incurred based on input measure of progress.

#### **Product Gross Profit and Gross Margin**

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.

	Three Months Ended June 30,				Change
	2019		2018		
	Gross Profit	Gross Margin	Gross Profit	Gross Margin	
	<i>(In thousands, except percentages)</i>				
Water	\$ 13,743	71.5%	\$ 11,476	67.0 %	\$ 2,267
Oil & Gas	0	0%	(46)	(15.9)%	46
Product gross profit and gross margin	\$ 13,743	71.5%	\$ 11,430	65.7%	\$ 2,313

In the three months ended June 30, 2019 compared to the three months ended June 30, 2018, product gross profit increased \$2.3 million, or 20.2%, due primarily to a \$2.3 million water gross profit increase comprised of a \$2.1 million increase from MPD and OEM volume and a \$0.8 beneficial price and mix, and offset by \$0.7 from lower AM volume. Product gross margin increased by 580 basis points to 71.5% in the three months ended June 30, 2019 compared to 65.7% in the three months ended June 30, 2018. This increase was largely driven by favorable price and product mix, continued improvements in manufacturing efficiencies and higher production levels in the Water Segment to support increased demand.

	Six Months Ended June 30,				
	2019		2018		Change
	Gross Profit	Gross Margin	Gross Profit	Gross Margin	Gross Profit
	<i>(In thousands, except percentages)</i>				
Water	\$ 24,964	70.9 %	\$ 19,296	68.5 %	\$ 5,668
Oil & Gas	(84)	(80.8)%	(122)	(40.7)%	38
Product gross profit and gross margin	\$ 24,880	70.5%	\$ 19,174	67.4%	\$ 5,706

In the six months ended June 30, 2019 compared to the six months ended June 30, 2018, product gross profit increased \$5.7 million, or 29.8%, due primarily to a favorable \$6.3 million impact from higher MPD volume and OEM volume and a favorable price and mix impact of \$0.5 million, offset by the unfavorable impact of \$1.1 million from lower AM volume. Product gross margin increased by 310 basis points to 70.5% in the six months ended June 30, 2019 compared to 67.4% in the six months ended June 30, 2018. This increase was largely driven by favorable price and product mix, continued improvements in manufacturing efficiencies and higher production levels in the Water Segment to support increased demand.

### Operating Expenses

	Three Months Ended June 30, 2019			Three Months Ended June 30, 2018		
	Water	Oil & Gas	Total	Water	Oil & Gas	Total
	<i>(In thousands)</i>					
Operating expenses - segment:						
General and administrative	\$ 563	\$ 412	\$ 975	\$ 666	\$ 371	\$ 1,037
Sales and marketing	1,559	319	1,878	1,363	318	1,681
Research and development	1,103	4,305	5,408	230	3,375	3,605
Amortization of intangibles	157	0	157	158	0	158
Total operating expenses - segment	\$ 3,382	\$ 5,036	8,418	\$ 2,417	\$ 4,064	6,481
Corporate operating expenses			4,900			4,067
Total operating expenses			\$ 13,318			\$ 10,548

#### Operating Expenses - Segment

Water Segment operating expenses increased \$1.0 million to \$3.4 million for the three months ended June 30, 2019 compared to \$2.4 million for the three months ended June 30, 2018, an increase of 40%, primarily due to a \$0.9 million increase in research and development expenses. This increase in expenditures is related to both the expansion of the Company's current product offering as well as to improve existing technologies.

Oil & Gas Segment operating expenses increased \$1.0 million to \$5.0 million for the three months ended June 30, 2019 compared to \$4.1 million for the three months ended June 30, 2018, an increase of 24%, primarily due to a \$0.9 million increase in research and development expenses. This increase in expenditures is related to the commercialization of new technologies.

### Corporate Operating Expenses

Corporate operating expenses increased \$0.8 million to \$4.9 million for the three months ended June 30, 2019 compared to \$4.1 million for the three months ended June 30, 2018, an increase of 20%, primarily due to an increase in the general and administrative expenses related to higher employee headcount and related expenses.

### Total Operating Expenses

Total operating expenses increased \$2.8 million to \$13.3 million for the three months ended June 30, 2019 compared to \$10.5 million for the three months ended June 30, 2018, an increase of 26%, due to a \$0.6 million increase in general and administrative expenses, a \$0.3 million increase in sales and marketing expenses and a \$1.9 million increase in research and development expenses. Total operating expenses for the quarter increased to 58% of total revenue from 51% of total revenue, an increase of 700 basis points when compared to the three months of the previous year.

General and administrative expense increased \$0.6 million, or 12%, in the three months ended June 30, 2019 compared to the three months ended June 30, 2018, due primarily to an increase in headcount and other personnel-related costs.

For the three months ended June 30, 2019 compared to the three months ended June 30, 2018, sales and marketing expense increased by \$0.3 million, or 17%, due primarily to an increase in headcount and other personnel-related costs.

For the three months ended June 30, 2019 compared to the three months ended June 30, 2018, research and development expense increased by \$1.9 million, or 52%, due primarily to higher employee related expenses of \$0.4 million, a higher depreciation expense of \$0.2 million and a greater investment in supplies and equipment of \$1.3 million related to research and development activities.

Amortization of intangible assets is related to finite-lived intangible assets acquired as a result of our purchase of Pump Engineering, LLC in December 2009. Amortization expense in the three and six months ended June 30, 2019 compared to the three and six months ended June 30, 2018 did not materially change.

	Six Months Ended June 30, 2019			Six Months Ended June 30, 2018		
	Water	Oil & Gas	Total	Water	Oil & Gas	Total
<i>(In thousands)</i>						
<b>Operating expenses - segment:</b>						
General and administrative	\$ 1,097	\$ 776	\$ 1,873	\$ 971	\$ 1,022	\$ 1,993
Sales and marketing	3,208	582	3,790	2,808	662	3,470
Research and development	1,908	7,668	9,576	474	7,040	7,514
Amortization of intangibles	313	0	313	316	0	316
Total operating expenses - segment	<u>\$ 6,526</u>	<u>\$ 9,026</u>	<u>15,552</u>	<u>\$ 4,569</u>	<u>\$ 8,724</u>	<u>13,293</u>
Corporate operating expenses			<u>9,917</u>			<u>9,079</u>
Total operating expenses			<u>\$ 25,469</u>			<u>\$ 22,372</u>

### Operating Expenses - Segment

Water Segment operating expenses increased to \$6.5 million for the six months ended June 30, 2019 compared to \$4.6 million for the six months ended June 30, 2018, an increase of 43%, primarily due to a \$1.4 million increase in research and development expenses. This increase in expenditures is related to both the expansion of the Company's current product offering as well as to improve existing technologies.

Oil & Gas Segment operating expenses increased \$0.3 million to \$9.0 million for the six months ended June 30, 2019 compared to \$8.7 million for the six months ended June 30, 2018, an increase of 3%, primarily due to a \$0.6 million increase in research and development expenses, but offset by decreases in general and administrative and sales and marketing expenses. This increase in expenditures is related to the commercialization of new technologies.

### Corporate Operating Expenses

Corporate operating expenses increased \$0.8 million to \$9.9 million for the six months ended June 30, 2019 compared to \$9.1 million for the six months ended June 30, 2018, an increase of 9%, primarily due to an increase in the general and administrative expenses related to higher employee headcount and related expenses.

### Total Operating Expenses

Total operating expenses increased \$3.1 million to \$25.5 million for the six months ended June 30, 2019 compared to \$22.4 million for the six months ended June 30, 2018, an increase of 14%, due to a \$0.3 million increase in general and administrative expenses, a \$0.6 million increase in sales and marketing expenses and a \$2.2 million increase in research and development expenses. Total operating expenses for the six months decreased to 60% of total revenue from 65% of total revenue, a decrease of 500 basis points when compared to the six months of the previous year.

General and administrative expense increased \$0.3 million, or 3%, in the six months ended June 30, 2019 compared to the six months ended June 30, 2018, due primarily to an increase in headcount and other personnel-related costs.

For the six months ended June 30, 2019 compared to the six months ended June 30, 2018, sales and marketing expense increased by \$0.6 million, or 15%, due primarily to an increase in headcount and other personnel-related costs.

For the six months ended June 30, 2019 compared to the six months ended June 30, 2018, research and development expense increased by \$2.2 million, or 29%, due primarily to higher employee related expenses of \$0.7 million, higher expenses related to employee travel of \$0.2 million, a higher depreciation expense of \$0.3 million and a greater investment in supplies and equipment of \$1.0 million related to research and development activities.

### Other Income, Net

	Three Months Ended June 30,			
	2019		2018	
	\$	% of Total Revenue	\$	% of Total Revenue
<i>(In thousands, except percentages)</i>				
Other income:				
Interest income	\$ 528	2.3%	\$ 373	1.8%
Interest expense	0	0.0%	(1)	0.0%
Other non-operating (expense) income, net	(48)	(0.2)%	9	0.0%
Total other income, net	\$ 480	2.1%	\$ 381	1.8%

Total other income, net, increased in the three months ended June 30, 2019 compared to the three months ended June 30, 2018, due primarily to an increase in interest income on higher investment balances.

	Six Months Ended June 30,			
	2019		2018	
	\$	% of Total Revenue	\$	% of Total Revenue
<i>(In thousands, except percentages)</i>				
Other income:				
Interest income	\$ 1,051	2.5%	\$ 674	1.9%
Interest expense	0	0.0%	(1)	0.0%
Other non-operating expense, net	(72)	(0.2)%	(44)	(0.1)%
Total other income, net	\$ 979	2.3%	\$ 629	1.8%

Total other income, net, increased \$0.4 million in the six months ended June 30, 2019 compared to the six months ended June 30, 2018, due primarily to an increase in interest income on higher investment balances.

### Income Taxes

For the six months ended June 30, 2019, the Company recognized an income tax expense of \$1.3 million, which included a \$0.4 million discrete tax benefit related to tax deductions from stock-based compensation. For the six months ended

June 30, 2018, the Company recognized an income tax benefit of \$11.5 million, which included a \$12.5 million discrete tax benefit. The year to date June 2018 discrete tax benefit includes an \$11.9 million tax benefit related to the tax effects of the Company electing in the second quarter of 2018 to change the tax status of its Irish subsidiaries as disregarded from an U.S. income tax perspective as part of the Company's international restructuring in the context of the 2017 U.S. Tax Cuts and Jobs Act regulations. This election resulted in the recognition of U.S. federal and state deferred tax assets related to existing Irish company book-tax temporary differences as a tax benefit in the second quarter of 2018. The \$11.5 million tax benefit for the six months ended June 30, 2018 also included a \$0.5 million discrete tax benefit related to tax deductions from stock-based compensation.

The effective tax rate for the six months ended June 30, 2019 and 2018 was 17.1% and (324.4)%, respectively. Excluding the discrete tax income tax items, the effective tax rate for the six months ended June 30, 2019 and 2018 was 21.6% and 27.8%, respectively. The effective tax rate for June 30, 2018 was adversely impacted by the full valuation allowance related to the losses in the Company's Irish operations.

## **Liquidity and Capital Resources**

### ***Overview***

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

As of June 30, 2019, our principal sources of liquidity consisted of: (i) unrestricted cash and cash equivalents of \$23.3 million, (ii) short-term investments of \$71.9 million that are primarily invested in marketable debt instruments such as corporate notes and bonds and U.S. Treasury securities and (iii) accounts receivable, net of allowances of \$15.2 million. We invest cash not needed for current operations predominantly in high-quality, investment-grade, marketable debt instruments with the intent to make such funds available for operating purposes as needed.

At June 30, 2019 and December 31, 2018, we had \$1.9 million and \$4.1 million, respectively, of short-term contract assets which represents unbilled receivables. In the Water Segment, we had contract assets of \$1.9 million pertaining to customer contractual holdback provisions, whereby we will invoice the final retention payment(s) due under certain sales contracts in the next 12 months as of June 30, 2019. The customer holdbacks represent amounts intended to provide a form of security for the customer and, accordingly, these contract assets have not been discounted to present value. In the Oil & Gas Segment, there were no unbilled project costs at June 30, 2019.

### ***Loan Agreements***

On January 27, 2017, the Company entered into a loan and pledge agreement (the "Loan and Pledge Agreement") with a financial institution. The Loan and Pledge Agreement provides for a committed revolving credit line of \$16.0 million and an uncommitted revolving credit line of \$4.0 million. Under the Loan and Pledge Agreement, the Company is allowed to borrow and request letters of credit against the eligible assets held from time to time in the pledged account maintained with the financial institution. Stand-by letters of credit ("SBLCs") are secured by pledged U.S. investments and there is no cash collateral balance required. SBLCs are subject to fees, in an amount equal to 0.7% per annum of the face amount of the letter of credit, that are payable quarterly and are non-refundable. Revolving loans incur interest per annum at a base rate equal to the LIBOR rate plus 1.5%. Any default bears the aforementioned interest rate plus an additional 2%. The unused portion of the credit line is subject to a fee equal to the product of 0.2% per annum multiplied by the difference, if positive, between \$16.0 million and the average daily balance of all advances under the committed facility plus aggregate average daily undrawn amounts of all letters of credit issued under the committed facility during the immediately preceding month or portion thereof.

The Loan and Pledge Agreement was amended on March 17, 2017 to increase the amount of allowable SBLCs held with other financial institutions from \$4.1 million to \$5.1 million.

The Loan and Pledge Agreement was further amended on March 30, 2018 to extend the termination date of the Loan and Pledge Agreement from March 31, 2018 to March 31, 2020. The covenants of the Loan and Pledge Agreement were further amended on August 24, 2018 to permit the Company to incur indebtedness owed to a foreign subsidiary in an aggregate amount not to exceed \$66.0 million, which amount is subordinated to any amounts outstanding under the Loan and Pledge Agreement.

The Loan and Pledge Agreement was subsequently amended on April 8, 2019 to extend the term of any Letter of Credit to not exceed two years, and to permit the Company to issue SBLCs up to one year past the expiration date of the loan agreement. On April 8, 2019, and on April 23, 2019, the Loan and Pledge Agreement was amended to clarify certain additional terms.



The Loan and Pledge Agreement was again amended on June 17, 2019 to extend the termination date to June 30, 2022 and limit the term of any SBLC to three years. The Loan and Pledge Agreement was amended to clarify certain additional terms.

As of June 30, 2019 and December 31, 2018, no debt was outstanding under the Loan and Pledge Agreement, however, the SBLCs are deducted from the total revolving credit line. See our 2018 Annual Report on Form 10-K.

#### ***Stand-By Letters of Credit***

As of June 30, 2019, we had stand-by letters of credit (“SBLCs”) with various financial institutions totaling \$9.2 million whereby we are required to maintain a U.S. investment balance of \$9.2 million. SBLCs are subject to fees based on the amount of the letter of credit that are payable quarterly and are non-refundable.

#### ***Share Repurchase Programs***

Our Board of Directors has authorized various share repurchase programs since 2012. On March 7, 2018, our Board of Directors authorized a share repurchase program (the “March 2018 Authorization”) under which the Company, at the discretion of management, may repurchase up to \$10.0 million in aggregate cost of our outstanding common stock through September 30, 2018. As of June 30, 2019, we have repurchased 1.2 million shares for \$10.0 million under the March 2018 Authorization. Since the initial authorization of the share repurchase programs, we have spent an aggregate \$30.5 million, including commissions, to repurchase 5.5 million shares. The March 2018 Authorization expired in September 2018 and no other authorization is in place as of June 30, 2019.

#### ***Cash Flows***

Our cash flows are summarized in the following table.

	<b>Six Months Ended June 30,</b>	
	<b>2019</b>	<b>2018</b>
	<i>(In thousands)</i>	
Net cash provided by (used in) operating activities	\$ 3	\$ (1,670)
Net cash used in investing activities	(3,241)	(4,015)
Net cash provided by (used in) financing activities	4,519	(7,691)
Effect of exchange rate differences on cash and cash equivalents	—	22
Net change in cash, cash equivalents and restricted cash	<u>\$ 1,281</u>	<u>\$ (13,354)</u>

#### ***Cash Flows from Operating Activities***

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

Cash provided by operating activities improved in the six months ended June 30, 2019 compared to the cash used in operating activities for the six months ended June 30, 2018. Despite a decrease net income for the six months ended June 30, 2019 compared to the corresponding period in 2018, the cash provided by operating activities improved by \$1.7 million. Substantial improvements were found in the positive effect of the change in deferred income taxes of \$12.8 million as well as the positive effect of a change in balance in prepaid assets of \$11.5 million, but offset by negative effect of a change in balance in accrued expenses and other liabilities of \$10.5 million and a negative effect of a change in balance in accounts receivable of \$5.8 million.

Due to the project driven, non-cyclical nature of our business, operating cash flow can fluctuate significantly from quarter to quarter due to the timing of receipts of large project orders. Operating cash flow may be negative in one quarter and significantly positive in the next, consequently individual quarterly results and comparisons may not necessarily indicate a significant trend - either positive or negative. Similarly, the nature and timing of investing activities and financing activities may be linked to available cash and the timing of events outside those of operating activities. Therefore, it may be difficult to derive meaning directly from quarterly comparisons of cash flow.

#### ***Cash Flows from Investing Activities***

Net cash used in investing activities primarily relates to maturities and purchases of marketable securities, to capital expenditures supporting our growth and to changes in our restricted cash used to collateralize our stand-by letters of credit and other contingent considerations. Our investments in marketable securities are structured to preserve principal and liquidity while at the same time maximizing yields without significantly increasing risk.

Cash used in investing activities was lower in the six months ended June 30, 2019 compared to the cash used in investing activities for the six months ended June 30, 2018 by \$0.8 million primarily due to greater maturities of investments net of purchases (due to the nature and timing of investment activities) by \$3.9 million, which were partially offset by a higher use of cash for capital expenditures by \$3.1 million for the first six months of 2019 as compared to the same six months in 2018.

#### *Cash Flows from Financing Activities*

Net cash provided by (used in) financing activities primarily relates to the issuance of equity typically from stock-based compensation, to equity buy-backs and to incurring additional or repaying long-term debt.

Cash provided by financing activities was higher in the six months ended June 30, 2019 compared to cash used in financing activities for the six months ended June 30, 2018 by \$12.2 million primarily due to the use of \$10.0 million cash in the first six months of 2018 for the repurchase of common stock that was not undertaken in the six months ended June 30, 2019. Further, proceeds from the issuance of common stock were higher by \$2.2 million for the first six months of 2019 as compared to the same six months in 2018.

### **Liquidity and Capital Resource Requirements**

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

### **Off-Balance Sheet Arrangements**

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

### **Recent Accounting Pronouncements**

None applicable. Refer to Note 1, "Description of Business and Significant Accounting Policies" of the Condensed Consolidated Financial Statements included in the Quarterly Report on 10-Q.

### **Item 3 — Quantitative and Qualitative Disclosures About Market Risk**

Our exposure to market risk may be found primarily in two areas, foreign currency and interest rates.

#### **Foreign Currency Risk**

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

Our revenue contracts have been denominated in USD. At times, our international customers may have difficulty in obtaining USD to pay our receivables, thus increasing collection risk and potential doubtful account expense. As we expand our international sales, a portion of our revenue could be denominated in foreign currencies. As a result, our cash and cash equivalents and operating results could be increasingly affected by changes in exchange rates.

In addition, we pay many vendors in foreign currency and, therefore, are subject to changes in foreign currency exchange rates. Our international sales and service operations incur expense that is denominated in foreign currencies. This expense could be materially affected by currency fluctuations. Our international sales and services operations also maintain cash balances denominated in foreign currencies. To decrease the inherent risk associated with translation of foreign cash balances into our reporting currency, we do not maintain excess cash balances in foreign currencies.

We have not hedged our exposure to changes in foreign currency exchange rates because expenses in foreign currencies have been insignificant to date and exchange rate fluctuations have had little impact on our operating results and cash flows.

**Interest Rate Risk and Credit Risk**

We have an investment portfolio of fixed-income marketable debt securities including amounts classified as cash equivalents and short-term investments. The primary objective of our investment activities is to preserve principal and liquidity while at the same time maximizing yields without significantly increasing risk. We invest primarily in investment-grade short-term and long-term debt instruments of high-quality corporate issuers and instruments of the U.S. government and its agencies. These investments are subject to counter-party credit risk. To minimize this risk, we invest pursuant to an investment policy approved by our Board. The policy mandates high credit rating requirements and restricts our exposure to any single corporate issuer by imposing concentration limits.

At June 30, 2019, our investments totaled approximately \$73.4 million. These investments were presented in short-term investments and long-term investments on our Condensed Consolidated Balance Sheets as of June 30, 2019. These investments are subject to interest rate fluctuations and will decrease in market value if interest rates increase. To minimize the exposure due to adverse shifts in interest rates, we maintain investments with an average maturity of less than seven months. A hypothetical 1% increase in interest rates would have resulted in an approximately \$0.3 million decrease in the fair value of our fixed-income debt securities as of June 30, 2019.

**Item 4. — Controls and Procedures****Evaluation of Disclosure Controls and Procedures**

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

Based on that evaluation, our President and Chief Executive Officer and our Chief Financial Officer have concluded that, as of June 30, 2019, our disclosure controls and procedures are effective.

**Changes in Internal Controls**

There were no changes in our internal control over financial reporting during the period covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II — OTHER INFORMATION

### Item 1. — Legal Proceedings

Note 16, “Litigation” of our Annual Report on Form 10-K filed with the SEC on March 7, 2019, as amended on March 12, 2019, provides information on certain litigation in which we are involved.

For an update on the litigation matters previously disclosed in our Form 10-K, see the discussion in Note 8, “Commitments and Contingencies – Litigation” of the Notes to Condensed Consolidated Financial Statements of this Quarterly Report on Form 10-Q, which discussion is incorporated by reference into this Item 1.

### Item 1A. — Risk Factors

The following discussion sets forth what management currently believes could be the most significant risks and uncertainties that could impact our businesses, results of operations and financial condition. Other risks and uncertainties, including those not currently known to the Company or its management, could also negatively impact our businesses, results of operations and financial conditions. Accordingly, the following should not be considered a complete discussion of all of the risks and uncertainties the Company may face. We may amend or supplement these risk factors from time to time in other reports we file with the SEC.

#### Risk Related to our Water Segment

***Our Water Segment depends on the construction of new desalination plants for revenue and, as a result, our operating results have experienced, and may continue to experience, significant variability due to volatility in capital spending, availability of project financing and other factors affecting the water desalination industry.***

We currently derive the majority of our revenue from sales of products and services used in desalination plants for municipalities, hotels, mobile containerized desalination solutions, resorts and agricultural operations in dry or drought-ridden regions of the world. The demand for our Water Segment products may decrease if the construction of desalination plants declines for political, economic or other factors, especially in these dry or drought-ridden regions. Other factors that could affect the number and capacity of desalination plants built, or the timing of their completion, include the availability of required engineering and design resources, a weak global economy, shortage in the supply of credit and other forms of financing, changes in government regulation, permitting requirements or priorities and reduced capital spending for desalination. Each of these factors could result in reduced or uneven demand for our Water Segment products. Pronounced variability or delays in the construction of desalination plants or reductions in spending for desalination could negatively impact our Water Segment sales and revenue, which in turn could have an adverse effect on our entire business, financial condition or results of operations and make it difficult for us to accurately forecast our future sales and revenue.

***Our Water Segment faces competition from a number of companies that offer competing energy recovery and pump solutions. If any one of these companies produces superior technology or offers more cost-effective products, our competitive position in the market could be harmed and our profits may decline.***

The market for ERD and pumps for desalination plants is competitive and evolving. We expect competition, especially competition on price, to persist and intensify as the desalination market grows and new competitors enter the market. Some of our current and potential competitors may have significantly greater financial, technical, marketing and other resources, longer operating histories or greater name recognition. They may also have more extensive products and product lines that would enable them to offer multi-product or packaged solutions as well as competing products at lower prices or with other more favorable terms and conditions. As a result, our ability to sustain our market share may be adversely impacted, which would affect our business, operating results and financial condition. In addition, if one of our competitors were to merge or partner with another company, the change in the competitive landscape could adversely affect our continuing ability to compete effectively.

***If we are unable to collect unbilled receivables which are caused in part by holdback provisions, our operating results could be adversely affected.***

Our contracts with large engineering, procurement and construction firms generally contain holdback provisions that typically delay final installment payments for our products by up to 24 months after the product has been shipped and revenue has been recognized. Generally, 10% or less of the revenue we recognize pursuant to our customer contracts is subject to such holdback provisions and is accounted for as contract assets. Such holdbacks may result in relatively high unbilled receivables. If we are unable to collect these performance holdbacks, our results of operations would be adversely affected.

***We depend on a limited number of suppliers for some of our components. If our suppliers are not able to meet our demand and/or requirements, our business could be harmed.***

We rely on a limited number of suppliers for vessel housings, stainless steel ports, alumina powder and tungsten carbide for our portfolio of PX ERDs and stainless steel castings and components for our turbochargers and pumps. Our reliance on a limited number of manufacturers for these supplies involves several risks, including reduced control over delivery schedules, quality assurance, manufacturing yields, production costs and lack of guaranteed production capacity or product supply. We do not have long-term supply agreements with these suppliers but secure these supplies on a purchase order basis. Our suppliers have no obligation to supply products to us for any specific period, in any specific quantity or at any specific price, except as set forth in a particular purchase order. Our requirements may represent a small portion of the total production capacities of these suppliers, and our suppliers may reallocate capacity to other customers, even during periods of high demand for our products. We have in the past experienced, and may in the future experience, product quality issues and delivery delays with our suppliers due to factors such as high industry demand or the inability of our vendors to consistently meet our quality or delivery requirements. If our suppliers were to cancel or materially change their commitments to us or fail to meet quality or delivery requirements needed to satisfy customer orders for our products, we could lose time-sensitive customer orders, be unable to develop or sell our products cost-effectively or on a timely basis, if at all, and have significantly decreased revenue, which could harm our business, operating results and financial condition. We may qualify additional suppliers in the future, which would require time and resources. If we do not qualify additional suppliers, we may be exposed to increased risk of capacity shortages due to our dependence on current suppliers.

#### **Risk Related to our Oil & Gas Segment**

***We may not be able to successfully commercialize the VorTeq.***

In October 2015, we entered into the VorTeq License Agreement with the VorTeq Licensee, which provides the VorTeq Licensee with exclusive worldwide rights to our VorTeq technology for hydraulic fracturing onshore applications. Once the VorTeq is commercialized, the VorTeq Licensee will begin paying ongoing recurring royalty fees to us for the VorTeq technology. In order to commercialize the VorTeq, the VorTeq License Agreement provides, among other things, that we successfully meet certain specified milestones against key performance indicators set forth in the license agreement. The VorTeq is a relatively new technology and the hydraulic fracturing process is extremely complex, which presents a wide range of technological challenges for us. If we are unable to successfully solve these challenges and, as a result, fail to meet the milestones, we may not be able to successfully commercialize the VorTeq. In that circumstance, we will not receive any royalty payments from the VorTeq Licensee, which could have an adverse effect on our entire business, financial condition or results of operation.

***If the VorTeq Licensee fails to adopt the VorTeq for any reason, we may not receive royalty payments or be able to successfully commercialize the VorTeq.***

The successful commercialization of the VorTeq depends heavily on the VorTeq Licensee's support and ultimate adoption of the technology. If the VorTeq Licensee fails to adopt the VorTeq for any reason, we may not be able to successfully commercialize the VorTeq with the VorTeq Licensee and, consequently, we may not receive any royalties under the VorTeq License Agreement. In addition, we may not be able to find a suitable replacement for the VorTeq Licensee or be able to negotiate royalties similar to those contained in the VorTeq License Agreement or to commercialize the VorTeq at all. Failure to commercialize the VorTeq could have an adverse effect on our entire business, financial condition or results of operation.

***We may not meet the key performance indicators necessary to meet the two milestones in the VorTeq License Agreement***

The VorTeq License Agreement calls for certain milestone key performance indicators that, if met, will result in payments to the Company of \$25 million for each of two milestones. Achievement of these milestones is uncertain and, while we believe we can meet the milestones, if we are unable to do so the milestone payments will be delayed until such time as the milestones are met or may not be earned and received at all. Failure to meet said milestones may also jeopardize commercialization and the rate of adoption of our VorTeq.

***We may not be able to successfully complete early stage testing of the MTeq, enter into a long term licensing agreement for the MTeq or fail to commercialize the MTeq.***

We introduced the MTeq in 2017 and entered into a strategic early stage testing agreement in the second quarter of 2017. Like the VorTeq, we intend to find a long-term licensing partner for the MTeq and to ultimately commercialize the MTeq. Even if early stage testing proves to be successful, we may not be able to identify a licensing partner for the technology to assist us in bringing the MTeq solution to the market. If we were able to enter into such a licensing agreement, we may still fail to produce a viable commercialized solution given the complex and extreme conditions found in mud pumping, which present a wide range of technological challenges for us. If we are unable to successfully complete early stage testing, fail to locate and

successfully negotiate a licensing or similar agreement with a long-term partner or fail to solve any of the technological challenges, we may not be able to successfully commercialize the MTeq, which could have an adverse effect on our entire business, financial condition or results of operation.

***Our Oil & Gas Segment may be impacted by prolonged deflation in global oil prices which may cause delays or cancellations of projects by Oil & Gas Segment customers, negatively affecting the rate of our market penetration and, consequently, our revenue and profitability.***

A deflationary oil environment may delay and even stall adoption and deployment of our products within our Oil & Gas Segment including but not limited to the VorTeq as licensed for onshore applications by the VorTeq Licensee. Emerging market economies, those dependent on commodity exports and especially those for whom oil exports make up a significant percent of total exports, may be unable to retrofit or expand their oil exploration, production and gas processing infrastructure thus negatively impacting our addressable market and future revenue. Additionally, oil price deflation may continue to lead to widespread liquidity and insolvency issues for exploration, production and processing customers, which may negatively affect our addressable markets and therefore our financial performance.

#### **Risk Related to our Entire Business**

***Our diversification into new fluid flow markets such as oil and gas may not be successful***

We have made a substantial investment in research, development and sales to execute on our diversification strategy into fluid flow markets such as oil and gas and chemical processing. While we see diversification as core to our growth strategy, there is no guarantee that we will be successful in our efforts. Our model for growth is based in part on our ability to initiate and embrace disruptive technology trends, to enter new markets, both in terms of geographies and product areas, and to drive broad adoption of the products and services that we develop and market. Any inability to execute this model for growth could damage our reputation, limit our growth and negatively affect our operation results. For example, while we believe that our products will enable gas processing plant operators to operate at a high level of energy efficiency with minimal downtime, we may be subject to warranty claims if customers of these offerings experience significant downtimes or failures for which our warranty reserves may be inadequate given the lack of historical failure rates associated with new product introductions. We also could be subject to damage claims based on our products, which we may not be able to properly insure. In addition, profitability, if any, in new industrial verticals may be lower than in our Water Segment and we may not be sufficiently successful in our diversification efforts to recoup investments.

***Our operating results may fluctuate significantly, making our future operating results difficult to predict and causing our operating results to fall below expectations.***

Our operating results may fluctuate due to a variety of factors, many of which are outside of our control.

We have experienced significant fluctuations in revenue from quarter-to-quarter and year-to-year, and we expect such fluctuations to continue. In addition, in the past, customer buying patterns led to a significant portion of our sales occurring in the fourth quarter. This presents the risk that delays, cancellations or other adverse events in the fourth quarter could have a substantial negative impact on annual results. As a result, comparing our operating results on a period-to-period basis may not be meaningful. Since it is difficult for us to anticipate our future results and in the event our revenue or operating results fall below the expectations of investors or securities analysts, our stock price may decline.

***Our sales cycles can be long and unpredictable and our sales efforts require considerable time and expense. As a result, our sales are difficult to predict and may vary substantially from quarter to quarter, which may cause our operating results to fluctuate.***

Our sales efforts involve substantial education of our current and prospective customers about the use and benefits of our energy recovery products. This education process can be time-consuming and typically involves a significant product evaluation process which is particularly pronounced when dealing with product introduction into new fluid flow industrial verticals. In our Water Segment, the sales cycle for our OEM customers, which are involved with smaller desalination plants, averages one to 12 months. The Water Segment sales cycle for our international engineering, procurement and construction firm customers, which are involved with larger desalination plants, ranges from 16 to 36 months. These long sales cycles make quarter-by-quarter revenue predictions difficult and results in our expending significant resources well in advance of orders for our products.

***Our business entails significant costs that are fixed or difficult to reduce in the short term while demand for our products is variable and subject to fluctuation, which may adversely affect our operating results.***

Our business requires investments in facilities, equipment, research and development and training that are either fixed or difficult to reduce or scale in the short term. At the same time, the market for our products is variable and has experienced downturns due to factors such as economic recessions, increased precipitation, uncertain global financial markets and political

changes, many of which are outside of our control. During periods of reduced product demand, we may experience higher relative costs and excess manufacturing capacity, resulting in high overhead and lower gross profit margins while causing cash flow and profitability to decline. Similarly, although we believe that our existing manufacturing facilities are capable of meeting current demand and demand for the foreseeable future, the continued success of our business depends on our ability to expand our manufacturing, research and development and testing facilities to meet market needs. If we are unable to respond timely to an increase in demand, our revenue, gross profit margin, net income and cash flow may be adversely affected.

***Parts of our inventory may become excess or obsolete, which would increase our cost of revenues.***

Inventory of raw materials, parts, components, work in-process or finished products may accumulate, and we may encounter losses due to a variety of factors, including technological change in the water desalination and oil and gas industries that result in product changes, long delays in shipment of our products or order cancellations, our need to order raw materials that have long lead times and our inability to estimate exact amounts and types of items needed, especially with regard to the configuration of our high-efficiency pumps and IsoBoost and IsoGen systems, and cost reduction initiatives resulting in component changes within the products.

In addition, we may from time to time purchase more inventory than is immediately required in order to shorten our delivery time in case of an anticipated increase in demand for our products. If we are unable to forecast demand for our products with a reasonable degree of certainty and our actual orders from our customers are lower than these forecasts, we may accumulate excess inventory that we may be required to write off, and our business, financial condition and results of operations could be adversely affected.

***We may not generate positive returns on our research and development strategy***

Developing our products is expensive and the investment in product development may involve a long payback cycle. For the years ended December 31, 2018, 2017 and 2016, our R&D expenses were \$17.0 million, or approximately 23% of our total revenue, \$13.4 million, or approximately 19% of our total revenue, and \$10.1 million, or approximately 18% of our total revenue, respectively. We believe one of our greatest strengths lies in our innovation and our product development efforts. By investing in R&D, we believe we are well positioned to continue to execute on our product strategy, take into consideration our customers' cost and efficiency sensitivities and take advantage of other market opportunities. We expect that our results of operations may be impacted by the timing and size of these investments. In addition, these investments may take several years to generate positive returns, if ever.

***We are subject to risks related to product defects, which could lead to warranty claims in excess of our warranty provision or result in a significant or a large number of warranty or other claims in any given year.***

We provide a warranty for certain products for a period of 18 to 30 months and provide up to a five-year warranty for the ceramic components of our PX-branded products. We test our products in our manufacturing facilities through a variety of means; however, there can be no assurance that our testing will reveal latent defects in our products, which may not become apparent until after the products have been sold into the market. The testing may not replicate the harsh, corrosive and varied conditions of the desalination and other plants in which they are installed. It is also possible that components purchased from our suppliers could break down under those conditions. Certain components of our turbochargers and pumps are custom-made and may not scale or perform as required in production environments. Accordingly, there is a risk that we may have significant warranty claims or we may breach supply agreements due to product defects. We may incur additional cost of revenue if our warranty provisions are not sufficient to cover the actual cost of resolving issues related to defects in our products. If these additional expenses are significant, which could adversely affect our business, financial condition and results of operations.

***Business interruptions may damage our facilities or those of our suppliers.***

Our operations and those of our suppliers may be vulnerable to interruption by fire, earthquake, flood, and other natural disasters, as well as power loss, telecommunications failure, and other events beyond our control. Our facilities in California are located near major earthquake faults and have experienced earthquakes in the past. If a natural disaster occurs, our ability to conduct our operations could be seriously impaired, which could harm our business, financial condition, results of operations, and cash flows. We cannot be sure that the insurance we maintain against general business interruptions will be adequate to cover all of our losses.

***If we are unable to protect our technology or enforce our intellectual property rights, our competitive position could be harmed and we could be required to incur significant expenses to enforce our rights.***

Our competitive position depends on our ability to establish and maintain proprietary rights in our technology and to protect our technology from copying by others. We rely on trade secret, patent, copyright and trademark laws as well as confidentiality agreements with employees and third parties, all of which may offer only limited protection. We hold a number of U.S. and counterpart international patents and when their terms expire, we could become more vulnerable to increased competition. The protection of our intellectual property in some countries may be limited. While we have expanded our

portfolio of patent applications, we do not know whether any of our pending patent applications will result in the issuance of patents or whether the examination process will require us to narrow our claims, and even if patents are issued, they may be contested, circumvented or invalidated. Moreover, while we believe our issued patents and patent pending applications are essential to the protection of our technology, the rights granted under any of our issued patents or patents that may be issued in the future may not provide us with proprietary protection or competitive advantages and, as with any technology, competitors may be able to develop similar or superior technologies now or in the future. In addition, our granted patents may not prevent misappropriation of our technology, particularly in foreign countries where intellectual property laws may not protect our proprietary rights as fully as those in the United States. This may render our patents impaired or useless and ultimately expose us to currently unanticipated competition. Protecting against the unauthorized use of our products, trademarks and other proprietary rights is expensive, difficult and, in some cases, impossible. Litigation may be necessary in the future to enforce or defend our intellectual property rights or to determine the validity and scope of the proprietary rights of others. Intellectual property litigation could result in substantial costs and diversion of management resources, either of which could harm our business.

***Claims by others that we are infringing on their proprietary rights could harm our business.***

Third parties could claim that our technology infringes their intellectual property rights. In addition, we or our customers may be contacted by third parties suggesting that we obtain a license to certain of their intellectual property rights that they may believe we are infringing. We expect that infringement claims against us may increase as the number of products and competitors in our market increases and overlaps occur. In addition, to the extent that we gain greater visibility, we believe that we will face a higher risk of being the subject of intellectual property infringement claims. Any claim of infringement by a third party, even those without merit, could cause us to incur substantial costs defending against the claim and could distract management from our business. Furthermore, a party making such a claim, if successful, could secure a judgment that requires us to pay substantial damages. A judgment against us could also include an injunction or other court order that could prevent us from offering our products. In addition, we might be required to seek a license for the use of such intellectual property, which may not be available on commercially reasonable terms, or at all. Alternatively, we may be required to develop non-infringing technology, which could require significant effort and expense and may ultimately not be successful. Any of these events could seriously harm our business. Third parties may also assert infringement claims against our customers. Because we generally indemnify our customers if our products infringe the proprietary rights of third parties, any such claims would require us to initiate or defend protracted and costly litigation on their behalf in one or more jurisdictions, regardless of the merits of these claims. If any of these claims succeed, we may be forced to pay damages on behalf of our customers.

***We are currently involved in legal proceedings, and may be subject to additional future legal proceedings, that may result in material adverse outcomes.***

In addition to the intellectual property litigation risks discussed above, we are presently involved, and may become involved in the future, in various commercial and other disputes as well as related claims and legal proceedings that arise from time to time in the course of our business. See Note 16, "Litigation" of the Notes to Consolidated Financial Statements in Part II, Item 8, "Financial Statements and Supplementary Data," of our Annual Report on Form 10-K for the year ended December 31, 2018 for information about certain legal proceedings in which we are involved. Our current legal proceedings and any future lawsuits to which we may become a party are and will likely be expensive and time consuming to investigate, defend and resolve, and will divert our management's attention. Any litigation to which we are a party may result in an onerous or unfavorable judgment that may not be reversed upon appeal or in payments of substantial monetary damages or fines, or we may decide to settle lawsuits on similarly unfavorable terms, which could have an adverse effect on our business, financial condition or results of operations.

***Our global operations expose us to risks and challenges associated with conducting business internationally, and our results of operations may be adversely affected by our efforts to comply with the laws of other countries, as well as U.S. laws which apply to international operations, such as the Foreign Corrupt Practices Act (FCPA) and U.S. export control laws.***

We operate on a global basis with offices or activities in Europe, Africa, Asia, South America, the Middle East and North America. We face risks inherent in conducting business internationally including compliance with international and U.S. laws and regulations that apply to our international operations. These laws and regulations include tax laws, anti-competition regulations, import and trade restrictions, export control laws and laws which prohibit corrupt payments to governmental officials or certain payments or remunerations to customers including the U.S. Foreign Corrupt Practices Act ("FCPA") or other anti-corruption laws that have recently been the subject of a substantial increase in global enforcement. Many of our products are subject to U.S. export law restrictions that limit the destinations and types of customers to which our products may be sold or which may require an export license in connection with sales outside the United States. Given the high level of complexity of these laws, there is a risk that some provisions may be inadvertently or intentionally breached. Examples include breaches through fraudulent or negligent behavior of individual employees or through our failure to comply with certain formal documentation requirements, or otherwise. Also, we may be held liable for actions taken by our local dealers and partners.



Violations of these laws and regulations could result in fines and criminal sanctions against us, our officers or our employees, and prohibitions or conditions on the conduct of our business. Any such violations could include prohibitions or conditions on our ability to offer our products in one or more countries and could materially damage our reputation, our brand, our business and our operating results. In addition, we operate in many parts of the world that have experienced significant governmental corruption to some degree and, in certain circumstances, strict compliance with anti-bribery laws may conflict with local customs and practices. We may be subject to competitive disadvantages to the extent that our competitors are able to secure business, licenses or other preferential treatment by making payments to government officials and others in positions of influence or through other methods that relevant law and regulations prohibit us from using. Our success depends, in part, on our ability to anticipate these risks and manage these difficulties. These factors or any combination of these factors may adversely affect our revenue or our overall financial performance.

***Our global operations expose us to risks and uncertainty in the global geopolitical landscape which may impact our operations outside the United States.***

There is uncertainty as to the position the United States will take with respect to world affairs. This uncertainty may include such issues as U.S. support for existing treaty and trade relationships with other countries, including notably, China. This uncertainty, together with other recent key global events (such as recently enacted currency control regulations and tariff regimes in or against China, the continuing uncertainty arising from the Brexit referendum in the United Kingdom as well as ongoing terrorist activity and potential hostilities in the Middle East) may adversely impact (i) the ability or willingness of non-U.S. companies to transact business in the United States, including with us, (ii) our ability to transact business in other regions, including the Middle East, where many of the water mega-projects are planned, (iii) regulation and trade agreements affecting U.S. companies, (iv) global stock markets (including The Nasdaq Global Market on which our common shares are traded), and (v) general global economic conditions. All of these factors are outside of our control, but may nonetheless cause us to adjust our strategy in order to compete effectively in global markets.

***Our global operations expose us to risks and uncertainty related to acts of war or terrorism.***

Threats or acts of war or terrorism can adversely affect our business. Terrorist attacks in the United States, Europe and in other regions and continuing hostilities in the Middle East and elsewhere have created significant instability and uncertainty in the world. These and future events may have a material adverse effect on world financial markets as well as the water industry, as many large existing and planned water desalination plants are located in the Middle East. In addition, threats or acts of war or terrorism can cause our customers to curtail their purchase of our products. These factors or any combination of these factors may adversely affect our revenue or our overall financial performance.

***The U.S. Congress and Presidential Administration may make substantial changes to fiscal, political, regulation and other federal policies that may adversely affect our business, financial condition, operating results and cash flows.***

Changes in general economic or political conditions in the United States or other countries could adversely affect our business. There have been and may be significant changes in, and uncertainty with respect to, legislation, regulation and government policy. While it is not possible to predict whether and when any such changes will occur, changes at the local, state or federal level could impact our business. Specific legislative and regulatory proposals that could have a material impact on us include, but are not limited to, modifications to international trade policy, public company reporting requirements and environmental regulation.

Additionally, on July 6, 2018, 25% tariffs on a variety of imports from China was imposed, including certain components imported into the U.S. for our manufacturing activities. The Administration subsequently imposed tariffs on two additional lists of products from China; the first of these additional lists involves 25% tariffs and the second list imposes 10% tariffs which were originally scheduled to increase to 25% on January 1, 2019. On November 19, 2018, the U.S. Bureau of Industry and Security proposed export control rules on emerging technologies for public comment.

China responded to the multiple U.S. tariff lists by announcing several lists of products from the U.S. that are subject to additional tariffs upon import to China. The first round of Chinese retaliatory tariffs went into effect on July 6, 2018, and a second set was implemented on August 23, 2018. Our products are not impacted by these tariffs. A third group of items subject to 5% to 10% tariff went into effect on September 24, 2018, which includes our PX Pressure Exchanger, Turbocharger, and pump products. On December 2, 2018, the U.S. and China agreed to refrain from increasing tariffs or imposing new tariffs until March 1, 2019. On February 24, 2019, the Administration announced a delay in the increases in tariffs due to recent progress in trade talks.

We cannot predict what actions may ultimately be taken with respect to tariffs or trade relations between the United States and other countries, what products may be subject to such actions or what actions may be taken by the other countries in retaliation. Accordingly, it is difficult to predict how such actions may impact our business or the business of our customers. Our business operations, as well as the businesses of our customers on which we are substantially dependent, are located in various countries at risk for escalating trade disputes, including the United States and China. Any resulting trade war could

have a significant adverse effect on world trade and could adversely impact our revenues, gross margins and business operations.

***Regulations related to conflict minerals could adversely impact our business.***

The Dodd-Frank Wall Street Reform and Consumer Protection Act contains provisions to improve transparency and accountability concerning the supply of certain minerals, known as conflict minerals, originating from the Democratic Republic of Congo (“DRC”) and adjoining countries. As a result, in August 2012, the SEC adopted annual disclosure and reporting requirements for those companies who use conflict minerals mined from the DRC and adjoining countries in their products. Based on our purchasing policy and supplier selection, it is considered unlikely that any conflict minerals are used in the manufacturing of our products. Nevertheless, we have conducted a reasonable country of origin inquiry and have implemented a program of due diligence on the source and chain of custody for conflict minerals. There are costs associated with complying with these disclosure requirements including loss of customers and potential changes to products, processes or sources of supply. The implementation of these rules could adversely affect the sourcing, supply and pricing of materials used in our products. As there may be only a limited number of suppliers offering “conflict free” minerals, we cannot be sure that we will be able to obtain necessary materials from such suppliers in sufficient quantities or at competitive prices, if at all. Also, we may face reputational challenges if we determine that certain of our products contain minerals not determined to be conflict-free or if we are unable to sufficiently verify the origins for all conflict minerals used in our products through the procedures we have implemented.

***We may have risks associated with security of our information technology systems.***

We make significant efforts to maintain the security and integrity of our information technology systems and data. Despite significant efforts to create security barriers to such systems, it is virtually impossible for us to entirely mitigate this risk. There is a risk of industrial espionage, cyber-attacks, misuse or theft of information or assets or damage to assets by people who may gain unauthorized access to our facilities, systems or information. Such cybersecurity breaches, misuse or other disruptions could lead to the disclosure of confidential information, improper usage and distribution of our intellectual property, theft, manipulation and the destruction of private and proprietary data as well as cause production downtimes. Although we actively employ measures to prevent unauthorized access to our information systems, preventing unauthorized use or infringement of our rights is inherently difficult. These events could adversely affect our financial results and any legal action in connection with any such cybersecurity breach could be costly and time-consuming and may divert management’s attention and adversely affect the market’s perception of us and our products. In addition, we must frequently expand our internal information system to meet increasing demand in storage, computing and communication, which may result in increased costs. Our internal information system is expensive to expand and must be highly secure due to the sensitive nature of our customers’ information that we transmit. Building and managing the support necessary for our growth places significant demands on our management and resources. These demands may divert these resources from the continued growth of our business and implementation of our business strategy.

***We may have risks associated with our international tax optimization structure.***

In 2015, we implemented an international tax optimization structure. While the Company continues to conclude that uncertain tax positions are unlikely, it is possible that the international tax structure could be examined by the Internal Revenue Service in the U.S. and/or the Tax Authorities in Ireland, and it is possible that such an examination could result in an unfavorable impact on us.

***The enactment of legislation implementing changes in taxation of international business activities, the adoption of other corporate tax reform policies or changes in tax legislation or policies could materially impact our financial position and results of operations.***

Corporate tax reform, base-erosion efforts and tax transparency continue to be high priorities in many tax jurisdictions where we have business operations. As a result, policies regarding corporate income and other taxes in numerous jurisdictions are under heightened scrutiny, and tax reform legislation is being proposed or enacted in a number of jurisdictions. For example, on December 22, 2017, “H.R.1”, known as the “Tax Cuts and Jobs Act” (the “Tax Act”), was enacted, which significantly changes existing U.S. tax laws.

In addition, many countries are beginning to implement legislation and other guidance to align their international tax rules with the Organisation for Economic Co-operation’s Base Erosion and Profit Shifting recommendations and action plan that aim to standardize and modernize global corporate tax policy, including changes to cross-border tax, transfer-pricing documentation rules and nexus-based tax incentive practices. As a result of the heightened scrutiny of corporate taxation policies, prior decisions by tax authorities regarding treatments and positions of corporate income taxes could be subject to enforcement activities, and legislative investigation and inquiry, which could also result in changes in tax policies or prior tax rulings. Any such changes in policies or rulings may also result in the taxes we previously paid being subject to change.

Due to the scale of our international business activities any substantial changes in international corporate tax policies, enforcement activities or legislative initiatives may materially and adversely affect our business, the amount of taxes we are required to pay and our financial condition and results of operations generally.

***If we need additional capital to fund future growth, it may not be available on favorable terms, or at all.***

Our primary source of cash historically has been customer payments for our products and services and proceeds from the issuance of common stock supplemented by lines of credit from banking institutions. This has funded our operations and capital expenditures. We may require additional capital from equity or debt financing in the future to fund our operations or respond to competitive pressures or strategic opportunities such as a potential acquisition or the expansion of operations. We may not be able to secure such additional financing on favorable terms, or at all. The terms of additional financing may place limits on our financial and operational flexibility. If we raise additional funds through further issuances of equity, convertible debt securities or other securities convertible into equity, our existing stockholders could suffer significant dilution in their percentage ownership of our Company, and any new securities that we issue could have rights, preferences or privileges senior to those of existing or future holders of our common stock. If we are unable to obtain necessary financing on terms satisfactory to us if and when we require it, our ability to grow or support our business and to respond to business challenges or opportunities could be significantly limited.

***We may seek to expand through acquisitions of and investments in other businesses, technologies and assets. These acquisition activities may be unsuccessful or divert management's attention.***

We may consider strategic and complementary acquisitions of and investments in other businesses, technologies and assets, and such acquisitions or investments are subject to risks that could affect our business, including risks related to:

- the necessity of coordinating geographically disparate organizations;
- implementing common systems and controls;
- integrating personnel with diverse business and cultural backgrounds;
- integrating acquired research and manufacturing facilities, technology and products;
- combining different corporate cultures and legal systems;
- unanticipated expenses related to integration, including technical and operational integration;
- increased costs and unanticipated liabilities, including with respect to registration, environmental, health and safety matters that may affect sales and operating results;
- retaining key employees;
- obtaining required government and third-party approvals;
- legal limitations in new jurisdictions;
- installing effective internal controls and audit procedures;
- issuing common stock that could dilute the interests of our existing stockholders;
- spending cash and incurring debt;
- assuming contingent liabilities; and
- creating additional expenses.

We may not be able to identify opportunities or complete transactions on commercially reasonable terms, or at all, or actually realize any anticipated benefits from such acquisitions or investments. Similarly, we may not be able to obtain financing for acquisitions or investments on attractive terms. If we do complete acquisitions, we cannot ensure that they will ultimately strengthen our competitive or financial position or that they will not be viewed negatively by customers, financial markets, investors or the media. In addition, the success of any acquisitions or investments also will depend, in part, on our ability to integrate the acquisition or investment with our existing operations.

The integration of businesses that we may acquire is likely to be a complex, time-consuming and expensive process and we may not realize the anticipated revenues or other benefits associated with our acquisitions if we fail to successfully manage and operate the acquired business. If we fail in any acquisition integration efforts and are unable to efficiently operate as a combined organization utilizing common information and communication systems, operating procedures, financial controls and human resources practices, our business, financial condition and results of operations may be adversely affected.

In connection with certain acquisitions, we may agree to issue common stock or assume equity awards that dilute the ownership of our current stockholders, use a substantial portion of our cash resources, assume liabilities, record goodwill and amortizable intangible assets that will be subject to impairment testing on a regular basis and potential periodic impairment charges, incur amortization expenses related to certain intangible assets, and incur large and immediate write-offs and restructuring and other related expenses, all of which could harm our financial condition and results of operations.

***Our actual operating results may differ significantly from our guidance***

We release guidance in our quarterly earnings conference calls, quarterly earnings releases, or otherwise, regarding our future performance that represents our management's estimates as of the date of release. This guidance, which includes forward-looking statements, will be based on projections prepared by our management. These projections will not be prepared with a view toward compliance with published guidelines of the American Institute of Certified Public Accountants, and neither our registered public accountants nor any other independent expert or outside party compiles or examines the projections. Accordingly, no such person will express any opinion or any other form of assurance with respect to the projections. Except as required by law, we undertake no obligation to revise or update publicly any forward-looking statements for any reason.

Projections are based upon a number of assumptions and estimates that, while presented with numerical specificity, are inherently subject to significant business, economic and competitive uncertainties and contingencies, many of which are beyond our control and are based upon specific assumptions with respect to future business decisions, some of which will change. We will continue to state possible outcomes as high and low ranges which are intended to provide a sensitivity analysis as variables are changed but are not intended to imply that actual results could not fall outside of the suggested ranges. The principal reason that we release guidance is to provide a basis for our management to discuss our business outlook with analysts and investors. We do not accept any responsibility for any projections or reports published by any such third parties.

Guidance is necessarily speculative in nature, and it can be expected that some or all of the assumptions underlying the guidance furnished by us will not materialize or will vary significantly from actual results. Accordingly, our guidance is only an estimate of what management believes is realizable as of the date of release. Actual results may vary from our guidance and the variations may be material. In light of the foregoing, investors are urged not to rely upon our guidance in making an investment decision regarding our common stock.

Any failure to successfully implement our operating strategy or the occurrence of any of the events or circumstances set forth in this "Risk Factors" section in this Annual Report on Form 10-K could result in the actual operating results being different from our guidance and the differences may be adverse and material.

***Insiders and principal stockholders will likely have significant influence over matters requiring stockholder approval.***

Our directors, executive officers and other principal stockholders beneficially own, in the aggregate, a substantial amount of our outstanding common stock. These stockholders could likely have significant influence over all matters requiring stockholder approval, including the election of directors and approval of significant corporate transactions such as a merger or other sale of our company or its assets.

***The market price of our common stock may continue to be volatile.***

The market price of our common stock has been, and is likely to continue to be, volatile and subject to fluctuations. Changes in the stock market generally, as it concerns our industry as well as geopolitical, economic and business factors unrelated to us, may also affect our stock price. Significant declines in the market price of our common stock or failure of the market price to increase could harm our ability to recruit and retain key employees, reduce our access to debt or equity capital and otherwise harm our business or financial condition. In addition, we may not be able to use our common stock effectively as consideration in connection with any future acquisitions.

***Anti-takeover provisions in our charter documents and under Delaware law could discourage, delay or prevent a change in control of our company and may affect the trading price of our common stock.***

Provisions in our amended and restated certificate of incorporation and bylaws may have the effect of delaying or preventing a change of control or changes in our management. Our amended and restated certificate of incorporation and amended and restated bylaws include provisions that:

- authorize our Board of Directors to issue, without further action by the stockholders, up to 10,000,000 shares of undesignated preferred stock;
- require that any action to be taken by our stockholders be effected at a duly called annual or special meeting and not by written consent;
- specify that special meetings of our stockholders can be called only by our Board of Directors, the chairman of the board, the chief executive officer or the president;
- establish an advance notice procedure for stockholder approvals to be brought before an annual meeting of our stockholders, including proposed nominations of persons for election to our Board of Directors;
- establish that our Board of Directors is divided into three classes, Class I, Class II and Class III, with each class serving staggered terms;
- provide that our directors may be removed only for cause;

- provide that vacancies on our Board of Directors may be filled only by a majority vote of directors then in office, even though less than a quorum;
- specify that no stockholder is permitted to cumulate votes at any election of directors; and
- require a super-majority of votes to amend certain of the above-mentioned provisions.

In addition, we are subject to the provisions of Section 203 of the Delaware General Corporation Law regulating corporate takeovers. Section 203 generally prohibits us from engaging in a business combination with an interested stockholder, subject to certain exceptions.

***Changes in United States Generally Accepted Accounting Principles (“GAAP”) could adversely affect our financial results and may require significant changes to our internal accounting systems and processes.***

We prepare our consolidated financial statements in conformity with GAAP. These principles are subject to interpretation by the Financial Accounting Standards Board (“FASB”), the SEC and various bodies formed to interpret and create appropriate accounting principles and guidance. The FASB periodically issues new accounting standards on a variety of topics. For information regarding new accounting standards, please refer to the section headed “Recent Accounting Pronouncements” contained within Note 1, “Description of Business and Significant Accounting Policies” contained in the Condensed Consolidated Financial Statements of this Quarterly Filing on Form 10-Q. These and other such standards generally result in different accounting principles which may significantly impact our reported results or could result in variability of our financial results.

***In preparing our financial statements we make certain assumptions, judgments and estimates that affect amounts reported in our consolidated financial statements which, if not accurate, may significantly impact our financial results.***

We make assumptions, judgments and estimates for a number of items, including the fair value of financial instruments, goodwill, long-lived assets and other intangible assets, the realizability of deferred tax assets, the recognition of revenue and the fair value of stock awards. We also make assumptions, judgments and estimates in determining the accruals for employee-related liabilities including commissions and variable compensation, in determining the accruals for uncertain tax positions, in valuation allowances on deferred tax assets, in allowances for doubtful accounts and in legal contingencies. These assumptions, judgments and estimates are drawn from historical experience and various other factors that we believe are reasonable under the circumstances as of the date of the consolidated financial statements. Actual results could differ materially from our estimates, and such differences could significantly impact our financial results.

***Our business could be negatively affected as a result of actions of activist shareholders, and such activism could impact the trading value of our securities.***

In recent years, shareholder activists have become involved in numerous public companies. Shareholder activists frequently propose to involve themselves in the governance, strategic direction and operations of the Company. Such proposals may disrupt our business and divert the attention of our Board of Directors and our management and employees, and any perceived uncertainties as to our future direction resulting from such a situation could result in the loss of potential business opportunities, interfere with our ability to execute our strategic plan be exploited by our competitors, cause concern to our current or potential customers and make it more difficult to attract and retain qualified personnel and business partners, all of which could adversely affect our business. A proxy contest for the election of directors at our annual meeting could also require us to incur significant legal fees and proxy solicitation expenses. In addition, actions of activist shareholders may cause significant fluctuations in our stock price based on temporary or speculative market perceptions or other factors that do not necessarily reflect the underlying fundamentals and prospects of our business.

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

### **Purchases of Equity Securities by the Issuer and Affiliated Purchasers**

There has been no activity with respect to the program to repurchase outstanding units during the six months ended June 30, 2019.

Pursuant to the March 2018 Authorization, the Company, at the discretion of management, was authorized to repurchase up to \$10.0 million in aggregate cost of our outstanding common stock. As of June 30, 2019, 1.2 million shares at an aggregate cost of \$10.0 million had been repurchased under the March 2018 Authorization. The aggregate cost includes fees charged in connection with acquiring the outstanding common stock.

### **Item 3. — Defaults Upon Senior Securities**

None.

**Item 4. — Mine Safety Disclosures**

Not applicable.

**Item 5. — Other Information**

None.

**Item 6. — Exhibits**

See the following Exhibit Index for a list of exhibits filed or furnished with this report, which Exhibit Index is incorporated herein by reference.

**EXHIBIT INDEX**

Exhibit Number	Exhibit Description	Incorporated by Reference				Filed Herewith
		Form	File No.	Exhibit	Filing Date	
10.1	<a href="#">Sixth Amendment to Loan and Pledge Agreement between Energy Recovery, Inc. and Citibank, N.A.</a>					X
31.1.	<a href="#">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.</a>					X
31.2	<a href="#">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.</a>					X
32.1*	<a href="#">Certification of Principal Executive Officer and Principal Financial Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.</a>					
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					

\* The certifications furnished in Exhibits 32.1 are deemed to accompany this Form 10-Q and are not deemed "filed" for purposes of Section 18 of the Exchange Act, or otherwise subject to the liability of that section, nor shall they be deemed incorporated by reference into any filing under the Securities Act or the Exchange Act.

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**ENERGY RECOVERY, INC.**

Date: August 2, 2019

By: /s/ CHRIS GANNON

Chris Gannon

*President and Chief Executive Officer*

*(Principal Executive Officer)*

Date: August 2, 2019

By: /s/ JOSHUA BALLARD

Joshua Ballard

*Chief Financial Officer*

*(Principal Financial and Accounting Officer)*



## SIXTH AMENDMENT TO LOAN AND PLEDGE AGREEMENT

Dated as of June 10, 2019

Reference is made to that certain Loan and Pledge Agreement dated as of January 27, 2017 (as amended, supplemented, waived or otherwise modified from time to time prior to the date hereof, the "Loan and Pledge Agreement") between Energy Recovery, Inc., as borrower (the "Borrower"), and Citibank, N.A., as lender (the "Lender"). Capitalized terms used herein but not defined shall have the meaning assigned to such terms in the Loan and Pledge Agreement.

The parties hereto agree that, effective as of the Amendment Effective Date, the definition of the term "LIBOR Rate" set forth in Section 1.1 of the Loan and Pledge Agreement is hereby amended by deleting the stricken text and adding the double-underlined text as set forth below:

“LIBOR Rate” means, for any Interest Period, the rate per annum equal to the British Bankers Association LIBOR Rate (“BBA LIBOR”), as it appears in the ICE Benchmark Administration’s Secure Financial Transaction Protocol service or through a third-party redistributor of such information, which shall note an average ICE Benchmark Administration Limited Fixing for US Dollar (or another commercially available source providing quotations of BBA LIBOR as designated by Lender from time to time) at approximately 11:00 a.m. (London time) two Business Days prior to the commencement of such Interest Period, for U.S. dollar deposits (for delivery on the first day of such Interest Period) with a term equivalent to such Interest Period. If such rate is not available at such time for any reason, then the “LIBOR Rate” for such Interest Period shall be the rate per annum determined by Lender to be the rate at which U.S. dollar deposits with a term equivalent to such Interest Period would be offered by Citibank in London, England to major banks in the London or other offshore interbank market at approximately 11:00 a.m. (London time) two Business Days prior to the commencement of such Interest Period. If the Board of Governors of the Federal Reserve System (or any successor) imposes a LIBOR Reserve Percentage with respect to LIBOR deposits, then, the LIBOR Rate shall be the foregoing rate divided by 1 minus the LIBOR Reserve Percentage. If the LIBOR Rate shall be less than zero percent, the LIBOR Rate shall be deemed to be zero percent for purposes of this Agreement.

The parties hereto agree that, effective as of the Amendment Effective Date, the definition of the term “Termination Date” set forth in Section 1.1 of the Loan and Pledge Agreement is hereby amended by deleting the stricken text and adding the double-underlined text as set forth below:

“Termination Date” means June 30, 2022.”

The parties hereto agree that, effective as of the Amendment Effective Date, the first sentence of Section 2.7(a) of the Loan and Pledge Agreement is hereby amended by deleting the stricken text and adding the double-underlined text as set forth below:

“The term of any Letter of Credit shall not exceed three (3) years from the date of its issuance, subject to renewal in accordance with the terms thereof.”

The parties hereto agree that, effective as of the Amendment Effective Date, the following clauses of Section 8.1 of the Loan and Pledge Agreement are hereby amended by deleting the stricken text and adding the double-underlined text as set forth below:

---

“(g) Borrower shall: (i) liquidate, wind-up or dissolve itself (or suffer any liquidation or dissolution); or (ii) acquire by purchase or otherwise all or any substantial part of the business or assets of any other Person, or otherwise enter into any transaction of merger or consolidation, unless in each case Borrower is the surviving legal entity;

(h) the occurrence of any "Event of Default" as defined in the Standby Letter of Credit Agreement; or

(i) any event or condition shall occur which results in the acceleration of the maturity of any Indebtedness of the Borrower which Indebtedness in the aggregate is at least \$5,000,000 or enables (or, with the giving of notice or lapse of time or both would enable) the holder of such Indebtedness or any Person acting on such holder's behalf to accelerate the maturity thereof.”

As used herein, the term “Amendment Effective Date” shall mean the first date upon which the Lender shall have executed and delivered one or more counterparts of this Sixth Amendment to Loan and Pledge Agreement (the “Agreement of Amendment”) and shall have received one or more counterparts of this Agreement of Amendment executed by the other parties hereto.

The Borrower represents and warrants to the Lender that (i) immediately after giving effect to this Agreement of Amendment and the transactions contemplated hereby, its representations and warranties set forth in the Loan and Pledge Agreement and the other Loan Documents are true and correct in all material respects (unless such representations and warranties relate to an earlier date, in which case such representations and warranties shall be true and correct as of such earlier date), (ii) no Default or Event of Default has occurred and is continuing or will result from the transactions contemplated by this Agreement of Amendment, and (iii) this Agreement of Amendment has been duly and validly executed and delivered by it and constitutes its legal, valid and binding obligation, enforceable against it in accordance with its terms, except as enforceability may be limited by applicable insolvency, bankruptcy, or other laws affecting creditor's rights generally, or general principals of equity, whether such enforceability is considered in a proceeding in equity or at law.

All references in any Loan Document to the Loan and Pledge Agreement on and after the Amendment Effective Date, shall be deemed to refer to the Loan and Pledge Agreement, as amended hereby, and the parties hereto agree that on and after the Amendment Effective Date, the Loan and Pledge Agreement, as amended hereby, is in full force and effect.

This Agreement of Amendment may be executed in any number of counterparts, each of which when so executed shall be deemed to be an original and all of which when taken together shall constitute one and the same agreement.

THIS AGREEMENT OF AMENDMENT SHALL BE GOVERNED BY AND CONSTRUED IN ACCORDANCE WITH THE LAWS OF THE STATE OF NEW YORK.

*[Signature Pages Follow]*

---

IN WITNESS WHEREOF, the parties hereto have caused this Sixth Amendment to Loan and Pledge Agreement to be executed and delivered by their duly authorized officers as of the date first above written.

ENERGY RECOVERY, InC.,  
as Borrower

By: \_\_\_\_\_

Name:  
Title:

CITIBANK, N.A.,  
as Lender

By: \_\_\_\_\_  
Name:

**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**

I, Chris Gannon, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Energy Recovery, Inc. for the period ended June 30, 2019;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. I am responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. I have disclosed, based on my most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's Board of Directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 2, 2019

/s/ CHRIS GANNON

Name: Chris Gannon  
President and Chief Executive Officer  
Title: (Principal Executive Officer)

**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**

I, Joshua Ballard, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Energy Recovery, Inc. for the period ended June 30, 2019;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. I am responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. I have disclosed, based on my most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's Board of Directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 2, 2019

/s/ JOSHUA BALLARD

Name: Joshua Ballard  
Title: Chief Financial Officer  
(Principal Financial Officer)

--

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER,  
PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO SECTION 906 OF THE  
SARBANES-OXLEY ACT OF 2002\***

Pursuant to the requirement set forth in Rule 13a-14(b) of the Securities and Exchange Act of 1934, as amended (the "Exchange Act"), and Section 1350 of Chapter 63 of Title 18 of the United States Code, Chris Gannon, President and Chief Executive Officer of Energy Recovery, Inc., and Joshua Ballard, Chief Financial Officer of Energy Recovery, Inc., each hereby certify that, to the best of his knowledge:

1. The Company's Quarterly Report on Form 10-Q for the period ended June 30, 2019, to which this Certification is attached as Exhibit 32.1 (the "Quarterly Report"), fully complies with the requirements of Section 13(a) or Section 15(d) of the Exchange Act, and
2. The information contained in the Quarterly Report fairly presents, in all material respects, the financial condition of the Company at the end of the period covered by the Quarterly Report and results of operations of the Company for the period covered by the Quarterly Report.

IN WITNESS WHEREOF, the undersigned has set his hand hereto:

Date: August 2, 2019

/s/ CHRIS GANNON

Chris Gannon

President and Chief Executive Officer

Date: August 2, 2019

/s/JOSHUA BALLARD

Joshua Ballard

Chief Financial Officer

- \* This certification accompanies the Form 10-Q to which it relates, is not deemed filed with the Securities and Exchange Commission and is not to be incorporated by reference into any filing of Energy Recovery, Inc. under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended (whether made before or after the date of the Form 10-Q), irrespective of any general incorporation language contained in such filing.