

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 March 31, 2020
OR

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

For the transition period from _____ to _____

Commission File Number: 001-34112



Energy Recovery, Inc.

(Exact Name of Registrant as Specified in its Charter)

Delaware

(State or Other Jurisdiction of Incorporation)

01-0616867

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

1717 Doolittle Drive, San Leandro, California 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:

Title of each class

Common

Trading Symbol

ERII

Name of each exchange on which registered

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 April 24, 2020, there were 55,546,399 shares of the registrant's common stock outstanding.

ENERGY RECOVERY, INC.
TABLE OF CONTENTS

		Page No.
PART I		
FINANCIAL INFORMATION		
Item 1	Financial Statements (Unaudited)	
	Condensed Consolidated Balance Sheets as of March 31, 2020 and December 31, 2019	3
	Condensed Consolidated Statements of Operations for the Three Months Ended March 31, 2020 and 2019	4
	Condensed Consolidated Statements of Comprehensive Income for the Three Months Ended March 31, 2020 and 2019	5
	Condensed Consolidated Statements of Cash Flows for the Three Months Ended March 31, 2020 and 2019	6
	Condensed Consolidated Statements of Stockholders' Equity for the Three Months Ended March 31, 2020 and 2019	7
	Notes to Condensed Consolidated Financial Statements	8
Item 2	Management's Discussion and Analysis of Financial Condition and Results of Operations	21
Item 3	Quantitative and Qualitative Disclosures About Market Risk	32
Item 4	Controls and Procedures	33
PART II		
OTHER INFORMATION		
Item 1	Legal Proceedings	34
Item 1A	Risk Factors	34
Item 2	Unregistered Sales of Equity Securities and Use of Proceeds	35
Item 3	Defaults Upon Senior Securities	35
Item 4	Mine Safety Disclosures	35
Item 5	Other Information	35
Item 6	Exhibits	36
	Signatures	37

PART I — FINANCIAL INFORMATION

Item 1 — Financial Statements (unaudited)

ENERGY RECOVERY, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS

	March 31, 2020	December 31, 2019
<i>(In thousands, except share data and par value)</i>		
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 32,842	\$ 26,387
Short-term investments	40,995	58,736
Accounts receivable, net	13,841	12,979
Inventories, net	10,938	10,317
Prepaid expenses and other current assets	5,187	4,548
Total current assets	103,803	112,967
Long-term investments	19,361	15,419
Deferred tax assets, non-current	16,932	16,897
Property and equipment, net	19,780	18,843
Operating lease, right of use asset	17,253	11,195
Goodwill	12,790	12,790
Other intangible assets, net	61	65
Other assets, non-current	632	598
Total assets	\$ 190,612	\$ 188,774
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 1,868	\$ 1,192
Accrued expenses and other current liabilities	6,156	9,869
Lease liabilities	1,209	1,023
Contract liabilities	16,509	15,746
Total current liabilities	25,742	27,830
Lease liabilities, non-current	17,523	11,533
Contract liabilities, non-current	8,805	13,120
Other non-current liabilities	277	278
Total liabilities	52,347	52,761
Commitments and contingencies (Note 8)		
Stockholders' equity:		
Common stock	61	61
Additional paid-in capital	171,954	170,028
Accumulated other comprehensive loss	(332)	(37)
Treasury stock	(30,486)	(30,486)
Accumulated deficit	(2,932)	(3,553)
Total stockholders' equity	138,265	136,013
Total liabilities and stockholders' equity	\$ 190,612	\$ 188,774

See Accompanying Notes to Condensed Consolidated Financial Statements

ENERGY RECOVERY, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

	Three Months Ended March 31,	
	2020	2019
	<i>(In thousands, except per share data)</i>	
Product revenue	\$ 19,001	\$ 16,072
Product cost of revenue	5,684	4,935
Product gross profit	13,317	11,137
License and development revenue	2,543	3,723
Operating expenses:		
General and administrative	6,881	5,579
Sales and marketing	2,138	2,162
Research and development	6,709	4,254
Amortization of intangible assets	4	156
Total operating expenses	15,732	12,151
Income from operations	128	2,709
Other income (expense):		
Interest income	420	523
Other non-operating expense, net	(12)	(24)
Total other income, net	408	499
Income before income taxes	536	3,208
(Benefit from) provision for income taxes	(85)	554
Net income	\$ 621	\$ 2,654
Earnings per share:		
Basic	\$ 0.01	\$ 0.05
Diluted	\$ 0.01	\$ 0.05
Number of shares used in per share calculations:		
Basic	55,412	54,116
Diluted	56,542	55,368

See Accompanying Notes to Condensed Consolidated Financial Statements

ENERGY RECOVERY, INC.
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

	Three Months Ended March 31,	
	2020	2019
	<i>(In thousands)</i>	
Net income	\$ 621	\$ 2,654
Other comprehensive (loss) income, net of tax		
Foreign currency translation adjustments	(25)	(24)
Unrealized (loss) gain on investments	(270)	84
Other comprehensive (loss) income, net of tax	(295)	60
Comprehensive income	\$ 326	\$ 2,714

See Accompanying Notes to Condensed Consolidated Financial Statements

ENERGY RECOVERY, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Three Months Ended March 31,	
	2020	2019
<i>(In thousands)</i>		
Cash flows from operating activities:		
Net income	\$ 621	\$ 2,654
Adjustments to reconcile net income to cash used in operating activities		
Stock-based compensation	1,503	1,678
Depreciation and amortization	1,258	900
Amortization (accretion) of premiums and discounts on investments	220	(26)
Deferred income taxes	(35)	549
Provision for warranty claims	98	152
Other non-cash adjustments	47	(68)
Changes in operating assets and liabilities:		
Accounts receivable, net	(902)	(7,162)
Contract assets	(244)	2,977
Inventories, net	(692)	(218)
Prepaid and other assets	(428)	(140)
Accounts payable	745	18
Accrued expenses and other liabilities	(4,514)	(3,353)
Income taxes	3	10
Contract liabilities	(3,552)	(3,922)
Net cash used in operating activities	<u>(5,872)</u>	<u>(5,951)</u>
Cash flows from investing activities:		
Sales of marketable securities	4,974	—
Maturities of marketable securities	21,195	19,599
Purchases of marketable securities	(12,855)	(19,198)
Capital expenditures	(1,380)	(1,566)
Net cash provided by (used in) investing activities	<u>11,934</u>	<u>(1,165)</u>
Cash flows from financing activities:		
Net proceeds from issuance of common stock	440	2,191
Tax payment for employee shares withheld	(22)	(34)
Net cash provided by financing activities	<u>418</u>	<u>2,157</u>
Effect of exchange rate differences on cash and cash equivalents	(25)	(4)
Net change in cash, cash equivalents and restricted cash	6,455	(4,963)
Cash, cash equivalents and restricted cash, beginning of year	26,488	22,138
Cash, cash equivalents and restricted cash, end of period	<u>\$ 32,943</u>	<u>\$ 17,175</u>

See Accompanying Notes to Condensed Consolidated Financial Statements

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

	Three Months Ended March 31,	
	2020	2019
	<i>(In thousands)</i>	
Common stock		
Beginning balance	\$ 61	\$ 59
Issuance of common stock, net	—	1
Ending balance	<u>61</u>	<u>60</u>
Additional paid-in capital		
Beginning balance	170,028	158,404
Issuance of common stock, net	418	2,156
Stock-based compensation	1,508	1,671
Ending balance	<u>171,954</u>	<u>162,231</u>
Accumulated other comprehensive loss		
Beginning balance	(37)	(133)
Other comprehensive (loss) income		
Foreign currency translation adjustments	(25)	(24)
Unrealized (loss) gain on investments	(270)	84
Total other comprehensive (loss) income, net	<u>(295)</u>	<u>60</u>
Ending balance	<u>(332)</u>	<u>(73)</u>
Treasury stock		
Beginning and ending balance	<u>(30,486)</u>	<u>(30,486)</u>
Accumulated deficit		
Beginning balance	(3,553)	(14,466)
Net income	621	2,654
Ending balance	<u>(2,932)</u>	<u>(11,812)</u>
Total stockholders' equity	<u>\$ 138,265</u>	<u>\$ 119,920</u>
Common stock issued (number of shares)		
Beginning balance	60,718	59,396
Issuance of common stock, net	281	523
Ending balance	<u>60,999</u>	<u>59,919</u>
Treasury stock (number of shares)		
Beginning and ending balance	<u>5,456</u>	<u>5,456</u>

See Accompanying Notes to Condensed Consolidated Financial Statements

ENERGY RECOVERY, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 1 — Description of Business and Significant Accounting Policies

Energy Recovery, Inc. and its wholly-owned subsidiaries (the “Company” or “Energy Recovery”) has, for more than 20 years, created technologies that solve complex challenges for industrial fluid flow markets worldwide. The Company designs and manufactures solutions that reduce waste, improve operational efficiency, and lower the production costs of clean water and oil & gas. 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 the Company 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, 2019 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 March 31, 2020 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, 2019 included in the Company’s Annual Report on Form 10-K filed with the SEC on March 6, 2020 (“2019 Annual Report”).

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 and that 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 (“R&D”) assets; allowance for doubtful accounts; allowance for product warranty; 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.

Due to the novel coronavirus (“COVID-19”) pandemic, the reduced demand of oil and gas, as well as the oversupply of oil, there has been uncertainty and disruption in the global economy and financial markets. The Company is not aware of any specific event or circumstance that would require an update to its estimates or judgments or a revision of the carrying value of its assets or liabilities as of May 1, 2020, the date of issuance of this Quarterly Report on Form 10-Q. These estimates may change, as new events occur and additional information is obtained. Actual results could differ materially from these estimates under different assumptions or conditions. The Company undertakes no obligation to update publicly these estimates for any reason after the date of this Quarterly Report on Form 10-Q, except as required by law.

ENERGY RECOVERY, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Significant Accounting Policies

Except for adopting new accounting pronouncements, as noted under “Recently Adopted Accounting Pronouncements,” there have been no material changes to the Company’s significant accounting policies in Note 1, “Description of Business and Significant Accounting Policies,” of the Notes to Consolidated Financial Statements included in the 2019 Annual Report.

Recent Accounting Pronouncements*Recently Adopted Accounting Pronouncements*

In June 2016, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2016-13, *Measurement of Credit Losses on Financial Instruments* (“ASU 2016-13”), which amends Accounting Standards Codification (“ASC”) 326, *Financial Instruments-Credit Losses* (“ASC 326”). Subsequent to the issuance of ASU 2016-13, ASC 326 was amended by various updates that amend and clarify the impact and implementation of the aforementioned update. The new guidance introduces the current expected credit loss (“CECL”) model, which will require an entity to record an allowance for credit losses for certain financial instruments and financial assets, including trade receivables, based on expected losses rather than incurred losses. Under this update, on initial recognition and at each reporting period, an entity will be required to recognize an allowance that reflects the entity’s current estimate of credit losses expected to be incurred over the life of the financial instrument. In February 2020, the FASB issued ASU No. 2020-02, *Financial Instruments-Credit Losses (Topic 326) and Leases (Topic 842)-Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 119 and Update to SEC Section on Effective Date Related to Accounting Standards Update No. 2016-02, Leases (Topic 842)* (“ASU 2020-02”), which amends the language in Subtopic 326-20 and addresses questions primarily regarding documentation and company policies. ASU 2016-13 and its amendments are effective for the Company for interim and annual periods in fiscal years beginning after December 15, 2019, on a modified retrospective basis. The adoption of ASU 2016-13 and its amendments on January 1, 2020 did not have a material impact on the Company’s Condensed Consolidated Financial Statements and related disclosures. The Company will continue to actively monitor the impact of the recent COVID-19 pandemic, the reduced demand of oil and gas, as well as the oversupply of oil, on expected credit losses.

In March 2020, the FASB issued ASU No. 2020-03, *Codification Improvements to Financial Instruments* (“ASU 2020-03”). This ASU improves and clarifies various financial instruments topics, including the CECL standard issued in 2016. ASU 2020-03 includes seven different issues that describe the areas of improvement and the related amendments to GAAP, intended to make the standards easier to understand and apply by eliminating inconsistencies and providing clarifications. The amendments have different effective dates. The adoption of ASU 2020-03 on January 1, 2020 did not have a material impact on the Company’s Condensed Consolidated Financial Statements and related disclosures.

Recently Issued Accounting Pronouncements Not Yet Adopted

In March 2020, the FASB issued ASU No. 2020-04, *Reference Rate Reform (Topic 848)* (“ASU 2020-04”), which provides optional expedients and exceptions for applying U.S. GAAP to contracts, hedging relationships, and other transactions affected by the discontinuation of the London Interbank Offered Rate (“LIBOR”) or by another reference rate expected to be discontinued. Entities may apply the provisions of the new standard as of the beginning of the reporting period when the election is made (*i.e.*, as early as the first quarter 2020). Unlike other topics, the provisions of this update are only available until December 31, 2022, when the reference rate replacement activity is expected to have completed. The Company is currently evaluating the impact of the provisions of ASU 2020-04 on its financial condition, results of operation, and cash flows.

ENERGY RECOVERY, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 2 — Revenue

	Three Months Ended March 31, 2020			Three Months Ended March 31, 2019		
	Water	Oil & Gas	Total	Water	Oil & Gas	Total
<i>(In thousands)</i>						
Primary geographical market						
Middle East and Africa	\$ 16,231	\$ —	\$ 16,231	\$ 8,698	\$ 104	\$ 8,802
Americas	1,201	2,543	3,744	4,023	3,723	7,746
Europe	794	—	794	1,113	—	1,113
Asia	775	—	775	2,134	—	2,134
Total revenue	<u>\$ 19,001</u>	<u>\$ 2,543</u>	<u>\$ 21,544</u>	<u>\$ 15,968</u>	<u>\$ 3,827</u>	<u>\$ 19,795</u>
Major product/service line						
PX Pressure Exchangers, pumps and turbo devices	\$ 19,001	\$ —	\$ 19,001	\$ 15,968	\$ 104	\$ 16,072
License and development	—	2,543	2,543	—	3,723	3,723
Total revenue	<u>\$ 19,001</u>	<u>\$ 2,543</u>	<u>\$ 21,544</u>	<u>\$ 15,968</u>	<u>\$ 3,827</u>	<u>\$ 19,795</u>

Contract Balances

The following table presents contract balances by category.

	March 31, 2020	December 31, 2019
	<i>(In thousands)</i>	
Accounts receivable, net	<u>\$ 13,841</u>	<u>\$ 12,979</u>
Contract assets:		
Contract assets, current (included in prepaid expenses and other current assets)	\$ 936	\$ 501
Contract assets, non-current (included in other assets, non-current)	—	191
Total contract assets	<u>\$ 936</u>	<u>\$ 692</u>
Current contract liabilities:		
Customer deposits	\$ 536	\$ 1,506
Deferred revenue:		
License and development	15,636	13,846
Product	78	78
Service	259	316
Total deferred revenue	<u>15,973</u>	<u>14,240</u>
Total current contract liability	<u>16,509</u>	<u>15,746</u>
Non-current contract liabilities, deferred revenue		
License and development	8,717	13,048
Product	88	72
Total non-current contract liability	<u>8,805</u>	<u>13,120</u>
Total contract liability	<u>\$ 25,314</u>	<u>\$ 28,866</u>

ENERGY RECOVERY, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

The Company records unbilled receivables as contract assets. The following table presents significant changes in contract assets during the period.

	March 31, 2020	December 31, 2019
	<i>(In thousands)</i>	
Contract assets balance, beginning of year	\$ 692	\$ 4,083
Transferred to trade receivables	(5,579)	(13,155)
Additions to contract assets	5,823	9,764
Contract assets balance, end of period	<u>\$ 936</u>	<u>\$ 692</u>

The Company records contract liabilities when cash payments are received in advance of the Company's performance. The following table presents significant changes in contract liabilities during the period.

	March 31, 2020	December 31, 2019
	<i>(In thousands)</i>	
Contract liabilities balance, beginning of year	\$ 28,866	\$ 42,809
Revenue recognized	(3,980)	(15,247)
Increase due to cash received, excluding amounts recognized as revenue during the period	428	1,304
Contract liabilities balance, end of period	<u>\$ 25,314</u>	<u>\$ 28,866</u>

Transaction Price Allocated to the Remaining Performance Obligation

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

	March 31, 2020
	<i>(In thousands)</i>
Year:	
2020 (remaining nine months)	\$ 26,185
2021	17,931
2022	661
2023	646
2024 and thereafter	4,385
Total performance obligation	<u>\$ 49,808</u>

Note 3 — Earnings per Share

Net income for the reported period is divided by the weighted average number of common shares outstanding during the reported period to calculate basic earnings per common share. Basic earnings per share exclude any dilutive effect of stock options and restricted stock units ("RSU").

Diluted earnings 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 (collectively referred to as "stock awards"). Certain shares of common stock issuable under stock options and RSUs have been omitted from the diluted earnings per share calculations because their inclusion is considered anti-dilutive.

ENERGY RECOVERY, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

The following table presents the computation of basic and diluted earnings per share.

	Three Months Ended March 31,	
	2020	2019
<i>(In thousands, except per share amounts)</i>		
Numerator:		
Net income	\$ 621	\$ 2,654
Denominator (weighted average shares):		
Basic common shares outstanding	55,412	54,116
Dilutive stock awards	1,130	1,252
Diluted common shares outstanding	56,542	55,368
Earnings per share:		
Basic	\$ 0.01	\$ 0.05
Diluted	\$ 0.01	\$ 0.05

The following table presents the potential common shares issuable under stock awards that were excluded from the computation of diluted earnings per share, as their effect would have been anti-dilutive.

	Three Months Ended March 31,	
	2020	2019
<i>(In thousands)</i>		
Anti-dilutive stock awards	2,495	2,461

Note 4 — Other Financial Information

Cash, Cash Equivalents and Restricted Cash

The Company's Condensed Consolidated Statement of Cash Flows explains the change in the total of cash, cash equivalents and restricted cash. The following table presents a reconciliation of cash, cash equivalents and restricted cash reported within the Condensed Consolidated Balance Sheets that sum to the total of such amounts presented.

	March 31, 2020	December 31, 2019
<i>(In thousands)</i>		
Cash and cash equivalents	\$ 32,842	\$ 26,387
Restricted cash, non-current (included in other assets, non-current)	101	101
Total cash, cash equivalents and restricted cash	\$ 32,943	\$ 26,488

The Company pledged cash in connection with certain stand-by letters of credit and Company credit cards. The Company deposited corresponding amounts into restricted accounts at several financial institutions.

Accounts Receivable, net

	March 31, 2020	December 31, 2019
<i>(In thousands)</i>		
Accounts receivable, gross	\$ 14,189	\$ 13,287
Allowance for doubtful accounts	(348)	(308)
Accounts receivable, net	\$ 13,841	\$ 12,979

ENERGY RECOVERY, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Inventories

	March 31, 2020	December 31, 2019
	<i>(In thousands)</i>	
Raw materials	\$ 4,947	\$ 3,742
Work in process	2,230	2,141
Finished goods	3,761	4,434
Inventories, net	<u>\$ 10,938</u>	<u>\$ 10,317</u>

Inventories are stated at the lower of cost or net realizable value (using the first-in, first-out method). Valuation adjustments for excess and obsolete inventory reflected as a reduction of inventory was \$0.4 million at March 31, 2020 and December 31, 2019. During the three months ended March 31, 2020, due to the COVID-19 pandemic, the Company expensed \$0.5 million to product cost of revenue related to the reduced utilization of its manufacturing facility due to the Company's decision to temporarily suspend its manufacturing activities in light of measures adopted by state and local authorities to contain the spread of COVID-19. Subsequent to the quarter ended March 31, 2020, the Company has commenced limited manufacturing at its two facilities in accordance with federal, state and local regulations and guidance.

Accrued Expenses and Other Current Liabilities

	March 31, 2020	December 31, 2019
	<i>(In thousands)</i>	
Payroll, incentives and commissions payable	\$ 3,538	\$ 6,040
Accrued warranty reserve	665	631
Other accrued expenses and current liabilities	1,953	3,198
Total accrued expenses and other current liabilities	<u>\$ 6,156</u>	<u>\$ 9,869</u>

Note 5 — Investments and Fair Value Measurements

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

	March 31, 2020	December 31, 2019
	<i>(In thousands)</i>	
Cash equivalents	\$ 20,638	\$ 11,668
Short-term investments	40,995	58,736
Long-term investments	19,361	15,419
Total cash equivalents and marketable securities	<u>\$ 80,994</u>	<u>\$ 85,823</u>

As of March 31, 2020 and December 31, 2019, there were no available-for-sale investments reported in cash equivalents.

Available-for-Sale Investments

The Company's short-term and long-term investments are all classified as available-for-sale. As of March 31, 2020 and December 31, 2019, all available-for-sale investments were either classified as short-term with maturities less than 12 months or long-term with maturities over 12 months.

ENERGY RECOVERY, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

The Company generally holds available-for-sale investments until maturity; however, from time-to-time, the Company may elect to sell certain available-for-sale investments prior to maturity. The following table presents the sales of available-for-sale investments.

	Three Months Ended March 31,	
	2020	2019
	<i>(In thousands)</i>	
Corporate notes and bonds	\$ 4,974	\$ —

The following tables present available-for-sale investments and their related gross unrealized holding gains and losses as of March 31, 2020 and December 31, 2019.

	March 31, 2020			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	<i>(In thousands)</i>			
Short-term investments				
U.S. treasury securities	\$ 3,558	\$ 33	\$ —	\$ 3,591
Corporate notes and bonds	37,540	5	(141)	37,404
Total short-term investments	41,098	38	(141)	40,995
Long-term investments				
U.S. treasury securities	809	13	—	822
Corporate notes and bonds	18,751	11	(223)	18,539
Total long-term investments	19,560	24	(223)	19,361
Total available-for-sale investments	\$ 60,658	\$ 62	\$ (364)	\$ 60,356
	December 31, 2019			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	<i>(In thousands)</i>			
Short-term investments				
U.S. treasury securities	\$ 2,746	\$ 1	\$ —	\$ 2,747
Corporate notes and bonds	55,951	49	(11)	55,989
Total short-term investments	58,697	50	(11)	58,736
Long-term investments				
Corporate notes and bonds	15,415	9	(5)	15,419
Total long-term investments	15,415	9	(5)	15,419
Total available-for-sale investments	\$ 74,112	\$ 59	\$ (16)	\$ 74,155

The Company monitors investments for impairment. It was determined that unrealized gains and losses at March 31, 2020 and December 31, 2019, are temporary in nature, because the changes in market value for these securities resulted from fluctuating interest rates, rather than a deterioration of the credit worthiness of the issuers. The Company is unlikely to experience gains or losses if these securities are held to maturity. In the event that the Company disposes of these securities before maturity, it is expected that the realized gains or losses, if any, will be immaterial.

ENERGY RECOVERY, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Expected maturities can differ from contractual maturities because borrowers may have the right to prepay obligations without prepayment penalties. The following table presents the amortized cost and the related fair value of short- and long-term available-for-sale securities with stated maturities shown by contractual maturity.

	March 31, 2020	
	Amortized Cost	Fair Value
	<i>(In thousands)</i>	
Due in one year or less	\$ 41,098	\$ 40,995
Due in greater than one year	19,560	19,361
Total	\$ 60,658	\$ 60,356

Fair Value of Financial Instruments

All of the Company's financial assets and liabilities are remeasured and reported at fair value at each reporting period; and 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.

The following tables present the fair value of financial assets measured on a recurring basis. As of March 31, 2020 and December 31, 2019, the Company had no financial liabilities.

	March 31, 2020			
	Total	Level 1	Level 2	Level 3
	<i>(In thousands)</i>			
Cash equivalents				
Money market securities	\$ 20,638	\$ 20,638	\$ —	\$ —
Total cash equivalents	20,638	20,638	—	—
Short-term investments				
U.S. treasury securities	3,591	—	3,591	—
Corporate notes and bonds	37,404	—	37,404	—
Total short-term investments	40,995	—	40,995	—
Long-term investments				
U.S. treasury securities	822	—	822	—
Corporate notes and bonds	18,539	—	18,539	—
Total long-term investments	19,361	—	19,361	—
Total fair value of financial assets	\$ 80,994	\$ 20,638	\$ 60,356	\$ —

ENERGY RECOVERY, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

	December 31, 2019			
	Total	Level 1	Level 2	Level 3
	<i>(In thousands)</i>			
Cash equivalents				
Money market securities	\$ 86	\$ 86	\$ —	\$ —
U.S. treasury securities	11,582	—	11,582	—
Total cash equivalents	11,668	86	11,582	—
Short-term investments				
U.S. treasury securities	2,747	—	2,747	—
Corporate notes and bonds	55,989	—	55,989	—
Total short-term investments	58,736	—	58,736	—
Long-term investments				
Corporate notes and bonds	15,419	—	15,419	—
Total long-term investments	15,419	—	15,419	—
Total fair value of financial assets	\$ 85,823	\$ 86	\$ 85,737	\$ —

During the three months ended March 31, 2020 and year ended December 31, 2019, the Company had no transfers of financial assets between any levels.

The following table presents a summary of the fair value and gross unrealized holding losses on the available-for-sale securities that have been in a continuous unrealized loss position, aggregated by type of investment instrument as of March 31, 2020 and December 31, 2019. The available-for-sale for investments that were in an unrealized gain position have been excluded from the table.

	March 31, 2020		December 31, 2019	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
	<i>(In thousands)</i>			
U.S. treasury securities	\$ —	\$ —	\$ 2,027	\$ —
Corporate notes and bonds	47,237	(364)	18,754	(16)
Total available-for-sale investments with unrealized loss positions	\$ 47,237	\$ (364)	\$ 20,781	\$ (16)

Note 6 — Goodwill and Intangible Assets

Goodwill

The net carrying amount of goodwill as of March 31, 2020 and December 31, 2019 was \$12.8 million. As of March 31, 2020, the Company's goodwill was not impaired.

ENERGY RECOVERY, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Other Intangible Assets

The following table presents identifiable intangible assets as of the date indicated, all of which are finite-lived. All intangible assets are amortized on a straight-line basis over their useful life.

	March 31, 2020	December 31, 2019
	<i>(In thousands)</i>	
Finite-lived intangible assets	\$ 286	\$ 6,386
Accumulated amortization	(225)	(6,321)
Intangible assets, net	\$ 61	\$ 65

The reduction in the balance, from December 31, 2019 to March 31, 2020, of the gross other intangible assets and related accumulated amortization was due to the retirement of fully amortized patent assets.

Note 7 — Lines of Credit**Loan and Pledge Agreement**

The Company entered into a loan and pledge agreement with a financial institution on January 27, 2017. Since inception, this loan and pledge agreement has been amended multiple times to accommodate the growth of the Company (the amended loan and pledge agreement is hereinafter referred to as the “Loan and Pledge Agreement”). The Loan and Pledge Agreement, as amended, which will expire on June 30, 2022, provides for a committed revolving credit line of \$16.0 million and an uncommitted revolving credit line of \$4.0 million. The covenants of the Loan and Pledge Agreement allow 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.

As of March 31, 2020 and December 31, 2019, there was no debt outstanding under the Loan and Pledge Agreement.

Stand-By Letters of Credit

Under the Loan and Pledge Agreement, the Company is allowed to issue stand-by letters of credit (“SBLCs”) up to one year past the expiration date of the Loan and Pledge Agreement and to hold SBLCs with other financial institutions up to \$5.1 million. SBLCs have a term limit of three years, are secured by pledged U.S. investments, and do not have any cash collateral balance requirements. SBLCs are deducted from the total revolving credit line under the Loan and Pledge Agreement, and are subject to a non-refundable quarterly fee that is in an amount equal to 0.7% per annum of the face amount of the outstanding SBLCs.

As of March 31, 2020 and December 31, 2019, there were \$11.6 million and \$11.8 million, respectively, of outstanding SBLCs.

Note 8 — Commitments and Contingencies**Operating Lease Obligations**

The Company leases office facilities and equipment under operating leases that expire on various dates through fiscal year 2030.

On January 10, 2019, the Company entered into an industrial lease agreement, which commenced on January 1, 2020. This new lease for a commercial development center for oil & gas field testing, manufacturing, and training, located in Katy, Texas (the “Katy Lease”), includes an office and warehouse space of approximately 25,200 square feet (“sqft.”) and land of approximately 4.5 acres. The Company’s annual base rent obligation, paid monthly, will be approximately \$0.3 million with an increase of approximately 3% annually thereafter, totaling \$3.6 million, over the term of the lease. The initial term of the Katy Lease is 120 months after the commencement date, and the Company has two options to extend the lease by an additional five-year term per option, which must be exercised by written notice at least six months prior to the end of the relevant term.

ENERGY RECOVERY, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

On February 10, 2020, the Company entered into a lease agreement, that commenced on March 1, 2020, for an additional office and warehouse space of approximately 54,429 sqft., located in Tracy, California (the "Tracy Lease"). The new lease will supplement the existing manufacturing, warehouse and distribution of the Company's energy recovery devices ("ERDs") and other products. The Company's annual base rent obligation, paid monthly, is approximately \$0.4 million, with an increase of approximately 3% annually thereafter, totaling \$5.0 million, over the term of the lease. The initial term of the Tracy Lease is 122 months after the commencement date, and the Company has one option to extend the lease by an additional five-year term, which must be exercised by written notice at least nine months prior to the end of the original lease term.

The following table presents operating lease activities related to all leased properties.

	Three Months Ended March 31,	
	2020	2019
	<i>(In thousands)</i>	
Operating lease expense	\$ 603	\$ 477
Cash payments	490	447
Non-cash lease liabilities arising from obtaining right-of-use assets	6,384	—

The following table presents other information related to outstanding operating leases as of March 31, 2020.

Weighted average remaining lease term	9.1 years
Weighted average discount rate	7.0%

The following table presents the minimum lease payments under noncancelable operating leases, exclusive of executory costs as of March 31, 2020.

	Lease Amounts	
	<i>(In thousands)</i>	
Year:		
2020 (remaining nine months)	\$	1,956
2021		2,468
2022		2,650
2023		2,580
2024		2,812
2025 and thereafter		13,198
Total		25,664
Less imputed lease interest		(6,932)
Total lease liabilities	\$	18,732

Warranty

The following table presents the changes in the Company's accrued product warranty reserve.

	Three Months Ended March 31,	
	2020	2019
	<i>(In thousands)</i>	
Warranty reserve balance, beginning of period	\$ 631	\$ 478
Warranty costs charged to cost of revenue	98	152
Utilization charges against reserve	(1)	(12)
Release of accrual related to expired warranties	(63)	(47)
Warranty reserve balance, end of period	\$ 665	\$ 571

ENERGY RECOVERY, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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 March 31, 2020. 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 purchase order arrangements are related to various raw materials and components parts, as well as for capital equipment. As of March 31, 2020, the Company had approximately \$11.3 million of such open cancellable purchase order arrangements.

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. As of March 31, 2020, there were no material losses which were probable or reasonably possible.

Note 9 — Income Taxes

For the three months ended March 31, 2020, the Company recognized an income tax benefit of \$0.1 million, which included a discrete tax benefit of \$0.2 million, due primarily to stock-based compensation windfalls. For the three months ended March 31, 2019, the Company recognized an income tax expense of \$0.6 million, which included a discrete tax benefit of \$0.1 million, due primarily to stock-based compensation windfalls.

The effective tax rate for the three months ended March 31, 2020 and 2019 was (15.9%) and 17.3%, respectively. Excluding the discrete tax income tax items, the effective tax rate of 19.5% for the three months ended March 31, 2020, compared to 21.3% for the three months ended March 31, 2019, was lower due primarily to higher anticipated R&D credits in 2020.

Note 10 — Business Segment

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 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.

ENERGY RECOVERY, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

The following table presents a summary of the Company's financial information by segment and corporate operating expenses.

	Three Months Ended March 31, 2020			Three Months Ended March 31, 2019		
	Water	Oil & Gas	Total	Water	Oil & Gas	Total
	<i>(In thousands)</i>					
Product revenue	\$ 19,001	\$ —	\$ 19,001	\$ 15,968	\$ 104	\$ 16,072
Product cost of revenue	5,684	—	5,684	4,747	188	4,935
Product gross profit (loss)	13,317	—	13,317	11,221	(84)	11,137
License and development revenue	—	2,543	2,543	—	3,723	3,723
Operating expenses						
General and administrative	405	741	1,146	535	364	899
Sales and marketing	1,676	58	1,734	1,649	263	1,912
Research and development	902	5,247	6,149	804	3,363	4,167
Amortization of intangibles	4	—	4	156	—	156
Total operating expenses	2,987	6,046	9,033	3,144	3,990	7,134
Operating income (loss)	\$ 10,330	\$ (3,503)	6,827	\$ 8,077	\$ (351)	7,726
Less: Corporate operating expenses			6,699			5,017
Income from operations			128			2,709
Other income, net			408			499
Income before income taxes			\$ 536			\$ 3,208

Note 11 — Concentrations**Product Revenue**

The following table presents customers accounting for 10% or more of the Company's product revenue by segment.

	Segment	Three Months Ended March 31,	
		2020	2019
Customer A	Water	25%	**
Customer B	Water	20%	29%
Customer C	Water	10%	**
Customer D	Water	**	14%
Customer E	Water	**	12%
Customer F	Water	**	10%

** Zero or less than 10%.

License and Development Revenue

One international Oil & Gas segment customer accounted for 100% of the Company's license and development revenue for each of the three months ended March 31, 2020 and 2019.

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

Forward Looking Information

This Quarterly Report on Form 10-Q for the three months ended March 31, 2020 and 2019, including select information for the year ended December 31, 2019 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 the cash on hand, marketable securities and ongoing cash generated from operations should be sufficient to cover the Company’s capital requirements for the next 12 months;
- our belief that our gross margins will continue to be negatively affected until we are able to operate our manufacturing facilities as originally planned prior to the novel coronavirus (“COVID-19”) global pandemic;
- our belief that we will be able to fulfill most, if not all, of our existing delivery obligations in fiscal year 2020.
- 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[®] 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[™] hydraulic fracturing system;
- our belief that the VorTeq hydraulic fracturing system 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[™] 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;

Table of Contents

- *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;*
- *the impact of changes in internal control over financial reporting;*
and
- *the development of major public health concerns, including the COVID-19 outbreak or other pandemics arising globally, and the future impact of it and COVID-19 on our business and operations.*

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, 2019, 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. 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

We have, for more than 20 years, created technologies that solve complex challenges for industrial fluid flow markets worldwide. We design and manufacture solutions that reduce waste, improve operational efficiency, and lower the production costs of clean water and oil & gas. What began as a game-changing invention for water desalination has grown into a global business delivering solutions that enable more affordable access to these critical resources.

We were incorporated in Virginia in 1992 and reincorporated in Delaware in 2001. Our headquarters and principal research, development and manufacturing facility is located in San Leandro, California, and, as of January 2020, we opened our commercial development center for oil & gas field testing, manufacturing, and training, located in Katy, Texas. On February 10, 2020, we leased an additional office and warehouse space located in Tracy, California that commenced on March 1, 2020, to supplement the existing manufacturing, warehouse and distribution of our energy recovery devices (“ERDs”). Our worldwide sales and technical service organization provides on-site support for our line of water solutions, and we maintain direct sales offices and technical support centers in Europe, the Middle East and Asia.

Engineering, research and development have been, and remain, an essential part of our history, culture and corporate strategy. Since our formation, we have developed and become experts in our unique PX Pressure Exchanger technology, which provides benefits when applied to industrial fluid flow system with pressure differentials. Today, we believe our PX Pressure Exchanger is the industry standard in the reverse osmosis desalination industry. In addition, we have been actively developing new applications of our pressure exchanger technology in the oil & gas industry. This focus on engineering, research and development will continue to be a core component of our future strategy as we focus on developing new products outside of our water and oil & gas business units.

Our reportable operating segments consist of the Water and Oil & Gas segments. These segments are based on the industries in which the technology solutions are sold, the type of ERD or other technology sold and the related solution and service. In addition, our Corporate operating expenses includes expenditures in support of Water and Oil & Gas segments, as well as research and development expenditures applicable to potential future industry verticals, or enabling technologies that could benefit either or both existing business units.

Water Segment

Our Water segment consists of revenues and expenses associated with solutions sold for use in reverse osmosis desalination applications. Our Water segment revenue is principally derived from the sale of ERDs and high-pressure and circulation pumps to our mega-project development (“MPD”), original equipment manufacturers (“OEM”) and aftermarket (“AM”) channels. MPD sales are typically made to global EPC firms to build very large desalination plants worldwide. Our typical MPD sale consists of our PX Pressure Exchangers, and each MPD sale represents revenue opportunities generally ranging from \$1 million to \$18 million. Our packaged solutions to OEMs include our PX Pressure Exchangers, 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 significantly into research and development, sales, and marketing to expand our business into pressurized fluid flow industries within the oil & gas industry.

Quarterly Highlights

COVID-19 Pandemic

In March 2020, the World Health Organization declared the outbreak of novel coronavirus (“COVID-19”), a pandemic which has resulted in authorities across the globe implementing numerous measures to contain the virus, including travel bans and restrictions, quarantines, shelter-in-place orders, and business limitations and shutdowns. In response to measures taken by state and local governments in mid-March, we elected to temporarily suspend our manufacturing activities at our San Leandro headquarters to assess the impact of these orders and to implement health and safety actions recommended by government and health officials to better protect our employees who are required to be present at one of our facilities. In addition, the majority of our employees have been working remotely since that time. In early April, we commenced limited manufacturing at our two facilities in accordance with federal, state and local regulations and guidance.

While we are unable to accurately predict the full impact that COVID-19 will have on our long-term financial condition, result of operations, liquidity and cash flows due to uncertainties, our compliance with these measures did not have a material adverse impact on our financial results for the first quarter of fiscal year 2020. We have, however, begun to take precautionary measures to manage our resources conservatively by reducing and/or deferring capital and operating expenses to mitigate any potential adverse impacts of the pandemic as well as to conserve cash. Based on current projections, which are subject to numerous uncertainties, including the duration and severity of the pandemic and containment measures and the effect of these on the industries in which we compete, we believe our cash on hand and marketable securities, as well as our ongoing cash generated from operations, should be sufficient to cover our capital requirements for the next 12 months from the issuance of this quarterly report. In addition, as a result of our reduced manufacturing levels, our gross margin for the first quarter was negatively affected, and will likely continue to be impacted until such time that we are able to operate our manufacturing facilities as originally planned prior to the COVID-19 pandemic. Notwithstanding the reduction in our manufacturing levels, based on our current rate of production, we believe that we will be able to fulfill most, if not all, of our existing delivery obligations in fiscal year 2020.

While we anticipate that the foregoing measures are temporary, we cannot predict the specific duration for which these precautionary measures will stay in effect, and our business may be adversely impacted as a result of the pandemic’s global economic impact. In the future, the pandemic may cause reduced demand for our products if it results in a recessionary global economic environment. It could also lead to volatility in access to our products due to government actions impacting our ability to produce and ship products or impacting the construction of large water desalination projects. For a discussion of the key trends and uncertainties that have affected our revenues, income and liquidity, see Part II, Item 1A, “Risk Factors,” of this Form 10-Q and Part I, Item 1A, “Risk Factors,” in our Annual Report on Form 10-K for the year ended December 31, 2019 filed with the U.S. Securities and Exchange Commission on March 6, 2020 (the “2019 Annual Report”).

Water Segment

- We have opened our new office and warehouse space in Tracy, California. The new facility will supplement the existing manufacturing, warehouse and distribution of our PX Pressure Exchangers, turbochargers and pumps. Commissioning of this new plant is expected to occur during the summer of 2020, although COVID-19 related disruptions may cause delays.

Results of Operations

A discussion regarding our financial condition and results of operations for the three months ended March 31, 2020 compared to the three months ended March 31, 2019 is presented below.

Total Revenue

Total revenue consists of both product revenue and license and development revenue. See Note 2, "Revenue" and Note 11, "Concentrations" for further discussion of disaggregated revenue by primary geographical region and product type, and customer revenue concentration, respectively, of the Notes to Condensed Consolidated Financial Statements in Part I, Item 1, "Financial Statements (unaudited)," of this Quarterly Report on Form 10-Q.

	Three Months Ended March 31,						Change	
	2020		2019					
	\$	% of Total Revenue	\$	% of Total Revenue	\$	%		
<i>(In thousands, except percentages)</i>								
Water	\$ 19,001	88%	\$ 15,968	81%	\$ 3,033	19%		
Oil & Gas	—	—%	104	—%	(104)	(100%)		
Product revenue	19,001	88%	16,072	81%	2,929	18%		
License and development revenue	2,543	12%	3,723	19%	(1,180)	(32%)		
Total revenue	\$ 21,544	100%	\$ 19,795	100%	\$ 1,749	9%		

Water Segment

During the three months ended March 31, 2020, compared to the three months ended March 31, 2019, Water segment product revenue increased by \$3.0 million, or 19%, due primarily to an increase of shipments to MPD customers, partially offset by lower shipments to AM and OEM customers. Significant variability from quarter to quarter is typical, and year on year quarterly comparisons are not necessarily indicative of the trend for the full year due to these variations.

In response to measures taken by state and local authorities in mid-March, 2020, we elected to suspend our manufacturing activities to assess the impact of these measures and to implement health and safety procedures at our facilities to better protect our employees. These measures did not have a material effect on our revenues in the first quarter.

Oil & Gas Segment

During the three months ended March 31, 2020, compared to the three months ended March 31, 2019, Oil & Gas segment product revenue decreased by \$0.1 million as there were no product sales in the first quarter of 2020. Our Oil & Gas segment revenue, which is primarily comprised of license and development revenue that is calculated as a percentage of cost to total cost, decreased by \$1.2 million, or (32%), in the three months ended March 31, 2020, compared to the three months ended March 31, 2019. Oil & Gas revenue in the first quarter consisted only of license and development revenue, which is calculated as a percentage of cost to total cost. There was a decrease in expenditures in the first quarter due to the reallocation of resources to VorTeq related activities unrelated to the recognition of this license and development revenue, which subsequently reduced revenue recognition for the quarter.

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 March 31,					
	2020		2019		Change	
	Gross Profit (Deficit)	Gross Margin	Gross Profit (Deficit)	Gross Margin	Gross Profit (Deficit)	Gross Margin
	<i>(In thousands, except percentages)</i>					
Water	\$ 13,317	70.1%	\$ 11,221	70.3%	\$ 2,096	(0.2%)
Oil & Gas	—	—%	(84)	(80.8%)	84	—%
Product gross profit and gross margin	\$ 13,317	70.1%	\$ 11,137	69.3%	\$ 2,180	0.8%

During the three months ended March 31, 2020, compared to the three months ended March 31, 2019, product gross profit increased \$2.2 million, or 19.6%, due primarily to higher volume of products sold.

Product gross margin increased by 80 basis points to 70.1% in the three months ended March 31, 2020, compared to 69.3% in the three months ended March 31, 2019, despite an increase of \$0.5 million, or 3%, in cost of product revenue related to the reduced utilization of our manufacturing facility in the last two weeks of the quarter due to our decision to temporarily suspend our manufacturing activities in light of measures adopted by state and local authorities to contain the spread of COVID-19, product gross margin increased largely driven by favorable product mix.

Operating Expenses

Total Operating Expenses

	Three Months Ended March 31,					
	2020		2019		Change	
	\$	% of Total Revenue	\$	% of Total Revenue	\$	%
	<i>(In thousands, except percentages)</i>					
General and administrative	\$ 6,881	32%	\$ 5,579	28%	\$ 1,302	23%
Sales and marketing	2,138	10%	2,162	11%	(24)	(1%)
Research and development	6,709	31%	4,254	22%	2,455	58%
Amortization of intangible assets	4	—%	156	1%	(152)	(97%)
Total operating expenses	\$ 15,732	73%	\$ 12,151	61%	\$ 3,581	30%

General and administrative (“G&A”) expenses of \$6.9 million for the three months ended March 31, 2020, compared to \$5.6 million for the three months ended March 31, 2019, increased \$1.3 million, or 23%, due primarily to an increase in employee-related costs of \$0.6 million, other costs of \$0.4 million and higher professional services of \$0.3 million. The increase in employee-related costs was due primarily to recruitment costs related to our Chief Executive Officer search, severance costs, and an increase in salaries and benefits due primarily to higher headcount, partially offset by lower share-based compensation expense.

Sales and marketing (“S&M”) expenses of \$2.1 million for the three months ended March 31, 2020, compared to \$2.2 million for the three months ended March 31, 2019, decreased 1%, due primarily to a decrease in outside commissions of \$0.2 million and marketing costs of \$0.1 million, partially offset by an increase in employee-related costs of \$0.3 million.

Table of Contents

Research and development (“R&D”) expenses of \$6.7 million for the three months ended March 31, 2020, compared to \$4.3 million for the three months ended March 31, 2019, increased \$2.5 million, or 58%, due primarily to higher testing supplies expenditures of \$1.5 million, an increase in employee-related costs of \$0.6 million, an increase in other costs of \$0.3 million, and higher depreciation expense of certain test equipment of \$0.1 million. The increase in employee-related costs was due primarily to higher headcount.

Amortization expense in the three months ended March 31, 2020, compared to the three months ended March 31, 2019, was lower due primarily to certain finite-life intangible assets that were fully expensed in the prior year.

COVID-19 did not have a material effect on operating expenditures during the three months ended March 31, 2020.

Segment and Corporate Operating Expenses

	Three Months Ended March 31, 2020				Three Months Ended March 31, 2019			
	Water	Oil & Gas	Corporate	Total	Water	Oil & Gas	Corporate	Total
<i>(In thousands)</i>								
Operating expenses								
General and administrative	\$ 405	\$ 741	\$ 5,735	\$ 6,881	\$ 535	\$ 364	\$ 4,680	\$ 5,579
Sales and marketing	1,676	58	404	2,138	1,649	263	250	2,162
Research and development	902	5,247	560	6,709	804	3,363	87	4,254
Amortization of intangibles	4	—	—	4	156	—	—	156
Total operating expenses	<u>\$ 2,987</u>	<u>\$ 6,046</u>	<u>\$ 6,699</u>	<u>15,732</u>	<u>\$ 3,144</u>	<u>\$ 3,990</u>	<u>\$ 5,017</u>	<u>\$ 12,151</u>

Water segment operating expenses were \$3.0 million for the three months ended March 31, 2020, compared to \$3.1 million for the three months ended March 31, 2019, a decrease of \$0.2 million, or (5%), due primarily to lower commission costs, partially offset by higher employee-related costs and R&D costs to support further development of our PX Pressure Exchanger, turbocharger and pump. The increase in employee-related costs was due primarily to higher salaries and employee-related benefits related to an increase in headcount in both G&A and R&D, partially offset by lower share-based compensation.

Oil & Gas segment operating expenses were \$6.0 million for the three months ended March 31, 2020, compared to \$4.0 million for the three months ended March 31, 2019, an increase of \$2.1 million, or 52%, due primarily to higher R&D costs related to testing supply expenditures, and increased segment employee-related costs and equipment depreciation. The increase in segment employee-related cost was due primarily to severance costs and higher salaries and employee-related benefits related to an increase in R&D headcount, partially offset by lower share-based compensation.

Corporate operating expenses were \$6.7 million for the three months ended March 31, 2020, compared to \$5.0 million for the three months ended March 31, 2019, an increase of \$1.7 million, or 34%, due primarily to higher employee-related costs, facility and office costs, and professional service costs. The increase in employee-related costs was due primarily to recruiting costs related to our Chief Executive Officer search, and salaries and employee-related benefits due primarily to an increase in G&A headcount.

Other Income, Net

	Three Months Ended March 31,			
	2020		2019	
	\$	% of Total Revenue	\$	% of Total Revenue
<i>(In thousands, except percentages)</i>				
Other income:				
Interest income	\$ 420	2%	\$ 523	3%
Other non-operating expense, net	(12)	—%	(24)	—%
Total other income, net	\$ 408	2%	\$ 499	3%

Total other income, net, decreased \$0.1 million during the three months ended March 31, 2020, compared to the three months ended March 31, 2019, due primarily to a decrease in interest income.

Income Taxes

For the three months ended March 31, 2020, we recognized an income tax benefit of \$0.1 million, which included a discrete tax benefit of \$0.2 million, due primarily to stock-based compensation windfalls. For the three months ended March 31, 2019, we recognized an income tax expense of \$0.6 million, which included a discrete tax benefit of \$0.1 million, due primarily to stock-based compensation windfalls.

The effective tax rate for the three months ended March 31, 2020 and 2019 was (15.9%) and 17.3%, respectively. Excluding the discrete tax income tax items, the effective tax rate of 19.5% for the three months ended March 31, 2020, compared to 21.3% for the three months ended March 31, 2019, was lower due primarily to higher anticipated R&D credits in 2020.

On March 18, 2020, the U.S. government enacted the “Families First Coronavirus Response Act” (“FFCRA”). The FFCRA provides, among other things, a refundable payroll tax credit for emergency sick and family and medical leave required to be paid to employees under the FFCRA. On March 27, 2020, the U.S. government also enacted the “Coronavirus Aid, Relief and Economic Security Act” (“CARES Act”). The CARES Act, among other things, includes provisions relating to net operating losses, acceleration of alternative minimum tax credit refunds, modifications to the net interest deduction limitations and technical corrections to tax depreciation methods for qualified improvement property. As a result of the alternative minimum tax credit refund acceleration provision, we expect to receive an additional \$0.1 million of tax refund of minimum tax credits carried over from fiscal year 2018. Additionally, the CARES Act provides a refundable payroll tax credit against the employer’s share of social security tax (the “Employee Retention Credit”), and permits employers to defer, until fiscal years 2021 and 2022, payment of their remaining payroll tax liability (“Payroll Tax Deferral”). To date, we have applied for both the Employee Retention Credit and the Payroll Tax Deferral, which will delay federal social security taxes payments. These federal social security taxes payments will in turn be paid out in equal installments in fiscal years 2021 and 2022.

Liquidity and Capital Resources

Overview

As of March 31, 2020, our principal sources of liquidity consisted of: (i) unrestricted cash and cash equivalents of \$32.8 million, (ii) short-term investments of \$41.0 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 \$13.8 million. As of March 31, 2020, our unrestricted cash, cash equivalents, and short- and long-term investments held outside the U.S. were \$3.6 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. Although these securities are available for sale, we generally hold these securities to maturity, and therefore do not currently see a need to trade these securities in order to support our liquidity needs in the foreseeable future. Therefore, the risk of this portfolio to us is in the ability of the underlying companies to cover their obligations at maturity, not in our ability to trade these securities at a profit. Based on current projections, we believe existing cash balances and future cash inflows from this portfolio will meet the liquidity needs for the company for at least the next 12 months.

As of March 31, 2020 and December 31, 2019, we had \$0.9 million and \$0.5 million, respectively, of short-term contract assets which represents unbilled trade receivables. In the Water segment, we had contract assets of \$0.9 million pertaining to customer contractual holdback provisions, pursuant to which we will invoice the final retention payment due under certain sales contracts in the next 12 months from March 31, 2020. 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. The retention payments with no performance conditions are recorded as unbilled trade receivables. In the Oil & Gas segment, there were no unbilled project costs at March 31, 2020.

Loan and Pledge Agreement

We entered into a loan and pledge agreement with a financial institution on January 27, 2017. Since inception, this loan and pledge agreement has been amended multiple times to accommodate our growth (the amended loan and pledge agreement is hereinafter referred to as the “Loan and Pledge Agreement”). The Loan and Pledge Agreement, which will expire on June 30, 2022, provides for a committed revolving credit line of \$16.0 million and an uncommitted revolving credit line of \$4.0 million. The covenants of the Loan and Pledge Agreement allows us 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. We are in compliance with all covenants related to this Loan and Pledge Agreement.

Stand-By Letters of Credit

Under the Loan and Pledge Agreement, we are allowed to issue stand-by letters of credit (“SBLCs”) up to one year past the expiration date of the Loan and Pledge Agreement and to hold SBLCs with other financial institutions up to \$5.1 million. SBLCs have a term limit of three years, are secured by pledged U.S. investments, and do not have any cash collateral balance requirement. SBLCs are deducted from the total revolving credit line under the Loan and Pledge Agreement and are subject to a non-refundable quarterly fee that is in an amount equal to 0.7% per annum of the face amount of the outstanding SBLCs. As of March 31, 2020, outstanding SBLC totaled \$11.6 million.

CARES Act

With regards to the CARES Act, we were not able to avail ourselves of the loans made available, including both the Payroll Protection Program and the Economic Injury Disaster Loan Program. This is due to the fact that we have neither experienced a loss of revenue compared to prior quarters due to COVID-19, nor have we experienced hardship as basis for these loans. We continue to monitor the programs the Federal government and State of California are putting in place and will participate in those programs for which we are eligible.

Cash Flows

	Three Months Ended March 31,	
	2020	2019
	<i>(In thousands)</i>	
Net cash used in operating activities	\$ (5,872)	\$ (5,951)
Net cash provided by (used in) investing activities	11,934	(1,165)
Net cash provided by financing activities	418	2,157
Effect of exchange rate differences on cash and cash equivalents	(25)	(4)
Net change in cash, cash equivalents and restricted cash	<u>\$ 6,455</u>	<u>\$ (4,963)</u>

Due to the project driven, non-cyclical nature of our business, operating cash flow can fluctuate significantly from quarter to quarter, and year to year, due to the timing of receipts of large project orders. Operating cash flow may be negative in one quarter or year 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 and annual comparisons of cash flow.

Cash Flows from Operating Activities

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

Cash used in operating activities in 2020 was on par to cash used in operating activities in 2019. Comparing 2020 to 2019, cash used for assets and liabilities was \$2.2 million lower and cash provided by net income adjusted for non-cash items was \$2.1 million lower.

Net change of cash used for assets and liabilities of \$9.6 million in 2020 was due primarily to a \$4.5 million decrease in accrued expenses and other liabilities due primarily to lower accrued payroll, incentive and commission payable, a \$3.6 million decrease in contract liabilities due to the recognition of revenue during the period, a \$1.1 million net increase in accounts receivable and contract assets due to the timing of invoices and payments, a \$0.7 million increase in inventory due to higher production, and a \$0.4 million increase in prepaid and other assets, partially offset by a \$0.7 million increase in accounts payable due to timing of invoices and payments.

We have seen no material effect to our operating cash flows due to COVID-19 during the three months ended March 31, 2020. Our greatest risks to our operating cash flows in this crisis are the strength of our existing and projected backlog, as well as customer receivables in a time when many companies are experiencing stress to their operating cash flows.

Cash Flows from Investing Activities

Net cash provided by (used in) investing activities primarily relates to maturities and purchases of marketable securities, and capital expenditures supporting our growth. Our investments in marketable securities are structured to preserve principal and liquidity while at the same time maximizing yields without significantly increasing risk.

Cash provided by investing activities in 2020 of \$11.9 million was due primarily to \$21.2 million and \$5.0 million in maturities and sales, respectively, of marketable security investments, partially offset by \$12.9 million used to purchase investments and \$1.4 million for capital expenditures.

Cash Flows from Financing Activities

Net cash provided by financing activities primarily relates to the issuance of equity typically from stock-based compensation.

Net cash provided by financing activities in 2020 of \$0.4 million was due primarily to the issuance of common stock related to option exercises, net of taxes paid on vested restricted stock units.

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.

Contractual Obligations

We lease facilities and equipment under fixed noncancelable operating leases that expire on various dates through fiscal year 2030. The following table presents a summary of our contractual obligations as of March 31, 2020.

	Total	Payments Due by Period			
		1 Year (remaining nine months of 2020)	2-3 Years (2021-2022)	3-4 Years (2023-2024)	5 Years + (2025 and thereafter)
		<i>(In thousands)</i>			
Operating lease obligations	\$ 25,664	\$ 1,956	\$ 5,118	\$ 5,392	\$ 13,198
Purchase obligations ⁽¹⁾	11,343	11,283	60	—	—
Total contractual obligations	\$ 37,007	\$ 13,239	\$ 5,178	\$ 5,392	\$ 13,198

⁽¹⁾ Purchase obligations are related to open purchase orders for materials and supplies.

This table excludes agreements with guarantees or indemnity provisions that we have entered into with customers and others in the ordinary course of business. Based on our historical experience and information known to us as of March 31, 2020, we believe, as of March 31, 2020, that our exposure related to these guarantees and indemnities was not material.

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

Refer to Note 1, “Description of Business and Significant Accounting Policies – Recent Accounting Pronouncements,” of the Notes to Condensed Consolidated Financial Statements in Part I, Item 1, “Financial Statements (unaudited),” of this Quarterly Report on Form 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, European 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 and Credit Risks

We have an investment portfolio of fixed-income marketable debt securities including amounts classified as cash equivalents, and short- and long-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 of directors. The policy mandates high credit rating requirements and restricts our exposure to any single corporate issuer by imposing concentration limits.

As of March 31, 2020, our total debt security investments which totaled approximately \$60.4 million, are presented in short- and long-term investments on our Condensed Consolidated Balance Sheets. 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. As of March 31, 2020, a hypothetical 1% increase in interest rates would have resulted in an approximately \$0.4 million decrease in the fair value of our fixed-income debt securities.

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 March 31, 2020, 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 8, “Commitments and Contingencies – Litigation,” of the Notes to Consolidated Financial Statements in Part II, Item 8, “Financial Statements and Supplementary Data,” of the 2019 Annual Report, provides information on certain litigation in which we are involved.

For an update on the litigation matters previously disclosed in the 2019 Annual Report, 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

Other than the risk factor(s) provided below, there have been no material changes in our risk factors from those disclosed in Part I, Item 1A, “Risk Factors,” in the 2019 Annual Report.

We have global operations and face risks related to health epidemics, including the novel coronavirus (“COVID-19”) global pandemic, that could materially impact our results of operations.

Our business could be materially adversely affected by the effects of a widespread outbreak of contagious disease, including the recent COVID-19. Any outbreak of contagious diseases and other adverse public health developments could have a material and adverse effect on our business operations. These could include disruptions or restrictions on our ability to travel or to distribute our products, as well as temporary closures of our facilities or the facilities of our suppliers or customers. Any disruption of our suppliers or customers would likely impact our sales and operating results. In addition, a significant outbreak of contagious diseases in the human population could result in a widespread health crisis that could adversely affect the economies and financial markets of many countries, resulting in an economic downturn that could impact our operating results.

Our business may suffer from the severity or longevity of the COVID-19 global pandemic.

COVID-19 is currently impacting countries, communities and markets around the world. While to date, COVID-19 has not had a material impact on us, we cannot, at this time, predict whether COVID-19 will have a long term material adverse impact on our financial condition and result of operations. If significant portions of our workforce are unable to work effectively due to illness, quarantines, government actions or orders, facility closures or other reasons in connection with the COVID-19 pandemic, our operations will likely be impacted. We may be unable to manufacture sufficient products to perform fully on our contracts and some of our costs may not be fully recoverable or adequately covered by insurance. The severity and longevity of the COVID-19 pandemic may also cause customers to suspend their decisions on using our products and/or services, and give rise to significant changes in regional and global economic conditions that could interfere with the planning and construction of large desalination plants, which we rely on. In addition, these changes may disrupt our supply chain. Any significant disruption to travel, including travel restrictions and other potential protective quarantine measures against COVID-19 by governmental agencies, may increase the difficulty and could make it impossible to deliver goods and/or provide services to our customers. While we have contingency plans to carry on essential operations, these may not be able to mitigate all of the potential impacts. The extent to which COVID-19 impacts our business, sales and results of operations will depend on future developments, which are highly uncertain and cannot be predicted.

Table of Contents

A sustained downturn in the energy industry, due to decreased global demand and lower oil and natural gas prices, could impact future desalination plants and the retrofit of existing plants, which could result in decreased demand for our water products and services.

The demand for our water products and services depends primarily on the continued construction of new large scale desalination plants and the retrofit of existing plants. Many of these plants are planned in the countries that make up the Gulf Cooperation Council (“GCC”). The recent decline in global demand for oil and natural gas caused by the spread of COVID-19, coupled with the over-supply of oil and natural gas caused by actions taken by Saudi Arabia and Russia may have a negative economic impact on these countries. This may impact the availability of project financing for these projects, impact their ability to secure credit, result in the postponement or cancellation of these projects, change government priorities or otherwise reduce spending for desalination projects, each of which could result in decreased demand for our water products and services. A significant portion of our revenues are derived from projects located in the GCC and any impact on future desalination projects in the GCC could have an adverse effect on our entire business, financial condition or results of operations.

Item 2 — Unregistered Sales of Equity Securities and Use of Proceeds

None.

Item 3 — Defaults Upon Senior Securities

None.

Item 4 — Mine Safety Disclosures

Not applicable.

Item 5 — Other Information

None.

Table of Contents

Item 6 — Exhibits

A list of exhibits filed or furnished with this report, or incorporated herein by reference is found in the Exhibit Index below.

Exhibit Number	Exhibit Description	Incorporated by Reference				Filed Herewith
		Form	File No.	Exhibit	Filing Date	
10.1	Lease Agreement, dated as of February 10, 2020, by and between Energy Recovery, Inc. and Prologis, L.P.					X
10.2	Settlement Agreement and Release, dated as of March 24, 2020, by and between Energy Recovery, Inc., and Eric Siebert.	8-K	001-34112	10.1	3/25/2020	
31.1	Certification of Principal Executive Officer, pursuant to Exchange Act Rule 13a-14(a) or 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.					X
31.2	Certification of Principal Financial Officer, pursuant to Exchange Act Rule 13a-14(a) or 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.					X
32.1*	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.					
101	Inline XBRL Document Set for the consolidated financial statements and accompanying notes in Part I, “Financial Information” of this Quarterly Report on Form 10-Q.					
104	Inline XBRL for the cover page of this Quarterly Report on Form 10-Q, included in the Exhibit 101 Inline XBRL Document Set.					

* 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: May 1, 2020

By: /s/ ROBERT YU LANG MAO
Robert Yu Lang Mao
Interim President and Chief Executive Officer
(Principal Executive Officer)

Date: May 1, 2020

By: /s/ JOSHUA BALLARD
Joshua Ballard
Chief Financial Officer
(Principal Financial and Accounting Officer)

PROLOGIS CLEAR LEASE

Simplify your lease. Simplify your business.

THIS LEASE AGREEMENT is made between Landlord and Tenant as of the Effective Date below.

1. **General Defined Terms.**

- a) **Effective Date:** February 10th 2020
- b) **Landlord:** Prologis, L.P.
- c) **Landlord Notice Address:**

Prologis	With copy to: Prologis
815 International Parkway	1800 Wazee Street
Tracy, CA 95377	Suite 500
Attn: Market Officer	Denver, Colorado 80202
	Attn: General Counsel
- d) **Tenant:** Energy Recovery Inc.
- e) **Tenant Notice Address:**

1717 Doolittle Drive	With copy to: 2000 N Chabot Court
San Leandro, CA 94577	Tracy, CA 95376
	Attn: General Counsel

Landlord shall also endeavor to e-mail a copy of any notice to Tenant at: weung@energyrecovery.com.

- f) **Premises:** That portion of the Building containing approximately 54,429 rentable square feet as shown on Exhibit A; Tenant shall additionally have the exclusive use of loading docks which exclusively serve the Premises and shared use of the parking areas in accordance with the terms of this Lease.
- g) **Building:** Tracy 7
2000 N. Chabot Court
Tracy, CA 95376
- h) **Project:** Prologis Park Tracy
- i) **Tenant's Proportionate Share:** 19.05%
- j) **Lease Term:** Beginning on the Commencement Date and ending on the day which is 122 full calendar months following the Commencement Date (the "Expiration Date").
- k) **Commencement Date:** 03/01/2020

l) **Monthly Base Rent:**

	<u>Period</u>		<u>Monthly Base Rent</u>
	03/01/2020 through 04/30/2020		*USD\$35,923.14
	05/01/2020 through 02/28/2021		USD\$35,923.14
	03/01/2021 through 02/28/2022		USD\$37,000.83
	03/01/2022 through 02/28/2023		USD\$38,110.86
	03/01/2023 through 02/29/2024		USD\$39,254.19
	03/01/2024 through 02/28/2025		USD\$40,431.81
	03/01/2025 through 02/28/2026		USD\$41,644.76
	03/01/2026 through 02/28/2027		USD\$42,894.11
	03/01/2027 through 02/29/2028		USD\$44,180.93
	03/01/2028 through 02/28/2029		USD\$45,506.36
	03/01/2029 through 02/28/2030		USD\$46,871.55
	03/01/2030 through 04/30/2030		USD\$48,277.70

*Monthly Base Rent is abated during this period. Monthly FOE and Taxes will be due as provided in the Lease during this period.

- m) **Monthly Fixed Operating Expenses ("Monthly FOE"):**

	Operating Expenses: USD\$3,476.46
	Capital Repairs/Replacements: USD\$584.29
	Total Monthly FOE: USD\$4,060.75
- n) **Annual FOE Increase:** 2.40%
- o) **Initial Estimated Monthly Taxes:** USD\$2,449.31
- p) **Security Deposit:** \$225,000.00

q) Landlord Broker:

Jim Martin of Lee & Associates Central Valley, Inc.

PLD Property ID: [eba03301]
[CA]

- 1 -



r) **Tenant Broker:** Charlie Allen of Avison Young

s) **Exhibits:**

- Exhibit A - Site Plan
- Exhibit B - Project Rules and Regulations
- Exhibit C - Commencement Date Certificate
- Exhibit D - Move-out Conditions
- Exhibit E - One Renewal Option at Market
- Exhibit F - Construction
- Exhibit G - Storage and Use of Permitted Hazardous Materials
- Exhibit H - Preliminary Plans for Kiln
- Exhibit I - Site Plan for initial Tenant-Made Alterations

2. **Granting Clause.** In consideration of the obligation of Tenant to pay rent and of the other terms, covenants, and conditions as herein provided, Landlord leases to Tenant, and Tenant takes from Landlord, the Premises, for the Lease Term, subject to the terms, covenants and conditions of this Lease.

3. **Acceptance of Premises.** Landlord and Tenant shall conduct an initial walkthrough of the Premises which shall include using the checklist provided in Exhibit D as a guideline for any damages that exist as of the Commencement Date that neither party shall be responsible for repairing throughout the Lease Term or upon surrender of the Premises. Subject to Landlord's Substantial Completion of the Initial Improvements pursuant to Exhibit F, Tenant accepts the Premises in its condition as of the Commencement Date, subject to all applicable laws, ordinances, regulations, covenants and restrictions. Landlord represents and warrants, to its knowledge, that as of the Commencement Date the Premises' HVAC, electrical, plumbing and other mechanical systems are in good working order and Landlord warrants such systems for a period of six (6) months from the Commencement Date; provided, however, that such warranty shall not be effective for any maintenance, repairs or replacements necessitated due to the misuse of, or damages caused by, Tenant, its employees, contractors, agents, subtenants, or invitees. Except as expressly set forth in this Lease (including, without limitation, Landlord's representation set forth in Paragraph 4 regarding compliance with Legal Requirements and in Paragraph 30 regarding compliance with Environmental Requirements), Landlord has made no representation or warranty as to the suitability of the Premises for the conduct of Tenant's business, and Tenant waives any implied warranty that the Premises are suitable for Tenant's intended purposes. Except as expressly set forth herein, in no event shall Landlord have any obligation for any defects in the Premises and in no event shall Landlord have any obligation for any limitation on Tenant's use.

No later than 10 days after the Commencement Date, Tenant shall execute and deliver to Landlord a Commencement Date Certificate in the form of Exhibit C. Any occupation of the Premises by Tenant prior to the Commencement Date shall be subject to all obligations of Tenant under this Lease except for the payment of Base Rent, Monthly FOE, and Taxes. Landlord represents and warrants that the Premises are now vacant. With prior notice and coordination with Landlord, at any time after February 1, 2020 Tenant's architect, engineer and general contractor shall have reasonable temporary access to the Premises prior to the Commencement Date in order to do visual inspections, measurements, design work and construction plans to enable Tenant to apply for permits, incentives, draft construction drawings and begin construction on or before the Commencement Date. In the event that Landlord is unable to deliver exclusive possession of the Premises to Tenant on or before June 1, 2020, then Tenant may terminate the Lease by written notice to Landlord delivered at any time prior to Landlord delivering such possession.

4. **Use.** The Premises shall be used only for the purpose of receiving, manufacturing, storing, assembling, testing, servicing, shipping and selling (but specifically excluding retail selling) products and components, and for such other lawful purposes incidental thereto; provided that all Class 1, 2, and 3 liquids (as such class of flammability is designated in Exhibit G) shall be stored in a Flammable Liquids cabinet. Without limiting the generality of the foregoing, the use may include installation of a series of CNC machines, a dust collector, a natural gas fueled kiln as well as a pressurized water testing loop. Tenant shall not conduct any auction, liquidation, or similar activities at the Premises, and will use the Premises, Building, and Project in a safe manner and will not commit waste, overload the floor or structure of the Premises, or subject the Premises to use that would damage the Premises. Landlord understands that Tenant expects to construct and operate a natural gas fueled kiln in the Premises, and will do so only with proper permits and in accordance with all Legal Requirements and this Lease. At no cost, expense, or liability to Landlord, Landlord shall reasonably cooperate with Tenant's efforts to secure those permits. Tenant shall not permit any outside storage, nuisance or objectionable odors, or vibrations to emanate from the Premises; without limitation, in the event of nuisance or vibration that emanates from the Premises (whether from Tenant's kiln or otherwise), at Tenant's sole cost, Tenant shall move such equipment to another area of the Premises and perform any other necessary measures to prevent such nuisance or vibration from emanating from the Premises. Tenant shall use the Premises in compliance with all federal, state, local, and municipal laws, orders, judgments, ordinances, regulations, codes, permits, licenses, covenants and restrictions now or hereafter applicable to the Premises (collectively, "Legal Requirements"). The Premises shall

not be used as a place of public accommodation under the Americans With Disabilities Act, similar state statutes,

- 2 -

2350919.6

local ordinances, or any related regulations, as may be amended from time to time. Landlord represents and warrants that, as of the Commencement Date, no written notice has been received by Landlord of non-compliance with any Legal Requirements in connection with the Premises. In the event that Landlord receives notice that the Premises is not in compliance with applicable Legal Requirements existing as of the Commencement Date, or which come into effect after the Commencement Date, and such non-compliance is not related to Tenant's specific use of the Premises or Tenant-Made Alterations to the Premises performed by Tenant, Landlord shall make such modifications as may be required by order or directive of applicable governmental authority in order to bring the Premises into compliance with such applicable Legal Requirements without cost or expense to Tenant. Tenant shall, at its expense, make any alterations or modifications to the Premises or Project that are required by Legal Requirements as a result of Tenant's use or occupation of the Premises.

5. **Base Rent.** The first month's Base Rent, Taxes, and Monthly FOE shall be due and payable upon execution of this Lease, which amounts shall be applied to the first month when such amounts become due and payable. Tenant shall pay to Landlord in advance, without demand, subsequent monthly installments of Base Rent on, or before, the first day of each calendar month following the Commencement Date (prorated for any fractional calendar month). All payments by Tenant to Landlord (or to such other party or at such location as Landlord may from time to time specify in writing) shall be made by Electronic Fund Transfer or Automated Clearing House. The obligation of Tenant to pay Base Rent and other sums to Landlord and the obligations of Landlord under this Lease are independent obligations. If Tenant is delinquent in any monthly installment of Base Rent, Taxes, Monthly FOE, or other amounts due and payable herein beyond 5 days after the due date thereof, and after notice as provided below, Tenant shall pay to Landlord on demand a late charge equal to five percent (5%) of such delinquent sum. Tenant shall not be obligated to pay the late charge until Landlord has given Tenant 5 days written notice of the delinquent payment (which may be given at any time during the delinquency); provided, however, that such notice shall not be required more than twice in any 12-month period. The provision for such late charge shall be in addition to all of Landlord's other rights and remedies hereunder or at law and shall not be construed as a penalty or as limiting Landlord's remedies in any manner.
6. **FOE.** In addition to the Base Rent, on the same date that Base Rent is due, Tenant shall pay Landlord an amount equal to the Monthly FOE provided in Paragraph 1, which Landlord and Tenant agree shall be reimbursement for Landlord's maintenance, repair, and replacement obligations as provided in Paragraph 11, and the insurance premiums incurred by Landlord as provided in Paragraph 10. Effective on each annual anniversary of the Commencement Date (or, if the first annual anniversary occurs on a date other than the first day of a calendar month, then on the first day of the immediately subsequent calendar month and on each annual anniversary date thereafter), the Monthly FOE shall be automatically increased by the percentage set forth as the Annual FOE Increase.
7. **Security Deposit.** The Security Deposit, if any, shall be due and payable to Landlord upon execution of this Lease, and shall be held by Landlord as security for the performance of Tenant's obligations. The Security Deposit is not an advance rental deposit, or a measure of Landlord's damages in an Event of Default (as hereinafter defined). Upon any Event of Default, Landlord may use all, or part of, the Security Deposit to pay delinquent payments due under this Lease, and the cost of any damage, injury, expense or liability caused by such Event of Default, without prejudice to any other remedy provided herein or provided by law. Tenant shall pay Landlord on demand the amount that will restore the Security Deposit to its original amount. Landlord's obligation respecting the Security Deposit is that of a debtor, not a trustee. The Security Deposit shall be the property of Landlord, and shall be promptly paid to Tenant when Tenant's obligations under this Lease have been fulfilled. Landlord shall not be required to keep the Security Deposit separate from its general accounts, and no interest shall accrue thereon. Tenant waives any limitations set forth in California Civil Code Section 1950.7 limiting the use to which a security deposit may be applied. Landlord shall be released from any obligation with respect to the Security Deposit upon transfer of this Lease and the Premises to a person or entity assuming Landlord's obligations.
8. **Utilities.** Tenant shall pay the utility provider directly for all separately metered, or contracted public and private utilities serving the Premises, including, but not limited to, water, gas, electricity, telephone, sewer, and trash collection, along with any taxes, penalties, or surcharges with respect to such utilities. As of the Effective Date, the electrical service is separately metered, the gas service will be separately metered when installed, and the water and sewer serving the Premises are shared. In the event Tenant's use of water and sewer services materially exceeds the foregoing limitations, Landlord may utilize Tenant's metering system for determining usage or may separately meter the water and sewer services at Tenant's expense and require Tenant to pay the service provider directly or Landlord may charge Tenant for water and sewer based on Landlord's reasonable determinations of Tenant's usage. Interruptions or failures of utilities shall not result in a default by Landlord, termination of this Lease, or the abatement of rent.
9. **Taxes.** Subject to reimbursement as provided below, Landlord shall pay all taxes, assessments, governmental

charges, and fees payable to tax consultants and attorneys for consultation and contesting taxes (collectively

referred to as "Taxes") that accrue against the Building or Project during the Lease Term. Landlord may contest the amount, validity, or application of any Taxes. All capital levies or other taxes assessed or imposed upon the rents payable to Landlord under this Lease and any franchise tax, excise, use, margin, transaction, sales or privilege tax, assessment, levy or charge measured by or based, in whole or in part, upon such rents from or the value of the Premises and/or the Project or any portion thereof shall be paid by Tenant to Landlord upon demand as additional rent; provided, however, in no event shall Tenant be liable for any net income taxes imposed on Landlord unless such net income taxes are in substitution for any Taxes payable hereunder. If any tax or excise is levied or assessed directly against Tenant, or the Premises, or results from any Tenant-Made Alterations (defined below), or against any personal property or fixtures placed in the Premises, then Tenant shall pay such tax or excise as required by the taxing authority, even if levied or assessed against the Landlord.

During each month of the Lease Term, on the same date that Base Rent is due, Tenant shall pay Landlord an amount equal to 1/12 of the annual cost (prorated for any fractional calendar month), as estimated by Landlord, of Tenant's Proportionate Share (hereinafter defined) of Taxes for the Project or Building. If Tenant's total payments of Taxes for any year are less than Tenant's Proportionate Share of actual Taxes for such year, then Tenant shall pay the difference to Landlord within 30 days after demand, and if more, then Landlord shall pay such refund to Tenant. Any payment required to be paid by Landlord shall be delivered to the most recent address Tenant has provided to Landlord and, if undeliverable, shall be deemed forfeited by Tenant. At the time of Taxes billing Landlord will provide Tenant with a reasonably detailed accounting of the Taxes as well as the calculation for Tenant's Proportionate Share. Tenant's "Proportionate Share" shall be the percentage set forth in Paragraph 1 as reasonably adjusted by Landlord for future changes in the physical size of the Premises, Building, or Project. The Taxes set forth in Paragraph 1 is an initial estimate and the accuracy of such estimate is not guaranteed by Landlord.

- 10. Insurance.** Landlord shall maintain all risk property insurance covering the full replacement cost of the Building and commercial general liability insurance on the Project in forms and amounts customary for properties substantially similar to the Building and Project which may be included in a blanket policy or captive insurance program. Tenant will not use the Premises in any manner that would void Tenant's or Landlord's insurance, or cause the disallowance of any insurance credits. If an increase in the cost of any insurance on the Building or the Project is caused by Tenant's use of the Premises, then Tenant shall pay the amount of such increase to Landlord.

Tenant, at its sole expense, shall at all times maintain the following insurance: (i) commercial general liability insurance, on an occurrence basis, covering Tenant, and its activities at the Project, having a minimum limit of \$2,000,000 per occurrence (which requirement may be satisfied by a combination of primary and excess policy limits); and in the event property of Tenant's invitees or customers are kept in the Premises or Project, Tenant shall maintain warehouse's legal liability or bailee customers insurance for the full value of such property as determined by the warehouse contract between Tenant and its customer (and, in the event that no property of Tenant's invitees or customers are kept in the Premises or Project, then Tenant shall not be required to carry such insurance); (ii) all risk property insurance covering the full replacement cost of all property and improvements placed in the Premises by, or on behalf of, Tenant; (iii) workers' compensation insurance as required by the applicable state statute (or equivalent coverage reasonably acceptable to Landlord in the event there is no such statutory requirement) which shall include a waiver of subrogation in favor of Landlord, Prologis, Inc., its affiliates, and property manager (Landlord and such parties are collectively referred to herein as the "Landlord Parties"); (iv) employers liability insurance of at least \$1,000,000, (v) business automobile liability insurance having a combined single limit of not less than \$2,000,000 per occurrence which can be satisfied by a combination of primary and excess policy limits insuring Tenant against liability arising out of the ownership maintenance or use of any owned, hired or non-owned vehicles, and (vi) business interruption insurance covering at least 6 months of income. Tenant's insurance companies shall have an A.M. Best rating of not less than A-VIII and provide primary and non-contributory coverage to the Landlord Parties (any policy issued to Landlord providing duplicate or similar coverage shall be deemed excess over Tenant's policies). All commercial general liability policies shall name the Landlord Parties as additional insureds. The limits and types of insurance maintained by Tenant shall not limit Tenant's liability under this Lease. Tenant shall provide Landlord with available Acord certificates of such insurance in forms reasonably acceptable to Landlord prior to the date Tenant is in possession of the Premises, and thereafter within 5 days prior to the expiration of the insurance coverage, or 15 days following Tenant's receipt of Landlord's request for such certificates. Acceptance by Landlord of delivery of any Acord certificates of insurance does not constitute approval or agreement by Landlord that the insurance requirements of this section have been met. In the event any of the insurance policies required to be carried by Tenant under this Lease shall be cancelled, or if Tenant receives notice of any cancellation from the insurer prior to the expiration date of such policy, Tenant shall promptly replace such insurance policy in order to assure no lapse of coverage shall occur.

The all risk property insurance obtained by Landlord and Tenant shall include a waiver of subrogation by the insurers and all rights based upon an assignment from its insured, against Landlord, and Landlord Parties or Tenant, and Tenant Parties (as defined in Paragraph 30), in connection with any insured loss or damage. Neither

party, nor its Landlord or Tenant Parties (as applicable), shall be liable to the other for loss or damage caused

-4-

2350919,6

by any risk coverable by all risk property insurance, and each party waives any claims against the other party, and against the Landlord Parties and Tenant Parties (as applicable) for such loss or damage. The failure of a party to insure its property shall not void this waiver. Neither party, nor the Landlord Parties and Tenant Parties, shall be liable to the other for any business interruption loss incurred, and each party waives any claims against the other party, and the Landlord Parties and Tenant Parties, for such business interruption loss from any cause whatsoever, including, but not limited to damage caused in whole or in part, directly or indirectly, by the negligent acts of the other party at the Premises or the Project. Notwithstanding the foregoing to the contrary, with respect to any damage to the Premises caused by Tenant, or Tenant Parties, Tenant shall pay Landlord's all-risk property insurance deductible, not to exceed \$25,000 per occurrence, within thirty (30) days following notice for such amount.

11. Landlord's Repairs and Maintenance. Landlord, at Landlord's expense, shall maintain repair, and replace as reasonably necessary to keep in good working order the following elements of the Building: structure and structural components, roof, exterior walls, parking areas, driveways, alleys, utility lines from the property line to the point of exclusive service to the Premises, landscaping, lighting, fire sprinkler/suppression system, heating, ventilation, and air conditioning units serving the office portion of the Premises (the "HVAC Units"), exterior louvers or ventilation fans for typical warehouse air changes, heating and/or any evaporative cooler systems serving the warehouse portion of the Premises (the "Warehouse Systems"), and the below slab water and sewer lines, each excluding reasonable wear and tear, and damages caused by Tenant Parties which are not coverable by insurance. The HVAC Units and Warehouse Systems, if any, are collectively referred to as "Landlord's HVAC Obligations". In addition, if customary in the market where the Project is located, Landlord, at Landlord's expense, shall provide snow removal, and parking lot sweeping for the Project in a manner consistent with owners of similar buildings and projects in the market where the Building is located. The term "walls" as used in this Paragraph shall not include windows, glass, doors, overhead doors, store fronts, dock doors and dock equipment. Tenant shall promptly give Landlord written notice of any repair required by Landlord pursuant to this Lease. In the course of conducting its repairs, maintenance and replacements, Landlord shall endeavor to avoid material disruptions to Tenant's business operations, provided in no event shall Landlord be required to engaged personnel outside of business hours, or to pay overtime and nothing contained in the following shall restrict Landlord's ability to respond to an emergency.

12. Tenant's Repairs. Subject to Landlord's obligation in Paragraph 11, and subject to Paragraphs 10 and 16, Tenant, at its expense, shall repair, replace, and maintain in good condition all areas, improvements and systems exclusively serving the Premises including, without limitation, dock and loading areas, dock doors, dock equipment, plumbing, fixtures, above slab water and sewer lines, entries, doors, ceilings, windows, and interior walls. Repair and replacement obligations may include capital repairs whose benefit may extend beyond the Expiration Date. Landlord's HVAC Obligations shall not include any HVAC systems installed by Tenant, any specialty HVAC equipment or systems (including but not limited to IT room supplemental HVAC, any air conditioning systems serving the warehouse portion of the Premises other than the Warehouse Systems, or which are necessary for temperature-controlled product)(collectively the "Tenant's HVAC"), and Tenant, at Tenant's expense, shall be responsible for the maintenance, repair, and replacement of Tenant's HVAC, as well as the exhaust fans, ductwork, vents, and registers serving Tenant's HVAC. Tenant agrees to maintain throughout the Lease Term a preventative maintenance/service contract, using qualified contractors, for the servicing all doors and dock equipment serving the Premises. If Tenant fails to perform any maintenance, repair, or replacement for which it is responsible, Landlord may perform such work and be reimbursed by Tenant within 30 days after demand. Subject to Paragraphs 10 and 16, Tenant shall bear the cost of any repair or replacement to any part of the Premises, Building or Project that results from damage caused by Tenant, its agents, contractors, or invitees, or Tenant's failure to maintain the Premises in accordance with this Lease.

13. Tenant-Made Alterations and Trade Fixtures. Tenant shall have the right to make alterations, additions, or improvements to the Premises ("Tenant-Made Alterations"), which are interior, do not impact the structure of the Building, and the cost of which does not exceed \$50,000 in each instance, without Landlord's consent; provided Tenant provides Landlord with a written notice of such Tenant-Made Alterations containing sufficient and complete information regarding such Tenant-Made Alterations. All other Tenant-Made Alterations shall require Landlord's prior written consent, and approval of the plans, not to be unreasonably withheld, delayed or conditioned provided such alteration does not impact the structure of the Building, modify the exterior of the Building, or modify the utility or mechanical systems of the Project. Tenant shall reimburse Landlord for its reasonable third party, out-of-pocket costs in reviewing plans and specifications and for monitoring construction. Landlord's right to review plans and specifications and to monitor construction shall be solely for its own benefit, and Landlord shall have no duty to see that such plans and specifications or construction comply with Legal Requirements. Tenant shall cause, at its expense, all Tenant-Made Alterations to: (a) be constructed in a good and workmanlike manner by contractors reasonably acceptable to Landlord using only good grades of materials, and (b) comply with Landlord's insurance and Legal Requirements. Tenant shall provide Landlord with the names and mailing addresses of all persons performing work or supplying materials, prior to beginning such construction, and Landlord may post on and about the Premises notices of non-responsibility pursuant to

applicable law. Tenant shall cause its contractor to provide certificates of insurance for worker's compensation,

including a waiver of subrogation in favor of the Landlord Parties, and commercial general liability in an amount equal to USD\$2,000,000 from an insurance company satisfactory to Landlord, including a provision of additional insured status for the Landlord Parties, from any contractor completing work on Tenant-Made Alterations. Upon completion of any Tenant-Made Alterations, Tenant shall deliver to Landlord all final lien waivers from all contractors and subcontractors. Upon surrender of the Premises all Tenant-Made Alterations and any leasehold improvements constructed by Landlord or Tenant shall remain on the Premises as Landlord's property, except to the extent Landlord requires removal, in which case, at Tenant's expense, Tenant shall repair any damage caused by such removal. Upon Tenant's prior written request made at the time Tenant requests Landlord's approval to a Tenant-Made Alteration, Landlord shall confirm if Landlord will require Tenant to remove such Tenant-Made Alteration upon surrender of the Premises.

Tenant has delivered to Landlord its preliminary plans for the kiln dated December 13th, 2019, as shown on Exhibit H, and Landlord has no objections to those preliminary plans, subject to any material modifications of such plans being subject to Landlord's approval; such kiln will be a Tenant-Made Alteration otherwise subject to the terms of this Lease. Tenant will deliver final plans to Landlord prior to commencing construction of the kiln. At the end of the Lease term Tenant shall fill in and level the kiln hole with matching concrete or another similar material acceptable to Landlord. Furthermore, Landlord approves the Site Plan attached hereto as Exhibit I, subject to Landlord's approval as to any material modifications or new specifications therefor.

Without Landlord's prior approval, Tenant may erect shelves, racking, bins, machinery and trade fixtures (collectively "Trade Fixtures") provided that such items do not overload the Premises, may be removed without damaging the floor slab or the Premises, and installation thereof complies with all Legal Requirements. Upon surrender of the Premises Tenant shall remove its Trade Fixtures and shall repair any damage to the floor slab or the Premises caused by such removal.

14. **Signs.** Tenant shall not install any decorations, flags, pennants, banners, exterior awnings, window or door lettering, placards, advertising media, lights or signs to the exterior of the Building, or interior window blinds, draperies, bars, or other window treatments which are visible from the exterior of the Building, without Landlord's prior written consent, which consent may be withheld in Landlord's reasonable discretion. Prior to the surrender or vacation of the Premises, Tenant shall remove all signs and repair, paint, and/or replace the building facia surface damaged as a result. Tenant, at its expense, shall obtain all applicable governmental permits and approvals for any sign.
15. **Parking.** Tenant may park operable vehicles in areas of the Project designated for non-reserved parking and park operable vehicles and trailers overnight at the truck loading docks and designated truck and trailer parking areas for the Premises, provided there is no interference with the access of other tenants to the Building and Project parking lots and truck courts. Landlord may allocate parking spaces among Tenant and other tenants if Landlord reasonably determines such allocation is beneficial to the Project. Landlord shall not be responsible for enforcing Tenant's parking rights against any third parties. If Tenant fails to comply with any of the parking requirements, and such failure continues for more than 3 days, Landlord may, in addition to any other rights, cause vehicles in violation to be towed at Tenant's cost without liability to Landlord, or Landlord may hire a parking management company to enforce parking rules at the Project and Tenant shall reimburse Landlord for all costs incurred with such parking management no later than thirty (30) days from receipt of an invoice for such amount. Notwithstanding the provisions of this Paragraph, Landlord agrees that Tenant shall at all times during the Lease Term be entitled to the use of twenty (20) non-exclusive parking spaces (but without imposing any obligation on Landlord to prevent third parties from using such parking spaces).
16. **Restoration.** If at any time during the Lease Term the Premises are damaged by a fire or other casualty, Landlord shall notify Tenant within 60 days after such damage as to the amount of time Landlord reasonably estimates it will take to restore the Premises. If the restoration time is estimated to exceed 6 months, either Landlord or Tenant may elect to terminate this Lease upon notice to the other party given no later than 30 days after Landlord's notice. If neither party elects to terminate this Lease, or if Landlord estimates that restoration will take 6 months or less, then Landlord shall, subject to delays arising from the collection of insurance proceeds or from events of Force Majeure, promptly restore the Premises, excluding any Tenant-Made Alterations. Tenant at Tenant's expense shall promptly perform, subject to delays arising from the collection of insurance proceeds, or from Force Majeure events, all repairs or restoration not required to be done by Landlord. Notwithstanding the foregoing, either party may terminate this Lease if the Premises are damaged during the last year of the Lease Term and Landlord reasonably estimates that it will take more than one month to repair such damage. Base Rent, Taxes, and the Monthly FOE shall be abated for the period of repair and restoration commencing on the date of such casualty event in the proportion of the Premises, if any, which is not reasonably usable by Tenant in conducting its business bears to the total area of the Premises. Such abatement shall be the sole remedy of Tenant, and except as provided above, Tenant waives any right to terminate the Lease by reason of damage or casualty loss.

17. Condemnation. If any part of the Premises or the Project are taken for any public or quasi-public use under governmental law, ordinance, or regulation, or by right of eminent domain, or by private purchase in lieu thereof (a "Taking" or "Taken"), and the Taking would materially interfere with or impair Landlord's ownership or operation of the Building, then upon written notice by Landlord this Lease shall terminate and Base Rent, Monthly FOE, and Taxes shall be apportioned as of such date. If part of the Premises is Taken, and this Lease is not terminated as provided above, the Base Rent and Monthly FOE shall be proportionately reduced to such extent as may be fair and reasonable under the circumstances. In the event of any such Taking, Landlord shall be entitled to receive the entire price or award from any such Taking without any payment to Tenant, and Tenant hereby assigns to Landlord Tenant's interest, if any, in such award. Without diminishing Landlord's award, Tenant shall have the right to make a separate claim against the condemning authority (but not Landlord) for such compensation as may be separately awarded or recoverable by Tenant for moving expenses and damage to Tenant's Trade Fixtures.

18. Assignment and Subletting. Except as provided below, Tenant shall not assign this Lease or sublease the Premises or any part thereof, without Landlord's prior written consent, which consent shall not be unreasonably withheld, conditioned or delayed, and any attempt to do so without Landlord's consent shall be void and of no effect. Furthermore, Tenant shall not mortgage, or pledge, its leasehold interest in this Lease. It shall be reasonable for the Landlord to withhold, delay or condition consent to any assignment or sublease if the intended use of the Premises by the assignee or sublessee would impact the operations of other tenants, their use of the Project, or impair Landlord's ability to re-lease other space in the Building or Project. Tenant shall provide to Landlord all information concerning the assignee or sublessee as Landlord may reasonably request, and any approved assignment or sublease shall be (i) expressly subject to the terms and conditions of this Lease, and (ii) revocable in the Event of Default. For purposes of this Paragraph, a transfer of the ownership interests controlling Tenant shall be deemed an assignment of this Lease unless such ownership interests are publicly traded. Notwithstanding the foregoing to the contrary, provided no uncured default has occurred under this Lease, and subject to the provisions herein, Tenant may, without Landlord's prior written consent, assign this Lease to any entity into which Tenant is merged or consolidated, or to any entity to which substantially all of Tenant's assets are transferred, provided the following conditions are met: (x) such merger, consolidation, or transfer of assets is not principally for the purpose of transferring Tenant's leasehold estate, (y) such merger, consolidation, or transfer of assets does not adversely affect the legal existence of the Tenant hereunder (or, if it does adversely affect the legal existence of Tenant, then provided the successor assumes all liabilities and obligations of Tenant including, without limitation, those occurring prior to the transfer), and (z) such merger, consolidation, or transfer of assets of Tenant does not reduce the tangible net worth of Tenant (as it existed on execution of the Commencement Date) after giving effect to such transfer ("Permitted Transfer"). Tenant hereby agrees to give Landlord written notice thirty (30) days prior to such merger, consolidation, or transfer of assets along with any documentation reasonably requested by Landlord related to the required conditions as provided above. Notwithstanding the above, Tenant may assign or sublet the Premises, or any part thereof, to any entity controlling Tenant, controlled by Tenant or under common control with Tenant (a "Tenant Affiliate"), without the prior written consent of Landlord. Landlord may charge Tenant USD\$1,500 in connection with any assignment or sublease for which Landlord's consent is required. This Lease shall be binding upon Tenant and its successors and permitted assigns. Upon Landlord's receipt of Tenant's written notice of a desire to assign or sublet the Premises, or any part thereof (other than to a Tenant Affiliate), Landlord may, by giving written notice to Tenant within 30 days, terminate this Lease as of the commencement date specified in Tenant's notice, with respect to the space described in Tenant's notice.

Notwithstanding any assignment or subletting, Tenant and any guarantor of Tenant's obligations shall remain liable for the payment of the Base Rent, Taxes, Monthly FOE and any other amounts due, and compliance with all of Tenant's obligations under this Lease (regardless of whether Landlord's approval has been obtained for any such assignment or subletting). In the event that the rent due by a sublessee or assignee exceeds the rental payable under this Lease after deduction of Tenant's actual expenses for reasonable attorneys' fees, customary commissions, and cash incentives paid to the transferee, then Tenant shall pay to Landlord 50% of such excess as additional rent within 10 days following receipt by Tenant.

If this Lease is assigned or if the Premises are subleased (whether in whole or in part), or if the Premises are occupied by anyone other than Tenant, then upon an Event of Default Landlord may collect rent from any occupant and, except to the extent set forth in the preceding paragraph, apply the amount collected to the next rent payable hereunder.

19. Indemnification. Except for the negligence of the Landlord Parties, Tenant agrees to indemnify, defend and hold harmless the Landlord Parties, and Landlord's agents, employees, and contractors, from and against all losses, liabilities, damages, costs and expenses (including reasonable attorneys' fees) resulting from claims by third parties for injuries to any person and damage to or theft or misappropriation or loss of property occurring in or about the Project and arising from the use and occupancy of the Premises or from any activity, work, or thing done, permitted or suffered by Tenant in or about the Premises or due to any other act or omission of



Tenant, its subtenants, assignees, invitees, employees, contractors and agents. The furnishing of insurance required hereunder shall not be deemed to limit Tenant's obligations under this Paragraph.

Except for the negligence of Tenant, its agents, employees or contractors, and to the extent permitted by law, Landlord agrees to indemnify, defend and hold harmless Tenant, and Tenant's agents, employees and contractors, from and against any and all losses, liabilities, damages, costs and expenses (including attorneys' fees) resulting from claims by third parties for injuries to any person and damage to or theft or misappropriation or loss of property occurring in or about the Project and arising from any activity, work, or thing done, permitted or suffered by Landlord in or about the Project and arising from any other act or omission of Landlord, its assignees, invitees, employees, contractors and agents. The furnishing of insurance required hereunder shall not be deemed to limit Landlord's obligations under this Paragraph 19.

If a claim under the foregoing indemnity is made against the indemnitee which the indemnitee believes to be covered by an indemnitor's indemnification obligations hereunder, the indemnitee shall promptly notify the indemnitor of the claim and, in such notice shall offer to the indemnitor the opportunity to assume the defense of the claim within 10 business days after receipt of the notice (with counsel reasonably acceptable to the indemnitee). If the indemnitor timely elects to assume the defense of the claim, the indemnitor shall have the right to settle the claim on any terms it considers reasonable and without the indemnitee's prior written consent, as long as the settlement shall not require the indemnitee to render any performance or pay any consideration, and the indemnitee shall not have the right to settle any such claim. If the indemnitor fails to timely elect to assume the defense of the claim or fails to defend the claim with diligence, then the indemnitee shall have the right to take over the defense of the claim and to settle the claim on any terms the indemnitee considers reasonable. Any such settlement shall be valid as against the indemnitor. If the indemnitor assumes the defense of a claim, the indemnitee may employ its own counsel but such employment shall be at the sole expense of the indemnitee. If any such claim arises out of the negligence of both Landlord and Tenant, responsibility for such claim shall be allocated between Landlord and Tenant based on their respective degrees of negligence.

This indemnity does not cover claims arising from the presence or release of Hazardous Materials.

20. Inspection, Data and Access. Landlord and its agents, representatives, and contractors may enter the Premises at reasonable times and on reasonable notice (except in an emergency, in which case no notice shall be required) to inspect the Premises, for any business purpose including the installation of Devices, and, during the last year of the Lease Term, to show the Premises to prospective tenants. All such access shall be subject to complying with Tenant's reasonable and usual security procedures for so long as Tenant supplies any required personnel at the time appointed by Landlord pursuant to the first sentence and provided further that, in the event that Tenant's security procedures restrict Landlord's access to any area of the Premises, Landlord shall have no obligations under this Lease for its inability to repair, maintain or replace such portion of the Premises. Landlord may erect signs on the Building stating the Premises are available to lease or that the Project is available for sale. Landlord may grant easements, make public dedications, designate and modify common areas and create restrictions affecting the Project (collectively "Encumbrances"), provided that such Encumbrances do not materially interfere with Tenant's use or occupancy of, or materially increase the cost to Tenant to conduct its business at the Premises and Tenant agrees to execute any instruments as may be reasonably necessary for such Encumbrances. Landlord has asked for Tenant's cooperation in order for Landlord to more efficiently manage the Building and to reduce emissions and operating costs. To that end, Landlord shall have the right to enter the Premises for the purpose of the installation and maintenance of Devices, and the collection of Data from the Devices during the Lease Term, provided that such installation and maintenance of the Devices and collection of Data does not interfere with Tenant's use or occupancy of the Premises and provided that such Data does not include any information identifying employees or unique aspects of Tenant's business including without limitation Tenant's equipment, manufacturing processes, products, confidential information, know-how and prospective developments. Landlord shall not sell or disclose, for commercial purposes, the Data in any way that identifies Tenant, Tenant's equipment, manufacturing processes, equipment or Tenant's personnel. Landlord may disclose Data to the extent required by applicable law, for benchmarking purposes, or in order to provide, maintain, improve, and keep in good working order the properties of Landlord, Prologis, Inc. and its affiliates. Tenant shall not interfere with Landlord's use of the Data authorized to be collected from such Devices solely for the purposes stated (and which Data, collected in compliance with this paragraph, shall belong solely to Landlord). Tenant shall not tamper with or interfere with the Devices. The term "Devices" as used herein shall mean any sensors, computers or electronic devices, systems and application software, peripherals, meters, or other data collection devices installed and owned by Landlord; provided that the same shall not include any audio or video measurement or collection devices. The term "Data" as used herein shall mean any information associated with, created or generated by, or transmitting through a Device, collected for the intention of improving the efficiency and operation of the Building, and shall expressly exclude any information collected or maintained by Tenant or any Tenant Parties. The foregoing shall be independent from the utilities information required of Tenant pursuant to Paragraph 37(q).

21. Quiet Enjoyment. Absent any Event of Default subject to the terms of this Lease, Tenant shall have peaceful and quiet enjoyment of the Premises against any person claiming by, through or under Landlord.



22. Surrender. Upon the Expiration Date or earlier termination of Tenant's right of possession, Tenant shall surrender the Premises to Landlord in the same condition as received, ordinary wear and tear, casualty loss and condemnation covered by Paragraphs 16 and 17 excepted and otherwise in accordance with the Move Out Conditions attached hereto. Any Trade Fixtures, Tenant-Made Alterations and property not removed by Tenant as required shall either, at Landlord's election: (i) become the property of Landlord, or (ii) be deemed abandoned in which case it may be stored, removed, and disposed of by Landlord at Tenant's expense, and Tenant waives all claims against Landlord for any damages resulting from Landlord's retention and disposition of such property. Any outstanding Tenant obligations under this Lease shall survive the termination of the Lease Term, including without limitation, indemnity obligations, payment of Taxes, and all obligations concerning the condition and repair of the Premises.

23. Holding Over. If Tenant retains possession of the Premises after the Expiration Date, such possession shall be subject to immediate termination by Landlord, and all terms of this Lease shall be applicable during such holdover period except (i) any expansion, renewal, or similar right or option, and (ii) Base Rent for the holdover period shall be 150% of the then-effective Base Rent. All other amounts payable under this Lease shall continue under the terms of this Lease. In addition, Tenant shall be liable for all damages incurred by Landlord as a result of such holding over. Holding over by Tenant (with or without consent of Landlord) shall not extend this Lease except as otherwise expressly provided, and this Paragraph shall not be construed as consent for Tenant to retain possession of the Premises. For purposes of this Paragraph, "possession of the Premises" shall continue until Landlord has been given physical control over the Premises, all keys have been delivered, and Tenant has fulfilled all required obligations upon termination of the Lease concerning the condition and repair of the Premises.

24. Events of Default. Each of the following shall be an event of default ("Event of Default") by Tenant:

- a) Tenant shall fail to pay any installment of Base Rent, Taxes, Monthly FOE, or any other payment required herein when due, and such failure shall continue for a period of 5 days after written notice from Landlord to Tenant that such payment was due; provided, however, that Landlord shall not be obligated to provide written notice of such failure more than 1 time in any consecutive 12-month period, and the failure of Tenant to pay any second or subsequent installment of Base Rent or any other payment required herein when due in any consecutive 12-month period shall constitute an Event of Default by Tenant under this Lease without the requirement of notice or opportunity to cure; provided, however, that any such notice shall be in lieu of, and not in addition to, any notice required under applicable law.
- b) Tenant shall (i) make a general assignment for the benefit of creditors; (ii) commence any case, proceeding or other action seeking to have an order for relief entered on its behalf as a debtor or to adjudicate it as bankrupt or insolvent, or seeking reorganization, arrangement, adjustment, liquidation, dissolution or composition of it or its debts or seeking appointment of a receiver, trustee, custodian or other similar official for it or for all or of any substantial part of its property (collectively a "proceeding for relief"); (iii) become the subject of any proceeding for debt relief which is not dismissed within 60 days of its filing or entry; or (iv) die or suffer a legal disability (if Tenant, guarantor, or surety is an individual) or be dissolved or otherwise fail to maintain its legal existence other than as described or permitted in Paragraph 18 (if Tenant, guarantor or surety is a corporation, partnership or other entity).
- c) Any insurance required to be maintained by Tenant pursuant to this Lease is: (i) cancelled, terminated, or expires unless the same is replaced prior to any lapse in coverage, or (ii) is reduced or materially changed (except, in each case, as permitted in this Lease) or Tenant fails to timely deliver to Landlord any Acond certificate of insurance as required under Paragraph 10 and such failure under (ii) shall continue for period of 10 days after written notice from Landlord to Tenant.
- d) Tenant vacates the Premises and fails to make arrangements reasonably acceptable to Landlord to ensure that (i) Tenant's insurance for the Premises will not be voided or cancelled, (ii) the Premises will be secured, and (iii) the Premises will be properly maintained, including maintaining utility services. Tenant shall inspect the Premises at least monthly and report to Landlord in the event the condition of the Premises has adversely changed.
- e) Tenant assigns, subleases or transfers Tenant's interest in this Lease except as permitted in this Lease.
- f) Tenant fails to discharge any lien placed upon the Premises or Building resulting from any action taken by or authorized by Tenant (which excludes any lien granted by Landlord or which arises from work requested by, or on behalf of, Landlord) within 20 days after such lien or encumbrance is filed against the Premises or Building.
- g) Tenant fails to comply with any provision of this Lease other than those specifically referred to in this Paragraph, and such default shall continue for more than 30 days after Landlord has given Tenant written notice of such default specifying the nature of such default, except as otherwise provided in this Lease (said notice being in lieu of, and not in addition to, any notice required as a prerequisite to a forcible entry and detainer or similar action for possession of the Premises); provided however, if Tenant's violation or failure cannot reasonably be cured within 30 days, Tenant shall be allowed such additional time as is reasonably



necessary to cure the violation or failure so long as Tenant promptly undertakes the cure and diligently pursues the cure to completion.

Tenant agrees that any notice given by Landlord pursuant to this Paragraph of the Lease shall satisfy the requirements for notice under California Code of Civil Procedure Section 1161, and Landlord shall not be required to give any additional notice in order to be entitled to commence an unlawful detainer proceeding.

25. Landlord's Remedies. Upon each occurrence of an Event of Default and so long as such Event of Default continues, Landlord may at any time elect to: (i) terminate this Lease or Tenant's right of possession, (but Tenant shall remain liable as hereinafter provided), and/or (ii) pursue any other remedies at law or in equity. Upon the termination of this Lease or termination of Tenant's right of possession, Landlord may, without formal demand or notice of any kind, re-enter the Premises by summary dispossession proceedings or any other action or proceeding authorized by law and remove Tenant, and all persons and property therefrom. If Landlord re-enters the Premises, Landlord shall have the right to keep in place and use, or remove and store, all property at the Premises. Notwithstanding anything contained herein to the contrary, in the event Landlord delivers three notices of an Event of Default under this Lease in any twelve month period which Tenant does not reasonably dispute, any subsequent Event of Default under the Lease shall be deemed an immediate Event of Default, and Tenant shall have no cure period as otherwise provided in this Lease, and Landlord may immediately pursue all of its remedies as provided in this Lease.

If Landlord terminates Tenant's right to possession (but not this Lease) without terminating the Lease after an Event of Default, Landlord shall use commercially reasonable efforts to relet the Premises without thereby releasing Tenant from any liability hereunder and without demand or notice of any kind to Tenant; provided, however, (a) Landlord shall not be obligated to accept any tenant proposed by Tenant, (b) Landlord shall have the right to lease any other space controlled by Landlord first, and (c) any proposed tenant shall meet all of Landlord's leasing criteria. Except as otherwise provided in the next paragraph, if Tenant breaches this Lease and abandoned the Premises prior to the end of the term hereof, or if Tenant's right to possession is terminated by Landlord because of an Event of Default by Tenant under this Lease, this Lease shall terminate. Upon such termination, Landlord may recover from Tenant the following, as provided in Section 1951.2 of the Civil Code of California: (i) the worth at the time of award of the unpaid Base Rent, Taxes, Monthly FOE, and other charges under this Lease that had been earned at the time of termination; (ii) the worth at the time of award of the amount by which the reasonable value of the unpaid Base Rent, Taxes, Monthly FOE, and other charges under this Lease which would have been earned after termination until the time of award exceeds the amount of such rental loss that Tenant proves could have been reasonably avoided; (iii) the worth at the time of award by which the reasonable value of the unpaid Base Rent, Taxes, Monthly FOE, and other charges under this Lease for the balance of the term of this Lease after the time of award exceeds the amount of such rental loss that Tenant proves could have been reasonably avoided; and (iv) any other amount necessary to compensate Landlord for all the detriment proximately caused by Tenant's failure to perform its obligations under this Lease or that in the ordinary course of things would be likely to result therefrom. As used herein, the following terms are defined: (a) The "worth at the time of award" of the amounts referred to in Sections (i) and (ii) is computed by allowing interest at the lesser of 15 percent per annum or the maximum lawful rate. The "worth at the time of award" of the amount referred to in Section (iii) is computed by discounting such amount at the discount rate of the Federal Reserve Bank of San Francisco at the time of award plus one percent; (b) The "time of award" as used in clauses (i), (ii), and (iii) above is the date on which judgment is entered by a court of competent jurisdiction; (c) The "reasonable value" of the amount referred to in clause (ii) above is computed by determining the mathematical product of (1) the "reasonable annual rental value" (as defined herein) and (2) the number of years, including fractional parts thereof, between the date of termination and the time of award. The "reasonable value" of the amount referred to in clause (iii) is computed by determining the mathematical product of (1) the annual Base Rent, Taxes, Monthly FOE, and other charges under this Lease and (2) the number of years including fractional parts thereof remaining in the balance of the term of this Lease after the time of award. Tenant acknowledges and agrees that the term "detriment proximately caused by Tenant's failure to perform its obligations under this Lease" includes, without limitation, the value of any initial abated or free rent given to Tenant.

Even though Tenant has breached this Lease and abandoned the Premises, this Lease shall continue in effect for so long as Landlord does not terminate Tenant's right to possession, and Landlord may enforce all its rights and remedies under this Lease, including the right to recover rent as it becomes due. This remedy is intended to be the remedy described in California Civil Code Section 1951.4, and the following provision from such Civil Code Section is hereby repeated: "The Lessor has the remedy described in California Civil Code Section 1951.4 (lessor may continue lease in effect after lessee's breach and abandonment and recover rent as it becomes due, if lessee has right to sublet or assign subject only to reasonable limitations)." Tenant shall immediately pay any such deficiency upon demand and Tenant agrees that Landlord may file suit to recover any sums as they become due. Notwithstanding any such reletting without termination, Landlord may at any time thereafter elect in writing to terminate this Lease for such previous breach.



Landlord's exercise of any remedies shall not be deemed to be an acceptance of surrender of the Premises and/or a termination of this Lease by Landlord. Any law, usage, or custom to the contrary notwithstanding, Landlord shall have the right at all times to enforce the provisions of this Lease in strict accordance with the terms hereof; and the failure of Landlord at any time to enforce its rights under this Lease strictly in accordance with the terms hereof shall not be construed as having created a custom or manner in any way contrary to the specific terms, provisions, and covenants of this Lease or as having modified the same. Tenant and Landlord further agree that forbearance or waiver by Landlord to enforce its rights pursuant to this Lease or at law or in equity, shall not be a waiver of Landlord's right to enforce one or more of its rights in connection with any subsequent Event of Default. Receipt by Landlord of rent or other payment with knowledge of the breach of any covenant hereof shall not be deemed a waiver of such breach, and no waiver by Landlord of any provision of this Lease shall be deemed to have been made unless agreed in writing and signed by Landlord. To the greatest extent permitted by law, Tenant waives all right of redemption in case the Lease is terminated, or Tenant shall be dispossessed by a judgment or by warrant of any court or judge. In the event Landlord properly exercises self-help, or lock-out, remedies as allowed by law, Tenant hereby waives all claims against Landlord for any business loss or business interruption which Tenant may incur and any property remaining on the Premises shall be deemed abandoned by Tenant and Landlord may store, remove, or disposed of such property at Tenant's expense. The terms "enter," "re-enter," "entry" or "re-entry," as used in this Lease, are not restricted to their technical legal meanings.

- 26. Tenant's Remedies/Limitation of Liability.** Landlord shall not be in default unless Landlord fails to perform any of its obligations within 30 days after written notice from Tenant specifying such failure (unless such performance will, due to the nature of the obligation, require more than 30 days, then after such period of time as is reasonably necessary). All obligations of Landlord shall be construed as covenants, not conditions; and, except as may be otherwise provided in this Lease, Tenant may not terminate this Lease for breach of Landlord's obligations hereunder, but Tenant shall be entitled to all other rights and remedies available at law or in equity (including, without limitation, specific performance to cause, or prevent, the action of Landlord in violation of this Lease). All obligations of Landlord under this Lease will be binding upon Landlord only during the period of its ownership of the Premises and not thereafter. The term "Landlord" in this Lease shall mean only the then current owner of the Premises, and in the event of a transfer of ownership of the Premises, such transferring owner shall be released and discharged from all obligations of Landlord thereafter accruing, but such obligations shall be binding during the Lease Term upon each new owner for the duration of such owner's ownership. Any liability of Landlord under this Lease shall be limited solely to its interest in the Building, and in no event shall any personal liability or recourse to any other property or assets of Landlord be asserted against Landlord in connection with this Lease.

In the event of an emergency (being defined as an imminent threat of personal injury to Tenant's employees or material damage to Tenant's equipment or other property at the Premises), Tenant shall have the right to make such temporary, emergency repairs to the roof, foundation, floors and exterior walls of the building of which the Premises are a part, or the roof membrane, skylights, roof vents, drains and downspouts of the Project, and the exterior and under slab utility systems for the Project, as may be reasonably necessary to prevent such material damage to the equipment or property of Tenant situated in the Premises, or such personal injury to Tenant's employees, provided Tenant has no reasonable alternative and has notified or attempted in good faith to notify Landlord's representative of such emergency by telephone (with subsequent written notice as soon as practicable). The provisions of this paragraph do not constitute an authorization by Landlord for Tenant to enter the premises of any other tenant of the Project, and Tenant has not been designated as Landlord's agent for the purposes of any such entry. Landlord shall reimburse Tenant for the reasonable, out-of-pocket costs incurred by Tenant in making such emergency repairs to the roof, foundation or exterior walls, as applicable, up to (but not to exceed) \$50,000.00 with respect to each such occurrence, within thirty (30) days after submission by Tenant to Landlord of an invoice therefore, accompanied by reasonable supporting documentation for the costs so incurred. In the event Landlord fails or refuses to reimburse Tenant for such costs within such thirty (30) day period and Tenant brings an action for recovery of such amounts from Landlord as provided for in this Lease, then Tenant shall be entitled to recover, in addition to the amount of such costs, interest on such amounts from the date incurred by Tenant until recovered from Landlord, at the rate provided in Paragraph 37(k) of this Lease, and the reasonable attorneys' fees and other costs of court incurred by Tenant in pursuing such action.

Notwithstanding anything contained herein to the contrary, neither Tenant nor Landlord shall have any liability for any consequential, punitive or indirect damages, whether proximately or remotely related to such party's default, except as the same relates to holdover in the Premises or Tenant's environmental obligations contained herein.

- 27. Subordination.** Without the necessity of any further instrument or act of Tenant, this Lease, and Tenant's interest and rights hereunder, are, and shall be, subject and subordinate at all times to the lien of any existing or future first mortgage on the Building or any ground lease which the Building is subject to, and all

amendments, modifications, assignments and extensions thereof. Tenant agrees, at the election of the holder

of any such mortgage, or lessor for any ground lease, to attorn to any such holder or lessor. Tenant agrees upon demand to execute, acknowledge and deliver such reasonable instruments, confirming such subordination and such instruments of attornment as shall be requested by any such holder. Notwithstanding the foregoing, any such holder may at any time subordinate its mortgage to this Lease, without Tenant's consent, by notice in writing to Tenant. The term "mortgage" whenever used in this Lease shall be deemed to include deeds of trust, security assignments and any other encumbrances, and any reference to the "holder" of a mortgage shall be deemed to include the beneficiary under a deed of trust. Landlord represents to Tenant that as of the date hereof the Building is not subject to or encumbered by a mortgage.

Notwithstanding the preceding provisions of this Paragraph, this Lease and Tenant's interest in the Premises shall not be subordinate to any future mortgage or deed of trust on the Building, and Tenant shall not be obligated to execute an instrument subordinating this Lease or Tenant's interest in the Premises to any future mortgage or deed of trust on the Building, unless concurrently with such subordination the holder of such mortgage or deed of trust agrees in such instrument of subordination not to disturb Tenant's possession of the Premises (so long as no default exists under the Lease) in the event such holder acquires title to the Premises through foreclosure, deed in lieu of foreclosure or otherwise.

28. Mechanic's Liens. Tenant has no express or implied authority to create or place any lien or encumbrance of any kind upon the Building, the Premises or this Lease. Tenant covenants and agrees that it will save and hold Landlord harmless from all loss, cost or expense based on or arising out of claims or liens asserted against the leasehold estate, the interest of Landlord in the Premises, or under this Lease (except to the extent arising due to work or services requested by, or on behalf of, Landlord). Tenant shall give Landlord immediate written notice of any lien or encumbrance placed against the Premises and cause such lien or encumbrance to be discharged, or bonded over in a manner satisfactory to Landlord, within 20 days of the filing or recording thereof.

29. Estoppel Certificates. Each party agrees, from time to time, within 20 days after request of the requesting party, to execute and deliver to the requesting party, or the requesting party's designee, any estoppel certificate requested by the other, stating, if true, that this Lease is in full force and effect, the date to which rent has been paid, that the requesting party is not in default hereunder (or specifying in detail the nature of the requesting party's default), the Expiration Date and such other matters pertaining to this Lease as may be reasonably requested by the requesting party. Each party's obligation to furnish each estoppel certificate in a timely fashion is a material inducement for each party's execution of this Lease. No cure or grace period provided in this Lease shall apply to either party's obligations to timely deliver an estoppel certificate.

30. Environmental Requirements. Except for Permitted Hazardous Materials Used pursuant to Exhibit G, and except for Hazardous Materials contained in: (i) products used by Tenant in de minimis quantities for ordinary cleaning and office purposes; (ii) forklift propane tanks, and (iii) products stored and/or distributed by Tenant in their original, sealed, and unopened containers, Tenant shall not bring, permit, or cause any party to bring any Hazardous Material onto the Project, or transport, store, use, generate, manufacture, or dispose of any Hazardous Material in, on, or about the Project without Landlord's prior written consent. Tenant, at its sole cost and expense, shall: (v) operate its business at the Project in strict compliance with all Environmental Requirements, including complying with all reporting obligations imposed by applicable Environmental Requirements in the capacity as "operator" of Tenant's "facility" and the "owner" (as such terms are used in applicable Environmental Requirements) of all Hazardous Materials brought onto the Project by Tenant, or any Tenant Parties (as defined below), and the wastes, by-products, or residues generated, resulting, or produced therefrom, or extracted from the Project; (w) promptly provide copies of any claims, reports, complaints, notices, letters, warnings or asserted violations against Tenant relating in any way to Hazardous Materials at the Project which Tenant receives or sends; (x) promptly and diligently remediate in a manner reasonably satisfactory to Landlord any Hazardous Materials released on, or from, the Project by Tenant, its agents, employees, contractors, subtenants, licensees, or invitees (collectively, the "Tenant Parties") and otherwise in a manner that is in compliance with Environmental Requirements; (y) promptly notify Landlord in writing of any spill, release, discharge, or disposal of any Hazardous Material in, on, or under the Project; and (z) promptly complete and deliver any disclosure or certification requested by Landlord concerning Tenant's, or any Tenant Parties', transportation, storage, use, generation, manufacture or release of Hazardous Materials in, on, or about the Project. Tenant shall be strictly liable to Landlord for any violation of Environmental Requirements cause by Tenant or any Tenant Parties regarding transportation, storage, use, generation, manufacturing, disposal, or release of Hazardous Materials at the Project without regard to the fault or negligence of any other party. No cure or grace period provided in this Lease shall apply to Tenant's obligations to promptly commence and diligently pursue its remediation obligations in accordance with the terms and conditions of this Paragraph. The term "Environmental Requirements" means all applicable present and future statutes, regulations, ordinances, rules, codes, judgments, orders, or other similar enactments of any governmental authority or agency regulating or relating to health, safety, or environmental conditions, including, without limitation, the following: the Comprehensive Environmental Response, Compensation and Liability Act; the Resource Conservation and Recovery Act; and all state and local counterparts thereto, and any regulations or policies

promulgated or issued thereunder. The term "Hazardous Materials" means and includes any substance,

material, waste, pollutant, or contaminant regulated by any Environmental Requirements, asbestos, radioactive materials, and petroleum (including crude oil or any fraction thereof, natural gas liquids, liquefied natural gas, or synthetic gas usable for fuel or mixtures of natural gas and such synthetic gas).

Landlord represents to Tenant that to Landlord's current, actual knowledge there are no Hazardous Materials in reportable quantities at the Building. The phrase "current, actual knowledge of Landlord" shall mean and refer only to the best of the current, actual knowledge of the officers of Landlord having direct, operational responsibility for the Building, with the express limitations and qualifications that the knowledge of any contractor or consultant shall not be imputed to Landlord, and none of such officers has made any special investigation or inquiry, and none of such officers has any duty or obligation of diligent investigation or inquiry, or any other duty or obligation, to acquire or to attempt to acquire information beyond or in addition to the current, actual knowledge of such persons.

Tenant shall have no liability of any kind to Landlord as to Hazardous Materials or spills, releases or disposal thereof on, in or under the Project which arise prior to the Commencement Date, or during the Lease Term, which were caused or permitted by any party other than Tenant, or any Tenant Parties.

Tenant shall indemnify, defend, and hold the Landlord Parties harmless from and against any and all losses (including diminution in value of the Premises or the Project, and loss of rental income from the Project), claims, demands, actions, suits, damages (including punitive damages), costs and expenses (including reasonable attorney, consultant, and expert fees) which are brought or recoverable against, or suffered or incurred by Landlord as a result of: (i) any release of Hazardous Materials on, or from, the Project by Tenant, or any Tenant Parties, or (ii) Tenant's, or any Tenant Parties', breach of, or noncompliance with, this Paragraph, regardless of whether Tenant had knowledge of such noncompliance. Tenant's obligations under this Paragraph shall survive the Expiration Date or earlier termination of this Lease.

Landlord (including Landlord's consultants, lenders, or designees) shall have reasonable access to, and the right to inspect and perform tests at the Premises to assess the condition of the Premises, or determine Tenant's compliance with this Paragraph, or any applicable Environmental Requirements. If such inspection reveals noncompliance by Tenant, Tenant shall promptly reimburse Landlord for the reasonable cost of such inspection and testing. Landlord's receipt of a 'clean' environmental assessment shall in no way release Tenant from its obligations under this Paragraph or constitute a waiver by Landlord of its rights and remedies herein.

31. **Rules and Regulations.** Tenant shall comply with all rules and regulations reasonably established by Landlord covering use of the Premises and the Project. The current rules and regulations are attached hereto as Exhibit B. Landlord shall not have any liability or obligation for the breach of any rules or regulations by other tenants in the Project.
32. **Security Service.** Tenant acknowledges and agrees that, while Landlord may patrol the Project, Landlord is not providing any security services and that Landlord shall not be liable to Tenant for, and except for Landlord's grossly negligence or intentional unlawful acts, Tenant waives any claim against Landlord with respect to, any breach of security or loss by theft or any other damage suffered or incurred by Tenant.
33. **Force Majeure.** Except for monetary obligations, neither Landlord nor Tenant shall be responsible for delays in the performance of its obligations hereunder caused by labor disputes, acts of God, inability to obtain labor or materials, governmental restrictions or regulations or delay in issuance of permits, enemy or hostile governmental action, civil commotion, casualty, and other causes beyond the reasonable control of Landlord or Tenant, as the case may be ("Force Majeure").
34. **Entire Agreement.** This Lease constitutes the entire agreement of Landlord and Tenant with respect to the subject matter hereof. Any prior agreements, promises, negotiations, or representations are superseded by this Lease. This Lease may only be amended by an instrument in writing signed by both parties hereto.
35. **Severability.** If any clause of this Lease is illegal, invalid or unenforceable under present or future laws, then and in that event, it is the intention of the parties that such clause be replaced with a valid clause of similar meaning and that the remainder of this Lease shall not be affected.
36. **Brokers.** Each party represents and warrants to the other that it has dealt with no broker, agent or other person in connection with this transaction and that no broker, agent or other person brought about this transaction, other than the Landlord Broker and Tenant Broker, if any, set forth in Paragraph 1 of this Lease, and each party agrees to indemnify and hold the other harmless from and against any claims by any other broker, agent or



other person claiming a commission or other form of compensation by virtue of having dealt with the indemnifying party with regard to this leasing transaction.

37. Miscellaneous

- a) TIME IS OF THE ESSENCE AS TO THE PERFORMANCE OF TENANT'S AND LANDLORD'S OBLIGATIONS UNDER THIS LEASE.**
- b) Any payments or charges due from Tenant to Landlord hereunder shall be considered rent for all purposes of this Lease.
- c) If the term "Tenant," includes more than one person, firm or corporation, each shall be jointly and severally liable for the obligations of Tenant.
- d) All notices provided under this Lease shall be in writing and shall be sent by registered or certified mail, return receipt requested, or by a reputable national overnight courier service, postage prepaid, or by hand delivery addressed to Landlord or Tenant at the applicable notice address as provided in Paragraph 1 of this Lease. Either party may, by the above notice, change its notice address for all subsequent notices or add an additional party to be copied on all subsequent notices. Except where otherwise provided to the contrary, notice shall be deemed given upon delivery.
- e) Except as otherwise provided in this Lease or as otherwise required by law, in any event where approval or consent is required of either Landlord or Tenant either by the terms of this Lease or otherwise, such approval or consent shall not be unreasonably withheld, conditioned or delayed. This provision shall be self-operative as if such provision was included as part of the approval or consent where the same appears in this Lease or otherwise.
- f) In the event of (i) a default by Tenant of its obligations under the Lease, or (ii) a need by Landlord to effectuate a financing transaction or sale of the Building, or (iii) an assignment or subletting of the Lease by Tenant, then at Landlord's request from time to time, but subject to commercially reasonable confidentiality requirements, Tenant shall furnish Landlord with true and complete copies of its most recent annual and quarterly financial statements prepared by Tenant or Tenant's accountants and any other financial information or summaries that Tenant typically provides to its lenders or shareholders; provided however that Tenant need not comply with this requirement so long as Tenant is a publicly traded company and its financial information is available to Landlord through readily available public services.
- g) Neither this Lease, nor a memorandum of lease, shall be recorded by or on behalf of Tenant; however, upon request by Landlord, Tenant will execute, and Landlord may record, a memorandum of lease.
- h) The normal rule of construction to the effect that any ambiguities are to be resolved against the drafting party shall not be employed in the interpretation of this Lease or any exhibits or amendments to the Lease.
- i) The submission by Landlord to Tenant of this Lease shall have no binding force or effect, shall not constitute an option for the leasing of the Premises, nor confer any right or impose any obligations upon either party until execution of this Lease by both parties.
- j) Words of any gender used in this Lease shall be held and construed to include any other gender, and words in the singular number shall be held to include the plural, unless the context otherwise requires. The captions inserted in this Lease are for convenience only and in no way define, limit or otherwise describe the scope or intent of this Lease, or any provision hereof, or in any way affect the interpretation of this Lease.
- k) Any amount not paid by a party to the other when due shall bear interest from such due date until paid in full at the lesser of the highest rate permitted by applicable law or 15 percent per year. Construction and interpretation of this Lease shall be governed by the laws of the state in which the Project is located, excluding any principles of conflicts of laws.
- l) All exhibits and addenda attached hereto are hereby incorporated into this Lease and made a part hereof. In the event of any conflict between such exhibits or addenda and the terms of this Lease, such exhibits or addenda shall control.
- m) In the event either party initiates litigation to enforce the terms and provisions of this Lease, the non-prevailing party in such action shall reimburse the prevailing party for its reasonable attorney's fees, filing fees, and court costs.
- n) Tenant agrees that Landlord shall have the right, without Tenant's consent, to place a solar electric generating system on the roof of the Building or enter into a lease for the roof of the Building whereby such roof tenant shall have the right to install a solar electric generating system on the roof of the Building (provided that the exercise of Landlord's rights does not adversely affect Tenant's use and occupancy of the Premises or subject Tenant to additional costs). In the event that Landlord controls such solar electric generating system and the use of the benefits therefrom, Landlord and Tenant shall use good faith efforts to negotiate and sign a separate agreement for Tenant's use of the electrical benefits of such system. Except as provided otherwise in this Lease (i.e. for typical Tenant signage identifying Premises location in the Building), Tenant hereby waives all rights to use, and agrees and acknowledges that Landlord shall retain the exclusive right to the use of the exterior of the Building and Project for any signage purposes, virtual or

otherwise. Landlord may request in writing, and Tenant shall deliver to Landlord, at Tenant's sole cost and

expense, data regarding utility usage consumed in the operation of the Premises as required by applicable law and for the purposes of benchmarking or in order to provide, maintain, improve, and keep in good working order the Project. Tenant can satisfy the requirement to provide utility data by either: (a) executing a written consent as necessary for Landlord to obtain such information directly from the utility company, or (b) providing the data to Landlord in an electronic format reasonably acceptable to Landlord.

- o) This agreement may be executed in multiple counterparts, each of which shall be considered an original, but all of which shall constitute one and the same agreement. The signature of a party transmitted electronically (e.g., e-signature) or by facsimile, PDF and/or other electronic image file format shall constitute and have the same force and effect as the original signature of the party. Following execution, a PDF (or similar image file format) of this entire agreement (whether signed electronically or in ink) shall be considered to be the original agreement for all purposes.
- p) All references and uses of the term "days" in this Lease shall mean calendar days unless otherwise specified.
- q) Within fifteen (15) days of Landlord's written request, Tenant agrees to deliver to Landlord such information and/or documents as Landlord requires for Landlord to comply with California Public Resources Code Section 25402.10, or successor statute(s), and California Energy Commission adopted regulations set forth in California Code of Regulations, Title 20, Division 2, Chapter 4, Article 9, Sections 1680-1685, and successor and related California Code of Regulations, relating to commercial building energy ratings. Landlord makes the following statement based on Landlord's actual knowledge in order to comply with California Civil Code Section 1938: The Building and Premises have not undergone an inspection by a Certified Access Specialist ("CASp"). A CASp can inspect the subject Premises and determine whether the subject Premises comply with all of the applicable construction-related accessibility standards under state law. Although state law does not require a CASp inspection of the subject Premises, the Landlord may not prohibit the Tenant from obtaining a CASp inspection of the subject Premises for the occupancy or potential occupancy of the Tenant, if requested by the Tenant. The parties shall mutually agree on the arrangements for the time and manner of the CASp inspection, the payment of the fee for the CASp inspection, and the cost of making any repairs necessary to correct violations of construction-related accessibility standards within the Premises. Landlord and Tenant hereby agree that a Tenant-requested CASp inspection shall be at Tenant's sole cost and expense and that the cost of making any repairs necessary to correct violations of construction-related accessibility standards within the Premises shall be governed by Paragraph 4 of the Lease.
- r) Tenant represents to Landlord and Landlord hereby represents to Tenant that,
 - (i) such entity, nor any person or entity that directly owns a 10% or greater equity interest in it nor any of its officers, directors or managing members is a person or entity (each, a "Prohibited Person") with whom U.S. persons or entities are restricted from doing business under regulations of the Office of Foreign Asset Control ("OFAC") of the Department of the Treasury, including those parties names on the OFAC's Specially Designated and Blocked Persons List and those covered pursuant to Executive Order 13224 (the "Executive Order") signed on September 24, 2001, entitled "Blocking Property and Prohibiting Transactions with Persons Who Commit, Threaten to Commit, or Support Terrorism), or other governmental action; and
 - (ii) that such entity's activities do not violate the International Money Laundering Abatement and Financial Anti-Terrorism Act of 2001 or USA Patriot Act or the regulations or orders promulgated thereunder (as amended from time to time, the "Money Laundering Acts").

38. WAIVER OF JURY TRIAL. TENANT AND LANDLORD WAIVE ANY RIGHT TO TRIAL BY JURY OR TO HAVE A JURY PARTICIPATE IN RESOLVING ANY DISPUTE (IN CONTRACT, TORT, OR OTHERWISE), BETWEEN LANDLORD AND TENANT ARISING OUT OF THIS LEASE OR ANY OTHER INSTRUMENT, DOCUMENT, OR AGREEMENT EXECUTED OR DELIVERED IN CONNECTION HERewith OR THE TRANSACTIONS RELATED HERETO.

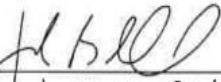
[SIGNATURE PAGES TO FOLLOW]



IN WITNESS WHEREOF, Landlord and Tenant have executed this Lease as of the Effective Date.

TENANT:

Energy Recovery Inc., a Delaware
corporation

By: 
Name: JOSHUA BALLARD
Title: CFO

LANDLORD:

PROLOGIS, L.P.
a Delaware limited partnership

By: Prologis, Inc., a Maryland
corporation, its general partner

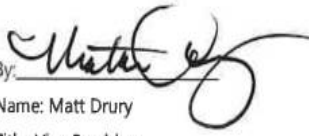
By: 
Name: Matt Drury
Title: Vice President



Exhibit A: SITE PLAN

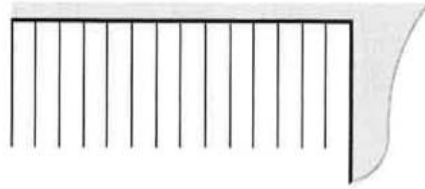


Exhibit B: PROJECT RULES AND REGULATIONS

1. The sidewalk, entries, and driveways of the Project shall not be obstructed by Tenant, or its agents, or used by them for any purpose other than ingress and egress to and from the Premises.
2. Tenant shall not place any personal property or objects in the parking areas, landscaped areas or other areas outside of its Premises, or on the roof of the Project.
3. Except for service dogs, no animals shall be allowed in, or on, any part of the Building or the Project.
4. If Tenant desires telegraphic, telephonic or other electric connections in the Premises, Landlord or its agent will direct the electrician as to where and how any conduit or wires may be introduced; and, without such direction, no boring or cutting of existing wires or conduit is permitted. Any such installation or connection shall be made at Tenant's expense.
5. Tenant shall not install or operate any steam or gas boiler. Except with respect to Tenant's manufacturing process including the approved kiln, the use of oil, gas or flammable liquids for heating, lighting or any other purpose is expressly prohibited. Explosives or other articles deemed extra hazardous shall not be brought into the Project.
6. Parking any type of recreational vehicles or boats is specifically prohibited on or about the Project. Parking any type of trucks, trailers or other vehicles in the Building is specifically prohibited. In no event shall any inoperable vehicles be parked at the Project, nor shall any "For Sale" or other advertising signs be displayed for any parked vehicle. No repair, maintenance or washing of vehicles shall take place on the Project. All vehicles shall be parked in designated parking areas in conformity with all signs and other markings.
7. Tenant shall maintain the Premises free from rodents, insects and other pests.
8. Landlord reserves the right to exclude or expel from the Project any person who, in the judgment of Landlord, is intoxicated or under the influence of liquor or drugs or who shall in any manner do any act in violation of the Rules and Regulations of the Project.
9. All moveable trash receptacles provided by the trash disposal firm for the Premises must be kept in the trash enclosure areas provided, and all trash receptacles shall remain closed at all times.
10. The Premises shall not be used for lodging, sleeping or cooking (other than kitchenette or break room use) or for any immoral or illegal purposes or for any purpose other than that specified in the Lease. No gaming devices shall be operated in the Premises except personal devices in employee break rooms and only in accordance with Legal Requirements.
11. Except for Landlord's gross negligence, Tenant assumes full responsibility for protecting the Premises from theft, robbery and pilferage.
12. Tenant shall not permit recreational or medical marijuana to be grown, sold, dispensed, or consumed on the Premises or Project.
13. Tenant shall not permit smoking in any interior area of the Premises.
14. Tenant shall provide advance notice to Landlord of the date Tenant, or Tenant Parties, require access to the roof of the Building. Tenant shall follow all Legal Requirements, including, but not limited to, OSHA requirements, when Tenant or Tenant Parties access the roof of the Building, and shall use reasonable and appropriate safety precautions in order to ensure such employees, contractors, or agents are not subject to injury or death.

Exhibit C: FORM OF COMMENCEMENT DATE CERTIFICATE

Notice Contact Name
Company Name
Notice Street Address
City, State Zip Code

RE: Lease dated _____, 20__ between Landlord and Tenant for Premises Address

Dear Salutation Notice Contact Last Name:

Welcome to your new facility. We would like to confirm the terms of the above referenced lease agreement:

Commencement Date:	Date
Expiration Date:	Date
Base Rent Commencement Date:	Date

We are pleased to welcome you as a customer of Prologis and look forward to working with you. Please indicate your agreement with the above changes to your lease by signing and returning the enclosed copy of this letter to me. If I can be of service, please do not hesitate to contact me.

Sincerely,

Property Manager Name
Title

Accepted by: Tenant Date:

By: _____

Printed: _____

Title: _____



Exhibit D: MOVE-OUT CONDITIONS

Tenant shall surrender the Premises in the same condition as received, ordinary wear and tear, casualty loss, and condemnation covered by Paragraphs 16 and 17 excepted.

Before surrendering the Premises, Tenant shall remove all personal property, trade fixtures, and such alterations or additions to the Premises made by Tenant as may be required herein. The following list is designed to assist Tenant with the move-out procedures. Upon Tenant's completion of its surrender obligations as provided in this Lease, please contact Landlord's property manager to coordinate turning in keys, utility and fiberoptic internet changeover, and scheduling an inspection of the Premises. In the event Tenant fails to arrange a joint inspection of the Premises with Landlord upon Tenant's vacating of the Premises, Landlord's inspection at, or subsequent to, Tenant's vacation of the Premises shall be conclusively deemed correct for the purpose of determining Tenant's responsibilities with respect to the repair and restoration of the Premises.

1. Lights: All interior office, warehouse, dock, emergency and exit lights will be fully operational with all bulbs, ballasts and fixtures functioning.
2. Dock Levelers, Service Doors and Truck Doors: All truck doors, service doors, and dock levelers shall be serviced and placed in good operating order, including the replacement of any dented or damaged truck door panels and adjustment of door tension to insure proper operation. All door panels which are replaced must be painted to match the building standard.
3. Dock Seals/Dock Bumpers: Free of tears and broken backboards repaired. All dock bumpers must be left in place and well secured.
4. Columns: All columns in the warehouse and office shall be inspected for damage caused by Tenant. Necessary structural repairs must be pre-approved by Landlord prior to implementation. Any markings removed.
5. Warehouse Floor: Free of stains and swept clean with no racking bolts and other protrusions or holes left in floor. Cracks, spalling, and racking bolt damage must be repaired with mm-80 (or equivalent) epoxy or polymer to match concrete color and finished smooth with slab surface. All floor striping (including paint or tape) in the Premises shall be removed with no residual staining or other indication that such striping or taping existed.
6. Tenant-Installed Equipment and Wiring: Air lines, conveyor or process electrical distribution, junction boxes, conduit, etc., removed and space returned to the original condition when leased.
7. Walls: Sheetrock (drywall) and/ or plywood damage patched and fire-taped so that there are no holes in either office or warehouse walls. Any damage to perimeter concrete or metal walls similarly repaired.
8. Floor Finishes (Carpet and Tile): Carpet and vinyl or ceramic tiles should be in a clean condition and absent any holes or chips, ordinary wear and tear excepted provided they have been maintained.
9. Roof: Any Tenant-installed equipment must be removed with all roof penetrations properly repaired by a licensed roofing contractor approved by Landlord. Leaks arising from any Tenant-installed equipment or roof penetrations must be fixed in accordance with Landlord's maintenance and repair recommendations.
10. Signs: All exterior signs must be removed with holes patched and painted to match Building standard paint as necessary. All window or other interior signs must be removed.
11. Electrical & Plumbing: All electrical and plumbing equipment to be returned in good working condition conforming to code.
12. Overall Cleanliness: Clean windows, sanitize bathroom(s), vacuum carpet, and remove all trash and debris from office and warehouse. Remove all pallets and debris from exterior of Premises. All trade fixtures, dumpsters, racking, vending machines and other personal property to be removed.
13. Odors: Remove any lingering odor which may exist in the Premises resulting from Tenant's use and occupancy prior to surrendering or vacating the Premises.

Exhibit E: ONE RENEWAL OPTION AT MARKET (CLEAR LEASE BASEBALL ARBITRATION)

(a) Provided that as of the time of the giving of the First Extension Notice and the Commencement Date of the First Extension Term (as such terms are defined below), (x) Tenant is the Tenant originally named herein, or a Tenant Affiliate or Permitted Transferee (y) Tenant actually occupies all of the Premises initially demised under this Lease and any space added to the Premises, and (z) no Event of Default exists, then Tenant shall have the right to extend the Lease Term for an additional term of 60 months (such additional term is hereinafter called the "First Extension Term") commencing on the day following the expiration of the Lease Term (hereinafter referred to as the "Commencement Date of the First Extension Term"). Tenant must give Landlord notice (hereinafter called the "First Extension Notice") of its election to extend the term of the Lease Term at least 9 months, but not more than 12 months, prior to the Expiration Date.

(b) The Base Rent payable by Tenant to Landlord during the First Extension Term shall be the greater of:

(i) the Base Rent in effect on the Expiration Date (if the Base Rent is stated as an annual or other periodic rate, adjusted for the length of the Lease Term), and

(ii) the Fair Market Rent, as defined and determined pursuant to Paragraphs (c) and (d) below.

(c) The term "Fair Market Rent" shall mean the Base Rent, expressed as an annual rent per square foot of floor area, which Landlord would have received from leasing the Premises for the First Extension Term to an unaffiliated person which is not then a tenant in the Project, assuming that such space were to be delivered in "as-is" condition, and taking into account the rental which such other tenant would most likely have paid for such premises, including market escalations, provided that Fair Market Rent shall not in any event be less than the Base Rent for the Premises as of the expiration of the Lease Term. Fair Market Rent shall not be reduced by reason of any costs or expenses saved by Landlord by reason of Landlord's not having to find a new tenant for the Premises (including without limitation brokerage commissions, cost of improvements necessary to prepare the space for such tenant's occupancy, rent concession, or lost rental income during any vacancy period). Fair Market Rent means only the rent component defined as Base Rent in the Lease and does not include reimbursements and payments by Tenant to Landlord with respect to Monthly FOE, Taxes, or other items payable or reimbursable by Tenant under the Lease. In addition to its obligation to pay Base Rent (as determined herein), Tenant shall continue to pay and reimburse Landlord as set forth in the Lease with respect to such Monthly FOE (subject to be increased by Landlord), Taxes, and other items with respect to the Premises during the First Extension Term. The arbitration process described below shall be limited to the determination of the Base Rent and shall not affect or otherwise reduce or modify the Tenant's obligation to pay or reimburse Landlord for such Monthly FOE, Taxes, and other reimbursable items.

(d) Landlord shall notify Tenant of its determination of the Fair Market Rent for the First Extension Term, along with the Monthly FOE and the Annual FOE Increase, each as determined in Landlord's reasonable determination based on the Project's actual operating expenses and Landlord's expectation of annual increases, applicable to the First Extension Term (the "Fair Market Rent Notice"), and Tenant shall deliver written notice to Landlord within 10 days of receipt of the Fair Market Rent Notice of any objection to the Fair Market Rent Notice. Failure to respond within the 10-day period shall constitute Tenant's acceptance of such Fair Market Rent, Monthly FOE, and the Annual FOE Increase. If Tenant objects, Landlord and Tenant shall commence negotiations to attempt to agree upon the Fair Market Rent within 30 days of Landlord's receipt of Tenant's notice. If the parties cannot agree, each acting in good faith but without any obligation to agree, then the Lease Term shall not be extended and shall terminate on its scheduled termination date and Tenant shall have no further right hereunder or any remedy by reason of the parties' failure to agree unless Tenant or Landlord invokes the arbitration procedure provided below to determine the Fair Market Rent. Notwithstanding anything contained herein to the contrary, in no event shall either party have the right to invoke the arbitration provision as provided herein until Landlord and Tenant have mutually agreed (or be deemed to have agreed) to the Monthly FOE and Annual FOE Increase applicable during the First Extension Term, and any attempt to invoke arbitration absent such agreement shall be null and void. The arbitration process described below shall be limited to the determination of the Base Rent and shall not affect or otherwise reduce or modify the Tenant's obligation to pay or reimburse Landlord for the Monthly FOE, Taxes, or any other reimbursable items.

(e) Arbitration to determine the Fair Market Rent shall be in accordance with the Real Estate Valuation Arbitration Rules of the American Arbitration Association. Unless otherwise required by state law, arbitration shall be conducted in the metropolitan area where the Project is located by a single arbitrator unaffiliated with either party. Either party may elect to arbitrate by sending written notice to the other party and the Regional Office of the American Arbitration Association within 5 days after the 30-day negotiating period provided in Paragraph (d), invoking the binding arbitration provisions of this paragraph. Landlord and Tenant shall each submit to the arbitrator their

respective proposal of Fair Market Rent. The arbitrator must choose between the Landlord's proposal and the Tenant's

proposal and may not compromise between the two or select some other amount. Notwithstanding any other provision herein, the Fair Market Rent determined by the arbitrator shall not be less than, and the arbitrator shall have no authority to determine a Fair Market Rent less than, the Base Rent in effect as of the scheduled expiration of the Lease Term. The cost of the arbitration shall be paid by Landlord if the Fair Market Rent is that proposed by Tenant and by Tenant if the Fair Market Rent is that proposed by Landlord; and shall be borne equally otherwise. If the arbitrator has not determined the Fair Market Rent as of the end of the Lease Term, Tenant shall pay 105 percent of the Base Rent in effect under the Lease as of the end of the Lease Term until the Fair Market Rent is determined as provided herein. Upon such determination, Landlord and Tenant shall make the appropriate adjustments to the payments between them.

(f) The parties consent to the jurisdiction of any appropriate court to enforce the arbitration provisions of this Exhibit and to enter judgment upon the decision of the arbitrator.

(g) Except for the Base Rent, Monthly FOE, and the Annual FOE Increase, Tenant's occupancy of the Premises during the First Extension Term shall be on the same terms and conditions as are in effect immediately prior to the expiration of the initial Lease Term; provided, however, Tenant shall have no further right to extend the Lease Term pursuant to this Exhibit or to any allowances, credits or abatements or options to expand, contract, renew or extend the Lease.

(h) If Tenant does not send the First Extension Notice within the period set forth in Paragraph (a), Tenant's right to extend the Lease Term shall automatically terminate. Time is of the essence as to the giving of the First Extension Notice and the notice of Tenant's objection under Paragraph (d).

(i) Landlord shall have no obligation to refurbish or otherwise improve the Premises for the First Extension Term. The Premises shall be tendered on the Commencement Date of the First Extension Term in "as-is" condition.

(j) If the Lease is extended for the First Extension Term, then Landlord shall prepare and Tenant shall execute an amendment to the Lease confirming the extension of the Lease Term, the Base Rent, the Monthly FOE, and the Annual FOE Increase applicable to the First Extension Term, and the other provisions applicable thereto (the "Amendment").

(k) If Tenant exercises its right to extend the term of the Lease for the First Extension Term pursuant to this Exhibit, the term "Lease Term" as used in the Lease, shall be construed to include, when practicable, the First Extension Term except as provided in (g) above.



EXHIBIT F: CONSTRUCTION

(a) In addition to a clean and freshly painted office and broom cleaned warehouse, Landlord agrees to perform at Landlord's sole cost and expense the following improvements (the "Initial Improvements"):

- Landlord to install additional 800 amps power in order to upgrade electrical service to 1,000 amps at 277/480 volt, 3 phase.

(b) If Tenant shall desire any changes, Tenant shall advise Landlord in writing and Landlord shall determine whether such changes can be made in a reasonable and feasible manner. All costs of reviewing any requested changes, and all costs of making any changes to the Initial Improvements which Tenant may request and which Landlord may agree to shall be at Tenant's sole cost and expense and shall be paid to Landlord upon demand and before execution of the change order.

(c) Landlord shall proceed with and complete the construction of the Initial Improvements at lease signing. As soon as such improvements have been Substantially Completed, Landlord shall notify Tenant in writing of the date that the Initial Improvements were Substantially Completed. The Initial Improvements shall be deemed substantially completed ("Substantially Completed" or "Substantial Completion") when, Landlord has received permit sign-offs from the relevant authority for the Initial Improvements and in the opinion of the construction manager (whether an employee or agent of Landlord or a third party construction manager) ("Construction Manager"), the Initial Improvements are substantially completed except for punch list items which do not prevent in any material way the use of the Initial Improvements for the purposes for which they were intended. In the event Tenant, its employees, agents, or contractors cause construction of such improvements to be delayed, the date of Substantial Completion shall be deemed to be the date that, in the opinion of the Construction Manager, Substantial Completion would have occurred if such delays had not taken place. Tenant shall be solely responsible for delays caused by Tenant's request for any changes in the plans, Tenant's request for long lead items or Tenant's interference with the construction of the Initial Improvements, and such delays shall not cause a deferral of the Commencement Date. After the date the Initial Improvements are Substantially Completed Tenant shall, upon demand, execute and deliver to Landlord a letter of acceptance of the Initial Improvements. In the event of any dispute as to the Initial Improvements the certificate of the Construction Manager shall be conclusive absent manifest error. Landlord, at Landlord's sole cost, agrees to enforce to Tenant's benefits any guarantees or warranties, if any, that Landlord receives for the Initial Improvements and which relate to any maintenance or repair to be completed by Tenant; additionally, Landlord shall use commercially reasonable efforts to get at least a 1-year warranty on the Initial Improvements otherwise on industry-standard terms.

(d) Additionally, at Tenant's sole cost, Landlord agrees to perform the following improvements ("Tenant Improvements")

- Landlord, in conjunction with a mutually approved General Contractor, agrees to assist with and help coordinate the installation of natural gas into the Premises. Landlord shall advise tenant of expected costs of such work prior to commencement of work and Tenant agrees to pay 50% of the total expected cost prior to start ("The 50% Deposit") and the remaining balance within 15 days of completion of Tenant Improvements.

(e) Landlord shall proceed with the construction of the Tenant Improvements at the written request of Tenant and after receipt of the The 50% Deposit. As soon as such improvements have been Substantially Completed, Landlord shall notify Tenant in writing of the date that the Tenant Improvements were Substantially Completed and will provide a written request for the remaining balance due, which shall be due within 15 days of receipt of written request. The Tenant Improvements shall be deemed substantially completed ("Substantially Completed" or "Substantial Completion") when, in the opinion of the construction manager (whether an employee or agent of Landlord or a third party construction manager) ("Construction Manager"), the Tenant Improvements are substantially completed except for punch list items which do not prevent in any material way the use of the Tenant Improvements for the purposes for which they were intended. In the event Tenant, its employees, agents, or contractors cause construction of such improvements to be delayed, the date of Substantial Completion shall be deemed to be the date that, in the opinion of the Construction Manager, Substantial Completion would have occurred if such delays had not taken place. Tenant shall be solely responsible for delays caused by Tenant's request for any changes in the plans, Tenant's request for long lead items or Tenant's interference with the construction of the Tenant Improvements, and such delays shall not cause a deferral of the Commencement Date. After the date the Tenant Improvements are Substantially Completed Tenant shall, upon demand, execute and deliver to Landlord a letter of acceptance of the Tenant Improvements. In the event of any dispute as to the Tenant Improvements the certificate of the Construction Manager shall be conclusive absent manifest error.



(d) Tenant's failure to take possession of or to occupy the Premises shall not serve to relieve Tenant of its obligations arising on the Commencement Date or to delay the payment of rent by Tenant. Subject to applicable Legal Requirements, Tenant shall be allowed to install its own improvements, Trade Fixtures or other property on the Premises during the final stages of Landlord's construction, estimated to be approximately February 16, 2020 (and subject to Force Majeure delays), provided that Tenant does not interfere with completion of Landlord's construction or cause any labor dispute. Tenant hereby agrees to indemnify, defend, and hold Landlord harmless from any loss or damage to such property, and all liability, loss, or damage arising from any injury to the Project or the property of Landlord, its contractors, subcontractors, or materialmen, and any death or personal injury to any person or persons arising out of such installations, unless any such loss, damage, liability, death, or personal injury was caused by Landlord's negligence. Any such occupancy or installation of Tenant's own improvements or Trade Fixtures in the Premises shall be in accordance with the provisions governing Tenant-Made Alterations and Trade Fixtures in the Lease, and shall be subject to Tenant providing to Landlord satisfactory evidence of insurance for personal injury and property damage related to such installations and satisfactory payment arrangements with respect to installations permitted hereunder. Delay in putting Tenant in possession of the Premises shall not serve to extend the Lease Term or to make Landlord liable for any damages arising therefrom.



EXHIBIT G: STORAGE AND USE OF PERMITTED HAZARDOUS MATERIALS

1. Permitted Hazardous Materials and Use. Tenant has requested Landlord's consent to Use (hereinafter defined) the Hazardous Materials listed below in its business at the Project (the "Permitted Hazardous Materials"). Landlord hereby consents to the Use of the Permitted Hazardous Materials subject to the terms of this Exhibit. Any Use of the Permitted Hazardous Materials in, on, or about the Project shall be done in a manner consistent with good engineering practice and in compliance with all Environmental Requirements.

Permitted Hazardous Materials (including maximum quantities):

List of Flammable Materials for 2000 Chabot, Tracy						
Item	Name	Type	Flammability Category	Application	Container size	unit size
1	BOESHIELD-T-9	Aerosole	1	Corrosion Inhibitor	4	oz
2	Canola Oil Cooking Spray	Aerosole	4	Lubricant	17	oz
3	Cote All	Liquid	3	Lubricant	1	qrt
4	Isopropyl Alcohol	Liquid	2	Cleaner	22	oz
5	Klean-Strip Industrial Maintenance Coating Thinner	Liquid	2	Cleaner	1	gal
6	Klean-Strip Thinner	Liquid	3	Cleaner	1	gal
7	Krylon	Liquid	2	Paint	1	gal
8	Lecoset 7000 Liquid I	Liquid	3	Molding	1	qrt
9	Liquid Grease Arerosole	Aerosole	4	Lubricant	8	oz
10	Nalco 71D5 Plus	Liquid	4	Cleaner	25	kg
11	Rockhound Oil	Liquid	1	Lubricant	1	gal
12	SKC-S	Aerosole	2	Cleaner	16	oz
13	TRI-FLOW® Industrial Lubricant	Aerosole	1	Lubricant	12	oz
14	WD40	Liquid	3	Lubricant	16.6	oz
15	ZYGLO® ZL-27A - aerosol	Aerosole	1	Paint	16	oz
Item	Name	Type	Flammability Category	Application	Container size	unit size
16	Ammonium Hydroxide	Liquid	N/A	De-greaser	1	qrt
17	Calcined Alumina	Powder	N/A	Raw Material, Non-Hazardous	650	lb
18	Cimperial 1070	Liquid	N/A	Grinding Fluid	5	gal
19	Electrolyte Formula MSC4	Liquid	N/A	Cleaner	1	qrt
20	Hydrolubric 120	Liquid	N/A	Lubricant	1	drum
21	Hyperz W lubricant	Liquid	N/A	Lubricant	1	qrt
22	Loctitte LB8014	Liquid	N/A	Lubricant	8	oz
23	Micro-90 concentrated Cleaner	Liquid	N/A	Cleaner	1	gal
24	Sulflo #1	Liquid	N/A	Lubricant	1	gal

25	ZYGLO ZL-4C	Liquid	N/A	Paint	1 gal
----	-------------	--------	-----	-------	-------

26	Drywall Primer	Liquid	N/A	Paint	5 gal
27	HYP-R25	Liquid	N/A	Lubricant	1 gal
28	Lubrimatic LMX	Gel	N/A	Lubricant	20 oz
29	RoClean P111	Powder	N/A	Cleaner	45 lb
30	Sodium Hydroxide	Powder	N/A	De-greaser	1 lb
31	Triadine 20 Industrial Microbiostat	Liquid	N/A	Anti-septic	1 qrt
32	Ty-Ion B20	Liquid	N/A	Corrosion Inhibitor	1 gal
33	Clorox toilet bowl cleaner	Liquid	N/A	Cleaner	1 qrt
34	Uline S-249	Aerosole	N/A	Paint	17 oz
35	Cimperial 1070	Liquid	N/A	Coolant	5 gal
	Category 1	A flashpoint below 73.4 F and boiling point below 95 F			
	Category 2	A flashpoint below 73.4 F and boiling point above 95 F			
	Category 3	A flashpoint above 73.4 F and at or below 140 F			
	Category 4	A flashpoint above 140 F and at or below 199.4 F			

Use. The generation, receipt, maintenance, treatment, manufacturing, storage, use, process, transportation, or disposal (the "Use") involving the Permitted Hazardous Materials are further described below [If limited to receiving and storage, so specify]:

See attached table above.

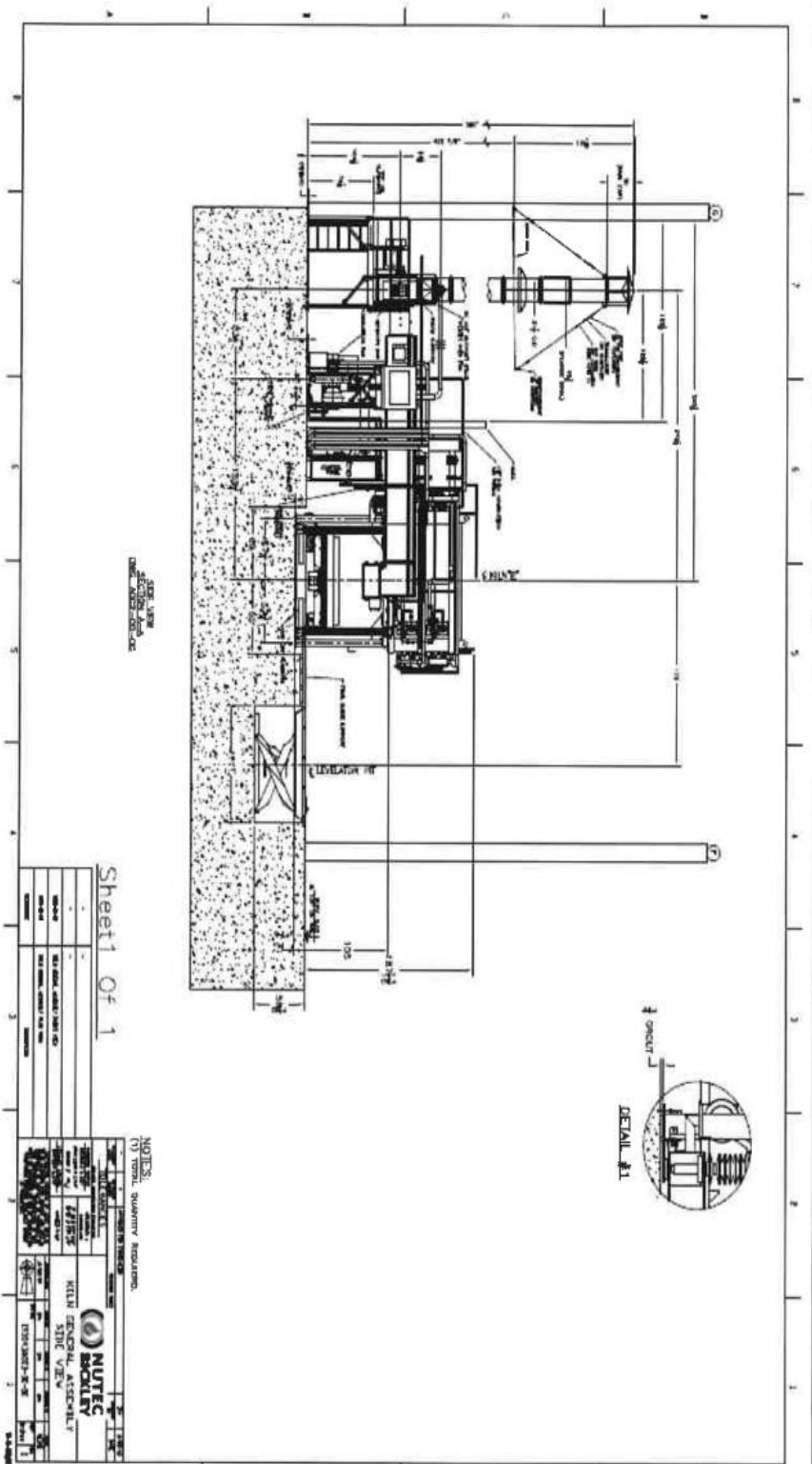
2. No Current Investigation. Tenant represents and warrants that it is not currently subject to an inquiry, regulatory investigation, enforcement order, or any other proceeding regarding the generation, use, treatment, storage, or disposal of a Hazardous Material.

3. Indemnification. Tenant's indemnity obligation under the Lease with respect to Hazardous Materials shall include indemnification for Tenant, or any Tenant Parties', Use of Hazardous Materials, or Tenant's breach of obligations or representations set forth herein. Tenant shall be strictly liable to Landlord as a result of Tenant or any Tenant Parties' Use of Hazardous Materials without regard to the fault or negligence of any other party.

4. Disposal Upon Lease Termination. At the expiration or earlier termination of the Lease Term, Tenant, at its sole cost and expense, shall, in strict compliance with all applicable Environmental Requirements: (i) remove and dispose of any drums, containers, receptacles, structures, or tanks storing or containing (or which have stored or contained) Hazardous Materials and the contents thereof; (ii) remove, empty, and purge all underground and above ground storage tank systems, including connected piping, of all vapors, liquids, sludges, and residues; (iii) close out any permits, registrations, business plans, etc. with the relevant authorities; and (iv) complete the decontamination of any ventilation systems, structural elements, flooring, and other elements of the Project affected by such Use of Hazardous Materials. Tenant's obligations under this Paragraph shall survive any expiration or termination of this Lease.



EXHIBIT H: PRELIMINARY PLANS FOR KILN



Sheet 1 of 1

NO.	DESCRIPTION	DATE
1	REVISION	
2	REVISION	
3	REVISION	

NOTES: SUMMARY REQUIRED

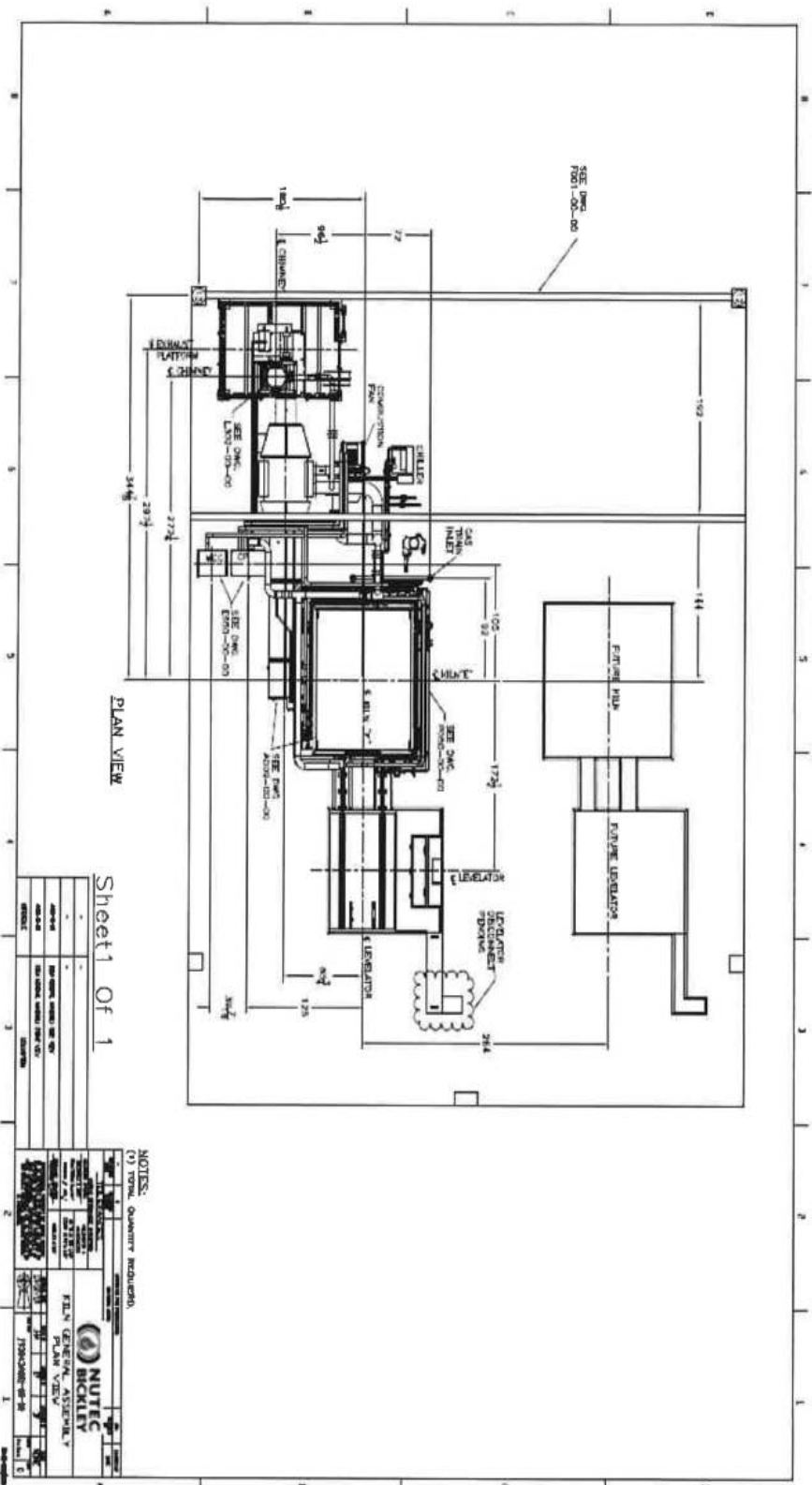
MUTEC
ROCKLEY

KILN DESIGN AND ASSEMBLY

1234567890

1234567890





PLAN VIEW

Sheet 1 of 1

NO.	DESCRIPTION	QTY.	UNIT
1	...	...	...
2	...	...	...
3	...	...	...
4	...	...	...
5	...	...	...
6	...	...	...
7	...	...	...
8	...	...	...
9	...	...	...
10	...	...	...
11	...	...	...
12	...	...	...
13	...	...	...
14	...	...	...
15	...	...	...
16	...	...	...
17	...	...	...
18	...	...	...
19	...	...	...
20	...	...	...
21	...	...	...
22	...	...	...
23	...	...	...
24	...	...	...
25	...	...	...
26	...	...	...
27	...	...	...
28	...	...	...
29	...	...	...
30	...	...	...
31	...	...	...
32	...	...	...
33	...	...	...
34	...	...	...
35	...	...	...
36	...	...	...
37	...	...	...
38	...	...	...
39	...	...	...
40	...	...	...
41	...	...	...
42	...	...	...
43	...	...	...
44	...	...	...
45	...	...	...
46	...	...	...
47	...	...	...
48	...	...	...
49	...	...	...
50	...	...	...
51	...	...	...
52	...	...	...
53	...	...	...
54	...	...	...
55	...	...	...
56	...	...	...
57	...	...	...
58	...	...	...
59	...	...	...
60	...	...	...
61	...	...	...
62	...	...	...
63	...	...	...
64	...	...	...
65	...	...	...
66	...	...	...
67	...	...	...
68	...	...	...
69	...	...	...
70	...	...	...
71	...	...	...
72	...	...	...
73	...	...	...
74	...	...	...
75	...	...	...
76	...	...	...
77	...	...	...
78	...	...	...
79	...	...	...
80	...	...	...
81	...	...	...
82	...	...	...
83	...	...	...
84	...	...	...
85	...	...	...
86	...	...	...
87	...	...	...
88	...	...	...
89	...	...	...
90	...	...	...
91	...	...	...
92	...	...	...
93	...	...	...
94	...	...	...
95	...	...	...
96	...	...	...
97	...	...	...
98	...	...	...
99	...	...	...
100	...	...	...

NOTES:
 (1) TOTAL QUANTITY REQUIRED

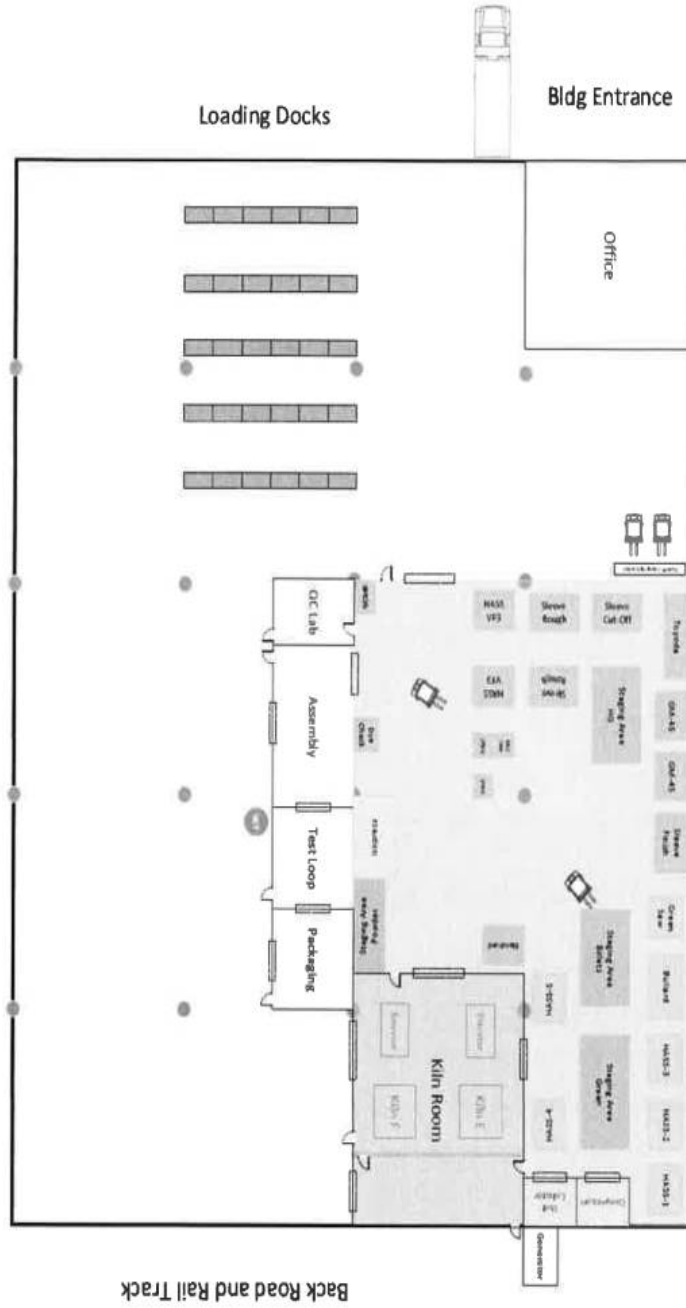
NUTEC
ROULET

FLN GENERAL ASSEMBLY
 PLAN VIEW

17500000-01-01



EXHIBIT I: SITE PLAN FOR INITIAL TENANT-MADE ALTERATIONS





**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, Robert Yu Lang Mao, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Energy Recovery, Inc. for the period ended March 31, 2020;
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: May 1, 2020

/s/ ROBERT YU LANG MAO

Name: Robert Yu Lang Mao

Title: Interim President and Chief Executive Officer
(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 March 31, 2020;
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: May 1, 2020

/s/ JOSHUA BALLARD

Name: Joshua Ballard

Title: Chief Financial Officer

(Principal Financial and Accounting 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, Robert Yu Lang Mao, Interim 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 March 31, 2020, 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: May 1, 2020

/s/ ROBERT YU LANG MAO

Robert Yu Lang Mao

Interim President and Chief Executive Officer

Date: May 1, 2020

/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.