Energy Recovery, Inc.
Form 10-Q
November 06, 2009

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

(Mark One)

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

For the quarterly period ended September 30, 2009

OR

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

For the transition period from __________ to __________

Commission File Number: 001-34112

Energy Recovery, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**01-0616867**
(State of Incorporation)	**(IRS Employer Identification No.)**
1908 Doolittle Drive **San Leandro, CA 94577**	**94577**
(Address of Principal Executive Offices)	**(Zip Code)**

(510) 483-7370
(Telephone No.)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes o No o

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

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

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

As of October 31, 2009, there were 50,165,344 shares of the registrant s common stock outstanding.

ENERGY RECOVERY, INC.
QUARTERLY REPORT ON FORM 10-Q FOR THE PERIOD ENDED SEPTEMBER 30, 2009
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PART I FINANCIAL INFORMATION
Item 1. Financial Statements (unaudited)

ENERGY RECOVERY, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except share data)
(unaudited)

	September 30, 2009	December 31, 2008
ASSETS		
Current assets:		
Cash and cash equivalents	$ 74,725	$ 79,287
Restricted cash	2,938	246
Accounts receivable, net of allowance for doubtful accounts of $28 and $59 at September 30, 2009 and December 31, 2008, respectively	10,319	20,615
Unbilled receivables, current	6,315	4,948
Inventories	10,510	8,493
Deferred tax assets, net	1,950	1,755
Prepaid income taxes	749	
Prepaid expenses and other current assets	1,515	984
Total current assets	109,021	116,328
Unbilled receivables, non-current	229	1,929
Restricted cash, non-current	2,588	19
Property and equipment, net	7,031	1,845
Intangible assets, net	309	321
Deferred tax assets, non-current, net	106	119
Other assets, non-current	52	51
Total assets	$ 119,336	$ 120,612
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 803	$ 2,270
Accrued expenses and other current liabilities	4,778	4,787
Income taxes payable	38	1,657
Accrued warranty reserve	312	270
Deferred revenue	1,549	4,000
Current portion of long-term debt	128	172
Current portion of capital lease obligations	36	37
Total current liabilities	7,644	13,193
Long-term debt	245	385
Capital lease obligations, non-current		27
Other non-current liabilities	4	8
Total liabilities	7,893	13,613

Commitments and Contingencies (Note 6)				
Stockholders equity:				
Preferred stock, $0.001 par value; 10,000,000 shares authorized; no shares issued or outstanding				
Common stock, $0.001 par value; 200,000,000 shares authorized; 50,164,317 and 50,015,718 shares issued and outstanding at September 30, 2009 and December 31, 2008, respectively		50		50
Additional paid-in capital		100,749		98,527
Notes receivable from stockholders		(88)		(296)
Accumulated other comprehensive loss		(63)		(44)
Retained earnings		10,795		8,762
Total stockholders equity		111,443		106,999
Total liabilities and stockholders equity	$	119,336	$	120,612

See accompanying notes to unaudited Condensed Consolidated Financial Statements.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	**2008**	**2009**	**2008**
Net revenue	$ 9,545	$ 9,044	$ 31,280	$ 30,125
Cost of revenue	3,387	3,497	11,251	11,122
Gross profit	6,158	5,547	20,029	19,003
Operating expenses:				
General and administrative	3,043	2,696	9,705	8,211
Sales and marketing	1,634	1,467	4,795	4,263
Research and development	779	678	2,409	1,723
Total operating expenses	5,456	4,841	16,909	14,197
Income from operations	702	706	3,120	4,806
Other income (expense):				
Interest expense	(10)	(17)	(34)	(62)
Interest and other income (expense), net	30	217	59	841
Income before provision for income taxes	722	906	3,145	5,585
Provision for income taxes	172	283	1,112	2,186
Net income	$ 550	$ 623	$ 2,033	$ 3,399
Earnings per share:				
Basic	$ 0.01	$ 0.01	$ 0.04	$ 0.08
Diluted	$ 0.01	$ 0.01	$ 0.04	$ 0.07
Number of shares used in per share calculations:				
Basic	50,160	49,646	50,120	43,114
Diluted	52,584	52,396	52,614	45,647

See accompanying notes to unaudited Condensed Consolidated Financial Statements.

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

	Nine Months Ended September 30, 2009	Nine Months Ended September 30, 2008
Cash Flows From Operating Activities		
Net income	$ 2,033	$ 3,399
Adjustments to reconcile net income to net cash from operating activities:		
Depreciation and amortization	626	378
Interest accrued on notes receivables from stockholders	(4)	(12)
Stock-based compensation	1,815	676
Net unrealized gain on foreign currency transactions	(458)	(383)
Provision for doubtful accounts	(7)	6
Provision for (reversal of) warranty claims	55	(531)
Provision for excess or obsolete inventory	59	29
Changes in operating assets and liabilities:		
Accounts receivable	10,765	(1,069)
Unbilled receivables	325	495
Inventories	(2,076)	(5,017)
Deferred tax assets	(182)	
Prepaid and other assets	(1,280)	(2,700)
Accounts payable	(1,852)	393
Accrued expenses and other liabilities	(812)	2,653
Income taxes payable	(1,497)	(614)
Deferred revenue	(2,451)	3,489
Net cash provided by operating activities	5,059	1,192
Cash Flows From Investing Activities		
Capital expenditures	(4,635)	(376)
Restricted cash	(5,261)	1,587
Other	(7)	(1)
Net cash (used in) provided by investing activities	(9,903)	1,210
Cash Flows From Financing Activities		
Repayment of long-term debt	(184)	(129)
Repayment of capital lease obligation	(28)	(28)
Net proceeds from issuance of common stock	297	76,808
Repayment of notes receivables from stockholders	212	560
Other short term financing activities		(6)
Net cash provided by financing activities	297	77,205
Effect of exchange rate differences on cash and cash equivalents	(15)	(26)

Net change in cash and cash equivalents	(4,562)	79,581
Cash and cash equivalents, beginning of period	79,287	240
Cash and cash equivalents, end of period	$ 74,725	$ 79,821
Supplemental disclosure of cash flow information		
Cash paid for interest	$ 34	$ 60
Cash paid for income taxes	$ 3,545	$ 4,706
Supplemental disclosure of non-cash transactions		
Issuance of common stock in exchange for notes receivable from stockholders	$	$ 20

See accompanying notes to unaudited Condensed Consolidated Financial Statements.

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

Note 1 The Company and Summary of Significant Accounting Policies

The Company

Energy Recovery, Inc. (the Company or ERI) develops, manufactures and sells high-efficiency energy recovery devices for use in seawater desalination. Our products are sold under the trademarks ERI®, PX®, Pressure Exchanger® and PX Pressure Exchanger®. They make desalination affordable by recycling up to 98% of the otherwise lost pressure energy from the reject stream of the desalination process. Our products are developed and manufactured in the United States of America (U.S.) at ERI s headquarters located in San Leandro, California. The Company has direct sales offices and technical support centers in Madrid, Dubai, Shanghai and Fort Lauderdale.

The Company was incorporated in Virginia in April 1992 and reincorporated in Delaware in March 2001. The Company has three subsidiaries: Osmotic Power, Inc., Energy Recovery, Inc. International, and Energy Recovery Iberia, S.L. They were incorporated in September 2005, July 2006 and September 2006, respectively. ERI became a public company in July 2008.

Use of Estimates

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

Basis of Presentation

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

The accompanying Condensed Consolidated Financial Statements have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. GAAP have been condensed or omitted pursuant to such rules and regulations. The December 31, 2008 Condensed Consolidated Balance Sheet was derived from audited financial statements, but does not include all disclosures required by U.S. GAAP; however, the Company believes that the disclosures are adequate to make the information presented not misleading. Certain prior period amounts have been reclassified to conform to the current period presentation. These unaudited Condensed Consolidated Financial Statements should be read in conjunction with the audited Consolidated Financial Statements and the notes thereto for the fiscal year ended December 31, 2008 included in the Company s Annual Report on Form 10-K filed with the SEC on March 27, 2009.

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

The significant accounting policies followed by the Company for interim financial reporting are consistent with the accounting policies followed for annual financial reporting as disclosed in the Company s Annual Report on Form 10-K for the year ended December 31, 2008.

The Company s financial instruments include cash and cash equivalents, restricted cash, accounts receivable, accounts payable, and debt. The carrying amounts for these financial instruments reported in the consolidated condensed balance sheets approximate their fair values.

Recent Accounting Pronouncements

In June 2009, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2009-1, Topic 105, *Generally Accepted Accounting Principles*, which identifies the FASB Accounting Standards Codification (ASC or Codification) as the single source of authoritative U.S. GAAP effective for financial statements issued for interim and annual periods ending after September 15, 2009. The Codification supersedes all non-SEC accounting and reporting standards. All future accounting standards will be issued in the form of Accounting Standards Updates. Generally, the Codification is not expected to change GAAP. The adoption of the Codification did not have any impact on our condensed consolidated financial statements other than changes to references to applicable accounting guidance.

Effective June 30, 2009, the Company adopted ASC 855 10 05, *Subsequent Events.* This ASC establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued. The adoption of this guidance did not impact the Company s financial position or results of operations. All events or transactions that occurred after September 30, 2009 up through November 6, 2009, the date that these financial statements were available for issuance, have been evaluated. During this period, there were no material recognizable or unrecognizable subsequent events.

In August 2009, the FASB issued ASU No. 2009-05, *Measuring Liabilities at Fair Value.* ASU 2009-05 amends ASC 820, *Fair Value Measurements,* by providing additional guidance on determining the fair value of liabilities when a quoted price in an active market for an identical liability is not available. This ASU will become effective for the Company on October 1, 2009 and is not expected to have a significant impact on the measurement of our liabilities as of that date; however, the ASU may affect the fair value measurement of liabilities for future acquisitions and divestitures.

In October 2009, the FASB issued ASU No. 2009-13, *Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements (a consensus of the FASB Emerging Issues Task Force),* which amends ASC 605-25, *Revenue Recognition: Multiple-Element Arrangements.* ASU No. 2009-13 addresses how to determine whether an arrangement involving multiple deliverables contains more than one unit of accounting and how to allocate consideration to each unit of accounting in the arrangement. This ASU replaces all references to fair value as the measurement criteria with the term selling price and establishes a hierarchy for determining the selling price of a deliverable. ASU No. 2009-13 also eliminates the use of the residual value method for determining the allocation of arrangement consideration. Additionally, ASU No. 2009-13 requires expanded disclosures. This ASU will become effective for the Company for revenue arrangements entered into or materially modified on or after April 1, 2011. Earlier application is permitted with required transition disclosures based on the period of adoption. We are currently evaluating the application date and the impact of this standard on our consolidated financial statements.

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

Note 2 Earnings per Share

In accordance with SFAS No. 128, *Earnings per Share*, the following table sets forth the computation of basic and diluted earnings per share (in thousands, except per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	**2008**	**2009**	**2008**
Numerator:				
Net income	$ 550	$ 623	$ 2,033	$ 3,399
Denominator:				
Weighted average common shares outstanding	50,160	49,646	50,120	43,114
Effect of dilutive securities:				
Nonvested shares				7
Stock options	528	786	582	626

Warrants	1,896	1,964	1,912	1,900
Total shares for purpose of calculating diluted net income per share	52,584	52,396	52,614	45,647
Earnings per share:				
Basic	$ 0.01	$ 0.01	$ 0.04	$ 0.08
Diluted	$ 0.01	$ 0.01	$ 0.04	$ 0.07

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
Stock options	2,877	973	2,196	479
Restricted stock units	60		20	

Note 3 Balance Sheet Details

Restricted Cash

The Company has irrevocable standby letters of credit with two financial institutions securing performance and warranty commitments under contracts with customers and lessors and an outstanding equipment promissory note. The standby letters of credit are collateralized by either a line of credit (see Note 4) or restricted cash. At September 30, 2009 and December 31, 2008, the amount of restricted cash that collateralized irrevocable standby letters of credit was $5.1 million and $0.3 million, respectively. At September 30, 2009, restricted cash of $0.4 million secured the promissory note. The Company has deposited a corresponding amount into non-interest bearing accounts.

Inventories

Inventories consisted of the following (in thousands):

	September 30, 2009	December 31, 2008
Raw materials	$ 4,974	$ 2,894
Work in process	430	139
Finished goods	5,106	5,460
	$ 10,510	$ 8,493

Property and Equipment

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

	September 30, 2009	December 31, 2008
Machinery and equipment	$ 2,827	$ 2,434
Office equipment, furniture, and fixtures	1,100	772
Automobiles	22	22
Software	308	208
Leasehold improvements	476	466
Construction in progress	4,601	
	9,334	3,902
Less: accumulated depreciation and amortization	(2,303)	(2,057)
	$ 7,031	$ 1,845

Of the construction in progress costs at September 30, 2009, $2.5 million related to the construction and installation of specialized manufacturing equipment and $2.1 million related to the build out of leasehold improvements at the Company s new headquarters and manufacturing facilities. As of September 30, 2009, none of the assets related to construction in progress have been placed in service and therefore have not yet been subject to depreciation or amortization. See Note 6 for purchase commitments related to these projects.

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Accrued Expenses and Other Current Liabilities

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

	September 30, 2009	December 31, 2008
Accrued payroll and commission expenses	$ 2,934	$ 2,929
Capital projects	760	
Professional fees	428	193
Inventory in transit	83	251
Collaboration fees	111	916
Other accrued expenses and current liabilities	462	498
	$ 4,778	$ 4,787

Note 4 Long-Term Debt

Promissory Notes

In February 2009, the Company paid the outstanding balance of a fixed promissory note for a total of $83,000, including accrued interest.

As of September 30, 2009, long term debt consisted of one equipment promissory note payable. Future minimum principal payments due under this long-term debt arrangement consist of the following (in thousands):

	September 30, 2009
2009 (remaining three months)	$ 32
2010	128
2011	128
2012	85
	$ 373

Credit Agreements

In February 2009, the Company terminated a March 2008 credit agreement with a financial institution. As a result, during the first quarter of 2009, the Company transferred $9.1 million in cash to a restricted cash account as collateral for outstanding irrevocable standby letters of credit that were collateralized by the credit agreement as of the date of its termination and as collateral for an outstanding equipment promissory note. During the nine months ended September 30, 2009, $3.6 million of the restricted cash was released.

Upon the termination of the credit agreement, a new loan and security agreement with another financial institution became effective. The new agreement provides a total available credit line of $15.0 million. Under the new agreement, the Company is allowed to draw advances up to $10.0 million on a revolving line of credit or utilize up to $14.8 million as collateral for irrevocable standby letters of credit, provided that the aggregate of the advances and the collateral do not exceed $15.0 million. Advances under the revolving line of credit incur interest based on either a prime rate index or LIBOR plus 1.375%. The new agreement expires on December 31, 2009 and is collateralized by substantially all of the Company s assets. The Company is subject to certain financial and administrative covenants under this new agreement. As of September 30, 2009, the Company was in compliance with these covenants.

During the periods presented, the Company provided certain customers with irrevocable standby letters of credit to secure its obligations for the delivery of products, performance guarantees and warranty commitments in accordance with sales arrangements. These letters of credit were issued under the Company s credit line and generally terminate within 12 to 36 months from issuance. At September 30, 2009 and December 31, 2008, the amounts outstanding on the letters of credit collateralized by the Company s credit line totaled approximately $4.3 million and $8.4 million, respectively.

Note 5 Income Taxes

The Company s effective tax rate for the nine months ended September 30, 2009 and 2008 was 35.4% and 39.1%, respectively. These effective tax rates differ from the U.S. statutory rate principally due to the effect of state income taxes and non-deductible stock based compensation, offset in part by deductions and credits related to manufacturing and research and development, respectively.

There have been no material changes to the Company s income tax position during the nine months ended September 30, 2009.

Note 6 Commitments and Contingencies

Lease Obligations

The Company leases facilities under fixed non-cancelable operating leases that expire on various dates through July 2019. Future minimum lease payments consist of the following (in thousands):

	September 30, 2009
2009 (remaining three months)	$ 388
2010	1,589
2011	1,407
2012	1,379
2013	1,413
Thereafter	8,560
	$ 14,736

Product Warranty

The Company sells products with a limited warranty for a period ranging from one to five years. The Company accrues for warranty costs based on estimated product failure rates, historical activity and expectations of future costs. The Company periodically evaluates and adjusts the warranty costs to the extent actual warranty costs vary from the original estimates.

The following table summarizes the activity related to the product warranty liability during the three and nine months ended September 30, 2009 and 2008 (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
Balance at beginning of period	$ 295	$ 250	$ 270	$ 868
Warranty costs charged to cost of revenue	18	19	55	157
Utilization of warranty	(1)	(21)	(13)	(89)
Reduction of extended warranty reserve				(688)
Balance at end of period	$ 312	$ 248	$ 312	$ 248

Purchase Obligations

In 2008, the Company entered into a supply agreement with a vendor. Under this agreement, the Company is obligated to pay a fee of up to $250,000 if the Company does not meet minimum purchase requirements by the end of 2011.

As of September 30, 2009, the Company had entered into purchase commitments with multiple vendors for the purchase and installation of specialized manufacturing equipment. If the orders are canceled, the Company is generally obligated to pay the greater of total costs incurred by the vendor through the date of cancelation or a penalty of 10 30% of the original purchase order. As of September 30, 2009, open purchase commitments with these vendors totaled approximately $0.7 million.

The Company has entered into purchase commitments with multiple vendors for the construction and installation of leasehold improvements at a new corporate headquarters and manufacturing facility. Amounts remaining under these purchase commitments total approximately $1.7 million as of September 30, 2009.

In addition, the Company had purchase order arrangements related to various key raw materials and components parts with several vendors for which it had not received the related goods or services as of September 30, 2009. These arrangements are subject to change based on the Company s sales demand forecasts and the Company has the right to cancel the arrangements prior to the date of delivery. As of September 30, 2009, the Company had approximately

$3.8 million of these open purchase order arrangements.

Guarantees

The Company enters into indemnification provisions under its agreements with other companies in the ordinary course of business, typically with customers. Under these provisions, the Company generally indemnifies and holds harmless the indemnified party for losses suffered or incurred by the indemnified party as a result of the Company s activities, generally limited to personal injury and property damage caused by the Company s employees at a customer s desalination plant in proportion to the employee s percentage of fault for the accident. Damages incurred for these indemnifications would be covered by the Company s general liability insurance to the extent provided by the policy limitations. The Company has not incurred material costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, the estimated fair value of these agreements is not material. Accordingly, the Company has no liabilities recorded for these agreements as of September 30, 2009 and December 31, 2008.

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In certain cases, the Company issues warranty and product performance guarantees to its customers for amounts ranging from 10% to 30% of the total sales agreement to endorse the execution of product delivery and the warranty of design work, fabrication and operating performance of the PX device. These guarantees are issued in the form of standby letters of credit under the Company s credit facility (see Note 4) or collateralized by restricted cash (see Note 3). These guarantees typically remain in place for periods ranging from 12 to 36 months and, in some cases, up to 65 months, which generally relate to the corresponding underlying product warranty period.

Employee Agreements

The Company has an agreement with its chief executive officer governing the terms of his employment. The agreement expires in December 2009.

Litigation

The Company is not currently a party to any material litigation, and the Company is not aware of any pending or threatened litigation against it that the Company believes would adversely affect its business, operating results, financial condition or cash flows. However, in the future, the Company may be subject to legal proceedings in the ordinary course of business.

Note 7 Stockholders Equity

Equity Incentive Plans

The following table summarizes the stock option activity under the Company s equity incentive plans for the nine months ended September 30, 2009:

		Options Outstanding		
	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (in years)	Aggregate Intrinsic Value (in thousands)(1)
Balance at December 31, 2008	2,531,986	$5.48	8.6	$ 6,593
Options granted	1,612,800	7.04		
Options exercised	(148,599)	2.00		
Options forfeited	(138,085)	5.95		
Balance at September 30, 2009	3,858,102	6.25	8.6	$ 3,638
Vested and exercisable at September 30, 2009	1,062,559	$4.01	7.35	$ 2,792

(1) The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying options and the fair market value of the Company s stock as of September 30,

2009 of $5.84 per share. The aggregate intrinsic value excludes the effect of stock options that have a zero or negative intrinsic value.

In July 2009, the Company issued 60,000 restricted stock units to key management team members under the 2008 Equity Incentive Plan. The restricted stock units vest 25% on the first grant date anniversary and 1/48th monthly thereafter dependent upon continued employment. As the restricted stock units vest, the units are settled in shares of common stock based on a one to one ratio. The units are valued based on the market price on the date of grant.

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A summary of the status and changes in restricted stock units for the nine months ended September 30, 2009 is presented below:

	Shares	Weighted Average Grant-Date Fair Value (per share)
Balance at December 31, 2008		$
Awarded	60,000	7.13
Vested		
Forfeited		
Outstanding at September 30, 2009	60,000	7.13

As of September 30, 2008, 1,034,253 shares are available for issuance under the Company s stock based compensation plans.

Stock-based Compensation Expense

For the three and nine months ended September 30, 2009 and 2008, the Company recognized share-based compensation expense related to employees and consultants as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008 (1)	2009	2008 (1)
Cost of revenue	$ 71	$ 34	$ 139	$ 65
General and administrative	486	149	1,039	290
Sales and marketing	253	122	463	224
Research and development	93	52	174	97
	$ 903	$ 357	$ 1,815	$ 676

(1) Share-based compensation expense for the three and nine months ended September 30, 2008 included $12,000 and $155,000, respectively, related to employee share-based compensation arrangements accounted for in accordance with

the provisions of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25). APB 25 is part of a specific class of transactions, referred to as grandfathered GAAP, that is excluded from the initial release of the Codification because entities can no longer apply the guidance to new transactions. The Company did not recognize any expense under APB 25 during the three and nine months ended September 30, 2009.

As of September 30, 2009, total unrecognized compensation cost related to non-vested stock-based awards, net of forfeitures, was $8.2 million, which is expected to be recognized as expense over a weighted-average period of approximately 3.2 years.

Note 8 Business Segment and Geographic Information

The Company manufactures and sells high efficiency energy recovery products and related services and operates under one segment. The Company s chief operating decision maker is the chief executive officer (CEO). The CEO reviews financial information presented on a consolidated basis, accompanied by disaggregated information about revenue by geographic region for purposes of making operating decisions and assessing financial performance. Accordingly, the Company has concluded that it has one reportable segment.

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

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
	2009	**2008**	**2009**	**2008**

Domestic revenue	$ 415	$ 1,442	$ 1,837	$ 3,309
International revenue	9,130	7,602	29,443	26,816
Total revenue	$ 9,545	$ 9,044	$ 31,280	$ 30,125
Revenue by country:				
Israel	33%	5%	32%	3%
Algeria	27	*	25	15
Venezuela	17		5	
United States	4	16	6	11
China	3	30	2	16
Spain	*	17	5	22
Others	16	32	25	33
Total	100%	100%	100%	100%

* Less than 1%.

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Approximately 100% of the Company s long-lived assets were located in the United States at September 30, 2009 and December 31, 2008.

Note 9 Concentrations

Three customers accounted for approximately 46% of the Company s accounts receivable at September 30, 2009. As of December 31, 2008, five customers accounted for approximately 81% of accounts receivable.

Revenue from customers representing 10% or more of net revenue varies from period to period. For the three months ended September 30, 2009, IDE Technologies, Ltd., Acciona Agua, Via Maris Desalination Ltd. and UTE Cap Djinet, a consortium of Inima (Grupo OHL) and Aqualia (Grupo FCC), accounted for approximately 11%, 17%, 21% and 27% of the Company s net revenue, respectively. For the three months ended September 30, 2008, three customers, Hyflux Limited, GE Water and Process Technologies, and Geida, a consortium of Befesa Agua, Cobra-Tedagua, and Sadyt S.A, represented 20%, 14% and 13% of the Company s net revenue, respectively.

For the nine months ended September 30, 2009, IDE Technologies, Ltd. accounted for approximately 30% of net revenue and two consortiums formed by Inima and Aqualia, UTE Mostaganem and UTE Cap Djinet, accounted for approximately 17% and 8% of net revenue, respectively. For the nine months ended September 30, 2008, Multiplex Degremont J.V. and Geida, including its member companies, represented 15% and 19% of the Company s net revenue, respectively.

No other customer accounted for more than 10% of the Company s net revenue during any of these periods.

Note 10 Related Party Transactions

The Company entered into a supply agreement with Piedmont Pacific Corporation, a company owned by James Medanich, a former director of the Company. Expenses incurred under this supply agreement amounted to $19,000 for the three months ended September 30, 2009 and less than $1,000 for the three months ended September 30, 2008. Expenses incurred under this supply agreement for the nine months ending September 30, 2009 and 2008 were $53,000 and $4,000, respectively. There were no outstanding payments due to this vendor as of September 30, 2009 and December 31, 2008. The Company believes that the transactions under the supply agreement were conducted as if consummated on an arm s-length basis between two independent parties.

The Company entered into a consulting agreement with Darby Engineering, LLC (invoiced as Think Mechanical, LLC), a firm owned by Peter Darby, a former director of the Company. No expenses were incurred under this consulting agreement during the three months ended September 30, 2009. Expenses incurred under this consulting agreement amounted to $32,000 for the three months ending September 30, 2008. For the nine months ending September 30, 2009 and 2008, $38,000 and $92,000 in expenses were incurred under this agreement, respectively. No amounts were due to this vendor as of September 30, 2009. A balance of $27,000 was due to this vendor as of December 31, 2008. The Company believes that the transactions under the consulting agreement were conducted as if consummated on an arm s-length basis between two independent parties.

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

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

Forward-looking statements represent our current expectations about future events and 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.

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

- *our expectation that our expenditures for research and development will increase;*
- *our expectation that we will continue to rely on sales of our PX devices for a substantial portion of our revenue;*
- *our expectation that a significant portion of our annual sales will continue to occur during the fourth quarter;*
- *our expectation that sales outside of the United States will remain a significant portion of our revenue;*
- *our expectation that future sales and marketing expense will increase; and*
- *our belief that our existing cash balances and cash generated from our operations will be sufficient to meet our anticipated capital requirements for at least the next 12 months*

All forward-looking statements included in this document are subject to additional risks and uncertainties further discussed under Part II, Item 1A: Risk Factors and are based on information available to us as of November 6, 2009. 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. The factors that could cause our actual results to differ from those included in such forward-looking statements are set forth under the heading Part II, Item 1A: Risk Factors, and our results disclosed from time to time in our reports on Forms 10-K, 10-Q and 8-K and our Annual Reports to Stockholders.

The following should be read in conjunction with the condensed financial statements and related notes included in Part I, Item 1: Financial Statements of this quarterly report and the consolidated financial statements and related notes included in our Annual Report on Form 10-K as filed on March 27, 2009.

Overview

We are in the business of designing, developing and manufacturing energy recovery devices for seawater reverse osmosis desalination. Our company was founded in 1992 and we introduced the initial version of our energy recovery device, the PX®, in early 1997. As of September 30, 2009, we had shipped approximately 7,100 PX devices to desalination plants worldwide.

A majority of our net revenue has been generated by sales to large engineering and construction firms, which are involved with the design and construction of larger desalination plants. Sales to these firms often involve a long sales cycle, which can range from nine to 16 months. A single large desalination project can generate an order for numerous PX devices and generally represents an opportunity for significant revenue. We also sell PX devices to original equipment manufacturers, or OEMs, which commission smaller desalination plants, order fewer PX devices per plant and have shorter sales cycles.

Due to the fact that a single order for PX devices by a large engineering and construction firm for a particular plant may represent significant revenue, we often experience significant fluctuations in net revenue from quarter to quarter. In addition, our engineering and construction firm customers tend to order a significant amount of equipment for delivery in the fourth quarter and, as a consequence, a significant portion of our annual sales typically occurs during that quarter.

A limited number of our customers accounts for a substantial portion of our net revenue and accounts receivables. Revenue from customers representing 10% or more of total revenue varies from period to period.

For the three months ended September 30, 2009, four customers accounted for approximately 76% of the Company s net revenue. For the three months ended September 30, 2008, three customers accounted for approximately 47% of the Company s net revenue.

For the nine months ended September 30, 2009, three customers accounted for approximately 55% of the Company s net revenue. For the nine months ended September 30, 2008, two customers accounted for approximately 34% of the Company s net revenue.

As of September 30, 2009, three customers accounted for approximately 46% of our accounts receivable.

During the three and nine months ended September 30, 2009 and 2008, most of our revenue was attributable to sales outside of the United States. We expect sales outside of the United States to remain a significant portion of our revenue for the foreseeable future.

Our revenue is principally derived from the sales of our PX devices. We receive a small amount of revenue from the sale of high pressure circulation pumps, which we manufacture or purchase and sell in connection with PX devices to smaller desalination plants. We also receive incidental revenue from the sales of spare parts and services, such as product support, that we provide to our PX customers.

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

Third Quarter of 2009 Compared to Third Quarter of 2008

Results of Operations

The following table sets forth certain data from our historical operating results as a percentage of revenue for the periods indicated (in thousands, except percentages):

	Three Months Ended September 30,					
	2009		2008		Change Increase / (Decrease)	
Results of Operations:*						
Net revenue	$ 9,545	100.0%	$ 9,044	100.0%	$ 501	6%
Cost of revenue	3,387	35.5%	3,497	38.7%	(110)	(3)%
Gross profit	6,158	64.5%	5,547	61.3%	611	11%
Operating expenses:						
General and administrative	3,043	31.9%	2,696	29.8%	347	13%
Sales and marketing	1,634	17.1%	1,467	16.2%	167	11%
Research and development	779	8.2%	678	7.5%	101	15%
Total operating expenses	5,456	57.2%	4,841	53.5%	615	13%
Income from operations	702	7.4%	706	7.8%	(4)	(1)%
Other income (expense):						
Interest expense	(10)	(0.1)%	(17)	(0.2)%	(7)	(41)%

Interest income and other income (expense)	30	0.3%	217	2.4%	(187)	86%
Income before provision for income taxes	722	7.6%	906	10.0%	(184)	(20)%
Provision for income taxes	172	1.8%	283	3.1%	(111)	(39)%
Net income	$ 550	5.8%	$ 623	6.9%	$ (73)	(12)%

* Percentages may not add up to 100% due to rounding.

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Our net revenue increased 6% to $9.5 million for the three months ended September 30, 2009 from $9.0 million for the three months ended September 30, 2008. The increase in net revenue is primarily due to an overall increase in the average sales price of PX units resulting largely from increased sales of our higher-capacity PX-260 devices. The overall increase is partially offset by a slight decline in the number of PX units sold, primarily related to OEM customer shipments due to project delays attributable to the global economic downturn and financial market crisis. Additionally, there was a slight increase in service revenue due to efforts targeted at increasing after market sales and services.

For the three months ended September 30, 2009, the sales of PX devices accounted for approximately 89% of our revenue, pump sales accounted for approximately 4% and spare parts and service accounted for 7%. For the three months ended September 30, 2008, the sales of PX devices accounted for approximately 90% of revenue, pump sales accounted for approximately 6%, and spare parts and service accounted for 4%.

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

	Three Months Ended September 30,	
	2009	**2008**
Domestic revenue	$ 415	$ 1,442
International revenue	9,130	7,602
Total revenue	$ 9,545	$ 9,044
Revenue by country:		
Israel	33%	5%
Algeria	27	*
Venezuela	17	
United States	4	16
China	3	30
Spain	*	17
Others	16	32
Total	100%	100%

* Less than 1%.

Gross Profit

Gross profit represents our net revenue less our cost of revenue. Our cost of revenue consists primarily of raw materials, personnel costs (including stock-based compensation), manufacturing overhead, warranty costs, capital costs, excess and obsolete inventory expense, and manufactured components. The largest component of our cost of revenue is raw materials, primarily ceramic materials, which we obtain from multiple suppliers. For the three months ended September 30, 2009, gross profit as a percentage of net revenue was 64.5%. For the three months ended September 30, 2008, gross profit as a percentage of net revenue was 61.3%. The increase in gross margin as a percentage of net revenue was largely due to a higher average selling price during the third quarter of 2009 as compared to the third quarter of 2008 resulting largely from increased sales of our higher-capacity PX-260 devices.

Stock compensation expense included in cost of revenue was $71,000 and $34,000 for the three months ended September 30, 2009 and September 30, 2008, respectively.

Future gross profit as a percentage of net revenue is highly dependent on the product and customer mix of our future sales. Accordingly, we are not able to predict our future gross profit percentages with certainty.

General and Administrative Expense

General and administrative expense increased by $347,000, or 13%, to $3.0 million for the three months ended September 30, 2009 from $2.7 million for the three months ended September 30, 2008. As a percentage of net revenue, general and administrative expense was 31.9% for the three months ended September 30, 2009 and 29.8% for the three months ended September 30, 2008. The increase of general and administrative expense was attributable primarily to the increase in general and administrative headcount and professional services to support our growth in operations and to support the requirements for operating as a public company. General and administrative average headcount increased to 36 for the third quarter of 2009 from 27 for the third quarter of 2008.

Of the $347,000 increase in general and administrative expense, increases of $379,000 related to compensation and employee-related benefits, $241,000 related to professional services and $48,000 related to occupancy and other administrative costs were offset in part by a decrease of $272,000 related to bad debt expense and $49,000 related to Value Added Taxes (VAT). Stock-based compensation expense included in general and administrative expense was $486,000 for the three months ended September 30, 2009 and $149,000 for the three months ended September 30, 2008.

Sales and Marketing Expense

Sales and marketing expense increased by $167,000, or 11%, to $1.6 million for the three months ended September 30, 2009 from $1.5 million for the three months ended September 30, 2008. This increase was primarily related to the growth in our sales force that resulted in higher average headcount with sales and marketing average headcount increasing to 22 for the third quarter of 2009 from 20 for the third quarter of 2008.

As a percentage of our net revenue, sales and marketing expense increased slightly to 17% for the three months ended September 30, 2009 compared to 16% for the three months ended September 30, 2008. The increase was attributable primarily to our net revenue growing at a slightly lesser rate than our sales and marketing expense during the third quarter of 2009 compared to the same period last year.

Of the $167,000 net increase in sales and marketing expense for the three months ended September 30, 2009, $227,000 related to compensation, employee-related benefits and commissions to outside sales representatives and $16,000 related to occupancy and other administrative costs. The increases were partially offset by a decrease of $76,000 related to other sales and marketing costs. Stock-based compensation expense included in sales and marketing expense was $253,000 for the three months ended September 30, 2009 and $122,000 for the three months ended September 30, 2008.

We expect that our future sales and marketing expense will increase in absolute dollars as we continue to develop our sales and marketing operations.

Research and Development Expense

Research and development expense increased by $101,000, or 15%, to $779,000 for the three months ended September 30, 2009 from $678,000 for the three months ended September 30, 2008. This increase was primarily attributable to recent efforts to develop and strengthen our expertise in ceramics material science.

As a percentage of our net revenue, research and development expense remained constant at 8% for the three months ended September 30, 2009 compared to the three months ended September 30, 2008, as research and development expense increased at approximately the same rate as net revenue for those periods.

Of the $101,000 increase, increases of $122,000 related to compensation and employee-related benefits and $49,000 related to occupancy and other miscellaneous costs were partially offset by decreases of $39,000 related to research and development direct project costs and $31,000 related to consulting and professional service.

Average headcount in our research and development department increased to 11 for the third quarter of 2009 from nine for the third quarter of 2008. Stock-based compensation expense included in research and development expense was $93,000 for three months ended September 30, 2009 and $52,000 for the three months ended September 30, 2008.

We anticipate that our research and development expenditures will increase in the future as we expand and diversify our product offerings and further our expertise in advanced ceramics.

Other Income, Net

Other income, net, decreased $180,000 to $20,000 for the three months ended September 30, 2009 from $200,000 for the three months ended September 30, 2008. The decrease was primarily due to a decrease in interest income of $402,000 as a result of lower interest rates during the third quarter of 2009 compared to the third quarter of 2008. This decrease was partially offset by a favorable change of $215,000 related to net foreign currency gains and losses as a result of a decrease in our foreign currency denominated contracts and favorable changes in foreign currency rates for the three months ended September 30, 2009 compared to the three months ended September 30, 2008. Additionally, interest expense decreased $7,000 as a result of a reduction of debt in the first quarter of 2009.

Nine Months Ended September 30, 2009 Compared to Nine Months Ended September 30, 2008

Results of Operations

The following table sets forth certain data from our historical operating results as a percentage of revenue for the periods indicated (in thousands, except percentages):

	Nine Months Ended September 30,					
	2009		2008		Change Increase / (Decrease)	
Results of Operations:*						
Net revenue	$ 31,280	100.0%	$ 30,125	100.0%	$ 1,155	4%
Cost of revenue	11,251	36.0%	11,122	36.9%	129	1%
Gross profit	20,029	64.0%	19,003	63.1%	1,026	5%
Operating expenses:						
General and administrative	9,705	31.0%	8,211	27.3%	1,494	18%
Sales and marketing	4,795	15.3%	4,263	14.2%	532	12%
Research and development	2,409	7.7%	1,723	5.7%	686	40%
Total operating expenses	16,909	54.1%	14,197	47.1%	2,712	19%
Income from operations	3,120	10.0%	4,806	16.0%	(1,686)	(35)%
Other income (expense):						
Interest expense	(34)	(0.1)%	(62)	(0.2)%	(28)	(45)%
Interest income and other income (expense)	59	0.2%	841	2.8%	(782)	(93)%
Income before provision for income taxes	3,145	10.1%	5,585	18.5%	(2,440)	(44)%
Provision for income taxes	1,112	3.6%	2,186	7.3%	(1,074)	(49)%
Net income	$ 2,033	6.5%	$ 3,399	11.3%	$ (1,366)	(40)%

* Percentages may not add up to 100% due to rounding.

Our net revenue increased by $1.2 million, or 4%, to $31.3 million for the nine months ended September 30, 2009 from $30.1 million for the nine months ended September 30, 2008. The increase in net revenue is primarily due to an increase in the average sales price of PX units resulting largely from increased sales of our higher-capacity PX-260 devices. The overall increase is partially offset by a slight decline in the number of PX units sold, primarily related to OEM customer shipments due to project delays attributable to the global economic downturn and financial market crisis. Additionally, there was a slight increase in service revenue due to efforts targeted at increasing after market sales and services.

For the nine months ended September 30, 2009, the sales of PX devices accounted for approximately 90% of our revenue, pump sales accounted for approximately 5% and spare parts and service accounted for 5%. For the nine months ended September 30, 2008, the sales of PX devices accounted for approximately 92% of revenue, pump sales accounted for approximately 5%, and spare parts and service accounted for 3%.

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

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	Nine Months Ended September 30,	
	2009	2008
Domestic revenue	$ 1,837	$ 3,309
International revenue	29,443	26,816
Total revenue	$ 31,280	$ 30,125
Revenue by country:		
Israel	32%	3%
Algeria	25	15
United States	6	11
Spain	5	22
China	2	16
Others	30	33
Total	100%	100%

* Less than 1%.

Gross Profit

Gross profit represents our net revenue less our cost of revenue. Our cost of revenue consists primarily of raw materials, personnel costs (including stock-based compensation), manufacturing overhead, warranty costs, capital costs, excess and obsolete inventory expense, and manufactured components. The largest component of our cost of revenue is raw materials, primarily ceramic materials, which we obtain from multiple suppliers. For the nine months ended September 30, 2009, gross profit as a percentage of net revenue was 64.0%, as compared to 60.8% for the nine months ended September 30, 2008, excluding the reversal of a warranty provision in the amount of $688,000, or 2.3%, related to the cancellation of an extended product warranty contract. The increase in gross margin as a percentage of net revenue, when adjusted for the one time warranty provision reversal in 2008, was largely due to a higher average selling price during the first nine months of 2009 as compared to the first nine months of 2008 resulting largely from increased sales of our higher-capacity PX-260 devices.

Stock compensation expense included in cost of revenue was $139,000 and $65,000 for the nine months ended September 30, 2009 and September 30, 2008, respectively.

Future gross profit as a percentage of net revenue is highly dependent on the product and customer mix of our future sales. Accordingly, we are not able to predict our future gross profit percentages with certainty.

General and Administrative Expense

General and administrative expense increased by $1.5 million, or 18%, to $9.7 million for the nine months ended September 30, 2009 from $8.2 million for the nine months ended September 30, 2008. As a percentage of net revenue, general and administrative expense was 31% for the nine months ended September 30, 2009 and 27% for the nine months ended September 30, 2008. The increase of general and administrative expense was attributable primarily to the increase in general and administrative headcount to support our growth in operations and to support the requirements for operating as a public company. General and administrative average headcount increased to 35 for the nine months ended September 30, 2009 from 21 for the nine months ended September 30, 2008.

Of the $1.5 million increase in general and administrative expense, increases of $2.1 million in compensation and employee-related benefits and $110,000 in occupancy and other administrative costs were partially offset by decreases of $495,000 in professional services and $211,000 in Value Added Taxes (VAT). Stock-based compensation expense included in general and administrative expense was $1.0 million for the nine months ended September 30, 2009 and

$290,000 for the nine months ended September 30, 2008.

Sales and Marketing Expense

Sales and marketing expense increased by $532,000, or 12%, to $4.8 million for the nine months ended September 30, 2009 from $4.3 million for the nine months ended September 30, 2008. This increase was primarily related to growth in our sales force that resulted in higher headcount with sales and marketing average headcount increasing to 21 for the nine months ended September 30, 2009 from 18 for the nine months ended September 30, 2008. In addition, our sales team is compensated in part by commissions, resulting in increased sales expense as our sales increase.

As a percentage of our net revenue, sales and marketing expense increased to 15% for the nine months ended September 30, 2009 from 14% for the nine months ended September 30, 2008. The increase in 2009 was attributable primarily to our net revenue growing at a slightly lesser rate than our sales and marketing expense during the first nine months of 2009.

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Of the net increase in sales and marketing expense for the nine months ended September 30, 2009, $581,000 related to compensation, employee-related benefits and commissions to outside sales representatives and $49,000 related to occupancy and other administrative costs. These increases were partially offset by a decrease of $98,000 related to other sales and marketing costs. Stock-based compensation expense included in sales and marketing expense was $463,000 for the nine months ended September 30, 2009 and $224,000 for the nine months ended September 30, 2008.

We expect that our future sales and marketing expense will increase in absolute dollars as we continue to develop our sales and marketing operations.

Research and Development Expense

Research and development expense increased by $686,000, or 40%, to $2.4 million for the nine months ended September 30, 2009 from $1.7 million for the nine months ended September 30, 2008. As a percentage of our net revenue, research and development expense increased to 8% for the nine months ended September 30, 2009 compared to 6% for the nine months ended September 30, 2008. The increase in expense was primarily attributable to recent efforts to develop and strengthen our expertise in ceramics material science.

Of the $686,000 increase, compensation and employee-related benefits accounted for $384,000, research and development direct project costs accounted for $140,000, consulting and professional service fees accounted for $103,000, and occupancy and other miscellaneous costs accounted for $59,000.

Average headcount in our research and development department increased to 10 for the nine months ended September 30, 2009 from eight for the nine months ended September 30, 2008. Stock-based compensation expense included in research and development expense was $174,000 for the nine months ended September 30, 2009 and $97,000 for the nine months ended September 30, 2008.

We anticipate that our research and development expenditures will increase in the future as we expand and diversify our product offerings and further our expertise in advanced ceramic