

POWERSECURE INTERNATIONAL, INC.  
Form 10-Q/A  
February 03, 2015  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**

**FORM 10-Q/A**  
**Amendment No. 1**

**(Mark One)**

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

**For the quarterly period ended September 30, 2014**

**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 1-12014**

**POWERSECURE INTERNATIONAL, INC.**  
**(Exact name of registrant as specified in its charter)**

<b>Delaware</b> <b>(State or other jurisdiction of</b>	<b>84-1169358</b> <b>(I.R.S. Employer</b>
<b>incorporation or organization)</b>	<b>Identification No.)</b>
<b>1609 Heritage Commerce Court</b> <b>Wake Forest, North Carolina</b> <b>(Address of principal executive offices)</b>	<b>27587</b> <b>(Zip code)</b>
<b>(919) 556-3056</b>	
<b>(Registrant's telephone number, including area code)</b>	

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 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

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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.

Large accelerated filer  Accelerated filer

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

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

As of November 1, 2014, 22,370,100 shares of the issuer's Common Stock were outstanding.

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**EXPLANATORY NOTE**

This Amendment No. 1 on Form 10-Q/A (this Amendment) of PowerSecure International, Inc. (PowerSecure) amends PowerSecure's quarterly report on Form 10-Q for the fiscal quarter ended September 30, 2014 as filed with the Securities and Exchange Commission (the SEC) on November 5, 2014 (the Form 10-Q), and is being filed solely to refile Exhibits 10.3 through 10.6 in response to comments received from the staff of the SEC regarding a request for confidential treatment of certain portions of Exhibits 10.3 through 10.6 originally filed with the Form 10-Q. This Amendment contains the complete text of the original Form 10-Q, with the refiled exhibits appearing in Exhibits 10.3 through 10.6.

No revisions or changes were made to the Company's financial statements or notes thereto, and no changes were made to any other portion of the original Form 10-Q or any other disclosure contained in the Form 10-Q, other than Exhibits 10.3 through 10.6.

In addition, as required by Rule 12b-15 under the Securities Exchange Act of 1934, as amended, new certifications by our principal executive officer and principal financial officer are filed herewith as exhibits to this Amendment.

This Amendment does not reflect events occurring after the filing of the original Form 10-Q, or modify or update any disclosures that may be affected by subsequent events.

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**POWERSECURE INTERNATIONAL, INC.**

**FORM 10-Q**

**For the Quarterly Period Ended September 30, 2014**

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**Table of Contents****PART I.****FINANCIAL INFORMATION****Item 1. Financial Statements****POWERSECURE INTERNATIONAL, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS (unaudited)****(in thousands, except share data)**

	<b>September 30, 2014</b>	<b>December 31, 2013</b>
<b>Assets</b>		
Current Assets:		
Cash and cash equivalents	\$ 43,860	\$ 50,915
Trade receivables, net of allowance for doubtful accounts of \$602 and \$544, respectively	79,342	89,801
Inventories	29,871	16,864
Income taxes receivable	5,784	1,045
Deferred tax asset, net	5,289	5,368
Prepaid expenses and other current assets	3,811	2,235
<b>Total current assets</b>	<b>167,957</b>	<b>166,228</b>
Property, plant and equipment:		
Equipment	63,587	56,706
Furniture and fixtures	593	572
Land, building and improvements	6,283	6,134
<b>Total property, plant and equipment, at cost</b>	<b>70,463</b>	<b>63,412</b>
<b>Less accumulated depreciation and amortization</b>	<b>21,414</b>	<b>17,467</b>
<b>Property, plant and equipment, net</b>	<b>49,049</b>	<b>45,945</b>
Other assets:		
Goodwill	30,832	30,226
Restricted annuity contract	3,137	3,137
Intangible rights and capitalized software costs, net of accumulated amortization of \$6,639 and \$4,955, respectively	7,847	8,715
Other assets	1,887	1,240
<b>Total other assets</b>	<b>43,703</b>	<b>43,318</b>

<b>Total Assets</b>	\$	260,709	\$	255,491
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*See accompanying notes to condensed consolidated financial statements.*

**Table of Contents****POWERSECURE INTERNATIONAL, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS (unaudited)**

(in thousands, except share data)

	September 30, 2014	December 31, 2013
<b>Liabilities and Stockholders Equity</b>		
Current liabilities:		
Accounts payable	\$ 29,500	\$ 24,299
Accrued and other liabilities	39,376	31,195
Accrued restructuring liabilities	185	965
Current portion of long-term debt	3,731	3,731
Current portion of capital lease obligation	973	935
Total current liabilities	73,765	61,125
Long-term liabilities:		
Revolving line of credit		
Long-term debt, net of current portion	18,765	21,563
Capital lease obligation, net of current portion	252	986
Deferred tax liability, net	8,884	8,865
Other long-term liabilities	3,816	3,365
Total long-term liabilities	31,717	34,779
Commitments and contingencies (Notes 7 and 9)		
Stockholders Equity:		
PowerSecure International stockholders equity:		
Preferred stock - undesignated, \$.01 par value; 2,000,000 shares authorized; none issued and outstanding		
Preferred stock - Series C, \$.01 par value; 500,000 shares authorized; none issued and outstanding		
Common stock, \$.01 par value; 50,000,000 shares authorized; 22,370,100 and 21,945,720 shares issued and outstanding, respectively	224	219
Additional paid-in-capital	160,545	157,401
Retained earnings (deficit)	(5,492)	2,051
Accumulated other comprehensive income (loss)	(50)	(84)
Total stockholders equity	155,227	159,587
<b>Total Liabilities and Stockholders Equity</b>	<b>\$ 260,709</b>	<b>\$ 255,491</b>

See accompanying notes to condensed consolidated financial statements.





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**POWERSECURE INTERNATIONAL, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (unaudited)**

(in thousands, except per share data)

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30, 2014</b>	<b>2013</b>	<b>September 30, 2014</b>	<b>2013</b>
Revenues	\$ 65,044	\$ 81,510	\$ 174,910	\$ 196,654
Cost of sales (excluding depreciation and amortization)	46,973	60,060	131,467	141,581
Gross profit	18,071	21,450	43,443	55,073
Operating expenses:				
General and administrative	14,280	11,511	40,994	33,854
Selling, marketing and service	2,136	2,073	6,611	5,563
Depreciation and amortization	2,181	1,925	6,496	5,190
Restructuring charges			427	
Total operating expenses	18,597	15,509	54,528	44,607
Operating income (loss)	(526)	5,941	(11,085)	10,466
Other income and (expenses):				
Interest income and other income	5	21	14	61
Interest expense	(329)	(262)	(921)	(497)
Income (loss) before income taxes	(850)	5,700	(11,992)	10,030
Income tax expense (benefit)	(314)	2,227	(4,449)	3,906
Net income (loss)	(536)	3,473	(7,543)	6,124
Net loss attributable to non-controlling interest				181
Net income (loss) attributable to PowerSecure International, Inc.	\$ (536)	\$ 3,473	\$ (7,543)	\$ 6,305
Earnings (loss) per share attributable to PowerSecure International, Inc. common stockholders:				
Basic	\$ (0.02)	\$ 0.17	\$ (0.34)	\$ 0.33
Diluted	\$ (0.02)	\$ 0.17	\$ (0.34)	\$ 0.32
Weighted average common shares outstanding during the period:				
Basic	22,353	20,325	22,228	19,205
Diluted	22,353	20,654	22,228	19,528

*See accompanying notes to condensed consolidated financial statements.*

**Table of Contents****POWERSECURE INTERNATIONAL, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS) (unaudited)****(in thousands)**

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2014</b>	<b>2013</b>	<b>2014</b>	<b>2013</b>
Net income (loss)	\$ (536)	\$ 3,473	\$ (7,543)	\$ 6,124
Other comprehensive income (loss), net of tax:				
Cash flow hedge:				
Change in unrealized gain (loss)	25	(157)	(94)	(157)
Reclassification adjustment for net (gains) losses included in net income (loss)	41		128	
Total comprehensive income (loss), net of tax	(470)	3,316	(7,509)	5,967
Comprehensive loss attributable to non-controlling interest				181
Comprehensive income (loss) attributable to PowerSecure International, Inc.	\$ (470)	\$ 3,316	\$ (7,509)	\$ 6,148

*See accompanying notes to condensed consolidated financial statements.*

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**POWERSECURE INTERNATIONAL, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)**

(in thousands)

	<b>Nine Months Ended September 30, 2014      2013</b>	
<b>Cash flows from operating activities:</b>		
Net income (loss)	\$ (7,543)	\$ 6,124
Adjustments to reconcile net income (loss) to net cash used in operating activities:		
Depreciation and amortization	6,496	5,190
Stock compensation expense	1,504	438
(Gain) loss on disposal of miscellaneous assets	(92)	(21)
Changes in operating assets and liabilities, net of effect of acquisitions:		
Trade receivables, net	10,459	(16,496)
Inventories	(12,606)	(4,607)
Deferred taxes	79	
Other current assets and liabilities	(6,316)	3,129
Other noncurrent assets and liabilities	(482)	(446)
Accounts payable	5,201	8,022
Accrued and other liabilities	8,181	(9,967)
Accrued restructuring liabilities	(780)	(444)
Net cash provided by (used in) operating activities	4,101	(9,078)
<b>Cash flows from investing activities:</b>		
Acquisitions, net of cash acquired	(750)	(9,542)
Purchases of property, plant and equipment	(8,527)	(4,744)
Additions to intangible rights and software development	(494)	(469)
Proceeds from sale of property, plant and equipment	465	158
Net cash used in investing activities	(9,306)	(14,597)
<b>Cash flows from financing activities:</b>		
Net proceeds from stock offering		34,447
Borrowings (payments) on revolving line of credit		
Proceeds from long-term borrowings		25,000
Principal payments on long-term borrowings	(2,798)	(1,013)
Principal payments on capital lease obligations	(696)	(660)
Repurchases of common stock	(416)	(88)
Proceeds from stock option exercises	2,060	999
Net cash provided by (used in) financing activities	(1,850)	58,685

NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(7,055)	35,010
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	50,915	19,122
CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$ 43,860	\$ 54,132

*See accompanying notes to condensed consolidated financial statements.*

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**POWERSECURE INTERNATIONAL, INC. AND SUBSIDIARIES**

**Notes to Unaudited Condensed Consolidated Financial Statements**

As of September 30, 2014 and December 31, 2013 and

For the Three and Nine Month Periods Ended September 30, 2014 and 2013

(all amounts in thousands unless otherwise designated, except per share data)

**1. Description of Business and Basis of Presentation**

**Description of Business**

PowerSecure International, Inc., headquartered in Wake Forest, North Carolina, is a leading provider of products and services to electric utilities, and their large commercial, institutional and industrial customers.

We provide products and services through three operating segments: our Distributed Generation segment, our Utility Infrastructure segment, and our Energy Efficiency segment. These three operating segments constitute our major product and services offerings, each of which are focused on serving the needs of utilities and their commercial, institutional and industrial customers to help them generate, deliver, and utilize electricity more reliably and efficiently. Our strategy is focused on growing these three segments because they require unique knowledge and skills that utilize our core competencies, and because they address large market opportunities due to their strong customer value propositions. They share common or complementary utility relationships and customer types, common sales and overhead resources, and facilities. However, we discuss and distinguish our operations among these segments due to their unique products and services, market needs they are addressing, and the distinct technical disciplines and specific capabilities required for us to deliver them, including personnel, technology, engineering, and intellectual capital. We currently operate primarily out of our Wake Forest, North Carolina headquarters office, and our operations also include several satellite offices and manufacturing facilities, the largest of which are in the Raleigh and Greensboro, North Carolina, Atlanta, Georgia, Bethlehem, Pennsylvania, and Stamford, Connecticut areas. The locations of our sales organization and field employees for our operations are generally in close proximity to the utilities and commercial, industrial, and institutional customers they serve. Our three operating segments are operated through our principal operating wholly-owned subsidiary, PowerSecure, Inc.

Each of our three operating segments also represents a reporting segment. See Note 13 for more information concerning our reportable segments.

**Basis of Presentation**

**Organization** The accompanying condensed consolidated financial statements include the accounts of PowerSecure International, Inc. and its subsidiaries, primarily PowerSecure, Inc. and its majority-owned and wholly-owned subsidiaries, UtilityEngineering, Inc., PowerServices, Inc., PowerSecure Lighting, LLC ( PowerSecure Lighting ), Solais Lighting, Inc. ( Solais ), EnergyLite, Inc.( EnergyLite ), EfficientLights, LLC ( EfficientLights ), Innovative Electronic Solutions Lighting, LLC ( IES ), Reid s Trailer, Inc. d/b/a PowerFab ( PowerFab ), Innovation Energies, LLC, and PowerSecure Solar, LLC ( PowerSecure Solar ), which are collectively referred to as the Company or PowerSecure or we or us or our . On June 30, 2014, EfficientLights and IES were dissolved and merged into EnergyLite.

These condensed consolidated financial statements have been prepared pursuant to rules and regulations of the Securities and Exchange Commission. The accompanying condensed consolidated financial statements and notes thereto should be read in conjunction with the consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2013.

In management's opinion, all adjustments (all of which are normal and recurring) have been made which are necessary for a fair presentation of the condensed consolidated financial position of us and our subsidiaries as of September 30, 2014 and the condensed consolidated results of our operations and cash flows for the three and nine months ended September 30, 2014 and 2013.



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**Principles of Consolidation** The condensed consolidated financial statements include the accounts of PowerSecure International, Inc. and its subsidiaries after elimination of intercompany accounts and transactions.

**Comprehensive Income or Loss** Comprehensive income or loss represents the changes in stockholders' equity during a period resulting from transactions and other events and circumstances from non-owner sources. At September 30, 2014 and December 31, 2013, the balance of Accumulated other comprehensive income (loss) ( Accumulated OCI ) consisted solely of changes in the fair value of our interest rate cash flow hedge contracts, net of taxes.

**Non-controlling Interest** The non-controlling ownership interests in the income or losses of our majority-owned subsidiaries is included in our consolidated statements of operations as a reduction or addition to net income (loss) to derive income (loss) attributable to PowerSecure International stockholders. Similarly, the non-controlling ownership interest in the undistributed equity of our majority-owned subsidiaries is shown as a separate component of stockholders' equity in our consolidated balance sheet.

Until May 20, 2013, we held a 90% controlling ownership interest in PowerSecure Solar, a distributed solar energy company which we acquired in June 2012. In addition, until May 22, 2013, we also held a 67% controlling ownership interest in IES, an LED lighting company which we acquired 2010. On May 20, 2013, we acquired the 10% non-controlling ownership interest in PowerSecure Solar in exchange for a cash payment of \$153 thousand. On May 22, 2013, we acquired the 33% non-controlling ownership interest in IES in exchange for 209 thousand shares of our common stock valued at a total of \$2.9 million on the date of acquisition, issued pursuant to our acquisition shelf registration statement on Form S-4. As a result of these non-controlling interest acquisitions, both PowerSecure Solar and IES became wholly-owned subsidiaries and there has been no non-controlling interest in those entities after the acquisition dates. On June 30, 2014, IES was merged into EnergyLite.

There was no non-controlling interest activity for the nine months ended September 30, 2014. The following is a reconciliation of the amounts attributable to the non-controlling interest in IES and PowerSecure Solar for the nine months ended September 30, 2013:

	<b>Nine Months Ended September 30, 2013</b>		
	<b>IES</b>	<b>PowerSecure Solar</b>	<b>Total</b>
Balance, December 31, 2012	\$ (6)	\$ 446	\$ 440
Capital contribution			
Income (loss)	(143)	(38)	(181)
Acquisition of non-controlling interest	149	(408)	(259)
Balance, September 30, 2013	\$	\$	\$

**Use of Estimates** The preparation of our condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires that our management make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates include, among others, percentage-of-completion estimates for revenue and cost of sales recognition, incentive compensation and commissions, allowance for doubtful accounts receivable, sales allowances, inventory valuation reserves, warranty reserves, deferred tax valuation allowance, purchase price allocations on business acquisitions, fair value estimates of

interest rate swap contracts and any impairment charges on long-lived assets and goodwill.

**Reclassifications** Certain 2013 amounts have been reclassified to conform to current year presentation. Such reclassifications had no effect on net income (loss) or stockholders' equity as previously reported.

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### **2. Summary of Significant Accounting Policies and Recent Accounting Standards**

**Revenue Recognition** For our turn-key distributed generation projects, our utility infrastructure projects, and our energy services ( ESCO ) energy efficiency projects, we recognize revenue and profit as work progresses using the percentage-of-completion method, which relies on various estimates. These turn-key distributed generation, utility infrastructure, and ESCO projects are nearly always fixed-price contracts.

In applying the percentage-of-completion method to our distributed generation turn-key projects, including our traditional distributed generation projects and our solar projects, we have identified the key output project phases that are standard components of these projects. We have further identified, based on past experience, an estimate of the value of each of these output phases based on a combination of the costs incurred and the value added to the overall project. While the order of these phases varies depending on the project, each of these output phases is necessary to complete each project and each phase is an integral part of the turn-key product solution we deliver to our customers. We use these output phases and percentages to measure our progress toward completion of our construction projects. For each reporting period, the status of each project, by phase, is determined by employees who are managers of or are otherwise directly involved with the project, and this is reviewed by our accounting personnel. Utilizing this information, we recognize project revenues and associated project costs and gross profit based on the percentage associated with output phases that are complete or in process on each of our projects.

In applying the percentage-of-completion method to our utility infrastructure turn-key projects and our ESCO energy efficiency projects, revenues and gross profit are recognized as work is performed based on the relationship between actual costs incurred and total estimated costs at completion.

In all cases where we utilize the percentage-of-completion method, revenues and gross profit are adjusted prospectively for revisions in estimated total contract costs and contract values. Estimated losses, if any, are recorded when identified. While a project is in process, amounts billed to customers in excess of revenues recognized to date are classified as current liabilities. Likewise, amounts recognized as revenue in excess of actual billings to date are recorded as unbilled accounts receivable. In the event adjustments are made to the contract price, including, for example, adjustments for additional scope, we adjust the purchase price and related costs for these items when they are identified.

Because the percentage-of-completion method of accounting relies upon estimates described above, recognized revenues and profits are subject to revision as a project progresses to completion. Revisions in profit estimates are recorded to income in the period in which the facts that give rise to the revision become known. In the event we are required to adjust any particular project's estimated revenues or costs, the effect on the current period earnings may or may not be significant. If, however, conditions arise that require us to adjust our estimated revenues or costs for a series of similar construction projects, or on very large projects, the effect on current period earnings would more likely be significant. In addition, certain contracts contain cancellation provisions permitting the customer to cancel the contract prior to completion of a project. Such cancellation provisions generally require the customer to pay/reimburse us for costs we incurred on the project, but may result in an adjustment to profit already recognized in a prior period.

We recognize equipment and product revenue when persuasive evidence of a commercial arrangement exists, delivery has occurred and/or services have been rendered, the price is fixed or determinable, and collectability is reasonably assured. Equipment and product sales are generally made directly to end users of the product, who are responsible for payment for the product, although in some instances we can be a subcontractor, which occurs most frequently on larger jobs that involve more scope than our products and services.

Service revenue includes regulatory consulting and rate design services, power system engineering services, energy conservation services, compliance services, and monitoring and maintenance services. Revenues from these services are recognized when the service is performed and the customer has accepted the work.

Additionally, our utility infrastructure business provides services to utilities involving construction, maintenance, and upgrades to their electrical transmission and distribution systems which is not fixed price turn-key project-based work. These services are delivered by us under contracts which are generally of two types. In the first type, we are paid a fee based on the number of units of work we complete, an example of which could be the number of utility transmission poles we replace. In the second type, we are paid for the time and materials utilized to complete the work, plus a profit margin. In both of these cases, we recognize revenue as these services are delivered.

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Revenues for our recurring revenue distributed generation projects are recognized over the term of the contract or when energy savings are realized by the customer at its site. Under these arrangements, we provide utilities and their customers with access to PowerSecure-owned and operated distributed generation systems, for standby power and to deliver peak shaving benefits. These contracts can involve multiple parties, with one party paying us for the value of backup power (usually, but not always, a commercial, industrial, or institutional customer), and one party paying us a fee or credit for the value of the electrical capacity provided by the system during peak power demand (either the customer or a utility).

Sales of certain goods and services sometimes involve the provision of multiple deliverables. Revenues from contracts with multiple deliverables are recognized as each element is earned based on the selling price for each deliverable. The selling price for each deliverable is generally based on our selling price for that deliverable on a stand-alone basis, third-party evidence if we do not sell that deliverable on a stand-alone basis, or an estimated selling price if neither specific selling prices nor third-party evidence exists.

***Cash and Cash Equivalents*** Cash and all highly liquid investments with a maturity of three months or less from the date of purchase, including money market mutual funds, short-term time deposits, and government agency and corporate obligations, are classified as cash and cash equivalents.

***Accounts Receivable*** Our customers include a wide variety of mid-sized and large businesses, utilities and institutions. We perform ongoing credit evaluations of our customers' financial condition and generally do not require collateral. We monitor collections and payments from our customers and adjust credit limits of customers based upon payment history and a customer's current credit worthiness, as judged by us. In certain instances, from time to time, we may purchase credit insurance on our accounts receivable in order to minimize our exposure to potential credit loss. We maintain a provision for estimated credit losses.

***Concentration of Credit Risk*** We are subject to concentrations of credit risk from our cash and cash equivalents and accounts receivable. We limit our exposure to credit risk associated with cash and cash equivalents by placing them with multiple domestic financial institutions. Nevertheless, our cash in bank deposit accounts at these financial institutions frequently exceeds federally insured limits. We have not experienced any losses in such accounts.

From time to time, we have derived a material portion of our revenues from one or more significant customers. To date, nearly all our revenues have been derived from sales to customers within the United States.

***Inventories*** Inventories are stated at the lower of cost (determined primarily on a specific-identification basis) or market. Our raw materials, equipment and supplies inventory consist primarily of equipment with long lead-times purchased for anticipated customer orders. Our work in progress inventory consists primarily of equipment and parts allocated to specific distributed generation turn-key projects and our utility infrastructure and ESCO project costs accounted for on the percentage-of-completion basis. Our finished goods inventory consists primarily of LED-based lighting products stocked to meet customer order and delivery requirements. We provide a valuation reserve primarily for raw materials, equipment and supplies and certain work in process inventory items that may be in excess of our needs, obsolete or damaged and requiring repair or re-work.

***Property, Plant and Equipment*** Property, plant and equipment are stated at cost and are generally depreciated using the straight-line method over their estimated useful lives, which depending on asset class ranges from 3 to 30 years.

***Goodwill and Other Intangible Assets*** We amortize the cost of specifically identifiable intangible assets that do not have an indefinite life over their estimated useful lives. We do not amortize goodwill and intangible assets with indefinite lives. We perform reviews of goodwill and intangible assets with indefinite lives for impairment annually,

as of October 1, or more frequently if impairment indicators arise. We capitalize software development costs integral to our products once technological feasibility of the products and software has been determined. Purchased software and software development costs are amortized over five years, using the straight-line method. Patents and license agreements are amortized using the straight-line method over the lesser of their estimated economic lives or their legal term of existence, currently 3 to 5 years.

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***Debt Issuance Costs*** Debt issuance costs are capitalized and included in other current and non-current assets in our condensed consolidated balance sheets. These costs are amortized over the term of the corresponding debt instrument using the straight-line method for debt issuance costs related to the revolving portion of our credit facility and the effective interest method for debt issuance costs on our term loan debt. Amortization of debt issuance costs is included in interest expense in our condensed consolidated statements of operations.

***Warranty Reserve*** We provide a standard one year warranty for our distributed generation, switchgear, utility infrastructure, and ESCO equipment and a 5 to 10 year warranty for our LED lighting-based products. In certain cases, we offer extended warranty terms for those product lines. In addition, we provide longer warranties for our PowerSecure Solar products and services including a warranty period of generally 1 to 5 years for defects in material and workmanship, a warranty period that can extend to 10 to 20 years for declines in power performance, and a warranty period which can extend to 15 to 25 years on the functionality of solar panels which is generally backed by the panel manufacturer. We reserve for the estimated cost of product warranties when revenue is recognized, and we evaluate our reserve periodically by comparing our warranty repair experience by product. The purchase price for extended warranties or for extended warranties included in the contract terms are deferred as a component of our warranty reserve. The balance of our warranty reserve was \$1.3 million at both September 30, 2014 and December 31, 2013, and is included in accrued and other liabilities in the accompanying condensed consolidated balance sheet.

***Share-Based Compensation*** We measure compensation cost for all stock-based awards at their fair value on date of grant and recognize the compensation expense over the service period for awards expected to vest, net of estimated forfeitures. We measure the fair value of restricted stock awards based on the number of shares granted and the last sale price of our common stock on the date of the grant. We measure the fair value of performance unit awards based on the underlying number of shares included in the performance units and the last sale price of our common stock on the date of the grant. We measure the fair value of stock options using the Black-Scholes valuation model.

Pre-tax share-based compensation expense for our stock options, restricted stock and performance unit awards recognized during the three months ended September 30, 2014 and 2013 was \$0.6 million and \$0.1 million, respectively. Pre-tax share-based compensation expense for our stock options, restricted stock and performance unit awards recognized during the nine months ended September 30, 2014 and 2013 was \$1.5 million and \$0.4 million, respectively. All share-based compensation expense is included in general and administrative expense in the accompanying condensed consolidated statements of operations.

***Impairment or Disposal of Long-Lived Assets*** We evaluate our long-lived assets whenever significant events or changes in circumstances occur that indicate that the carrying amount of an asset may be impaired. Recoverability of these assets is determined by comparing the forecasted undiscounted future cash flows from the operations to which the assets relate, based on management's best estimates using appropriate assumptions and projections at the time, to the carrying amount of the assets. If the carrying value is determined not to be recoverable from future operating cash flows, the asset is deemed impaired and an impairment loss is recognized equal to the amount by which the carrying amount exceeds the estimated fair value of the asset or assets. We did not record any long-lived asset impairment charges during the three or nine months ended September 30, 2014 and 2013.

***Income Taxes*** We recognize deferred income tax assets and liabilities for the estimated future tax consequences attributable to temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. We have net operating loss carryforwards available in certain jurisdictions to reduce future taxable income. Future tax benefits for net operating loss carryforwards are recognized to the extent that realization of these benefits is considered more likely than not. To the extent that available evidence raises doubt about the realization of a deferred income tax asset, a valuation allowance is established.

We recognize a liability and income tax expense, including potential penalties and interest, for uncertain income tax positions taken or expected to be taken. The liability is adjusted for positions taken when the applicable statute of limitations expires or when the uncertainty of a particular position is resolved.

***Derivative Financial Instruments*** Our derivative financial instruments consist solely of two interest rate swap contracts that are used to hedge our interest rate risk on a portion of our variable rate debt. These interest rate swap contracts are designated as cash flow hedges. It is our policy to execute such interest rate swaps with creditworthy banks and we do not enter into derivative financial instruments for speculative purposes.



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***Fair Value Measurements*** We measure our derivative instruments at fair value on a recurring basis. The fair value measurements standard establishes a framework for measuring fair value. The framework provides a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements), and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy under the standard are described below:

Level 1 Inputs to the valuation methodology are unadjusted quoted prices for identical assets or liabilities in active markets.

Level 2 Inputs to the valuation methodology include:

Quoted market prices for similar assets or liabilities in active markets;

Quoted prices for identical or similar assets or liabilities in inactive markets;

Inputs other than quoted prices that are observable for the asset or liability;

Inputs that are derived principally from or corroborated by observable market data by correlation or other means.

If the asset or liability has a specified (contractual) term, the Level 2 input must be observable for substantially the full term of the asset or liability.

Level 3 Inputs to the valuation methodology are unobservable and significant to the fair value measurement. The asset's or liability's fair value measurement level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. Valuation techniques used need to maximize the use of observable inputs and minimize the use of unobservable inputs.

See Note 7 for more information concerning the fair value of our derivative instruments.

***Subsequent Events*** Subsequent events are events or transactions that occur after the balance sheet date but before the financial statements are issued or are available to be issued and are classified as either recognized subsequent events or non-recognized subsequent events. We recognize and include in our financial statements the effects of subsequent events that provide additional evidence about conditions that existed at the balance sheet date. We disclose non-recognized subsequent events that provide evidence about conditions that arise after the balance sheet date but are not yet reflected in our financial statements when such disclosure is required to prevent the financial statements from being misleading.

## Recent Accounting Pronouncements

**Going Concern Disclosures** In August 2014, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update ( ASU ) No. 2014-15: Disclosure of Uncertainties About an Entity's Ability to Continue as a Going Concern ( ASU 2014-15 ). ASU 2014-15 requires management to perform interim and annual assessments of an entity's ability to continue as a going concern within one year of the date the financial statements are issued and provides guidance on determining when and how to disclose going concern uncertainties in the financial statements. Certain disclosures will be required if conditions give rise to substantial doubt about an entity's ability to continue as a going concern. ASU 2014-15 is effective for annual and interim reporting periods ending after December 15, 2016, with early adoption permitted. We do not expect that the adoption of this standard will have a material effect on our consolidated financial statements.

**Stock Compensation** In June 2014, the FASB issued ASU No. 2014-12, Compensation - Stock Compensation (Topic 718): Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period ( ASU 2014-12 ). ASU 2014-12 requires that a performance target that affects vesting, and that could be achieved after the requisite service period, be treated as a performance condition. As such, the performance target should not be reflected in estimating the grant date fair value of the award. This standard further clarifies that compensation cost should be recognized in the period in which it becomes probable that the

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performance target will be achieved and should represent the compensation cost attributable to the periods for which the requisite service has already been rendered. The new standard is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015 and can be applied either prospectively or retrospectively to all awards outstanding as of the beginning of the earliest annual period presented as an adjustment to opening retained earnings. Early adoption is permitted. We are evaluating the impact, if any, this new standard will have on our consolidated financial statements.

***Revenue Recognition*** In May 2014, the FASB issued ASU No. 2014-09: Revenue from Contracts with Customers ( ASU 2014-09 ). This standard replaces existing accounting literature relating to how and when a company recognizes revenue. Under ASU 2014-09, a company will recognize revenue when it transfers goods or services to customers in an amount equal to the amount that it expects to be entitled to receive in exchange for those goods and services. This standard also requires additional disclosure about the nature, amount, timing and uncertainty of revenue and cash flows arising from customer contracts, including significant judgments and changes in judgments. ASU 2014-09 will be effective for annual and interim periods beginning after December 15, 2016, and will be effective for us for our fiscal year that begins January 1, 2017, and permits the use of either the retrospective or cumulative effect transition method. Early adoption is not permitted. We are in the process of determining the method of adoption and evaluating the impact, if any, the adoption of this standard will have on our consolidated financial statements and related disclosures.

***Reporting Discontinued Operations*** In April 2014, the FASB issued ASU No. 2014-08: Presentation of Financial Statements (Topic 205) and Property, Plant, and Equipment (Topic 360): Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity ( ASU 2014-08 ). ASU 2014-08 changes the definition of a discontinued operation to include only those disposals of components of an entity that represent a strategic shift that has (or will have) a major effect on an entity's operations and financial results, and changes the criteria and enhances disclosures for reporting discontinued operations. This standard is to be applied prospectively, and is effective for our fiscal year that begins January 1, 2015. We do not expect that the adoption of this standard will have a material effect on our consolidated financial statements.

***Presentation of Unrecognized Tax Benefit*** In July 2013, the FASB issued ASU No. 2013-11, Income Taxes (Topic 740): Presentation of an Unrecognized Tax Benefit when a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists ( ASU 2013-11 ). ASU 2013-11 requires an entity to present unrecognized tax benefits as a reduction to deferred tax assets when a net operating loss carryforward, similar tax loss or a tax credit carryforward exists, with limited exceptions. This standard became effective for us commencing January 1, 2014. We applied the standard on a retrospective basis. The adoption of this standard resulted in the reclassification of \$1.0 million and \$0.9 million of unrecognized tax benefit liabilities against the balance of our current deferred tax asset at September 30, 2014 and December 31, 2013, respectively, but had no effect on our net income (loss) or stockholders equity.

### **3. Earnings (Loss) per Share**

Basic earnings (loss) per share is computed by dividing net income (loss) attributable to PowerSecure International, Inc. common stockholders by the weighted average number of common shares outstanding during the period. Diluted earnings (loss) per share attributable to PowerSecure International, Inc. common stockholders is computed using the weighted average number of common shares outstanding and, when dilutive, potential common shares from stock options using the treasury stock method. Diluted earnings per share excludes the impact of potential common shares related to stock options in periods in which we reported a loss from continuing operations or in which the option exercise price is greater than the average market price of our common stock during the period because the effect

would be antidilutive. A total of 449 thousand common shares issuable upon the potential exercise of outstanding stock options were excluded from the calculation of diluted weighted average number of shares outstanding for the three and nine months ended September 30, 2014, because their effect was antidilutive to our net loss for those periods.

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The following table sets forth the calculation of basic and diluted earnings (loss) per share attributable to PowerSecure International, Inc. common stockholders:

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2014</b>	<b>2013</b>	<b>2014</b>	<b>2013</b>
Net income (loss) attributable to PowerSecure International, Inc.	\$ (536)	\$ 3,473	\$ (7,543)	\$ 6,305
Basic weighted-average common shares outstanding in period	22,353	20,325	22,228	19,205
Dilutive effect of stock options		329		323
Diluted weighted-average common shares outstanding in period	22,353	20,654	22,228	19,528
Basic earnings (loss) per common share	\$ (0.02)	\$ 0.17	\$ (0.34)	\$ 0.33
Diluted earnings (loss) per common share	\$ (0.02)	\$ 0.17	\$ (0.34)	\$ 0.32

**4. Acquisitions**

**Data Center Energy Services Business** On October 14, 2014, we acquired the data center energy services business and certain related assets of Power Design, Inc., a Florida corporation ( PDI ), pursuant to an Asset Purchase and Sale Agreement (the Purchase Agreement ), between PDI, as seller, and PowerSecure, Inc., as purchaser. The purchase price paid for the acquired business and assets was \$13.0 million in cash plus an additional earn-out cash payment in the amount of \$1.0 million if PowerSecure obtains firm backlog after the closing in the amount of at least \$5.0 million from the acquired business, or in the amount of \$2.0 million if the firm backlog amount obtained after closing is at least \$15.0 million. The results of the acquired business operations will be included with those of the Company commencing October 14, 2014, the date of acquisition.

The acquired business provides full turnkey electrical infrastructure design, implementation and commissioning services to data center owners. Our PowerSecure subsidiary has previously provided its data center solutions as a supplier to PDI. We anticipate that the acquisition will provide us with a direct customer channel and capabilities to accelerate our access to key data center decision makers who are designing and evaluating backup power and control systems for their facilities.

The Purchase Agreement contains representations and warranties as well as indemnification obligations by PDI and PowerSecure to each other, subject to a \$3.0 million indemnification cap. In addition, the Purchase Agreement contains a five year covenant not to compete by PDI against PowerSecure and its affiliates with respect to the key customers in the acquired business, and related customary restrictive covenants relating to non-solicitation and confidentiality.



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The following table summarizes a preliminary fair value estimate of the consideration paid and the preliminary allocation of the fair value of the assets acquired:

Consideration paid to Seller:	
Cash	\$ 13,070
Contingent consideration	1,824
 Total consideration paid	 \$ 14,894
Net working capital	\$ 68
Property, plant and equipment, net	100
Identifiable intangible assets:	
Customer relationships	4,750
Noncompetition agreements	350
Technology and know how	100
Backlog	50
 Total identifiable net assets	 5,418
Goodwill	9,476
	\$ 14,894

The preliminary fair value allocation of the purchase consideration is subject to change, based on additional analysis currently being performed. As part of the preliminary purchase price allocation, we determined that the separately identifiable intangible assets acquired consisted of customer relationships, noncompetition agreements, technology and know-how and backlog which were valued using the income approach. This approach calculates the fair value by discounting the forecasted after-tax cash flows for each intangible asset back to a present value at an appropriate risk-adjusted rate of return. The data for these analyses was the cash flow estimates used to price the transaction. Fair value estimates are based on a complex series of judgments about future events and uncertainties and rely heavily on estimates and assumptions.

In estimating the useful lives of the acquired assets, we considered ASC 350-30-35, *General Intangibles Other Than Goodwill*, and reviewed the following factors: the expected use of the assets acquired, the expected useful life of another asset (or group of assets) related to the acquired assets, legal, regulatory or other contractual provisions that may limit the useful life of an acquired asset, the effects of obsolescence, demand, competition and other economic factors, and the level of maintenance expenditures required to obtain the expected future cash flows from the assets. We amortize these intangible assets over their estimated useful lives on a straight-line basis.

The goodwill of \$9.4 million arising from the acquisition consists largely of the assembled salesforce and the synergies and economies of scale expected from combining the operations of our Distributed Generation segment and the data center energy services business acquired. We expect all of the goodwill will be assigned to our Distributed Generation segment. We expect that all of the acquired goodwill will be deductible for tax purposes.

Pro forma financial information has not yet been completed and is subject to the results of an audit of the acquired business currently being performed.

***Electrical Contracting Business*** On September 2, 2014, we acquired the electrical contracting business of Apex Controls, Inc., a Georgia corporation ( Apex ). The acquired business provides retrofit and electrical contracting services to major retailers, in most cases through general contractors. This acquisition is part of our strategy to expand our Energy Efficiency services market base to retailers. Apex is a corporation primarily owned and managed by Jonathan Hinton, the son of Sidney Hinton, our President and Chief Executive Officer. The transaction was approved by the Audit Committee of our Board of Directors.

The purchase price for the acquisition was \$0.8 million in cash, plus potential additional earn-out consideration of up to \$0.5 million in cash if the gross profits generated from the acquired business in 2015 and 2016 exceeds certain targeted thresholds. Total revenues and pre-tax income from the Apex electrical contracting business since the date of



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acquisition included in the accompanying consolidated statements of operations for the nine months ended September 30, 2014 were not material. In addition, acquisition related costs incurred by us in the amount of \$16 thousand were recognized as an expense during the nine months ended September 30, 2014, and are included in general and administrative expense in the accompanying condensed consolidated statements of operations.

The following table summarizes the fair value of the consideration paid to the Apex stockholders and the allocation of the purchase price:

Consideration paid to Seller:	
Cash	\$ 750
Contingent consideration	340
 Total consideration paid	 \$ 1,090
 Property, plant and equipment, net	 \$ 155
Identifiable intangible assets:	
Customer relationships	330
 Total identifiable net assets	 485
Goodwill	605
	\$ 1,090

As part of the purchase price allocation, we determined that the separately identifiable intangible assets acquired consisted of customer relationships which were valued using the income approach. This approach calculates the fair value by discounting the forecasted after-tax cash flows for each intangible asset back to a present value at an appropriate risk-adjusted rate of return. The data for this analysis was the cash flow estimates used to price the transaction. Fair value estimates are based on a complex series of judgments about future events and uncertainties and rely heavily on estimates and assumptions.

In estimating the useful lives of the acquired assets, we considered ASC 350-30-35, *General Intangibles Other Than Goodwill*, and reviewed the following factors: the expected use of the assets acquired, the expected useful life of another asset (or group of assets) related to the acquired assets, legal, regulatory or other contractual provisions that may limit the useful life of an acquired asset, the effects of obsolescence, demand, competition and other economic factors, and the level of maintenance expenditures required to obtain the expected future cash flows from the assets. We amortize intangible assets over their estimated useful lives on a straight-line basis.

The goodwill of \$0.6 million arising from the acquisition consists largely of the assembled workforce and the synergies and economies of scale expected from combining the operations of our Energy Efficiency segment and the Apex electrical contracting business. All of the goodwill was assigned to our Energy Efficiency segment. We expect that all of the acquired goodwill will be deductible for tax purposes.

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Supplemental pro forma information, as if the acquisition had occurred on January 1, 2013, is as follows:

<b>PowerSecure International, Inc.</b>		
<b>Acquisition of Electrical Contracting Business</b>		
<b>Pro Forma Results of Operations</b>		
<b>For the Nine Months Ended September 30,</b>		
	<b>2014</b>	<b>2013</b>
Revenues	\$ 176,653	\$ 200,577
Net income (loss) attributable to PowerSecure International, Inc.	\$ (7,441)	\$ 7,019
Earnings (loss) per share attributable to PowerSecure International, Inc.:		
Basic	\$ (0.33)	\$ 0.37
Diluted	\$ (0.33)	\$ 0.36

The supplemental pro forma information above is based on estimates and assumptions that we believe are reasonable. The pro forma information presented is not necessarily indicative of the consolidated results of operations in future periods or the results that actually would have been realized had the acquisition occurred on January 1, 2013. The supplemental pro forma results above for the nine months ended September 30, 2014 were adjusted to exclude the acquisition-related costs incurred by us in 2014.

**5. Restructuring Charges**

During 2013 and 2012, we engaged in two separate restructuring programs designed to reduce our cost structure and improve productivity. These initiatives consisted of realigning operations, reducing employee counts, rationalizing facilities, changing manufacturing sourcing, eliminating certain products, and other actions designed to reduce our cost structure and improve productivity. We also incurred inventory and long-term asset impairment charges in connection with our 2013 restructuring activities for assets sold or made obsolete. Our restructuring program activities and the balances of our accrued restructuring liabilities at September 30, 2014 and December 31, 2013 are described in greater detail below.

**2013 Business Realignment Charges** During the fourth quarter 2013, we initiated a business realignment program, taking actions to realign our operations to gain cost and performance efficiencies. These actions, which primarily involved our LED lighting operations in our Energy Efficiency segment, consisted of the sale of manufacturing equipment and parts inventory, reorganization and consolidation of the leadership teams, closing facilities and re-sourcing manufacturing to low-cost manufacturers, eliminating certain products, and the reduction of our overhead cost structure by eliminating duplicative facilities and personnel involved in production, sourcing, warehousing and distribution activities. As a result of these 2013 business realignment initiatives, we incurred pre-tax restructuring charges totaling \$0.7 million during the nine months ended September 30, 2014. These charges consisted of severance and related costs from the elimination of employee positions, inventory write offs, and lease abandonment charges. The inventory write-offs in the amount of \$0.3 million during the nine months ended September 30, 2014 are included in cost of sales. The expenses associated with the remaining 2013 business realignment charges total \$0.4 million and are included in restructuring charges as a component of operating expenses. We do not expect to incur any additional charges associated with the 2013 business realignment initiatives after September 30, 2014.



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The following table summarizes the 2013 business realignment plan activities, and the balance of our accrued liabilities at and for the nine months ended September 30, 2014:

	<b>Employee Termination Costs</b>	<b>Inventory Writedowns and Long Term Asset Disposals</b>	<b>Leasehold Termination and Other Facility Exit Costs</b>	<b>Total</b>
<b>2013 Business Realignment Charges:</b>				
Accrued 2013 business realignment charges, December 31, 2013	\$ 681	\$	\$ 110	\$ 791
Costs incurred and charged to cost of sales		312		312
Costs incurred and charged to restructuring expense	162	116	149	427
Costs paid or otherwise settled	(687)	(428)	(232)	(1,347)
Accrued 2013 business realignment charges, September 30, 2014	\$ 156	\$	\$ 27	\$ 183

**2012 Cost Reduction Program Charges** During the third quarter 2012, we initiated a cost reduction program, taking actions to restructure and streamline our organization to reduce our costs, and to set the framework to improve the scalability of our cost structure as we grow revenues. The goal of this cost reduction program was to reduce expenses as a percentage of revenues in future periods thereby improving our operating margin. The associated cost reduction charges were incurred entirely in the second half of 2012. The following table summarizes the 2012 cost reduction program activities, and the balance of the 2012 cost reduction program liabilities at and for the nine months ended September 30, 2014:

	<b>Employee Termination Costs</b>
<b>2012 Cost Reduction Program Charges:</b>	
Accrued 2012 cost reduction program charges, December 31, 2013	\$ 174
Costs incurred and charged to expense	
Costs paid or otherwise settled	(172)
Accrued 2012 cost reduction program charges, September 30, 2014	\$ 2

The balances of accrued restructuring charges at September 30, 2014 and December 31, 2013 are included in current liabilities in our consolidated balance sheet. We expect the majority of the balance of our accrued restructuring charges at September 30, 2014 will be paid or otherwise settled during the remainder of 2014.

## **6. Debt and Interest Rate Swap Contracts**

We have had a long-term credit facility with Citibank, N.A. ( Citibank ), as administrative agent and lender, and other lenders since entering into a credit agreement in August 2007, which has been amended and restated from time-to-time. At September 30, 2014 and December 31, 2013, our credit agreement with Citibank along with Branch Banking and Trust Company ( BB&T ) as additional lender, consisted of a \$20.0 million senior, first-priority secured revolving line of credit maturing on November 12, 2016, a \$2.6 million term loan maturing on November 12, 2016, and a \$25.0 million, 7 year amortizing term loan maturing on September 30, 2020. The credit agreement is guaranteed by all our active subsidiaries and is secured by the assets of us and those subsidiaries.

On July 2, 2014 we entered into an amendment to our credit agreement. The only provision of the credit agreement modified by this amendment was an increase in the letter of credit sublimit to \$12.0 million. The letter of credit sublimit, pursuant to which the lenders may issue letters of credit on our behalf to provide security arrangements to third parties on our behalf, is part of, but not an addition to, our \$20.0 million revolver under the credit agreement. In

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conjunction with this amendment, on July 2, 2014 our lenders issued a \$12.0 million letter of credit to our bonding surety to support our bonding arrangements under two contracts to construct two large solar energy projects for a major utility. Our bonding surety released the \$12.0 million letter of credit on August 29, 2014 upon receipt of acceptable surety bonding from the solar panel manufacturer.

The credit facility contains certain financial covenants. Under the credit agreement, if cash on hand does not exceed funded indebtedness by at least \$5.0 million, then our minimum fixed charge coverage ratio must be in excess of 1.25. On October 10, 2014, we entered into an amendment to our credit agreement to modify two financial covenants of the Company. First, the fixed charge coverage ratio covenant was amended so that, for the fiscal quarter ended September 30, 2014, it will be calculated based solely on the Company's financial results for that quarter. For the fiscal quarters ending December 31, 2014 and March 31, 2015, the fixed charge coverage ratio will be based on the Company's financial results for the third quarter 2014 and subsequent fiscal quarters. For the fiscal quarter ending June 30, 2015 and thereafter, the fixed charge coverage ratio will be based on our financial results for the previous four fiscal quarters on a rolling basis. This amendment did not modify the trigger for the fixed charge coverage ratio covenant or the minimum ratio itself. Second, this amendment replaced the consolidated tangible net worth covenant with a consolidated net worth covenant based on our consolidated net worth, subject to certain adjustments such as future net income or increases in shareholder's equity resulting from sales of equity similar to the adjustments to the prior consolidated tangible net worth covenant. At September 30, 2014 we were required to have a minimum \$142.1 million consolidated net worth. The October 10, 2014 amendment did not change the covenant requirement that we maintain a maximum debt to capitalization ratio, computed as funded indebtedness divided by the sum of funded indebtedness plus stockholders equity, of no more than 30%. As of September 30, 2014, we were in compliance with these financial covenants.

The following table summarizes the balances outstanding on our long-term debt, including our revolving line of credit, with Citibank and BB&T at September 30, 2014 and December 31, 2013:

	<b>September 30, 2014</b>	<b>December 31, 2013</b>
Revolving line of credit, maturing November 12, 2016	\$	\$
Term loan, principal of \$0.04 million plus interest payable quarterly at variable rates, maturing November 12, 2016	1,960	2,080
Term loan, principal of \$0.9 million plus interest payable quarterly at variable rates, maturing June 30, 2020	20,536	23,214
Total debt	22,496	25,294
Less: Current portion	(3,731)	(3,731)
Long-term debt, net of current portion	\$ 18,765	\$ 21,563

We have used, and intend to continue to use, the proceeds available under the credit facility to support our growth and future investments in Company-owned distributed generation projects, additional UtilityServices equipment, working capital, other capital expenditures, acquisitions and general corporate purposes.

Outstanding balances under the credit facility bear interest, at our discretion, at either the London Interbank Offered Rate ( LIBOR ) for the corresponding deposits of U. S. Dollars plus an applicable margin, which is on a sliding scale ranging from 2.00% to 3.25% based upon our leverage ratio, or at Citibank 's alternate base rate plus an applicable margin, on a sliding scale ranging from 0.25% to 1.50% based upon our leverage ratio. Letters of credit issued on our behalf bear interest at LIBOR plus the applicable margin. Our leverage ratio is the ratio of our funded indebtedness as of a given date, net of our cash on hand in excess of \$5.0 million, to our consolidated EBITDA, as defined in the credit agreement, as amended. Citibank 's alternate base rate is equal to the higher of the Federal Funds Rate as published by the Federal Reserve of New York plus 0.50%, Citibank 's prime commercial lending rate and 30 day LIBOR plus 1.00%.

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Scheduled remaining principal payments on our outstanding debt obligations at September 30, 2014, are as follows:

<b>Scheduled Principal Payments for the Year Ending December 31:</b>	<b>Revolving Line of Credit</b>	<b>\$25.0 Million Term Loan</b>	<b>\$2.6 Million Term Loan</b>	<b>Total Principal Payments</b>
Remainder of 2014	\$	\$ 893	\$ 40	\$ 933
2015		3,571	160	3,731
2016		3,571	1,760	5,331
2017		3,572		3,572
2018 and thereafter		8,929		8,929
<b>Total scheduled principal payments</b>	<b>\$</b>	<b>\$ 20,536</b>	<b>\$ 1,960</b>	<b>\$ 22,496</b>

In July 2013, we entered into two forward-starting interest rate swap contracts based on three-month LIBOR that effectively converted 80% of the outstanding balance of our \$25 million Term Loan to fixed rate debt. As discussed further in Note 7, we have designated the interest rate swaps as a cash flow hedge of the interest payments due on our floating rate debt. Accordingly, at September 30, 2014, \$16.4 million of our outstanding debt bears interest at a fixed rate of 3.73% and \$6.1 million of our outstanding debt bears interest at floating rates as described above. The termination dates of the swap contracts and the maturity date of the \$25 million Term Loan are both September 30, 2020.

The credit facility contains customary terms and conditions for credit facilities of this type, including restrictions or limits on our ability to incur additional indebtedness, create liens, enter into transactions with affiliates, pay dividends on our capital stock, repurchase stock, and consolidate or merge with other entities. In addition, the credit agreement contains customary events of default, including payment defaults, breach of representations and warranties, covenant defaults, cross-defaults, certain bankruptcy or insolvency events, judgment defaults and certain ERISA-related events.

Our obligations under the credit facility are secured by guarantees ( Guarantees ) and security agreements (the Security Agreements ) by each of our active subsidiaries, including PowerSecure, Inc. and its subsidiaries. The Guarantees guaranty all of our obligations under the credit facility, and the Security Agreements grant to the lenders a first priority security interest in virtually all of the assets of each of the parties to the credit agreement.

There was an aggregate balance of \$22.5 million outstanding under the two term loans under our credit facility as of September 30, 2014. There were no balances outstanding on the revolving portion of the credit facility at, or during the nine months ended, September 30, 2014 or at December 31, 2013 or at November 5, 2014. In addition, there were no outstanding letters of credit reducing the amount available to borrow under the revolving portion of the credit facility at September 30 or November 5, 2014. Accordingly, we currently have \$20.0 million available to borrow under the revolving portion of the credit facility. The availability of capital under our credit facility includes restrictions on the use of proceeds, and is dependent upon our ability to satisfy certain financial and operating covenants, as described above.

## 7. Derivative Instruments and Hedging Activities



In July 2013, we entered into two forward-starting interest rate swap contracts to manage interest rate risk associated with a portion of our \$25 million Term Loan floating rate debt (see Note 6). The interest rate swaps effectively converted 80% of the outstanding balance of our \$25.0 million floating rate term loan to a fixed rate term loan bearing interest at the rate of 3.73%. The notional amount of the interest rate swaps at September 30, 2014 was \$16.4 million. The termination dates of the swap contracts and the maturity date of the \$25 million Term Loan are both September 30, 2020.

In accordance with ASC 815, *Derivatives and Hedging*, we have designated both of our interest rate swaps as cash flow hedges of the interest payments due on our floating rate debt. To qualify for designation as a cash flow hedge, specific criteria must be met and the appropriate documentation maintained. Hedging relationships are established pursuant to our risk management policies and are initially and regularly evaluated to determine whether they are expected to be, and have been, highly effective hedges. For our interest rate swap contracts designated as a cash flow hedge of interest on our floating rate debt, the effective portion of the change in fair value of the derivative is reported in other

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comprehensive income and reclassified into earnings in the period in which the hedged item affects earnings. Any amounts excluded from the effectiveness calculation and any ineffective portion of the change in fair value of the derivative are recognized currently in earnings.

The interest rate swaps are measured at Level 2 fair value on a recurring basis, using standard pricing models and market-based assumptions for all significant inputs, such as LIBOR yield curves. The fair value of the interest rate swap contracts included within our consolidated balance sheets as of September 30, 2014 and December 31, 2013, are as follows:

**Derivative designated as**

hedging instrument:	Balance Sheet September 30, 2014		Balance Sheet December 31, 2013			
	Location	2014	2013	Location	2014	2013
				Other long-term		
Interest rate swaps	Other assets	\$	\$	liabilities	\$ 103	\$ 157

The following tables present the effects of derivative instruments designated as cash flow hedges on our consolidated statements of operations and accumulated other comprehensive income (loss) ( AOCI ):

AOCI Component	Amounts Reclassified from AOCI into income				Affected Line Item in the Consolidated Statements of Operations
	Three Months Ended September 30, 2014		Nine Months Ended September 30, 2013		
Gain (loss) on cash flow hedges:					
Interest rate swaps	\$ 65	\$	\$ 202	\$	Interest expense
	(24)		(74)		Tax expense (benefit)
	\$ 41	\$	\$ 128	\$	Net of tax

AOCI Component	Amount of gain (loss) recognized in AOCI			
	Three Months Ended September 30, 2014		Nine Months Ended September 30, 2013	
Gain (loss) on cash flow hedges:				
Unrealized gain (loss) - Interest rate swaps	\$ 39	\$ (257)	\$ (148)	\$ (257)
Tax (expense) benefit	(14)	100	54	100
Gain (loss) - net of tax	\$ 25	\$ (157)	\$ (94)	\$ (157)

We did not realize any ineffectiveness related to our cash flow hedges during the three and nine months ended September 30, 2014 and 2013.

**8. Capital Lease Obligations**

We have a capital lease with SunTrust Equipment Finance and Leasing, an affiliate of SunTrust Bank, from the sale and leaseback of distributed generation equipment placed in service at customer locations. We received \$5.9 million from the sale of the equipment in December 2008 which we are repaying under the terms of the lease with monthly principal and interest payments of \$0.1 million over a period of 84 months. At the expiration of the term of the lease in December 2015, we have the option to purchase the equipment for \$1 dollar, assuming no default under the lease by us has occurred and is then continuing. The lease is guaranteed by us under an equipment lease guaranty. The lease and the lease guaranty constitute permitted indebtedness under our current credit agreement.

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Proceeds of the lease financing were used to finance capital investments in equipment for our recurring revenue distributed generation projects. We account for the lease financing as a capital lease in our condensed consolidated financial statements.

The lease provides us with limited rights, subject to the lessor's approval which will not be unreasonably withheld, to relocate and substitute equipment during its term. The lease contains representations and warranties and covenants relating to the use and maintenance of the equipment, indemnification and events of default customary for leases of this nature. The lease also grants to the lessor certain remedies upon a default, including the right to cancel the lease, to accelerate all rent payments for the remainder of the term of the lease, to recover liquidated damages, or to repossess and re-lease, sell or otherwise dispose of the equipment.

The balance of our capital lease obligations shown in the accompanying condensed consolidated balance sheet at September 30, 2014 and December 31, 2013 consists entirely of our obligations under the equipment lease described above.

## **9. Share-Based Compensation**

We recognize compensation expense for all share-based awards made to employees and directors based on estimated fair values on the date of grant.

**Stock Plans** Historically, we have granted stock options and restricted stock awards to employees and directors under various stock plans. During 2014, we also commenced utilizing performance unit awards to compensate certain employees. We currently maintain two stock plans. Under our 1998 Stock Incentive Plan, as amended (the "1998 Stock Plan"), we granted incentive stock options, non-qualified stock options, stock appreciation rights, restricted stock, performance awards and other stock-based awards to our officers, directors, employees, consultants and advisors for shares of our common stock. Stock options granted under the 1998 Stock Plan contained exercise prices not less than the fair market value of our common stock on the date of grant, and had a term of 10 years from the date of grant. Nonqualified stock option grants to our directors under the 1998 Stock Plan generally vested over periods up to two years. Qualified stock option grants to our employees under the 1998 Stock Plan generally vested over periods up to five years. The 1998 Stock Plan expired on June 12, 2008, and no additional awards may be made under the 1998 Stock Plan, although awards granted prior to such date will remain outstanding and subject to the terms and conditions of those awards.

In March 2008, our board of directors adopted the PowerSecure International, Inc. 2008 Stock Incentive Plan (the "2008 Stock Plan"), which was approved by our stockholders at the Annual Meeting of Stockholders held on June 9, 2008. The 2008 Stock Plan authorizes our board of directors to grant incentive stock options, non-qualified stock options, stock appreciation rights, restricted stock, performance awards and other stock-based awards to our officers, directors, employees, consultants and advisors for up to an aggregate of 0.6 million shares of our common stock. Stock options granted under the 2008 Stock Plan must contain exercise prices not less than the fair market value of our common stock on the date of grant, and must contain a term not in excess of 10 years from the date of grant. On June 19, 2012, at our 2012 Annual Meeting of Stockholders, our stockholders adopted and approved an amendment and restatement of the 2008 Stock Incentive Plan, including an amendment to increase the number of shares of our common stock authorized thereunder by 1.4 million shares to a total of 2.0 million shares. The 2008 Stock Plan replaced our 1998 Stock Plan.

**Stock Options** Net income (loss) for the three months ended September 30, 2014 and 2013 includes \$49 thousand and \$35 thousand, respectively, of pre-tax compensation costs related to outstanding stock options. Net income (loss) for

the nine months ended September 30, 2014 and 2013 includes \$137 thousand and \$111 thousand, respectively, of pre-tax compensation costs related to outstanding stock options. All of the stock option compensation expense is included in general and administrative expenses in the accompanying condensed consolidated statements of operations.

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A summary of option activity for the nine months ended September 30, 2014 is as follows:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (years)	Aggregate Intrinsic Value
Balance, December 31, 2013	669	\$ 8.59		
Granted	30	13.55		
Exercised	(237)	8.68		
Expired				
Forfeited	(13)	4.58		
Balance, September 30, 2014	449	\$ 8.99	4.87	\$ 0.59
Exercisable, September 30, 2014	319	\$ 8.01	3.42	\$ 1.57

A summary of option activity for the nine months ended September 30, 2013 is as follows:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (years)	Aggregate Intrinsic Value
Balance, December 31, 2012	838	\$ 7.21		
Granted	70	14.97		
Exercised	(177)	5.64		
Expired				
Forfeited	(10)	6.74		
Balance, September 30, 2013	721	\$ 8.36	4.67	\$ 7.69
Exercisable, September 30, 2013	533	\$ 8.13	3.41	\$ 7.92

The weighted average grant date fair value of stock options granted during the nine months ended September 30, 2014 and 2013 was \$5.61 and \$6.04, respectively. The fair value of the stock options granted during the nine months ended September 30, 2014 and 2013 was measured using the Black-Scholes valuation model with the following assumptions:

	Nine Months Ended September 30,	
	2014	2013
Expected stock price volatility	45.8%	44.5%

Risk free interest rate	1.7%	1.4%
Annual dividends	\$	\$
Expected life (years)	5	5

The fair value of stock option grants is amortized to expense over the respective service periods using the straight-line method and assuming a forfeiture rate of 5%. As of September 30, 2014 and December 31, 2013, there was \$0.6 million and \$0.5 million, respectively, of total unrecognized compensation costs related to stock options. These costs at September 30, 2014 are expected to be recognized over a weighted average period of approximately 1.9 years.

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During the three months ended September 30, 2014 and 2013, the total intrinsic value of stock options exercised was \$40 thousand and \$76 thousand, respectively. Cash received from stock option exercises during the three months ended September 30, 2014 and 2013 was \$15 thousand and \$99 thousand, respectively. The total grant date fair value of stock options vested during the three months ended September 30, 2014 and 2013 was \$110 thousand and \$33 thousand, respectively.

During the nine months ended September 30, 2014 and 2013, the total intrinsic value of stock options exercised was \$3.3 million and \$1.3 million, respectively. Cash received from stock option exercises during the nine months ended September 30, 2014 and 2013 was \$2.0 million and \$1.0 million, respectively. The total grant date fair value of stock options vested during the nine months ended September 30, 2014 and 2013 was \$175 thousand and \$90 thousand, respectively.

**Restricted Stock Awards** Net income (loss) for the three months ended September 30, 2014 and 2013 includes \$0.5 million and \$0.1 million, respectively, of pre-tax compensation costs related to the vesting of outstanding restricted stock awards granted to directors and employees. Net income (loss) for the nine months ended September 30, 2014 and 2013 includes \$1.3 million and \$0.3 million, respectively, of pre-tax compensation costs related to the vesting of outstanding restricted stock awards granted to directors and employees. All of the restricted stock award compensation expense during the three and nine months ended September 30, 2014 and 2013 is included in general and administrative expenses in the accompanying condensed consolidated statements of operations.

A summary of restricted stock award activity for the nine months ended September 30, 2014 is as follows:

	<b>Unvested Restricted Shares</b>	<b>Weighted Average Grant Date Fair Value</b>
Balance, December 31, 2013	387	\$ 14.37
Granted	246	20.48
Vested	(32)	9.67
Forfeited	(5)	23.44
Balance, September 30, 2014	596	\$ 17.07

A summary of restricted stock award activity for the nine months ended September 30, 2013 is as follows:

	<b>Unvested Restricted Shares</b>	<b>Weighted Average Grant Date Fair Value</b>
Balance, December 31, 2012	100	\$ 5.62
Granted	68	12.02
Vested	(51)	5.65



## Forfeited

Balance, September 30, 2013	117	\$	9.32
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Restricted shares are subject to forfeiture and cannot be sold or otherwise transferred until they vest. If the holder of the restricted shares leaves us before the restricted shares vest, other than due to termination by us without cause, then any unvested restricted shares will be forfeited and returned to us. The restricted shares granted to directors vest in equal amounts over a period of one or three years, depending on the nature of the grant. The restricted shares granted to employees generally vest over five or ten years. All restricted and unvested shares automatically vest upon a change in control.

The fair value of the restricted shares is amortized on a straight-line basis over the respective vesting period. At September 30, 2014, the balance of unrecognized compensation cost related to unvested restricted shares was \$9.1 million, which is expected to be recognized over a weighted average period of approximately 4.6 years.

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**Performance Units** During the nine months ended September 30, 2014, our Board of Directors awarded performance units under our 2008 Stock Plan. The performance units obligate the Company to issue a variable number of shares of its common stock in the event certain cumulative earnings per share performance thresholds are met for quarterly reporting periods commencing June 30, 2014 and ending December 31, 2016. At September 30, 2014, the number of shares issuable upon attainment of performance thresholds ranges from 18 thousand to 55 thousand shares. Net loss for the three and nine months ended September 30, 2014 includes \$35 thousand of pre-tax compensation costs related to outstanding performance units. There was no performance unit compensation expense during the three or nine months ended September 30, 2013. All of the performance unit compensation expense during the three and nine months ended September 30, 2014 is included in general and administrative expenses in the accompanying condensed consolidated statements of operations.

**10. Commitments and Contingencies**

**Securities Class Action and Related Litigation** On May 22, 2014, a putative securities class action lawsuit was filed against us and certain of our executive officers in the United States District Court for the Eastern District of North Carolina. Subsequently, in May and in July 2014, two additional purported securities class action lawsuits were filed against the same defendants in the United States District Courts, one in the Eastern District of North Carolina and the other in the Western District of North Carolina. On October 10, 2014, these lawsuits were consolidated in the United States District Court for the Eastern District of North Carolina, and a lead plaintiff was appointed. As consolidated, the lawsuit was filed on behalf of all persons or entities that purchased our common stock during a purported class period from August 8, 2013 through May 7, 2014, which is the longer of the two different purported class periods used in the pre-consolidation lawsuits. A consolidated amended complaint is due to be filed on or before December 9, 2014. The action alleges that certain statements made by the defendants during the applicable class period violated federal securities laws. The lawsuit seeks damages in an unspecified amount, and no determination has been made on the status of the lawsuits proposed as class actions. We believe that the claims asserted in this class action litigation are without merit, and we intend to vigorously defend against all such allegations.

On August 15, 2014, a shareholder derivative complaint was filed against certain of our executive officers and each of our directors during the class period in the United States District Court for the Eastern District of North Carolina. The complaint alleges breach of fiduciary duty, waste of corporate assets and unjust enrichment by the named officers and directors in connection with substantially the same events as set forth in the class action lawsuit, seeking damages in an unspecified amount.

We have various insurance policies related to the risk associated with our business, including directors and officers liability insurance policies. However, there is no assurance that our insurance coverage will be sufficient or that our insurance carriers will cover all claims. The ultimate outcome of these proceedings cannot be accurately predicted due to the inherent uncertainty of litigation and the litigation is at a very early stage. Other than an immaterial amount for expected legal expenses, we have not accrued any costs for the securities class actions as we do not believe, based upon current information, that a loss relating to these matters is probable, or that an estimate of a range of potential loss relating to these matters, can reasonably be made.

**Performance Bonds and Letters of Credit** In the ordinary course of business, we are required by certain customers to post surety or performance bonds or letters of credit in connection with services that we provide to them. These bonds and letters of credit provide a guarantee to the customer that we will perform under the terms of a contract and that we will pay subcontractors and vendors. If we fail to perform under a contract or to pay subcontractors and vendors, the customer may demand that the surety, in the case of a performance bond, or our lenders, in the case of a letter of credit, make payments or provide services under the bond. We must reimburse the surety or our lenders for

any expenses or outlays they incur. On July 2, 2014, our surety issued a \$120.0 million surety bond on our behalf in connection with two utility-scale solar contracts. Our lenders posted a \$12.0 million letter of credit and we provided a \$3.0 million cash deposit as additional collateral to and for the benefit of our bonding agent to support our performance

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obligations under the contracts. Both the deposit and the letter of credit were released and canceled during the three months ended September 30, 2014 upon the receipt of acceptable performance bonds from the panel manufacturer that backstops the on-time delivery of quality panels. We have not been required to make any reimbursements to our sureties for bond-related costs, and we do not currently expect that we will have to fund significant claims under our surety arrangements in the foreseeable future. As of September 30, 2014, we had approximately \$249.5 million in surety bonds outstanding. Based upon the current status of our contracts and projects, we estimate our remaining exposure on these surety bonds was approximately \$142.7 million at September 30, 2014.

***Employee Matters*** From time to time, we hire employees that are subject to restrictive covenants, such as non-competition agreements with their former employers. We comply, and require our employees to comply, with the terms of all known restrictive covenants. However, we have in the past and may in the future receive claims and demands by some former employers alleging actual or potential violations of these restrictive covenants. These claims are inherently difficult to predict, and therefore we generally cannot provide any assurance of the outcome of claims. We do not have any specific claims outstanding at this time.

***Product Performance and Component Parts Matters*** From time to time, in the ordinary course of business we encounter issues with component parts that affect the performance of our distributed generation systems, switchgear systems, utility infrastructure products, engines, generators, alternators, breakers, fuel systems, LED and other lighting products, electrical circuit boards, power drivers, photovoltaic energy systems, inverters, and other complex electrical products. While we strive to utilize high quality component parts from reputable suppliers, and to back-up their quality and performance with manufacturers' warranties, even the best parts and components have performance issues from time to time, and these performance issues create significant financial and operating risks to our business, operations and financial results. In addition, because we regularly develop new products and technical designs, we often incorporate component parts into these new products in configurations, for uses, and in environments, for which limited experience exists and which exposes us to performance risks that may not be covered by warranties, or may invalidate warranties or performance certifications. As we strive to bring solutions to customers with unique capabilities that provide performance and cost advantages, from time to time we use new suppliers and new products for applications where track record of performance does not exist, or is difficult to ascertain. As a result, we can encounter situations in which the responsibility for the performance issues is unclear, or difficult to ascertain. Because of our strong focus on customer satisfaction, we often take on the cost of repairs in excess of our contractual obligations. Additionally, the outcome of any performance disputes or warranty claims is inherently difficult to predict due to the uncertainty of technical solutions, cost, customer requirements, and the uncertainty inherent in litigation and disputes generally. As a result, there is no assurance we will not be adversely affected by these, or other performance issues with key parts and components. Moreover, performance issues may not be covered by manufacturer's warranties, certain suppliers may not be financially able to fulfill their warranty obligations, and customers may also claim damages as a result of those performance issues. Also, the mere existence of performance issues, even if finally resolved with our suppliers and customers, can have an adverse effect on our reputation for quality, which could adversely affect our business.

We estimate that from time to time we have performance issues related to component parts which have a cost basis of approximately 5-10% of our estimated annual revenues, although not necessarily limited to this amount, which are installed in equipment we own and have sold to various customers across our business lines, and additional performance issues could arise in the future. In addition, the failure or inadequate performance of these components pose potential material and adverse effects on our business, operations, reputation and financial results, including reduced revenues for projects in process or future projects, reduced revenues for recurring revenue contracts which are dependent on the performance of the affected equipment, additional expenses and capital cost to repair or replace the affected equipment, inventory write-offs for defective components held in inventory, asset write-offs for company-owned systems which have been deployed, the cancellation or deferral of contracts by our customers, or

claims made by our customers for damages as a result of performance issues.

We have experienced performance issues with two types of component parts, in particular, which we have made progress in correcting or mitigating, but which continue to represent operational and financial risks to our business: 1) a component we incorporated into a distributed generation system configuration installed in many of the systems deployed for our customers has been deemed to invalidate the generator manufacturer's warranty and may cause other customer issues and costs, and 2) generators we purchased from a certain supplier have had performance issues in a system we own, and for which we have a performance-based recurring revenue contract that is dependent on the system's successful

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operation. In both of these matters, we have actively worked to correct and resolve the performance issues and have made progress in mitigating certain elements of their risk, but the risk is not eliminated. Given that we continue to have risk related to these matters, and the inherent uncertainty in assessing and quantifying the costs and certainty regarding their resolution, we are unable to estimate the potential negative impacts from these two particular items, if any, in addition to other component part performance issues discussed above. In addition, we have not recorded any specific adjustment to our warranty reserve for these particular performance issues, other than our regular reserves for minor repairs, as the estimated cost, if any, of fulfilling our obligations for these matters within a possible range of outcomes is not determinable as of this date.

***Utility-Scale Solar Project Contract Matters*** On July 2, 2014, we entered into two Engineering, Procurement and Construction Agreements ( EPC Contracts ) with a large investor-owned utility customer (the Utility ). Each of these EPC Contracts relates to a similarly sized large-scale solar distributed generation project which will be performed for the Utility for the benefit of the Utility s customer. We expect these solar projects to generate a total of \$120 million in revenues, and be completed over the course of 2015 and 2016. We also expect that these projects, which are large in scale and carry significantly lower gross profit margins as a percentage of revenues compared to traditional projects of this type, will carry single digit gross margins as a percentage of revenues. This will be dilutive to our consolidated gross margins, while being accretive to our net income and earnings per share.

The EPC Contracts, which are virtually identical in rights and obligations and differ primarily in project descriptions, provide for customary covenants, representations, warranties and indemnities to the Utility. The EPC Contracts also include terms requiring us to provide performance guarantees and indemnification to the Utility under certain circumstances, as well as provisions requiring us to pay the Utility liquidated damages upon the occurrence of certain events, including certain delays in substantial completion and when the system is placed in service. The aggregate limit on our liability to the Utility for delay liquidated damages under the EPC Contracts is approximately \$24 million per contract, and \$48 million in total. We could have additional liability to the Utility for any breaches of our covenants, representations or warranties in addition to delay liquidated damages. The EPC Contracts also contain typical events of default, including material breaches of the EPC Contracts after notice and cure periods and defaults relating to bonding and surety failures. The EPC Contracts may be terminated by us upon an event of default by the Utility, in which case we would be entitled to the payment for work performed and for actual costs incurred. We also provide a warranty on each project for three years after substantial completion of the project.

In addition, the solar projects covered by the EPC Contracts are subject to bonding and surety requirements. In connection with these requirements, we have obtained, for the benefit of the Utility, bonding and surety arrangements in the amount of approximately \$120 million. The panel manufacturer has provided a performance bond to our surety in the amount of approximately \$60 million that backstops the on-time delivery of quality panels.

The solar projects under each EPC Contract were subject to certain conditions that were required to be met within 120 days of the date of either EPC Contract. Those conditions have been timely met, and the Utility has issued a notice to proceed under the EPC Contracts, ending the prior rights to terminate the EPC Contracts. The scheduled substantial completion and placed in service dates of each EPC Contract are no later than August 1, 2016 and December 31, 2016, respectively.

***Other Matters*** From time to time, we are involved in other disputes, claims, proceedings and legal actions arising in the ordinary course of business. We intend to vigorously defend all claims against us, and pursue our full legal rights in cases where we have been harmed. Although the ultimate outcome of these proceedings cannot be accurately predicted due to the inherent uncertainty of litigation, in the opinion of management, based upon current information, no other currently pending or overtly threatened proceeding is expected to have a material adverse effect on our business, financial condition or results of operations.

**11. Income Taxes**

The income tax expense (benefit) for the three and nine months ended September 30, 2014 and 2013 represents our income (loss) before income taxes multiplied by our best estimate of our expected annual effective tax rate taking into consideration our expectation of future earnings, federal income tax, state income tax for state jurisdictions in which we expect taxable income, potential effects of adverse outcomes on tax positions we have taken, true-up effects of prior tax provision estimates compared to actual tax returns, and our net operating loss carryforwards.

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The balance of our current deferred tax asset at September 30, 2014 and December 31, 2013 includes the effects of \$1.0 million and \$0.9 million, respectively, of unrecognized tax benefit liabilities that are offset against our current deferred tax asset in accordance with the provision of ASU No. 2013-11.

## **12. Capital Stock**

**Stock Repurchases** In November 2011, our board of directors authorized a stock repurchase program of up to \$5.0 million in shares of our common stock. In December 2012, our board of directors authorized an increase of our stock repurchase program for an additional \$5.0 million in shares of our common stock and an extension of the period of the stock repurchase program for up to two years after that increase. Repurchases of shares may be made from time to time in open market purchases or in privately negotiated transactions. The timing and amount of any shares repurchased is determined in the discretion of management based on its evaluation of market conditions and other factors. During the nine months ended September 30, 2014, a total of 50 thousand shares were repurchased under the program at a gross purchase price, including commission costs, of \$0.4 million, or an average price of \$7.29 per share. During the nine months ended September 30, 2013, we did not repurchase any shares under the program. The stock repurchase program may continue through December 2014, although it may be suspended from time to time or discontinued at any time, or it may be renewed or extended, at the discretion of our board of directors. At September 30, 2014, a total of approximately \$4.7 million in shares of common stock remained available to be purchased under the stock repurchase program.

## **13. Segment Information**

Our operating and reportable segments are currently organized around the following products and services that we offer as part of our core business strategy:

Distributed Generation solutions;

Utility Infrastructure solutions; and

Energy Efficiency solutions.

These three reportable segments, described in greater detail below, had previously been reported on a combined basis under our Utility and Energy Technologies segment as they had been operated and evaluated as one operating segment. We experienced significant growth over the last several years in most of our product and service areas. As we have grown organically, and as we have added to our capabilities through acquisitions, our product and service areas have increased in scale and become more distinctly organized and managed under these three groupings. In addition, our chief operating decision maker ( CODM ) has begun reviewing results and managing and allocating resources among these three strategic business groupings, and we have begun budgeting using these business segments. Our segment information for the three and nine month periods ended September 30, 2013 have been reclassified to conform to our current presentation.

Our CODM reviews revenues including intersegment revenues, gross profit and operating income (loss) before income taxes when evaluating segment performance and allocating resources to each segment. Accordingly,



intersegment revenue is included in the segment revenues presented in the tables below and is eliminated from revenues and cost of sales in the Eliminations and Other column. The Eliminations and Other column also includes various expense items that we do not allocate to our operating segments. These expenses include corporate overhead and corporate-wide items such as legal and professional fees as well as expense items for which we have not identified a reasonable basis for allocation. The accounting policies of the reportable segments are the same as those described in Note 2 of the notes to condensed consolidated financial statements.

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### ***Distributed Generation***

Our Distributed Generation segment manufactures, installs and operates electric generation equipment on site at facilities where the power is used, including commercial, institutional and industrial operations. Our systems provide a highly dependable backup power supply during power outages, and provide a more efficient and environmentally friendly source of power during high cost periods of peak power demand. These two sources of value benefit both utilities and their large customers. In addition, our solar energy systems are included in this segment and provide utilities and their customers with environmentally friendly power to augment their core power requirements.

### ***Utility Infrastructure***

Our Utility Infrastructure segment is focused on helping electric utilities design, build, upgrade and maintain infrastructure that enhances the efficiency of their grid systems.

Our largest source of revenue within our Utility Infrastructure area is our UtilityServices products and services. We have significantly expanded our UtilityServices scope of utility relationships, customers and geography over the last few years. Our UtilityServices team provides utilities with transmission and distribution construction and maintenance, including substation construction and maintenance, advanced metering and lighting installations, and storm restoration. In addition to providing these services directly to utilities, we also perform this work on behalf of utilities for their large industrial and institutional customers, and directly to large oil and gas companies.

Through our Encari, UtilityEngineering and PowerServices teams, we serve the engineering and consulting needs of our utility clients, broadening our offerings to our utility partners. The scope of services that we offer through UtilityEngineering includes technical engineering services for our utility partners and their customers, including design and engineering relating to virtually every element of their transmission and distribution systems, substations and renewable energy facilities. Through PowerServices, we provide management consulting services to utilities and commercial and industrial customers, including planning and quality improvement, technical studies involving reliability analysis and rate analysis, acquisition studies, accident investigations and power supply contracts and negotiations. Our Encari business, which we acquired in October 2013, provides cybersecurity consulting and compliance services to the utility industry.

### ***Energy Efficiency***

We deliver Energy Efficiency products and services to assist our customers in the achievement of their energy efficiency goals. We have two primary product and service offerings in our Energy Efficiency segment: LED lighting fixtures and lamps, and energy efficiency upgrades for our ESCO customers. Our LED lighting products are primarily focused on the utility, commercial and industrial, and retail markets, while our ESCO energy efficiency solutions are focused on serving the ESCO customer base. In the future, we plan to bring our LED lighting products to our ESCO customer base. In both of our Energy Efficiency product and service lines we deliver highly engineered product solutions and upgrades with strong value propositions that are designed to reduce energy costs, improve operations and benefit the environment.

Summarized financial information concerning our reportable segments is shown in the following tables.

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	<b>Three Months Ended September 30, 2014</b>				
	<b>Distributed Generation</b>	<b>Utility Infrastructure</b>	<b>Energy Efficiency</b>	<b>Eliminations and Other</b>	<b>Total</b>
Revenues	\$ 25,946	\$ 22,460	\$ 16,806	\$ (168)	\$ 65,044
Cost of Sales (excluding depreciation and amortization)	17,606	19,145	10,390	(168)	46,973
<b>Gross Profit</b>	<b>8,340</b>	<b>3,315</b>	<b>6,416</b>		<b>18,071</b>
Operating expenses:					
General and administrative	3,615	2,738	2,744	5,183	14,280
Selling, marketing and service	1,173	536	616	(189)	2,136
Depreciation and amortization	811	886	319	165	2,181
Restructuring charges					
<b>Total operating expenses</b>	<b>5,599</b>	<b>4,160</b>	<b>3,679</b>	<b>5,159</b>	<b>18,597</b>
Operating income (loss)	2,741	(845)	2,737	(5,159)	(526)
Other income and (expenses):					
Interest income and other income				5	5
Interest expense				(329)	(329)
<b>Income (loss) before income taxes</b>	<b>\$ 2,741</b>	<b>\$ (845)</b>	<b>\$ 2,737</b>	<b>\$ (5,483)</b>	<b>\$ (850)</b>

	<b>Three Months Ended September 30, 2013</b>				
	<b>Distributed Generation</b>	<b>Utility Infrastructure</b>	<b>Energy Efficiency</b>	<b>Eliminations and Other</b>	<b>Total</b>
Revenues	\$ 40,648	\$ 24,166	\$ 16,696	\$	\$ 81,510
Cost of Sales (excluding depreciation and amortization)	26,759	21,192	12,109		60,060
<b>Gross Profit</b>	<b>13,889</b>	<b>2,974</b>	<b>4,587</b>		<b>21,450</b>
Operating expenses:					
General and administrative	3,567	2,826	3,048	2,070	11,511
Selling, marketing and service	1,140	495	411	27	2,073
Depreciation and amortization	679	677	409	160	1,925
Restructuring charges					
<b>Total operating expenses</b>	<b>5,386</b>	<b>3,998</b>	<b>3,868</b>	<b>2,257</b>	<b>15,509</b>
Operating income (loss)	8,503	(1,024)	719	(2,257)	5,941
Other income and (expenses):					
Interest income and other income				21	21
Interest expense				(262)	(262)

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Income (loss) before income taxes	\$ 8,503	\$ (1,024)	\$ 719	\$ (2,498)	\$ 5,700
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	Nine Months Ended September 30, 2014				
	Distributed Generation	Utility Infrastructure	Energy Efficiency	Eliminations and Other	Total
Revenues	\$ 65,753	\$ 73,059	\$ 36,687	\$ (589)	\$ 174,910
Cost of Sales (excluding depreciation and amortization)	43,855	63,566	24,635	(589)	131,467
Gross Profit	21,898	9,493	12,052		43,443
Operating expenses:					
General and administrative	10,507	8,287	7,455	14,745	40,994
Selling, marketing and service	3,434	1,159	1,787	231	6,611
Depreciation and amortization	2,417	2,612	985	482	6,496
Restructuring charges			427		427
Total operating expenses	16,358	12,058	10,654	15,458	54,528
Operating income (loss)	5,540	(2,565)	1,398	(15,458)	(11,085)
Other income and (expenses):					
Interest income and other income				14	14
Interest expense				(921)	(921)
Income (loss) before income taxes	\$ 5,540	\$ (2,565)	\$ 1,398	\$ (16,365)	\$ (11,992)

	Nine Months Ended September 30, 2013				
	Distributed Generation	Utility Infrastructure	Energy Efficiency	Eliminations and Other	Total
Revenues	\$ 85,186	\$ 74,128	\$ 37,340	\$	\$ 196,654
Cost of Sales (excluding depreciation and amortization)	55,082	58,881	27,618		141,581
Gross Profit	30,104	15,247	9,722		55,073
Operating expenses:					
General and administrative	10,334	8,060	6,850	8,610	33,854
Selling, marketing and service	3,198	1,243	991	131	5,563
Depreciation and amortization	2,025	1,858	916	391	5,190
Restructuring charges					
Total operating expenses	15,557	11,161	8,757	9,132	44,607
Operating income (loss)	14,547	4,086	965	(9,132)	10,466
Other income and (expenses):					
Interest income and other income				61	61
Interest expense				(497)	(497)

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Income (loss) before income taxes	\$ 14,547	\$ 4,086	\$ 965	\$ (9,568)	\$ 10,030
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### **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations** **Introduction**

The following discussion and analysis of our consolidated results of operations for the three and nine month periods ended September 30, 2014, which we refer to as the third quarter 2014 and nine month period 2014, respectively, and the three and nine month period ended September 30, 2013, which we refer to as the third quarter 2013 and nine month period 2013, respectively, and of our consolidated financial condition as of September 30, 2014 should be read in conjunction with our condensed consolidated financial statements and related notes included elsewhere in this report.

### **Cautionary Note Regarding Forward-Looking Statements**

This Quarterly Report on Form 10-Q and the documents incorporated into this report by reference contain forward-looking statements within the meaning of and made under the safe harbor provisions of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. From time to time in the future, we may make additional forward-looking statements in presentations, at conferences, in press releases, in other reports and filings and otherwise. Forward-looking statements are all statements other than statements of historical fact, including statements that refer to plans, intentions, objectives, goals, strategies, hopes, beliefs, projections, prospects, expectations or other characterizations of future events or performance, and assumptions underlying the foregoing. The words may, could, should, would, will, project, intend, continue, believe, anticipate, estimate, plan, potential, opportunity and scheduled, variations of such words, and other comparable terminology and similar expressions are often, but not always, used to identify forward-looking statements. Examples of forward-looking statements include, but are not limited to, statements about the following:

our prospects, including our future business, revenues, expenses, net income (loss), earnings (loss) per share, margins, profitability, cash flow, cash position, liquidity, financial condition and results of operations, our targeted growth rate and our expectations about realizing the revenues in our backlog and in our sales pipeline;

the effects on our business, financial condition and results of operations of current and future economic, business, market and regulatory conditions, including the current economic and market conditions and their effects on our customers and their capital spending and ability to finance purchases of our products, services, technologies and systems;

the effects of fluctuations in sales on our business, revenues, expenses, net income (loss), earnings (loss) per share, margins, profitability, cash flow, liquidity, financial condition and results of operations;

our products, services, technologies and systems, including their quality and performance in absolute terms and as compared to competitive alternatives, their benefits to our customers and their ability to meet our customers' requirements, and our ability to successfully develop and market new products, services, technologies and systems;

our markets, including our market position and our market share;

our ability to successfully develop, operate, grow and diversify our operations and businesses;

our business plans, strategies, goals and objectives, and our ability to successfully achieve them;

the effects on our financial condition, results of operations and prospects of our business acquisitions;

the sufficiency of our capital resources, including our cash and cash equivalents, funds generated from operations, availability of borrowings under our credit and financing arrangements and other capital resources, to meet our future working capital, capital expenditure, lease and debt service and business growth needs;

the value of our assets and businesses, including the revenues, profits and cash flow they are capable of delivering in the future;



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industry trends and customer preferences and the demand for our products, services, technologies and systems;

the nature and intensity of our competition, and our ability to successfully compete in our markets;

fluctuations in our effective tax rates, including the expectation that with the utilization of a significant portion of our tax net operating losses in recent years our tax expense in future years will likely approximate prevailing statutory tax rates;

fluctuations in the gross margins of our Utility Infrastructure segment, as well as our ability to improve inefficiencies in that segment designed to improve those gross margins;

the timing of, and our ability to successfully execute on, the recently awarded large solar projects;

business acquisitions, combinations, sales, alliances, ventures and other similar business transactions and relationships; and

the effects on our business, financial condition and results of operations of litigation, including but not limited to recently filed securities class action litigation, warranty claims and other claims and proceedings that arise from time to time.

Any forward-looking statements we make are based on our current plans, intentions, objectives, goals, strategies, hopes, beliefs, projections and expectations, as well as assumptions made by and information currently available to management. Forward-looking statements are not guarantees of future performance or events, but are subject to and qualified by substantial risks, uncertainties and other factors, which are difficult to predict and are often beyond our control. Forward-looking statements will be affected by assumptions and expectations we might make that do not materialize or that prove to be incorrect and by known and unknown risks, uncertainties and other factors that could cause actual results to differ materially from those expressed, anticipated or implied by such forward-looking statements. These risks, uncertainties and other factors include, but are not limited to, those described in our Annual Report on Form 10-K for the fiscal year ended December 31, 2013, as amended or supplemented in subsequently filed Quarterly Reports on Form 10-Q and Current Reports on Form 8-K, as well as other risks, uncertainties and factors discussed elsewhere in this report, in documents that we include as exhibits to or incorporate by reference in this report, and in other reports and documents we from time to time file with or furnish to the Securities and Exchange Commission. In light of these risks and uncertainties, you are cautioned not to place undue reliance on any forward-looking statements that we make.

Any forward-looking statements contained in this report speak only as of the date of this report, and any other forward-looking statements we make from time to time in the future speak only as of the date they are made. We undertake no duty or obligation to update or revise any forward-looking statement or to publicly disclose any update or revision for any reason, whether as a result of changes in our expectations or the underlying assumptions, the receipt of new information, the occurrence of future or unanticipated events, circumstances or conditions or otherwise.

## **Overview**

PowerSecure International, Inc., headquartered in Wake Forest, North Carolina, is a leading provider of products and services to electric utilities, and their large commercial, institutional and industrial customers.

Our operating and reporting segments are organized around our three product and service offerings: our Distributed Generation products and services, our Utility Infrastructure products and services, and our Energy Efficiency products and services. These three product and service segments are commonly focused on serving the needs of utilities and their commercial, institutional and industrial customers to help them generate, deliver and utilize electricity more reliably and efficiently.

These three reportable segments had previously been reported on a combined basis under our Utility and Energy Technologies segment as they had been operated and evaluated as one operating segment. We experienced significant growth over the last several years in most of our product and service areas. As we have grown organically, and as we have added to our capabilities through acquisitions, our product and service areas have become more distinctly organized under these three groupings. In addition, our chief operating decision maker ( CODM ) has begun reviewing results and managing and allocating resources among these three strategic business groupings, and we have begun budgeting using these business segments. Our segment information for the three and nine month periods ended September 30, 2013 have been reclassified to conform to our current presentation.

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Our strategy is focused on growing these three segments because they address large unmet market opportunities due to their strong customer value propositions, and because they require unique knowledge and skills that utilize our core competencies. They share a number of common or complementary utility relationships and customer types, common sales and overhead resources, and common facilities.

Our business operates primarily out of our Wake Forest, North Carolina headquarters office, and our operations also include several satellite offices and manufacturing facilities, the largest of which are in the following areas: Raleigh and Greensboro, North Carolina; Atlanta, Georgia; Bethlehem, Pennsylvania; and Stamford, Connecticut. The locations of our sales organization and field employees are generally in close proximity to the utilities we serve and to their commercial, industrial and institutional customers. We conduct our business through our wholly-owned subsidiary, PowerSecure, Inc.

The following provides greater details related to the three operating and reporting segments.

### ***Distributed Generation***

Our Distributed Generation segment manufactures, installs and operates electric generation equipment on site at a facility where the power is used, including commercial, institutional and industrial operations. Our systems provide a highly dependable backup power supply during power outages, and provide a more efficient and environmentally friendly source of power during high cost periods of peak power demand. These two sources of value benefit both utilities and their large customers. In addition, our solar energy systems provide utilities and their customers with environmentally friendly power to augment their core power requirements.

Our Distributed Generation systems are sold to customers utilizing two basic economic models, each of which can vary depending on the specific customer and application. In our traditional business model, which is our predominant model, we sell the Distributed Generation system to the customer. We refer to this as a project-based or a customer-owned model. For Distributed Generation systems sold under the project-based model, the customer acquires ownership of the Distributed Generation assets upon our completion of the project. Our revenues and profits from the sale of systems under this model are recognized over the period during which the system is installed. In the project-based model, after the system is installed we will also usually receive a modest amount of on-going monthly revenues to monitor the system for backup power and peak shaving purposes, as well as to maintain the system.

Our second business model is structured to generate long-term recurring revenues for us, which we refer to as our recurring revenue model or PowerSecure-owned or company-owned model. For Distributed Generation systems deployed under this model, we retain ownership of the Distributed Generation system after it is installed at the customer's site. Because of this, we invest the capital required to design and build the system, and our revenues are derived from regular fees paid over the life of the recurring revenue contract by the utility or the customer, or both, for access to the system for standby power and peak shaving. The life of these recurring revenue contracts is typically from five to fifteen years. The fees that generate our revenues in the recurring revenue model are generally paid to us on a monthly basis and are established at amounts intended to provide us with attractive returns on the capital we invest in installing and maintaining the Distributed Generation system. Our fees for recurring revenue contracts are generally structured as shared savings arrangements, although they can also be structured with fixed monthly payments. For our shared savings contracts, a portion or all of our fees are earned out of the pool of peak shaving savings the system creates for the customer.

In both economic models, we believe that the customer value proposition is strong. In the customer-owned model, where the customer pays for and obtains ownership of the system, the customer's typical targeted returns on investment range from 15% to 25%, with a payback targeted at three to five years. These paybacks to the customer

result from a combination of the benefits of peak shaving, which creates lower total electricity costs, and the value that the backup power provides in avoiding losses from business interruptions due to power outages. Additionally, utilities gain the benefits of smoother electricity demand curves and lower peaks, as the result of having highly reliable standby power supporting customers in their utility systems, power distribution and transmission efficiencies, and of avoiding major capital outlays that would have been required to build centralized power plants and related infrastructure for peaking needs. In our PowerSecure-owned model, where we pay for, install and maintain ownership of the system in exchange for

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the customer paying us fees over a period of years, and utilities and their customers receive access to our system without making a large up-front investment of capital. Under the PowerSecure-owned model, contracts can be structured between us and the utility, us and the customer, or all three parties.

In the nine month period 2014, 81.0% of our Distributed Generation revenues consisted of customer-owned sales, and 19.0% of our Distributed Generation revenues were derived from recurring revenue sales. Sales of customer-owned systems deliver revenues and profits that are recorded on our financial statements over the course of the project, which is generally over a three to 18 month timeframe depending on the size of the project, and sales of PowerSecure-owned projects are recorded over a longer time frame of five to 15 years depending on the life of the underlying contract. Therefore, shifts in the sales of customer-owned versus PowerSecure-owned systems have significant impacts on our near-term revenues and profits and cause them to fluctuate from period-to-period. An additional contrast of the two models is that sales under the PowerSecure-owned system model generate revenues and profits that are more consistent from period-to-period and have higher gross margins, and generate revenues and profits over a longer time period, although smaller in dollar amount in any particular period because they are recognized over the life of the contract. Our PowerSecure-owned recurring revenue model requires us to invest our own capital in the project without any return on capital until after the project is completed, installed, commissioned and successfully operating.

Our 2012 acquisition of PowerSecure Solar provides us with the ability to deliver solar energy systems through our Distributed Generation business platform. These solar energy systems are sold under the project-based , customer-owned model, and we also may own and operate certain systems in the future under a PowerSecure-owned , recurring revenue model.

## ***Utility Infrastructure***

Our Utility Infrastructure operating segment is focused on helping electric utilities design, build, upgrade and maintain infrastructure that enhances the efficiency of their grid systems.

Our largest source of revenue within our Utility Infrastructure segment is our UtilityServices products and services. We have significantly expanded our UtilityServices scope of utility relationships, customers and geography over the last few years. Our UtilityServices team provides utilities with transmission and distribution construction and maintenance, including substation construction and maintenance, advanced metering and lighting installations, and storm restoration. In addition to providing these services directly to utilities, we also perform this work on behalf of utilities for their large industrial and institutional customers, and directly to large oil and gas companies. Similar to the products and services we provide for utilities, our work for large utility customers includes turn-key design, procurement and construction services for large transmission and distribution projects, including substations. Our resources include a fleet of owned and leased utility vehicles along with experienced field personnel and engineers, and we also utilize third party resources from time to time, as needed, to supplement our internal resources on particular projects.

Through our Encari, UtilityEngineering and PowerServices teams, we serve the engineering and consulting needs of our utility clients, broadening our offerings to our utility partners. The scope of services that we offer through UtilityEngineering includes technical engineering services for our utility partners and their customers, including design and engineering relating to virtually every element of their transmission and distribution systems, substations and renewable energy facilities. Through PowerServices, we provide management consulting services to utilities and commercial and industrial customers, including planning and quality improvement, technical studies involving reliability analysis and rate analysis, acquisition studies, accident investigations and power supply contracts and negotiations. Our Encari business, which we acquired in October 2013, provides cybersecurity consulting and compliance services to the utility industry. Our team of engineers operates in various locations, with principal offices

in Raleigh, North Carolina.

Revenues for our UtilityServices products and services are generally earned, billed, and recognized using two primary models. Under the first model, we have regular, on-going assignments with utilities to provide maintenance and upgrade services. These services are earned, billed, and recognized either on a fixed unit fee basis, based on the number of work units we perform, such as the number of transmission poles we upgrade, or on a time and materials basis, based on the number of hours we invest in a particular project, plus amounts for the materials we utilize and install. Under the second model, we are engaged to design, build and install large infrastructure projects, including substations, transmission and distribution lines and similar infrastructure, for utilities and their customers. In these types of projects we are

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generally paid a fixed contractual price for the project, plus any modifications or scope adjustments. We recognize revenues from these projects on a percentage-of-completion basis as they are completed. In addition to these two primary models, in the future we could be engaged by utilities and their customers to build or upgrade transmission and distribution infrastructure that we own and maintain. In those cases, we would receive fees over a long-term contract in exchange for providing the customer with access to the infrastructure to transmit or receive power.

Revenues for our Encari, UtilityEngineering and PowerServices consulting services are earned, billed, and recognized based on the number of hours invested in the particular projects and engagements they are serving. Similar to most traditional consulting businesses, these hours are billed at rates that reflect the general technical skill or experience level of the consultant or supervisor providing the services. In some cases, our engineers and consultants are engaged on an on-going basis with utilities, providing resources to supplement utilities' internal engineering teams over long-term time horizons. In other cases, our engineers and consultants are engaged to provide services for very specific projects and assignments.

### ***Energy Efficiency***

We deliver Energy Efficiency solutions to assist our customers in the achievement of their energy efficiency goals. We have two primary product and service offerings in our Energy Efficiency segment: 1) LED lighting fixtures and lamps, and 2) energy efficiency upgrades for large energy services companies, which we refer to as our ESCO customers. Our LED lighting products are primarily focused on the utility, commercial and industrial, and retail markets, while our ESCO energy efficiency solutions are focused on serving the ESCO channel. In the future, we plan to bring our Distributed Generation and LED lighting products to our ESCO customer base. In both of our Energy Efficiency product and service lines we deliver highly engineered product solutions and upgrades with strong value propositions that are designed to reduce energy costs, improve operations and benefit the environment.

Our LED lighting products include our PowerSecure Lighting, Solais, EfficientLights, IES and EnergyLite operations and brands, all of which are focused on bringing LED lighting solutions to the marketplace. As a result of our acquisition of Solais in 2013, we recently realigned and consolidated these operations into PowerSecure Lighting, which is now leading all of our LED operations, although we may continue to have legacy brands in the marketplace for a period of time. In 2013, we acquired our ESCO business, which gives us the capability to provide general lighting, building envelope, HVAC and water efficiency solutions to the super ESCOs, which are the largest of the energy service companies and which deliver these energy efficiency solutions to commercial, industrial and institutional facilities. On September 2, 2014, we acquired the electrical contracting business of Apex Controls, Inc. The acquired business provides retrofit and electrical contracting services to major retailers, in most cases through general contractors, and provides us with the capacity to provide our Energy Efficiency services to large retailers.

Our LED lighting products, led by our PowerSecure Lighting team and operations, include the following:

Our Solais brand, which includes LED-based lamps and fixtures for department stores and other commercial applications. The 2013 acquisition of Solais strengthened and complemented our existing LED lighting business through the addition of these new product lines and customer channels. This acquisition also enhanced our skill sets around product design, product commercialization, and manufacturing and sourcing capabilities. Solais oversees all of our LED lighting operations.

Our EfficientLights brand, which includes LED-based lighting fixtures for grocery, drug and convenience stores. EfficientLights products include our EfficientLights fixture for reach-in refrigerated cases, shelf and canopy lighting for open refrigerated cases, overhead lighting for walk-in storage coolers.

Our IES brand, which includes LED-based lighting fixtures for utilities, commercial and industrial, and OEM applications. IES products include street lights, area lights, indoor overhead lighting, and other specialty lighting applications.

Our EnergyLite brand, which is used to market our IES and EfficientLights brands primarily, but we may also use it from time to time for other LED lighting products. EnergyLite s products are marketed to customers and utilities directly, and through third party distribution arrangements.



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The primary client base for our ESCO products and services include large energy service companies, referred to as super ESCOs. Through our relationships with super ESCOs, we provide facility upgrades for public sector customers, including federal, state and local government agencies and educational institutions. As super ESCOs are awarded project contracts with public sector clients, we assist them by providing energy efficiency expertise to develop and implement tailored solutions under their contracts. From time to time, we also serve larger retail, commercial and industrial clients for which we provide our products and services directly, when a super ESCO is not involved in the customer relationship.

We focus on deploying solutions to improve the energy efficiency of large facilities, including reducing energy-related expenditures, and the impact of energy use on operations and the environment. This helps the super ESCO's customers save money, improve facilities and meet energy efficiency goals and mandates. Our solutions include energy efficient lighting upgrades, energy efficient mechanical and electrical retrofit and upgrade services, water conservation, building weatherization, and renewable energy project development and implementation. We provide energy solutions across a range of facilities, including high-rise office buildings, distribution facilities, manufacturing plants, retail sites, multi-tenant residential buildings, mixed use complexes, hospitals, universities and large government sites. We plan to continue to offer our Distributed Generation and LED lighting products as part of these solutions.

Our LED lighting revenues are generated through the sale of LED-based light fixtures and lamps. Our portfolio of products consists exclusively of our proprietary designs, which are generally focused on very specific applications. These applications require our lights to be highly engineered to maximize the quality, and amount of light produced, at the lowest cost. This formula, in turn, enables us to provide our customers with lighting that maximizes the return on investment for their lighting spend. We design and manufacture our LED-based lights for utilities, commercial and industrial customers. Our lighting generally reduces energy consumption by 60-70%, improves the quality of light, reduces maintenance expense, extends light life, lowers a facilities' carbon footprint, and eliminates the use of traditional lighting which can contain environmental hazards.

Our LED lighting product line includes:

LED-based lamps and fixtures for department stores and other commercial applications, including display and down-lighting;

LED-based lighting fixtures for grocery, drug and convenience stores, including lights for reach-in refrigerated cases, shelf and canopy lighting for open refrigerated cases, and overhead lighting for walk-in storage coolers; and

LED-based lighting fixtures for utilities, commercial and industrial, and OEM applications, including street lights, area lights, indoor overhead lighting, and other specialty lighting applications.

The majority of our LED lights are sold as retrofits for existing traditional lighting, and to a lesser extent for new construction lighting installations. Additionally, the majority of our lights are sold by us directly to the customer, although we also have distributor relationships that serve certain product lines. Occasionally we provide installation services, although that is not a significant portion of our business. We also assist our customers in receiving utility incentives for LED lighting. Our customers are primarily large retail chains, utilities, department stores, and large commercial and industrial customers. These customers typically install LED lighting across numerous locations over a

diverse geographic scope. We expect our customer base and sales channels to continue to grow and develop as LED technology continues to be more widely adopted. As we bring additional products to market, we expect to employ a similar business model with our LED lighting products.

Our ESCO energy efficiency revenues are generated through a full range of turn-key services we provide to super ESCOs and retailers. We apply our engineering expertise to analyze each facility's energy consumption and operational needs, and develop customized energy efficiency and renewable energy solutions to optimize that facility's return on investment. We provide complete turn-key implementation services for a range of energy efficiency and renewable energy projects, including energy efficient lighting upgrades, energy efficiency mechanical and electrical retrofit and upgrade services, water conservation, weatherization, combined heat and power or cogeneration and renewable project development and implementation. We consider factors such as current facility infrastructure, best available technologies,

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building environmental conditions, hours of operation, energy costs, available utility rebates, tax incentives, and installation, operation and maintenance costs of various efficiency alternatives. Our extensive knowledge of energy solutions and their results in numerous environments enables us to apply the most appropriate, effective and proven technologies available in the marketplace.

## **Recent Developments**

On October 31, 2014, we announced that we received approximately \$13 million of new Distributed Generation business awards and approximately \$2 million of new Utility Infrastructure business awards. The \$13 million in new Distributed Generation business awards include a \$9 million solar project and approximately \$4 million of other Distributed Generation projects which include an expansion of service for an existing hospital customer, a federal facility and a new data center project. The \$2 million in new Utility Infrastructure awards include distribution work to provide electrical infrastructure to wellheads for a new oil and gas customer, and new distribution projects for an existing utility customer.

On October 15, 2014, we announced that we received approximately \$14.0 million of new Distributed Generation business awards, approximately \$9.0 million of new Utility Infrastructure business awards and approximately \$2.0 million of new Energy Efficiency business awards. The \$14 million in new Distributed Generation business awards include approximately \$9.0 million of projects for a variety of retail, healthcare, industrial and utility customers, and approximately \$5.0 million of new utility-grade solar projects. This total does not include the additional backlog acquired in the Company's recent acquisition of the data center energy services business from Power Design, Inc. The \$9.0 million in new Utility Infrastructure business awards include a large transmission project at a federal facility and a variety of additional transmission work for existing utility customers. The \$2.0 million in new Energy Efficiency business awards include both federal and retail ESCO awards. The federal award, which comprises the majority of the Energy Efficiency new business, is to provide energy efficiency improvements for a large international airport in the Northeast, on behalf of one of our ESCO customers. The new retail ESCO work is to provide electrical contracting and energy efficiency services for a new Fortune 100 retail customer.

On October 14, 2014, we announced that we acquired the data center energy services business and certain related assets of Power Design, Inc., a Florida corporation ( PDI ), pursuant to an Asset Purchase and Sale Agreement, between PDI, as seller, and PowerSecure, as purchaser. The purchase price paid for the acquired business and assets was \$13.0 million in cash plus an additional earn-out cash payment in the amount of \$1.0 million if PowerSecure obtains firm backlog after the closing in the amount of at least \$5.0 million from the acquired business, or in the amount of \$2.0 million if the firm backlog amount obtained after closing is at least \$15.0 million.

The acquired business provides full turn-key electrical infrastructure design, implementation and commissioning service to data center owners. Our PowerSecure subsidiary has previously provided its data center solutions as a supplier to PDI. We anticipate that the acquisition will provide us with a direct customer channel and capabilities to accelerate our access to key data center decision makers who are designing and evaluating backup power and control systems for their facilities.

The purchase agreement contains representations and warranties as well as indemnification obligations by PDI and PowerSecure to each other, subject to a \$3.0 million indemnification cap. In addition, the purchase agreement contains a five year covenant not to compete by PDI against PowerSecure and its affiliates with respect to the key customers in the acquired business, and related customary restrictive covenants relating to non-solicitation and confidentiality.

On September 26, 2014, we announced that we received approximately \$13.0 million of new Utility Infrastructure business awards and approximately \$12.0 million of new Energy Efficiency business awards. The \$13.0 million in

new Utility Infrastructure business awards include more than \$10.0 million of new transmission projects with new utility customers in the Midwest and Southwest, including one of the largest investor-owned utilities in the country, and additional distribution work for existing customers. The \$12.0 million in new Energy Efficiency business awards include approximately \$10.0 million in new energy efficiency services awards and approximately \$2.0 million in new LED lighting awards. The energy efficiency awards include new projects at several schools and federal facilities, and the first new project with a Fortune 100 retailer resulting from the company's recent acquisition of the electrical contracting business from Apex. The new LED award is to upgrade multiple locations of one of the leading restaurant chains in North America with PowerSecure's Solais lighting products.

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On September 2, 2014, we acquired the electrical contracting business of Apex Controls, Inc., a Georgia corporation ( Apex ). The acquired business provides retrofit and electrical contracting services to major retailers, in most cases through general contractors. This acquisition is part of our strategy to expand our Energy Efficiency services market base to retailers. Apex was a business primarily owned and managed by Jonathan Hinton, the son of Sidney Hinton, our President and Chief Executive Officer. The transaction was approved by the Audit Committee of our Board of Directors. The purchase price for the acquisition was \$0.75 million in cash, plus potential additional earn-out consideration of up to \$0.5 million in cash if the gross profits generated from the acquired business in 2015 and 2016 exceed certain targeted thresholds.

**Financial Results Highlights**

Our consolidated revenues in the third quarter 2014 were \$65.0 million, which decreased by \$16.5 million, or 20.2%, compared to our consolidated revenues during the third quarter 2013. The drivers of this year-over-year revenue decrease included a \$14.7 million, or 36.2%, reduction from Distributed Generation segment revenues and a \$1.7 million, or 7.1%, reduction from Utility Infrastructure segment revenues, partially offset by a \$0.1 million, or 0.7% increase in Energy Efficiency segment revenues. The reduction in our Distributed Generation segment revenues during the third quarter was a result of a reduction in traditional turn-key Distributed Generation project sales and, to a lesser extent, a reduction in solar Distributed Generation project sales. The reduction in our Utility Infrastructure revenues was due to a \$1.1 million decrease in UtilityServices revenue, together with a \$0.6 million reduction in revenues from engineering and consulting services. The decrease in our UtilityServices revenue was primarily due to us slowing and being more selective in our new business development activity in early 2014, which negatively impacted third quarter year-over-year revenues, as we focused on improving efficiencies and productivity in our UtilityServices operations.

Our third quarter 2014 gross margin as a percentage of revenue increased to 27.8%, compared to 26.3% in the third quarter 2013, on a consolidated basis. This year-over-year gross profit margin increase was driven primarily by improvements in our Utility Infrastructure segment and our Energy Efficiency segment, partially offset by a reduction in our gross profit margin in our Distributed Generation segment. Utility Infrastructure segment gross profit margins were 14.8% in the third quarter 2014 compared to 12.3% in the third quarter 2013. Energy Efficiency segment gross profit margins were 38.2% in the third quarter 2014 compared to 27.5% in the third quarter 2013. Distributed Generation segment gross profit margins were 32.1% in the third quarter 2014 compared to 34.2% in the third quarter 2013. The improvement in our Utility Infrastructure segment gross profit margin is due to improved operational efficiencies within our UtilityServices operations. The Energy Efficiency segment gross profit margin improvement was driven by improvements in both our LED and ESCO product and service gross margins. Our Distributed Generation segment gross profit margins decreased due to differences in the mix of projects period-to-period. Specifically, revenues from solar Distributed Generation projects increased as a percentage of total Distributed Generation segment revenue in the third quarter 2014 compared to the third quarter 2013, and gross profit margins on our solar Distributed Generation projects are generally lower than gross profit margins on our traditional turn-key Distributed Generation projects. As is always the case, variability in our quarterly and year-to-date gross profit margins is also caused by regular on-going differences in the mix of specific projects completed in each period.

Our operating expenses during the third quarter 2014 increased by \$3.1 million, or 19.9%, compared to our operating expenses during the third quarter 2013. The year-over-year increase in operating expenses was driven by increases in general and administrative expense due to increases in personnel, employee benefits and insurance, stock compensation expense, and professional fees to support our growing business platforms, an increase in selling expenses due to additional sales executives, and depreciation and amortization from our investments in utility infrastructure equipment, company-owned distributed generation systems, and acquisition-related intangibles.



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Our consolidated operating loss for the third quarter 2014 was (\$0.5) million compared to operating income of \$5.9 million for the third quarter 2013. The following table summarizes our operating income (loss) by reporting segment for the periods indicated (dollars in thousands):

	Quarter Ended		Period-over-Period	
	September 30, 2014	September 30, 2013	Difference \$	Difference %
Segment operating income (loss):				
Distributed Generation	\$ 2,741	\$ 8,503	\$ (5,762)	(67.8)%
Utility Infrastructure	(845)	(1,024)	179	(17.5)%
Energy Efficiency	2,737	719	2,018	280.7%
Corporate and other unallocated costs	(5,159)	(2,257)	(2,902)	128.6%
Total	\$ (526)	\$ 5,941	\$ (6,467)	(108.9)%

Our consolidated net loss attributable to PowerSecure International, Inc. shareholders for the third quarter 2014 was (\$0.5) million, or (\$0.02) per diluted share, compared to net income attributable to PowerSecure International, Inc. shareholders of \$3.5 million, or \$0.17 per diluted share, for the third quarter 2013.

Our consolidated revenues in the nine month period 2014 of \$174.9 million decreased by \$21.7 million, or 11.1%, compared to our consolidated revenues during the nine month period 2013. The drivers of this year-over-year revenue decrease included a \$19.4 million, or 22.8%, reduction in Distributed Generation segment revenues, a \$1.1 million, or 1.4%, reduction in Utility Infrastructure segment revenues, and a \$0.7 million, or 1.7%, reduction in Energy Efficiency segment revenues. The reduction in our Distributed Generation segment revenues during the nine month period was a result of a reduction in traditional turn-key Distributed Generation project sales, and to a lesser extent, a reduction in solar Distributed Generation project sales. The decrease in our UtilityServices revenue was primarily due to us slowing and being more selective in our new business development activity in early 2014, which negatively impacted year-over-year revenues, as we focused on improving efficiencies and productivity in our UtilityServices operations. In addition, our UtilityServices revenues were impacted by the ongoing effects of unfavorable service arrangements and work assignments from a large utility customer. In June 2014, we successfully modified the service arrangement with the utility customer to improve the terms of our ongoing service, including positive adjustments to future pricing, work assignments and expected improvements in the ongoing scope of work. The favorable effects of the modified terms, however, were not fully realized in the nine month period 2014 due to transitional matters, and we expect continued improvements from this customer relationship over the coming quarters. The reduction in our Energy Efficiency revenues during the quarter included a \$5.3 million decrease in revenues from energy efficiency services we provided as a subcontractor to larger ESCOs, due to difficult prior year comparisons as we acquired the ESCO business in early 2013 and we realized substantial revenue from project completions from acquired backlog in the initial post-acquisition periods. The ESCO customer decreases were partially offset by increases in revenues from our LED lighting products.

Our nine month period 2014 gross margin as a percentage of revenue decreased to 24.8%, compared to 28.0% in the nine month period 2013, on a consolidated basis. This year-over-year gross profit margin decrease was driven primarily by the continuing effect of inefficiencies in our Utility Infrastructure segment, in particular our UtilityServices group, due to unfavorable pricing and service assignments with one of our major utility customers, as well as lower revenues and less efficient utilization of personnel and equipment. The unfavorable terms from the major utility customer caused us to incur higher levels of personnel and equipment costs in our cost of goods sold as a

percentage of our revenues, driving the gross profit margin on our UtilityServices revenue to 8.5% for the nine month period 2014, and our overall Utility Infrastructure segment gross profit margin to 13.0%. This compares to 20.6% Utility Infrastructure segment gross profit margin in the nine month period 2013. In June 2014, we successfully modified the service arrangement with the utility customer to improve the terms of our ongoing service. The modifications include positive adjustments to future pricing, work assignments, and expected improvements in the ongoing scope of work. Based on these improvements, and the new mix of work expected to be allocated to us, we believe these changes will restore the profitability of the work provided by us to this utility and provide a solid platform for us to continue serving, and potentially expanding, our work for the customer. Distributed Generation segment gross profit margins were 33.3% in the nine month period 2014 compared to 35.3% in the nine month period 2013, due to differences in the mix of projects period-to-period. Energy Efficiency segment gross profit margins were 32.9% in the nine month period 2014 compared to 26.0% in the nine month period 2013, driven by increases in the gross margins of our LED products and our ESCO services. As is always the case, variability in our quarterly and year-to-date gross profit margins is also caused by regular on-going differences in the mix of specific projects completed in each period.



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Our operating expenses during the nine month period 2014 increased by \$9.9 million, or 22.2%, compared to our operating expenses during the nine month period 2013. The year-over-year increase in operating expenses was largely due to \$4.7 million of incremental operating expenses during the nine month period 2014 from our 2013 acquisitions of the Solais, Encari and ESCO operations, which caused operating cost increases in our Energy Efficiency and Utility Infrastructure segments, along with \$0.4 million of restructuring charges incurred during the nine month period 2014. The remaining year-over-year increase in our operating expenses was due to an increase in selling expenses, personnel, employee benefits and insurance, stock compensation expense, depreciation and amortization from capital expenditures driven by our investments in Company-owned distributed generation systems, utility infrastructure equipment and acquisition related intangibles.

Our consolidated operating loss for the nine month period 2014 was (\$11.1) million compared to operating income of \$10.5 million for the nine month period 2013. The following table summarizes our operating income (loss) by reporting segment for the periods indicated (dollars in thousands):

	Nine Months Ended		Period-over-Period	
	September 30, 2014	September 30, 2013	Difference	
			\$	%
Segment operating income (loss):				
Distributed Generation	\$ 5,540	\$ 14,547	\$ (9,007)	(61.9)%
Utility Infrastructure	(2,565)	4,086	(6,651)	(162.8)%
Energy Efficiency	1,398	965	433	44.9%
Corporate and other unallocated costs	(15,458)	(9,132)	(6,326)	69.3%
Total	\$ (11,085)	\$ 10,466	\$ (21,551)	(205.9)%

Our consolidated net loss attributable to PowerSecure International, Inc. shareholders for the nine month period 2014 was (\$7.5) million, or (\$0.34) per diluted share, which includes \$0.7 million restructuring charges, compared to net income attributable to PowerSecure International, Inc. shareholders of \$6.3 million, or \$0.32 per diluted share, for the nine month period 2013, during which period we did not incur any restructuring charges.

As discussed below under **Fluctuations**, our financial results will fluctuate from quarter to quarter and year to year. Thus, there is no assurance that our past results, including the results of our year ended December 31, 2013 or our quarter ended September 30, 2014, will be indicative of our future results, especially in light of the current economic conditions and unfavorable credit and capital markets.

**Backlog**

As of the date of this report, our revenue backlog expected to be recognized after September 30, 2014 is \$360 million. This includes revenue related to the new business awards described above under **Recent Developments**. Our revenue backlog represents revenue expected to be recognized after September 30, 2014, for periods including the fourth quarter of 2014 onward. This backlog figure compares to the revenue backlog of \$349 million we reported in our Quarterly Report on Form 10-Q for the quarter ended June 30, 2014 filed on August 6, 2014 (the date we last reported our backlog). Our revenue backlog and the estimated timing of revenue recognition is outlined below, including project-based revenues expected to be recognized as projects are completed and recurring revenues expected to be recognized over the life of the contracts:

*Revenue Backlog expected to be recognized after September 30, 2014*

Description		Anticipated Revenue	Estimated Primary Recognition Period
Project-based Revenue	Near term	\$ 173 million	4Q14 through 2Q15
Project-based Revenue	Long term	\$ 119 million	3Q15 through 2016
Recurring Revenue		\$ 68 million	4Q14 through 2020
<b>Revenue Backlog expected to be recognized after September 30, 2014</b>		<b>\$ 360 million</b>	

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*Note: Anticipated revenue and estimated primary recognition periods are subject to risks and uncertainties as indicated in **Cautionary Note Regarding Forward-Looking Statements** above. Consistent with past practice, these amounts are not intended to constitute our total revenue over the indicated time periods, as we have additional, regular on-going revenues. Examples of additional, regular recurring revenues include revenues from engineering fees, and service revenue, among others. Numbers may not add due to rounding.*

Orders in our backlog are subject to delay, deferral, acceleration, resizing, or cancellation from time to time by our customers, subject to contractual rights, and estimates are utilized in the determination of the backlog amounts. Given the irregular sales cycle of customer orders, and especially of large orders, our revenue backlog at any given time is not necessarily an accurate indication of our future revenues.

## **Operating Segments**

Our operating and reportable segments are currently organized around the following products and services that we offer as part of our core business strategy:

Distributed Generation solutions;

Utility Infrastructure solutions; and

Energy Efficiency solutions.

These three reportable segments, described in greater detail above, had previously been reported on a combined basis under our Utility and Energy Technologies segment as they had been operated and evaluated as one operating segment. We experienced significant growth over the last several years in most of our product and service areas. As we have grown organically, and as we have added to our capabilities through acquisitions, our product and service areas have become more distinctly organized under these three groupings. In addition, our CODM has begun reviewing results and allocating resources among these three strategic business groupings, and we have begun budgeting using these business segments. Our segment information for the three and nine month periods ended September 30, 2013 have been reclassified to conform to our current presentation.

## **Results of Operations**

The following discussion regarding segment revenues, gross profit, costs and expenses, and other income and expenses for the third quarter 2014 compared to the third quarter 2013 are entirely attributable to our reportable segments together with corporate and other unallocated cost items as noted in the tables and discussion below.

### ***Third Quarter 2014 Compared to Third Quarter 2013***

#### ***Revenues***

Our consolidated revenues are generated entirely by sales and services provided by our products and services segments, including Distributed Generation products and services, Utility Infrastructure products and services, and Energy Efficiency products and services. Intersegment revenues, if any, are eliminated from total segment revenues as reflected in the tables below. The following table summarizes our revenues, including intersegment revenues, by these

segments for the periods indicated (dollars in thousands):

	Quarter Ended September 30,		Period-over-Period Difference	
	2014	2013	\$	%
Segment Revenues:				
Distributed Generation	\$ 25,946	\$ 40,648	\$ (14,702)	(36.2)%
Utility Infrastructure	22,460	24,166	(1,706)	(7.1)%
Energy Efficiency	16,806	16,696	110	0.7%
Intersegment Eliminations	(168)		(168)	n/m
Total	\$ 65,044	\$ 81,510	\$ (16,466)	(20.2)%

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Our consolidated revenues in the third quarter 2014 of \$65.0 million decreased \$16.5 million, or 20.2%, compared to the third quarter 2013, due to a decrease in sales from our Distributed Generation and Utility Infrastructure segments. The third quarter 2014 reduction in revenues was driven by delays involving longer lead times in converting our pipeline of sales opportunities into contracted backlog and sales due to several factors including a focus on large customers with longer sales cycles, customer delays, the number, size and timing of our in-process projects.

Our revenues are significantly affected by the number, size and timing of our Distributed Generation, Utility Infrastructure and Energy Efficiency projects as well as the percentage of completion of in-process projects, and the percentage of customer-owned as opposed to PowerSecure-owned distributed generation recurring revenue projects. Our sales have fluctuated significantly in the past and are expected to continue to fluctuate significantly in the future. The decrease in our revenues in the third quarter 2014 over the third quarter 2013 consisted of a \$14.7 million, or 36.2%, reduction in revenues from our Distributed Generation segment and a \$1.7 million, or 7.1%, reduction in revenues from our Utility Infrastructure segment partially offset by a \$0.1 million, or 0.7%, increase in revenues from our Energy Efficiency segment.

The year-over-year decrease in our Distributed Generation segment revenues was driven primarily by a reduction in traditional turn-key Distributed Generation project sales, and to a lesser extent, a reduction in solar Distributed Generation project sales. The reduction in our traditional turn-key Distributed Generation project sales was due to delays converting sales opportunities in our Distributed Generation segment from our pipeline into our backlog of contracted revenues. The year-over-year reduction in our Utility Infrastructure segment revenues was due a \$1.1 million decrease in UtilityServices revenue, together with a \$0.6 million reduction in revenues from engineering and consulting services we provide to utilities. The decrease in our UtilityServices revenue was primarily due to us slowing and being more selective in our new business development activity in early 2014, which negatively impacted third quarter year-over-year revenues, as we focused on improving efficiencies and productivity in our UtilityServices operations. In addition, our revenues were impacted by the ongoing effects of unfavorable service arrangements and work assignments from a large utility customer. In June 2014, we successfully modified the service arrangement with the utility customer to improve the terms of our ongoing service, including positive adjustments to future pricing, work assignments and expected improvements in the ongoing scope of work. The favorable effects of the modified terms, however, were not fully realized in the third quarter 2014 due to transitional matters, and we expect continued improvements from this customer relationship over the coming quarters. In the near-term, we expect revenues to be less than prior year during the remainder of 2014 due to delays converting sales opportunities in our Utility Infrastructure and Distributed Generation segments from our pipeline into our backlog of contracted revenues. In 2015, we expect an increase in Utility Service revenues resulting from an increase in our new business development activities, including the expansion of UtilityServices revenues to additional utilities and other customers, and the modifications made to our service arrangement with our large utility customer. We also expect increases in solar Distributed Generation revenues commencing in 2015 resulting from increased new business development activities as well as from recently awarded large utility-scale solar projects, which have driven increases in our backlog of Distributed Generation projects.

Our future revenues will also depend on the continuing recovery of the domestic economy, the health of the credit markets and the continuing levels of customer spending for capital improvements and energy efficiency projects, as well as our ability to secure new significant purchase orders and to realize the growth opportunities provided by our recent acquisitions and any future acquisitions. The amount and timing of our future revenues will also be affected by the amount and proportion of revenues generated by future PowerSecure-owned distributed generation recurring revenue



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projects, which result in revenue being recognized over a longer period. We are particularly susceptible to changes in economic conditions because our product offerings are generally considered discretionary investment items by our customers, who may delay or defer large sales orders, depending on their business requirements and capital budgets.

*Gross Profit and Gross Profit Margin*

Our gross profit represents our revenues less our cost of sales. Our gross profit margin represents our gross profit divided by our revenues. The following table summarizes our cost of sales by segment, along with our segment gross profit and gross profit margins for the periods indicated (dollars in thousands):

	Quarter Ended September 30,		Period-over-Period Difference	
	2014	2013	\$	%
Segment Cost of Sales (excluding depreciation and amortization):				
Distributed Generation	\$ 17,606	\$ 26,759	\$ (9,153)	(34.2)%
Utility Infrastructure	19,145	21,192	(2,047)	(9.7)%
Energy Efficiency	10,390	12,109	(1,719)	(14.2)%
Intersegment Eliminations	(168)		(168)	n/m
<b>Total</b>	<b>\$ 46,973</b>	<b>\$ 60,060</b>	<b>\$ (13,087)</b>	<b>(21.8)%</b>
Segment Gross Profit:				
Distributed Generation	\$ 8,340	\$ 13,889	\$ (5,549)	(40.0)%
Utility Infrastructure	3,315	2,974	341	11.5%
Energy Efficiency	6,416	4,587	1,829	39.9%
<b>Total</b>	<b>\$ 18,071</b>	<b>\$ 21,450</b>	<b>\$ (3,379)</b>	<b>(15.8)%</b>
Segment Gross Profit Margins:				
Distributed Generation	32.1%	34.2%		
Utility Infrastructure	14.8%	12.3%		
Energy Efficiency	38.2%	27.5%		
<b>Total</b>	<b>27.8%</b>	<b>26.3%</b>		

Cost of sales includes materials, vehicles, personnel and related overhead costs incurred to manufacture products and provide services, but excludes depreciation and amortization. Cost of sales also includes inventory write-downs occurring in the normal course of business, as well as those occurring in connection with our 2013 restructuring and realignment actions which carried over into 2014. Intersegment cost of sales from intersegment revenues are eliminated from total cost of sales. The 21.8% decrease in our consolidated cost of sales and services for the third quarter 2014 compared to the third quarter 2013 was driven by the decrease in costs associated with the 20.2% decrease in sales and other factors discussed below leading to the improvement in our gross profit margin.

Our consolidated gross profit decreased \$3.4 million, or 15.8%, in the third quarter 2014 compared to the third quarter 2013. As a percentage of revenue, our consolidated gross margin in the third quarter 2014 was 27.8%, an increase of 1.5 percentage points compared to the third quarter 2013. This year-over-year gross profit margin increase was driven primarily by improvements in our Utility Infrastructure segment and our Energy Efficiency segment, partially offset

by a reduction in our gross profit margin in our Distributed Generation segment. Our Utility Infrastructure segment gross profit margins were 14.8% in the third quarter 2014 compared to 12.3% in the third quarter 2013. Our Energy Efficiency segment gross profit margins were 38.2% in the third quarter 2014 compared to 27.5% in the third quarter 2013. Our Distributed Generation segment gross profit margins were 32.1% in the third quarter 2014 compared to 34.2% in the third quarter 2013. The improvement in our Utility Infrastructure segment gross profit margin is due to improved operational efficiencies within our Utility Services operations. The improvement in our Energy Efficiency segment gross profit margin in the third quarter was due to increases in our ESCO service margins and our LED product margins due to the favorable



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effects of our acquisition of Solais in the second quarter 2013 and our 2013 restructuring and realignment program which utilized this acquisition to improve our manufacturing and sourcing processes and lower our cost of sales. Our Distributed Generation segment gross profit margins decreased due to differences in the mix of projects period-to-period. Specifically, revenues from solar Distributed Generation projects increased as a percentage of total Distributed Generation segment revenue in the third quarter 2014 compared to the third quarter 2013 and gross profit margins on our solar Distributed Generation projects are generally lower than gross profit margins on our traditional turn-key Distributed Generation projects.

As is always the case, variability in our quarterly and year-to-date gross profit margins is also caused by regular on-going differences in the mix of specific projects completed in each period. In the near-term, over the next few quarters, we expect our consolidated gross profit margins will be in the mid 20%-range driven by lower revenues and ongoing inefficiencies in the delivery of our Utility Infrastructure services resulting from the underutilization of personnel and assets. We expect these inefficiencies to improve as we grow our revenues and execute our plans to improve our Utility Infrastructure operations and focus on performance metrics. We expect these inefficiencies to be partially offset by continued positive results in the gross profit margins from our Energy Efficiency segment revenues and improved results in the gross profit margins from our traditional turn-key Distributed Generation revenues. However, overall Distributed Generation segment gross margins will be negatively impacted by lower gross profit margins on our newly announced large solar Distributed Generation projects. We expect these negative gross margin impacts to continue as these large solar projects are executed during 2015 and 2016. After this period, we expect that our gross profit margins will increase modestly over time because of anticipated greater revenues, a mix of revenues with higher gross margins, productivity, operations and manufacturing efficiencies, improvements in technology, and growth in our higher-margin Distributed Generation recurring revenue projects.

An important driver in the period-over-period change in our consolidated gross profit margin is the relative gross profit margins we generally earn in each of our Distributed Generation, Utility Infrastructure and Energy Efficiency product and service segments. Our Distributed Generation products and services generally yield gross profit margins in the 10-45% range (with our solar Distributed Generation revenues having gross profit margins that are generally at the lower end of this range, and which will be in the single digit range once our recently announced large solar projects begin to be recognized in our revenue), our Utility Infrastructure products and services generally yield gross profit margins in the 5-30% range, and our Energy Efficiency products generally yield gross profit margins in the 15-40% range (with our ESCO revenues having gross profit margins that are generally at the mid-point of this range). The gross profit margins we realize within these ranges largely correlates to the amount of value-added products and services we deliver, with highly engineered, turn-key projects realizing higher gross profit margins due to the benefits they deliver our customers and the value we deliver because we are vertically integrated. Because of these gross profit margin differences, changes in the mix of our segment revenues, and individual products and services within those segments, affect our consolidated gross profit margin results.

Our gross profit and gross profit margin have been, and we expect will continue to be, affected by many factors, including the following:

the absolute level of revenue achieved in any particular period, given that portions of our cost of sales are relatively fixed over the near-term, the most significant of which is personnel and equipment costs;

our ability to improve operational efficiencies in our Utility Infrastructure segment, in particular our UtilityServices area, including increasing our revenue and improving the productivity of our personnel and

equipment;

the allocation of revenue among each of our Distributed Generation, Utility Infrastructure and Energy Efficiency segments, and products and services within these segments, which have different gross profit margins, and certain types of projects within each segment, such as lower margin large solar projects in our Distributed Generation segment;

our ability to improve our operating efficiency and benefit from economies of scale, including the realignment of our Energy Efficiency segment and our efforts to re-source from low-cost manufacturers;

our level of investments in our businesses, particularly for anticipated or new business awards;

improvements in technology and manufacturing methods and processes;

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the mix of higher and lower margin projects, products and services, and the impact of new products and technologies on our pricing and volumes;

the impact of competition on our volumes or pricing;

our ability to manage our materials and labor costs, including any future inflationary pressures;

our ability to manage our Utility Infrastructure segment labor and asset costs during periods when work assignments, and therefore revenue, is lower or when our crews are in-between work assignments;

the costs to maintain and operate distributed generation systems we own in conjunction with recurring revenue contracts, including the price of fuel, run hours, weather, and the amount of fuel utilized in their operation, as well as their operating performance;

the geographic density of our projects;

the selling price of products and services sold to customers, and the revenues we expect to generate from recurring revenue projects;

the rate of growth of our new businesses, which tend to incur costs in excess of revenues in their earlier phases and then become profitable and more efficient over time if they are successful;

the impact of acquisitions of businesses, assets and technologies, including differing margins of new products and services acquired and our ability to strategically benefit from cost efficiencies these acquisitions provide and to manage the costs of our related growth from acquisitions;

the ability to realize gross profit margin increases from our recently acquired operations that have lower gross profit margin profiles, such as PowerSecure Solar and ESCO energy efficiency operations;

the impact of our recently announced large solar projects that we expect will deliver \$120 million of revenues at significantly lower gross margins primarily during 2015 and 2016;

costs and expenses of business shutdowns, when they occur; and

other factors described below under [Fluctuations](#) .

Some of these factors are not within our control, and we cannot provide any assurance that we can continue to improve upon those factors that are within our control, especially given the current economic climate as well as our movement to an expected higher percentage of recurring revenue projects. Moreover, our gross revenues are likely to fluctuate from quarter to quarter and from year to year, as discussed in *Fluctuations* below. Accordingly, there is no assurance that our future gross profit and gross profit margins will improve or even remain at historic levels in the future, and will likely decrease if revenues decrease.

### *Operating Expenses*

Our operating expenses include general and administrative expense, selling, marketing and service expense, depreciation and amortization, and, from time to time, restructuring charges. The following table sets forth our consolidated operating expenses for the periods indicated (dollars in thousands):

	Quarter Ended September 30,		Period-over-Period Difference	
	2014	2013	\$	%
<b>Consolidated Operating Expenses:</b>				
General and administrative	\$ 14,280	\$ 11,511	\$ 2,769	24.1%
Selling, marketing and service	2,136	2,073	63	3.0%
Depreciation and amortization	2,181	1,925	256	13.3%
<b>Total</b>	<b>\$ 18,597</b>	<b>\$ 15,509</b>	<b>\$ 3,088</b>	<b>19.9%</b>

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The following table sets forth our operating expenses by reportable segment for the periods indicated (dollars in thousands):

	Quarter Ended		Period-over-Period	
	September 30, 2014	2013	Difference \$	%
<b>Distributed Generation:</b>				
General and administrative	\$ 3,615	\$ 3,567	\$ 48	1.3%
Selling, marketing and service	1,173	1,140	33	2.9%
Depreciation and amortization	811	679	132	19.4%
<b>Total Distributed Generation operating expenses</b>	<b>\$ 5,599</b>	<b>\$ 5,386</b>	<b>\$ 213</b>	<b>4.0%</b>
<b>Utility Infrastructure:</b>				
General and administrative	\$ 2,738	\$ 2,826	\$ (88)	(3.1)%
Selling, marketing and service	536	495	41	8.3%
Depreciation and amortization	886	677	209	30.9%
<b>Total Utility Infrastructure operating expenses</b>	<b>\$ 4,160</b>	<b>\$ 3,998</b>	<b>\$ 162</b>	<b>4.1%</b>
<b>Energy Efficiency:</b>				
General and administrative	\$ 2,744	\$ 3,048	\$ (304)	(10.0)%
Selling, marketing and service	616	411	205	49.9%
Depreciation and amortization	319	409	(90)	(22.0)%
<b>Total Energy Efficiency operating expenses</b>	<b>\$ 3,679</b>	<b>\$ 3,868</b>	<b>\$ (189)</b>	<b>(4.9)%</b>

Corporate and other unallocated costs: