

ELECTRO SENSORS INC  
Form 10-Q  
August 12, 2016

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION

**Washington, DC 20549**

**Form 10-Q**

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

**For the quarterly period ended June 30, 2016**

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

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission File Number 000-9587**

**ELECTRO-SENSORS, INC.**

(Exact name of registrant as specified in its charter)

Minnesota  
Michigan  
(State Employer Identification No.)  
or  
other  
jurisdiction  
of

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incorporation  
or  
organization)

6111 Blue Circle Drive  
Minnetonka, Minnesota 55343-9108  
(Address of principal executive  
offices)

(952) 930-0100  
(Registrant's telephone number,  
including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 of 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 o

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

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

Large accelerated filer o Accelerated filer o  
Non-accelerated filer o (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 o No

The number of shares outstanding of the registrant's common stock, \$0.10 par value, on August 9, 2016 was 3,395,521.

**ELECTRO-SENSORS, INC.**

**Form 10-Q**

**For the Periods Ended June 30, 2016**

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**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****ELECTRO-SENSORS, INC.****CONSOLIDATED BALANCE SHEETS**

(in thousands except share and per share amounts)

|                                                                | June 30,<br>2016   | December<br>31,<br>2015 |
|----------------------------------------------------------------|--------------------|-------------------------|
|                                                                | <b>(unaudited)</b> |                         |
| <b>ASSETS</b>                                                  |                    |                         |
| Current assets                                                 |                    |                         |
| Cash and cash equivalents                                      | \$ 560             | \$ 569                  |
| Treasury bills                                                 | 7,488              | 7,872                   |
| Trade receivables, less allowance for doubtful accounts of \$8 | 1,035              | 689                     |
| Inventories                                                    | 1,517              | 1,564                   |
| Other current assets                                           | 130                | 170                     |
| Deferred income tax asset, current                             | 16                 | 14                      |
| Total current assets                                           | 10,746             | 10,878                  |
| Deferred income tax asset                                      | 189                | 170                     |
| Intangible assets, net                                         | 1,153              | 1,270                   |
| Property and equipment, net                                    | 1,065              | 1,103                   |
| Total assets                                                   | \$ 13,153          | \$ 13,421               |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                    |                    |                         |
| Current liabilities                                            |                    |                         |
| Current maturities of note payable                             | \$ 0               | \$ 390                  |
| Accounts payable                                               | 178                | 136                     |
| Accrued expenses                                               | 398                | 396                     |
| Accrued income tax                                             | 51                 | 4                       |

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|                                                                                                                    |           |           |
|--------------------------------------------------------------------------------------------------------------------|-----------|-----------|
| Total current liabilities                                                                                          | 627       | 926       |
| Long-term liabilities                                                                                              |           |           |
| Contingent earn-out                                                                                                | 383       | 455       |
| Total long-term liabilities                                                                                        | 383       | 455       |
| Commitments and contingencies                                                                                      |           |           |
| Stockholders' equity                                                                                               |           |           |
| Common stock par value \$0.10 per share; authorized 10,000,000 shares; 3,395,521 shares issued and outstanding     | 339       | 339       |
| Additional paid-in capital                                                                                         | 1,927     | 1,879     |
| Retained earnings                                                                                                  | 9,906     | 9,855     |
| Accumulated other comprehensive loss (unrealized loss on available-for-sale securities, net of income tax benefit) | (29 )     | (33 )     |
| Total stockholders' equity                                                                                         | 12,143    | 12,040    |
| Total liabilities and stockholders' equity                                                                         | \$ 13,153 | \$ 13,421 |

See accompanying notes to unaudited consolidated financial statements

**ELECTRO-SENSORS, INC.****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

(in thousands except share and per share amounts)

(unaudited)

|                                                                                | Three Months Ended<br>June 30, |         | Six Months Ended<br>June 30, |         |
|--------------------------------------------------------------------------------|--------------------------------|---------|------------------------------|---------|
|                                                                                | 2016                           | 2015    | 2016                         | 2015    |
| Net sales                                                                      | \$2,009                        | \$2,048 | \$3,725                      | \$3,933 |
| Cost of goods sold                                                             | 835                            | 922     | 1,617                        | 1,745   |
| Gross profit                                                                   | 1,174                          | 1,126   | 2,108                        | 2,188   |
| Operating expenses                                                             |                                |         |                              |         |
| Selling and marketing                                                          | 448                            | 411     | 875                          | 818     |
| General and administrative                                                     | 331                            | 399     | 813                          | 805     |
| Research and development                                                       | 188                            | 189     | 361                          | 405     |
| Total operating expenses                                                       | 967                            | 999     | 2,049                        | 2,028   |
| Operating income                                                               | 207                            | 127     | 59                           | 160     |
| Non-operating income (expense)                                                 |                                |         |                              |         |
| Interest expense                                                               | 0                              | (2)     | (1)                          | (6)     |
| Gain on sale of available-for-sale securities                                  | 0                              | 634     | 0                            | 1,449   |
| Interest income                                                                | 4                              | 1       | 15                           | 2       |
| Other income                                                                   | 6                              | 4       | 9                            | 7       |
| Total non-operating income, net                                                | 10                             | 637     | 23                           | 1,452   |
| Income before income taxes                                                     | 217                            | 764     | 82                           | 1,612   |
| Income taxes                                                                   | 77                             | 268     | 31                           | 563     |
| Net income                                                                     | \$140                          | \$496   | \$51                         | \$1,049 |
| Other comprehensive income (loss)                                              |                                |         |                              |         |
| Change in unrealized value of available-for-sale securities, net of income tax | 4                              | 63      | 4                            | 132     |
| Reclassification of gains included in net income, net of income tax            | 0                              | (394)   | 0                            | (899)   |

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|                                   |           |           |           |           |      |   |
|-----------------------------------|-----------|-----------|-----------|-----------|------|---|
| Other comprehensive income (loss) | 4         | (331      | )         | 4         | (767 | ) |
| Net comprehensive income          | \$144     | \$165     | \$55      | \$282     |      |   |
| Net income per share data:        |           |           |           |           |      |   |
| Basic                             |           |           |           |           |      |   |
| Net income per share              | \$0.04    | \$0.15    | \$0.01    | \$0.31    |      |   |
| Weighted average shares           | 3,395,521 | 3,395,521 | 3,395,521 | 3,395,521 |      |   |
| Diluted                           |           |           |           |           |      |   |
| Net income per share              | \$0.04    | \$0.14    | \$0.01    | \$0.29    |      |   |
| Weighted average shares           | 3,692,032 | 3,653,021 | 3,703,021 | 3,653,021 |      |   |

See accompanying notes to unaudited consolidated financial statements

**ELECTRO-SENSORS, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS**

(in thousands)

(unaudited)

|                                                                               | Six Months<br>Ended<br>June 30, |         |
|-------------------------------------------------------------------------------|---------------------------------|---------|
|                                                                               | 2016                            | 2015    |
| Cash flows from (used in) operating activities                                |                                 |         |
| Net income                                                                    | \$51                            | \$1,049 |
| Adjustments to reconcile net income to net cash used in operating activities: |                                 |         |
| Depreciation and amortization                                                 | 157                             | 177     |
| Realized gain on sale of available-for-sale securities                        | 0                               | (1,449) |
| Deferred income taxes                                                         | (21 )                           | (11 )   |
| Stock-based compensation expense                                              | 48                              | 31      |
| Change in contingent earn-out fair value                                      | (72 )                           | (17 )   |
| Other                                                                         | (15 )                           | (4 )    |
| Change in:                                                                    |                                 |         |
| Trade receivables                                                             | (346 )                          | (268 )  |
| Inventories                                                                   | 47                              | (234 )  |
| Other current assets                                                          | 40                              | 33      |
| Accounts payable                                                              | 42                              | 151     |
| Accrued expenses                                                              | 2                               | 40      |
| Accrued income taxes                                                          | 47                              | 198     |
| Net cash used in operating activities                                         | (20 )                           | (304 )  |
| Cash flows from (used in) investing activities                                |                                 |         |
| Proceeds from sale of available-for-sale securities                           | 0                               | 1,467   |
| Purchases of treasury bills                                                   | (3,440)                         | (5,641) |
| Proceeds from the maturity of treasury bills                                  | 3,843                           | 6,043   |
| Purchase of property and equipment                                            | (2 )                            | (15 )   |
| Net cash from investing activities                                            | 401                             | 1,854   |
| Cash flows used in financing activities                                       |                                 |         |



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|                                                      |        |         |
|------------------------------------------------------|--------|---------|
| Payments on long-term debt                           | (390 ) | (381 )  |
| Net cash used in financing activities                | (390 ) | (381 )  |
| Net increase (decrease) in cash and cash equivalents | (9 )   | 1,169   |
| Cash and cash equivalents, beginning                 | 569    | 1,190   |
| Cash and cash equivalents, ending                    | \$560  | \$2,359 |
| Supplemental cash flow information                   |        |         |
| Cash paid for income taxes                           | \$5    | \$377   |
| Cash paid for interest                               | \$10   | \$19    |

See accompanying notes to unaudited consolidated financial statements

**ELECTRO-SENSORS, INC.**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**FOR THE PERIOD ENDED JUNE 30, 2016**

**(in thousands except share and per share amounts)**

(unaudited)

**Note 1. Basis of Presentation**

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions and regulations of the Securities and Exchange Commission to Form 10-Q. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements.

This report should be read together with the Company's Annual Report on Form 10-K for the year ended December 31, 2015, including the audited consolidated financial statements and footnotes therein.

Management believes that the unaudited financial statements include all adjustments, consisting of normal recurring accruals, necessary to fairly state the financial position and results of operations as of June 30, 2016 and for the three and six-month periods then ended in accordance with accounting principles generally accepted in the United States of America. The results of interim periods may not be indicative of results to be expected for the year.

**Nature of Business**

Electro-Sensors, Inc. manufactures and markets a complete line of monitoring and control systems for a variety of industrial machinery. The Company uses leading-edge technology to continuously improve its products and make them easier to use, with the ultimate goal of manufacturing the industry-preferred product for every market served. The Company sells these products through an internal sales staff, manufacturers' representatives, and distributors to a wide variety of industries that use the products in a variety of applications to monitor process machinery operations. The Company markets its products to customers located throughout the United States, Canada, Latin America, Europe, and Asia.

### **Fair Value Measurements**

The carrying value of cash equivalents, treasury bills, trade receivables, accounts payable, and other financial working capital items approximates fair value at June 30, 2016 and December 31, 2015, due to the short maturity nature of these instruments.

### **Stock-Based Compensation**

The Company records compensation expense for stock options based on the estimated fair value of the options on the date of grant using the Black-Scholes-Merton (“BSM”) option pricing model. The Company uses historical data, among other factors, to estimate the expected price volatility, the expected option life, and the expected forfeiture rate. The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant for the estimated life of the option.

### **Use of Estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates. Significant estimates, including the underlying assumptions, consist of economic lives of long-lived assets, realizability of trade receivables, valuation of deferred tax assets/liabilities, inventory, investments, contingent earn-out, and stock compensation expense. It is at least reasonably possible that these estimates may change in the near term.

**ELECTRO-SENSORS, INC.**

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**FOR THE PERIOD ENDED JUNE 30, 2016**

(in thousands except share and per share amounts)

(unaudited)

## Note 2. Investments

The cost and estimated fair value of the Company's investments are as follows:

|                                      | <b>Cost</b> | <b>Gross<br/>unrealized<br/>gain</b> | <b>Gross<br/>unrealized<br/>loss</b> | <b>Fair<br/>value</b> |
|--------------------------------------|-------------|--------------------------------------|--------------------------------------|-----------------------|
| June 30, 2016                        |             |                                      |                                      |                       |
| Money Market                         | \$240       | \$0                                  | \$0                                  | \$240                 |
| Commercial Paper                     | 105         | 0                                    | 0                                    | 105                   |
| Treasury Bills                       | 7,478       | 10                                   | 0                                    | 7,488                 |
| Equity Securities                    | 54          | 0                                    | (54                                  | ) 0                   |
|                                      | 7,877       | 10                                   | (54                                  | ) 7,833               |
| Less Cash Equivalents                | 345         | 0                                    | 0                                    | 345                   |
| Total Investments, June 30, 2016     | \$7,532     | \$10                                 | \$(54                                | ) \$7,488             |
| December 31, 2015                    |             |                                      |                                      |                       |
| Money Market                         | \$246       | \$0                                  | \$0                                  | \$246                 |
| Commercial Paper                     | 247         | 0                                    | 0                                    | 247                   |
| Treasury Bills                       | 7,876       | 0                                    | (4                                   | ) 7,872               |
| Equity Securities                    | 54          | 0                                    | (54                                  | ) 0                   |
|                                      | 8,423       | 0                                    | (58                                  | ) 8,365               |
| Less Cash Equivalents                | 493         | 0                                    | 0                                    | 493                   |
| Total Investments, December 31, 2015 | \$7,930     | \$0                                  | \$(58                                | ) \$7,872             |

During the three-month period ended June 30, 2015, the Company sold 49,066 shares of Rudolph Technologies, Inc. (ticker symbol RTEC) stock and reported gains of \$632 in non-operating income. During the six-month period ended June 30, 2015, the Company sold 122,649 shares of RTEC stock and reported gains of \$1,447 in non-operating income. As of June 30, 2016, the Company held no shares of RTEC stock.



**ELECTRO-SENSORS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****FOR THE PERIOD ENDED JUNE 30, 2016****(in thousands except share and per share amounts)**

(unaudited)

**Note 3. Fair Value Measurements**

The following table provides information on those assets and liabilities measured at fair value on a recurring basis.

**June 30, 2016**

|                     | <b>Carrying<br/>amount<br/>in<br/>consolidated<br/>balance<br/>sheet</b> | <b>Fair<br/>Value</b> | <b>Fair Value<br/>Measurement Using</b> |                    |                    |
|---------------------|--------------------------------------------------------------------------|-----------------------|-----------------------------------------|--------------------|--------------------|
|                     |                                                                          |                       | <b>Level<br/>1</b>                      | <b>Level<br/>2</b> | <b>Level<br/>3</b> |
| <b>Assets:</b>      |                                                                          |                       |                                         |                    |                    |
| Cash equivalents    |                                                                          |                       |                                         |                    |                    |
| Money market funds  | \$ 240                                                                   | \$240                 | \$240                                   | \$ 0               | \$0                |
| Commercial paper    | 105                                                                      | 105                   | 105                                     | 0                  | 0                  |
| Treasury bills      | 7,488                                                                    | 7,488                 | 7,488                                   | 0                  | 0                  |
| Equity securities   | 0                                                                        | 0                     | 0                                       | 0                  | 0                  |
| <b>Liabilities:</b> |                                                                          |                       |                                         |                    |                    |
| Contingent earn-out | 383                                                                      | 383                   | 0                                       | 0                  | 383                |

**December 31, 2015**

|  | <b>Carrying<br/>amount<br/>in<br/>consolidated<br/>balance<br/>sheet</b> | <b>Fair<br/>Value</b> | <b>Fair Value<br/>Measurement Using</b> |                    |                    |
|--|--------------------------------------------------------------------------|-----------------------|-----------------------------------------|--------------------|--------------------|
|  |                                                                          |                       | <b>Level<br/>1</b>                      | <b>Level<br/>2</b> | <b>Level<br/>3</b> |

**Assets:**

|                    |        |       |       |      |     |
|--------------------|--------|-------|-------|------|-----|
| Cash equivalents   |        |       |       |      |     |
| Money market funds | \$ 246 | \$246 | \$246 | \$ 0 | \$0 |
| Commercial paper   | 247    | 247   | 247   | 0    | 0   |
| Treasury bills     | 7,872  | 7,872 | 7,872 | 0    | 0   |
| Equity securities  | 0      | 0     | 0     | 0    | 0   |

**Liabilities:**

|                     |     |     |   |   |     |
|---------------------|-----|-----|---|---|-----|
| Contingent earn-out | 455 | 455 | 0 | 0 | 455 |
|---------------------|-----|-----|---|---|-----|

The fair value of the money market funds, commercial paper and treasury bills is based on quoted market prices in an active market. The available-for-sale security is a limited-marketable company. There is an insignificant market for the limited-marketable company and the Company has determined its value based on financial and other factors, which are considered level 3 inputs in the fair value hierarchy. Management estimated the probability of meeting the revenue targets over the measurement period to determine the fair value of the contingent earn-out, which is considered a level 3 input in the fair value hierarchy.

The change in level 3 liabilities at fair value on a recurring basis is summarized as follows:

|                    | Period<br>Ended June<br>30,<br>2016 2015 |       |
|--------------------|------------------------------------------|-------|
| Beginning Balance  | \$455                                    | \$472 |
| Credit to earnings | (72 )                                    | (17 ) |
| Ending Balance     | \$383                                    | \$455 |

The decrease in the contingent liability reflects the Company's expectation of moderately lower future contingent payments throughout the four year earn-out period.

**ELECTRO-SENSORS, INC.**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**FOR THE PERIOD ENDED JUNE 30, 2016**

(in thousands except share and per share amounts)

(unaudited)

**Note 4. Note Payable**

The note payable consists of the following:

|                                                                                                                                                |                      |
|------------------------------------------------------------------------------------------------------------------------------------------------|----------------------|
|                                                                                                                                                | December<br>31, 2015 |
| Note payable to seller                                                                                                                         | \$ 400               |
| Payable in annual installments of principal of \$400. The note was paid off in February 2016. This note is non-interest bearing and unsecured. |                      |
| Less: Discount of note payable listed above                                                                                                    | (10 )                |
| Net note payable                                                                                                                               | 390                  |
| Less: Current maturities                                                                                                                       | 390                  |
| Note Payable – Long Term                                                                                                                       | \$ 0                 |

**Note 5. Stock-Based Compensation**

During the first quarter of 2016, the Company granted its Chief Executive Officer options to purchase 50,000 shares of common stock. The options were priced at fair market value and vested 20% on the grant date, with an additional 20% vesting on the first four anniversaries of the grant date. The options expire ten years from the date of grant.

The assumptions made in estimating the fair value of the options on the grant date based upon the BSM option-pricing model for the six months ended June 30, 2016 are as follows:

Dividend yield            0.00%



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|                         |         |
|-------------------------|---------|
| Expected volatility     | 36.17%  |
| Risk free interest rate | 1.31%   |
| Expected life           | 6 years |

As of June 30, 2016, there was approximately \$124 of unrecognized compensation expense. The Company expects to recognize this expense over the next four years.

**ELECTRO-SENSORS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****FOR THE PERIOD ENDED JUNE 30, 2016****(in thousands except share and per share amounts)**

(unaudited)

**Note 6. Segment Information**

As of January 1, 2016, the Company has one reportable operating segment: Production Monitoring. During 2015, the Company had two reportable operating segments: Production Monitoring and Investments. The Production Monitoring Division manufactures and markets a complete line of production monitoring equipment. ESI Investment Company held investments in marketable and non-marketable securities.

The accounting policies of the segments are the same as those described in Note 1 of the Notes to Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2015. In evaluating segment performance, management focuses on sales and income before income taxes. The Company had no inter-segment sales.

The following is financial information relating to the continuing operating segments:

|                            | Three Months<br>Ended<br>June 30, |         | Six Months<br>Ended<br>June 30, |         |
|----------------------------|-----------------------------------|---------|---------------------------------|---------|
|                            | 2016                              | 2015    | 2016                            | 2015    |
| External sales             |                                   |         |                                 |         |
| Production monitoring      | \$2,009                           | \$2,048 | \$3,725                         | \$3,933 |
| Total                      | \$2,009                           | \$2,048 | \$3,725                         | \$3,933 |
| Income before income taxes |                                   |         |                                 |         |
| Production monitoring      | \$217                             | \$129   | \$82                            | \$161   |
| Investments                | 0                                 | 635     | 0                               | 1,451   |
| Total                      | \$217                             | \$764   | \$82                            | \$1,612 |



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

### **FORWARD-LOOKING STATEMENTS**

This Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, including statements regarding our expectations, beliefs, intentions or strategies regarding the future. Forward-looking statements include, but are not limited to, statements relating to our marketing efforts or our efforts to accelerate growth; our business development activities; our efforts to maintain or reduce production costs; our expected use of cash on hand; our cash requirements; and the sufficiency of our cash flows. We consider any statement that is not based solely upon historical facts, including our strategies for the future and the outcome of events that have not yet occurred, as a forward-looking statement.

All forward-looking statements in this document are based on information available to us as of the date of this Form 10-Q, and we assume no obligation to update any of these forward-looking statements, other than as required by law. Our actual results could differ materially from those in these forward-looking statements. The forward-looking statements we make in this Quarterly Report are subject to certain risks and uncertainties that could cause future results to differ materially from our recent results or those projected in the forward-looking statements, including the accuracy of management’s assumptions with respect to industry trends, fluctuations in industry conditions, the accuracy of management’s assumptions regarding expenses and our cash needs and those listed under the heading “Cautionary Statements” under “Item 1—Business,” in our Annual Report on Form 10-K for the year ended December 31, 2015.

### **CRITICAL ACCOUNTING ESTIMATES**

The preparation of our consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make decisions based upon estimates, assumptions, and factors it considers relevant to the circumstances. These decisions include the selection of applicable accounting principles and the use of judgment in their application, and affect reported amounts and disclosures. Changes in economic conditions or other business circumstances may affect the outcomes of management’s estimates and assumptions. An in-depth description of our accounting estimates can be found in the interim financial statements included in this report and in our Annual Report on Form 10-K for the fiscal year ended December 31, 2015. No new estimates exist other than those discussed in our Annual Report.

The following table contains selected financial information, for the periods indicated, from our consolidated statements of comprehensive income expressed as a percentage of net sales.

|                                               | <b>Three Months</b>  |             | <b>Six Months</b>    |             |
|-----------------------------------------------|----------------------|-------------|----------------------|-------------|
|                                               | <b>Ended June 30</b> |             | <b>Ended June 30</b> |             |
|                                               | <b>2016</b>          | <b>2015</b> | <b>2016</b>          | <b>2015</b> |
| Net sales                                     | 100.0%               | 100.0%      | 100.0%               | 100.0%      |
| Cost of goods sold                            | 41.6                 | 45.0        | 43.4                 | 44.4        |
| Gross profit                                  | 58.4                 | 55.0        | 56.6                 | 55.6        |
| Operating expenses                            |                      |             |                      |             |
| Selling and marketing                         | 22.3                 | 20.1        | 23.5                 | 20.8        |
| General and administrative                    | 16.5                 | 19.5        | 21.8                 | 20.4        |
| Research and development                      | 9.3                  | 9.2         | 9.7                  | 10.3        |
| Total operating expenses                      | 48.1                 | 48.8        | 55.0                 | 51.5        |
| Operating income                              | 10.3                 | 6.2         | 1.6                  | 4.1         |
| Non-operating income (expense)                |                      |             |                      |             |
| Interest expense                              | 0.0                  | (0.1 )      | (0.0 )               | (0.2 )      |
| Gain on sale of available-for-sale securities | 0.0                  | 31.0        | 0.0                  | 36.8        |
| Interest income                               | 0.2                  | 0.0         | 0.4                  | 0.1         |
| Other income                                  | 0.3                  | 0.2         | 0.2                  | 0.2         |
| Total non-operating income, net               | 0.5                  | 31.1        | 0.6                  | 36.9        |
| Income before income taxes                    | 10.8                 | 37.3        | 2.2                  | 41.0        |
| Income taxes                                  | 3.8                  | 13.1        | 0.8                  | 14.3        |
| Net income                                    | 7.0                  | 24.2        | 1.4                  | 26.7        |

The following discusses the Company's performance for the three and six months ended June 30, 2016 and 2015.

## **RESULTS OF OPERATIONS (in thousands)**

### **Net Sales**

Net sales for the three-month period ended June 30, 2016 decreased \$39 or 1.9% over the same period in 2015. Net sales for the six-month period ended June 30, 2016 decreased \$208 or 5.3% over the same period in 2015. The second quarter decrease primarily resulted from lower sales in the north central US and overseas territories, each area declining 26% over the corresponding 2015 three-month period. These decreases were partially offset by a 51% increase in large-order performance. In addition, plant upgrades and expansions in the animal feed industry resulted in the Company achieving strong results in our analog sensor product line.

### **Gross Profit**

Gross profit for the three months ended June 30, 2016 increased \$48, or 4.3%, over the same period in 2015. Gross profit for the six months ended June 30, 2016 decreased \$80, or 3.7%, over the same period in 2015 due to lower revenue in the 2016 period. Gross margin, as a percentage of net sales, increased to 58.4% in the 2016 three-month period from 55.0% in the prior year, and increased to 56.6% in the 2016 six-month period compared to 55.6% in the prior year. Gross margin percentages were higher in the 2016 periods due to production efficiencies.

### **Operating Expenses**

Total operating expenses decreased \$32, or 3.2%, for the three months ended June 30, 2016 when compared to the same period in 2015 and decreased as a percentage of sales from 48.8% to 48.1%. Total operating expenses increased \$21, or 1.0%, for the six months ended June 30, 2016 when compared to the same period in 2015 and increased as a percentage of sales from 51.5% to 55.0%.

Selling and marketing expenses increased \$37, or 9.0%, in the 2016 three-month period over the prior year, and increased as a percentage of net sales to 22.3% from 20.1%. Selling and marketing expenses increased \$57, or 7.0%, in the 2016 six-month period over the prior year period, and increased as a percentage of net sales to 23.5% from 20.8%. The increase in expense dollars for the 2016 three-month period resulted from an increase in wages and

benefits due to hiring of additional personnel. The increase for the 2016 six-month period resulted from an increase in wages and benefits due to additional personnel, the cost of providing system demonstrations to potential customers and increased travel. The six month increase is partially offset by a decrease in commission paid to outside manufacturers' representatives due to lower sales volume.

General and administrative expenses decreased \$68, or 17.0%, for the 2016 three-month period compared to the same period in 2015 and decreased as a percentage of net sales to 16.5% from 19.5%. For the 2016 six-month period, general and administrative expenses increased \$8, or 1.0%, compared to the 2015 period and increased as a percentage of net sales to 21.8% from 20.4%. The decrease for the 2016 three-month period was due to a decrease in the accrual for the contingent earn-out liability related to the HazardPRO acquisition and the expensing of post-closing deliverables related to the HazardPRO acquisition in 2015. The increase for the 2016 six-month period was due to an increase in wages and benefits and stock compensation expense due to an option granted to the Chief Executive Officer in February 2016. The six month increase was partially offset by a decrease in depreciation expense, the decrease in the contingent earn-out liability related to the HazardPRO acquisition and the 2015 expensing of post-closing deliverables related to the HazardPRO acquisition. During the second quarter of 2016, the Company decreased the contingent earn-out by \$72 compared to a decrease of \$17 in the same period for 2015.

Research and development expenses decreased \$1, or 0.1%, in the 2016 three-month period from the same period in 2015 but increased as a percentage of net sales to 9.3% from 9.2%. For the 2016 six-month period, research and development expenses decreased \$44, or 10.9%, over the 2015 period, and decreased as a percentage of net sales to 9.7% from 10.3%. The percentage increase for the 2016 three-month period was due to lower sales in 2016 than in 2015. For the 2016 six-month period, the decrease was the result of lower wages and benefits due to reduced staffing levels in 2016 and costs incurred in 2015 related to lab testing fees for the HazardPRO product line. The decrease was partially offset by an increase in contract engineering related to the HazardPRO product line.

**Operating Income**

Three-month operating income grew 63.0% to \$207 from \$127 due to the 2016 higher gross margin and lower operating expenses while six-month operating revenue decreased 63.1% to \$59 from \$160, due primarily to lower fiscal 2016 first quarter revenue.

**Non-Operating Income**

Non-operating income decreased by \$627, or 98.4%, for the 2016 three-month period compared to the same 2015 period. Non-operating income decreased \$1,429, or 98.4%, in the six months ended June 30, 2016, when compared to the same period in 2015. This decrease was due to the liquidation of shares in Rudolph Technologies, Inc. in the second quarter of 2015. During the 2015 second quarter, we sold 49,066 shares of Rudolph Technologies, Inc. stock and recognized gain on the sales of \$632. During the six-month period ended June 30, 2015, we sold 122,649 shares of Rudolph Technologies, Inc. stock and recognized gain on the sales of \$1,447.

**Income Before Income Taxes**

Income before income taxes was \$217 for the three months ended June 30, 2016, representing a decrease of \$547, or 71.6%, when compared to the same period in 2015. Income before income taxes was \$82 for the six months ended June 30, 2016, representing a decrease of \$1,530, or 94.9%, when compared to the same period in 2015.

The decrease for both periods in 2016 was the result of a decrease in the sale of available-for-sale securities recognized in 2016. During the six-month period ended June 30, 2015, we recognized \$1,449 of gain on sale of available-for-sale securities (see “Non-Operating Income (Expense)”).

**LIQUIDITY AND CAPITAL RESOURCES**

Cash and cash equivalents were \$560 at June 30, 2016, and \$569 at December 31, 2015. The Company maintains a small cash balance and invests the majority of its available funds in United States Treasury securities.

Cash used in operations was favorably impacted by a decrease in inventories, and an increase in operating income, net of income taxes. For the 2016 six-month period we used \$284 less cash in operations compared to the 2015 six-month



period. In the 2016 period, the Company had a small decrease in inventories due to increased sales late in the 2016 second quarter. The increase in operating income, net of income taxes, is due to increased tax expense in 2015 due to the sales of available-for-sale securities.

Cash generated from investing activities was \$401 and \$1,854 for the six months ended June 30, 2016 and 2015, respectively. During the 2016 and 2015 six-month periods, the Company had net proceeds of Treasury Bills with a maturity date of more than three months of \$403 and \$402, respectively. In addition, the Company generated \$1,467 in proceeds on the sale of available-for-sale securities during 2015 from the sale of Rudolph stock.

Cash used in financing activities was \$390 and \$381 for respective 2016 and 2015 six-month periods. During the six months ended June 30, 2016 and 2015, we paid \$390 and \$381, respectively, on the long-term debt owed to Harvest Engineering, Inc. ("Harvest") for the technology purchased in February 2014. As of June 30, 2016, the note payable to Harvest has been paid in full.

Our ongoing cash requirements will be primarily for capital expenditures, research and development, and working capital. Management believes that cash on hand and any cash provided by operations will be sufficient to meet our cash requirements through at least the next 12 months.

#### ***Off-balance Sheet Arrangements***

As of June 30, 2016, the Company had no off-balance sheet arrangements or transactions.

#### ***Future Business Development Activities***

The Company continues to seek growth opportunities, both internally through the Company's existing portfolio of products, technologies and markets, as well as externally through technology partnerships or related-product acquisitions. Although the Company is continuing to explore these external opportunities, it currently has no agreements or understandings with any third parties.

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

Not Applicable.

### **Item 4. Controls and Procedures**

#### *Evaluation of Disclosure Controls and Procedures*

Based on an evaluation under the supervision and with the participation of the Company's management, the Company's principal executive officer and principal financial officer has concluded that the Company's disclosure controls and procedures as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended ("Exchange Act") were effective as of June 30, 2016 to ensure that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is (i) recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms and (ii) accumulated and communicated to the Company's management, including its principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

#### *Changes in Internal Control Over Financial Reporting*

There were no changes in the Company's internal control over financial reporting during the second quarter of 2016, which were identified in connection with management's evaluation required by paragraph (d) of Rules 13a-15 and 15d-15 under the Exchange Act, that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**PART II – OTHER INFORMATION**

**Item 1. Legal Proceedings - None.**

**Item 1A. Risk Factors - Not Applicable.**

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds - None.**

**Item 3. Defaults Upon Senior Securities - None.**

**Item 4. Mine Safety Disclosures – Not Applicable.**

**Item 5. Other Information - None.**

**Item 6. Exhibits**

(a) Exhibits - See Exhibit Index following signature page.

**SIGNATURES**

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

**Electro-Sensors, Inc.**

August 12, 2016 /s/ David L. Klenk  
David L. Klenk  
Chief Executive Officer and Chief Financial Officer

August 12, 2016 /s/ Gloria M. Grundhoefer  
Gloria M. Grundhoefer  
Controller

**EXHIBIT INDEX**

**ELECTRO-SENSORS, INC.**

**FORM 10-Q FOR QUARTER ENDED JUNE 30, 2016**

**Exhibit Description**

31.1 Certification of CEO and CFO Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32.1 Certification of CEO and CFO Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

101 The following financial information from Electro-Sensors, Inc.'s Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2016, formatted in eXtensible Business Reporting Language (XBRL): (i) Consolidated Balance Sheets as of June 30, 2016 and December 31, 2015, (ii) Consolidated Statements of Comprehensive Income for the three and six months ended June 30, 2016 and June 30, 2015, (iii) Consolidated Statements of Cash Flows for the six months ended June 30, 2016 and June 30, 2015, and (iv) Notes to Consolidated Financial Statements.