

POWER SOLUTIONS INTERNATIONAL, INC.

Form 10-Q

November 09, 2015

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**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

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

**For the Quarterly Period Ended: September 30, 2015**

**OR**

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

**For the Transition Period From \_\_\_\_\_ to \_\_\_\_\_**

**Commission File Number: 001-35944**

**Power Solutions International, Inc.**

**(Exact name of registrant as specified in its charter)**

**Delaware**  
**(State or other jurisdiction of**  
**incorporation or organization)**

**33-0963637**  
**(IRS Employer**  
**Identification No.)**

**201 Mittel Drive**

**Wood Dale, IL**  
**(Address of Principal Executive Offices)**

**60191**  
**(Zip Code)**

**Registrant's telephone number, including area code: (630) 350-9400**

**(Former name or former address, if changed since last report)**

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 Website, 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

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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 definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer   
Non-accelerated filer  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 5, 2015, there were 10,752,105 outstanding shares of Common Stock, par value \$0.001, of the registrant.

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**QUARTER ENDED SEPTEMBER 30, 2015**

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POWER SOLUTIONS INTERNATIONAL, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

(Dollar amounts in thousands, except per share amounts)	September 30, 2015	December 31, 2014
<b>ASSETS</b>		
Current assets		
Cash	\$ 12,253	\$ 6,561
Accounts receivable, net	96,863	81,740
Inventories, net	102,754	93,903
Prepaid expenses and other current assets	5,523	4,801
Deferred income taxes	3,998	3,998
 Total current assets	 221,391	 191,003
Property, plant & equipment, net	25,577	20,892
Intangible assets, net	33,598	21,392
Goodwill	41,800	23,546
Other noncurrent assets	7,706	5,804
 <b>TOTAL ASSETS</b>	 <b>\$ 330,072</b>	 <b>\$ 262,637</b>
 <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities		
Accounts payable	\$ 43,943	\$ 60,877
Income taxes payable		779
Accrued compensation and benefits	3,927	5,983
Current maturities of long-term debt		1,667
Other accrued liabilities	17,655	6,742
 Total current liabilities	 65,525	 76,048
Long-term obligations		
Revolving line of credit	99,061	78,030
Deferred income taxes	3,241	3,241
Private placement warrants	2,741	11,036

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Long-term debt, less current maturities, net	53,694	2,361
Other noncurrent liabilities	1,477	1,122
<b>TOTAL LIABILITIES</b>	<b>225,739</b>	<b>171,838</b>
<b>COMMITMENTS AND CONTINGENCIES</b>		
<b>STOCKHOLDERS EQUITY</b>		
Series A convertible preferred stock \$0.001 par value. Authorized: 114,000 shares. Issued and outstanding: -0- shares at September 30, 2015 and December 31, 2014.		
Common stock \$0.001 par value. Authorized: 50,000,000 shares. Issued: 11,580,608 and 11,562,209 shares at September 30, 2015 and December 31, 2014, respectively. Outstanding: 10,749,683 and 10,731,284 at September 30, 2015 and December 31, 2014, respectively.		
	12	12
Additional paid-in-capital	74,919	73,959
Retained earnings	33,652	21,078
Treasury stock, at cost, 830,925 shares at September 30, 2015 and December 31, 2014.	(4,250)	(4,250)
<b>TOTAL STOCKHOLDERS EQUITY</b>	<b>104,333</b>	<b>90,799</b>
<b>TOTAL LIABILITIES AND STOCKHOLDERS EQUITY</b>	<b>\$ 330,072</b>	<b>\$ 262,637</b>

*The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.*

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POWER SOLUTIONS INTERNATIONAL, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

(Dollar amounts in thousands, except per share amounts)	Three months ended September 30, 2015	Three months ended September 30, 2014	Nine months ended September 30, 2015	Nine months ended September 30, 2014
Net sales	\$ 112,008	\$ 93,972	\$ 292,776	\$ 244,085
Cost of sales	96,700	75,344	243,637	198,131
Gross profit	15,308	18,628	49,139	45,954
Operating expenses:				
Research & development and engineering	5,562	4,501	16,973	11,844
Selling and service	2,979	2,706	8,525	6,871
General and administrative	4,280	3,410	10,953	9,814
Amortization of intangible assets	1,099	492	2,755	492
Total operating expenses	13,920	11,109	39,206	29,021
Operating income	1,388	7,519	9,933	16,933
Other (income) expense:				
Interest expense	1,374	407	2,986	887
Contingent consideration	(50)	(3,208)	(50)	(3,782)
Private placement warrant	(8,750)	(858)	(8,040)	(1,190)
Other expense, net	171	34	260	109
Total other (income)	(7,255)	(3,625)	(4,844)	(3,976)
Income before income taxes	8,643	11,144	14,777	20,909
Income tax (benefit) provision	(466)	3,996	2,203	7,504
Net income	\$ 9,109	\$ 7,148	\$ 12,574	\$ 13,405
Weighted-average common shares outstanding:				
Basic	10,814,765	10,794,229	10,804,720	10,676,792
Diluted	11,068,925	11,167,598	11,120,721	11,125,116
Earnings per share basic Common shares	\$ 0.84	\$ 0.66	\$ 1.16	\$ 1.26

Earnings per share diluted									
Common shares	\$	0.03	\$	0.56	\$	0.41	\$	1.10	

*The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.*



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POWER SOLUTIONS INTERNATIONAL, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(Dollar amounts in thousands)	Nine months ended September 30, 2015	Nine months ended September 30, 2014
Cash flows from operating activities		
Net income	\$ 12,574	\$ 13,405
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Depreciation	3,067	1,799
Amortization	3,464	1,333
Deferred income taxes		1,512
Non-cash interest expense	305	62
Share-based compensation expense	854	982
Increase (decrease) in accounts receivable allowances	625	(250)
Increase in inventory reserves	698	615
Amortization of inventory step up to fair value	453	482
Decrease in valuation of private placement warrants liability	(8,040)	(1,190)
Decrease in valuation of contingent consideration liability	(50)	(3,782)
Loss on investment in joint ventures	260	136
Loss on disposal of assets	142	77
(Increase) decrease in operating assets, net of effects of business combinations:		
Accounts receivable	(10,605)	(21,917)
Inventories	589	(23,398)
Prepaid expenses and other assets	(1,795)	(2,342)
Increase (decrease) in operating liabilities, net of effects of business combinations:		
Accounts payable	(23,659)	19,549
Accrued compensation and benefits and other accrued liabilities	(1,046)	(133)
Income taxes payable	(779)	(27)
Other noncurrent liabilities	355	(363)
Net cash used in operating activities	(22,588)	(13,450)
Cash flows from investing activities		
Purchases of property, plant & equipment	(6,661)	(4,749)
Business combinations, net of cash acquired	(34,396)	(44,122)
Investment in joint ventures	(1,000)	(350)

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Net cash used in investing activities	(42,057)	(49,221)
<b>Cash flows from financing activities</b>		
Advances from revolving line of credit noncurrent obligation	85,180	67,946
Repayments of revolving line of credit noncurrent obligation	(64,149)	(11,831)
Proceeds from long-term debt	55,000	5,000
Proceeds from exercise of private placement warrants	65	1,425
Excess tax benefit from exercise of share-based awards	102	2,469
Payment of withholding taxes from net settlement of share-based awards	(316)	(361)
Payments on long-term debt	(4,028)	(555)
Cash paid for financing and transaction fees	(1,517)	(126)
Net cash provided by financing activities	70,337	63,967
Increase in cash	5,692	1,296
Cash at beginning of period	6,561	6,306
Cash at end of period	\$ 12,253	\$ 7,602
<b>Supplemental disclosures of cash flow information</b>		
Cash paid for interest	\$ 1,416	\$ 748
Cash paid for income taxes	5,971	3,828
<b>Supplemental disclosure of non-cash transactions</b>		
Unpaid property, plant & equipment	\$ 575	\$ 937
Fair value of private placement warrants exercised	255	7,320

*The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.*

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POWER SOLUTIONS INTERNATIONAL, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

(Tabular dollar amounts in thousands, except per share amounts)

**1. Description of the company and business operations**

***Description of the company***

Power Solutions International, Inc., a Delaware corporation ( *Company* ), is the successor in a migratory merger ( *Migratory Merger* ) effective August 26, 2011, to Power Solutions International, Inc., a Nevada corporation. Power Solutions International and PSI refer to Power Solutions International, Inc., a Nevada corporation, prior to the consummation of the Migratory Merger, and Power Solutions International, Inc., a Delaware corporation, following the consummation of the Migratory Merger.

Power Solutions International, Inc., a Nevada corporation, was formerly known as Format, Inc. ( *Format* ), and prior to the consummation of a reverse recapitalization, was engaged, to a limited extent, in EDGARizing corporate documents for filing with the Securities and Exchange Commission ( *SEC* ) and in providing limited commercial printing services. On April 29, 2011, Format consummated a reverse acquisition transaction with The W Group, Inc. and its subsidiaries ( *The W Group* ) ( *Reverse Recapitalization* ), and in connection with this transaction, Format changed its corporate name to Power Solutions International, Inc. The W Group was considered the accounting acquirer and remained as the surviving corporation of the reverse acquisition, becoming a wholly-owned subsidiary of Power Solutions International, Inc.

***Nature of business operations***

The Company is a global producer and distributor of a broad range of high performance, certified low emission power systems, including alternative fuel power systems for original equipment manufacturers of off-highway industrial equipment ( *industrial OEMs* ), on-road markets, and large custom-engineered integrated electrical power generation systems. The Company's customers include large, industry-leading and/or multinational organizations. The Company's products and services are sold predominantly to customers throughout North America, as well as to customers located throughout the Pacific Rim and Europe. The Company operates as one business and geographic segment.

The Company's power systems are highly engineered, comprehensive systems which, through its technologically sophisticated development and manufacturing processes, including its in-house design, prototyping, testing and engineering capabilities and its analysis and determination of the specific components to be integrated into a given power system (driven in large part by emission standards and cost restrictions required, or desired, to be met), allow the Company to provide its customers with power systems customized to meet specific industrial OEM application requirements, other technical specifications of customers, and requirements imposed by environmental regulatory bodies. The Company's power system configurations range from a basic engine integrated with appropriate fuel system components to completely packaged power systems that include any combination of cooling systems, electronic systems, air intake systems, fuel systems, housings, power takeoff systems, exhaust systems, hydraulic systems, enclosures, brackets, hoses, tubes and other assembled componentry. The Company purchases engines from third party suppliers and produces an internally-designed engine, all of which are then integrated into the Company's power systems. Additionally, the Company is designing and developing other engines in-house. Of the other components that the Company integrates into its power systems, a substantial portion consist of internally designed components and components for which the Company coordinates significant design efforts with third party suppliers, with the

remainder consisting largely of parts that are sourced off-the-shelf from third party suppliers. Some of the key components (including purchased engines) embody proprietary intellectual property of the Company's suppliers. As a result of its design and manufacturing capabilities, the Company is able to provide its customers with a comprehensive power system which can be incorporated, using a single part number, directly into a customer's specified application. Capitalizing on its expertise in developing and manufacturing emission-certified power systems and its access to the latest power system technologies, the Company believes that it is able to provide complete green power systems to industrial OEMs at a low cost and with fast design turnaround. In addition to the certified products described above, the Company sells diesel, gasoline and non-certified power systems and aftermarket components.

## **2. Basis of presentation**

### ***Unaudited condensed consolidated financial statements***

The unaudited condensed consolidated financial statements of Power Solutions International, Inc. present information in accordance with generally accepted accounting principles in the U.S. ( GAAP ), have been prepared pursuant to the rules and regulations of the SEC for interim financial reporting and, in the opinion of management, reflect all normal and recurring adjustments necessary to present fairly the interim periods of the unaudited condensed consolidated financial position, results of operations and cash flows of the Company and its wholly-owned subsidiaries for the periods presented.

Certain amounts recorded in the prior period unaudited condensed consolidated financial statements presented have been reclassified to conform to the current period financial statement presentation. These reclassifications had no effect on previously reported net income.

These unaudited condensed consolidated financial statements should be read in conjunction with, and have been prepared in conformity with the accounting principles reflected in, the consolidated financial statements and related notes included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2014. As these financial statements have been prepared pursuant to the rules and regulations of the SEC, certain information and disclosures normally included in annual financial statements and related notes prepared in accordance with GAAP have been condensed or omitted. The results of operations for the three and nine months ended September 30, 2015 are not necessarily indicative of the results to be expected for the full year.

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### ***Principles of consolidation***

The unaudited condensed consolidated financial statements presented herein include the accounts of Power Solutions International, Inc. and its direct and indirect wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation.

### ***Significant accounting policies***

The Company's significant accounting policies as of December 31, 2014 are described in the Company's Annual Report on Form 10-K, filed with the Securities and Exchange Commission on March 13, 2015. There have been no material changes with respect to the Company's significant accounting policies subsequent to December 31, 2014.

### **3. Recently issued accounting pronouncements**

The Company evaluates the pronouncements of authoritative accounting organizations, including the Financial Accounting Standards Board (FASB), to determine the impact of new pronouncements on GAAP and the Company. In May of 2014, the FASB and International Accounting Standards Board jointly issued a final standard on revenue recognition which outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers. This standard will supersede most current revenue recognition guidance. Under the new standard, entities are required to identify the following within a contract with a customer: the separate performance obligations in the contract; the transaction price; allocation of the transaction price to the separate performance obligations in the contract; and the appropriate amount of revenue to be recognized when (or as) the entity satisfies each performance obligation. Entities have the option of using either retrospective transition or a modified approach in applying the new standard. On July 9, 2015, the FASB voted to issue a final Accounting Standards Update (ASU) that defers for one year the effective date of the new revenue standard and allows early adoption as of the original effective date (i.e., annual reporting periods beginning after December 15, 2016, including interim reporting periods within those annual periods). After reviewing and discussing the feedback received, the Board decided to adopt the standard as originally proposed. Thus, the anticipated final ASU will be effective for annual reporting periods (including interim reporting periods within those periods) beginning after December 15, 2017. The Company is currently evaluating the approach it will use to apply the new standard and the impact that the adoption of the new standard will have on the Company's unaudited condensed consolidated financial statements.

In April of 2015, the FASB issued guidance to simplify the presentation of debt issuance costs. This new guidance requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. Although the standard is effective for financial statements issued for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years, the Company chose to early adopt this guidance as of June 30, 2015, and has therefore presented the debt issuance costs associated with the issuance of its 5.5% Senior Notes as a direct deduction from the carrying value of the liability as of September 30, 2015. Refer to Note 9, Debt for further details related to the issuance of the Company's 5.5% Senior Notes.

There were no additional new accounting pronouncements or guidance that have been issued or adopted by authoritative accounting organizations during the three months ended September 30, 2015, that are expected to have a significant effect on the Company's unaudited condensed consolidated financial statements.

### **4. Acquisitions**

When appropriate, the Company accounts for business combinations in accordance with ASC 805, *Business Combinations*, and, as such, assets acquired and liabilities assumed are recorded at their respective fair values. The excess of the acquisition consideration over the fair value of tangible and intangible assets acquired and liabilities assumed, if any, is then allocated to goodwill. Any goodwill ultimately recorded is generally attributable to one or more values ascribed to geographic expansion of product sales, manufacturing and other synergies of the combined businesses.

The estimated fair values of assets acquired and liabilities assumed are based on the information that was available through the date of the most recent balance sheet, and are provisional, until the Company has completed the required analysis of fair values to be assigned to the assets acquired and liabilities assumed. The ultimate determination of fair values assigned to the assets acquired and liabilities assumed requires management to make significant assumptions and estimates. The more significant assumptions include estimating future cash flows and developing appropriate discount rates. These estimates and assumptions of the fair value allocation are subject to change upon the finalization of all valuation analyses. When required, independent valuation specialists conduct valuations to assist management of the Company in determining the estimated fair values of trade receivables, inventory, machinery and equipment, intangible assets and liabilities assumed, including contingent consideration. The determination of these estimated fair values, the assets' useful lives and the amortization and depreciation methods are subject to finalization of the work performed by the independent valuation specialists. Fair value measurements can be highly subjective, and the reasonable application of measurement principles may result in a range of alternative estimates using the same facts and circumstances. The final allocation could be materially different from the preliminary allocation recorded in the Company's unaudited condensed consolidated balance sheet. However, the Company's management is ultimately responsible for the values assigned. Although the final determinations may result in asset fair values that are materially different from the preliminary estimates of the amounts included in the Company's unaudited condensed consolidated financial statements, the Company believes that the fair values ultimately assigned to the assets acquired and liabilities assumed will not materially differ from amounts initially recorded in the Company's unaudited condensed consolidated financial statements.

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The condensed consolidated statements of operations for the three and nine months ended September 30, 2015 and 2014, include the operating results of each acquired business since the date of each respective acquisition.

*Acquisition of Powertrain Integration, LLC*

On May 4, 2015, the Company entered into an Asset Purchase Agreement ( APA ) with Powertrain Integration, LLC ( Powertrain ) and its owners to acquire the assets of Powertrain. The acquisition closed on May 19, 2015 ( Powertrain Date of Acquisition ). Powertrain provides on-highway powertrain solutions, including systems, components and services for niche OEM automakers and fleets. Powertrain specializes in alternative-fuel as well as gasoline and diesel systems and offers design, engineering, testing and production capabilities to deliver one-stop vehicle integration. At closing, the Company paid cash of \$20,873,000 representing the initial cash consideration adjusted for estimated working capital. During the three months ended September 30, 2015, the Company recorded a \$97,000 favorable final working capital adjustment that reduced the cash paid to \$20,776,000. The purchase price is subject to further adjustments for assumed liabilities, a Base Earn-out Payment and Additional Earn-out Payment, all as described in the APA. Accordingly, the Company also initially recorded a liability of \$8,200,000 as of the Powertrain Date of Acquisition representing the contingent consideration associated with the Base Earn-out Payment and Additional Earn-out Payment for a provisional aggregate purchase price of \$28,976,000. The actual amount of the contingent consideration attributable to the Base Earn-out will be based upon the 2015 full year net sales of Powertrain. The Base Earn-out Payment is payable in cash while the Additional Earn-out Payment is payable, at the Company's discretion, in cash or shares of the Company's common stock. The Additional Earn-out Payment is defined as the greater of a 5% per annum return on the Base Earn-out Payment and the incremental growth of the Company's stock price since the acquisition was announced as determined in accordance with the formula defined in the APA. Under the terms of the APA, the Base Earn-out Payment and the Additional Earn-out Payment are expected to be settled and paid during the first quarter of 2016. The Company's liability for the contingent consideration was measured at fair value based on unobservable inputs, and thus was considered a Level 3 financial instrument. The fair value of the liability was primarily driven by the Company's expectations of achieving the performance targets required by the APA. The expected performance targets were used in a Monte Carlo simulation which provided for the most likely earn-out payment which was then discounted to present value in order to derive a fair value of the Base Earn-out Payment. A Modified Black-Scholes call option model considering the actual and forecasted share price, the measurement period and a volatility factor was used to derive a fair value of the Additional Earn-out Payment. As of September 30, 2015, the contingent consideration liability was adjusted downward by \$50,000, net, primarily due to a reduction in the estimated Additional Earn-out Payment arising from a decrease in the market value of the Company's common stock. The aggregate purchase price, inclusive of all potential payments is expected to be finalized in the first quarter of 2016.

The Company has accounted for this acquisition as a business combination in accordance with ASC 805, *Business Combinations*, and as such, the excess of the purchase price over the fair values assigned to the assets acquired and liabilities assumed has been provisionally allocated to goodwill subject to the completion of the fair value analysis of the assets acquired and liabilities assumed. The Company has treated the acquisition of Powertrain as a purchase of assets for income tax purposes. Accordingly, the financial and income tax bases of the assets and liabilities have been assumed to be the same at the Powertrain Date of Acquisition, and therefore, a provision for deferred income tax has not been recorded in connection with the purchase price allocation. Additionally, any excess of the purchase price over the fair value of the assets acquired is expected to be deductible for income tax purposes. The acquisition was funded by certain proceeds received from the issuance of the 5.50% Senior Notes described in Note 9, Debt .

The purchase price for this acquisition has been provisionally allocated to the assets acquired and liabilities assumed based on their estimated fair values as follows:



	May 19, 2015 (As initially reported)	Measurement period adjustment	May 19, 2015 (As adjusted)
<b>Assets acquired:</b>			
Accounts receivable	\$ 4,942	\$ (11)	\$ 4,931
Inventories	1,890		1,890
Prepaid expenses and other current assets	23		23
Property, plant & equipment	315	(1)	314
Other non-current assets	24		24
<b>Total tangible assets</b>	<b>7,194</b>	<b>(12)</b>	<b>7,182</b>
<b>Intangible assets:</b>			
Intangible assets	13,600		13,600
Goodwill	14,471	840	15,311
<b>Total assets acquired</b>	<b>35,265</b>	<b>828</b>	<b>36,093</b>
<b>Liabilities assumed:</b>			
Accounts payable	5,951		5,951
Accrued liabilities	241	925	1,166
<b>Total liabilities assumed</b>	<b>6,192</b>	<b>925</b>	<b>7,117</b>
<b>Net assets acquired</b>	<b>\$ 29,073</b>	<b>\$ (97 )</b>	<b>\$ 28,976</b>

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Cash paid at Powertrain Date of Acquisition	\$ 20,873
Contingent consideration	8,200
Working capital adjustment	(97)
Aggregate provisional consideration	\$ 28,976

The above estimated fair values of assets acquired and liabilities assumed were based on the information that was available through September 30, 2015 and are provisional. There are inherent uncertainties and management judgment required in these determinations. The fair value measurements of certain assets acquired and liabilities assumed were based on valuations involving significant unobservable inputs that are Level 3 inputs in the fair value hierarchy. The Company believes that these inputs provided a reasonable basis for estimating the fair values, but is waiting for certain additional information necessary to finalize those amounts. Thus, the provisional measurements of fair value reflected are subject to change. Except as discussed below, the assets acquired and the liabilities assumed were stated at their estimated fair values at the Powertrain Date of Acquisition.

The fair value of accounts receivable acquired was adjusted for amounts known or highly likely to be uncollectible based upon an assessment of known facts and circumstances as of the Powertrain Date of Acquisition and additional information arising subsequent to the Powertrain Date of Acquisition with respect to these known facts and circumstances.

The inventory acquired was revalued to its fair value. While the cost of raw materials generally approximated fair value, the value of finished goods inventory was stepped up by \$22,000, representing the estimated selling price of that inventory less the sum of costs to complete and a reasonable allowance for the Company's selling efforts, thereby reducing the margin on certain acquired inventory sold. The Company recognized all of this stepped up inventory value within cost of sales in the nine months ended September 30, 2015.

The identifiable intangible assets as a result of the acquisition will be amortized over their respective estimated useful lives as follows:

	Asset amount	Estimated life
Backlog	\$ 600	3 months
Customer relationships	13,000	12 years
<b>Total identifiable intangible assets</b>	<b>\$ 13,600</b>	

The weighted average useful life of the intangibles identified above is approximately 11.5 years. The fair value of backlog and customer relationships was derived using the multi-period excess earnings method.

The fair value of property, plant and equipment was based upon the acquisition costs of assets acquired as of the Powertrain Date of Acquisition adjusted for any known facts and circumstances necessary to approximate fair value.

Goodwill largely consists of geographic expansion of product sales, manufacturing and other synergies of the combined companies, and the value of the assembled workforce.

The accounts payable and accrued liabilities assumed were based on their book values which approximated their fair values at the Powertrain Date of Acquisition. Subsequent to the Powertrain Date of Acquisition, the accrued liabilities were further adjusted by \$925,000 primarily related to additional warranty reserves to more accurately reflect the liabilities assumed as of that date.

*Acquisition of Bi-Phase Technologies, LLC*

On May 1, 2015 ( Bi-Phase Date of Acquisition ), the Company acquired all of the membership interests in Bi-Phase Technologies, LLC, a Minnesota limited liability company ( Bi-Phase ) and wholly-owned subsidiary of TPB, Inc., a Minnesota corporation. Bi-Phase is engaged in the design and manufacture of liquid propane electronic fuel injection systems to allow for the conversion of vehicles from gasoline to propane. The initial purchase price was approximately \$3.5 million in cash plus certain working capital, assumption of certain liabilities and Earn-out Payments as defined in the Membership Interest Purchase Agreement. The cash paid at the Bi-Phase Date of Acquisition was \$3,619,000 including estimated working capital. During the quarter ended September 30, 2015, the Company paid an additional \$266,000 representing the final working capital adjustment for total cash consideration of \$3,885,000 before the contingent consideration. The Company also recorded a contingent consideration liability of \$540,000 representing an estimate of the Earn-out Payments expected to be payable in connection with the acquisition of Bi-Phase. This contingent consideration, payable to TPB, Inc., is based upon certain sales of Bi-Phase fuel systems over a period of three to five years. Accordingly, the provisional aggregate purchase price approximated \$4,425,000.

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The Company has accounted for this acquisition as a business combination in accordance with ASC 805, *Business Combinations*, and as such, the excess of the purchase price over the fair values assigned to the assets acquired and liabilities assumed has been provisionally allocated to goodwill. The Company has treated the acquisition of Bi-Phase as a purchase of assets for income tax purposes. Accordingly, the financial and income tax bases of the assets and liabilities have been assumed to be the same at the Bi-Phase Date of Acquisition, and therefore, a provision for deferred income tax has not been recorded in connection with the purchase price allocation. Additionally, any excess of the purchase price over the fair value of the assets acquired is expected to be deductible for income tax purposes. The acquisition was funded by the proceeds received from the issuance of the 5.50% Senior Notes described in Note 9, Debt .

The purchase price for this acquisition has been provisionally allocated to the assets acquired and liabilities assumed based on their estimated fair values as follows:

	May 1, 2015 (Bi-Phase Date of Acquisition)
<b>Assets acquired:</b>	
Accounts receivable	\$ 212
Inventories	2,103
Prepaid expenses	4
Property, plant & equipment	113
Other assets	162
<b>Total tangible assets</b>	<b>2,594</b>
<b>Intangible assets:</b>	
Intangible assets	860
Goodwill	1,217
<b>Total assets acquired</b>	<b>4,671</b>
<b>Liabilities assumed:</b>	
Accounts payable	199
Accrued liabilities	47
<b>Total liabilities assumed</b>	<b>246</b>
<b>Net assets acquired</b>	<b>\$ 4,425</b>
<b>Initial cash paid at Bi-Phase Date of Acquisition</b>	<b>\$ 3,619</b>
Contingent consideration	540
Working capital adjustment	266

Aggregate provisional consideration	\$	4,425
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The above estimated fair values of assets acquired and liabilities assumed were based on the information that was available through September 30, 2015 and are provisional. There are inherent uncertainties and management judgment required in these determinations. The fair value measurements of certain assets acquired and liabilities assumed were based on valuations involving significant unobservable inputs that are Level 3 inputs in the fair value hierarchy. The Company believes that these inputs provided a reasonable basis for estimating the fair values, but is waiting for certain additional information necessary to finalize those amounts. Thus, the provisional measurements of fair value reflected are subject to change. Except as discussed below, the assets acquired and the liabilities assumed were stated at their estimated fair values at the Bi-Phase Date of Acquisition.

The fair value of accounts receivable acquired was adjusted for amounts known or highly likely to be uncollectible based upon an assessment of known facts and circumstances as of the Bi-Phase Date of Acquisition and additional information arising subsequent to that date with respect to these known facts and circumstances.

The inventory acquired was revalued to its fair value. While the cost of raw materials generally approximated fair value, the value of finished goods inventory was stepped up by \$226,000, representing the estimated selling price of that inventory less the sum of costs to complete and a reasonable allowance for the Company's selling efforts, thereby reducing the margin on certain acquired inventory sold. The Company recognized \$85,000 and \$141,000, of this stepped up inventory value within cost of sales in the three and nine months ended September 30, 2015, respectively.

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The identifiable intangible assets as a result of the acquisition will be amortized over their respective estimated useful lives as follows:

	Asset amount	Estimated life
Developed technology	\$ 700	7 years
Customer relationships	160	15 years
<b>Total identifiable intangible assets</b>	<b>\$ 860</b>	

The weighted average useful life of the intangibles identified above is approximately 8.5 years. The fair value of developed technology and customer relationships was derived using the relief from royalty method and the multi-period excess earnings method, respectively.

The fair value of property, plant and equipment was based upon the acquisition costs of assets acquired as of the Bi-Phase Date of Acquisition adjusted for any known facts and circumstances necessary to approximate fair value.

Goodwill largely consists of geographic expansion of product sales, manufacturing and other synergies of the combined companies, and the value of the assembled workforce.

*Acquisition of Buck's Acquisition Company, LLC*

On March 18, 2015 ( Buck's Date of Acquisition ), the Company acquired all of the membership interests in Buck's Acquisition Company, LLC, ( Buck's ) from UE Powertrain d/b/a Buck's Engines and United Holdings, LLC, for an initial cash purchase price of approximately \$9,735,000, subject to certain adjustments as defined by the purchase agreement. Buck's is a manufacturer of alternative-fuel engines for industrial markets and was formerly a product line of United Engines, LLC. Buck's supplies a range of alternative-fuel engines that run on natural gas, propane and liquid propane gas fuels. Buck's targets an extensive range of industrial applications, including irrigation, gas compression, oil production, industrial equipment, power generation, mobile equipment, wind turbines, and re-power applications. The acquisition of Buck's has been accounted for as a business combination in accordance with ASC 805, *Business Combinations*, and as such, the excess of the purchase price over the fair values assigned to the assets acquired and liabilities assumed has been provisionally allocated to goodwill. The Company initially and provisionally recorded the assets acquired and liabilities assumed at their fair values subject to the completion of the fair value analysis of the assets acquired and liabilities assumed. The Company treated the acquisition of Buck's as a purchase of assets for income tax purposes. Accordingly, the financial and income tax bases of the assets and liabilities have been assumed to be the same at the Buck's Date of Acquisition, and therefore, a provision for deferred income tax has not been recorded in connection with the purchase price allocation. Any excess of the purchase price over the fair value of the assets acquired is expected to be deductible for income tax purposes. The acquisition of Buck's was funded through the Company's revolving line of credit.

The purchase price for this acquisition has been provisionally allocated to the assets acquired and liabilities assumed based on their estimated fair values as follows:

March 18, 2015 (Books  
Date  
of Acquisition)

<b>Assets acquired:</b>	
Inventories	\$ 6,598
Property, plant & equipment	231
Total tangible assets	6,829
<b>Intangible assets:</b>	
Intangible assets	1,380
Goodwill	1,526
Total assets acquired	\$ 9,735

The above estimated fair values of assets acquired were based on the information that was available through September 30, 2015 and are provisional. There are inherent uncertainties and management judgment required in these determinations. The fair value measurements of certain assets acquired were based on valuations involving significant unobservable inputs that are Level 3 inputs in the fair value hierarchy. The Company believes that these inputs provided a reasonable basis for estimating the fair values but is waiting for certain additional information necessary to finalize those amounts. Thus, the provisional measurements of fair value reflected are subject to change. Except as discussed below, the assets acquired and the liabilities assumed were stated at their estimated fair values at acquisition.

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The inventory acquired was revalued to its fair value. While the cost of raw materials generally approximated fair value, the value of finished goods inventory was stepped up by \$290,000, representing the estimated selling price of that inventory less the sum of costs to complete and a reasonable allowance for the Company's selling efforts, thereby reducing the margin on certain acquired inventory sold. The Company recognized \$145,000 and \$290,000, of this stepped up inventory value within cost of sales in the three and nine months ended September 30, 2015, respectively.

The identifiable intangible assets as a result of the acquisition will be amortized over their respective estimated useful lives as follows:

	Asset amount	Estimated life
Customer relationships	\$ 1,380	10 years

The fair value of customer relationships was derived using the multi-period excess earnings method.

The fair value of property, plant and equipment was based upon the acquisition costs of assets acquired as of the Buck's Date of Acquisition adjusted for any known facts and circumstances necessary to approximate fair value.

Goodwill largely consists of geographic expansion of product sales, manufacturing and other synergies of the combined companies, and the value of the assembled workforce.

The assets, liabilities, and operating results of Powertrain, Bi-Phase and Buck's have been included in the Company's unaudited condensed consolidated financial statements from their respective dates of acquisition to September 30, 2015.

*Acquisition of Professional Power Products, Inc.*

On April 1, 2014, the Company acquired Professional Power Products, Inc. (3PI), pursuant to a stock purchase agreement with Carl L. Trent and Kenneth C. Trent (collectively the Trents) and CKT Holdings Inc., a Wisconsin corporation owned by the Trents. 3PI is a leading designer and manufacturer of large, custom engineered integrated electrical power generation systems serving the global diesel and natural gas power generation markets. The Company treated the acquisition of 3PI as a purchase of assets for income tax purposes. The acquisition of 3PI was financed through the Company's revolving line of credit and from proceeds received from a secured term loan.

The following table provides a summary of the initial consideration for 3PI:

Fair value of assets acquired	\$ 60,104
Less liabilities assumed	(5,805)
Net assets acquired	54,299
Less value of shares of Company common stock expected to be issued at date of acquisition	(8,900)
Less cash acquired	(1,277)



Cash paid

\$ 44,122

The accompanying unaudited condensed consolidated statements of operations includes 3PI's sales, net of intercompany sales, of \$4,824,000 and \$13,624,000 for the three and nine months ended September 30, 2015, respectively, and \$6,286,000 and \$13,558,000 for the three and nine months ended September 30, 2014, respectively. 3PI's operating loss was \$3,579,000 and \$8,039,000, for the three and nine months ended September 30, 2015, respectively, and \$346,000 and \$377,000 for the three and nine months ended September 30, 2014, respectively. Amortization expense related to identifiable intangible assets associated with the acquisition and expense attributable to the stepped-up value of inventory acquired, in the unaudited condensed consolidated financial statements, was \$800,000 and \$2,481,000 for the three and nine months ended September 30, 2015, respectively and \$748,000 and \$1,303,000, for the three and nine months ended September 30, 2014, respectively.

The following supplemental pro forma information presents the financial results as if the transaction had occurred on January 1, 2014 as follows:

	Three months		
	ended	Nine months ended	
	September 30,	September 30,	September 30,
	2014	2015	2014
Net sales	\$ 93,972	\$ 292,776	\$ 249,265
Net income	7,148	12,574	12,792
Earnings per share, basic	\$ 0.66	\$ 1.16	\$ 1.20
Earnings per share, diluted	\$ 0.56	\$ 0.41	\$ 1.04

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The historical operating results of 3PI included in the proforma information above has been adjusted to exclude certain non-recurring expenses, principally transaction expenses which amount approximated to \$3,474,000 in 2014.

The pro forma information presented above is for information purposes only and is not indicative of the results of operations that would have been achieved if the acquisition had taken place at an earlier date, nor are these results necessarily indicative of future consolidated results of operations of the Company.

***Transaction fees and expenses***

The Company incurred total transaction costs related to its acquisition activities of \$79,000 and \$526,000, excluding lease termination expense associated with the Buck's building, for the three and nine months ended September 30, 2015, respectively, all of which was recognized as an operating expense and classified within general and administrative expenses in the Company's unaudited condensed consolidated statements of operations in accordance with GAAP. The Company incurred total transaction costs related to the 3PI acquisition of \$811,000 for the nine months ended September 30 2014, all of which was recognized in the three months ended March 31, 2014 in accordance with GAAP.

**5. Earnings per share**

The Company computes earnings per share by applying the guidance stated in ASC 260, *Earnings per Share*. The treasury stock method has been used to compute earnings per share. The Company has issued warrants ( Private Placement Warrants ) that represent the right to purchase shares of the Company's common stock, a stock appreciation right ( SAR ) and restricted stock, all of which have been evaluated for their potentially dilutive effect under the treasury stock method. Refer to Note 11, *Stockholders' equity* for a further description of the Private Placement Warrants and Note 10, *2012 Incentive compensation plan* for a further description of the SAR and restricted stock.

***Computation of dilutive common shares***

The Company utilizes the treasury stock method described in ASC 260-10-55 to determine the number of treasury shares assumed to be purchased from the hypothetical proceeds of exercise, with any residual shares representing the incremental common shares to be issued and included in diluted earnings per share. As of September 30, 2015 and 2014, the Company's Private Placement Warrants, SAR and restricted stock were evaluated for their potentially dilutive effect under the treasury stock method. See the table below for detail as to the dilutive effect of using the treasury stock method.

The computations of basic and diluted earnings per share for the three and nine months ended September 30, 2015 and 2014, were as follows:

	Three months ended September 30,		Nine months ended September 30,	
	2015	2014	2015	2014
<b><u>Numerator:</u></b>				
Net income	\$ 9,109	\$ 7,148	\$ 12,574	\$ 13,405
Change in the value of Private Placement Warrants	(8,750)	(858)	(8,040)	(1,190)

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\$ 359 \$ 6,290 \$ 4,534 \$ 12,215

Denominator:

Weighted average common shares outstanding-basic	10,814,765	10,794,229	10,804,720	10,676,792
Incremental shares from assumed exercise of Private Placement Warrants, SAR and restricted stock, if applicable	254,160	373,369	316,001	448,324

Weighted average common shares outstanding-diluted	11,068,925	11,167,598	11,120,721	11,125,116
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Earnings per share of common stock basic and diluted

Earnings per share of common stock basic	\$ 0.84	\$ 0.66	\$ 1.16	\$ 1.26
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Earnings per share of common stock diluted	\$ 0.03	\$ 0.56	\$ 0.41	\$ 1.10
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**Table of Contents****6. Inventories, net**

Inventories consist primarily of engines and parts. Engines are valued at the lower of cost, plus estimated freight-in, as determined by specific serial number identification, or market value. Parts are valued at the lower of cost (first-in, first-out) or market value.

When necessary, the Company writes down inventory for an estimated amount equal to the difference between the cost of the inventory and the estimated realizable value. Additionally, an inventory reserve is recorded based upon the Company's estimation of future demand for the quantity of inventory on hand. In determining an estimate of future demand, multiple factors are taken into consideration, including (i) customer purchase orders and customer forecasted demand, (ii) historical sales/usage for each inventory item, and (iii) utilization within a current or anticipated future power system.

Inventory consisted of the following as of:

	September 30, 2015	December 31, 2014
Raw material	\$ 83,439	\$ 87,133
Work in process	6,163	1,752
Finished goods	15,522	6,777
Total inventories	105,124	95,662
Inventory allowance	(2,370)	(1,759)
Inventories, net	\$ 102,754	\$ 93,903

**7. Property, plant and equipment, net**

The components of property, plant and equipment are recorded at cost and included the following as of:

	September 30, 2015	December 31, 2014
Land	\$ 260	\$ 260
Buildings and improvements	7,652	5,015
Office furniture and equipment	4,393	3,705
Tooling and equipment	20,443	13,736
Transportation equipment	539	525
Construction in process	3,239	6,056
Property, plant and equipment, at cost	36,526	29,297
Accumulated depreciation	(10,949)	(8,405)

Property, plant and equipment, net	\$	25,577	\$	20,892
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## 8. Fair value of financial instruments

As of September 30, 2015, and December 31, 2014, the Company measured its financial assets and liabilities under the amended ASC 820, *Fair Value Measurements and Disclosures of the Accounting Standards Codification*, which defines fair value as the price that would be received to sell an asset or paid to transfer a liability (i.e., exit price) in an orderly transaction between market participants at the measurement date. It also establishes a three-level valuation hierarchy for disclosures of fair value measurement as follows:

Level 1 quoted prices in active markets for identical assets or liabilities;

Level 2 other significant observable inputs for the assets or liabilities through corroborations with market data at the measurement date; and

Level 3 significant unobservable inputs that reflect management's best estimate of what market participants would use to price the assets or liabilities at the measurement date.

**Table of Contents*****Private placement warrants liability***

As of September 30, 2015 and December 31, 2014, the Company's liability for Private Placement Warrants was measured at fair value under ASC 820. The Company's liability for the Private Placement Warrants is measured at fair value based on unobservable inputs, and thus is considered a Level 3 financial instrument. The Company analyzes financial instruments with features of both liabilities and equity under ASC 480, *Distinguishing Liabilities from Equity* and ASC 815, *Derivatives and Hedging*.

As of September 30, 2015 and December 31, 2014, the Company estimated the fair value of its liability for Private Placement Warrants with a publicly traded stock pricing approach using the Black-Scholes option pricing model. The inputs of the Black-Scholes option pricing model included the following:

	September 30, 2015	December 31, 2014
Market value of the Company's common stock	\$ 22.71	\$ 51.61
Exercise price	\$ 13.00	\$ 13.00
Risk-free interest rate	0.12%	0.39%
Estimated price volatility	55.00%	55.00%
Contractual term	0.58 years	1.33 years
Dividend yield		

The market value of the Company's common stock was based on its closing price on September 30, 2015 and December 31, 2014, the date of each valuation. The volatility factors noted above represented the upper end of the range of implied volatility of publicly traded call options of benchmark companies. If all other assumptions were held constant, a 10% change in the estimated price volatility in the Black-Scholes option pricing model would have an insignificant effect on the recorded liability of the Private Placement Warrants.

The following table summarizes the change in the estimated fair value of the Company's Level 3 Private Placement Warrants liability in the nine months ended September 30, 2015:

Balance at December 31, 2014	\$ 11,036
Fair value of private placement warrants exercised	(255)
Change in the value of private placement warrants	(8,040)
Balance at September 30, 2015	\$ 2,741

For the three and nine months ended September 30, 2015, the Company recognized income of \$8,750,000 and \$8,040,000, respectively, due to a decrease in the estimated fair value of the Company's Private Placement Warrants. For the three and nine months ended September 30, 2014, the Company recognized income of \$858,000 and \$1,190,000, respectively, due to a decrease in the estimated fair value of the Company's liability for Private Placement Warrants. This income was recorded as Private placement warrant within Other (income) expense in the Company's unaudited condensed consolidated statements of operations for the respective periods.

***Contingent consideration liability***

As described in Note 4, Acquisitions a portion of the purchase price for the acquisition of Powertrain is in the form of contingent consideration. The contingent consideration consists of two components, a Base Earn-out Payment and an Additional Earn-out Payment, both as defined in the APA. The Base Earn-out Payment is payable in cash while the Additional Earn-out Payment is payable in cash and/or shares of the Company's common stock at the Company's discretion. As of September 30, 2015, the Company's potential contingent consideration payment relating to its acquisition of Powertrain was measured at fair value under ASC Topic 820. The Company's liability for this contingent consideration was measured at fair value based on unobservable inputs, and thus is considered a Level 3 financial instrument. The fair value of the liability determined by this analysis was primarily driven by the Company's expectations of achieving the performance targets required by the APA for Powertrain. The expected performance targets were used in a Monte Carlo simulation which provided for the most likely earn-out payment which was then discounted to its present value in order to derive a fair value of the Base Earn-out Payment. A Modified Black-Scholes call option model considering the actual and forecasted share price, the measurement period and a volatility factor was used to derive a fair value of the Additional Earn-out Payment.

As of September 30, 2015, the primary inputs of the Monte Carlo simulation model included the estimated performance forecast, stock price volatility and a risk free interest rate. The volatility factor was primarily derived from our historical stock price volatility as well as the implied volatility of publicly traded call options of benchmark companies. If all other assumptions were held constant, a ten percentage point change in the volatility factor would result in an immaterial increase or decrease in the fair value of the contingent consideration. As of September 30,



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2015, the Company has recorded an \$8,150,000 contingent consideration liability within Other accrued liabilities on its unaudited condensed consolidated balance sheet which represented a \$50,000 decrease from the prior valuation of this contingent consideration liability as of June 30, 2015.

Also as described in Note 4, Acquisitions a portion of the purchase price for the acquisition of Bi-Phase was in the form of contingent consideration. This contingent consideration, payable to TPB, Inc., was based upon certain sales of Bi-Phase fuel systems over a period of three to five years. The contingent consideration relating to the Company's acquisition of Bi-Phase was measured at fair value under ASC Topic 820 at the Bi-Phase Date of Acquisition. The Company's liability for this contingent consideration was measured at fair value based on unobservable inputs, and thus was considered a Level 3 financial instrument. The fair value of the liability determined by this analysis was primarily driven by the Company's expectations of sales following the closing date for each liquid propane engine sold by the Company that incorporated any part of the Bi-Phase fuel system or related technology as defined in the Membership Interest Purchase Agreement. Based on these expectations, the Company performed a discounted cash flow analysis to determine the fair value of the contingent consideration liability. The primary inputs of the discounted cash flow analysis included estimated units to be shipped, the per unit agreed-upon fee and discount rate. As a result, the Company initially recorded a \$540,000 contingent consideration liability within Other accrued liabilities on its unaudited condensed consolidated balance sheet at the Bi-Phase Date of Acquisition.

The following table summarizes the change in the estimated fair value of the Company's Level 3 contingent consideration liability in the nine months ended September 30, 2015:

Balance at December 31, 2014	\$
Powertrain Date of Acquisition	8,200
Bi-Phase Date of Acquisition	540
Change in the value of contingent consideration	(50)
Balance at September 30, 2015	\$ 8,690

For the three and nine months ended September 30, 2015, the Company recognized income of \$50,000 due to a decrease in the estimated fair value of the Company's contingent consideration liability in connection with the acquisition of Powertrain. For the three and nine months ended September 30, 2014, the Company recognized income of \$3,208,000 and \$3,782,000, respectively, due to a decrease in the estimated fair value of the Company's contingent consideration liability arising from the acquisition of 3PI in 2014. This income was classified within Other (income) expense in the Company's unaudited condensed consolidated statements of operations for the respective periods.

***Financial liabilities measured at fair value***

The following table summarizes fair value measurements by level as of September 30, 2015, for the Company's level 3 financial liabilities measured at fair value on a recurring basis:

	Level 1	Level 2	Level 3
Private placement warrants liability			\$ 2,741
Contingent consideration			8,690

The following table summarizes fair value measurement by level as of December 31, 2014, for the Company's level 3 financial liability measured at fair value on a recurring basis:

	Level 1	Level 2	Level 3
Private placement warrants liability			\$ 11,036
<i>Financial assets and liabilities not measured at fair value</i>			

As of September 30, 2015 and December 31, 2014, the Company's revolving line of credit and term debt, including accrued interest, recorded on the unaudited condensed consolidated balance sheets were carried at cost. The carrying value of the revolving line of credit and term debt approximated fair value because the interest rates fluctuate with market interest rates or the fixed rates approximate current rates offered to the Company for debt with similar terms and maturities, and the Company's credit profile had not changed significantly since the origination of these financial liabilities. Under ASC 825, *Financial Instruments*, these financial liabilities were defined as Level 2 in the three-level valuation hierarchy, as the inputs to their valuation are market observable. The carrying value of cash, accounts receivable, inventories, prepaid expenses and other current assets, accounts payable and other accrued liabilities approximated fair value because of their short maturities.

## 9. Debt

### *Revolving line of credit and term debt*

On June 28, 2013, the Company entered into a credit agreement with Wells Fargo Bank, National Association (the Wells Credit Agreement), which replaced its prior credit agreement with BMO Harris Bank N.A. The Wells Credit Agreement enabled the Company to

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borrow under a revolving line of credit secured by substantially all of the Company's tangible and intangible assets (other than real property). The Wells Credit Agreement (a) provided an initial maximum \$75.0 million revolving line of credit to the Company, which, at the Company's request and subject to the terms of the Wells Credit Agreement, could have been increased up to \$100.0 million during the term of the Wells Credit Agreement; (b) bore interest at the Wells Fargo Bank's prime rate plus an applicable margin ranging from 0% to 0.50%; or at the Company's option, all or a portion of the revolving line of credit could have been designated to bear interest at LIBOR plus an applicable margin ranging from 1.50% to 2.00%; (c) had an unused line fee of 0.25% and (d) required the Company to report its fixed charge coverage ratio, when its Availability (as defined in the Wells Credit Agreement) was less than the Threshold Amount (as defined in the Wells Credit Agreement) and to continue to report its fixed charge coverage ratio until the date that Availability for a period of 60 consecutive days, was greater than or equal to the Threshold Amount. The Company was required to meet a minimum monthly fixed charge coverage ratio of not less than 1.0 to 1.0, the testing of which commenced on the last day of the month prior to the date on which its Availability was less than the Threshold Amount. The Threshold Amount was defined in the Wells Credit Agreement as the greater of (i) \$9,375,000 or (ii) 12.5% of the maximum revolver amount of \$75.0 million or as it may have been increased during the term of the Wells Credit Agreement up to \$100.0 million.

On April 1, 2014, the Wells Credit Agreement was amended (the Amended Wells Credit Agreement) to increase the Company's revolving line of credit from \$75.0 million to \$90.0 million. The Amended Wells Credit Agreement (a) bears interest at the Wells Fargo Bank's prime rate plus an applicable margin ranging from 0% to 0.5%; or at the Company's option, all or a portion of the revolving line of credit can be designated to bear interest at LIBOR plus an applicable margin ranging from 1.50% to 2.00%; (b) has an unused line fee of 0.25%; (c) requires the Company to report its fixed charge coverage ratio and leverage ratio as described below; (d) includes a \$5.0 million term loan arrangement with Wells Fargo Bank; and (e) includes a letter of credit sub-facility of the revolving line of credit. The principal amount of the \$5.0 million term loan was payable in 36 equal monthly installments with the first payment due on June 1, 2014, plus interest at LIBOR plus 4.50%. Effective April 1, 2014 and during the period in which the term loan was outstanding, the Company was subject to a fixed charge coverage ratio covenant and a debt leverage ratio covenant. The Company was required to maintain a fixed charge coverage ratio of at least 1.20 to 1.00 and the Company's debt leverage ratio could not exceed 4.0 to 1.0 during the period in which the term loan was outstanding. At the time, the Company used borrowings under this expanded revolving line of credit as well as the proceeds from the term loan to finance the acquisition of 3PI which was consummated on April 1, 2014 as described in Note 4,

Acquisitions. The term loan was subsequently paid in full on April 29, 2015. In connection with the repayment of the term loan on April 29, 2015, the Company's minimum monthly fixed charge coverage ratio reverted back to 1.0 to 1.0, the testing of which commences on the last day of the month prior to the date on which the Company's Availability is less than the Threshold Amount.

On September 30, 2014 and again on February 11, 2015, the Company further amended its credit facility with Wells Fargo Bank, National Association, to increase its revolving line of credit facility to \$100.0 million and \$125.0 million, respectively (collectively with the Amended Wells Credit Agreement, the Amended Wells Credit Agreement II). The Amended Wells Credit Agreement II was scheduled to mature on June 28, 2018.

Other than the above-mentioned amendments, the terms and conditions of the Amended Wells Credit Agreement and Amended Wells Credit Agreement II are substantially similar to the Wells Credit Agreement. Under the Amended Wells Credit Agreement and Amended Wells Credit Agreement II, the amount that the Company may borrow is limited to the lesser of (i) the maximum available amount and (ii) borrowing base. The borrowing base is calculated as a percentage of the Company's eligible accounts receivable and eligible inventory, plus a defined amount based upon certain of the Company's fixed assets (all as defined in the Amended Wells Credit Agreement and Amended Wells Credit Agreement II). The Amended Wells Credit Agreement and Amended Wells Credit Agreement II also contain customary covenants and restrictions applicable to the Company, including agreements to provide financial

information, comply with laws, pay taxes and maintain insurance, restrictions on the incurrence of certain indebtedness, guarantees and liens, restrictions on mergers, acquisitions and certain dispositions of assets, and restrictions on the payment of dividends and distributions. The revolving line of credit is secured by substantially all of the Company's tangible and intangible assets (other than real property).

On April 29, 2015, the Company entered into an amended credit facility ( Amended Wells Credit Agreement III ) for the purpose of facilitating the issuance of the 5.50% Senior Notes (the Senior Notes ), as described below, and this amendment provided for the earlier maturity of the Amended Wells Credit Agreement III to insure that the Amended Wells Credit Agreement III will come due before the Senior Notes are payable as described below. While the Senior Notes are outstanding, the Amended Wells Credit Agreement III will become due 75 days prior to the earliest date that a Special Mandatory Purchase Date (as defined in the Indenture agreement) may occur or 90 days prior to the final maturity date of the Senior Notes, as described in the Indenture agreement below. Accordingly, under the above terms, the Amended Wells Credit Agreement III will become due no earlier than March 15, 2017, but no later than January 31, 2018.

As of September 30, 2015, \$99.0 million of the Company's outstanding borrowings under its revolving line of credit bore interest at the LIBOR rate, plus an applicable margin. The weighted average interest rate on these borrowings was 1.70% as of September 30, 2015. The remaining outstanding balance of \$61,000 as of September 30, 2015 had been designated to bear interest at the prime rate, plus an applicable margin, which equaled 3.25% with the applicable margin included. The unused and available revolving line of credit balance was \$13.4 million at September 30, 2015. The Company's term loan was repaid on April 29, 2015.

As of December 31, 2014, \$71.0 million of the Company's outstanding borrowings under its revolving line of credit bore interest at the LIBOR rate, plus an applicable margin. The weighted average interest rate on these borrowings was 1.66% as of December 31, 2014. The remaining outstanding balance of \$7.0 million as of December 31, 2014 had been designated to bear interest at the prime rate, plus an applicable margin, which equaled 3.25% with the applicable margin included. The unused and available revolving line of credit balance was \$21.2 million at December 31, 2014. As of December 31, 2014, the Company had approximately \$4,028,000 outstanding under the term loan, which bore interest at LIBOR plus 4.50%, which equaled 4.67% with the applicable margin included.

**Table of Contents*****5.50% Senior Notes***

On April 24, 2015, the Company entered into a purchase agreement with certain institutional investors for a private sale of an aggregate amount of \$55.0 million of the Company's unsecured 5.50% Senior Notes. The sale closed on April 29, 2015. In connection with the issuance of the Senior Notes, the Company entered into an indenture agreement ( "Indenture" ) dated April 29, 2015, by and among the Company, The Bank of New York Mellon, as Trustee, and the Company's subsidiaries as guarantors. The Company received net proceeds of \$53.5 million after transaction costs of approximately \$1.5 million. As discussed previously, in Note 3, "Recently issued accounting pronouncements", in accordance with the guidance issued to simplify the presentation of debt issuance costs, the Company has presented issuance costs associated with its 5.5% Senior Notes as a direct deduction from the carrying value of the obligation on the Company's unaudited condensed consolidated balance sheet as of September 30, 2015. The Senior Notes are unsecured debt of the Company and are effectively subordinated to the Company's existing and future secured debt including the debt in connection with the Amended Wells Credit Agreement III. The Senior Notes have a final maturity date of May 1, 2018, provided that a mandatory offer by the Company to purchase the Senior Notes must be made on or prior to May 1, 2017 in the event the Company cannot or does not certify compliance with certain financial covenants as more fully described below. In that event, the date of purchase will be no earlier than May 30, 2017.

The Company may redeem the Senior Notes in whole or in part at any time on or after May 1, 2016, at the option of the Company at the following redemption prices (expressed as percentages of the principal amount), together with accrued and unpaid interest to the date of redemption:

Redemption date	Redemption price
May 1, 2016 through October 31, 2016	101.0%
November 1, 2016 and thereafter	100.0%

At any time prior to May 1, 2016, the Company may redeem up to 35% of the Senior Notes with the net cash proceeds of certain equity offerings specified in the Indenture at a redemption price of 105.5% of the principal amount of the Senior Notes, together with accrued and unpaid interest to the date of redemption, but only if at least 65% of the original aggregate principal amount of the Senior Notes would remain outstanding following such redemption. In addition, prior to May 1, 2016, the Company may redeem the Senior Notes in whole or in part at a redemption price equal to 101.0% of the principal amount plus (i) accrued and unpaid interest to the redemption date and (ii) an Applicable Premium (as defined in the Indenture) that is intended as a "make-whole" to May 1, 2016.

The Senior Notes have a Special Mandatory Purchase Date as described in the Indenture and summarized as follows. Upon the occurrence of the earlier of (I) March 15, 2017, if the Trustee has not received on or within five days prior to such date an officers' certificate stating that (i) the Company's pro forma consolidated EBITDA (as defined in the Indenture) is at least equal to or greater than \$35.0 million for the most recent four full fiscal quarters for which financial statements are available as of such date and (ii) the Company's consolidated pro forma ratio of consolidated EBITDA to fixed charges (as defined in the Indenture) is at least equal to or greater than 3.25 to 1.0 for the most recent four full fiscal quarters for which financial statements are available as of such date or (II) the date on which the Company notifies the Trustee in writing (which date may be at any time on or after March 1, 2017 but on or prior to March 15, 2017) that the Company cannot or will not deliver such officers' certificate, then, unless the Company has given on or prior to March 15, 2017 a notice of redemption of all of the Senior Notes, the Company will make a mandatory offer to purchase all of the Senior Notes at a purchase price of 100.0% of the principal amount plus accrued and unpaid interest, if any, to the date of purchase in accordance with the procedures set forth in the Indenture.

The Indenture contains covenants that, among other things, limit or restrict the ability of the Company and its subsidiaries to incur additional debt, prepay subordinated indebtedness, pay dividends or make other distributions on capital stock, redeem or repurchase capital stock, make investments and restricted payments, enter into transactions with affiliates, sell assets, create liens on assets to secure debt, or effect a consolidation or merger or to sell all, or substantially all, of the Company's assets, in each case subject to certain qualifications and exceptions set forth in the Indenture. The Indenture also provides for customary events of default (subject in certain cases to customer grace and cure periods), which include nonpayment, breach of covenants in the Indenture, payment defaults or acceleration of other indebtedness, and certain events of bankruptcy and insolvency. Generally, if an event of default occurs, the Trustee or holders of at least 25.0% in principal amount of the then outstanding Senior Notes may declare the principal of and accrued but unpaid interest on all Senior Notes to be due and payable.

Interest on the Senior Notes accrues at a rate of 5.50% per annum and is payable semi-annually in arrears on May 1 and November 1 of each year, commencing on November 1, 2015. As of September 30, 2015, the accrued, but unpaid interest on the Senior Notes was \$1,302,000.

#### **10. 2012 Incentive compensation plan**

On May 30, 2012, the Board of Directors of the Company approved and adopted the Company's 2012 Incentive Compensation Plan (the "2012 Plan"), and the 2012 Plan was approved by a majority of the Company's stockholders at the Company's annual meeting held on August 29, 2012. The 2012 Plan is administered by the Compensation Committee of the Board of Directors, which consists only of independent, non-employee directors.

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The 2012 Plan is a broad-based plan which allows for a variety of different types of awards, including (but not limited to) non-qualified stock options, incentive stock options, SAR, restricted stock, deferred stock and performance units, to be made to the Company's executive officers, employees, consultants and directors. The 2012 Plan is intended to assist the Company in attracting and retaining exceptionally qualified employees, consultants and directors to support the sustained progress, growth and profitability of the Company.

Of the Company's 1,530,925 shares initially made available and reserved for awards under the 2012 Plan, 543,872 shares were originally underlying a SAR award granted to the Company's Chief Operating Officer on June 6, 2012 and 186,993 shares of restricted stock have been granted as of September 30, 2015 to eligible employees (as further described below). As of September 30, 2015, the Company had 800,060 shares of common stock available for future issuance under the 2012 Plan.

***SAR award agreement***

On June 6, 2012 (the SAR Grant Date), the Compensation Committee of the Board of Directors approved, and the Company granted, a SAR to the Company's Chief Operating Officer (Grantee), pursuant to the 2012 Plan and a Stock Appreciation Rights Award Agreement (SAR Award Agreement), dated as of the SAR Grant Date. The SAR granted to the Grantee covers an aggregate of 543,872 shares of Company common stock and is exercisable only in whole shares at a price per share of \$22.07. The SAR expires on the tenth anniversary of the SAR Grant Date.

The SAR granted to the Grantee vests and becomes exercisable ratably on each of the first three anniversaries of the SAR Grant Date (graded vesting). In addition, the SAR did not become exercisable until the date that was the last of any seven Valuation Dates (as defined in the SAR Award Agreement) within any period of ten or fewer consecutive Valuation Dates that commenced after the SAR Grant Date and prior to the expiration date on each of which the market value per share of Company common stock was at least \$22.07. This market condition was met during the year ended December 31, 2013.

The SAR entitles the Grantee to receive, upon any exercise, a number of shares of the Company's common stock equal to (i) the number of shares for which the SAR is being exercised multiplied by the value of one share of the Company's common stock on the date of exercise (determined as provided in the SAR Award Agreement), (ii) less the number of shares for which the SAR is being exercised multiplied by \$22.07, (iii) divided by the value of one share of the Company's common stock on the date of exercise (determined as provided in the SAR Award Agreement). The exercised SAR is to be settled only in whole shares of the Company's common stock, and the value of any fractional share of the Company's common stock will be forfeited.

The SAR is accounted for as equity, in accordance with ASC 718, *Compensation - Stock Compensation*, which states that options or similar instruments on shares shall be classified as liabilities if either the underlying shares are classified as liabilities or the entity can be required under any circumstance to settle the option or similar instrument by transferring cash or other assets. The Company's underlying shares are classified as equity, and under the terms of the SAR Award Agreement, the Company must settle the exercised portion of the SAR in shares of the Company's common stock. As such, the Company has accounted for the SAR as equity.

As of the SAR Grant Date, the fair value of the SAR was estimated using the Black-Scholes option pricing model. The inputs of the Black-Scholes option pricing model included the fair value of the Company's common stock, exercise price, risk-free interest rate, estimated price volatility, term and dividend yield. Due to the limited trading activity in the Company's common stock at the date of issuance of the SAR, the fair value of the Company's common stock was established through multiple valuation techniques, including (a) the income approach in the form of the discounted cash flow method and (b) the market approach in the form of (i) the guideline public company method and

(ii) the merger and acquisition method. After the fair value of the equity was determined, it was then allocated to the SAR using the Option Pricing Method. In addition to that described above, other assumptions used in the Black-Scholes method included the following as of the SAR Grant Date: an expected term of 6.0 years, a risk-free interest rate of 0.92%, an anticipated volatility factor of 55.0% and a zero dividend yield. The resulting valuation as of the SAR Grant Date, was discounted by 15%, reflecting an assessment of the then trading activity of the Company's common stock (and by extension the SAR). The suggested value from the Black-Scholes method reflected a fully marketable security that was not burdened by limited marketability; however, at that time, the Company's common stock (and by extension the SAR) did not have regular trading activity. Therefore, the Company considered it necessary to incorporate a discount to reflect the limited liquidity associated with the SAR. This approach was consistent with that utilized to value the Company's Private Placement Warrants at that time. The resulting fair value of the SAR granted was \$3.31 per underlying share.

ASC 718, *Compensation - Stock Compensation*, was utilized in order to estimate the fair value of the SAR. The term fair value has been defined in Note 8, Fair value of financial instruments. ASC 718 requires an entity to measure the cost of employee services received in exchange for an award of equity instruments based on the fair value of the award as of the grant date. That cost is then recognized over the period during which an employee is required to provide service in exchange for the award. ASC 718-10-55-72 provides that, if vesting (or exercisability) of an award is based on satisfying both a market condition and a performance or service condition and it is probable that the performance or service condition will be satisfied, the initial estimate of the service period is the longest of the explicit, implicit or derived service period. The Company has computed compensation expense by applying the guidance stated in ASC 718, on a straight-line basis over the requisite service period for each separately vesting portion of the award as if the award was, in-substance, multiple awards (graded vesting attribution method). Since, as noted above, the SAR granted by the Company includes both a market and service condition, the Company used the longest of the periods to define its requisite service period in each separately vesting portion or tranche. To determine the derived service period associated with the SAR's market condition, the Company performed a Monte Carlo analysis in order to estimate the likely timeframe until the Company's public equivalent value would exceed its aggregate exercise price over a period of seven days within a period of 10 or fewer trading days (i.e. the value



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at which the per share value of the Company's equity exceeds \$22.07). Based on the results of this analysis, the derived service period associated with the SAR's market condition was determined to be 1.78 years. Thus, compensation expense for the first tranche was computed on a straight-line basis over the derived service period of 1.78 years. The second and third tranches were computed on a straight-line basis over the explicit service period.

***Amendment to SAR award agreement***

On June 5, 2015, the Company and Grantee agreed to defer the vesting of the remaining unvested portion of the SAR granted to the Grantee for 30 days until July 6, 2015 pursuant to an amendment to the initial SAR Award Agreement. On July 6, 2015, the Company and the Grantee entered into a SAR and Bonus Agreement which amended the SAR Award Agreement by extending the vesting period applicable to the remaining unvested portion of the SAR granted to the Grantee under the Company's 2012 Incentive Compensation Plan. The unvested portion covers 181,290 underlying shares of the Company's common stock which, prior to the amendment, would have vested on June 6, 2015. The amendment extended the vesting of these shares to June 6, 2017 with respect to 100,000 underlying shares of the Company's common stock and to June 6, 2019 with respect to the remaining 81,290 shares of underlying Company stock (in each case subject to forfeiture upon termination of employment by the Company for Cause or by the Grantee for Good Reason (each as defined in the SAR and Bonus Agreement)). The SAR and Bonus Agreement also provides the Grantee with an annual bonus in the amount of \$250,000 for each of calendar years 2016, 2017, 2018 and 2019.

In the three and nine months ended September 30, 2015, the Company recognized \$41,000 and \$127,000, respectively, of expense related to the SAR. In the three and nine months ended September 30, 2014, the Company recognized \$51,000 and \$279,000, respectively, of expense related to the SAR. As of the amendment on July 6, 2015, the fair value of the unrecognized compensation expense of the SAR for the extension of the vesting period was estimated at \$333,000 using the Black-Scholes option pricing model which amount will be recognized through the vesting dates. Including the amendment discussed above, the total SAR expense is expected to be approximately \$2,133,000 from initial grant. The Company expects the remaining SAR expense to be recognized over the next 4 years through June 6, 2019.

***Restricted stock awards***

The Compensation Committee of the Board of Directors has approved, and the Company granted, shares of Company restricted stock ( Restricted Stock ) to various employees pursuant to the 2012 Plan and subject in each case to a Restricted Stock Award Agreement ( Restricted Stock Award Agreement ). Restricted stock activity consisted of the following for the nine months ended September 30, 2015:

	Shares	Weighted Average Grant Date Fair Value	
December 31, 2014	154,251	\$	42.18
Granted	1,000		28.48
Forfeited	(800)		65.51
Vested	(19,547)		40.33
September 30, 2015	134,904	\$	42.13

These shares of Restricted Stock vest in various increments and periods over a maximum of ten years from the date the stock was granted as defined under the applicable Restricted Stock Award Agreement. In the three and nine months ended September 30, 2015, the Company recognized approximately \$236,000 and \$727,000, respectively, of compensation expense in connection with the Restricted Stock granted under the 2012 Plan. In the three and nine months ended September 30, 2014, the Company recognized approximately \$268,000 and \$703,000, respectively, of compensation expense in connection with the Restricted Stock granted under the 2012 Plan. As of September 30, 2015, there was approximately \$5,144,000 of total unrecognized compensation expense related to the shares of Restricted Stock granted under the 2012 Plan. As of September 30, 2015, the weighted-average period over which the unrecognized compensation cost is expected to be recognized was approximately 6 years.

## **11. Stockholders equity**

The Company's equity securities and the Private Placement Warrants are described below.

### ***Common stock***

The Company has authorized 50,000,000 shares of common stock with a par value of \$0.001 per share. Issued shares and outstanding shares of the Company's common stock were 11,580,608 and 10,749,683, respectively, as of September 30, 2015. Issued shares and outstanding shares of the Company's common stock were 11,562,209 and 10,731,284, respectively, at December 31, 2014. Each holder of a share of the Company's common stock is entitled to one vote per share held on each matter to be considered by holders of the Company's common stock. Holders of the Company's common stock are entitled to receive ratably such dividends, if any, as may be declared by the Company's board of directors. The Company's current policy is to retain earnings for operations and growth. Upon any liquidation, dissolution or winding-up of the Company, the holders of the Company's common stock are entitled to share ratably in all assets available for distribution, after payment of, or provision for, all liabilities and the preferences of any then outstanding shares of Company preferred stock. The holders of the Company's common stock have no preemptive, subscription, redemption or conversion rights.

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**Table of Contents*****Series A Convertible preferred stock***

The Company has authorized 114,000 shares of Series A Convertible preferred stock with a par value of \$0.001 per share. As of September 30, 2015 and December 31, 2014, no shares of Series A Convertible preferred stock of the Company were issued or outstanding.

***SAR exercise for shares of Company common stock***

The Company granted a SAR to the Grantee on June 6, 2012 as further described in Note 10, 2012 Incentive compensation plan. The Grantee fully exercised the tranche that vested on June 6, 2013. During the nine months ended September 30, 2014, the Grantee exercised the SAR with respect to 120,000 of the 181,291 shares of common stock underlying the SAR that vested on June 6, 2014. The Company issued a total of 85,903 shares of the Company's common stock in these two exercises. In connection with these exercises, the excess of the underlying value of the common stock issued over the amount recognized as compensation expense in the Company's financial statements is a cost that is deductible for income tax purposes. In connection with the 2014 exercise, the Company realized an income tax benefit of \$2,248,000, which was recorded as a reduction in the Company's income tax liability and an increase in additional paid-in-capital. As of September 30, 2015, there were 61,291 unexercised shares under the tranche that vested on June 6, 2014 and 181,290 shares remaining subject to vest. See Note 10, 2012 Incentive compensation plan, for a further description of the SAR and the vesting of the final tranche.

***Restricted stock vesting for shares of Company common stock***

The Compensation Committee of the Board of Directors approved, and the Company granted, shares of Restricted Stock to various employees pursuant to the 2012 Plan and subject to a Restricted Stock Award Agreement as further described in Note 10, 2012 Incentive compensation plan. For the three and nine months ended September 30, 2015, various individuals' awards vested resulting in the net issuance of 1,819 shares and 13,399 shares, respectively. For the three and nine months ended September 30, 2014, various individuals' awards vested resulting in the net issuance of 656 shares and 11,503 shares, respectively. Under the terms of the 2012 Plan, at the option of certain of those vested restricted stock participants, the Company withheld shares issued to satisfy the income tax obligations of these participants. The cash equivalent of the aggregate number of shares withheld was \$27,000 and \$316,000 for the three and nine months ended September 30, 2015, respectively, representing the income tax withholding obligations of the participants, which was remitted by the Company to the applicable taxing authorities. Similarly, the cash equivalent of the aggregate number of shares withheld for the three and nine months ended September 30, 2014 was \$21,000 and \$361,000, respectively. The payments of the income tax withholding obligations were recorded as a reduction in additional paid-in-capital as of September 30, 2015 and 2014 for each respective period.

In connection with the vesting and issuance of shares of the Company's common stock under the 2012 Plan, other than the shares of common stock issued in connection with the SAR, the excess of the underlying value of the common stock issued over the amount recognized as compensation expense in the Company's unaudited condensed consolidated financial statements is a cost that is deductible for income tax purposes. As such, the Company realized an income tax benefit of \$102,000 and \$221,000 for this incremental amount which was recorded as a reduction in the Company's income tax liability and an increase in additional paid-in-capital as of and for the nine months ended September 30, 2015 and 2014, respectively.

***Private placement warrants***

In connection with a private placement ( Private Placement ) on April 29, 2011, investors in the Private Placement received Company preferred stock (which subsequently converted to shares of Company common stock) and Private

Placement Warrants. The Private Placement Warrants represented the right to purchase a total of 750,002 shares of the Company's common stock at an exercise price of \$13.00 per share, subject to further adjustment for non-cash dividends, distributions, stock splits or other reorganizations or reclassifications of the Company's common stock. The Private Placement Warrants are also subject to full ratchet anti-dilution protection whereby, upon the issuance (or deemed issuance) of shares of the Company's common stock at a price below the then-current exercise price of the Private Placement Warrants, subject to specified exceptions, the exercise price of the Private Placement Warrants will be reduced to the effective price of the Company's common stock so issued (or deemed to be issued). The Private Placement Warrants will expire on April 29, 2016.

At any time beginning six months after the closing of the Private Placement at which the Company is required to register the shares issuable upon exercise of the Private Placement Warrants pursuant to the registration rights agreement entered into in connection with the Private Placement, but such shares may not be freely sold to the public, the Private Placement Warrants may be cashlessly exercised by their holders. In such circumstances, the warrant holders may cashlessly exercise the Private Placement Warrants by causing the Company to withhold a number of shares of its common stock otherwise issuable upon such exercise having a value, based upon the market price of the Company's common stock (such market price as defined in the purchase agreement for the Private Placement), equal to the aggregate exercise price associated with such exercise. In other words, in such circumstances, the exercise of the Private Placement Warrants will occur without any cash being paid by the holders of the Private Placement Warrants. Because the shares issuable upon exercise of the Private Placement Warrants are currently available for resale pursuant to effective registration statements filed by the Company with the SEC, the Private Placement Warrants may not be cashlessly exercised at this time. The Private Placement Warrants further include a requirement that, the Company will keep reserved out of the authorized and unissued shares of its common stock sufficient shares to provide for the exercise of the Private Placement Warrants.

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The Company's Private Placement Warrants are accounted for as a liability, in accordance with ASC 480, *Distinguishing Liabilities from Equity*. ASC 480 states that, if an entity must or could settle an instrument by issuing a variable number of its own shares, and, as in this case, the obligation's monetary value is based solely or predominantly on variations in the fair value of the company's equity shares, but moves in the opposite direction, then the obligation to issue shares is to be recorded as a liability at the inception of the arrangement, and is adjusted with subsequent changes in the fair value of the underlying stock. The effect of the change in value of the obligation is reflected as Private placement warrant expense (income) in the Company's consolidated statements of operations.

The Private Placement Warrants issued had an estimated fair value of \$2,887,000 at the closing of the Reverse Recapitalization transaction and the Private Placement on April 29, 2011, determined based upon an agreed-upon exercise price of the Private Placement Warrants; the purchase price for (value of) the Company's preferred stock and Private Placement Warrants, in the aggregate as agreed upon with the investors in the Private Placement; an assessment of an appropriate risk-free interest rate of 2.1%, an anticipated volatility factor of 50.0%, and a zero percent dividend yield, all incorporated into a valuation using the Black-Scholes option pricing model. The Company determined that the five-year Treasury Bond yield was a reasonable assumption for a risk-free rate, and that an appropriate volatility rate would represent the upper end of the range of implied volatility of publicly traded call options of benchmark companies, which reflects the mid-range of their historical volatility. The Company's past history of not paying dividends and management's intentions to continue such a dividend policy resulted in a zero dividend yield assumption. The five-year term of the Private Placement Warrants, the stated warrant exercise price of \$13.00 per share (as adjusted for a reverse split), when the Private Placement Warrants became exercisable, and the Company's common stock valuation of \$10.08 per share (as adjusted for a reverse split), when the Private Placement Warrants became exercisable, comprised the balance of the inputs into the Black-Scholes pricing model for the warrant valuation.

See Note 8, Fair value of financial instruments, for detail describing the valuation approach for the Private Placement Warrants as of September 30, 2015 and December 31, 2014.

There were no warrants exercised during the three months ended September 30, 2015. During the nine months ended September 30, 2015, a portion of the Private Placement Warrants were exercised, resulting in the issuance of 5,000 shares of the Company's common stock. There were no warrants exercised during the three months ended September 30, 2014. During the nine months ended September 30, 2014, a portion of the Private Placement Warrants were exercised, resulting in the issuance of 109,585 shares of the Company's common stock.

As of September 30, 2015 and December 31, 2014, there were 282,257 shares and 287,257 shares, respectively, of Company common stock reserved for the exercise of the outstanding Private Placement Warrants, in accordance with the terms of the purchase agreement for the Private Placement.

***Registration rights agreement***

In connection with the Private Placement, the Company entered into a Registration Rights Agreement (the Private Placement Registration Rights Agreement) with the investors in the Private Placement and Roth Capital Partners, LLC, pursuant to which it agreed to file a registration statement on Form S-1, with the SEC, covering the resale of Registrable Securities (as defined below) (which includes the shares of the Company's common stock that were issuable upon conversion of shares of the Company's preferred stock originally issued in the Private Placement and shares of the Company's common stock issuable upon exercise of the Private Placement Warrants and shares of the Company's common stock that were issuable upon exercise of the Roth Warrant), on or before the date which is 30 days after the closing date of the Private Placement, and to use its commercially reasonable efforts to have such registration statement declared effective by the SEC as soon as practicable. The Company further agreed, within 30

days after it becomes eligible to use a registration statement on Form S-3 to register the Registrable Securities for resale, to file a registration statement on Form S-3 covering the Registrable Securities. On June 27, 2013, within 30 days after the Company became eligible to use a registration statement on Form S-3, in accordance with the Private Placement Registration Rights Agreement, it filed a registration statement on Form S-3 (as a post-effective amendment to the registration statement on Form S-1) covering the Registrable Securities, which was declared effective on June 27, 2013.

The Company is obligated to maintain the effectiveness of the registration statement until the earliest of (1) the first date on which all Registrable Securities covered by such registration statement have been sold, (2) the first date on which all Registrable Securities covered by such registration statement may be sold without restriction pursuant to Rule 144 or (3) the first date on which none of the securities included in the registration statement constitute Registrable Securities.

Pursuant to the Private Placement Registration Rights Agreement, the holders of Registrable Securities are also entitled to certain piggyback registration rights if the Registrable Securities are not covered by one or more effective registration statements. As of December 31, 2013, and as of the time of the closing of the public offering on July 16, 2013, all of the Registrable Securities were covered by an effective registration statement. Registrable Securities, as contemplated by the Private Placement Registration Rights Agreement, means certain shares of the Company's common stock, including those shares that were issuable upon conversion of shares of Company preferred stock issued in the Private Placement and shares of the Company's common stock issuable upon exercise of the Private Placement Warrants and the shares of the Company's common stock that were issued upon exercise of the Roth Warrant; provided, that, any such share shall cease to be a Registrable Security upon (A) sale pursuant to the registration statement or Rule 144 under the Securities Act, (B) such share becoming eligible for sale without restriction by the selling securityholder holding such security pursuant to Rule 144 under the Securities Act or (C) such share otherwise becoming eligible for sale without restriction pursuant to Section 4(1) of the Securities Act, provided that, any restrictive legend on any certificate or other instrument representing such shares has been removed or there has been delivered to the transfer agent for such shares irrevocable documentation (including any necessary legal opinion) to the effect that, upon submission by the applicable selling securityholder of the certificate or instrument representing such security, any such restrictive legend shall be removed.

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In connection with the consummation of the Reverse Recapitalization, the Company also entered into a registration rights agreement with the former stockholders of The W Group, pursuant to which it agreed to provide to such persons certain piggyback registration rights with respect to shares of the Company's capital stock, including shares issuable upon exercise, conversion or exchange of securities, held by such persons at any time on or after the closing of the Reverse Recapitalization. The piggyback registration rights under this registration rights agreement are subject to customary cutbacks and are junior to the piggyback registration rights granted to investors in the Private Placement and to Roth pursuant to the Private Placement Registration Rights Agreement.

### ***Universal shelf registration***

In addition, the Company filed a universal shelf registration statement, which was declared effective on February 14, 2014, pursuant to which the Company may offer, issue and sell, from time to time, in one or more offerings, common stock, preferred stock, debt securities, depositary shares, warrants, subscription rights, stock purchase contracts and units. On June 2, 2015, the Company updated the universal shelf registration statement to register 500,000 shares of common stock which may be offered and sold by certain selling stockholders from time to time.

## **12. Income taxes**

At the end of each interim period, the Company applies its estimated annual effective tax rate ( ETR ) to its interim earnings before considering the tax effect of any discrete items. The Company also records the tax impact of certain unusual or infrequently occurring items, including the effects of changes in valuation allowances and tax laws or rates, in the interim period in which they occur. A valuation allowance is established if it is determined that it is more likely than not that some portion or all of the net deferred income tax assets will not be realized. Management exercises significant judgment in determining the Company's provisions for income taxes, its deferred income tax assets and liabilities and its future taxable income for purposes of assessing its ability to utilize any future tax benefit from its deferred income tax assets. Although management believes that its tax estimates are reasonable, the ultimate tax determination involves significant judgments that could become subject to audit by tax authorities in the ordinary course of business. As of each reporting date management considers new evidence, both positive and negative, that could impact management's view with regards to future realization of deferred tax assets. As of September 30, 2015, management believes that it is more likely than not that all of the Company's deferred income tax assets will be realized and no valuation allowance was required on its U.S. deferred tax assets. The Company recognizes interest and penalties related to unrecognized tax benefits in income tax expense. As of September 30, 2015 and December 31, 2014, the amount accrued for interest and penalties was not material to the Company's unaudited condensed consolidated financial statements.

The computation of the estimated annual ETR for each interim period requires certain estimates and significant judgments, including, but not limited to, the expected operating income for the year, projections of the proportion of income earned and taxed in state jurisdictions, estimates of permanent and temporary differences, and the likelihood of recovering deferred tax assets generated in the current year. The accounting estimates used to compute the provision for income taxes may change as new events occur, additional information is obtained, or the tax environment changes. For the 2015 fiscal year, the Company's estimated annual ETR is 39.0%, which excludes the impact of changes in the valuation of the Private Placement Warrants, as such amounts are excluded from the calculation of taxable income. Given the subjectivity and volatility of the valuation of the Private Placement Warrants, it is not possible to project the impact of the change in the Private Placement Warrants in the computation of the Company's estimated annual ETR.

As a result, the Company's reported ETR will differ from the estimated annual ETR due to the changes in the valuation of the Private Placement Warrants in the periods in which such changes occur. For the nine months ended

September 30, 2015 and 2014, the Company recorded an income tax provision of \$2,203,000 and \$7,504,000, respectively. The Company's reported income tax rate was 14.9% for the nine months ended September 30, 2015. Excluding the impact of the change in the value of the Private Placement Warrants, the Company's reported income tax rate would have been 32.7% in the nine months ended September 30, 2015. The lower income tax rate for the nine months ended September 30, 2015 was attributable to the true-up of the Company's 2014 income taxes as filed in the Company's tax returns as compared to the income tax provision recorded on its books for the year ended December 31, 2014. The Company's tax credits arising from its research and development activities were higher than the amounts originally estimated at provision, representing the primary reason for the additional income tax benefit realized in the true-up of the income tax provision for 2014. The Company's reported income tax rate was 35.9% for the nine months ended September 30, 2014. Excluding the impact of the change in the value of the Private Placement Warrants, the Company's reported income tax rate would have been 38.1% in the nine months ended September 30, 2014.

The Company is currently under audit for its income taxes at the federal level for the tax year ended December 31, 2013 and the state level for the tax years ended December 31, 2011 and 2012. The ultimate impact, if any, as a result of these audits cannot be determined at this time. However, the Company does not believe that the outcome for these audits will have a material effect on its consolidated results of operations or its financial position.

### **13. Commitments and contingencies**

The Company is involved in various legal proceedings from time to time arising in the normal course of doing business. The Company is required to record a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably



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estimated; however, based upon a review of information currently available to the Company regarding the potential impact of negotiations, settlements, rulings, advice of legal counsel and other information and events pertaining to the legal proceedings in which the Company is currently involved, the resolution of these legal proceedings, either individually or in the aggregate, is not expected to have a material effect on the Company's consolidated results of operations, financial condition or cash flows.

On December 7, 2012, the Company entered into a joint venture with another entity for the purpose of manufacturing, assembling and selling certain engines into the Asian markets. In connection with this agreement, the Company has committed up to \$1.2 million toward the joint venture of which \$850,000 had been contributed since inception. On December 9, 2014, the Company signed an agreement to enter into a joint venture with a construction and utility equipment manufacturer headquartered in Incheon, South Korea. In connection with this agreement, the Company committed to contribute up to \$1.0 million which was contributed to the joint venture during the nine months ended September 30, 2015.

**14. Related-party transaction**

In connection with the acquisition of 3PI, the Company entered into a lease agreement effective April 1, 2014, with a limited liability company in which one of the former owners of 3PI is the sole member. The lease is for the land, buildings and certain equipment located at 3PI's facilities in Darien, Wisconsin. The initial term of the lease is for seven years through March 31, 2021 and the initial annual base rent is \$480,000 annually which is payable in equal monthly installments. The base rent is subject to annual increases as defined in the lease agreement. In the three and nine months ended September 30, 2015, the Company recognized expense of \$120,000 and \$360,000, respectively, in connection with this lease. In the three months and nine months ended September 30, 2014, the Company recognized expense of \$120,000 and \$240,000, respectively in connection with this lease. See Note 4, Acquisitions for further discussion of the acquisition. Since the time of the acquisition, the former 3PI owner is no longer employed by the Company and is no longer a related-party.

**15. Reconciliation of unaudited quarterly financial data**

In its annual report filed on Form 10-K with the SEC on March 13, 2015 for the year ended December 31, 2014, the Company reported revisions to its unaudited quarterly condensed consolidated operating results for the three months ended June 30, 2014 and September 30, 2014. The details giving rise to the revised unaudited quarterly condensed consolidated operating results were originally addressed in the Company's report filed on Form 10-K for the year ended December 31, 2014 and have been repeated herein.

As described in Note 4, Acquisitions, the Company acquired 3PI on April 1, 2014 for cash and additional initial consideration in the form of shares of the Company's common stock valued at \$8.9 million. The consideration payable in shares of the Company's common stock consisted of (i) fixed consideration and (ii) contingent consideration. The Company initially accounted for the entire \$8.9 million of additional consideration as a liability in its unaudited quarterly condensed consolidated balance sheet and, as such, reported the change in the fair value of the entire consideration as an adjustment classified within Other (income) expense in its unaudited quarterly condensed consolidated results of operations for the three months ended June 30, 2014. Prior to the completion and issuance of its results for the three months ended September 30, 2014, the Company determined that, because approximately \$5.1 million of the additional consideration was fixed, that portion of the consideration should have been recorded in stockholders' equity and not as a liability at the date of acquisition. Further, the fixed consideration was not subject to revaluation adjustment. The Company reclassified the fixed portion of the consideration from current liabilities to stockholders' equity on its balance sheet as of September 30, 2014 and appropriately excluded this amount from any further revaluation adjustment thereafter. The Company revised its unaudited quarterly condensed consolidated results

of operations that were initially reported for the quarter ended June 30, 2014 to exclude the change in the value of the consideration that was determined to be fixed and presented the revised quarterly unaudited condensed consolidated results of operations for the three months ended June 30, 2014 in its annual report filed on Form 10-K with the SEC on March 13, 2015.

The Company also initially did not provide income taxes in its quarterly income tax provision related to the change in the valuation of the contingent portion of the consideration for either of the three months ended June 30, 2014 or September 30, 2014. The Company subsequently concluded that it was required to recognize a deferred income tax liability arising from the change in the recorded value of the contingent consideration because the recognition of the change created a difference between the book basis and tax basis of goodwill. As such, the Company revised its unaudited quarterly condensed consolidated results of operations that were initially reported for the three months ended June 30, 2014 and September 30, 2014 to reflect the effect of recognizing deferred income tax expense and the corresponding deferred income tax liability for both periods. The Company revised its unaudited quarterly condensed consolidated results of operations that were initially reported for the three months ended June 30, 2014 to reflect this additional income tax provision and presented the revised unaudited quarterly condensed consolidated results of operations for the three months ended June 30, 2014 as well as the three months ended September 30, 2014 in its annual report filed on Form 10-K with the SEC on March 13, 2015 and herein. Accordingly, Income tax provision presented for 2014 for each of the three months ended June 30, 2014 and September 30, 2014 reflects the effect of recognizing deferred income tax expense and the corresponding deferred income tax liability arising from the change in the valuation of the contingent portion of the consideration as a result of the difference in the book basis and tax basis of goodwill associated with the acquisition of 3PI.

In evaluating the materiality of the foregoing revisions to the Company's previously issued unaudited quarterly condensed consolidated financial statements, the Company considered the guidance set forth in SEC Staff Accounting Bulletin No. 99, *Materiality*, as well as Staff Accounting Bulletin 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*. The Company concluded that in both instances the errors were not material, individually or in the aggregate, to either of the relevant interim reporting periods. The Company therefore determined that amendments of its previously filed quarterly reports were not required but

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presented the revised unaudited quarterly condensed consolidated results of operations in its annual report filed on Form 10-K with the SEC on March 13, 2015, for the year ended December 31, 2014. See below for the impact of the corrections for the three and nine months ended September 30, 2014:

	<b>Three months ended September 30, 2014</b>		
	<b>As previously reported</b>	<b>(a) Adjustment</b>	<b>As revised</b>
Income tax provision	\$ 2,713	\$ 1,283	\$ 3,996
Net income	8,431	(1,283)	7,148
Basic income per common share	\$ 0.78	\$ (0.12)	\$ 0.66
Diluted income per common share	0.68	(0.12)	0.56

- (a) The Company initially excluded the change in the contingent consideration associated with the acquisition of 3PI from its income tax provision calculation. The Company subsequently determined that the Company should have provided income tax expense arising from the change in this contingent consideration. Therefore, the adjustment classified in *Income tax provision* presents the recognition of deferred income tax expense in the three months ended September 30, 2014 in connection with the change in the valuation of the contingent portion of the consideration that was recognized in the Company's unaudited quarterly condensed consolidated statement of operations for the period.

	<b>Nine months ended September 30, 2014</b>		
	<b>As previously reported</b>	<b>(a) Adjustment</b>	<b>As revised</b>
Income tax provision	\$ 5,992	\$ 1,512	\$ 7,504
Net income	14,917	(1,512)	13,405
Basic income per common share	\$ 1.40	\$ (0.14)	\$ 1.26
Diluted income per common share	1.23	(0.13)	1.10

- (a) The Company initially excluded the change in the contingent consideration associated with the acquisition of 3PI from its income tax provision calculation. The Company subsequently determined that the Company should have provided income tax expense arising from the change in this contingent consideration. Therefore, the adjustment classified in *Income tax provision* presents the recognition of deferred income tax expense in the nine months ended September 30, 2014 in connection with the change in the valuation of the contingent portion of the consideration that was recognized in the Company's unaudited quarterly condensed consolidated statement of operations for the period.

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

**Management's Discussion and Analysis of  
Financial Condition and Results of Operations**

*The following discussion and analysis should be read in conjunction with our unaudited condensed consolidated financial statements and the related notes included in this report and our audited consolidated financial statements and the related notes for the fiscal year ended December 31, 2014, and the related management's discussion and analysis of financial condition and results of operations, contained in our annual report on Form 10-K for the fiscal year ended December 31, 2014, filed with the Securities and Exchange Commission on March 13, 2015 (our 2014 Annual Report). References to we, us, our and our company refer to Power Solutions International, Inc. and its subsidiaries.*

*The discussion and analysis below includes forward-looking statements about our business, financial condition and results of operations, including discussions about management's expectations for our business. These statements represent projections, beliefs and expectations based on current circumstances and conditions and are in light of recent events and trends, and you should not construe these statements either as assurances of performance or as promises of a given course of action. Instead, various known and unknown factors are likely to cause our actual performance and management's actions to vary, and the results of these variances may be both material and adverse. In evaluating such statements, you should carefully consider the various factors identified in this report and our 2014 Annual Report which could cause actual results to differ materially from those expressed in, or implied by, any forward-looking statements, including those factors set forth under the heading Cautionary Note Regarding Forward-Looking Statements at the end of this Item 2 in this Quarterly Report on Form 10-Q.*

**Overview**

**Organization**

We design, manufacture, distribute and support power systems and large custom-engineered integrated electrical power generation systems for industrial OEMs across a broad range of industries including stationary electricity power generation, oil and gas, material handling, aerial work platforms, industrial sweepers, arbor, welding, airport ground support, turf, agricultural, construction and irrigation. We also develop and deliver power systems aimed at on-road markets including medium duty fleets, delivery trucks, school buses and garbage trucks. Our engineering personnel design and test power system solutions and components supporting those solutions. We operate as one business and geographic segment. Accordingly, the following discussion is based upon this presentation.

*Net sales*

We generate revenues and cash primarily from the sale of off-highway industrial power systems and aftermarket parts to industrial OEMs and power systems to on-road markets. Our products and services are sold predominantly to customers throughout North America, as well as, to customers located throughout the Pacific Rim and Europe. Net sales are derived from gross sales less sales returns and/or sales discounts.

*Cost of sales*

We manufacture and assemble our products at our primary facilities in Wood Dale, Illinois, Darien, Wisconsin and Madison Heights, Michigan. Materials used to manufacture and assemble our power systems account for the most

significant component of our costs. Our cost of sales includes, labor, freight, depreciation and other inventoriable costs such as allocated overhead. Additionally, we also include the costs to procure materials and service our products as components of our cost of sales.

*Operating expenses*

Operating expenses include research & development and engineering, selling and service and general and administrative expenses. Research & development and engineering expense includes both internal personnel costs and expenses associated with outsourced third party engineering relationships. Research & development and engineering activities are staff intensive. Costs incurred primarily consist of salaries and benefits for professional engineers, materials used in the development of new products and applications, and amounts paid to third parties under contractual engineering agreements. Research & development and engineering staff focus on advanced product development, application design, customer product support and other engineering related activities. Our advanced product development and application design staff primarily focus on current and future product design, prototyping, testing and application development activities. Our customer product support group provides dedicated engineering and technical attention to customer production support, including a direct communication link with our internal operations.

Selling and service expense represents the costs of our sales team, an aftermarket sales group and certain costs associated with field service and support of our products. We utilize a direct sales and marketing approach to maintain maximum customer interface and service support. Salaries and benefits, together with expenses associated with travel, account for the majority of the costs in this category.

General and administrative expense principally represents costs of our corporate office and personnel that provide management, accounting, finance, human resources, information systems and related services which support the organization. In addition to salaries and benefits, costs include public company expenses, consulting and professional services fees, insurance premiums, banking fees and other general facility and administrative support costs.

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Amortization expense principally represents costs associated with the amortization of certain acquisition-related intangible assets.

### *Other (income) expense*

Other (income) expense includes interest expense on our revolving line of credit and other obligations upon which we pay interest, changes in the valuation of the warrants issued in the private placement that closed on April 29, 2011, and other pre-tax transactions which require classification in non-operating results. The change in the valuation of our private placement warrants liability is based upon fluctuations in the market price of our common stock which can vary significantly from period to period. Other (income) expense may also include other non-operating expenses from time to time, such as a loss on debt extinguishment, valuation adjustments associated with acquisition activity, and other matters which are not otherwise considered operating income or expense.

## **2015 Significant developments**

### *Retirement of Chief Financial Officer*

On October 5, 2015, we announced the retirement of our Chief Financial Officer, effective October 19, 2015. Our new Chief Financial Officer, Michael Lewis, joined us effective October 19, 2015 as our new Chief Financial Officer. As contemplated by Mr. Lewis' Executive Employment Agreement, he was granted a stock appreciation right pursuant to the 2012 Incentive Compensation Plan, as amended. The award of the SAR was approved by the Compensation Committee of the Board of Directors and the terms of the SAR are set forth in a Stock Appreciation Rights Agreement, dated as of October 19, 2015 (the Grant Date). The SAR provides for the right to receive, upon exercise, shares of the Company's common stock, par value \$0.001 per share, based upon the appreciation in market value (determined as provided in the Stock Appreciation Rights Agreement) of the shares of our common stock covered by the SAR above a strike price of \$24.41 per share. The SAR covers an aggregate of 60,000 shares of our common stock and is to be settled only in whole shares of our common stock. It will vest ratably and become exercisable with respect to one fourth of the covered shares beginning on the third anniversary of the Grant Date.

### *5.50% Senior Notes Due 2018*

On April 24, 2015, we entered into a purchase agreement with certain institutional investors for a private sale of an aggregate amount of \$55.0 million in unsecured 5.50% Senior Notes. The sale closed on April 29, 2015. In connection with the issuance of the Senior Notes, we entered into an indenture agreement dated April 29, 2015, by and among us, The Bank of New York Mellon, as Trustee, and our subsidiaries as guarantors. We received net proceeds of \$53.5 million after transaction costs of approximately \$1.5 million. The Senior Notes are unsecured debt of our Company and are effectively subordinated to our existing and future secured debt including the obligation under our revolving line of credit. The Senior Notes have a final maturity date of May 1, 2018, subject to earlier repurchase, under certain circumstances, as more fully described below under, *Credit Agreements, 5.50% Senior Notes Due 2018*.

### *Acquisition of Powertrain Integration, LLC*

On May 4, 2015, we entered into an Asset Purchase Agreement (APA) with Powertrain Integration, LLC (Powertrain) and its owners, to acquire the assets of Powertrain. Powertrain provides on-highway powertrain solutions, including systems, components and services for niche OEM automakers and fleets. Powertrain also specializes in alternative-fuel as well as gasoline and diesel systems and offers design, engineering, testing and production capabilities to deliver one-stop vehicle integration. The acquisition was completed on May 19, 2015. The cash consideration paid, net of working capital adjustments totaled \$20,776,000. The purchase price is subject to further

adjustments for the, assumed liabilities, a Base Earn-out Payment and Additional Earn-out Payment, all as described in the APA. We also recorded an initial liability of \$8,200,000 as of the date of acquisition representing the contingent consideration associated with the Base Earn-out Payment and Additional Earn-out Payment for a provisional aggregate purchase price of \$28,976,000. The actual amount of the contingent consideration will be based upon the 2015 full year net sales of Powertrain. The Base Earn-out Payment is payable in cash while the Additional Earn-out Payment is payable, at our discretion, in cash or shares of our common stock. The aggregate purchase price, inclusive of all potential payments has not yet been finalized. We have accounted for this acquisition as a business combination in accordance with ASC 805, *Business Combinations*, and as such, the excess of the purchase price over the fair values assigned to the assets acquired and liabilities assumed has been provisionally allocated to goodwill subject to the completion of the fair value analysis of the assets acquired and liabilities assumed. The acquisition of Powertrain has been accounted for as a purchase of assets for income tax purposes. Accordingly, the financial and income tax bases of the assets and liabilities have been assumed to be the same at the date of acquisition, and therefore, a provision for deferred income tax has not been recorded in connection with the purchase price allocation. Additionally, any excess of the purchase price over the fair value of the assets acquired is expected to be deductible for income tax purposes. Refer to Note 4, *Acquisitions* to our unaudited condensed consolidated financial statements, for a further discussion of the acquisition. The acquisition was funded by the proceeds received from the issuance of the 5.50% Senior Notes described in Note 9, *Debt*, to our unaudited condensed consolidated financial statements.

#### *Acquisition of Bi-Phase Technologies, LLC*

On May 1, 2015, we acquired all of the membership interests in Bi-Phase Technologies, LLC, a Minnesota limited liability company ( *Bi-Phase* ) and wholly-owned subsidiary of TPB, Inc., a Minnesota corporation. Bi-Phase is engaged in the design and manufacture of liquid propane electronic fuel injection systems to allow for the conversion of vehicles from gasoline to propane. The purchase price was \$3,500,000 plus certain working capital, assumption of certain liabilities and Earn-out Payments as defined in the Membership Interest Purchase Agreement. The cash paid was \$3,885,000 which represented the initial purchase price of \$3,500,000 plus working capital. We also recorded a contingent consideration liability of \$540,000, representing an estimate of the Earn-out Payments expected to be payable in connection with the acquisition of Bi-Phase. This contingent consideration, payable to TPB, Inc., is based upon sales of Bi-Phase fuel systems over a period of three to five years. Accordingly, the provisional aggregate purchase price approximated \$4,425,000.



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We have accounted for this acquisition as a business combination in accordance with ASC 805, *Business Combinations*, and as such, subject to the completion of the fair value analysis of the assets acquired and liabilities assumed, the excess of the purchase price over the fair values assigned to the assets acquired and liabilities assumed has been provisionally allocated to goodwill. The acquisition of Bi-Phase has been accounted for as a purchase of assets for income tax purposes. Accordingly, the financial and income tax bases of the assets and liabilities have been assumed to be the same at the date of acquisition, and a provision for deferred income tax has not been recorded in connection with the purchase price allocation.

Additionally, any excess of the purchase price over the fair value of the assets acquired is expected to be deductible for income tax purposes. Refer to Note 4, *Acquisitions* to our unaudited condensed consolidated financial statements, for a further discussion of the acquisition. The acquisition was funded by the proceeds received from the issuance of the 5.50% Senior Notes described in Note 9, *Debt*, to our unaudited condensed consolidated financial statements.

### *Amended credit agreement*

On April 29, 2015, we entered into an amendment with Wells Fargo Bank, National Association, for the purpose of facilitating the issuance of 5.50% Senior Notes, as described above, and this amendment also provides for the earlier maturity of our revolving credit agreement to insure that the revolving line of credit will come due before the Senior Notes are payable. The Amended Wells Credit Agreement will become due 75 days prior to the earliest date that a Special Mandatory Purchase Date (as defined in the Indenture agreement) may occur or 90 days prior to the final maturity date of the Senior Notes, all as described in the Indenture agreement below under, *Credit agreements*.

## **Factors affecting comparability**

We have set forth below selected factors that we believe have had, or can be expected to have, a significant effect on the comparability of recent or future results of operations:

### *5.50% Senior Notes Due 2018*

As discussed above, we entered into a purchase agreement with certain institutional investors for a private sale of an aggregate amount of \$55.0 million in unsecured 5.50% Senior Notes. We received net proceeds of \$53.5 million after transaction costs of approximately \$1.5 million. As a result, interest expense related to the Senior Notes included in *Interest expense* was \$772,000 and \$1,302,000 for the three and nine months ended September 30, 2015 as compared to none in the comparable periods in 2014.

### *Acquisitions*

Our unaudited condensed consolidated financial statements as of and for the nine months ended September 30, 2015, includes the results of operations of three acquisitions which we completed during 2015. In addition to Powertrain and Bi-Phase discussed above, on March 18, 2015, we acquired all of the membership interests in Buck's Acquisition Company, LLC ( *Buck's* ) from UE Powertrain d/b/a Buck's Engines and United Holdings, LLC. Buck's is a manufacturer of alternative-fuel engines for industrial markets and was formerly a product line of United Engines, LLC. Buck's supplies a range of alternative-fuel engines that run on natural gas, propane and liquid propane gas fuels. Buck's targets an extensive range of industrial applications, including irrigation, gas compression, oil production, industrial equipment, power generation, mobile equipment, wind turbines, and re-power applications. We initially paid cash of \$9,735,000 for the acquisition of Buck's. Including our acquisitions of Powertrain and Bi-Phase, the initial cash paid for the acquisition of these businesses was \$34,396,000 in the nine months ended September 30, 2015.

On April 1, 2014, we acquired Professional Power Products, Inc. ( 3PI ). As a result of this acquisition, the unaudited condensed consolidated results of operations for the nine months ended September 30, 2015 include 3PI for the entire nine month period while the unaudited condensed consolidated results of operations for the nine months ended September 30, 2014 do not include any operating results attributable to 3PI for the first quarter of 2014.

See Note 4, *Acquisitions* to our unaudited condensed consolidated financial statements for a further discussion of our acquisitions during 2015.

*Acquisition expenses*

We incurred total transaction costs related to acquisition activities of \$79,000 and \$526,000, excluding lease termination expense associated with the Buck s facility, in the three and nine months ended September 30, 2015, respectively, all of which was recognized as an expense classified within general and administrative expense, in accordance with generally accepted accounting principles in the U.S. We incurred \$811,000 of transaction costs related to acquisitions in 2014 all of which was recognized as an expense within general and administrative expense in the three months ended March 31, 2014.

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### *Joint venture with South Korean manufacturer*

We entered into a joint venture with a construction and utility equipment manufacturer headquartered in Incheon, South Korea for the purpose of designing, developing, manufacturing, marketing and selling specific engines throughout the global markets except North America and South Korea. We and our joint venture partner each have a 50% equity interest in the joint venture. In connection with this agreement, we were required to contribute \$1,000,000 to the joint venture which payment was made during the second quarter of 2015. We expect to account for the results of the joint venture as an equity investment in our consolidated financial statements.

### *Private placement warrants*

Our year-to-year and year-over-year results can be impacted by our private placement warrant liability. The change in estimated fair value of the liability associated with the private placement warrants is primarily attributable to fluctuations in the value of our common stock during a period.

### *Other events affecting sales and profitability comparisons*

Our year-to-year and year-over-year operating results (including our sales, gross profit and net (loss) income) and cash flows can be impacted by a variety of internal and external events associated with our business operations. Examples of such events include (1) changes in regulatory emission requirements (which generally occur on January 1 of the year in which they become effective), (2) customer product phase-in/phase-out programs, (3) supplier product (e.g., a specific engine model) phase-in/phase-out programs, (4) changes in pricing by suppliers to us of engines, components and other parts (typically effective January 1 of any year), and (5) changes in our pricing to our customers (typically effective January 1 of any year), which may be related to changes in the pricing by suppliers to us. In order to mitigate potential availability or pricing issues, customers may adjust their demand requirements from traditional patterns. We may also extend special programs to customers in advance of such events, and we are more likely to offer such programs in our fourth quarter of a year in anticipation of events expected to occur in the first quarter of the next year. The occurrence of any of the events discussed above may result in fluctuations in our operating results (including sales and profitability) and cash flows between and among reporting periods.

## **Results of operations**

### *Three months ended September 30, 2015 compared with three months ended September 30, 2014*

#### *Net sales*

Our net sales increased \$18,036,000 (19.2%) to \$112,008,000 for the three months ended September 30, 2015 compared to \$93,972,000 in the three months ended September 30, 2014. Approximately \$19.2 million of the sales increase was attributable to acquisitions of businesses which was offset by an organic sales decrease of approximately \$1.2 million. A decrease in sales volume (as opposed to price decreases) of approximately \$1.2 million was the primary driver of the organic sales decrease in the three months ended September 30, 2015 as compared to the same period in 2014.

#### *Gross profit*

Our gross profit decreased \$3,320,000 (17.8%) to \$15,308,000 for the three months ended September 30, 2015, from \$18,628,000 in the comparable period of 2014. Our gross profit decreased due to higher production spending and production inefficiencies in anticipation of contemplated higher throughput. In addition, our gross profit arising from

sales of our large custom engineered power generation systems decreased due to current competitive pricing for such products as well as general production inefficiencies associated with these systems. As a percentage of net sales, gross margin was 13.7% for the three months ended September 30, 2015, compared to 19.8% for the same period in 2014.

*Research & development and engineering*

Research & development and engineering expense increased \$1,061,000 (23.6%) to \$5,562,000 for the three months ended September 30, 2015, as compared to \$4,501,000 for the same period in 2014. Approximately \$655,000 of the increase was attributable to activities of our recently acquired businesses.

Excluding the expenses of our recently acquired businesses, research & development and engineering expense increased approximately \$406,000 in the three months ended September 30, 2015, as compared to the same period in 2014. We incur significant costs for the salaries and benefits of our professional engineers, support personnel and amounts paid to third parties for contract services associated with our research & development activities, including the design of our proprietary engines. Wages and benefits increased \$133,000 as we increased headcount. Emissions expenses related to certification and testing also increased \$165,000 in the three months ended September 30, 2015, as compared to the same period in 2014. The remaining net increase in other research & development and engineering expense was \$108,000, of which none of the individual components was individually significant in the three months ended September 30, 2015, as compared to the same period in 2014. As a percentage of net sales, research & development and engineering expense increased to 5.0% in the three months ended September 30, 2015, as compared to 4.8% for the same period in 2014.

*Selling and service*

Selling and service expense increased \$273,000 (10.1%) to \$2,979,000 for the three months ended September 30, 2015, from \$2,706,000 in the comparable period of 2014. Bad debt expense increased \$285,000 in the three months ended September 30, 2015, as compared to the same period in 2014 as we increased our allowance for doubtful accounts. Other selling and service expenses accounted for the remaining net decrease of \$12,000 period over period, of which none of the components was individually significant. As a percentage of net sales, selling and service expenses decreased to 2.7% in the three months ended September 30, 2015, compared to 2.9% for the same period in 2014.

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General and administrative expense, increased \$870,000 (25.5%) to \$4,280,000 for the three months ended September 30, 2015. General and administrative expense attributable to our acquisitions increased approximately \$300,000 arising from expenses incurred by the activities of our recent acquisitions in the three months ended September 30, 2015 as compared to none in the comparable period in 2014. In addition, we incurred approximately \$79,000 and \$184,000 in transaction related expenses and lease termination expense, respectively, in the three months ended September 30, 2015 in connection with our acquisition activities as compared to none in the three months ended September 30, 2014.

Excluding the expenses attributable to our acquisitions, general and administrative expenses increased \$307,000 in the three months ended September 30, 2015 as compared to the same period in 2014. Higher consulting and professional fees of \$519,000 were partially offset by a \$255,000 decrease in wages and benefits in the three months ended September 30, 2015, as compared to the same period in 2014. None of the remaining individual expense components in general and administrative expense was individually significant.

As a percentage of net sales, general and administrative expenses increased to 3.8% in the three months ended September 30, 2015, compared to 3.6% for the same period in 2014. As a percentage of net sales, general and administrative expenses, excluding transaction expense, was 3.6% in each of the three months ended September 30, 2015 and 2014.

*Amortization of intangible assets*

Amortization of intangible assets expense increased \$607,000 (123.4%) to \$1,099,000 for the three months ended September 30, 2015, from \$492,000 in the comparable period of 2014. The increase in amortization expense was principally attributable to the amortization of intangible assets, including customer relationships and trade names, among other assets, to which a value was ascribed, in certain of our recent acquisitions. As a percentage of net sales, amortization of intangible assets expense increased to 1.0% in the three months ended September 30, 2015, compared to 0.5% for the same period in 2014.

*Other (income) expense*

Interest expense increased \$967,000 to \$1,374,000 in the three months ended September 30, 2015, as compared to \$407,000 for the same period in 2014. The increase in interest expense was principally attributable to interest on the 5.50% Senior Notes that we issued effective April 29, 2015. We used proceeds from the 5.50% Senior Notes to facilitate acquisition activity and provide additional sources of liquidity. Interest expense attributable to the 5.50% Senior Notes was \$899,000, including \$127,000 of amortization of debt issuance costs, in the three months ended September 30, 2015 as compared to none for the same period in 2014. The remaining \$68,000 increase in interest expense was principally attributable to an increase in the overall average amount outstanding on our revolving line of credit during the three months ended September 30, 2015, as compared to the same period in 2014. Excluding the 5.50% Senior Notes, our average borrowings outstanding were approximately \$104.1 million during the three months ended September 30, 2015 as compared to approximately \$74.8 million during the three months ended September 30, 2014. Our revolving line of credit weighted average borrowing rate was 1.70% for the three months ended September 30, 2015, as compared to 1.86% for the same period in 2014. Holding all other variables constant, we believe that our effective interest rate for the full year of 2015 will increase modestly from the effective interest rate reported for the three months ended September 30, 2015 due to an increase in the base rate charged under our revolving line of credit.

Our results for the three months ended September 30, 2015 and September 30, 2014 included \$50,000 and \$3,208,000, respectively, of income arising from a reduction in the valuation of a contingent consideration liability. The change in the value of the contingent consideration in the three months ended September 30, 2015 was attributable to the purchase of Powertrain in 2015. The contingent consideration payable is based upon Powertrain achieving certain sales targets for the full year 2015 plus additional consideration as defined in the APA. Changes in estimates for the additional consideration and the reduction of contingent consideration liability, primarily related to changes in the market value of the company's stock price. The contingent consideration in the three months ended September 30, 2014 was attributable to our acquisition of 3PI in 2014. For the quarter ended September 30, 2014, the reduced contingent consideration was attributable to our acquisition of 3PI in 2014. The value of the contingent consideration liability decreased as a result of 3PI not achieving the expected financial performance measures set forth in the stock purchase agreement.

Private placement warrant income was \$8,750,000 in the three months ended September 30, 2015, as compared to income of \$858,000 for the same period in 2014. Private placement warrant income and expense results from the change in the fair value of our private placement warrants, which is determined either at the date that the private placement warrants are exercised or the end of the reporting period, as applicable, and the value of the warrants at the end of the prior period multiplied by the number of shares of our common stock underlying the outstanding private placement warrants. We are required to recognize changes in the estimated fair value of unexercised private placement warrants in our unaudited condensed consolidated statement of operations.

Other expense was \$171,000 in the three months ended September 30, 2015, as compared to \$34,000 for the same period in 2014.

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### *Income tax expense*

Our income tax expense decreased \$4,462,000 to an income tax benefit of \$466,000 in the three months ended September 30, 2015, as compared to income tax expense of \$3,996,000 for the same period in 2014.

The change in the valuation of our private placement warrants is a non-taxable transaction. Given the subjectivity and volatility of the valuation of the private placement warrants, we are unable to estimate the annual impact of the change in the private placement warrants and the corresponding effect on our effective income tax rate for the full year. Accordingly, we include the effect of the change in the valuation of the private placement warrants, when known, in the period in which it occurs. Excluding this change for 2015, our adjusted income before the income tax provision would have been a loss of \$107,000 in the three months ended September 30, 2015 and income of \$10,286,000 in the three months ended September 30, 2014. The income tax rate excluding this amount would not be meaningful for the three months ended September 30, 2015. Excluding the amount for 2014, the reported income tax rate would have been 38.8% for three months ended September 30, 2014.

The income tax benefit for the three months ended September 30, 2015 was attributable to the true-up of our 2014 income tax provision filed in our tax returns as compared to the income tax provision recorded on our books for the year ended December 31, 2014. Our actual tax credits arising from our research and development activities were higher than the amount estimated at provision and were the principal reasons for the reduction in the tax provision in the three months ended September 30, 2015. The federal research tax credit expired at the end of 2014 and this federal research tax credit has not yet been re-enacted for 2015.

### **Nine months ended September 30, 2015 compared with the nine months ended September 30, 2014**

#### *Net sales*

Our net sales increased \$48,691,000 (19.9%) to \$292,776,000 in the nine months ended September 30, 2015 compared to \$244,085,000 for the same period of 2014. Organic sales growth accounted for \$14.6 million or approximately 30% of the increase in sales and the remaining increase of approximately \$34.1 million was attributable to incremental sales from acquisitions of businesses. An increase in sales volume (as opposed to price increases) accounted for approximately \$13.3 million of the \$14.6 million increase in organic sales in the nine months ended September 30, 2015 as compared to the same period in 2014.

#### *Gross profit*

Our gross profit increased \$3,185,000 (6.9%) to \$49,139,000 in the nine months ended September 30, 2015, from \$45,954,000 in the comparable period of 2014. Our gross profit increased primarily due to the previously discussed increase in sales volumes. As a percentage of net sales, gross margin was 16.8% for the nine months ended September 30, 2015, compared to 18.8% for the same period in 2014. The higher gross profit during 2015 was principally attributable to an increase in sales volume. Our gross margin, however, declined as a result of deterioration in the gross margins on our large custom-engineered power generation systems, impacted by competitive pricing and lower throughput quarter over quarter combined with generally higher production costs in anticipation of contemplated higher throughput.

#### *Research & development and engineering*

Research & development and engineering expense increased \$5,129,000 (43.3%) to \$16,973,000 in the nine months ended September 30, 2015, as compared to \$11,844,000 for the same period in 2014. Approximately \$1,165,000 of

the increase was a result of the research & development and engineering expense attributable to the activities of our recent acquisitions in 2015 for which there was an immaterial amount in the comparable period in 2014.

Excluding the expenses of our recently acquired businesses, research & development and engineering expense increased approximately \$3,964,000 in the nine months ended September 30, 2015, as compared to the same period in 2014. Wages and benefits increased \$1,072,000 as we increased headcount while consulting and outside services, including product testing, increased \$2,471,000 to support activities related to development of new engines and pursuing on-road applications for our products, among other things. The remaining net increase in other research & development and engineering expense was \$421,000 of which none of the individual components was individually significant as compared to the same period in 2014. As a percentage of net sales, research & development and engineering expense increased to 5.8% in the nine months ended September 30, 2015, as compared to 4.9% for the same period in 2014.



*Selling and service*

Selling and service expense increased \$1,654,000 (24.1%) to \$8,525,000 in the nine months ended September 30, 2015, from \$6,871,000 in the comparable period of 2014. The increase was principally a result of the incremental selling and service expense attributable to the activities of our acquisitions which totaled \$1,552,000 in 2015 and \$677,000 in 2014, an increase of \$875,000 period over period. Selling and service expense includes nine months of expenses for 3PI in 2015 as compared to six months in 2014 as 3PI was acquired on April 1, 2014. Powertrain and Bi-Phase were recently acquired in May of 2015.

Excluding the incremental expenses attributable to our acquisitions, selling and service expense increased approximately \$779,000 in the nine months ended September 30, 2015 as compared to the same period in 2014. Wages and benefits increased \$252,000 in the nine months ended September 30, 2015, as compared to the same period in 2014 as we have increased our staff to pursue growth opportunities. Bad debt expense increased \$252,000 as we increased our allowance for doubtful accounts and other selling and service expenses accounted for the remaining net increase of \$275,000 period over period, of which none of the components was individually significant. As a percentage of net sales, selling and service expenses increased to 2.9% in the nine months ended September 30, 2015, compared to 2.8% for the same period in 2014.

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**Table of Contents***General and administrative*

General and administrative expense, increased \$1,139,000 (11.6%) to \$10,953,000 for the nine months ended September 30, 2015, from \$9,814,000 in the comparable period of 2014. The increase was partially a result of incremental general and administrative expense attributable to our acquired businesses and accounted for \$1,015,000 of the period over period increase.

Excluding the expenses attributable to our acquired businesses, general and administrative expenses increased \$124,000 in the nine months ended September 30, 2015 as compared to the same period in 2014. Lower expenses for wages and benefits expense of \$1,011,000 were partially offset by higher consulting and professional fees of \$765,000 resulting from the growth of the business. The remaining individual expense components resulted in a net increase in general and administrative expense of \$370,000 of which none of the individual components was individually significant in the nine months ended September 30, 2015 as compared to the same period in 2014.

As a percentage of net sales, general and administrative expenses decreased to 3.7% in the nine months ended September 30, 2015, compared to 4.0% for the same period in 2014. As a percentage of net sales, general and administrative expenses, excluding transaction expense, was 3.5% in the nine months ended September 30, 2015, compared to 3.7% for the same period in 2014.

*Amortization of intangible assets*

Amortization of intangible assets increased \$2,263,000 (460.0%) to \$2,755,000 for the nine months ended September 30, 2015, from \$492,000 in the comparable period of 2014. An increase of \$1,910,000 in amortization expense at 3PI accounted for the majority of the increase for the nine months ended September 30, 2015 and amortization expense related to our recent acquisitions accounted for the remaining increase of \$353,000 period over period. As a percentage of net sales, amortization of intangible assets expense increased to 0.9% in the nine months ended September 30, 2015, compared to 0.2% for the same period in 2014.

*Other (income) expense*

Interest expense increased \$2,099,000 to \$2,986,000 in the nine months ended September 30, 2015, as compared to \$887,000 for the same period in 2014. Interest expense attributable to the 5.50% Senior Notes was \$1,513,000, including \$211,000 of amortization of debt issuance costs for the nine months ended September 30, 2015, as compared to none for the same period in 2014. The remaining \$586,000 increase in interest expense was principally attributable to an increase in the overall average amount outstanding on our revolving line of credit during the nine months ended September 30, 2015, as compared to the same period in 2014. Our average borrowings outstanding were approximately \$97.1 million during the nine months ended September 30, 2015 as compared to approximately \$55.1 million during the nine months ended September 30, 2014. Including our revolving line of credit and our term loan which was paid in full on April 29, 2015, our weighted average borrowing rate was 1.81% for the nine months ended September 30, 2015 as compared to 1.86% for the same period in 2014.

Our results for the nine months ended September 30, 2015 and 2014 included \$50,000 and \$3,782,000, respectively of income arising from a reduction in the valuation of contingent consideration liabilities as described above.

Private placement warrant income was \$8,040,000 in the nine months ended September 30, 2015, as compared to income of \$1,190,000 for the same period in 2014. The change in estimated fair value of the private placement warrants was attributable to fluctuations in the trading price of our common stock at each balance sheet date or upon the date that the warrants were exercised.

Remaining other expense was \$260,000 and \$109,000 in the nine months ended September 30, 2015 and 2014, respectively.

*Income tax expense*

Our income tax expense decreased \$5,301,000 to \$2,203,000 in the nine months ended September 30, 2015, as compared to \$7,504,000 for the same period in 2014. Our reported income tax rate was 14.9% for the nine months ended September 30, 2015 and 35.9% for the same period in 2014. Excluding the effects of the change in the valuation of the private placement warrants, our reported income tax rates would have been 32.7% and 38.1% in the nine months ended September 30, 2015 and 2014, respectively. The lower income tax rate in 2015 was principally attributable to the additional income tax benefit arising from the true-up of the federal research tax credit computed and filed in our tax returns as compared to the income tax provision recorded on our books for the year ended December 31, 2014.

## **Liquidity and capital resources**

Our cash requirements are dependent upon a variety of factors, foremost of which is the execution of our strategic plan. We expect to continue to devote substantial capital resources to running our business. Our primary sources of liquidity have been and are expected to continue to be cash flows from operations, principally collections of customer accounts receivable, and borrowing capacity under our credit facility. Effective February 11, 2015, we amended our \$100.0 million credit facility with Wells Fargo Bank, National Association, to increase our revolving line of credit facility to \$125.0 million. We had previously amended our credit facility on September 30, 2014 to \$100.0 million and prior to that on April 1, 2014 to \$90.0 million from \$75.0 million. Also on April 1, 2014, we secured a \$5.0 million term loan. The term loan and credit agreement are further described below under *Credit agreements* . The increase in our credit facility effective April 1, 2014 and the proceeds from the term loan were used to finance our acquisition of 3PI. On April 29, 2015, we issued \$55.0 million in 5.50% Senior Notes, before transaction costs, to facilitate acquisition activity and provide additional sources of liquidity. We paid off the term loan with a portion of the proceeds received on the 5.50% Senior Notes.

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Based on our current forecasts and assumptions, we believe that our sources of cash, namely the sales of our power systems and aftermarket products and access to borrowings on our existing or future credit facilities, will be sufficient to meet our anticipated cash needs for working capital and capital expenditures over at least the next twelve months. Although we believe our existing sources of liquidity will also be sufficient on a longer-term basis, that will depend on numerous factors, including the following: the continuation of our existing customer relationships and our development of new customer relationships; market acceptance of our existing and future products; the success of our product development and commercialization efforts and the costs associated with those efforts; and the costs associated with any future acquisitions, joint ventures or other strategic transactions. Accordingly, in the future we may pursue various financing alternatives, including a larger credit facility, other debt financing and/or additional equity financing.

As of September 30, 2015, we had working capital of \$155,866,000 compared to \$114,955,000 as of December 31, 2014. Our working capital increase of \$40,911,000 was attributable primarily to a \$15,123,000 increase in accounts receivable, net from December 31, 2014, principally resulting from continued growth in our business and incremental sales attributable to our recent acquisitions. Cash on hand increased by \$5,692,000 and accounts payable decreased by \$16,934,000 principally arising from the timing of payments to suppliers. Also contributing to the increase in working capital was an \$8,851,000 increase in our net inventory as well as a \$722,000 increase in prepaid and other current assets. These increases to working capital were partially offset by an \$8,857,000 increase in accrued compensation and benefits and other liabilities, a \$1,667,000 decrease in the current portion of long-term debt and a \$779,000 decrease in our income tax liability account. The increase in accrued compensation and liabilities was principally attributable to an \$8,150,000 contingent consideration liability that we recognized in connection with our acquisition of Powertrain. Additionally, the decrease in the current portion of our long-term debt arose from the payoff of this obligation from the proceeds received from the 5.50% Senior Notes as previously discussed.

A limited number of our customers have payment terms which may extend up to 150 days. As of September 30, 2015 and December 31, 2014, our trade receivables included \$8.3 million and \$11.2 million, respectively, which represented aggregate customer account balances subject to these terms. Of these amounts, \$5.1 million and \$7.5 million at September 30, 2015 and December 31, 2014, respectively, represented the portion of the balance outstanding with these extended trade terms. Under our revolving line of credit, which funds our working capital as needed, these trade receivables represent eligible collateral on the same basis as our other trade receivables and remain eligible as collateral upon which we may borrow up to their extended due date of 150 days.

***Cash flows for the nine months ended September 30, 2015******Operating activities***

Net income and changes in working capital are the primary drivers of our cash flows from operations. For the nine months ended September 30, 2015, we used \$22,588,000 to fund our operations.

In the nine months ended September 30, 2015, we had net income of \$12,574,000 and non-cash adjustments totaling \$1,778,000, resulting in cash generated from operations of \$14,352,000 before considering changes in our operating assets and liabilities. Our non-cash adjustments favorably affecting our cash from operations in the nine months ended September 30, 2015 primarily included (i) \$6,531,000 of depreciation and amortization, (ii) \$854,000 of share-based compensation expense, (iii) \$698,000 of inventory provisions, (iv) \$625,000 of uncollectible receivable expense, (v) \$453,000 of amortization expense recognized for the step-up valuation of certain inventory acquired through acquisitions, and (vi) \$305,000 of non-cash interest expense. These increases were partially offset by income of \$8,040,000 derived from an adjustment to the fair value of our private placement warrants in the nine months ended September 30, 2015. The remaining other non-cash adjustments totaled \$352,000, none of which was individually

significant.

Cash generated of \$14,352,000 from our net income adjusted for non-cash items was offset by \$36,940,000 of cash used by operating assets and liabilities in the nine months ended September 30, 2015. Our trade receivables increased by \$10,605,000 as sales increased in the nine months ended September 30, 2015 as compared to the nine months ended December 31, 2014. We used \$23,659,000 to pay down our trade payables since December 31, 2014 and our prepaid expenses and other assets increased \$1,795,000. In addition, accrued compensation and benefits and other accrued liabilities and income taxes payable decreased \$1,046,000 and \$779,000, respectively since December 31, 2014. Nominally offsetting this cash used were decreases in inventory of \$589,000 and an increase in other non-current liabilities in the nine months ended September 30, 2015.

#### *Investing activities*

Net cash used in investing activities was \$42,057,000 in the nine months ended September 30, 2015. Cash used for acquisitions discussed above totaled \$34,396,000 in the nine months ended September 30, 2015. The property and equipment additions accounted for \$6,661,000 of cash used in the nine months ended September 30, 2015 for equipment as well as the build-out of a new and significantly larger facility to support our research and development activities. In addition, we contributed \$1,000,000 representing an equity investment in a joint venture with a construction and utility equipment manufacturer headquartered in Incheon, South Korea.

#### *Financing activities*

We generated \$70,337,000 of cash from financing activities for the nine months ended September 30, 2015. As discussed above, we issued unsecured 5.50% Senior Notes for which we received proceeds of \$55,000,000 before transaction fees of \$1,517,000. In addition, we generated cash of \$21,031,000 from net borrowings under our revolving line of credit in the nine months ended September 30, 2015. We also realized an

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increase in cash arising from compensation costs deductible only for income tax purposes and arising from the issuance of our common stock under our 2012 Incentive Compensation Plan and the exercise of private placement warrants. These increases were partially offset by a \$4,028,000 repayment of a term loan with an initial principal balance of \$5,000,000 that was originally secured on April 1, 2014 as well as the payment of withholding taxes for the net settlement of share-based awards which vested in the nine months ended September 30, 2015. We also received \$65,000 from the exercise of private placement warrants held by our investors.

***Cash flows for the nine months ended September 30, 2014******Operating activities***

For the nine months ended September 30, 2014, we used \$13,450,000 to fund our operations.

In the nine months ended September 30, 2014, we had reported net income of \$13,405,000, which, after adjustment for non-cash items of \$1,776,000, resulted in net cash generated of \$15,181,000 before considering changes in our operating assets and liabilities. Our significant non-cash adjustments in the nine months ended September 30, 2014, included (i) \$3,132,000 of depreciation and amortization expense, (ii) \$1,512,000 of deferred income taxes related to the decrease in the contingent consideration liability associated with the acquisition of 3PI, (iii) \$982,000 of share-based compensation expense, (iv) \$615,000 of inventory provisions, (v) \$482,000 of expense recognized for the step-up valuation of certain inventory acquired in our acquisition of 3PI, and (vi) other non-cash increases of \$275,000. These increases were partially offset by (i) \$3,782,000 decrease in the contingent consideration liability as a result of the likelihood that 3PI will not achieve the expected financial performance measures set forth in the stock purchase agreement, (ii) \$1,190,000 due to a decrease in the fair value of the private placement warrants liability, also arising from a decrease in the market value of our common stock, and (iii) other non-cash adjustments totaling \$250,000, none of which was individually significant.

Cash generated of \$15,181,000 from operations adjusted for non-cash expenses, was offset by \$28,631,000 of cash used by changes in operating assets and liabilities in the nine months ended September 30, 2014, principally arising from the higher level of sales activity period over period.

Our inventories increased \$23,398,000 as we built up our inventory, including strategic engine block purchases, to support current and future period sales. Our accounts receivable increased \$21,917,000 as we realized continued sales growth in the nine months ended September 30, 2014 as compared to the prior nine months ended December 31, 2013. Prepaid expenses and other assets also increased \$2,342,000 principally attributable to investments in our growth. We also used \$133,000 in cash resulting in a net reduction of our other accrued liabilities, which includes our accrued compensation costs. Offsetting the cash used was a \$19,549,000 increase in accounts payable to support our continued growth. The remaining other changes in the components of operating assets and liabilities resulted in net cash used of \$390,000, none of which was individually significant.

***Investing activities***

Net cash used in investing activities was \$49,221,000 in the nine months ended September 30, 2014. As discussed previously, we acquired 3PI on April 1, 2014 in a taxable transaction. We initially paid \$44,122,000 for 3PI, net of cash acquired. Property and equipment additions accounted for \$4,749,000 in the nine months ended September 30, 2014 and we also contributed an additional investment of \$350,000 to our joint venture in China. In December 2012, we entered into a joint venture with MAT Holdings, Inc. for the purpose of manufacturing, assembling and selling certain engines into the Asian market. The joint venture initially provides for an investment of \$1.2 million from each joint venture partner. Through September 30, 2014, our total investment into the joint venture was \$850,000.

*Financing activities*

We generated approximately \$63,967,000 of cash from financing activities for the nine months ended September 30, 2014. We generated cash of \$56,115,000 from net borrowings under our revolving line of credit in the nine months ended September 30, 2014. We secured a term loan of \$5,000,000 and received proceeds of \$1,425,000 from the exercise of private placement warrants by our investors. We also realized an income tax benefit of \$2,469,000 from compensation costs deductible only for income tax purposes and arising from the issuance of our common stock under our 2012 Incentive Compensation Plan. Offsetting these proceeds was (i) \$555,000 for the installment payments due on our term loan, (ii) \$361,000 in the payment of withholding taxes for the net settlement of share-based awards which vested in the nine months ended September 30, 2014, and (iii) \$126,000 of fees paid in connection with the amendment of our credit facility with Wells Fargo Bank, National Association, as further discussed below under *Credit agreements*.



***Credit agreements***

*Wells Fargo Bank, National Association, credit agreement*

On June 28, 2013, we entered into a credit agreement with Wells Fargo Bank, National Association (the Wells Credit Agreement), which replaced our prior credit agreement with BMO Harris Bank N.A. The Wells Credit Agreement enabled us to borrow under a revolving line of credit secured by substantially all of our tangible and intangible assets (other than real property). The Wells Credit Agreement (a) provided an initial maximum \$75.0 million revolving line of credit to us, which, at our request and subject to the terms of the Wells Credit Agreement, could have been increased up to \$100.0 million during the term of the Wells Credit Agreement; (b) bore interest at the Wells Fargo Bank's prime rate plus an applicable margin ranging from 0% to 0.50%; or at our option, all or a portion of the revolving line of credit could have been designated to bear interest at LIBOR plus an applicable margin ranging from 1.50% to 2.00%; (c) had an unused line fee of 0.25% and (d) required us to report our fixed charge coverage ratio, when our Availability (as defined in the Wells Credit Agreement) was less than the Threshold Amount (as

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defined in the Wells Credit Agreement) and to continue to report our fixed charge coverage ratio until the date that Availability for a period of 60 consecutive days, was greater than or equal to the Threshold Amount. We were required to meet a minimum monthly fixed charge coverage ratio of not less than 1.0 to 1.0, the testing of which commenced on the last day of the month prior to the date on which our Availability was less than the Threshold Amount. The Threshold Amount was defined in the Wells Credit Agreement as the greater of (i) \$9,375,000 or (ii) 12.5% of the maximum revolver amount of \$75.0 million or as it may have been increased during the term of the Wells Credit Agreement up to \$100.0 million.

On April 1, 2014, the Wells Credit Agreement was amended (the Amended Wells Credit Agreement ) to increase our revolving line of credit from \$75.0 million to \$90.0 million. The Amended Wells Credit Agreement (a) bears interest at the Wells Fargo Bank's prime rate plus an applicable margin ranging from 0% to 0.5%; or at our option, all or a portion of the revolving line of credit can be designated to bear interest at LIBOR plus an applicable margin ranging from 1.50% to 2.00%; (b) has an unused line fee of 0.25%; (c) requires us to report our fixed charge coverage ratio and leverage ratio as described below; (d) includes a \$5.0 million term loan arrangement with Wells Fargo Bank; and (e) includes a letter of credit sub-facility of the revolving line of credit. The principal amount of the \$5.0 million term loan was payable in 36 equal monthly installments with the first payment due on June 1, 2014, plus interest at LIBOR plus 4.50%. The term loan was payable in whole or in part without penalty at any time after June 30, 2014 upon at least 10 business days prior notice. Effective April 1, 2014 and during the period in which the term loan was outstanding, we were subject to a fixed charge coverage ratio covenant and a debt leverage ratio covenant. We were required to maintain a fixed charge coverage ratio of at least 1.20 to 1.00 and our debt leverage ratio could not exceed 4.0 to 1.0 during the period in which the term loan was outstanding. At the time, we used borrowings under this expanded revolving line of credit as well as the proceeds from the term loan to finance the acquisition of 3PI which was consummated on April 1, 2014 as described in Note 4, Acquisitions to our unaudited condensed consolidated financial statements. The term loan was subsequently paid in full on April 29, 2015. In connection with the repayment of the term loan on April 29, 2015, our minimum monthly fixed charge coverage ratio reverted back to 1.0 to 1.0, the testing of which commences on the last day of the month prior to the date on which our Availability is less than the Threshold Amount.

On September 30, 2014 and again on February 11, 2015, we further amended our credit facility with Wells Fargo Bank, National Association to increase our revolving line of credit facility to \$100.0 million and \$125.0 million, respectively (collectively with the Amended Wells Credit Agreement, the Amended Wells Credit Agreement II ). The Amended Wells Credit Agreement II was scheduled to mature on June 28, 2018.

Other than the above-mentioned amendments, the terms and conditions of the Amended Wells Credit Agreement and Amended Wells Credit Agreement II are substantially similar to the Wells Credit Agreement. Under the Amended Wells Credit Agreement and Amended Wells Credit Agreement II, the amount that we may borrow is limited to the lesser of (i) the maximum available amount and (ii) borrowing base. The borrowing base is calculated as a percentage of our eligible accounts receivable and eligible inventory, plus a defined amount based upon certain of our fixed assets (all as defined in the Amended Wells Credit Agreement and Amended Wells Credit Agreement II). The Amended Wells Credit Agreement and Amended Wells Credit Agreement II also contain customary covenants and restrictions applicable to us, including agreements to provide financial information, comply with laws, pay taxes and maintain insurance, restrictions on the incurrence of certain indebtedness, guarantees and liens, restrictions on mergers, acquisitions and certain dispositions of assets, and restrictions on the payment of dividends and distributions. The revolving line of credit is secured by substantially all of our tangible and intangible assets (other than real property).

On April 29, 2015, we entered into an amended credit facility ( Amended Wells Credit Agreement III ) for the purpose of facilitating the issuance of the 5.50% Senior Notes (the Senior Notes ), as described below, and this amendment provides for the earlier maturity of the Amended Wells Credit Agreement III to insure that the Amended Wells Credit

Agreement III will come due before the Senior Notes are payable as described below. While the Senior Notes are outstanding, the Amended Wells Credit Agreement III will become due 75 days prior to the earliest date that a Special Mandatory Purchase Date (as defined in the Indenture agreement) may occur or 90 days prior to the final maturity date of the Senior Notes, as described in the Indenture agreement below. Accordingly, under the above terms, the Amended Wells Credit Agreement III will become due no earlier than March 15, 2017, but no later than January 31, 2018.

*5.50% Senior Notes Due 2018*

On April 24, 2015, we entered into a purchase agreement with certain institutional investors for a private sale of an aggregate amount of \$55.0 million in our unsecured 5.50% Senior Notes. The sale closed on April 29, 2015. In connection with the issuance of the Senior Notes, we entered into an indenture agreement ( *Indenture* ) dated April 29, 2015, by and among us, The Bank of New York Mellon, as Trustee, and our subsidiaries as guarantors. We received net proceeds of \$53.5 million after initial transaction costs of approximately \$1.5 million. The Senior Notes are unsecured debt of our Company and are effectively subordinated to our existing and future secured debt including the debt in connection with the Amended Wells Credit Agreement III. The Senior Notes have a final maturity date of May 1, 2018, provided that a mandatory offer by us to purchase the Senior Notes must be made on or prior to May 1, 2017 in the event we cannot or do not certify compliance with certain financial covenants as more fully described below. In that event, the date of purchase will be no earlier than May 30, 2017.

We may redeem the Senior Notes in whole or in part at any time on or after May 1, 2016, at our option following redemption prices (expressed as percentages of the principal amount), together with accrued and unpaid interest to the date of redemption:

Redemption date	Redemption price
May 1, 2016 through October 31, 2016	101.0%
November 1, 2016 and thereafter	100.0%

At any time prior to May 1, 2016, we may redeem up to 35% of the Senior Notes with the net cash proceeds of certain equity offerings specified in the Indenture at a redemption price of 105.5% of the principal amount of the Senior Notes, together with accrued and unpaid interest

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to the date of redemption, but only if at least 65% of the original aggregate principal amount of the Senior Notes would remain outstanding following such redemption. In addition, prior to May 1, 2016, we may redeem the Senior Notes in whole or in part at a redemption price equal to 101.0% of the principal amount plus (i) accrued and unpaid interest to the redemption date and (ii) an Applicable Premium (as defined in the Indenture) that is intended as a make-whole to May 1, 2016.

The Senior Notes have a Special Mandatory Purchase Date as described in the Indenture and summarized as follows. Upon the occurrence of the earlier of (I) March 15, 2017, if the Trustee has not received on or within five days prior to such date an officers' certificate stating that (i) our pro forma consolidated EBITDA (as defined in the Indenture) is at least equal to or greater than \$35.0 million for the most recent four full fiscal quarters for which financial statements are available as of such date and (ii) our consolidated pro forma ratio of consolidated EBITDA to fixed charges (as defined in the Indenture) is at least equal to or greater than 3.25 to 1.0 for the most recent four full fiscal quarters for which financial statements are available as of such date or (II) the date on which we notify the Trustee in writing (which date may be at any time on or after March 1, 2017 but on or prior to March 15, 2017) that we cannot or will not deliver such officers' certificate, then, unless we have given on or prior to March 15, 2017 a notice of redemption of all of the Senior Notes, we will make a mandatory offer to purchase all of the Senior Notes at a purchase price of 100.0% of the principal amount plus accrued and unpaid interest, if any, to the date of purchase in accordance with the procedures set forth in the Indenture.

The Indenture contains covenants that, among other things, limit or restrict our ability and the ability of our subsidiaries to incur additional debt, prepay subordinated indebtedness, pay dividends or make other distributions on capital stock, redeem or repurchase capital stock, make investments and restricted payments, enter into transactions with affiliates, sell assets, create liens on assets to secure debt, or effect a consolidation or merger or to sell all, or substantially all, of our assets, in each case subject to certain qualifications and exceptions set forth in the Indenture. The Indenture also provides for customary events of default (subject in certain cases to customer grace and cure periods), which include nonpayment, breach of covenants in the Indenture, payment defaults or acceleration of other indebtedness, and certain events of bankruptcy and insolvency. Generally, if an event of default occurs, the Trustee or holders of at least 25.0% in principal amount of the then outstanding Senior Notes may declare the principal of and accrued but unpaid interest on all Senior Notes to be due and payable.

Interest on the Senior Notes accrues at a rate of 5.50% per annum and is payable semi-annually in arrears on May 1 and November 1 of each year, commencing on November 1, 2015.

*Outstanding borrowings*

As of September 30, 2015, \$99.0 million of our outstanding borrowings under our revolving line of credit bore interest at the LIBOR rate, plus an applicable margin. The weighted average interest rate on these borrowings was 1.70% as of September 30, 2015. The remaining outstanding balance of approximately \$61,000 as of September 30, 2015, had been designated to bear interest at the prime rate, plus an applicable margin, which equaled 3.25% with the applicable margin included. The unused and available revolving line of credit balance was \$13.4 million at September 30, 2015. Our term loan was repaid on April 29, 2015.

As of December 31, 2014, \$71.0 million of our outstanding borrowings under our revolving line of credit bore interest at the LIBOR rate, plus an applicable margin. The weighted average interest rate on these borrowings was 1.66% as of December 31, 2014. The remaining outstanding balance of \$7.0 million as of December 31, 2014 had been designated to bear interest at the prime rate, plus an applicable margin, which equaled 3.25% with the applicable margin included. The unused and available revolving line of credit balance was \$21.2 million at December 31, 2014. As of December 31, 2014, we had approximately \$4,028,000 outstanding under the term loan, which bore interest at LIBOR

plus 4.50%, which equaled 4.67% with the applicable margin included.

**Contractual obligations and commitments**

There have been no material changes to our contractual obligations and commitments included in Item 7,

Management's Discussion and Analysis of Financial Condition and Results of Operations of our annual report on Form 10-K for the year ended December 31, 2014, except for the issuance of our 5.50% Senior Notes Due 2018 described above and in Note 9, Debt, to our unaudited condensed consolidated financial statements.

**Off-balance sheet arrangements**

We do not have any material off-balance sheet arrangements (as defined in Item 303(a) (4) of Regulation S-K).

**Impact of recently issued accounting standards**

We evaluate the pronouncements of various authoritative accounting organizations, including the Financial Accounting Standards Board (FASB) and the SEC, to determine the impact of new pronouncements on GAAP and our consolidated financial statements. In May of 2014, the FASB and International Accounting Standards Board jointly issued a final standard on revenue recognition which outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers. This standard will supersede most current revenue recognition guidance. Under the new standard, entities are required to identify the following within a contract with a customer: the separate performance obligations in the contract; the transaction price; allocation of the transaction price to the separate performance obligations in the contract; and the appropriate amount of revenue to be recognized when (or as) the entity satisfies each performance obligation. Entities have the option of using either retrospective transition or a modified approach in applying the new standard. On July 9, 2015, the FSAB voted to issue a final Accounting Standards Update (ASU) that defers for one year the effective date of the new revenue standard and allows early

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adoption as of the original effective date (i.e., annual reporting periods beginning after December 15, 2016, including interim reporting periods within those annual periods). After reviewing and discussing the feedback received, the Board decided to adopt the standard as originally proposed. Thus, the anticipated final ASU will be effective for annual reporting periods (including interim reporting periods within those periods) beginning after December 15, 2017. We are currently evaluating the approach to use to apply the new standard and the impact that the adoption of the new standard will have on our unaudited condensed consolidated financial statements.

In April of 2015, the FASB issued guidance to simplify the presentation of debt issuance costs. This new guidance requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. Although the standard is effective for financial statements issued for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years, we chose to early adopt as of June 30, 2015. We have presented the debt issuance costs associated with the issuance of our 5.5% Senior Notes as a direct deduction from the carrying value of the liability as of September 30, 2015. Refer to Note 9, Debt, to our unaudited condensed consolidated financial statements, for a further discussion related to the issuance of our 5.5% Senior Notes.

There were no additional new accounting pronouncements or guidance that have been issued or adopted by authoritative accounting organizations during the three months ended September 30, 2015, that we expect will have a significant effect on our unaudited condensed consolidated financial statements.

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

This report includes forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act), and Section 27A of the Securities Act of 1933, as amended (the Securities Act), that reflect our expectations and projections about our future results, performance, prospects and opportunities. In this report, the words anticipate, believe, could, estimate, expect, intend, may, plan, project, potential, would, and similar expressions, as they relate to us, our business or our management, are intended to identify forward-looking statements, but they are not the exclusive means of identifying them.

A number of risks, uncertainties and other factors could cause our actual results, performance, financial condition, cash flows, prospects and opportunities to differ materially from those expressed in, or implied by, the forward-looking statements included in this report. These risks, uncertainties and other factors, many of which have been previously identified and described in greater detail under the heading Risk Factors in our 2014 Annual Report and in this Form 10-Q, include but are not limited to the following:

## **Risks Related to our Business and our Industry**

*The market for alternative fuel spark-ignited power systems may not continue to develop according to our expectations and, as a result, our business may not grow as planned and our business plan may be adversely affected.*

*Our 8.8 liter engine block is the first engine block manufactured in-house by our company, and may not be successful.*



*We may have difficulty managing the expansion of our operations.*

*We may not succeed with the expansion of our product into the on-road market.*

*New products, including new engines we develop, may not achieve widespread adoption.*

*Changes in environmental and regulatory policies could hurt the market for our products.*

*We currently face, and will continue to face, significant competition, which could result in a decrease in our revenue.*

*Our industrial OEM customers may not continue to outsource their power system needs.*

*We are dependent on certain products and industrial OEM market categories for a significant share of our revenues and profits.*

*We are dependent on relationships with our OEM customers and any change in our relationships with any of our key OEM customers could have a material adverse effect on our business and financial results.*

*We are dependent on relationships with our material suppliers, and the partial or complete loss of one of these key suppliers, or the failure to find replacement suppliers or manufacturers in a timely manner, could adversely affect our business.*

*We derive a substantial majority of our diesel power systems revenues from our relationships with Perkins and Caterpillar.*

*The quality and performance of our power systems are, in part, dependent on the quality of their component parts that we obtain from various suppliers, which makes us susceptible to performance issues that could materially and adversely affect our business, reputation and financial results.*

*We maintain a significant investment in inventory, and a decline in our customers' purchases could lead to a decline in our sales and profitability and cause us to accumulate excess inventory.*

*Changes in our product mix could materially and adversely affect our business.*

*Our financial position, results of operations and cash flows have been, and may in the future be, negatively impacted by challenging global economic conditions.*

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*Fuel price differentials are hard to predict and may have an adverse impact on the demand for our products in the future.*

*The volatility of oil and gas prices may indirectly affect our stock price.*

*Price increases in some of the key components in our power systems could materially and adversely affect our operating results and cash flows.*

*Many of our power systems involve long and variable design and sales cycles, which could have a negative impact on our results of operations for any given quarter or year.*

*Our existing debt or new debt that we incur could adversely affect our business and growth prospects.*

*Our quarterly operating results are subject to variability from quarter to quarter.*

*If we fail to adequately protect our intellectual property rights, we could lose important proprietary technology, which could materially and adversely affect our business.*

*If we face claims of intellectual property infringement by third parties, we could encounter expensive litigation, be liable for significant damages or incur restrictions on our ability to sell our products and services.*

*We could suffer warranty claims or be subject to product liability claims, both of which could materially and adversely affect our business.*

*If we do not properly manage the sales of our products into foreign markets, our business could suffer.*

*If our production facilities become inoperable, our business, including our ability to manufacture our power systems, will be harmed.*

*We may be adversely impacted by work stoppages and other labor matters.*

*Our business could be adversely affected by increased compensation costs, including those related to acquisitions.*

*Difficulties in attracting staff and retaining qualified personnel, including those related to acquisitions, could harm our business.*

*The loss of one or more key members of our senior management and the transition of new members of our senior management could harm our business.*

*Our products could become subject to additional emissions regulations under the EPA if our headcount exceeds threshold amounts codified under federal regulations in the U.S. and the compliance cost and development timing required to support these potential additional regulations could adversely affect our operating results.*

*Governmental regulation may adversely affect our existing and future operations and financial results, including harming our ability to expand or by increasing our operating costs.*

*We could be adversely affected by risks associated with acquisitions and joint ventures, including those in the Asian markets.*

*Failure to raise additional capital or to generate the significant capital necessary to continue our growth could reduce our ability to compete and could harm our business.*

*We are and will continue to be subject to foreign laws, rules and regulations as our business expands into these foreign markets and cannot be certain as to our continued compliance and costs related thereto.*

*We could become liable for damages resulting from our manufacturing activities.*

*We may have unanticipated tax liabilities that could adversely impact our results of operations and financial condition.*

*Changes in accounting standards or inaccurate estimates or assumptions in applying accounting policies could have adverse effects.*

*Variability in self-insurance liability estimates could significantly impact our results of operations.*

#### **Risks Related to the Ownership of our Common Stock**

*We incur significant costs and demands upon management and accounting and finance resources as a result of complying with the laws and regulations affecting public companies; any failure to establish and maintain adequate internal control over financial reporting or to recruit, train and retain necessary accounting and finance personnel could have an adverse effect on our ability to accurately and timely prepare our financial statements.*

*Concentration of ownership among our existing executive officers may prevent new investors from influencing significant corporate decisions.*

*The price of our stock may be volatile and may decline or be subject to fluctuations in value.*

*Future sales by us or our existing stockholders could depress the market price of our common stock.*

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

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*We have discretion in the use of borrowings under our revolving line of credit and may use them in a manner in which our stockholders would not consider appropriate.*

*Anti-takeover provisions contained in our certificate of incorporation and bylaws, as well as provisions of Delaware law, could impair a takeover attempt.*

*Our stockholders may experience significant dilution if future equity offerings are used to fund operations or acquire complementary businesses.*

*If securities or industry analysts cease publishing, research or reports about us, our business or our market, or if they change their recommendations regarding our stock adversely, our stock price and trading volume could decline.*

*We do not anticipate paying any dividends in the foreseeable future.*

Forward looking statements speak only as of the date of this report. Except as expressly required under federal securities laws and the rules and regulations of the SEC, we do not undertake any obligation to update any forward-looking statements to reflect events or circumstances arising after the date of this report, whether as a result of new information or future events or otherwise. You should not place undue reliance on the forward-looking statements included in this report or that may be made elsewhere from time to time by us, or on our behalf. Our results of operations in any past period should not be considered indicative of the results to be expected for future periods. Fluctuations in operating results may also result in fluctuations in the price of our common stock. All forward-looking statements attributable to us are expressly qualified by these cautionary statements.

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

The Company is exposed to changes in interest rates primarily due to its outstanding balances under the Amended Wells Credit Agreement III. If interest rates were to fluctuate, there is a risk that any outstanding balance would be impacted by the prevailing rate, which may further impact our ability to repay the outstanding balance. A one percentage point increase or decrease in interest rates would increase or decrease our interest expense by approximately \$991,000 annually based on our revolving line of credit outstanding as of September 30, 2015. Our 5.50% Senior Notes outstanding as of September 30, 2015 are fixed and not subject to changes in interest rates.

For a discussion of our liability for the Private Placement Warrants, see Note 8, Fair value of financial instruments, to the unaudited condensed consolidated financial statements.

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

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

We maintain a system of disclosure controls and procedures that is designed to ensure that information required to be disclosed in the reports that we file or submit under the Securities Exchange Act of 1934, as amended (the Exchange Act), is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely

decisions regarding required disclosure.

As of the end of the period covered by this report and pursuant to Rule 13a-15(b) under the Exchange Act, our management, including the Chief Executive Officer and Chief Financial Officer, conducted an evaluation of the effectiveness and design of our disclosure controls and procedures (as that term is defined in Rule 13a-15(b) under the Exchange Act). Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of the end of the period covered under this report.

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

Except as described below, there have been no changes in our internal control over financial reporting during the quarter ended September 30, 2015 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

In the period covered under this report, we acquired three companies whose operations were not deemed to be significant for purposes of internal control over financial reporting. It is our intent to exclude the operations of these companies from the scope of our report on internal control over financial reporting for the year ending December 31, 2015. We will begin the process of evaluating controls of these companies and implementing any additional internal control structure over the acquired operations during 2015. We expect that the necessary and appropriate internal controls will be in place beginning in 2016, and the acquired companies will be included within the scope of our report on internal control for the year ending December 31, 2016.

### **Inherent Limitations on the Effectiveness of Controls**

Our management does not expect that our disclosure controls and procedures or our internal controls will prevent or detect all errors and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in a cost-effective control system, no controls can provide absolute assurance that misstatements due to error or fraud will not occur, and no evaluation of any such controls can provide absolute assurance that control issues and instances of fraud, if any, within our company have been detected.

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These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple error or mistake. Controls can also be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is based in part on certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Projections of any evaluation of controls' effectiveness to future periods are subject to risks. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with policies and procedures.

## **PART II. OTHER INFORMATION**

### **Item 1. Legal Proceedings**

From time to time, in the normal course of business, we are party to various legal proceedings. Presently, we do not expect that any current pending legal proceedings will have a material adverse effect on our business, results of operations or financial condition.

### **Item 1.A. Risk Factors**

There are no material changes from the risk factors previously disclosed under the caption "Risk Factors" in Item 1A of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2014 and in Item 1A of our Quarterly Report on Form 10-Q for the period ended March 31, 2015.

### **Item 5. Other Information**

The Company has rescheduled the 2016 Annual Meeting of Stockholders for April 28, 2016 at 10:00 a.m. central time. Therefore, in accordance with Rule 14a-8 under the Exchange Act, proposals of stockholders for the 2016 Annual Meeting of Stockholders will not be included in the proxy statement for that annual meeting unless the proposal is proper for inclusion in the proxy statement and is received by the Secretary of the Company at our principal executive offices not later than January 29, 2016.

Further, pursuant to Rule 14a-4(c)(1) under the Exchange Act, if stockholders desiring to bring business before the 2016 Annual Meeting of Stockholders, including proposals with respect to stockholder nominations of persons for election to the Board, other than business to be included in the Company's proxy materials pursuant to Regulation 14a-8, fail to provide notice to the Secretary of the Company at our principal executive offices by February 26, 2016, the proxy for the 2016 Annual Meeting of Stockholders will confer discretionary authority to vote on such business.

### **Item 6. Exhibits**

See Exhibit Index.



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**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.

POWER SOLUTIONS INTERNATIONAL, INC.

Date: November 9, 2015

By: /s/ Michael P. Lewis  
Michael P. Lewis  
Chief Financial Officer  
(Principal Financial and Accounting Officer)

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<b>Exhibit</b>	<b>Description</b>
3.1	Amended and Restated Bylaws of Power Solutions International, Inc., dated August 13, 2015 (incorporated by reference from Exhibit 3.1 to the registrant's Current Report on Form 8-K dated August 13, 2015 and filed with the Commission on August 18, 2015).
10.1*	SAR and Bonus Agreement, dated as of July 6, 2015, by and between Power Solutions International, Inc. and Eric A. Cohen (incorporated by reference from Exhibit 10.1 to the registrant's Current Report on Form 8-K, dated and filed with the Commission on July 8, 2015).
10.2*	Cooperation and Transition Agreement, dated October 4, 2015, by and between Power Solutions International, Inc. and Daniel P. Gorey (incorporated by reference from Exhibit 10.1 to the registrant's Current Report on Form 8-K dated October 2, 2015 and filed with the Commission on October 6, 2015).
10.3*	Executive Employment Agreement, dated October 2, 2015, by and between Power Solutions International, Inc. and Michael P. Lewis (incorporated by reference from Exhibit 10.2 to the registrant's Current Report on Form 8-K dated October 2, 2015 and filed with the Commission on October 6, 2015).
10.4*	Stock Appreciation Rights Agreement, dated October 19, 2015, by and between Power Solutions International, Inc. and Michael P. Lewis (incorporated by reference from Exhibit 10.1 to the registrant's Current Report on Form 8-K dated October 19, 2015 and filed with the Commission on October 22, 2015).
31.1	Certification of the Chief Executive Officer pursuant to Exchange Act Rule 13a-14(a).
31.2	Certification of the Chief Financial Officer pursuant to Exchange Act Rule 13a-14(a).
32.1	Certification of the Chief Executive Officer pursuant to Section 906 of the Sarbanes Oxley Act of 2002.
32.2	Certification of the Chief Financial Officer pursuant to Section 906 of the Sarbanes Oxley Act of 2002.

\* Indicates management contract or compensatory plan or arrangement.

101.INS	XBRL Instance Document.
101.SCH	XBRL Taxonomy Extension Schema Document.
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document.
101.LAB	XBRL Taxonomy Extension Labels Linkbase Document.
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document.
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document.