

ORION ENERGY SYSTEMS, INC.

Form 10-Q

November 09, 2011

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

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934  
For the Quarterly Period Ended September 30, 2011**

**OR**

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934  
Commission file number 001-33887  
Orion Energy Systems, Inc.**

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

**Wisconsin**

**39-1847269**

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

**(I.R.S. Employer Identification number)**

**2210 Woodland Drive, Manitowoc, Wisconsin**

**54220**

**(Address of principal executive offices)**

**(Zip code)**

**Registrant's telephone number, including area code: (920) 892-9340**

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes  No   
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405) during the preceding 12 months (or for shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of accelerated filer, large 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   
(Do not check if a 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

There were 23,010,653 shares of the Registrant's common stock outstanding on November 4, 2011.



**Orion Energy Systems, Inc.**  
**Quarterly Report On Form 10-Q**  
**For The Quarter Ended September 30, 2011**  
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**Table of Contents****PART I FINANCIAL INFORMATION****Item 1: Financial Statements**

**ORION ENERGY SYSTEMS, INC. AND SUBSIDIARIES**  
**UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS**  
(in thousands, except share and per share amounts)

|  | <b>March 31,<br/>2011</b> | <b>September 30,<br/>2011</b> |
|--|---------------------------|-------------------------------|
| <b>Assets</b>  |                           |                               |
| Cash and cash equivalents  | \$ 11,560                 | \$ 15,559                     |
| Short-term investments   | 1,011                     | 1,014                         |
| Accounts receivable, net of allowances of \$436 and \$485  | 27,618                    | 21,637                        |
| Inventories, net   | 29,507                    | 32,844                        |
| Deferred tax assets  | 947                       | 1,268                         |
| Prepaid expenses and other current assets  | 2,499                     | 4,052                         |
| <br>   |                           |                               |
| Total current assets   | 73,142                    | 76,374                        |
| Property and equipment, net  | 30,017                    | 30,233                        |
| Patents and licenses, net  | 1,620                     | 1,677                         |
| Long-term accounts receivable  | 6,030                     | 7,948                         |
| Deferred tax assets  | 2,112                     | 2,358                         |
| Other long-term assets   | 2,069                     | 1,984                         |
| <br>   |                           |                               |
| Total assets   | \$ 114,990                | \$ 120,574                    |
| <br>   |                           |                               |
| <b>Liabilities and Shareholders Equity</b>   |                           |                               |
| Accounts payable   | \$ 12,479                 | \$ 10,384                     |
| Accrued expenses and other   | 2,324                     | 2,683                         |
| Deferred revenue, current  | 262                       | 3,077                         |
| Current maturities of long-term debt   | 1,137                     | 2,351                         |
| <br>   |                           |                               |
| Total current liabilities  | 16,202                    | 18,495                        |
| Long-term debt, less current maturities  | 4,225                     | 6,930                         |
| Deferred revenue, long-term  | 1,777                     | 1,583                         |
| Other long-term liabilities  | 399                       | 400                           |
| <br>   |                           |                               |
| Total liabilities  | 22,603                    | 27,408                        |
| <br>   |                           |                               |
| Commitments and contingencies (See Note F)   |                           |                               |
| Shareholders equity:   |                           |                               |
| Preferred stock, \$0.01 par value: Shares authorized: 30,000,000 shares at March 31, 2011 and September 30, 2011; no shares issued and outstanding at March 31, 2011 and September 30, 2011  |                           |                               |
| Common stock, no par value: Shares authorized: 200,000,000 at March 31, 2011 and September 30, 2011; shares issued: 30,312,758 and 30,403,067 at March 31, 2011 and September 30, 2011; shares outstanding: 22,893,803 and 23,010,653 at March 31, 2011 and September 30, 2011 |                           |                               |
| Additional paid-in capital   | 124,805                   | 126,002                       |
| Shareholder notes receivable   | (193)                     | (244)                         |

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|   |            |            |
|---|------------|------------|
| Treasury stock: 7,418,955 and 7,392,414 common shares at March 31, 2011 and<br>September 30, 2011 | (31,708)   | (31,757)   |
| Accumulated deficit   | (517)      | (835)      |
| Total shareholders' equity  | 92,387     | 93,166     |
| Total liabilities and shareholders' equity  | \$ 114,990 | \$ 120,574 |

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

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**ORION ENERGY SYSTEMS, INC. AND SUBSIDIARIES**  
**UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
(in thousands, except share and per share amounts)

|  | Three Months Ended September |            | Six Months Ended September |            |
|--|------------------------------|------------|----------------------------|------------|
|  | 30,                          |            | 30,                        |            |
|  | 2010                         | 2011       | 2010                       | 2011       |
| Product revenue  | \$ 15,086                    | \$ 18,718  | \$ 30,844                  | \$ 40,397  |
| Service revenue  | 767                          | 542        | 1,986                      | 1,637      |
| Total revenue  | 15,853                       | 19,260     | 32,830                     | 42,034     |
| Cost of product revenue  | 9,745                        | 12,059     | 20,053                     | 27,063     |
| Cost of service revenue  | 498                          | 382        | 1,415                      | 1,116      |
| Total cost of revenue  | 10,243                       | 12,441     | 21,468                     | 28,179     |
| Gross profit   | 5,610                        | 6,819      | 11,362                     | 13,855     |
| Operating expenses:  |                              |            |                            |            |
| General and administrative   | 2,988                        | 2,724      | 5,933                      | 5,800      |
| Sales and marketing  | 3,299                        | 3,736      | 6,889                      | 7,504      |
| Research and development   | 573                          | 593        | 1,183                      | 1,215      |
| Total operating expenses   | 6,860                        | 7,053      | 14,005                     | 14,519     |
| Loss from operations   | (1,250)                      | (234)      | (2,643)                    | (664)      |
| Other income (expense):  |                              |            |                            |            |
| Interest expense   | (55)                         | (150)      | (124)                      | (237)      |
| Dividend and interest income   | 153                          | 214        | 246                        | 368        |
| Total other income   | 98                           | 64         | 122                        | 131        |
| Loss before income tax   | (1,152)                      | (170)      | (2,521)                    | (533)      |
| Income tax benefit   | (1,692)                      | (71)       | (2,525)                    | (215)      |
| Net income (loss)  | \$ 540                       | \$ (99)    | \$ 4                       | \$ (318)   |
| Basic net income (loss) per share<br>attributable to common shareholders   | \$ 0.02                      | \$ 0.00    | \$ 0.00                    | \$ (0.01)  |
| Weighted-average common shares<br>outstanding                              | 22,638,638                   | 22,989,502 | 22,581,188                 | 22,955,655 |
| Diluted net income (loss) per share<br>attributable to common shareholders | \$ 0.02                      | \$ 0.00    | \$ 0.00                    | \$ (0.01)  |
| Weighted-average common shares<br>outstanding                              | 22,901,590                   | 22,989,502 | 23,007,067                 | 22,955,655 |

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





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**ORION ENERGY SYSTEMS, INC. AND SUBSIDIARIES**  
**UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(in thousands)

|  | Six Months Ended September |                |
|--|----------------------------|----------------|
|  | 30,                        |                |
|  | 2010                       | 2011           |
| <b>Operating activities</b>  |                            |                |
| Net income (loss)  | \$ 4                       | \$ (318)       |
| Adjustments to reconcile net income (loss) to net cash used in operating activities: |                            |                |
| Depreciation and amortization  | 1,543                      | 1,876          |
| Stock-based compensation expense   | 611                        | 657            |
| Deferred income tax benefit  | (1,374)                    | (567)          |
| Change in allowance for notes and accounts receivable                                | 64                         | 49             |
| Other  | 34                         | 37             |
| Changes in operating assets and liabilities:   |                            |                |
| Accounts receivable  | 2,546                      | 4,014          |
| Inventories  | (7,715)                    | (3,337)        |
| Prepaid expenses and other   | (6,454)                    | (1,373)        |
| Deferred revenue   | 991                        | 2,621          |
| Accounts payable   | 1,474                      | (2,095)        |
| Accrued expenses   | (357)                      | 360            |
| <b>Net cash provided by (used in) operating activities</b>                           | <b>(8,633)</b>             | <b>1,924</b>   |
| <b>Investing activities</b>  |                            |                |
| Purchase of property and equipment   | (1,957)                    | (2,003)        |
| Purchase of property and equipment held under operating leases                       | (1,630)                    | (3)            |
| Purchase of short-term investments   | (7)                        | (3)            |
| Additions to patents and licenses  | (110)                      | (125)          |
| Proceeds from sales of property, plant and equipment                                 | 1                          | 1              |
| Long-term assets   | (330)                      |                |
| <b>Net cash used in investing activities</b>   | <b>(4,033)</b>             | <b>(2,133)</b> |
| <b>Financing activities</b>  |                            |                |
| Payment of long-term debt  | (271)                      | (664)          |
| Proceeds from long-term debt   | 2,689                      | 4,583          |
| Proceeds from repayment of shareholder notes   |                            | 13             |
| Excess tax benefits from stock-based compensation                                    |                            | 271            |
| Deferred financing costs   | (61)                       | (113)          |
| Proceeds from issuance of common stock   | 269                        | 118            |
| <b>Net cash provided by financing activities</b>                                     | <b>2,626</b>               | <b>4,208</b>   |
| Net increase (decrease) in cash and cash equivalents                                 | (10,040)                   | 3,999          |
| Cash and cash equivalents at beginning of period                                     | 23,364                     | 11,560         |
| Cash and cash equivalents at end of period   | \$ 13,324                  | \$ 15,559      |

**Supplemental cash flow information:**

|                            |    |     |    |     |
|----------------------------|----|-----|----|-----|
| Cash paid for interest     | \$ | 126 | \$ | 201 |
| Cash paid for income taxes |    | 28  |    | 63  |

**Supplemental disclosure of non-cash investing and financing activities:**

|   |    |     |    |    |
|---|----|-----|----|----|
| Shares issued from treasury for shareholder note receivable | \$ | 121 | \$ | 64 |
| Shares surrendered into treasury from stock option exercise | \$ | 51  |    |    |

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

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**ORION ENERGY SYSTEMS, INC. AND SUBSIDIARIES**

**UNAUDITED NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE A DESCRIPTION OF BUSINESS**

***Organization***

The Company includes Orion Energy Systems, Inc., a Wisconsin corporation, and all consolidated subsidiaries. The Company is a developer, manufacturer and seller of lighting and energy management systems and a seller and integrator of renewable energy technologies to commercial and industrial businesses, predominantly in North America.

In August 2009, the Company created Orion Engineered Systems, a new operating division offering additional alternative renewable energy systems. During the quarter ended December 31, 2010, the new division exceeded the thresholds for segment reporting and, accordingly, the Company introduced the presentation of operating segments in that quarter. See Note I Segment Reporting of these financial statements for further discussion of our reportable segments.

The Company's corporate offices and manufacturing operations are located in Manitowoc, Wisconsin and an operations facility occupied by Orion Engineered Systems is located in Plymouth, Wisconsin.

**NOTE B SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

***Principles of Consolidation***

The condensed consolidated financial statements include the accounts of Orion Energy Systems, Inc. and its wholly-owned subsidiaries. All significant intercompany transactions and balances have been eliminated in consolidation.

***Reclassifications***

Where appropriate, certain reclassifications have been made to prior years' financial statements to conform to the current year presentation.

***Basis of Presentation***

The accompanying unaudited condensed consolidated financial statements of the Company have been prepared in accordance with accounting principles generally accepted in the United States (GAAP) for interim financial information and with the rules and regulations of the Securities and Exchange Commission. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments, consisting of normal recurring adjustments, considered necessary for a fair presentation have been included. Interim results are not necessarily indicative of results that may be expected for the fiscal year ending March 31, 2012 or other interim periods.

The condensed consolidated balance sheet at March 31, 2011 has been derived from the audited consolidated financial statements at that date but does not include all of the information required by GAAP for complete financial statements.

The accompanying unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and footnotes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended March 31, 2011 filed with the Securities and Exchange Commission on July 22, 2011.

***Use of Estimates***

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during that reporting period. Areas that require the use of significant management estimates include revenue recognition, inventory obsolescence and bad debt reserves, accruals for warranty expenses, income taxes and certain equity transactions. Accordingly, actual results could differ from those estimates.

**Table of Contents****Cash and Cash Equivalents**

The Company considers all highly liquid, short-term investments with original maturities of three months or less to be cash equivalents.

**Short-term Investments**

The amortized cost and fair value of marketable securities, with gross unrealized gains and losses, as of March 31, 2011 and September 30, 2011 were as follows (in thousands):

|                             | March 31, 2011 |            |            |          | Cash and<br>Cash<br>Equivalents | Short<br>Term<br>Investments |
|-----------------------------|----------------|------------|------------|----------|---------------------------------|------------------------------|
|                             | Amortized      | Unrealized | Unrealized | Fair     |                                 |                              |
|                             | Cost           | Gains      | Losses     | Value    |                                 |                              |
| Money market funds          | \$ 485         | \$         | \$         | \$ 485   | \$ 485                          | \$                           |
| Bank certificate of deposit | 1,011          |            |            | 1,011    |                                 | 1,011                        |
| Total                       | \$ 1,496       | \$         | \$         | \$ 1,496 | \$ 485                          | \$ 1,011                     |

|                             | September 30, 2011 |            |            |          | Cash and<br>Cash<br>Equivalents | Short<br>Term<br>Investments |
|-----------------------------|--------------------|------------|------------|----------|---------------------------------|------------------------------|
|                             | Amortized          | Unrealized | Unrealized | Fair     |                                 |                              |
|                             | Cost               | Gains      | Losses     | Value    |                                 |                              |
| Money market funds          | \$ 485             | \$         | \$         | \$ 485   | \$ 485                          | \$                           |
| Bank certificate of deposit | 1,014              |            |            | 1,014    |                                 | 1,014                        |
| Total                       | \$ 1,499           | \$         | \$         | \$ 1,499 | \$ 485                          | \$ 1,014                     |

As of March 31, 2011 and September 30, 2011, the Company's financial assets described in the table above were measured at fair value on a recurring basis employing quoted prices in active markets for identical assets (level 1 inputs).

The Company's certificate of deposit is pledged as security for an equipment lease.

**Fair Value of Financial Instruments**

The carrying amounts of the Company's financial instruments, which include cash and cash equivalents, investments, accounts receivable, and accounts payable, approximate their respective fair values due to the relatively short-term nature of these instruments. Based upon interest rates currently available to the Company for debt with similar terms, the carrying value of the Company's long-term debt is also approximately equal to its fair value. Valuation techniques used to measure fair value must maximize the use of observable inputs and minimize the use of unobservable inputs. GAAP describes a fair value hierarchy based on the following three levels of inputs, of which the first two are considered observable and the last unobservable, that may be used to measure fair value:

Level 1 Valuations are based on unadjusted quoted prices in active markets for identical assets or liabilities.

Level 2 Valuations are based on quoted prices for similar assets or liabilities in active markets, or quoted prices in markets that are not active for which significant inputs are observable, either directly or indirectly.

Level 3 Valuations are based on prices or valuation techniques that require inputs that are both unobservable and significant to the overall fair value measurement. Inputs reflect management's best estimate of what market participants would use in valuing the asset or liability at the measurement date.

**Accounts Receivable**

The majority of the Company's accounts receivable are due from companies in the commercial, industrial and agricultural industries, as well as from wholesalers. Credit is extended based on an evaluation of a customer's financial

condition. Generally, collateral is not required for end users; however, the payment of certain trade accounts receivable from wholesalers is secured by irrevocable standby letters of credit. Accounts receivable are due within 30-60 days. Accounts receivable are stated at the amount the Company expects to collect from outstanding balances. The Company provides for probable uncollectible amounts through a charge to earnings and a credit to an allowance for doubtful accounts based on its assessment of the current status of individual accounts. Balances that are still outstanding after the Company has used reasonable collection efforts are written off through a charge to the allowance for doubtful accounts and a credit to accounts receivable.

**Table of Contents****Financing Receivables**

The Company considers its lease balances included in consolidated current and long-term accounts receivable from its Orion Throughput Agreement, or OTA, sales-type leases to be financing receivables. Additional disclosures on the credit quality of the Company's OTA receivables included in accounts receivable are as follows:

*Aging Analysis as of September 30, 2011 (in thousands):*

|   | Not Past<br>Due | 1-90 days<br>past due | Greater than<br>90<br>days past due | Total past<br>due | Total<br>sales-type<br>leases |
|---|-----------------|-----------------------|-------------------------------------|-------------------|-------------------------------|
| Lease balances included in consolidated accounts receivable current   | \$ 2,659        | \$ 32                 | \$ 11                               | \$ 43             | \$ 2,702                      |
| Lease balances included in consolidated accounts receivable long-term | 5,442           |                       |                                     |                   | 5,442                         |
| Total gross sales-type leases   | 8,101           | 32                    | 11                                  | 43                | 8,144                         |
| Allowance   |                 |                       | (7)                                 | (7)               | (7)                           |
| Total net sales-type leases   | \$ 8,101        | \$ 32                 | \$ 4                                | \$ 36             | \$ 8,137                      |

**Allowance for Credit Losses**

The Company's allowance for credit losses is based on management's assessment of the collectability of customer accounts. A considerable amount of judgment is required in order to make this assessment, including a detailed analysis of the aging of the lease receivables and the current credit worthiness of the Company's customers and an analysis of historical bad debts and other adjustments. If there is a deterioration of a major customer's credit worthiness or if actual defaults are higher than historical experience, the estimate of the recoverability of amounts due could be adversely affected. The Company reviews in detail the allowance for doubtful accounts on a quarterly basis and adjusts the allowance estimate to reflect actual portfolio performance and any changes in future portfolio performance expectations. The Company did not incur any provision write-offs or credit losses against its OTA sales-type lease receivable balances in either fiscal 2011 or for the six months ended September 30, 2011.

**Inventories**

Inventories consist of raw materials and components, such as ballasts, metal sheet and coil stock and molded parts; work in process inventories, such as frames and reflectors; and finished goods, including completed fixtures and systems, and wireless energy management systems and accessories, such as lamps, meters and power supplies. All inventories are stated at the lower of cost or market value with cost determined using the first-in, first-out (FIFO) method. The Company reduces the carrying value of its inventories for differences between the cost and estimated net realizable value, taking into consideration usage in the preceding 12 months, expected demand, and other information indicating obsolescence. The Company records as a charge to cost of product revenue the amount required to reduce the carrying value of inventory to net realizable value. As of March 31, 2011 and September 30, 2011, the Company had inventory obsolescence reserves of \$811,000 and \$818,000, respectively.

Costs associated with the procurement and warehousing of inventories, such as inbound freight charges and purchasing and receiving costs, are also included in cost of product revenue.

Inventories were comprised of the following (in thousands):

|                              | March 31,<br>2011 | September 30,<br>2011 |
|------------------------------|-------------------|-----------------------|
| Raw materials and components | \$ 12,005         | \$ 12,347             |

|                 |           |           |
|-----------------|-----------|-----------|
| Work in process | 459       | 1,103     |
| Finished goods  | 17,043    | 19,394    |
|                 | \$ 29,507 | \$ 32,844 |

***Prepaid Expenses and Other Current Assets***

Prepaid expenses and other current assets consist primarily of deferred costs related to in-process OTA projects, prepaid insurance premiums, prepaid license fees, purchase deposits, advance payments to contractors, advance commission payments and miscellaneous receivables.

**Table of Contents****Property and Equipment**

Property and equipment were comprised of the following (in thousands):

|   | <b>March 31,<br/>2011</b> | <b>September 30,<br/>2011</b> |
|---|---------------------------|-------------------------------|
| Land and land improvements                                    | \$ 1,474                  | \$ 1,489                      |
| Buildings   | 15,104                    | 15,170                        |
| Furniture, fixtures and office equipment                      | 8,323                     | 10,613                        |
| Leasehold improvements  | 9                         | 54                            |
| Equipment leased to customers under Power Purchase Agreements | 4,994                     | 4,997                         |
| Plant equipment   | 8,067                     | 8,461                         |
| Construction in progress                                      | 2,272                     | 1,411                         |
|   | 40,243                    | 42,195                        |
| Less: accumulated depreciation and amortization               | (10,226)                  | (11,962)                      |
| Net property and equipment                                    | \$ 30,017                 | \$ 30,233                     |

Depreciation is provided over the estimated useful lives of the respective assets, using the straight-line method. Depreciable lives by asset category are as follows:

|  |  |
|--|--|
| Land improvements                        | 10 15 years                            |
| Buildings                                | 10 39 years                            |
| Leasehold improvements                   | Shorter of asset life or life of lease |
| Furniture, fixtures and office equipment | 2 10 years                             |
| Plant equipment                          | 3 10 years                             |

**Patents and Licenses**

Patents and licenses are amortized over their estimated useful life, ranging from 7 to 17 years, using the straight line method.

**Long-Term Receivables**

The Company records a long-term receivable for the non-current portion of its sales-type capital lease OTA contracts. The receivable is recorded at the net present value of the future cash flows from scheduled customer payments. The Company uses the implied cost of capital from each individual contract as the discount rate. Long-term receivables from OTA contracts were \$5.4 million as of September 30, 2011.

Also included in other long-term receivables are amounts due from a third party finance company to which the Company has sold, without recourse, the future cash flows from OTAs entered into with customers. Such receivables are recorded at the present value of the future cash flows discounted between 8.8% and 11%. As of September 30, 2011, the following amounts were due from the third party finance company in future periods (in thousands):

|                                    |        |
|------------------------------------|--------|
| Fiscal 2013                        | \$ 955 |
| Fiscal 2014                        | 1,015  |
| Fiscal 2015                        | 958    |
| Fiscal 2016                        | 310    |
| Fiscal 2017                        | 9      |
| Total gross long-term receivable   | 3,247  |
| Less: amount representing interest | (690)  |



Net long-term receivable \$ 2,557

***Other Long-Term Assets***

Other long-term assets include long-term security deposits, prepaid licensing costs and deferred financing costs. Other long-term assets include \$55,000 and \$152,000 of deferred financing costs as of March 31, 2011 and September 30, 2011. Deferred financing costs related to debt issuances are amortized to interest expense over the life of the related debt issue (2 to 10 years).

**Table of Contents****Accrued Expenses**

Accrued expenses include warranty accruals, accrued wages and benefits, accrued vacation, sales tax payable and other various unpaid expenses. No accrued expenses exceeded 5% of current liabilities as of either March 31, 2011, or September 30, 2011.

The Company generally offers a limited warranty of one year on its own manufactured products in addition to those standard warranties offered by major original equipment component manufacturers. The manufacturers' warranties cover lamps and ballasts, which are significant components in the Company's manufactured products.

Changes in the Company's warranty accrual were as follows (in thousands):

|                                      | <b>Three Months Ended</b> |             | <b>Six Months Ended</b> |             |
|--------------------------------------|---------------------------|-------------|-------------------------|-------------|
|                                      | <b>September 30,</b>      |             | <b>September 30,</b>    |             |
|                                      | <b>2010</b>               | <b>2011</b> | <b>2010</b>             | <b>2011</b> |
| Beginning of period                  | \$ 59                     | \$ 59       | \$ 60                   | \$ 59       |
| Provision to product cost of revenue | 27                        | 28          | 75                      | 59          |
| Charges                              | (27)                      | (22)        | (76)                    | (53)        |
| End of period                        | \$ 59                     | \$ 65       | \$ 59                   | \$ 65       |

**Revenue Recognition**

The Company offers a financing program, called an OTA, for a customer's lease of the Company's energy management systems. The OTA is structured as a sales-type capital lease and upon successful installation of the system and customer acknowledgement that the system is operating as specified, product revenue is recognized at the Company's net investment in the lease, which typically is the net present value of the future cash flows.

The Company offers a separate program, called a power purchase agreement, or PPA, for the Company's renewable energy product offerings. A PPA is a supply side agreement for the generation of electricity and subsequent sale to the end user. Upon the customer's acknowledgement that the system is operating as specified, product revenue is recognized on a monthly basis over the life of the PPA contract, typically in excess of 10 years.

Other than for OTA and PPA sales, revenue is recognized when the following four criteria are met:

persuasive evidence of an arrangement exists;

delivery has occurred and title has passed to the customer;

the sales price is fixed and determinable and no further obligation exists; and

collectability is reasonably assured

These four criteria are met for the Company's product-only revenue upon delivery of the product and title passing to the customer. At that time, the Company provides for estimated costs that may be incurred for product warranties and sales returns. Revenues are presented net of sales tax and other sales related taxes.

For sales contracts consisting of multiple elements of revenue, such as a combination of product sales and services, the Company determines revenue by allocating the total contract revenue to each element based on their relative selling prices. In such circumstances, the Company uses a hierarchy to determine the selling price to be used for allocating revenue to deliverables: (1) vendor-specific objective evidence (VSOE) of fair value, if available, (2) third-party evidence (TPE) of selling price if VSOE is not available, and (3) best estimate of the selling price if neither VSOE nor TPE is available (a description as to how the Company determined VSOE, TPE and estimated selling price is provided below).

The nature of the Company's multiple element arrangements is similar to a construction project, with materials being delivered and contracting and project management activities occurring according to an installation schedule. The significant deliverables include the shipment of products and related transfer of title and the installation.



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To determine the selling price in multiple-element arrangements, the Company established VSOE of the selling price for its HIF lighting and energy management system products using the price charged for a deliverable when sold separately. In addition, the Company records in service revenue the selling price for its installation and recycling services using management's best estimate of selling price, as VSOE or TPE evidence does not exist. Service revenue is recognized when services are completed and customer acceptance has been received. Recycling services provided in connection with installation entail the disposal of the customer's legacy lighting fixtures. The Company's service revenues, other than for installation and recycling that are completed prior to delivery of the product, are included in product revenue using management's best estimate of selling price, as VSOE or TPE evidence does not exist. These services include comprehensive site assessment, site field verification, utility incentive and government subsidy management, engineering design, and project management. For these services and for installation and recycling services, management's best estimate of selling price is determined by considering several external and internal factors including, but not limited to, pricing practices, margin objectives, competition, geographies in which the Company offers its products and services and internal costs. The determination of estimated selling price is made through consultation with and approval by management, taking into account all of the preceding factors.

To determine the selling price for solar renewable product and services sold through the Company's Engineered Systems division, the Company uses management's best estimate of selling price giving consideration to external and internal factors including, but not limited to, pricing practices, margin objectives, competition, scope and size of individual projects, geographies in which the Company offers its products and services and internal costs. The Company has completed a limited number of renewable project sales and accordingly, does not have sufficient VSOE or TPE evidence.

Costs of products delivered, and services performed, that are subject to additional performance obligations or customer acceptance are deferred and recorded in prepaid expenses and other current assets on the Consolidated Balance Sheet. These deferred costs are expensed at the time the related revenue is recognized. Deferred costs amounted to \$0.8 million and \$2.4 million as of March 31, 2011 and September 30, 2011.

Deferred revenue relates to advance customer billings, investment tax grants received related to PPAs and a separate obligation to provide maintenance on OTAs, and is classified as a liability on the Consolidated Balance Sheet. The fair value of the maintenance is readily determinable based upon pricing from third-party vendors. Deferred revenue related to maintenance services is recognized when the services are delivered, which occurs in excess of a year after the original OTA is executed.

Deferred revenue was comprised of the following (in thousands):

|  | <b>March 31,<br/>2011</b> | <b>September 30,<br/>2011</b> |
|--|---------------------------|-------------------------------|
| Deferred revenue - current liability   | \$ 262                    | \$ 3,077                      |
| Deferred revenue - long term liability | 1,777                     | 1,583                         |
| Total deferred revenue                 | \$ 2,039                  | \$ 4,660                      |

**Income Taxes**

The Company recognizes deferred tax assets and liabilities for the future tax consequences of temporary differences between financial reporting and income tax basis of assets and liabilities, measured using the enacted tax rates and laws expected to be in effect when the temporary differences reverse. Deferred income taxes also arise from the future tax benefits of operating loss and tax credit carryforwards. A valuation allowance is established when management determines that it is more likely than not that all or a portion of a deferred tax asset will not be realized.

ASC 740, *Income Taxes*, also prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of tax positions taken or expected to be taken in a tax return. For those benefits to be recognized, a tax position must be more-likely-than-not to be sustained upon examination. The Company has classified the amounts recorded for uncertain tax benefits in the balance sheet as other liabilities (non-current) to the extent that payment is not anticipated within one year. The Company recognizes penalties and interest related to

uncertain tax liabilities in income tax expense. Penalties and interest are immaterial and are included in the unrecognized tax benefits.

Deferred tax benefits have not been recognized for income tax effects resulting from the exercise of non-qualified stock options. These benefits will be recognized in the period in which the benefits are realized as a reduction in taxes payable and an increase in additional paid-in capital. For the six months ended September 30, 2010 and 2011, there were none and \$0.3 million realized tax benefits from the exercise of stock options.

**Table of Contents****Stock Option Plans**

The fair value of each option grant for the three and six months ended September 30, 2010 and 2011 was determined using the assumptions in the following table:

|                                | Three months Ended<br>September 30, |           | Six months Ended September<br>30, |             |
|--------------------------------|-------------------------------------|-----------|-----------------------------------|-------------|
|                                | 2010                                | 2011      | 2010                              | 2011        |
| Weighted average expected term | 8.3 years                           | 6.8 years | 5.8 years                         | 5.7 years   |
| Risk-free interest rate        | 2.24%                               | 1.64%     | 2.25%                             | 1.83%       |
| Expected volatility            | 60%                                 | 49.5%     | 60%                               | 49.5%-58.4% |
| Expected forfeiture rate       | 10%                                 | 11.4%     | 10%                               | 11.4%       |
| Expected dividend yield        | 0%                                  | 0%        | 0%                                | 0%          |

**Net Income (Loss) per Common Share**

Basic net income (loss) per common share is computed by dividing net income (loss) attributable to common shareholders by the weighted-average number of common shares outstanding for the period and does not consider common stock equivalents.

Diluted net income per common share reflects the dilution that would occur if warrants and employee stock options were exercised. In the computation of diluted net income per common share, the Company uses the treasury stock method for outstanding options and warrants. Diluted net loss per common share is the same as basic net loss per common share for the periods ended September 30, 2011, because the effects of potentially dilutive securities are anti-dilutive. The effect of net income (loss) per common share is calculated based upon the following shares (in thousands except share amounts):

|   | Three months Ended September<br>30, |            | Six months Ended September<br>30, |            |
|---|-------------------------------------|------------|-----------------------------------|------------|
|   | 2010                                | 2011       | 2010                              | 2011       |
| Numerator:  |                                     |            |                                   |            |
| Net income (loss) (in thousands)  | \$ 540                              | \$ (99)    | \$ 4                              | \$ (318)   |
| Denominator:  |                                     |            |                                   |            |
| Weighted-average common shares outstanding                                  | 22,638,638                          | 22,989,502 | 22,581,188                        | 22,955,655 |
| Weighted-average effect of assumed conversion of stock options and warrants | 262,952                             |            | 425,879                           |            |
| Weighted-average common shares and common share equivalents outstanding     | 22,901,590                          | 22,989,502 | 23,007,067                        | 22,955,655 |
| Net income (loss) per common share:   |                                     |            |                                   |            |
| Basic   | \$ 0.02                             | \$ 0.00    | \$ 0.00                           | \$ (0.01)  |
| Diluted   | \$ 0.02                             | \$ 0.00    | \$ 0.00                           | \$ (0.01)  |

The following table indicates the number of potentially dilutive securities as of the end of each period:

|                       | September 30,<br>2010 | September 30,<br>2011 |
|-----------------------|-----------------------|-----------------------|
| Common stock options  | 3,638,252             | 4,018,917             |
| Common stock warrants | 76,240                | 38,980                |

|       |           |           |
|-------|-----------|-----------|
| Total | 3,714,492 | 4,057,897 |
|-------|-----------|-----------|

***Concentration of Credit Risk and Other Risks and Uncertainties***

The Company currently depends on one supplier for a number of components necessary for its products, including ballasts and lamps. If the supply of these components were to be disrupted or terminated, or if this supplier were unable to supply the quantities of components required, the Company may have short-term difficulty in locating alternative suppliers at required volumes. Purchases from this supplier accounted for 44% and 15% of total cost of revenue for the three months ended September 30, 2010 and 2011 and 34% and 13% of total cost of revenue for the six months ended September 30, 2010 and 2011.

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The Company currently purchases a majority of its solar panels from one supplier for its sales of solar generating systems through its Orion Engineered Systems Division. The Company does have alternative vendor sources for its sale of PV solar generating systems. Purchases from this supplier accounted for 19% and 30% of total cost of revenue for the three months ended September 30, 2010 and 2011 and 15% and 32% of total cost of revenue for the six months ended September 30, 2010 and 2011.

For the three and six months ended September 30, 2010 and 2011, no customer accounted for more than 10% of revenue.

As of March 31, 2011 and September 30, 2011, one customer accounted for 16% and 11% of accounts receivable, respectively.

***Recent Accounting Pronouncements***

In July 2010, the FASB issued Accounting Standards Update 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses* (ASU 2010-20). ASU 2010-20 requires further disaggregated disclosures that improve financial statement users' understanding of (1) the nature of an entity's credit risk associated with its financing receivables and (2) the entity's assessment of that risk in estimating its allowance for credit losses as well as changes in the allowance and the reasons for those changes. The new and amended disclosures as of the end of a reporting period are effective for interim and annual reporting periods ending on or after December 15, 2010. The adoption of ASU 2010-20 did not have a significant impact on the Company's consolidated financial statements.

In April, 2011, the FASB issued ASU No. 2011-03 *Transfers and Servicing (Topic 860): Reconsideration of Effective Control for Repurchase Agreements* (ASU 2011-03). ASU No. 2011-03 affects all entities that enter into agreements to transfer financial assets that both entitle and obligate the transferor to repurchase or redeem the financial assets before their maturity. The amendments in ASU 2011-03 remove from the assessment of effective control the criterion relating to the transferor's ability to repurchase or redeem financial assets on substantially all of the agreed terms, even in the event of default by the transferee. ASU 2011-03 also eliminates the requirement to demonstrate that the transferor possesses adequate collateral to fund substantially all the cost of purchasing replacement financial assets. The guidance is effective for the Company's reporting period ended March 31, 2012. ASU 2011-03 is required to be applied prospectively to transactions or modifications of existing transactions that occur on or after January 1, 2012. The Company does not expect that the adoption of ASU 2011-03 will have a significant impact on the Company's consolidated financial statements.

In May 2011, the FASB issued ASU No. 2011-04 *Fair Value Measurements (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in US GAAP and International Financial Reporting Standards (IFRS)* (ASU 2011-04). ASU 2011-04 represents the converged guidance of the FASB and the IASB (the Boards) on fair value measurements. The collective efforts of the Boards and their staffs, reflected in ASU 2011-04, have resulted in common requirements for measuring fair value and for disclosing information about fair value measurements, including a consistent meaning of the term fair value. The Boards have concluded the common requirements will result in greater comparability of fair value measurements presented and disclosed in financial statements prepared in accordance with GAAP and IFRSs. The amendments in this ASU are required to be applied prospectively, and are effective for interim and annual periods beginning after December 15, 2011. The Company does not expect that the adoption of ASU 2011-04 will have a significant impact on the Company's consolidated financial statements.

In June 2011, the FASB issued ASU No. 2011-05, *Comprehensive Income (ASC Topic 220): Presentation of Comprehensive Income*, (ASU 2011-05) which amends current comprehensive income guidance. This accounting update eliminates the option to present the components of other comprehensive income as part of the statement of shareholders' equity. Instead, the Company must report comprehensive income in either a single continuous statement of comprehensive income which contains two sections, net income and other comprehensive income, or in two separate but consecutive statements. ASU 2011-05 will be effective for public companies during the interim and annual periods beginning after December 15, 2011 with early adoption permitted. The adoption of ASU 2011-05 will not have a significant impact on the Company's consolidated statements as it only requires a change in the format of the current presentation.



**NOTE C RELATED PARTY TRANSACTIONS**

During the six months ended September 30, 2010 and 2011, the Company recorded revenue of \$11,000 and \$0.3 million, respectively, for products and services sold to an entity for which a then current director of the Company was formerly the executive chairman. During the same six month periods, the Company purchased goods and services from the same entity in the amounts of none and \$4,700, respectively. The terms and conditions of such relationship are believed to be not materially more favorable to the Company or the entity than could be obtained from an independent third party.

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During the six months ended September 30, 2010 and 2011, the Company purchased goods and services from an entity of \$19,000 and \$23,000, respectively, for which a director of the Company serves as a member of the board of directors. The terms and conditions of such relationship are believed to be not materially more favorable to the Company or the entity than could be obtained from an independent third party.

**NOTE D DEBT**

Long-term debt as of March 31, 2011 and September 30, 2011 consisted of the following (in thousands):

|  | <b>March 31,<br/>2011</b> | <b>September 30,<br/>2011</b> |
|--|---------------------------|-------------------------------|
| Term note                                | \$ 782                    | \$ 659                        |
| Customer equipment finance notes payable | 1,793                     | 6,028                         |
| First mortgage note payable              | 853                       | 815                           |
| Debenture payable                        | 807                       | 787                           |
| Other long-term debt                     | 1,127                     | 992                           |
| <br>                                     |                           |                               |
| Total long-term debt                     | 5,362                     | 9,281                         |
| Less current maturities                  | (1,137)                   | (2,351)                       |
| <br>                                     |                           |                               |
| Long-term debt, less current maturities  | \$ 4,225                  | \$ 6,930                      |

***New Debt Arrangements***

In September 2011, the Company entered into a credit agreement with JP Morgan Chase Bank, N.A. (JP Morgan) that provided the Company with \$5.0 million immediately available to fund completed customer contracts under the Company's OTA finance program and an additional \$5.0 million upon the Company's achievement of meeting a trailing 12-month earnings before interest, taxes, depreciation and amortization (EBITDA) target of \$8.0 million. The Company has one-year from the date of the commitment to borrow under the credit agreement. In September 2011, the Company borrowed \$1.8 million. The borrowing is collateralized by the OTA-related equipment and the expected future monthly payments under the supporting 27 individual OTA customer contracts. The current borrowing under the credit agreement bears interest at LIBOR plus 4% and matures in September 2016. The credit agreement includes certain financial covenants, including funded debt to EBITDA and debt service coverage ratios. The Company was in compliance with all covenants in the credit agreement as of September 30, 2011.

***Revolving Credit Agreement***

On June 30, 2010, the Company entered into a new credit agreement (Credit Agreement) with JP Morgan. The Credit Agreement replaced the former credit agreement with a different bank.

The Credit Agreement provides for a revolving credit facility (Credit Facility) that matures on June 30, 2012. Borrowings under the Credit Facility are limited to (i) \$15.0 million or (ii) during periods in which the outstanding principal balance of outstanding loans under the Credit Facility is greater than \$5.0 million, the lesser of (A) \$15.0 million or (B) the sum of 75% of the outstanding principal balance of certain accounts receivable of the Company and 45% of certain inventory of the Company. The Credit Agreement contains certain financial covenants, including minimum unencumbered liquidity requirements and requirements that the Company maintain a total liabilities to tangible net worth ratio not to exceed 0.50 to 1.00 as of the last day of any fiscal quarter. The Credit Agreement also contains certain restrictions on the ability of the Company to make capital or lease expenditures over prescribed limits, incur additional indebtedness, consolidate or merge, guarantee obligations of third parties, make loans or advances, declare or pay any dividend or distribution on its stock, redeem or repurchase shares of its stock or pledge assets. The Company also may cause JP Morgan to issue letters of credit for the Company's account in the aggregate principal amount of up to \$2.0 million, with the dollar amount of each issued letter of credit counting against the overall limit on borrowings under the Credit Facility. As of September 30, 2011, the Company had outstanding letters of credit totaling \$1.7 million, primarily for securing collateral requirements under equipment operating leases. In fiscal 2011, the Company incurred \$57,000 of total deferred financing costs related to the Credit

Agreement which is being amortized over the two-year term of the Credit Agreement. There were no borrowings by the Company under the Credit Agreement as of March 31, 2011 or September 30, 2011. The Company was in compliance with all of its covenants under the Credit Agreement as of September 30, 2011.

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The Credit Agreement is secured by a first lien security interest in the Company's accounts receivable, inventory and general intangibles, and a second lien priority in the Company's equipment and fixtures. All OTAs, PPAs, leases, supply agreements and/or similar agreements relating to solar PV and wind turbine systems or facilities, as well as all accounts receivable and assets of the Company related to the foregoing, are excluded from these liens.

The Company must pay a fee of 0.25% on the average daily unused amount of the Credit Facility and a fee of 2.00% on the daily average face amount of undrawn issued letters of credit. The fee on unused amounts is waived if the Company or its affiliates maintain funds on deposit with JP Morgan or its affiliates above a specified amount. The deposit threshold requirement was met as of September 30, 2011.

**NOTE E INCOME TAXES**

The income tax provision for the six months ended September 30, 2011 was determined by applying an estimated annual effective tax rate of 40.3% to income before taxes. The estimated effective income tax rate was determined by applying statutory tax rates to pretax income adjusted for certain permanent book to tax differences and tax credits.

Below is a reconciliation of the statutory federal income tax rate and the effective income tax rate:

|                                  | <b>Six Months Ended September</b> |             |
|----------------------------------|-----------------------------------|-------------|
|                                  | <b>30,</b>                        |             |
|                                  | <b>2010</b>                       | <b>2011</b> |
| Statutory federal tax rate       | (34.0)%                           | 34.0%       |
| State taxes, net                 | (9.9)%                            | 4.9%        |
| Stock-based compensation expense | (44.6)%                           | 1.4%        |
| Federal tax credit               | 7.9%                              | (2.2)%      |
| State tax credit                 | 2.1%                              | 0.0%        |
| Permanent items                  | (11.7)%                           | 1.0%        |
| Change in valuation reserve      | (10.4)%                           | 0.0%        |
| Other, net                       | 0.4%                              | 1.4%        |
| Effective income tax rate        | (100.2)%                          | 40.3%       |

The Company is eligible for tax benefits associated with the excess of the tax deduction available for exercises of non-qualified stock options, or NQSOs, over the amount recorded at grant. The amount of the benefit is based on the ultimate deduction reflected in the applicable income tax return. Benefits of \$0.5 million were recorded in fiscal 2011 as a reduction in taxes payable and a credit to additional paid in capital based on the amount that was utilized during the year. Benefits of \$0.3 million were recorded for the six months ended September 30, 2011.

During fiscal 2011, the Company converted almost all of its existing incentive stock options, or ISOs, to NQSOs. This conversion was applied retrospectively, allowing the Company to benefit by reducing \$0.6 million of income tax expense during fiscal 2011 related to non-deductible ISO stock compensation expense that was previously deferred for income tax purposes. The conversion will greatly reduce the impact of stock-based compensation expense on the effective tax rate in the table above. Since July 30, 2008, all stock option grants have been issued as NQSOs.

As of September 30, 2011, the Company had federal net operating loss carryforwards of approximately \$7.6 million, of which \$4.5 million are associated with the exercise of NQSOs that have not yet been recognized by the Company in its financial statements. The Company also has state net operating loss carryforwards of approximately \$4.6 million, of which \$2.5 million are associated with the exercise of NQSOs. The Company also has federal tax credit carryforwards of approximately \$1.0 million and state tax credits of \$0.6 million. A full valuation allowance has been set up for the state tax credits due to the state apportioned income and the potential expiration of the state tax credits due to the carry forward period. These federal and state net operating losses and credit carryforwards are available, subject to the discussion in the following paragraph, to offset future taxable income and, if not utilized, will begin to expire in varying amounts between 2014 - 2030.

In 2007, the Company's past issuances and transfers of stock caused an ownership change. As a result, the Company's ability to use its net operating loss carryforwards, attributable to the period prior to such ownership change, to offset

taxable income will be subject to limitations in a particular year, which could potentially result in increased future tax liability for the Company. The Company does not believe the ownership change affects the use of the full amount of the net operating loss carryforwards.

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As of September 30, 2011, the Company's U.S. federal income tax returns for tax years 2009 to 2011 remain subject to examination. The Company has various federal income tax return positions in the process of examination for 2009 and 2010. The Company currently believes that the ultimate resolution of these matters, individually or in the aggregate, will not have a material effect on its business, financial condition, results of operations or liquidity.

**Uncertain tax positions**

As of September 30, 2011, the balance of gross unrecognized tax benefits was approximately \$0.4 million, all of which would reduce the Company's effective tax rate if recognized. The Company does not expect this amount to change in the next 12 months as none of the issues are currently under examination, the statutes of limitations do not expire within the period, and the Company is not aware of any pending litigation. Due to the existence of net operating loss and credit carryforwards, all years since 2002 are open to examination by tax authorities.

The Company has classified the amounts recorded for uncertain tax benefits in the balance sheet as other liabilities (non-current) to the extent that payment is not anticipated within one year. The Company recognizes penalties and interest related to uncertain tax liabilities in income tax expense. Penalties and interest are immaterial as of the date of adoption and are included in the unrecognized tax benefits. For the six months ended September 30, 2010 and 2011, the Company had the following unrecognized tax benefit activity (in thousands):

|  | <b>Six Months<br/>Ended<br/>September 30,<br/>2010</b> | <b>Six Months<br/>Ended<br/>September 30,<br/>2011</b> |
|--|--|--|
| Unrecognized tax benefits as of beginning of period                      | \$ 399   | \$ 399   |
| Decreases relating to settlements with tax authorities                   |  |  |
| Additions based on tax positions related to the current period positions | 1  | 1  |
| Unrecognized tax benefits as of end of period                            | \$ 399   | \$ 400   |

**NOTE F COMMITMENTS****Operating Leases and Purchase Commitments**

The Company leases vehicles and equipment under operating leases. Rent expense under operating leases was \$0.4 million and \$0.5 million for the three months ended September 30, 2010 and 2011; and \$0.8 million and \$1.0 million for the six months ended September 30, 2010 and 2011. The Company enters into non-cancellable purchase commitments for certain inventory items in order to secure better pricing and ensure materials on hand, as well as for capital expenditures. As of September 30, 2011, the Company had entered into \$10.1 million of purchase commitments related to fiscal 2012, including \$1.7 million for operating lease commitments and \$8.4 million for inventory purchase commitments.

**NOTE G SHAREHOLDERS EQUITY****Shareholder Rights Plan**

On January 7, 2009, the Company's Board of Directors adopted a shareholder rights plan and declared a dividend distribution of one common share purchase right (a "Right") for each outstanding share of the Company's common stock. The issuance date for the distribution of the Rights was February 15, 2009 to shareholders of record on February 1, 2009. Each Right entitles the registered holder to purchase from the Company one share of the Company's common stock at a price of \$30.00 per share, subject to adjustment (the "Purchase Price").

The Rights will not be exercisable (and will be transferable only with the Company's common stock) until a "Distribution Date" occurs (or the Rights are earlier redeemed or expire). A Distribution Date generally will occur on the earlier of a public announcement that a person or group of affiliated or associated persons (an "Acquiring Person") has acquired beneficial ownership of 20% or more of the Company's outstanding common stock (a "Shares Acquisition Date") or 10 business days after the commencement of, or the announcement of an intention to make, a tender offer or exchange offer that would result in any such person or group of persons acquiring such beneficial ownership.



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If a person becomes an Acquiring Person, holders of Rights (except as otherwise provided in the shareholder rights plan) will have the right to receive that number of shares of the Company's common stock having a market value of two times the then-current Purchase Price, and all Rights beneficially owned by an Acquiring Person, or by certain related parties or transferees, will be null and void. If, after a Shares Acquisition Date, the Company is acquired in a merger or other business combination transaction or 50% or more of its consolidated assets or earning power are sold, proper provision will be made so that each holder of a Right (except as otherwise provided in the shareholder rights plan) will thereafter have the right to receive that number of shares of the acquiring company's common stock which at the time of such transaction will have a market value of two times the then-current Purchase Price.

Until a Right is exercised, the holder thereof, as such, will have no rights as a shareholder of the Company. At any time prior to a person becoming an Acquiring Person, the Board of Directors of the Company may redeem the Rights in whole, but not in part, at a price of \$0.001 per Right. Unless they are extended or earlier redeemed or exchanged, the Rights will expire on January 7, 2019.

**Employee Stock Purchase Plan**

In August 2010, the Company's Board of Directors approved a non-compensatory employee stock purchase plan, or ESPP. The ESPP authorizes 2,500,000 shares to be issued from treasury or authorized shares to satisfy employee share purchases under the ESPP. All full-time employees of the Company are eligible to be granted a non-transferable purchase right each calendar quarter to purchase directly from the Company up to \$20,000 of the Company's common stock at a purchase price equal to 100% of the closing sale price of the Company's common stock on the NYSE Amex exchange on the last trading day of each quarter. The ESPP allows for employee loans from the Company, except for Section 16 officers, limited to 20% of an individual's annual income and no more than \$250,000 outstanding at any one time. Interest on the loans is charged at the 10-year loan IRS rate and is payable at the end of each calendar year or upon loan maturity. The loans are secured by a pledge of any and all the Company's shares purchased by the participant under the ESPP and the Company has full recourse against the employee, including offset against compensation payable. The Company had the following shares issued from treasury during fiscal 2011 and for the six months ended September 30, 2011:

|                                     | Shares<br>Issued<br>Under<br>ESPP<br>Plan | Closing<br>Market<br>Price | Shares<br>Issued<br>Under Loan<br>Program | Dollar Value<br>of<br>Loans Issued | Repayment<br>of<br>Loans |
|-------------------------------------|---|----------------------------|---|------------------------------------|--------------------------|
| Fiscal Year Ended March 31,<br>2011 | 65,776                                    | \$ 3.37                    | 58,655                                    | \$ 196,100                         | \$ 2,685                 |
| Quarter Ended June 30, 2011         | 9,788                                     | 3.93                       | 8,601                                     | 33,800                             | 1,649                    |
| Quarter Ended September<br>30, 2011 | 16,753                                    | 2.65                       | 11,264                                    | 29,850                             | 11,102                   |
| Total                               | 92,317                                    | \$ 3.30                    | 78,520                                    | \$ 259,750                         | \$ 15,436                |

Loans issued to employees are reflected on the Company's balance sheet as a contra-equity account.

**Share Repurchase Program**

In October 2011, the Company's Board of Directors approved a share repurchase program authorizing the Company to repurchase in aggregate up to a maximum of \$1.0 million of the Company's outstanding common stock.

**NOTE H STOCK OPTIONS AND WARRANTS**

The Company grants stock options under its 2003 Stock Option and 2004 Stock and Incentive Awards Plans (the Plans). Under the terms of the Plans, the Company has reserved 12,000,000 shares for issuance to key employees, consultants and directors. The Company's board of directors approved an increase to the number of shares available under the 2004 Stock and Incentive Awards Plan of 1,500,000 shares, and such share increase was approved by the Company's shareholders at the 2010 annual shareholders meeting and such shares are included above, other than as



described below. In addition, the Company's board of directors subsequently approved an additional increase to the number of shares available under the Plan by 1,000,000 shares contingent upon the Company's achievement of at least 100% of each of the targeted financial metrics under its bonus program for fiscal 2012. The contingent share increase was approved by the Company's shareholders at the 2011 annual shareholders meeting and such shares are not included in the total above. The options generally vest and become exercisable ratably between one month and five years although longer vesting periods have been used in certain circumstances. Exercisability of the options granted to employees are contingent on the employees' continued employment and non-vested options are subject to forfeiture if employment terminates for any reason. Options under the Plans have a maximum life of 10 years. In the past, the Company has granted both ISOs and NQSOs, although in July 2008, the Company adopted a policy of thereafter only granting NQSOs. Restricted stock awards have no vesting period and have been issued to certain non-employee directors in lieu of cash compensation pursuant to elections made under the Company's non-employee director compensation program. The Plans also provide to certain employees accelerated vesting in the event of certain changes of control of the Company as well as under other special circumstances.

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In fiscal 2011, the Company converted all of its existing ISO awards to NQSO awards. No consideration was given to the employees for their voluntary conversion of ISO awards.

The Company granted accelerated vesting stock options in May 2011 under its 2004 Stock and Incentive Awards to provide an opportunity for its employees to earn long-term equity incentive awards based on the Company's financial performance for fiscal 2012. An aggregate of 459,041 stock options were granted on the third business day following the Company's public release of its fiscal 2011 results at an exercise price per share of \$4.19, which was the closing sale price of the Company's Common Stock on that date. The stock options will only vest, however, if the optionee remains employed and the Company is successful in achieving at least 100% of the target levels for each of the Company's three financial metric targets for fiscal 2012, and if the Company's stock price equals or exceeds \$5.00 per share for at least 20 trading days during any 90-day period during the options' ten-year term.

For the three and six months ended September 30, 2011, the Company granted 7,614 and 10,896 shares under the 2004 Stock and Incentive Awards Plan to certain non-employee directors who elected to receive stock awards in lieu of cash compensation. The shares were valued at \$3.12 per share and \$4.19 per share, the closing market prices as of the grant dates.

The following amounts of stock-based compensation were recorded (in thousands):

|                            | <b>Three Months Ended</b> |               | <b>Six Months Ended</b> |               |
|----------------------------|---------------------------|---------------|-------------------------|---------------|
|                            | <b>September 30,</b>      |               | <b>September 30,</b>    |               |
|                            | <b>2010</b>               | <b>2011</b>   | <b>2010</b>             | <b>2011</b>   |
| Cost of product revenue    | \$ 38                     | \$ 35         | \$ 74                   | \$ 77         |
| General and administrative | 173                       | 140           | 271                     | 296           |
| Sales and marketing        | 145                       | 124           | 254                     | 272           |
| Research and development   | 7                         | 7             | 12                      | 12            |
| <b>Total</b>               | <b>\$ 363</b>             | <b>\$ 306</b> | <b>\$ 611</b>           | <b>\$ 657</b> |

As of September 30, 2011, compensation cost related to non-vested common stock-based compensation, excluding performance stock option awards amounted to \$3.8 million over a remaining weighted average expected term of 6.9 years.

The following table summarizes information with respect to the Plans:

|                               | <b>Options Outstanding</b>        |                         |  |   |                                  |
|-------------------------------|-----------------------------------|-------------------------|--|---|----------------------------------|
|                               | <b>Shares Available for Grant</b> | <b>Number of Shares</b> | <b>Weighted Average Exercise Price</b> | <b>Weighted Average Remaining Contractual Term (in years)</b> | <b>Aggregate Intrinsic value</b> |
| Balance at March 31, 2011     | 1,577,676                         | 3,658,768               | \$ 3.83                                | 6.60  |                                  |
| Granted stock options         | (986,356)                         | 986,356                 | 4.08                                   |   |                                  |
| Granted shares                | (10,896)                          |                         |  |   |                                  |
| Forfeited                     | 546,794                           | (546,794)               | 4.32                                   |   |                                  |
| Exercised                     |                                   | (79,413)                | 1.24                                   |   |                                  |
| Balance at September 30, 2011 | 1,127,218                         | 4,018,917               | \$ 3.97                                | 7.17  | \$ 444,261                       |
|                               |                                   | 1,723,065               | \$ 3.97                                | 5.52  | \$ 316,911                       |

Exercisable at September 30,  
2011

The aggregate intrinsic value represents the total pre-tax intrinsic value, which is calculated as the difference between the exercise price of the underlying stock options and the fair value of the Company's closing common stock price of \$2.65 as of September 30, 2011.

A summary of the status of the Company's outstanding non-vested stock options as of September 30, 2011 was as follows:

|                                  |           |
|----------------------------------|-----------|
| Non-vested at March 31, 2011     | 1,832,167 |
| Granted                          | 986,356   |
| Vested                           | (209,881) |
| Forfeited                        | (312,790) |
| Non-vested at September 30, 2011 | 2,295,852 |

The Company has previously issued warrants in connection with various private placement stock offerings and services rendered. The warrants granted the holder the option to purchase common stock at specified prices for a specified period of time. No warrants were issued in fiscal 2011 or during the six months ended September 30, 2011.

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Outstanding warrants are comprised of the following:

|                               | <b>Number of<br/>Shares</b> | <b>Weighted<br/>Average<br/>Exercise<br/>Price</b> |
|-------------------------------|-----------------------------|--|
| Balance at March 31, 2011     | 38,980                      | \$ 2.25  |
| Issued                        |                             |  |
| Exercised                     |                             |  |
| Cancelled                     |                             |  |
| Balance at September 30, 2011 | 38,980                      | \$ 2.25  |

A summary of outstanding warrants at September 30, 2011 follows:

| <b>Exercise Price</b> | <b>Number of<br/>Warrants</b> | <b>Expiration</b> |
|-----------------------|-------------------------------|-------------------|
| \$2.25                | 38,980                        | Fiscal 2015       |

**NOTE I SEGMENT DATA**

During the fiscal 2011 third quarter, certain activity of the Orion Engineered Systems Division exceeded the quantitative thresholds required for segment reporting. As such, descriptions of the Company's segments and their summary financial information are summarized below.

**Energy Management**

The Energy Management Division develops, manufactures and sells commercial high intensity fluorescent, or HIF, lighting systems and energy management systems.

**Engineered Systems**

The Engineered Systems Division sells and integrates alternative renewable energy systems, such as solar and wind, and provides technical services for the Company's sale of HIF lighting systems and energy management systems.

**Corporate and Other**

Corporate and Other is comprised of selling, general and administrative expenses not directly allocated to the Company's segments and adjustments to reconcile to consolidated results, which primarily include intercompany eliminations.

| (dollars in thousands) | <b>Revenues<br/>For the Three Months Ended<br/>September 30,</b> |           | <b>Operating (Loss) Income<br/>For the Three Months Ended<br/>September 30,</b> |          |
|------------------------|--|-----------|---|----------|
|                        | 2010   | 2011      | 2010  | 2011     |
| Segments:              |  |           |   |          |
| Energy Management      | \$ 14,371  | \$ 16,686 | \$ 1,301  | \$ 1,415 |
| Engineered Systems     | 1,482  | 2,574     | (429)   | (449)    |
| Corporate and Other    |  |           | (2,122)   | (1,200)  |
|                        | \$ 15,853  | \$ 19,260 | \$ (1,250)  | \$ (234) |

| (dollars in thousands) | <b>Revenues<br/>For the Six Months Ended<br/>September 30,</b> |      | <b>Operating (Loss) Income<br/>For the Six Months Ended<br/>September 30,</b> |      |
|------------------------|--|------|---|------|
|                        | 2010   | 2011 | 2010  | 2011 |

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Segments:

|                     |    |        |    |        |    |         |    |         |
|---------------------|----|--------|----|--------|----|---------|----|---------|
| Energy Management   | \$ | 29,769 | \$ | 33,128 | \$ | 1,592   | \$ | 2,228   |
| Engineered Systems  |    | 3,061  |    | 8,906  |    | (841)   |    | (365)   |
| Corporate and Other |    |        |    |        |    | (3,394) |    | (2,527) |
|                     | \$ | 32,830 | \$ | 42,034 | \$ | (2,643) | \$ | (664)   |

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| (dollars in thousands) | <b>Total Assets</b> |                       | <b>Deferred Revenue</b> |                       |
|------------------------|---------------------|-----------------------|-------------------------|-----------------------|
|                        | March 31,<br>2011   | September 30,<br>2011 | March 31,<br>2011       | September 30,<br>2011 |
| Segments:              |                     |                       |                         |                       |
| Energy Management      | \$ 67,449           | \$ 63,574             | \$ 533                  | \$ 750                |
| Engineered Systems     | 14,405              | 14,737                | 1,506                   | 3,910                 |
| Corporate and Other    | 33,136              | 42,263                |                         |                       |
|                        | \$ 114,990          | \$ 120,574            | \$ 2,039                | \$ 4,660              |

The Company's revenue and long-lived assets outside the United States are insignificant.

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

*The following discussion and analysis of our financial condition and results of operations should be read together with our unaudited condensed consolidated financial statements and related notes included elsewhere in the Form 10-Q. It should also be read in conjunction with our audited consolidated financial statements and related notes included in our Annual Report on Form 10-K for the year ended March 31, 2011.*

**Cautionary Note Regarding Forward-Looking Statements**

Any statements in this Quarterly Report on Form 10-Q about our expectations, beliefs, plans, objectives, prospects, financial condition, assumptions or future events or performance are not historical facts and are forward-looking statements as that term is defined under the federal securities laws. These statements are often, but not always, made through the use of words or phrases such as believe, anticipate, should, intend, plan, will, expects, estimate, positioned, strategy, outlook and similar words. You should read the statements that contain these types of words carefully. Such forward-looking statements are subject to a number of risks, uncertainties and other factors that could cause actual results to differ materially from what is expressed or implied in such forward-looking statements. There may be events in the future that we are not able to predict accurately or over which we have no control. Potential risks and uncertainties include, but are not limited to, those discussed in Part I, Item 1A. Risk Factors in our fiscal 2011 Annual Report filed on Form 10-K for the fiscal year ended March 31, 2011 and elsewhere in this Quarterly Report. We urge you not to place undue reliance on these forward-looking statements, which speak only as the date of this report. We do not undertake any obligation to release publicly any revisions to such forward-looking statements to reflect events or uncertainties after the date hereof or to reflect the occurrence of unanticipated events.

**Overview**

We design, manufacture, market and implement energy management systems consisting primarily of high-performance, energy efficient lighting systems, controls and related services and market and implement renewable energy systems consisting primarily of solar generating photovoltaic, or PV, systems and wind turbines. We operate in two business segments, which we refer to as our Energy Management Division and our Engineered Systems Division.

We currently generate the substantial majority of our revenue from sales of high intensity fluorescent, or HIF, lighting systems and related services to commercial and industrial customers. We typically sell our HIF lighting systems in replacement of our customers' existing high intensity discharge, or HID, fixtures. We call this replacement process a retrofit. We frequently engage our customers' existing electrical contractor to provide installation and project management services. We also sell our HIF lighting systems on a wholesale basis, principally to electrical contractors and value-added resellers to sell to their own customer bases.

We have sold and installed more than 2,176,000 of our HIF lighting systems in over 7,368 facilities from December 1, 2001 through September 30, 2011. We have sold our products to 137 Fortune 500 companies, many of which have installed our HIF lighting systems in multiple facilities. Our top direct customers by revenue in fiscal 2011 included Coca-Cola Enterprises Inc., U.S. Foodservice, SYSCO Corp., Ball Corporation, MillerCoors and Pepsico, Inc. and its affiliates.

Our fiscal year ends on March 31. We call our prior fiscal year which ended on March 31, 2011, fiscal 2011. We call our current fiscal year, which will end on March 31, 2012, fiscal 2012. Our fiscal first quarter ended on June 30, our fiscal second quarter ended on September 30, our fiscal third quarter ends on December 31 and our fiscal fourth quarter ends on March 31.

Because of the recessed state of the global economy, especially as it impacted capital equipment manufacturers, our results for the first half of fiscal 2011 were impacted by lengthened customer sales cycles and sluggish customer capital spending. During the second half of fiscal 2011 and the first half of fiscal 2012, capital equipment purchases were slightly improved and we continue to remain optimistic regarding customer behaviors for the remainder of fiscal year 2012. To address these difficult economic conditions, we implemented \$3.2 million of annualized cost reductions during the first quarter of fiscal 2010. These cost containment initiatives included reductions related to headcount, work hours and discretionary spending and began to show results in the second half of fiscal 2010 and the first half of fiscal 2011. During the second quarter of fiscal 2011, we identified an additional \$1 million of annualized cost

reductions related to decreased product costs, improved manufacturing efficiencies and reduced operating expenses. We realized these cost reductions beginning during the fiscal 2011 third quarter through reduction in general and administrative expenses and improved product margins for our HIF lighting systems.



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Despite these recent economic challenges, we remain optimistic about our near-term and long-term financial performance. Our near-term optimism is based upon our record level of revenue in fiscal 2011 along with our return to profitability, our record level of order backlog heading into the back half of fiscal 2012, the increasing volume of unit sales in the first half of fiscal 2012 of our new products, specifically our exterior HIF fixtures, InteLite wireless dynamic controls, and our Apollo light pipes, and our cost reduction plans completed during fiscal 2011. Our long-term optimism is based upon the considerable size of the existing market opportunity for lighting retrofits, the continued development of our new products and product enhancements, the opportunity for additional revenue from sales of renewable technologies through our Orion Engineered Systems Division, the opportunity for our participation in the replacement part aftermarket and the increasing national recognition of the importance of environmental stewardship, including legislation in the State of Wisconsin passed in fiscal 2011 that recognized our solar Apollo light pipe as a renewable product offering and qualified it for incentives currently offered to other renewable technologies.

In August 2009, we created Orion Engineered Systems, a new operating division which has been offering our customers additional alternative renewable energy systems. In fiscal 2010, we sold and installed three solar PV electricity generating projects, completing our test analysis on two of the three in the fiscal 2010 third quarter, and executed our first cash sale and our first power purchase agreement, or PPA, as a result of the successful testing of these systems. We completed the installation and customer acceptance of the third system, a cash sale, during our fiscal 2011 first quarter. During our fiscal 2011 second quarter, we received an \$8.2 million cash order for a solar PV generating system for which we recognized \$6.6 million of revenue in fiscal 2011.

During our fiscal 2011 third quarter, revenue from our Orion Engineered Systems Division exceeded the quantitative threshold for generally accepted accounting principles, or GAAP, segment accounting. We now report our Energy Management and Engineered Systems Divisions as separate segments. Our Energy Management Division develops, manufactures and sells commercial high intensity fluorescent, or HIF, lighting systems and energy management systems. Our Engineered Systems Division sells and integrates alternative renewable energy systems and provides technical services for the Company's sale of HIF lighting systems and energy management systems.

In response to the constraints on our customers' capital spending budgets, we have more aggressively promoted the advantages to our customers of purchasing our energy management systems through our Orion Throughput Agreement, or OTA, finance program. Our OTA financing program provides for our customer's purchase of our energy management systems without an up-front capital outlay. The OTA contracts under this sales-type financing are either structured with a fixed term, typically 60 months, and a bargain purchase option at the end of the term, or are one year in duration and, at the completion of the initial one-year term, provide for (i) one to four automatic one-year renewals at agreed upon pricing; (ii) an early buyout for cash; or (iii) the return of the equipment at the customer's expense. The revenue that we are entitled to receive from the sale of our energy management systems under our OTA financing program is fixed and is based on the cost of the energy management system and applicable profit margin. Our revenue from agreements entered into under this program is not dependent upon our customers' actual energy savings. Upon completion of the installation, we may choose to sell the future cash flows and residual rights to the equipment on a non-recourse basis to an unrelated third party finance company in exchange for cash and future payments. We expect that the number of customers who choose to purchase our systems by using our OTA financing program will continue to increase in future periods. Additionally, we have provided a financing program to our alternative renewable energy system customers called a solar power purchase agreement, or PPA, as an alternative to purchasing our systems for cash. The PPA is a supply side agreement for the generation of electricity and subsequent sale to the end user. We do not intend to use our own cash balances to fund future PPA Opportunities. We have secured one external funding source to fund PPA's and continue to look for additional external sources of funding for PPA's on behalf of our customers.

**Revenue and Expense Components**

*Revenue.* We sell our energy management products and services directly to commercial and industrial customers, and indirectly to end users through wholesale sales to electrical contractors and value-added resellers. We currently generate the substantial majority of our revenue from sales of HIF lighting systems and related services to commercial and industrial customers. While our services include comprehensive site assessment, site field verification, utility

incentive and government subsidy management, engineering design, project management, installation and recycling in connection with our retrofit installations, we separately recognize service revenue only for our installation and recycling services. Our service revenues are recognized when services are complete and customer acceptance has been received. In fiscal 2011, we increased our efforts to expand our value-added reseller channels, including through developing a partner standard operating procedural kit, providing our partners with product marketing materials and providing training to channel partners on our sales methodologies. These wholesale channels accounted for approximately 53% of our total revenue in fiscal 2011, not taking into consideration our renewable technologies revenue generated through our Orion Engineered Systems Division. During the fiscal 2012 first half, wholesale revenues accounted for approximately 61% of our total revenue, not taking into consideration our renewable technologies revenue generated through our Orion Engineered Systems Division, compared to 53% for the first half of fiscal 2011. We are changing the manner in which we sell our solar PV systems. Instead of reselling the solar PV equipment obtained from a solar PV equipment manufacturer, we are encouraging our customers to purchase their solar PV systems directly from the manufacturer, while we provide the value-added installation and integration services. This change in approach is expected to result in reduced revenue from solar orders, but is expected to result in improved gross margins as discussed below.

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Additionally, we offer our OTA sales-type financing program under which we finance the customer's purchase of our energy management systems. We recognize revenue from OTA contracts at the net present value of the future cash flows at the completion date of the installation of the energy management systems and the customer's acknowledgement that the system is operating as specified.

In fiscal 2011, we recognized \$10.7 million of revenue from 127 completed OTA contracts. For the three months ended September 30, 2011, we recognized \$3.6 million of revenue from 29 completed contracts. For the six months ended September 30, 2011, we recognized \$6.5 million of revenue from 82 completed contracts. In the future, we expect an increase in the volume of OTA contracts as our customers take advantage of the value proposition without incurring any up-front capital cost.

Our PPA financing program provides for our customer's purchase of electricity from our renewable energy generating assets without an upfront capital outlay. Our PPA is a longer-term contract, typically in excess of 10 years, in which we receive monthly payments over the life of the contract. This program creates an ongoing recurring revenue stream, but reduces near-term revenue as the payments are recognized as revenue on a monthly basis over the life of the contract versus upfront upon product shipment or project completion. In fiscal 2011, we recognized \$0.4 million of revenue from completed PPAs. In the first half of fiscal 2012, we recognized \$0.4 million of revenue from completed PPAs. As of September 30, 2011, we had signed one customer to two separate PPAs representing future potential discounted revenue streams of \$3.5 million. We discount the future revenue from PPAs due to the long-term nature of the contracts, typically in excess of 10 years. The timing of expected future discounted GAAP revenue recognition and the resulting operating cash inflows from PPAs, assuming the systems perform as designed, was as follows as of September 30, 2011 (in thousands):

|  |    |       |
|--|----|-------|
| Fiscal 2012  | \$ | 324   |
| Fiscal 2013  |    | 646   |
| Fiscal 2014  |    | 536   |
| Fiscal 2015  |    | 426   |
| Fiscal 2016  |    | 425   |
| Beyond   |    | 1,152 |
| Total expected future discounted revenue from PPAs | \$ | 3,509 |

Other than for OTA and PPA revenue, we recognize revenue on product only sales at the time of shipment. For projects consisting of multiple elements of revenue, such as a combination of product sales and services, we recognize revenue by allocating the total contract revenue to each element based on their relative selling prices. We determine the selling price of products based upon the price charged when these products are sold separately. For services, we determine the selling price based upon management's best estimate giving consideration to pricing practices, margin objectives, competition, scope and size of individual projects, geographies in which we offer our products and services, and internal costs. We recognize revenue at the time of product shipment on product sales and on services completed prior to product shipment. We recognize revenue associated with services provided after product shipment, based on their relative selling price, when the services are completed and customer acceptance has been received. When other significant obligations or acceptance terms remain after products are delivered, revenue is recognized only after such obligations are fulfilled or acceptance by the customer has occurred.

Our dependence on individual key customers can vary from period to period as a result of the significant size of some of our retrofit and multi-facility roll-out projects. Our top 10 customers accounted for approximately 38% and 28% of our total revenue for the first half of fiscal 2012 and fiscal 2011, respectively. No customer accounted for more than 10% of our total revenue in the first half of fiscal 2012 or fiscal 2011. To the extent that large retrofit and roll-out projects become a greater component of our total revenue, we may experience more customer concentration in given periods. The loss of, or substantial reduction in sales volume to, any of our significant customers could have a material adverse effect on our total revenue in any given period and may result in significant annual and quarterly revenue variations.

Our level of total revenue for any given period is dependent upon a number of factors, including (i) the demand for our products and systems, including our OTA and PPA programs, and any new products, applications and service that we may introduce through our Orion Engineered Systems Division; (ii) changes in capital investment levels by our customers and prospects, (iii) the number and timing of large retrofit and multi-facility retrofit, or roll-out, projects; (iv) the level of our wholesale sales; (v) our ability to realize revenue from our services; (vi) market conditions; (vii) our execution of our sales process; (viii) our ability to compete in a highly competitive market and our ability to respond successfully to market competition; (ix) the selling price of our products and services; and (x) customer sales and budget cycles. As a result, our total revenue may be subject to quarterly variations and our total revenue for any particular fiscal quarter may not be indicative of future results.

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*Backlog.* We define backlog as the total contractual value of all firm orders received for our lighting and solar products and services where delivery of product or completion of services has not yet occurred as of the end of any particular reporting period. Such orders must be evidenced by a signed proposal acceptance or purchase order from the customer. Our backlog does not include PPAs or national contracts that have been negotiated, but under which we have not yet received a purchase order for the specific location. As of September 30, 2011, we had a backlog of firm purchase orders of approximately \$23.6 million, which included \$16.5 million of solar PV orders, compared to \$11.6 million as of June 30, 2011, which included \$4.2 million of solar PV orders. We generally expect this level of firm purchase order backlog related to HIF lighting systems to be converted into revenue within the following quarter and our firm purchase order backlog related to solar PV systems to be recognized within the following two quarters. Principally as a result of the continued lengthening of our customer's purchasing decisions because of current recessed economic conditions and related factors and the continued shortening of our installation cycles, a comparison of backlog from period to period is not necessarily meaningful and may not be indicative of actual revenue recognized in future periods.

*Cost of Revenue.* Our total cost of revenue consists of costs for: (i) raw materials, including sheet, coiled and specialty reflective aluminum; (ii) electrical components, including ballasts, power supplies and lamps; (iii) wages and related personnel expenses, including stock-based compensation charges, for our fabricating, coating, assembly, logistics and project installation service organizations; (iv) manufacturing facilities, including depreciation on our manufacturing facilities and equipment, taxes, insurance and utilities; (v) warranty expenses; (vi) installation and integration; and (vii) shipping and handling. Our cost of aluminum can be subject to commodity price fluctuations, which we attempt to mitigate with forward fixed-price, minimum quantity purchase commitments with our suppliers. We also purchase many of our electrical components through forward purchase contracts. We buy most of our specialty reflective aluminum from a single supplier, and most of our ballast and lamp components from a single supplier, although we believe we could obtain sufficient quantities of these raw materials and components on a price and quality competitive basis from other suppliers if necessary. Purchases from our current primary supplier of ballast and lamp components constituted 13% of our total cost of revenue for the first half of fiscal 2012 and were 34% of our total cost of revenue for the first half of fiscal 2011. Our cost of revenue from OTA projects is recorded upon customer acceptance and acknowledgement that the system is operating as specified. Our production labor force is non-union and, as a result, our production labor costs have been relatively stable. We have been expanding our network of qualified third-party installers to realize efficiencies in the installation process.

*Gross Margin.* Our gross profit has been, and will continue to be, affected by the relative levels of our total revenue and our total cost of revenue, and as a result, our gross profit may be subject to quarterly variation. Our gross profit as a percentage of total revenue, or gross margin, is affected by a number of factors, including: (i) our level of solar PV sales which generally have substantially lower relative gross margins than our traditional energy management systems; (ii) our mix of large retrofit and multi-facility roll-out projects with national accounts; (iii) the level of our wholesale and partner sales (which generally have historically resulted in lower relative gross margins, but higher relative net margins, than our sales to direct customers); (iv) our realization rate on our billable services; (v) our project pricing; (vi) our level of warranty claims; (vii) our level of utilization of our manufacturing facilities and production equipment and related absorption of our manufacturing overhead costs; (viii) our level of efficiencies in our manufacturing operations; and (ix) our level of efficiencies from our subcontracted installation service providers. We are changing the manner in which we sell our solar PV systems. Instead of reselling the solar PV equipment obtained from a solar PV equipment manufacturer, we are encouraging our customers to purchase their solar PV systems directly from the manufacturer, while we provide the value-added installation and integration services. This change in approach is expected to result in increased solar PV gross margins.

*Operating Expenses.* Our operating expenses consist of: (i) general and administrative expenses; (ii) sales and marketing expenses; and (iii) research and development expenses. Personnel related costs are our largest operating expense. In fiscal 2012, we are increasing personnel in our sales areas for telemarketing and direct sales employees as we believe that future opportunities within our business remain strong.

Our general and administrative expenses consist primarily of costs for: (i) salaries and related personnel expenses, including stock-based compensation charges related to our executive, finance, human resource, information

technology and operations organizations; (ii) public company costs, including investor relations, external audit and internal audit; (iii) occupancy expenses; (iv) professional services fees; (v) technology related costs and amortization; (vi) bad debt and asset impairment charges; and (vii) corporate-related travel.

Our sales and marketing expenses consist primarily of costs for: (i) salaries and related personnel expenses, including stock-based compensation charges related to our sales and marketing organization; (ii) internal and external sales commissions and bonuses; (iii) travel, lodging and other out-of-pocket expenses associated with our selling efforts; (iv) marketing programs; (v) pre-sales costs; and (vi) other related overhead.

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Our research and development expenses consist primarily of costs for: (i) salaries and related personnel expenses, including stock-based compensation charges, related to our engineering organization; (ii) payments to consultants; (iii) the design and development of new energy management products and enhancements to our existing energy management system; (iv) quality assurance and testing; and (v) other related overhead. We expense research and development costs as incurred.

In fiscal 2011 and continuing in the first half of fiscal 2012, we invested in marketing efforts to our direct end customers and to our channel partners through increasing advertising, marketing collateral materials and participating in national industry and customer trade shows. We expense all pre-sale costs incurred in connection with our sales process prior to obtaining a purchase order. These pre-sale costs may reduce our net income in a given period prior to recognizing any corresponding revenue. We also intend to continue investing in our research and development of new and enhanced energy management products and services.

We recognize compensation expense for the fair value of our stock option awards granted over their related vesting period. We recognized \$0.7 million in the first half of fiscal 2012 and \$0.6 million in the first half of fiscal 2011. As a result of prior option grants, we expect to recognize an additional \$3.8 million of stock-based compensation over a weighted average period of approximately seven years, including \$0.7 million in the last six months of fiscal 2012. These charges have been, and will continue to be, allocated to cost of product revenue, general and administrative expenses, sales and marketing expenses and research and development expenses based on the departments in which the personnel receiving such awards have primary responsibility. A substantial majority of these charges have been, and likely will continue to be, allocated to general and administrative expenses and sales and marketing expenses.

*Interest Expense.* Our interest expense is comprised primarily of interest expense on outstanding borrowings under long-term debt obligations, including the amortization of previously incurred financing costs. We amortize deferred financing costs to interest expense over the life of the related debt instrument, ranging from two to ten years.

*Interest Income.* We report interest income earned on our cash and cash equivalents and short term investments. We also report interest income earned from our financed OTA contracts.

*Income Taxes.* As of September 30, 2011, we had net operating loss carryforwards of approximately \$7.6 million for federal tax purposes and \$4.6 million for state tax purposes. Included in these loss carryforwards were \$4.5 million for federal and \$2.5 million for state tax purposes of compensation expenses that were associated with the exercise of nonqualified stock options. The benefit from our net operating losses created from these compensation expenses has not yet been recognized in our financial statements and will be accounted for in our shareholders' equity as a credit to additional paid-in capital as the deduction reduces our income taxes payable. We also had federal tax credit carryforwards of approximately \$1.0 million and state credit carryforwards of approximately \$0.6 million. A full valuation allowance has been set up for the state tax credits. We believe it is more likely than not that we will realize the benefits of most of these assets and we have reserved for an allowance due to our state apportioned income and the potential expiration of the state tax credits due to the carryforward period. These federal and state net operating losses and credit carryforwards are available, subject to the discussion in the following paragraph, to offset future taxable income and, if not utilized, will begin to expire in varying amounts between 2014 and 2030.

Generally, a change of more than 50% in the ownership of a company's stock, by value, over a three-year period constitutes an ownership change for federal income tax purposes. An ownership change may limit a company's ability to use its net operating loss carryforwards attributable to the period prior to such change. In fiscal 2007 and prior to our IPO, past issuances and transfers of stock caused an ownership change for certain tax purposes. When certain ownership changes occur, tax laws require that a calculation be made to establish a limitation on the use of net operating loss carryforwards created in periods prior to such ownership change. For fiscal year 2008, utilization of our federal loss carryforwards was limited to \$3.0 million. There was no limitation that occurred for fiscal 2010 or fiscal 2011. For fiscal 2012, we do not anticipate a limitation on the use of our net operating loss carryforwards.

**Table of Contents****Results of Operations**

The following table sets forth the line items of our consolidated statements of operations on an absolute dollar basis and as a relative percentage of our total revenue for each applicable period, together with the relative percentage change in such line item between applicable comparable periods set forth below (dollars in thousands):

|                                     | Three Months Ended September 30, |              |           |              |          | Six Months Ended September 30, |              |           |              |            |
|-------------------------------------|----------------------------------|--------------|-----------|--------------|----------|--------------------------------|--------------|-----------|--------------|------------|
|                                     | 2010                             |              | 2011      |              | % Change | 2010                           |              | 2011      |              | % Change   |
|                                     | Amount                           | % of Revenue | Amount    | % of Revenue |          | Amount                         | % of Revenue | Amount    | % of Revenue |            |
| Product revenue                     | \$ 15,086                        | 95.2%        | \$ 18,718 | 97.2%        | 24.1%    | \$ 30,844                      | 94.0%        | \$ 40,397 | 96.1%        | 31.0%      |
| Service revenue                     | 767                              | 4.8%         | 542       | 2.8%         | (29.3)%  | 1,986                          | 6.0%         | 1,637     | 3.9%         | (17.6)%    |
| Total revenue                       | 15,853                           | 100.0%       | 19,260    | 100.0%       | 21.5%    | 32,830                         | 100.0%       | 42,034    | 100.0%       | 28.0%      |
| Cost of product revenue             | 9,745                            | 61.5%        | 12,059    | 62.6%        | 23.7%    | 20,053                         | 61.1%        | 27,063    | 64.4%        | 35.0%      |
| Cost of service revenue             | 498                              | 3.1%         | 382       | 2.0%         | (23.3)%  | 1,415                          | 4.3%         | 1,116     | 2.7%         | (21.1)%    |
| Total cost of revenue               | 10,243                           | 64.6%        | 12,441    | 64.6%        | 21.5%    | 21,468                         | 65.4%        | 28,179    | 67.0%        | 31.3%      |
| Gross profit                        | 5,610                            | 35.4%        | 6,819     | 35.4%        | 21.6%    | 11,362                         | 34.6%        | 13,855    | 33.0%        | 21.9%      |
| General and administrative expenses | 2,988                            | 18.8%        | 2,724     | 14.1%        | (8.8)%   | 5,933                          | 18.1%        | 5,800     | 13.8%        | (2.2)%     |
| Sales and marketing expenses        | 3,299                            | 20.8%        | 3,736     | 19.4%        | 13.2%    | 6,889                          | 21.0%        | 7,504     | 17.9%        | 8.9%       |
| Research and development expenses   | 573                              | 3.6%         | 593       | 3.1%         | 3.5%     | 1,183                          | 3.6%         | 1,215     | 2.9%         | 2.7%       |
| Loss from operations                | (1,250)                          | (7.9)%       | (234)     | (1.2)%       | 81.3%    | (2,643)                        | (8.1)%       | (664)     | (1.6)%       | 74.9%      |
| Interest expense                    | 55                               | 0.3%         | 150       | 0.8%         | 172.7%   | 124                            | 0.4%         | 237       | 0.6%         | 91.1%      |
| Dividend and interest income        | 153                              | 1.0%         | 214       | 1.1%         | 39.9%    | 246                            | 0.8%         | 368       | 0.9%         | 49.6%      |
| Loss before income tax              | (1,152)                          | (7.3)%       | (170)     | (0.9)%       | 85.2%    | (2,521)                        | (7.7)%       | (533)     | (1.3)%       | 78.9%      |
| Income tax benefit                  | (1,692)                          | (10.7)%      | (71)      | (0.4)%       | 95.8%    | (2,525)                        | (7.7)%       | (215)     | (0.5)%       | 91.5%      |
|                                     | \$ 540                           | 3.4%         | \$ (99)   | (0.5)%       | (118.3)% | \$ 4                           | 0.0%         | \$ (318)  | (0.8)%       | (8,050.0)% |



Net income  
(loss)

*Revenue.* Product revenue increased from \$15.1 million for the fiscal 2011 second quarter to \$18.7 million for the fiscal 2012 second quarter, an increase of \$3.6 million, or 24%. The increase in product revenue was a result of increased sales of our HIF lighting systems and renewable energy systems. Service revenue decreased from \$0.8 million for the fiscal 2011 second quarter to \$0.5 million for the fiscal 2012 second quarter, a decrease of \$0.3 million, or 38%. The decrease in service revenues was a result of the continued percentage increase of our total revenues generated by our wholesale channels, where our services are not provided. Total revenue from renewable energy systems was \$2.0 million for the fiscal 2012 second quarter compared to none for the fiscal 2011 second quarter. Product revenue increased from \$30.8 million for the fiscal 2011 first half to \$40.4 million for the fiscal 2012 first half, an increase of \$9.6 million, or 31%. Total revenue from renewable energy systems was \$7.4 million for the fiscal 2012 first half compared to \$0.4 million for the fiscal 2011 first half, an increase of \$7.0 million, or 1,750%. Service revenue decreased from \$2.0 million for the fiscal 2011 first half to \$1.6 million for the fiscal 2012 first half, a decrease of \$0.4 million, or 20%. The decrease in service revenue was a result of the continued percentage increase of total revenue to our wholesale channels where services are not provided.

*Cost of Revenue and Gross Margin.* Our cost of product revenue increased from \$9.7 million for the fiscal 2011 second quarter to \$12.1 million for the fiscal 2012 second quarter, an increase of \$2.4 million, or 25%. Our cost of service revenue decreased from \$0.5 million for the fiscal 2011 second quarter to \$0.4 million for the fiscal 2012 second quarter, a decrease of \$0.1 million, or 20%. Total gross margin was 35.4% for the fiscal 2011 second quarter and fiscal 2012 second quarters, respectively. Total cost of product revenue increased from \$20.1 million for the fiscal 2011 first half to \$27.1 million for the fiscal 2012 first half, an increase of \$7.0 million, or 35%. Our cost of service revenue decreased from \$1.4 million for the fiscal 2011 first half to \$1.1 million for the fiscal 2012 first half, a decrease of \$0.3 million, or 21%. Total gross margin decreased from 34.6% for the fiscal 2011 first half to 33.0% for the fiscal 2012 first half. For the fiscal 2012 first half, our gross margin declined due to a higher mix of renewable product and service revenues from our Orion Engineered Systems Division. Our gross margin on renewable revenues was 14.7% during the fiscal 2012 first half. Gross margin from our HIF integrated systems revenue for the fiscal 2012 first half was 36.9%.

*General and Administrative.* Our general and administrative expenses decreased from \$3.0 million for the fiscal 2011 second quarter to \$2.7 million for the fiscal 2012 second quarter, a decrease of \$0.3 million, or 10%. Our general and administrative expenses decreased from \$5.9 million for the fiscal 2011 first half to \$5.8 million for the fiscal 2012 first half, a decrease of \$0.1 million, or 2%. The decrease was a result of reduced headcounts in management and information technologies offset by increased expenses for depreciation and software license costs for our new enterprise resource planning, or ERP, system.

*Sales and Marketing.* Our sales and marketing expenses increased from \$3.3 million for the fiscal 2011 second quarter to \$3.7 million for the fiscal 2012 second quarter, an increase of \$0.4 million, or 12%. Our sales and marketing expenses increased from \$6.9 million for the fiscal 2011 first half to \$7.5 million for the fiscal 2012 first half, an increase of \$0.6 million, or 9%. The increase was a result of increased costs for headcount additions to our direct sales force and for our newly formed telemarketing department, higher commission expense on our increased revenue and increased depreciation for our new customer relationship management, or CRM, system. Total sales and marketing employee headcount was 79 and 93 at September 30, 2010 and September 30, 2011, respectively.

*Research and Development.* Our research and development expenses of \$0.6 million for the fiscal 2012 second quarter were similar to our research and development expenses for our fiscal 2011 second quarter. Our research and development expenses of \$1.2 million for the fiscal 2012 first half were similar to our research and development expenses for our fiscal 2011 first half. Expenses incurred in the fiscal 2012 first half related to compensation costs for the development and support of our new products, depreciation expenses for lab and research equipment and sample, and testing costs related to our dynamic control devices and our light emitting diode, or LED, product initiatives.

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*Interest Expense.* Our interest expense increased from \$55,000 for the fiscal 2011 second quarter to \$150,000 for the fiscal 2012 second quarter, an increase of \$95,000, or 173%. Our interest expense increased from \$0.1 million for the fiscal 2011 first half to \$0.2 million for the fiscal 2012 first half, an increase of \$0.1 million or 100%. The increase in our interest expense was due to additional financings completed during the second half of fiscal 2011 and the first half of fiscal 2012 for the purpose of financing our OTA projects.

*Interest Income.* Interest income increased from \$153,000 for the fiscal 2011 second quarter to \$214,000 for the fiscal 2012 second quarter, an increase of \$61,000 or 40%. Interest income increased from \$0.2 million for the fiscal 2011 first half to \$0.4 million for the fiscal 2012 first half, an increase of \$0.2 million, or 100%. Interest income increased due to an increase in the number and dollar amount of completed OTA contracts and the related interest income under the financing terms.

*Income Taxes.* Our income tax benefit decreased from a benefit of \$1.7 million for the fiscal 2011 second quarter to an income tax benefit of \$0.1 million for the fiscal 2012 second quarter, a decrease of \$1.6 million, or 94%. Our income tax benefit decreased from a benefit of \$2.5 million for the fiscal 2011 first half to an income tax benefit of \$0.2 million for the fiscal 2012 first half, a decrease of \$2.3 million, or 92%. Our effective income tax rate for the fiscal 2011 first half was 100.2%, compared to 40.3% for the fiscal 2012 first half. The change in effective rate was due to the conversion of our incentive stock options, or ISOs, to non-qualified stock options, or NQSOs, completed during the fourth quarter of fiscal 2011, a decrease from the prior year for non-deductible expenses and an increase in fiscal 2011 for the state valuation reserve. The conversion of our ISOs to NQSOs eliminated the volatility in our effective tax rates at lower pre-tax earnings levels and should result in an effective tax rate in the 40% range for future periods.

**Energy Management Segment**

The following table summarizes our Energy Management segment operating results:

| (dollars in thousands) | For the Three Months Ended<br>September 30, |           | For the Six Months Ended<br>September 30, |           |
|------------------------|---|-----------|---|-----------|
|                        | 2010  | 2011      | 2010                                      | 2011      |
| Revenues               | \$ 14,371                                   | \$ 16,686 | \$ 29,769                                 | \$ 33,128 |
| Operating income       | \$ 1,301                                    | \$ 1,415  | \$ 1,592                                  | \$ 2,228  |
| Operating margin       | 9.1%  | 8.5%      | 5.3%                                      | 6.7%      |

Energy Management segment revenue increased \$2.3 million, or 16%, from \$14.4 million for the fiscal 2011 first quarter to \$16.7 million for the fiscal 2012 first quarter. Energy Management segment revenue increased \$3.4 million, or 11%, from \$29.8 million for the fiscal 2011 first half to \$33.1 million for the fiscal 2012 first half. The increase was due to increased sales of our HIF lighting systems to our wholesale customers.

Energy Management segment operating income increased \$0.1 million, or 8%, from \$1.3 million for the fiscal 2011 first quarter to \$1.4 million for the fiscal 2012 first quarter. Energy Management segment operating income increased \$0.6 million, or 38%, from \$1.6 million for the fiscal 2011 first half to \$2.2 million for the fiscal 2012 first half. The increase in operating income was a result of additional revenue and improved gross margins on our HIF lighting systems.

**Engineered Systems Segment**

The following table summarizes our Engineered Systems segment operating results:

| (dollars in thousands) | For the Three Months Ended<br>September 30, |          | For the Six Months Ended<br>September 30, |          |
|------------------------|---|----------|---|----------|
|                        | 2010  | 2011     | 2010                                      | 2011     |
| Revenues               | \$ 1,482                                    | \$ 2,574 | \$ 3,061                                  | \$ 8,906 |
| Operating loss         | \$ (429)                                    | \$ (449) | \$ (841)                                  | \$ (365) |
| Operating margin       | (28.9)%                                     | (17.4)%  | (27.5)%                                   | (4.1)%   |



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Engineered Systems segment revenue increased \$1.1 million, or 73%, from \$1.5 million for the fiscal 2011 first quarter to \$2.6 million for the fiscal 2012 first quarter. Engineered Systems segment revenue increased \$5.8 million, or 187%, from \$3.1 million for the fiscal 2011 first half to \$8.9 million for the fiscal 2012 first half. The increase was due to increased sales of solar renewable technologies. During the first half of fiscal 2011, our Engineered Systems segment efforts were focused on continuing to build sales pipeline and determination of the market for these renewable technologies within our customer base.

Engineered Systems segment operating loss of \$0.4 million for the fiscal 2011 first quarter was similar to Engineered Systems segment operating income for the fiscal 2012 first quarter. Energy Management segment operating loss decreased \$0.5 million, or 63%, from \$0.8 million for the fiscal 2011 first half to \$0.4 million for the fiscal 2012 first half. The reduction in operating loss was a result of the increased revenue volume and resulting contribution margin from sales of solar renewable energy systems.

**Liquidity and Capital Resources****Overview**

We had approximately \$15.6 million in cash and cash equivalents and \$1.0 million in short-term investments as of September 30, 2011, compared to \$11.6 million and \$1.0 million at March 31, 2011. Our cash equivalents are invested in money market accounts with maturities of less than 90 days and an average yield of 0.2%. Our short-term investment account consists of a bank certificate of deposit in the amount of \$1.0 million with an expiration date of December 2011 and a yield of 0.50%. Additionally, as of September 30, 2011, we had \$13.3 million of borrowing availability under our revolving credit agreement. We also had \$3.2 million of availability on our recently completed OTA credit agreement, which can be utilized for the sole purpose of funding customer OTA projects. During the first half of fiscal 2012, we borrowed \$4.6 million to finance our OTA projects. We have now secured multiple debt sources for our OTA finance contracts and believe that our sources of OTA funding are sufficient to meet near-term OTA finance program requirements. In October 2011, our board of directors approved a \$1.0 million share repurchase plan. We believe that our existing cash and cash equivalents, our anticipated cash flows from operating activities and our borrowing capacity under our revolving credit facility and our OTA credit facility will be sufficient to meet our anticipated cash needs for at least the next 12 months, dependent upon our growth opportunities with our cash and finance customers.

**Cash Flows**

The following table summarizes our cash flows for the six months ended September 30, 2010 and 2011 (in thousands):

|                                       | <b>Six Months Ended<br/>September 30,</b> |             |
|---------------------------------------|---|-------------|
|                                       | <b>2010</b>                               | <b>2011</b> |
| Operating activities                  | \$ (8,633)                                | \$ 1,924    |
| Investing activities                  | (4,033)                                   | (2,133)     |
| Financing activities                  | 2,626                                     | 4,208       |
| Decrease in cash and cash equivalents | \$ (10,040)                               | \$ 3,999    |

*Cash Flows Related to Operating Activities.* Cash provided by operating activities for the fiscal 2012 first half was \$1.9 million and consisted of net cash provided from changes in operating assets and liabilities of \$0.2 million and a net loss adjusted for non-cash expense items of \$1.7 million. Cash provided by changes in operating assets and liabilities consisted of a decrease of \$4.0 million in total accounts receivable due to customer payments received during the quarter and a \$2.6 million increase in deferred revenue due to customer deposit payments received. Cash used from changes in operating assets and liabilities included a \$3.3 million increase in inventory for purchases of solar panel inventory and increases in our work-in-process and lighting fixture inventories for orders that are expected to ship during the fiscal 2012 third quarter, a \$1.4 million increase in prepaid and other expenses related to deferred costs from projects still in implementation and a \$2.1 million decrease in accounts payable due to vendor payments.

Cash used in operating activities for the fiscal 2011 first half was \$8.6 million and consisted of net cash of \$9.5 million used for changes in operating assets and liabilities offset by a net loss adjusted for non-cash expense items of \$0.9 million. Cash used for changes in operating assets and liabilities consisted of an increase in accounts receivables due to the increase of our OTA program and the long-term nature of the contracts and an increase of \$7.7 million for inventory purchases, including \$3.8 million for purchases of wireless control inventories based upon our Phase 2 initiatives, a \$1.9 million increase in solar panel inventories in anticipation of the receipt of customer purchase orders and a \$3.1 million increase in ballast component inventories due to concerns over supply availability and component shortages. Cash provided by changes in operating assets and liabilities included a \$1.5 million increase in accounts payable related to payment terms on inventory purchases and a \$0.8 million increase in deferred revenue related to an investment tax grant received for a solar asset owned under our power purchase agreement, or PPA, finance program.

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*Cash Flows Related to Investing Activities.* For the fiscal 2012 first half, cash used in investing activities was \$2.1 million. This included a net \$2.0 million for capital improvements related to our information technology systems, manufacturing and tooling improvements and facility investments and \$0.1 million for investment in patent activities. For the fiscal 2011 first half, cash used in investing activities was \$4.0 million. This included \$2.0 million for capital improvements related to our information technology systems, renewable technologies, manufacturing and tooling improvements and facility investments, \$1.6 million invested in equipment related to our PPA finance programs, \$0.3 million for long-term investments and \$0.1 million for patent investments.

*Cash Flows Related to Financing Activities.* For the fiscal 2012 first half, cash flows provided by financing activities were \$4.2 million. This included \$4.6 million in new debt borrowings to fund OTAs, \$0.3 million for excess tax benefits from stock-based compensation and \$0.1 million received from stock option and warrant exercises. Cash flows used in financing activities included \$0.7 million for repayment of long-term debt and \$0.1 million for debt closing costs.

For the fiscal 2011 first half, cash flows provided by financing activities was \$2.6 million. This included \$2.7 million in new debt borrowings to fund OTA and capital projects and \$0.3 million received from stock option exercises. Cash flows used in financing activities included \$0.3 million for repayment of long-term debt and \$0.1 million for costs related to our new credit agreement.

***Working Capital***

Our net working capital as of September 30, 2011 was \$57.9 million, consisting of \$76.4 million in current assets and \$18.5 million in current liabilities. Our net working capital as of March 31, 2011 was \$56.9 million, consisting of \$73.1 million in current assets and \$16.2 million in current liabilities. Our current accounts receivables decreased from fiscal 2011 year-end by \$6.0 million as a result of the collection of payments from customers. Our inventories increased from our fiscal 2011 year-end by \$3.3 million due to a \$1.8 million increase in solar panel inventories in anticipation of the receipt of customer purchase orders, a \$0.7 million increase in our work-in process inventories for product orders to be delivered in our fiscal 2012 third quarter, a \$0.1 million increase in raw materials and a \$0.7 million increase in finished goods for orders expected to ship in our fiscal 2012 back half.

During fiscal 2011, we increased our inventory levels of key electronic components, specifically electronic ballasts, to avoid potential shortages and customer service issues as a result of lengthening supply lead times and product availability issues. We continue to monitor supply side concerns within the electronic component market and believe that our current inventory levels are sufficient to protect us against the risk of being unable to deliver product as specified by our customers' requirements. Recently, we were made aware of concerns over shortages of rare earth minerals used in the production of fluorescent lamps. We have increased our purchase commitments related to these components to ensure that we will have product availability to meet customer demands. We are continually monitoring supply side concerns through conversations with our key vendors and currently believe that supply availability concerns appear to have moderated, but have not diminished to the point where we anticipate reducing safety stock to the levels that existed prior to the electrical components supply issues.

We generally attempt to maintain at least a three-month supply of on-hand inventory of purchased components and raw materials to meet anticipated demand, as well as to reduce our risk of unexpected raw material or component shortages or supply interruptions. Our accounts receivables, inventory and payables may increase to the extent our revenue and order levels increase.

***Indebtedness******Revolving Credit Agreement***

On June 30, 2010, we entered into a new credit agreement (Credit Agreement) with JP Morgan Chase Bank, N.A. (JP Morgan). The Credit Agreement replaced our former credit agreement.

The Credit Agreement provides for a revolving credit facility (Credit Facility) that matures on June 30, 2012. Borrowings under the Credit Facility are limited to (i) \$15.0 million or (ii) during periods in which the outstanding principal balance of outstanding loans under the Credit Facility is greater than \$5.0 million, the lesser of (A) \$15.0 million or (B) the sum of 75% of the outstanding principal balance of certain accounts receivable of the Company and 45% of certain inventory of the Company. The Credit Agreement contains certain financial covenants, including minimum unencumbered liquidity requirements and requirements that we maintain a total liabilities to

tangible net worth ratio not to exceed 0.50 to 1.00 as of the last day of any fiscal quarter. The Credit Agreement also contains certain restrictions on our ability to make capital or lease expenditures over prescribed limits, incur additional indebtedness, consolidate or merge, guarantee obligations of third parties, make loans or advances, declare or pay any dividend or distribution on its

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stock, redeem or repurchase shares of its stock or pledge assets. We also may cause JP Morgan to issue letters of credit for the Company's account in the aggregate principal amount of up to \$2.0 million, with the dollar amount of each issued letter of credit counting against the overall limit on borrowings under the Credit Facility. As of September 30, 2011, we had had outstanding letters of credit totaling \$1.7 million, primarily for securing collateral requirements under equipment operating leases. In fiscal 2011, we incurred \$57,000 of total deferred financing costs related to the Credit Agreement which is being amortized over the two-year term of the Credit Agreement. We had no outstanding borrowings under the Credit Agreement as of March 31, 2011 or September 30, 2011. We were in compliance with all of its covenants under the Credit Agreement as of September 30, 2011.

The Credit Agreement is secured by a first lien security interest in our accounts receivable, inventory and general intangibles, and a second lien priority in our equipment and fixtures. All OTAs, PPAs, leases, supply agreements and/or similar agreements relating to solar PV and wind turbine systems or facilities, as well as all of our accounts receivable and assets related to the foregoing, are excluded from these liens.

We must pay a fee of 0.25% on the average daily unused amount of the Credit Facility and a fee of 2.00% on the daily average face amount of undrawn issued letters of credit. The fee on unused amounts is waived if we or our affiliates maintain funds on deposit with JP Morgan or its affiliates above a specified amount. We satisfied the deposit requirement to waive the unused fee as of September 30, 2011.

**OTA Credit Agreement**

In September 2011, we entered into a credit agreement with JP Morgan that provided us with \$5.0 million immediately available to fund completed customer contracts under our OTA finance program and an additional \$5.0 million upon our achievement of meeting a trailing 12-month earnings before interest, taxes, depreciation and amortization (EBITDA) target of \$8.0 million. We have one-year from the date of the commitment to borrow under the credit agreement. In September 2011, we borrowed \$1.8 million. The borrowing is collateralized by the OTA-related equipment and the expected future monthly payments under the supporting 27 individual OTA customer contracts. The current borrowing under the credit agreement bears interest at LIBOR plus 4% and matures in September 2016. The credit agreement includes certain financial covenants, including funded debt to EBITDA and debt service coverage ratios. We were in compliance with all covenants in the credit agreement as of September 30, 2011.

**Capital Spending**

Capital expenditures totaled \$2.0 million during the fiscal 2012 first half due to investments in information technologies and other tooling and equipment for new products, as well as cost improvements in our manufacturing facility. We expect to incur a total of \$1.0 to \$1.4 million in capital expenditures during the remainder of fiscal 2012, excluding capital to support our OTA contracts. Our capital spending plans predominantly consist of further cost improvements in our manufacturing facility, improvements to our building and headquarters, new product development and investment in information technology systems. We consider the investment in our information systems critical to our long-term success and our ability to ensure a strong control environment over financial reporting and operations. We expect to finance these capital expenditures primarily through our existing cash, equipment secured loans and leases, to the extent needed, long-term debt financing, or by using our available capacity under our credit facility.

**Contractual Obligations and Commitments**

The following table is a summary of our long-term contractual obligations as of September 30, 2011 (dollars in thousands):

|   | <b>Total</b> | <b>Less than 1<br/>Year</b> | <b>1-3 Years</b> | <b>3-5 Years</b> | <b>More than 5<br/>Years</b> |
|---|--------------|-----------------------------|------------------|------------------|------------------------------|
| Bank debt obligations                     | \$ 9,281     | \$ 2,351                    | \$ 4,150         | \$ 1,837         | \$ 943                       |
| Cash interest payments on debt            | 1,546        | 496                         | 579              | 192              | 279                          |
| Operating lease obligations               | 8,499        | 1,715                       | 1,945            | 1,734            | 3,105                        |
| Purchase order and cap-ex commitments (1) | 16,028       | 8,386                       | 7,642            |                  |                              |



|       |    |        |    |        |    |        |    |       |    |       |
|-------|----|--------|----|--------|----|--------|----|-------|----|-------|
| Total | \$ | 35,354 | \$ | 12,948 | \$ | 14,316 | \$ | 3,763 | \$ | 4,327 |
|-------|----|--------|----|--------|----|--------|----|-------|----|-------|

- (1) Reflects non-cancellable purchase order commitments in the amount of \$16.0 million for certain inventory items entered into in order to secure better pricing and ensure materials on hand.

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**Off-Balance Sheet Arrangements**

We have no off-balance sheet arrangements.

**Inflation**

Our results from operations have not been, and we do not expect them to be, materially affected by inflation.

**Critical Accounting Policies and Estimates**

The discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of our consolidated financial statements requires us to make certain estimates and judgments that affect our reported assets, liabilities, revenue and expenses, and our related disclosure of contingent assets and liabilities. We re-evaluate our estimates on an ongoing basis, including those related to revenue recognition, inventory valuation, the collectability of receivables, stock-based compensation, warranty reserves and income taxes. We base our estimates on historical experience and on various assumptions that we believe to be reasonable under the circumstances. Actual results may differ from these estimates. A summary of our critical accounting policies is set forth in the Critical Accounting Policies and Estimates section of our Management's Discussion and Analysis of Financial Condition and Results of Operations contained in our Annual Report on Form 10-K for the year ended March 31, 2011. There have been no material changes in any of our accounting policies since March 31, 2011.

**Recent Accounting Pronouncements**

For a complete discussion of recent accounting pronouncements, refer to Note B in the condensed consolidated financial statements included elsewhere in this report.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Our exposure to market risk was discussed in the Quantitative and Qualitative Disclosures About Market Risk section contained in our Annual Report on Form 10-K for the year ended March 31, 2011. There have been no material changes to such exposures since March 31, 2011.

**ITEM 4. CONTROLS AND PROCEDURES**

**Evaluation of Disclosure Controls and Procedures**

We maintain a system of disclosure controls and procedures designed to provide reasonable assurance as to the reliability of our published financial statements and other disclosures included in this report. Our management evaluated, with the participation of our Chief Executive Officer and our Chief Financial Officer, the effectiveness of the design and operation of our disclosure controls and procedures as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, or the Exchange Act, as of the end of the quarter ended September 30, 2011 pursuant to Rule 13a-15(b) of the Exchange Act. Based upon their evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that our disclosure controls and procedures were effective as of the end of the quarter ended September 30, 2011.

There was no change in our internal control over financial reporting that occurred during the quarter ended September 30, 2011 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**PART II OTHER INFORMATION**

**ITEM 1A. RISK FACTORS**

We operate in a rapidly changing environment that involves a number of risks that could materially affect our business, financial condition or future results, some of which are beyond our control. In addition to the other information set forth in this Quarterly Report on Form 10-Q, the risks and uncertainties that we believe are most important for you to consider are discussed in Part I Item 1A under the heading Risk Factors in our Annual Report on Form 10-K for the fiscal year ended March 31, 2011, which we filed with the SEC on July 22, 2011. During the three months ended September 30, 2011, there were no material changes to the risk factors that were disclosed in Part I Item 1A under the heading Risk Factors in our Annual Report on Form 10-K for the fiscal year ended March 31, 2011.

**Table of Contents****ITEM 5. OTHER INFORMATION****Statistical Data**

The following table presents certain statistical data, cumulative from December 1, 2001 through September 30, 2011, regarding sales of our HIF lighting systems, total units sold (including HIF lighting systems), customer kilowatt demand reduction, customer kilowatt hours saved, customer electricity costs saved, indirect carbon dioxide emission reductions from customers' energy savings, and square footage we have retrofitted. The assumptions behind our calculations are described in the footnotes to the table below.

|  | <b>Cumulative From<br/>December 1, 2001<br/>Through September 30,<br/>2011<br/>(in thousands, unaudited)</b> |
|--|--|
| HIF lighting systems sold(1)   | 2,176  |
| Total units sold (including HIF lighting systems)                                    | 2,904  |
| Customer kilowatt demand reduction(2)  | 679  |
| Customer kilowatt hours saved(2)(3)  | 17,970,668   |
| Customer electricity costs saved(4)  | \$ 1,383,741   |
| Indirect carbon dioxide emission reductions from customers' energy savings (tons)(5) | 11,677   |
| Square footage retrofitted(6)  | 1,119,001  |

- (1) HIF lighting systems includes all HIF units sold under the brand name Compact Modular and its predecessor, Illuminator.
- (2) A substantial majority of our HIF lighting systems, which generally operate at approximately 224 watts per six-lamp fixture, are installed in replacement of HID fixtures, which generally operate at approximately 465 watts per fixture in commercial and industrial applications. We calculate that each six-lamp HIF lighting system we install in replacement of an HID fixture generally reduces electricity consumption by approximately 241 watts (the difference between 465 watts and 224 watts). In retrofit projects where we replace fixtures other than HID fixtures, or where we replace fixtures with products other than our HIF lighting systems (which other products generally consist of products with lamps similar to those used in our HIF systems, but with varying frames, ballasts or power packs), we generally achieve similar wattage reductions (based on an analysis of the operating wattages of each of our fixtures compared to the operating wattage of the fixtures they typically replace). We calculate the amount of kilowatt demand reduction by multiplying (i) 0.241 kilowatts per six-lamp equivalent unit we install by (ii) the number of units we have installed in the period presented, including products other than our HIF lighting systems (or a total of approximately 2.9 million units).
- (3) We calculate the number of kilowatt hours saved on a cumulative basis by assuming the demand (kW) reduction for each fixture and assuming that each such unit has averaged 7,500 annual operating hours since its installation.
- (4) We calculate our customers' electricity costs saved by multiplying the cumulative total customer kilowatt hours saved indicated in the table by \$0.077 per kilowatt hour. The national average rate for 2010, which is the most current full year for which this information is available, was \$0.0988 per kilowatt hour according to the United States Energy Information Administration.
- (5) We calculate this figure by multiplying (i) the estimated amount of carbon dioxide emissions that result from the generation of one kilowatt hour of electricity (determined using the Emissions and Generation Resource Integration Database, or EGrid, prepared by the United States Environmental Protection Agency), by (ii) the

number of customer kilowatt hours saved as indicated in the table.

- (6) Based on 2.90 million total units sold, which contain a total of approximately 14.5 million lamps. Each lamp illuminates approximately 75 square feet. The majority of our installed fixtures contain six lamps and typically illuminate approximately 450 square feet.

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**ITEM 6. EXHIBITS**

**(a) Exhibits**

|         |  |
|---------|--|
| 31.1    | Certification of Chief Executive Officer of Orion Energy Systems, Inc. pursuant to Rule 13a-14(a) or Rule 15d-14(a) promulgated under the Securities Exchange Act of 1934, as amended.   |
| 31.2    | Certification of Chief Financial Officer of Orion Energy Systems, Inc. pursuant to Rule 13a-14(a) or Rule 15d-14(a) promulgated under the Securities Exchange Act of 1934, as amended.   |
| 32.1    | Certification of Chief Executive Officer of Orion Energy Systems, Inc. pursuant to Rule 13a-14(b) promulgated under the Securities Exchange Act of 1934, as amended, and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 32.2    | Certification of Chief Financial Officer of Orion Energy Systems, Inc. pursuant to Rule 13a-14(b) promulgated under the Securities Exchange Act of 1934, as amended, and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 101.INS | XBRL Instance Document   |
| 101.SCH | Taxonomy extension schema document   |
| 101.CAL | Taxonomy extension calculation linkbase document   |
| 101.LAB | Taxonomy extension label linkbase document   |
| 101.PRE | Taxonomy extension presentation linkbase document  |

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**SIGNATURE**

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, on November 9, 2011.

ORION ENERGY SYSTEMS, INC.  
Registrant

By /s/ Scott R. Jensen  
Scott R. Jensen  
Chief Financial Officer  
(Principal Financial Officer and Authorized  
Signatory)

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**Exhibit Index to Form 10-Q for the Period Ended September 30, 2011**

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