

ENERGY FOCUS, INC/DE
Form 10-K
March 10, 2016

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

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

For the fiscal year ended December 31, 2015

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

For the transition period from _____ to _____

Commission file number 0-24230

ENERGY FOCUS, INC.

(Exact name of registrant as specified in its charter)

DELAWARE

94-3021850

(State of incorporation)

(I.R.S. Employer Identification No.)

32000 Aurora Road, Suite B

Solon, Ohio 44139

(Address of principal executive offices, including zip code)

Registrant's telephone number, including area code: 440.715.1300

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Exchange Act:

Title of Each Class

Common Stock, Par Value \$0.0001

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined by Rule 405 of the Securities Act of 1933. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act. Yes No

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements

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incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company.

Large accelerated filer

Accelerated filer

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

Smaller reporting company

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

The aggregate value of the Company's common stock held by non-affiliates of the Company was approximately \$56.7 million as of June 30, 2015, the last day of the Company's most recently completed second fiscal quarter, when the last reported sales price was \$8.74 per share.

Number of the registrant's shares of common stock outstanding as of March 4, 2016: 11,648,978

Documents Incorporated by Reference

Portions of the Company's definitive Proxy Statement for its 2016 Annual Meeting of Stockholders are incorporated by reference into Part III, Items 10-14 of this Annual Report on Form 10-K.

TABLE OF CONTENTS

	Page
PART I	
ITEM 1. BUSINESS	3
ITEM 1A. RISK FACTORS	8
ITEM 1B. UNRESOLVED STAFF COMMENTS	16
ITEM 2. PROPERTIES	16
ITEM 3. LEGAL PROCEEDINGS	16
ITEM 4. MINE SAFETY DISCLOSURES	16
PART II	
ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS, AND ISSUER PURCHASES OF EQUITY SECURITIES	18
ITEM 6. SELECTED FINANCIAL DATA	19
ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS	20
ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA	30
ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURES	59
ITEM 9A. CONTROLS AND PROCEDURES	59
ITEM 9B. OTHER INFORMATION	60
PART III	
ITEM 10. DIRECTORS, EXECUTIVE OFFICERS, AND CORPORATE GOVERNANCE	61
ITEM 11. EXECUTIVE COMPENSATION	61
ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS	61
ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE	61
ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES	61

PART IV

ITEM 15.	EXHIBITS AND FINANCIAL STATEMENT SCHEDULES	62
	SIGNATURES	63
	EXHIBIT INDEX	64

PART I

Forward-looking statements

Unless the context otherwise requires, all references to “Energy Focus,” “we,” “us,” “our,” “our company,” or “the Company” to Energy Focus, Inc., a Delaware corporation, and its subsidiaries, and their respective predecessor entities for the applicable periods, considered as a single enterprise.

This Annual Report on Form 10-K (“Annual Report”) includes statements that express our opinions, expectations, beliefs, plans, objectives, assumptions or projections regarding future events or future results and therefore are, or may be deemed to be, “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These forward-looking statements can generally be identified by the use of forward-looking terminology, including the terms “believes,” “estimates,” “anticipates,” “expects,” “feels,” “seeks,” “forecasts,” “projects,” “intends,” “plans,” “may,” “will,” “should,” “could” or “would,” and their negative or other variations or comparable terminology. These forward-looking statements include all matters that are not historical facts. They appear in a number of places throughout this Annual Report and include statements regarding our intentions, beliefs, or current expectations concerning, among other things, our results of operations, financial condition, liquidity, prospects, growth, strategies, capital expenditures, and the industry in which we operate.

By their nature, forward-looking statements involve risks and uncertainties because they relate to events and depend on circumstances that may or may not occur in the future. Although we base these forward-looking statements on assumptions that we believe are reasonable when made, we caution you that forward-looking statements are not guarantees of future performance and that our actual results of operations, financial condition and liquidity, and industry developments may differ materially from statements made in or suggested by the forward-looking statements contained in this Annual Report. In addition, even if our results of operations, financial condition and liquidity, and industry developments are consistent with the forward-looking statements contained in this Annual Report, those results or developments may not be indicative of results or developments in subsequent periods.

We believe that important factors that could cause our actual results to differ materially from forward-looking statements include, but are not limited to, the risks and uncertainties outlined under “Risk Factors” under Item 1A and other matters described in this Annual Report generally. Some of these factors include:

- our reliance on a limited number of customers, in particular our sales of products for the U.S. Navy, for a significant portion of our revenue, and our ability to maintain or grow such sales levels;
- our history of operating losses and our ability to generate sufficient cash from operations or receive sufficient financing, on acceptable terms, to continue our operations;
- general economic conditions in the United States and in other markets in which we operate;
- our ability to implement and manage our growth plans and control expenses to increase sales;
- our ability to increase demand in our targeted markets;
- the timing of large customer orders and significant expenses as we invest in growth opportunities;
- market acceptance of LED lighting technology;
- our dependence on military maritime customers and on the levels of government funding available to such customers;
- our ability to respond to new lighting technologies and market trends with safe and reliable products;
- our ability to compete effectively against companies with greater resources;
- our ability to protect our intellectual property rights and the impact of any type of legal claim or dispute;
- our ability to obtain critical components and finished products from third-party suppliers on acceptable terms;
- risks inherent in international markets, such as economic and political uncertainty, changing regulatory and tax requirements and currency fluctuations; and
- our ability to maintain effective internal controls and otherwise comply with our obligations as a public company.

In light of the foregoing, we caution you not to place undue reliance on our forward-looking statements. Any forward-looking statement that we make in this Annual Report speaks only as of the date of such statement, and we undertake no obligation to update any forward-looking statement or to publicly announce the results of any revision to any of those statements to reflect future events or developments. Comparisons of results for current and any prior periods are not intended to express any future trends or indications of future performance, unless specifically expressed as such, and should only be viewed as historical data.

Energy Focus® and Intellitube® are our registered trademarks. We may also refer to trademarks of other corporations and organizations in this document.

ITEM 1. BUSINESS

Overview

Energy Focus, Inc. and its subsidiaries engage in the design, development, manufacturing, marketing, installation, and sale of energy-efficient lighting systems. We operate in a single industry segment, developing and selling our energy-efficient light-emitting diode ("LED") lighting products into the military maritime market, and general commercial and industrial markets. Recently, we have aligned our resources and focused our efforts on the sale of our LED lighting products, in particular our military and commercial tubular LED ("TLED") lines of products, into targeted vertical markets. Our goal is to become a leader in the LED lighting retrofit market by replacing fluorescent lamps in general purpose and high-intensity discharge ("HID") lighting in low-bay and high-bay applications with our innovative, high-quality TLED products.

During 2014, we shifted our focus away from the turnkey solutions business operated through our subsidiary, Energy Focus LED Solutions, LLC, which had historically incurred lower gross margins, and as of September 2015, had fully exited the solutions business. In August 2015, we sold our United Kingdom subsidiary, Crescent Lighting Limited. As a result of exiting the turnkey solutions and Crescent Lighting Limited businesses, we have eliminated all net sales and expenses associated with both businesses from the Consolidated Statements of Operations and have reported the net loss as discontinued operations. Please refer to Note 3, "Discontinued Operations," for more information on our disposition of these businesses.

The Company was founded in 1985 as Fiberstars, Inc., a California corporation, and reincorporated in Delaware in November 2006. In May 2007, Fiberstars, Inc. merged with and became Energy Focus, Inc., also a Delaware corporation. Our principal executive offices are located at 32000 Aurora Road, Suite B, Solon, Ohio 44139. Our telephone number is 440.715.1300. Our website address is www.energyfocusinc.com. Information on our website is not part of this Annual Report.

Our industry

We are committed to developing and bringing our high-quality, energy-efficient, long-lived and mercury-free TLED products to our targeted military maritime, government, and commercial and industrial markets to replace linear fluorescent lamps in general purpose lighting applications and HID lamps in low-bay and high-bay lighting applications. We believe there is a significant growth opportunity for our business as the lighting market continues its transition to more energy-efficient technologies such as LED lighting, driven by technological improvements and emerging regulatory requirements. As the efficiency and cost of LED lighting continue to improve, we believe that market adoption will accelerate, particularly in commercial and industrial applications, due to the significant potential for energy savings and the early stage of LED adoption in these applications.

Our products

We produce, source, and/or market a wide variety of LED lighting technologies to serve our primary end markets, including the following:

Military maritime products to serve the U.S. Navy and allied foreign navies:

- ♣Military Intellitube®;
- ♣Military globe lights;
- ♣Military berth light; and

Commercial products to serve our targeted and general commercial and industrial markets:

- Commercial Intellitube® TLED replacement for linear fluorescent lamps;
- Direct-wire TLED replacements for linear fluorescent lamps;
- LED dock lights;
- Vapor tight lighting;
- Low-bay and high-bay lighting, for HID applications; and
- LED retrofit kits.

The key features of our products are as follows:

3

Many of our products meet the lighting efficiency standards mandated by the Energy Independence and Security Act of 2007.

Many of our products qualify for federal and state tax and rebate incentives for commercial and residential consumers in certain states.

Many of our products make use of proprietary optical and electronics delivery systems that enable high efficiencies with superior lighting qualities.

Our strengths and strategy

Our LED products are more energy-efficient than traditional lighting products such as incandescent bulbs and fluorescent lamps, and we believe they can provide significant long-term energy and maintenance cost savings to potential clients.

Our strengths, which we believe provide a strategic competitive advantage, include the following:

- providing what we believe to be the only military-spec qualified LED fluorescent replacement lamps for the U.S. Navy;

- owning and controlling the development, design, and construction of our TLED products to ensure performance, quality, and cost advantages;

- providing our commercial Intellitube® product, which we believe is the first single end powered TLED that is UL approved to work with both direct wire, as a single ended lamp, as well as an end-to-end lamp for direct fit into ballasted fixtures;

- concentrated on developing and providing high-quality, price competitive TLED lamps to replace fluorescent and HID lamps for commercial and industrial markets;

- a long developmental history, with broad and intimate understanding of lighting technologies and LED lighting applications;

- establishing production capabilities for TLED products that will be “Buy American”;

- product inventory availability through carrying limited SKUs; and

- a deep understanding of the adoption dynamics for energy-efficient lighting products in existing commercial and industrial building markets.

Through our strengths, we seek to achieve the following objectives:

- become the LED lighting leader in the targeted markets;

- continuing sales growth and profitable financial performance;

- further penetration of our military-grade LED lighting products to the military maritime market, including both the U.S. Navy and allied foreign navy market;

- replication of our success in the military maritime market by penetrating the government and commercial vertical markets for our commercial LED lighting products; and

- a streamlined and high-performing organization that is focused on providing industry-leading LED lighting products that generate energy savings and reduce carbon emissions for our clients.

Our strategy to achieve these objectives includes the following actions:

- continue to utilize our patents and proprietary know-how to develop innovative LED lighting products that are differentiated by their quality, reliability, adaptability and cost of ownership;

- increase awareness and knowledge of our technology and offerings within our targeted markets;

- establish relationships with key clients and early adopters to demonstrate our technology and value in targeted vertical markets;

• rapidly scale our sales efforts to increase the penetration of our technology in our targeted markets; and
• expand selectively into geographical markets.

Targeted vertical markets

We are focusing on markets where the economic benefits of our lighting product offerings are most compelling. To do so, we are currently targeting specific vertical and geographic segments within three markets: military maritime, government, and commercial and industrial.

4

We have achieved substantial growth in the military maritime market since 2014, capitalizing on our long-standing relationship with the U.S. Navy and our status as what we believe to be the only U.S. Navy military-spec qualified TLED lamp provider. In the second half of 2014, we began receiving sizable orders for our military Intellitube[®] product as the Navy embarked on a fleet-wide LED retrofit project. Sales of our products to the U.S. Navy or distributors for the U.S. Navy were approximately \$51.3 million for the year ended December 31, 2015, or 80 percent of total net sales. Through December 31, 2015, we believe approximately 30 percent of the Navy's potentially replaceable fluorescent tubes have been retrofitted with our military Intellitube[®] product.

We are optimistic that we will continue generating strong sales of our military Intellitube[®] product in the near-term as the transformation of the U.S. Navy fleet to LED lighting continues. In addition, we announced our first order for the Royal Australian Navy in the second quarter of 2015, and we believe there is a significant opportunity to build on our success with the U.S. Navy by targeting allied foreign navies in the long term. We also believe that our success and experience working with the U.S. military, coupled with the introduction of our commercial Intellitube[®] product in the second quarter of 2015, as well as our capability to manufacture "Buy American" products, provides an enhanced opportunity for us to market our products to approximately 200 major military bases in the U.S. Our efforts with military bases are still in the early stages, but we are actively pursuing the opportunity.

In the commercial and industrial markets, we are currently targeting the following verticals in the United States: healthcare, education, industrial and manufacturing, and national retail.

In healthcare, we are currently working with several hospital systems to introduce our products and demonstrate our technology. Given the 24/7 lighting requirements of hospital systems, we believe the quality and value of our products are particularly attractive. We are aggressively expanding our sales effort in the healthcare vertical market in an attempt to increase our penetration, and in 2015 announced a supply agreement with a major northeast Ohio hospital system to retrofit the system's main campus.

In education, we are gaining traction in the K-12 market and have received orders to retrofit school districts in various states. In addition, through a partnership in the TLED category with the Center for Green Schools at the U.S. Green Building Council that we announced in the second quarter of 2015, we are working to build awareness and adoption of our LED lighting technology in schools initially within our current geographic markets, including the North East, Mid-Atlantic and Midwest. As we advocate for the benefits of LED lighting in schools, both in terms of energy-efficiency and in creating a healthy learning environment, we believe additional opportunities to penetrate the K-12 market will arise.

We are also in the early stages of our efforts in the industrial and manufacturing and national retail vertical markets, which are large addressable markets and provide an attractive opportunity for us. In the industrial and manufacturing market in particular, due to the usage of HID lighting, the energy savings that can be achieved by switching to our LED products could be substantial and we believe we have attractive product offerings in this space.

Sales and marketing

Our products are sold through a combination of direct sales employees, independent sales representatives, electrical and lighting contractors, and distributors.

We currently sell the majority of our products for the U.S. Navy through distributor and sales representative arrangements. Until the third quarter of 2015, our primary distributor was LED Lighting Solutions Global, LLC (an affiliate of Energy Management Products, LLC) ("LLS"), which now serves as a sales representative with respect to our U.S. Navy business and a distributor for foreign navies and the U.S. Navy Military Sealift Command. In the third quarter of 2015, we entered into exclusive distribution agreements for 2016 with Atlantic Diving Supply, Inc. ("ADS") and LLS, under which ADS and LLS purchase our products under minimum commitment requirements for supply to the U.S. Navy, and to foreign navies and the U.S. Navy Military Sealift Command, respectively. Sales of our products

for the U.S. Navy through ADS and LLS combined were \$48.2 million during 2015, or 75 percent of our total sales for the period. The remainder of our sales of products for the U.S. Navy in the year ended December 31, 2015 were made pursuant to a contract we were awarded in 2011.

Within the commercial and industrial market, we continue to focus on direct corporate accounts, general contractors, and lighting retrofit companies (“LRCs”) especially in the healthcare, education, industrial and manufacturing, and retail markets. We intend to continue to expand our business development capabilities, sales organizations, and geographic markets to support our efforts in these areas.

Concentration of sales

In 2015, sales of our products to the U.S. Navy or to distributors for the U.S. Navy accounted for approximately 80 percent of net sales from continuing operations. Customers accounting for greater than 10 percent of our net sales from continuing operations included LLS, which accounted for approximately 59 percent, and ADS, which accounted for approximately 16 percent. There were no other customers accounting for greater than 10 percent of our net sales.

Competition

Our commercial lighting products compete against a variety of lighting products, including conventional light sources such as compact fluorescent lamps and HID lamps, as well as other TLEDs and full fixture lighting products. Our ability to compete depends substantially upon the superior performance and lower lifecycle cost of our products. Principal competitors in our markets include large lamp manufacturers and lighting fixture companies, as well as Asian TLED manufacturers whose financial resources may substantially exceed ours. These competitors may introduce new or improved products that may reduce or eliminate some of the competitive advantage of our products. We anticipate that the competition for our products will also come from new technologies that offer increased energy efficiency, lower maintenance costs, and/or advanced features. In certain commercial applications, we compete with LED systems produced by large lighting companies such as Royal Philips, CREE, Inc., Osram Sylvania, and GE, Inc. Some of these competitors offer products with performance characteristics similar to those of our products.

In our military product line, we compete with a small number of qualified military lighting lamp and fixture suppliers, who in the future might also provide LED lighting products.

Manufacturing and suppliers

We produce our lighting products and systems through a combination of internal manufacturing and assembly at our Solon, Ohio facility, and sourced finished goods. Our internal lighting system manufacturing consists primarily of final assembly, testing, and quality control. We have worked with a number of our vendors to design custom components to meet our specific needs. Our quality assurance program provides for testing of all sub-assemblies at key stages in the assembly process, as well as testing of finished products produced both internally and sourced through third parties.

In an effort to reduce manufacturing costs, we have outsourced the production of certain parts and components, as well as finished goods in certain product lines, to a small number of vendors in various locations throughout the world, primarily in the United States and China. In some cases, we rely upon a single supplier to source certain components, sub-assemblies, or finished goods. We continually attempt to improve our global supply chain practices in order to satisfy client demands in terms of quality and volumes, while controlling our costs and achieving targeted gross margins.

Additionally, we are establishing a "Buy American" line of TLEDs and we believe this will offer us a competitive advantage in certain targeted vertical markets.

Product development

Product development is a key area of focus for us. Our product development team is dedicated to developing and designing leading LED lighting products, and we have recently opened product development centers in Taiwan and Minnesota.

Gross product development expenses for the years ended December 31, 2015, 2014, and 2013 were \$3.0 million, \$1.7 million, and \$3.5 million respectively. As we previously announced, in 2014 we curtailed our efforts on bidding on research contracts and grants in order to focus our resources exclusively on projects and contracts that support LED technologies.

Intellectual property

We have a policy of seeking to protect our intellectual property through patents, license agreements, trademark registrations, confidential disclosure agreements, and trade secrets as management deems appropriate. We have approximately 10 patents that we consider key to our current product lines. Additionally, we have various pending United States patent applications, and various pending Patent Cooperation Treaty patent applications filed with the World Intellectual Property Organization that serve as the basis for national patent filings in countries of interest. Our issued patents expire at various times through July 2032. Generally, the term of patent protection is twenty years from the earliest effective filing date of the patent application. There can be no assurance, however, that our issued patents are valid or that any patents applied for will be issued, and that our competitors or clients will not copy aspects of our lighting systems or obtain information that we regard as

proprietary. There can also be no assurance that others will not independently develop products similar to ours. The laws of some foreign countries in which we sell or may sell our products do not protect proprietary rights to products to the same extent as the laws of the United States.

Insurance

All of our properties and equipment are covered by insurance and we believe that such insurance is adequate. In addition, we maintain general liability and workers compensation insurance in amounts we believe to be consistent with our risk of loss and industry practice.

Employees

At December 31, 2015, we had 122 full-time employees, 4 of whom were located in Taiwan and 118 in the United States. None of our employees are subject to any collective bargaining agreement.

Business segments

During the third quarter of 2015, we completed the exit of our turnkey solutions business and reported the historical results of that business as discontinued operations. We currently operate in a single business segment that includes the marketing and sale of commercial, industrial, and military maritime lighting products, and research and development services. Our products are sold primarily in North America through a combination of direct sales employees, independent sales representatives, and distributors.

Please refer to Note 3, "Discontinued Operations" and Note 13, "Product and Geographic Information," included in Item 8 of this Annual Report, for additional information.

Available information

Our website is located at www.energyfocusinc.com. We make available free of charge, on or through our website, our annual, quarterly, and current reports, as well as any amendments to those reports, as soon as reasonably practicable after electronically filing such reports with the Securities and Exchange Commission. Information contained on our website is not part of this Annual Report.

ITEM 1A. RISK FACTORS

Risks associated with our business

We have a history of operating losses and may incur losses in the future.

While we reported net income from continuing operations of \$9.5 million for the year ended December 31, 2015, we have experienced net losses from continuing operations of approximately \$4.2 million and \$5.9 million for the years ended December 31, 2014 and 2013, respectively. As of December 31, 2015, we had cash and cash equivalents of approximately \$34.6 million and an accumulated deficit of \$80.1 million.

In order for us to attain sustainable profitability and growth, we will need to execute our marketing and sales plans for our energy-efficient LED lighting products, develop new technologies and products that allow us to effectively compete in new markets and continue to improve our supply chain. Our recent improved financial performance has been due in large part to increased sales of our military maritime products for the U.S. Navy. In order to continue to generate profits over the long-term, we will need to diversify our customer base and product offerings. Our efforts to expand our offerings and reach additional markets are in their early stages and there can be no assurance we will be successful.

We derive a significant portion of our revenue from a few customers and the loss of one of these customers, or a reduction in their demand for our products, could adversely affect our business, financial condition, results of operations and prospects.

Our customer base is highly concentrated. One or a few customers have represented a substantial portion of our net sales and our concentration has recently increased as our sales of products for the U.S. Navy have grown. For the year ended December 31, 2015, LLS and ADS, distributors for the U.S. Navy, accounted for approximately 59 percent and 16 percent, respectively, of net sales from continuing operations, and total sales of products for the U.S. Navy accounted for approximately 80 percent of net sales from continuing operations. We anticipate that sales of products for the U.S. Navy will continue to comprise a significant portion of our revenue in the near-term, and that a limited number of customers could continue to comprise a substantial portion of our revenue for the foreseeable future. In the fourth quarter of 2015, we entered into distribution agreements with ADS and LLS, under which ADS and LLS purchase our products under minimum commitment requirements in regard to the applicable territories in order to maintain exclusivity. We generally do not have long-term contracts with our customers that commit them to purchase any minimum amount of our products or require them to continue to do business with us. Significant customers, including distributors or end-users such as the U.S. Navy, could discontinue purchasing our products at any time. We could lose business from the U.S. Navy or another significant customer for a variety of reasons, many of which are outside of our control. These reasons could include changes in levels of funding available to military maritime customers, our inability to comply with government contracting laws and regulations, changes in customers' procurement strategies or their lighting retrofit plans, new competitors entering particular markets, our failure to keep pace with technological advances and damage to our professional reputation, among others.

Even if we continue to do business with our significant customers, our concentration can cause variability in our results because we cannot control the timing or amounts of their purchases. If a significant end-user like the U.S. Navy, for example, changes the scope or timing of its energy efficiency initiatives, it could adversely affect our results of operations and cash flows in particular periods.

Depressed general economic conditions may adversely affect our operating results and financial condition.

Our business is sensitive to changes in general economic conditions, both inside and outside the United States. An economic downturn may adversely affect our business. Slow growth in the economy or an economic downturn could adversely affect our ability to meet our working capital requirements and growth objectives, or could otherwise

adversely affect our business, financial condition, and results of operations. As a result, any general or market-specific economic downturns, particularly those affecting construction and building renovation, or that cause end-users to reduce or delay their purchases of lighting products, services, or retrofit activities, would have a material adverse effect on our business, cash flows, financial condition and results of operations. LED lighting retrofit projects, in particular, tend to require a significant capital commitment, which is offset by cost savings achieved over time. As such, a lack of available capital, whether due to economic factors or conditions