

ENERGY FOCUS, INC/DE

Form 10-Q

May 13, 2010

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549  
Form 10-Q**

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

**For the quarterly period ended March 31, 2010**

**OR**

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

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

**Commission file number 0-24230**

**ENERGY FOCUS, INC.**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of incorporation or organization)

**94-3021850**

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

**32000 Aurora Rd., Solon, OH**

(Address of principal executive offices)

**44139**

(Zip Code)

(Registrant's telephone number, including area code): **(440) 715-1300**

(Former Name, Former Address and Former Fiscal Year, If Changed Since Last Report)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T 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 whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of "large accelerated filer", "accelerated filer", and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

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

The number of outstanding shares of the registrant's Common Stock, \$0.0001 par value, as of April 30, 2010 was 22,930,366.



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**ENERGY FOCUS, INC.**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
*(amounts in thousands except share and per share data)*

|  | <b>March 31,<br/>2010<br/>(unaudited)</b> | <b>December<br/>31,<br/>2009</b> |
|--|---|----------------------------------|
| <b>ASSETS</b>  |   |                                  |
| Current assets:  |   |                                  |
| Cash and cash equivalents  | \$ 1,810                                  | \$ 1,062                         |
| Accounts receivable trade, net   | 5,351                                     | 2,922                            |
| Inventories, net   | 3,298                                     | 3,770                            |
| Prepaid and other current assets   | 573                                       | 509                              |
| Total current assets   | 11,032                                    | 8,263                            |
| Fixed assets, net  | 2,894                                     | 3,091                            |
| Goodwill, net  | 672                                       | 672                              |
| Intangible assets, net   | 2,482                                     | 2,750                            |
| Collateralized assets  | 2,500                                     | 2,500                            |
| Other assets   | 81  | 102                              |
| Total assets   | \$ 19,661                                 | \$ 17,378                        |
| <b>LIABILITIES</b>   |   |                                  |
| Current liabilities:   |   |                                  |
| Accounts payable   | \$ 4,070                                  | \$ 1,677                         |
| Accrued liabilities  | 2,426                                     | 1,854                            |
| Deferred revenue   | 591                                       | 295                              |
| Total current liabilities  | 7,087                                     | 3,826                            |
| Other deferred liabilities   | 130                                       | 149                              |
| Acquisition-related contingent liabilities   | 1,062                                     | 1,183                            |
| Long-term borrowings   | 1,655                                     | 715                              |
| Total liabilities  | 9,934                                     | 5,873                            |
| <b>SHAREHOLDERS EQUITY</b>   |   |                                  |
| <i>Preferred stock, par value \$0.0001 per share:</i>                              |   |                                  |
| Authorized: 2,000,000 shares in 2010 and 2009 Issued and outstanding: no shares in |   |                                  |
| <i>Common stock, par value \$0.0001 per share:</i>                                 |   |                                  |
| Authorized: 30,000,000 shares in 2010 and 2009 Issued and outstanding:             |   |                                  |
| 21,370,000 in 2010 and 21,250,000 in 2009  | 1   | 1                                |
| Additional paid-in capital   | 73,242                                    | 71,373                           |

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|  |           |           |
|--|-----------|-----------|
| Accumulated other comprehensive income     | 397       | 474       |
| Accumulated deficit                        | (63,913)  | (60,343)  |
| Total shareholders' equity                 | 9,727     | 11,505    |
| Total liabilities and shareholders' equity | \$ 19,661 | \$ 17,378 |

The accompanying notes are an integral part of these financial statements.

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**ENERGY FOCUS, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
*(amounts in thousands except per share amounts)*  
**(unaudited)**

|   | <b>Three months ended</b> |             |
|---|---------------------------|-------------|
|   | <b>March 31,</b>          |             |
|   | <b>2010</b>               | <b>2009</b> |
| Net sales   | \$ 8,357                  | \$ 2,523    |
| Cost of sales                                       | 6,962                     | 2,295       |
| Gross profit  | 1,395                     | 228         |
| Operating expenses:                                 |                           |             |
| Research and development                            | 55                        | 156         |
| Sales and marketing                                 | 1,619                     | 1,546       |
| General and administrative                          | 1,679                     | 1,264       |
| Revaluation of equity instruments                   | 1,421                     |             |
| Restructuring expense                               | 26                        |             |
| Total operating expenses                            | 4,800                     | 2,966       |
| Loss from operations                                | (3,405)                   | (2,738)     |
| Other (expense) income:                             |                           |             |
| Other (expense) income                              | (65)                      | 19          |
| Interest expense                                    | (99)                      | (20)        |
| Loss from continuing operations before income taxes | (3,569)                   | (2,739)     |
| Provision for income taxes                          | (1)                       |             |
| Net loss from continuing operations                 | \$ (3,570)                | \$ (2,739)  |
| Discontinued operations:                            |                           |             |
| Loss before income taxes of discontinued operations |                           | (302)       |
| Provision for income taxes                          |                           |             |
| Loss from discontinued operations                   |                           | (302)       |
| Net loss  | \$ (3,570)                | \$ (3,041)  |

|   |                   |           |           |
|---|-------------------|-----------|-----------|
| Net loss per share                          | basic and diluted | \$ (0.17) | \$ (0.21) |
| Shares used in computing net loss per share | basic and diluted | 21,270    | 14,835    |

The accompanying notes are an integral part of these financial statements.

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**ENERGY FOCUS, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)**  
*(amounts in thousands)*  
**(unaudited)**

|  | <b>Three months ended</b> |             |
|--|---------------------------|-------------|
|  | <b>March 31,</b>          |             |
|  | <b>2010</b>               | <b>2009</b> |
| Net loss                                 | \$(3,570)                 | \$(3,041)   |
| Other comprehensive loss                 |                           |             |
| Foreign currency translation adjustments | (77)                      | (44)        |
| Comprehensive loss                       | \$(3,647)                 | \$(3,085)   |

The accompanying notes are an integral part of these financial statements.

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**ENERGY FOCUS, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
*(amounts in thousands)*  
**(unaudited)**

|  | <b>Three months ended</b> |             |
|--|---------------------------|-------------|
|  | <b>March 31,</b>          |             |
|  | <b>2010</b>               | <b>2009</b> |
| <b>Cash flows from operating activities:</b>   |                           |             |
| Net loss   | \$ (3,570)                | \$ (3,041)  |
| Less: loss from discontinued operations  |                           | (302)       |
| Net loss from continuing operations  | (3,570)                   | (2,739)     |
| Adjustments to reconcile net loss from continuing operations to net cash used in operating activities: |                           |             |
| Depreciation   | 208                       | 262         |
| Stock-based compensation   | 147                       | 196         |
| Revaluation of equity instruments  | 1,421                     |             |
| Provision for doubtful accounts receivable   | 7                         | (11)        |
| Amortization of intangible assets  | 268                       |             |
| Amortization of discounts on long-term borrowings  | 36                        |             |
| Deferred revenue   | 296                       | (118)       |
| Changes in assets and liabilities:   |                           |             |
| Accounts receivable, inventories, and other assets   | (2,118)                   | 651         |
| Accounts payable and accrued liabilities   | 2,867                     | (2,282)     |
| Total adjustments  | 3,132                     | (1,302)     |
| Net cash used in continuing operations   | (438)                     | (4,041)     |
| Net cash provided by discontinued operations   |                           | 444         |
| Net cash used in operating activities  | (438)                     | (3,597)     |
| <b>Cash flows from investing activities:</b>   |                           |             |
| Acquisition of fixed assets  | (16)                      | (81)        |
| Net cash used in continuing investing activities   | (16)                      | (81)        |
| Net cash used in discontinued investing activities   |                           | (2)         |
| Net cash used in investing activities  | (16)                      | (83)        |
| <b>Cash flows from financing activities:</b>   |                           |             |
| Cash proceeds from issuances of common stock, net  | 55                        |             |
| Discounts on notes payable   | 246                       |             |
| Borrowings on long-term borrowings   | 904                       |             |
| Net cash provided by continuing financing activities   | 1,205                     | 0           |

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|  |          |          |
|--|----------|----------|
| Net cash used in discontinued financing activities   |          | (132)    |
| Net cash provided by (used in) financing activities  | 1,205    | (132)    |
| Effect of exchange rate changes on cash              | (3)      | 44       |
| Net increase (decrease) in cash and cash equivalents | 748      | (3,768)  |
| Cash and cash equivalents at beginning of period     | 1,062    | 10,568   |
| Cash and cash equivalents at end of period           | \$ 1,810 | \$ 6,800 |

The accompanying notes are an integral part of these financial statements.

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**ENERGY FOCUS, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**MARCH 31, 2010**  
**(Unaudited)**

**NOTE 1. NATURE OF OPERATIONS**

Energy Focus, Inc. and its subsidiaries ( the company ) engage in the design, development, manufacturing, marketing, and installation of energy-efficient lighting systems where the company serves two segments:

solutions-based sales providing turnkey, high-quality, energy-efficient lighting application alternatives; and

product-based sales featuring pool lighting and general commercial lighting, each of which markets and sells energy-efficient lighting systems.

The company continues to evolve its business strategy to include providing its customers with turnkey, comprehensive energy-efficient lighting solutions, which use, but are not limited to, its patented and proprietary technology. The company s solutions include light-emitting diode ( LED ), ceramic metal halide ( CMH ), fiber optic ( EFO ), high-intensity discharge ( HID ), and other highly energy-efficient lighting technologies. Typical savings of the company s current technology approximates 80% in electricity costs, while providing full-spectrum light closely simulating daylight colors. The company s strategy also incorporates continued investment into the research of new and emerging energy sources including, but not limited to, solar energy.

**NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

The significant accounting policies of the company, which are summarized below, are consistent with generally accepted accounting principles and reflect practices appropriate to the business in which it operates.

*Use of Estimates*

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Estimates include, but are not limited to, the establishment of reserves for accounts receivable, sales returns, inventory obsolescence, and warranty claims; the useful lives for property, equipment, and intangible assets; and stock-based compensation. In addition, estimates and assumptions associated with the determination of fair value of financial instruments and evaluation of goodwill and long-lived assets for impairment requires considerable judgment. Actual results could differ from those estimates.

*Reclassifications*

Certain prior year amounts have been reclassified within the Consolidated Financial Statements ( financial statements ) to be consistent with the current year presentation.

*Basis of Presentation*

The financial statements include the accounts of the company and its subsidiaries, Stones River Companies, LLC ( SRC ) in Nashville, Tennessee, and Crescent Lighting Limited ( CLL ) located in the United Kingdom. LBM Lichtleit-Fasertechnik ( LBM ) located in Berching, Germany, was sold in December, 2009 and is included in these financial statements as discontinued operations. All significant inter-company balances and transactions have been eliminated.

*Interim Financial Statements (unaudited)*

Although unaudited, the interim financial statements in this report reflect all adjustments, consisting only of all normal recurring adjustments, which are, in the opinion of management, necessary for a fair statement of financial position, results of operations, and cash flows for the interim periods covered and of the financial condition of the company at the interim balance sheet date. The results of operations for the interim periods presented are not necessarily indicative of the results expected for the entire year.

*Year-end Balance Sheet*

The year-end balance sheet information was derived from audited financial statements but does not include all disclosures required by generally accepted accounting principles. These financial statements should be read in conjunction with the company s audited financial statements and notes thereto for the year ended December 31, 2009,

which are contained in the company's 2009 Annual Report on Form 10-K.

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**ENERGY FOCUS, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**MARCH 31, 2009**  
**(Unaudited)**

*Foreign Currency Translation*

The company's international subsidiary uses its local currency as its functional currency. Assets and liabilities are translated at exchange rates in effect at the balance sheet date and income and expense accounts at average exchange rates during the year. Resulting translation adjustments are recorded directly to accumulated comprehensive income within the statement of shareholders' equity. Foreign currency transaction gains and losses are included as a component of interest income and other. Gains and losses from foreign currency translation are included as a separate component of comprehensive income (expense) within the consolidated statement of comprehensive income (loss).

*Liquidity*

The company has incurred losses attributable to operational performance which has led to negative cash flows. Although management believes that it has addressed many of the legacy issues that have historically burdened the company's financial performance, the company still faces challenges in order to reach profitability. In order for the company to attain profitability and growth, it will need to successfully address these challenges, including the continuation of cost reductions throughout its organization, execution of its marketing and sales plans for its new turnkey energy-efficient lighting solutions business, continued evaluation and divestiture of non-core business product lines, and continued improvements in its supply chain performance.

Although the company is optimistic about obtaining the funding necessary for it to continue as a going concern, there can be no assurances that this objective will be successful. The company is currently aggressively pursuing the following external funding sources:

- obtain financing and/or grants available through federal, state, and/or local governmental agencies,

- obtain financing from various financial institutions,

- obtain financing from non-traditional investment capital organizations,

- potential sale or divestiture of one or more operating units, and

- obtain funding from the sale of our common stock or other equity instruments.

Obtaining financing through the above-mentioned mechanisms contains risks, including:

- government stimulus and/or grant money is not allocated to us despite our focus on the design, development, and manufacturing of energy efficient lighting systems,

- loans or other debt instruments may have terms and/or conditions, such as interest rate, restrictive covenants, and control or revocation provisions, which are not acceptable to management or our Board of Directors,

- the current global economic crisis combined with our current financial condition may prevent us from being able to obtain any debt financing,

- financing may not be available for parties interested in pursuing the acquisition of one or more of our operating units, and

- additional equity financing may not be available to us in the current economic environment and could lead to further dilution of shareholder value for current shareholders of record.

*Collateralized Assets*

The company maintains \$2,500,000 of cash securitization related to the company's \$10,000,000 surety bonding program associated with the acquisition of SRC on December 31, 2009. This cash is secured for a period of not less

than 24 months, unless the company is able to provide sufficient alternative means of securitization satisfactory to the surety carrier.

*Earnings (Loss) per Share*

Basic loss per share is computed by dividing net loss available to common shareholders by the weighted average number of common shares outstanding for the period. Diluted loss per share is computed giving effect to all dilutive potential common shares that were outstanding during the period. Dilutive potential common shares consist of incremental shares upon exercise of stock options and warrants, unless the effect would be anti-dilutive.

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**ENERGY FOCUS, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**MARCH 31, 2010**  
**(Unaudited)**

A reconciliation of the numerator and denominator of basic and diluted loss per share is provided as follows (in thousands, except per share amounts):

|  | <b>Three months ended<br/>March 31,</b> |             |
|--|---|-------------|
|  | <b>2010</b>                             | <b>2009</b> |
| Numerator basis and diluted loss per share   |   |             |
| Net loss                                     | \$ (3,570)                              | \$ (3,041)  |
| Denominator basis and diluted loss per share |   |             |
| Weighted average shares outstanding          | 21,270                                  | 14,835      |
| Basic and diluted net loss per share         | \$ (0.17)                               | \$ (0.21)   |

At March 31, 2010, options and warrants to purchase 7,963,000 shares of common stock were outstanding, but were not included in the calculation of diluted net loss per share because their inclusion would have been anti-dilutive. Options and warrants to purchase 5,665,000 shares of common stock were outstanding at March 31, 2009, but were not included in the calculation of diluted net loss per share because their inclusion would have been anti-dilutive.

*Stock-Based Compensation*

The company's stock-based compensation plan is described in detail in its Annual Report on Form 10-K for the year ended December 31, 2009.

For the quarter ended March 31, 2010, the company recorded compensation expense of \$147,000 compared to \$196,000 for the quarter ended March 31, 2009. Total unearned compensation of \$1,444,000 remains at March 31, 2010 compared to \$1,279,000 at March 31, 2009. These costs will be charged to expense, amortized on a straight line basis, in future periods through the first quarter of 2014. The remaining weighted average life of the outstanding options is approximately 1.9 years.

The fair value of each stock option is estimated on the date of grant using the Black-Scholes option pricing model. Estimates utilized in the calculation include the expected life of option, risk-free interest rate, and expected volatility, and are further comparatively detailed below.

|                              | <b>Three months ended<br/>March 31,</b> |             |
|------------------------------|---|-------------|
|                              | <b>2010</b>                             | <b>2009</b> |
| Fair value of options issued | \$ 0.70                                 | \$ 0.50     |
| Exercise price               | \$ 1.02                                 | \$ 0.84     |
| Expected life of option      | 4.0 years                               | 4.0 years   |
| Risk-free interest rate      | 1.86%                                   | 1.53%       |
| Expected volatility          | 97.40%                                  | 82.40%      |
| Dividend yield               | 0%                                      | 0%          |

The company granted 1,010,000 stock options during the quarter ended March 31, 2010, and 360,000 during the quarter ended March 31, 2009. The options granted during the quarter ended March 31, 2010 are contingent upon the approval of the increase to the maximum aggregate number of stock options awarded under the 2008 Incentive Stock Plan from 1,000,000 shares to 3,000,000 shares by shareholders at the 2010 Annual Meeting of Shareholders ( Annual Meeting ) to be held on June 16, 2010.





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**ENERGY FOCUS, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**MARCH 31, 2010**  
**(Unaudited)**

On December 31, 2009, the company's five senior executive officers, along with two other key executives of the company, agreed to accept voluntary cash salary reductions through June 30, 2010. Each officer and key executive voluntarily accepted a ten percent ( 10% ) salary reduction for this six month period, except for one officer who voluntarily accepted a forty percent ( 40% ) decrease for this six month period. The number of restricted shares of common stock issued to each officer and executive was equal to the dollar value of the individual's salary reduction divided by the closing price per share of the company's common stock on December 30, 2009. The total number of restricted shares of common stock issued to these officers and executives was 209,000. The company reserves the right to extend these salary reductions beyond that date. The company recorded compensation expense of \$58,000 for the quarter ended March 31, 2010 related to these voluntary salary reductions.

*Product Warranties*

The company warrants finished goods against defects in material and workmanship under normal use and service for periods of one to three years for illuminators and fiber. Settlement costs consist of actual amounts expensed for warranty services which are largely a result of third-party service calls, and the costs of replacement products. A liability for the estimated future costs under product warranties is maintained for products outstanding under warranty and is included in accrued expenses in the Condensed Consolidated Balance Sheet. The warranty activity for the respective years is as follows (in thousands):

|   | <b>Three months ended<br/>March 31,</b> |             |
|---|---|-------------|
|   | <b>2010</b>                             | <b>2009</b> |
| Balance at the beginning of the period                  | \$ 211                                  | \$ 308      |
| Accruals for warranties issued                          | (5)                                     | 24          |
| Settlements made during the period (in cash or in kind) | (20)                                    | (27)        |
| Balance at the end of the period                        | \$ 186                                  | \$ 305      |

**NOTE 3. ACQUISITION**

On December 31, 2009, the company acquired 100% of the members' interest of SRC, a Tennessee limited liability company, from TLC Investments, LLC ( TLC ), a Tennessee limited liability company, for a combination of cash, convertible debt, a contingent based earn-out, and shares of the company's common stock. SRC is a lighting retro fit company and an energy systems and solutions provider located in Nashville, Tennessee. SRC provides the company with the reputation and strong brand recognition within in the existing public sector buildings market based upon its 20 years of experience serving these markets. Given the significant existing contract backlog, pipeline of potential future contracts, proven delivery performance and strong existing relationships with its customer base that SRC brings to the company; it will be able to readily penetrate these markets with its unique and proven technology while simultaneously benefiting from the other natural synergies that exist between our two businesses. This acquisition is the foundation by which the company will emerge into a national turn-key energy solutions provider.

The company acquired approximately \$4,700,000 in assets, including accounts receivable, fixed assets, and other intangible assets. \$672,000 of the purchase price was recorded on the company's Consolidated Balance Sheet as goodwill. Purchase price consideration was paid in the form of \$1,500,000 of cash, 1,000,000 shares of Energy Focus Class A common stock, and a \$500,000 note convertible into 500,000 shares of the company's Class A common stock. The transaction also includes performance-related contingent consideration including a 2.5% payout on the annual revenues of the acquired business over the next 42 months, and a \$500,000 fee if the market price of the company's common stock is not equal to or greater than \$2.00 per share for at least twenty trading days between June 30, 2010 and June 30, 2013.

The acquisition has been accounted for as a stock purchase and, accordingly, has been included in the accompanying Consolidated Financial Statements of the company as of December 31, 2009. Due to the absence of activity between the purchase date, December 31, 2009, and the date of our Consolidated Financial Statements, there were no results of operations to be reported. In addition, comparative pro forma information has not been presented as SRC was not a comparable stand-alone entity prior to the acquisition.

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**ENERGY FOCUS, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**MARCH 31, 2010**  
**(Unaudited)**

The purchase price was allocated based on the fair value of the assets acquired leading to the purchase price allocation as follows (in thousands):

| <b>Assets acquired:</b> | <b>Amortization<br/>Life<br/>(in years)</b> | <b>Amount</b> |
|-------------------------|---|---------------|
| Accounts receivable     |   | \$ 1,258      |
| Fixed asset             |   | 20            |
| Goodwill                | n/a   | 672           |
| Intangible assets:      |   |               |
| Tradename               | 10  | 500           |
| Client relationships    | 5   | 2,250         |
| Total purchase price    |   | \$ 4,700      |

The purchase price in excess of the fair value of the tangible assets acquired has been allocated to intangible assets and goodwill. The company engaged an independent third-party expert to assist in the allocation of the purchase price to the various specific separately identifiable intangible assets. The methods utilized by this third-party are based upon generally accepted accounting valuation conventions used in acquisition-related valuations and include peer volatility analysis, discounted cash flow analysis, annuity stream valuation and earnings based valuation techniques. These conventions were reviewed and approved by management as well as the company's current independent public accounting firm.

These intangible assets have estimated useful lives as set forth in the table above and amortization expense for the following fiscal years for the acquired intangible assets is estimated to be as follow (in thousands):

| <b>Year ending March 31,</b> | <b>Amount</b> |
|------------------------------|---------------|
| 2011                         | \$ 967        |
| 2012                         | 592           |
| 2013                         | 378           |
| 2014                         | 216           |
| 2015 and thereafter          | 329           |
| Total amortization expense   | \$ 2,482      |

Of the intangible assets acquired, \$672,000 was assigned to goodwill. None of the goodwill is expected to be deductible for tax purposes.

**NOTE 4. DISCONTINUED OPERATIONS**

As part of the company's strategy of evaluating the viability of its non-core businesses and its aggressive pursuit of capital funding, the company determined that its German subsidiary was not directly aligned with its objective to become a leading provider of turnkey, comprehensive energy-efficient lighting systems. Therefore, in the third quarter of 2009, the company committed to a plan to divest its German subsidiary, LBM.

In December 2009, the company completed the sale of its ownership rights in LBM for \$225,000 comprised of cash and a promissory note. Furthermore, the company will receive an earn out equal to ten percent ( 10% ) of post-acquisition, pre-amortization, pre-tax profit for a period of 24 months commencing January, 2010. Excluding this earn out, the company recorded a loss on disposal of subsidiary of \$664,000. As part of this transaction, the purchaser

assumed all rights to both tangible and intangible assets as well as all of the liabilities of LBM.

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The following table summarizes the components included with net loss from discontinued operations within the company's Condensed Consolidated Statement of Operations for the period indicated (amounts in thousands):

|   | <b>Three<br/>Months<br/>Ended<br/>March 31,<br/>2009</b> |
|---|--|
| Net sales                                       | \$ 265   |
| Total expenses                                  | 567  |
| Loss from operations of discontinued operations | (302)  |
| Provision for income tax                        |  |
| Net loss from discontinued operations           | \$ (302)   |

**NOTE 5. INVENTORIES**

Inventories are stated at the lower of standard cost (which approximates actual cost determined using the first-in, first-out cost method) or market and consist of the following (in thousands):

|                   | <b>March<br/>31,<br/>2010</b> | <b>December<br/>31,<br/>2009</b> |
|-------------------|-------------------------------|----------------------------------|
| Raw materials     | \$ 2,862                      | \$ 2,785                         |
| Inventory reserve | (974)                         | (1,010)                          |
| Finished goods    | 1,410                         | 1,995                            |
| Inventories       | \$ 3,298                      | \$ 3,770                         |

**NOTE 6. FIXED ASSETS**

Fixed assets are stated at cost and are depreciated using the straight-line method over the estimated useful lives of the related assets and consist of the following (in thousands):

|   | <b>March 31,<br/>2010</b> | <b>December<br/>31,<br/>2009</b> |
|---|---------------------------|----------------------------------|
| Equipment (useful life 3 - 15 years)                              | \$ 7,702                  | \$ 7,856                         |
| Tooling (useful life 2 - 5 years)                                 | 2,303                     | 2,305                            |
| Furniture and fixtures (useful life 5 years)                      | 167                       | 168                              |
| Computer software (useful life 3 years)                           | 474                       | 476                              |
| Leasehold improvements (the shorter of useful life or lease life) | 887                       | 911                              |
| Fixed assets at cost  | 11,533                    | 11,716                           |
| Less: accumulated depreciation                                    | (8,639)                   | (8,625)                          |

|                   |    |       |    |       |
|-------------------|----|-------|----|-------|
| Fixed assets, net | \$ | 2,894 | \$ | 3,091 |
|-------------------|----|-------|----|-------|

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**NOTE 7. LONG-TERM BORROWINGS**

Effective October 15, 2008, the company entered into a one year credit agreement with Silicon Valley Bank ( SVB ) incorporating a \$4,000,000 revolving line of credit which replaced all existing facilities including the United States term loans. This new line of credit included a \$1,500,000 sub-limit for cash management products, letters of credit and foreign currency exchange. Under this agreement, all domestic existing term loans and revolving credit lines were repaid and funded by this new borrowing arrangement. Borrowings under this agreement were collateralized by the company s assets, including intellectual property, and bore interest at the SVB Prime Rate plus 1%. The company was required to maintain 85% of its cash and cash equivalents in operating and investment accounts with SVB and was also required to comply with certain covenant requirements, including a tangible net worth covenant. The amount of borrowings available to the company was the lesser of \$4,000,000 or the sum of up to 75% of eligible accounts receivable, as defined by the agreement, and 50% of our cash balance in deposit at SVB, capped at \$1,500,000. At December 31, 2008, the company was not in compliance with the tangible net worth covenant requirement and such condition continued throughout 2009. As such, the company entered into a series of loan modification and forbearance agreements ( agreements ) with effective dates ranging from January 31, 2009 through November 17, 2009. In conjunction with these agreements, the terms of its credit facility were revised culminating in a reduction to its revolving line of credit to \$1,300,000 with a maturity date of October 15, 2009 and a change in the rates of interest charged throughout 2009 in the range of SVB Prime Rate plus 1.5% to 3.00%. Under this revised credit facility, the company was required to maintain all of its cash and cash equivalents in operating and investment accounts with SVB and SVB s affiliates, and was also required to continue compliance with certain covenant requirements, including the tangible net worth covenant. During the third quarter of 2009, SVB informed the company that it did not intend to renew the company s revolving line of credit when it was set to expire on October 15, 2009. Ultimately, the company was able to extend the maturity date of this credit facility to December 31, 2009 at which time it liquidated the outstanding balance of \$253,000 on the line of credit. The company has not replaced this credit facility but is actively pursuing other potential financial resources to replace and/or compensate for the loss of the line of credit. On May 27, 2009, the company entered into an unsecured Promissory Note ( Note ) with The Quercus Trust ( The Trust ) in the amount of \$70,000. Under the terms of this Note, we are obligated to pay The Trust the principal sum of the Note and interest accruing at a yearly rate of 1.00% in one lump sum payment on or before June 1, 2109. The company received these funds on June 9, 2009. On December 29, 2009 and in conjunction with the acquisition of SRC, the company entered into Letter of Credit Agreements ( LOC s ) with John Davenport, President of the company, and with The Trust, for \$250,000 and \$300,000, respectively. These LOC s have a term of 24 months and bear interest at a rate of 12.5% on the face amount. The LOC s are collateralized by a percentage of the capital stock of Crescent Lighting Ltd. ( CLL ) which in turn is based on CLL s net worth as of November 30, 2009 and is subordinated to the senior indebtedness of the company and CLL. In addition, subject to approval by shareholders at the next annual meeting, the company will issue five-year, detachable penny warrants (\$.01 per share) to purchase the company s common stock at a rate of 0.5 warrants per dollar of the face amount of the LOC. In conjunction with the acquisition of SRC on December 31, 2009, the company entered into an agreement with the seller, TLC Investments, LLC ( TLC ), whereby a Convertible Promissory Note ( Convertible Note ) was issued for the principal amount of \$500,000. This Convertible Note bears interest at the Wall Street Journal Prime Rate plus two percent (2%), which along with the principal, is due and payable on June 30, 2013 ( maturity date ). Additionally, TLC has the right to convert the principal of the Convertible Note, in whole, into 500,000 shares of the company s common stock at any time during the period commencing on June 30, 2010 and through the maturity date. Additionally, as a provision to the Convertible Note, if the reported closing price of a share of the company s common stock shall not be equal to or greater than \$2.00 for at least twenty (20) trading days between June 30, 2010 and June 30, 2013, the company shall pay TLC an additional fee of \$500,000 on the maturity date.





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On March 30, 2010, the company entered into an agreement with EF Energy Partners LLC, an Ohio limited liability company ( "EF Energy" ), under which it sold to EF Energy a Secured Subordinated Promissory Note ( "Subordinated Note" ) for the principal amount of \$1,150,000. The company secured the full amount of this financing with a pledge of its United States gross accounts receivable and selected capital equipment. This Subordinated Note bears interest at a rate of 12.5%, which is payable quarterly, in arrears, commencing September 30, 2010. The entire outstanding principal balance of this Subordinated Note, together with all accrued interest thereon, is due and payable on March 30, 2013. Additionally, the company issued to the eight investors in EF Energy five-year, detachable penny warrants to purchase shares of the company's common stock at a rate of 0.2 warrants per dollar of financing, or 230,000 warrants, with an expiration date of March 30, 2015. The company and EF Energy are not related. Through the company's United Kingdom subsidiary, the company maintains a British pounds sterling-denominated bank overdraft facility with Lloyds Bank Plc, in the amount of \$379,000, based on the exchange rate at March 31, 2010. There were no borrowings against this facility as of March 31, 2010 or December 31, 2009. The facility is renewed annually on January 1. The interest rate on the facility was 2.75% at March 31, 2010 and December 31, 2009. Future maturities of remaining borrowings are (in thousands):

| <b>Year ending March 31,</b>            | <b>Long-Term Borrowings</b> |
|---|-----------------------------|
| 2011                                    | \$                          |
| 2012                                    | 550                         |
| 2013                                    | 1,650                       |
| 2014                                    |                             |
| 2015 and thereafter                     | 70                          |
| Gross long-term borrowings              | 2,270                       |
| Less: discounts on long-term borrowings | (615)                       |
| Total commitment, net                   | \$ 1,655                    |

**NOTE 8. COMPREHENSIVE OPERATIONS**

Comprehensive income (loss) is defined as net income (loss) plus sales, expenses, gains, and losses that, under generally accepted accounting principles, are included in comprehensive income (loss) but excluded from net income (loss). A separate statement of comprehensive loss has been presented with this report.

**NOTE 9. SEGMENTS AND GEOGRAPHIC INFORMATION**

The company has two reportable segments: product-based sales featuring pool lighting and general commercial lighting, each of which markets and sells lighting systems, and solutions-based sales providing turnkey, high-quality, energy-efficient lighting application alternatives. The company's products are sold through a combination of direct sales employees, independent sales representatives, and various distributors in different geographic markets throughout the world. The company's solutions-based sales are designed to enhance total value by positively impacting customers' profitability, the environment, and the communities it serves. These solutions are sold through our direct sales employees as well as our SRC subsidiary, and include not only the company's proprietary energy-efficient lighting solutions, but also sourced lighting systems, energy audits, and service agreements.

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The following summarizes the company's reportable segment data for periods indicated (in thousands):

|  | <b>Three months ended</b> |             |
|--|---------------------------|-------------|
|  | <b>March 31,</b>          |             |
|  | <b>2010</b>               | <b>2009</b> |
| Solutions  |                           |             |
| Net sales  | \$ 5,280                  | \$          |
| Cost of goods sold                                   | 4,287                     |             |
| Gross profit   | 993                       |             |
| Operating expenses:                                  |                           |             |
| Sales and marketing                                  | 269                       |             |
| General and administrative                           | 338                       |             |
| Total operating expenses                             | 607                       |             |
| Segment income (loss)                                | \$ 386                    | \$          |
| Products:  |                           |             |
| Net sales  | \$ 3,077                  | \$ 2,523    |
| Cost of goods sold                                   | 2,675                     | 2,295       |
| Gross profit   | 402                       | 228         |
| Operating expenses:                                  |                           |             |
| Research and development                             | 55                        | 156         |
| Sales and marketing                                  | 1,295                     | 1,495       |
| General and administrative                           | 69                        | 69          |
| Restructuring expense                                | 26                        |             |
| Total operating expenses                             | 1,445                     | 1,720       |
| Segment loss   | \$ (1,043)                | \$ (1,492)  |
| Reconciliation of segment income (loss) to net loss: |                           |             |
| Segment income (loss)                                |                           |             |
| Solutions  | \$ 386                    | \$          |
| Products   | (1,043)                   | (1,492)     |
| Total segment loss                                   | (657)                     | (1,492)     |
| Operating expenses:                                  |                           |             |
| Sales and marketing                                  | 55                        | 51          |
| General and administrative                           | 1,272                     | 1,195       |
| Revaluation of equity instruments                    | 1,421                     |             |

|   |            |            |
|---|------------|------------|
| Total operating expenses                                | 2,748      | 1,246      |
| Other expense   | (164)      | (1)        |
| Net loss from continuing operations before income taxes | (3,569)    | (2,739)    |
| Provision for income taxes                              | (1)        |            |
| Net loss from continuing operations                     | (3,570)    | (2,739)    |
| Loss from discontinued operations                       |            | (302)      |
| Net loss  | \$ (3,570) | \$ (3,041) |

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A geographic summary of net sales from continuing operations is as follows (in thousands):

|                                      | <b>Three months ended</b> |             |
|--------------------------------------|---------------------------|-------------|
|                                      | <b>March 31,</b>          |             |
|                                      | <b>2010</b>               | <b>2009</b> |
| United States Domestic               | \$ 7,284                  | \$ 1,587    |
| Other Countries                      | 1,073                     | 936         |
| Net sales from continuing operations | \$ 8,357                  | \$ 2,523    |

A geographic summary of long-lived assets, which consists of fixed assets, goodwill, and intangible assets, is as follows (in thousands):

|                        | <b>March</b> | <b>December</b> |
|------------------------|--------------|-----------------|
|                        | <b>31,</b>   | <b>31,</b>      |
|                        | <b>2010</b>  | <b>2009</b>     |
| United States Domestic | \$ 5,869     | \$ 6,306        |
| Other Countries        | 179          | 207             |
| Long-lived assets, net | \$ 6,048     | \$ 6,513        |

**NOTE 10. INCOME TAXES**

At March 31, 2010, the company has recorded a full valuation allowance against its deferred tax asset in the United States, due to uncertainties related to the company's ability to utilize its deferred tax assets, primarily consisting of certain net operating losses carried forward. The valuation allowance is based upon the company's estimates of taxable income by jurisdiction and the period over which its deferred tax assets will be recoverable.

**NOTE 11. COMMITMENTS AND CONTINGENCIES**

In connection with the acquisition of SRC, the company maintains a performance-related contingent obligation related to the 2.5% payout based upon the annual revenues of the acquired business over the 42 months commencing January 1, 2010, and a \$500,000 fee if the market price of the company's common stock is not equal to or greater than \$2.00 per share for at least twenty trading days between June 30, 2010 and June 30, 2013. Payments related to the performance-related contingent obligation totaling \$126,000 were made during the three months ended March 31, 2010.

**NOTE 12. RELATED PARTY TRANSACTIONS**

On February 3, 2006, the company had entered into a consulting agreement with David Ruckert, a member of its Board of Directors. This agreement was terminated on June 30, 2007. No payments were made during the three months ended March 31, 2010 or March 31, 2009. Additionally, Mr. Ruckert was granted options to purchase 32,000 shares of the company's common stock. Stock compensation expense incurred under ASC 718 related to these options was \$7,000 for the quarter ended March 31, 2010 and \$7,000 for the quarter ended March 31, 2009.

On May 27, 2009, the company entered into a Promissory Note ( Note ) with The Trust in the amount of \$70,000. Please refer to Note 7, Long-Term Borrowings, for discussion of the terms of the Note.

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In November 2009, the company received an additional \$3,344,000 in equity financing, net of expenses by selling 4,813,000 shares of common stock in a registered offering. The investment was made by numerous current Energy Focus shareholders, including two then current members of the company's Board of Directors. The investment was made under the company's registration statement for a \$3,500,000 common stock subscription rights offering. Under the terms of the rights offering, the company distributed, at no charge to its shareholders, transferable rights to purchase up to \$3.5 million of the company's common stock at the established subscription price per share of \$0.75, which was set by the company's Board of Directors. At the time the offering began, the company distributed to each shareholder one transferable right for each share of common stock owned by the shareholder. Each right entitled the holder to purchase one share of the company's common stock, par value \$0.0001 per share, subject to a maximum of 4,600,000 shares to be issued in the offering. Shareholders were entitled to subscribe for shares not subscribed for by other shareholders. Among the investors were Philip E. Wolfson, a member of the company's Board of Directors at the time of the transaction, and who invested approximately \$8,000 in the aggregate. Also among the investors was The Trust, whose trustees include David Gelbaum.

In the company's subscription rights offering discussed above, an investor inadvertently purchased 1,000,000 shares of our common stock at \$0.75 per share. The company agreed to facilitate the sale of these shares to another shareholder or investor or to purchase them directly. A purchase of those shares by the company would have severely depleted its cash-on-hand and working capital. After contacting selected shareholders and investors, the company introduced the investor to The Trust, the company's largest shareholder. The company was informed on December 30, 2009, by the investor and The Trust that The Trust had agreed to purchase those shares at \$0.80 per share. At that time, the closing market price of a share of the company's common stock was approximately \$0.65 per share. To facilitate the purchase of the 1,000,000 shares by The Trust, on December 30, 2009, the company agreed with The Trust to reduce the exercise price of the 1,560,062 warrants issued to The Trust in March 2008 to \$0.01 per share upon the completion of the purchase of all 1,000,000 shares in 2010. The purchase of the 1,000,000 shares by The Trust was completed on February 20, 2010. The company incurred a non-cash charge of \$1,421,000 for the quarter ended March 31, 2010 related to the revaluation of the warrants to purchase shares of the company's common stock acquired by The Quercus Trust in the company's March 2008 equity financing. On April 28, 2010, The Trust exercised the 2008 warrants. The company has asked its shareholders to approve the reduction in the exercise price at its Annual Meeting.

On December 29, 2009, and in conjunction with the acquisition of SRC, the company entered into Letter of Credit Agreements (LOC's) with John Davenport, President of the company, and with The Trust, for \$250,000 and \$300,000, respectively. Please refer to Note 7, Long-Term Borrowings, for discussion of the terms of these LOC's.

Rob Wilson, the company's Vice President of SRC, is a minority owner in TLC Investments, LLC (TLC), a Tennessee limited liability company, as well as in Woodstone Energy, LLC (Woodstone), a Tennessee limited liability company, both of which are located in Nashville, Tennessee.

In conjunction with the acquisition of SRC on December 31, 2009, the company entered into an agreement with TLC whereby a Convertible Promissory Note (Convertible Note) was issued for the principal amount of \$500,000. This Convertible Note bears interest at a rate of the Wall Street Journal Prime Rate plus two percent (2%), which along with the principal, is due and payable on June 30, 2013. Additionally, TLC has the right to convert the principal of the Convertible Note, in whole, into 500,000 shares of the company's common stock at any time during the period commencing on June 30, 2010 and ending the maturity date. Additionally, as a provision to the Convertible Note, if the reported closing price of a share of the company's common stock shall not be equal to or greater than \$2.00 for at least twenty (20) trading days between June 30, 2010 and June 30, 2013, the company shall pay TLC an additional fee of \$500,000 on the maturity date.

On December 31, 2009, the company issued to Woodstone warrants to purchase up to 600,000 shares of the company's common stock at an exercise price of \$0.65 per share, and with a term ending on December 31, 2014. The warrants become exercisable only if SRC receives from Woodstone firm contracts or purchase orders for at least \$10,000,000

by June 30, 2013. The warrants vest in two tranches: 400,000 shares when contracts or purchase orders between SRC and Woodstone reach \$10,000,000 and an additional 200,000 shares when contracts or purchase orders between SRC and Woodstone reach an additional \$5,000,000. The warrants include registration rights for the shares of common stock to be issued upon exercise of the warrants.

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**NOTE 13. LEGAL MATTERS**

On January 20, 2010 a competitor and former supplier filed a complaint against the company in the Court of Chancery of the State of Delaware, alleging that the company has misused proprietary trade secrets, breached a contract, and engaged in deceptive trade practices relating to one of its lighting products. The complaint seeks injunctive relief and damages. The company has answered the complaint and filed a counterclaim for breach of contract. The company strongly denies any impropriety, believes that the complaint is without merit, and intends to vigorously defend itself. In the opinion of management, this lawsuit should not have an adverse effect on the company's financial condition, cash flows, or results of operations.

The company is not currently engaged in any other litigation and does not anticipate becoming involved in any in the foreseeable future.



**Table of Contents****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 in conjunction with the Condensed Consolidated Financial Statements ( financial statements ) and related notes included elsewhere in this report and the section entitled Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended December 31, 2009.

*When used in this discussion, the words expects, anticipates, estimates, plan, and similar expressions are intended to identify forward-looking statements. These statements, which include statements as to our expected sales and gross profit margins, expected operating expenses and capital expenditure levels, our sales and marketing expenses, our general and administrative expenses, expected expenses related to compliance with the Sarbanes-Oxley Act of 2002, the adequacy of capital resources and necessity to raise additional funds, our critical accounting policies, expected restructuring costs related to our consolidation in Solon, Ohio, expected benefits from our consolidation and statements regarding pending litigation are subject to risks and uncertainties that could cause actual results to differ materially from those projected. These risks and uncertainties include, but are not limited to, those risks discussed below, as well as our ability to manage expenses, our ability to reduce manufacturing overhead and general and administrative expenses as a percentage of sales, our ability to collect on doubtful accounts receivable, our ability to increase cash balances in future quarters, the cost of enforcing or defending intellectual property, unforeseen adverse competitive, economic or other factors that may impact our cash position, risks associated with raising additional funds, and risks associated with our pending litigation. These forward-looking statements speak only as of the date hereof. We expressly disclaim any obligation or undertaking to release publicly any updates or revisions to any forward-looking statements contained herein to reflect any change in our expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based.*

**Overview**

Energy Focus, Inc. and its subsidiaries ( the company ) engage in the design, development, manufacturing, marketing, and installation of energy-efficient lighting systems where we serve two segments:

solutions-based sales providing turnkey, high-quality, energy-efficient lighting application alternatives; and

product-based sales featuring pool lighting and general commercial lighting, each of which markets and sells energy-efficient lighting systems.

We continue to evolve our business strategy to include providing its customers with turnkey, comprehensive energy-efficient lighting solutions, which use, but are not limited to, its patented and proprietary technology. Our solutions include light-emitting diode ( LED ), ceramic metal halide ( CMH ), fiber optic ( EFO ), high-intensity discharge ( HID ), and other highly energy-efficient lighting technologies. Typical savings related to our current technology approximates 80% in electricity costs, while providing full-spectrum light closely simulating daylight colors. Our strategy also incorporates continued investment into the research of new and emerging energy sources including, but not limited to, solar energy.

Our development of solar technology is continuing through our leadership role in the United States government's Very High Efficiency Solar Cell ( VHESC ) Consortium sponsored by the Defense Advanced Research Projects Agency ( DARPA ). The goal of the VHESC project is to develop a 40% or greater efficient solar cell for United States military applications, which would also be available to the public for commercial application.

**Results of Operations***Cash Utilization*

Cash utilization was \$402,000 for the quarter ended March 31, 2010, excluding \$1,150,000 of cash received from the selling of a Secured Subordinated Promissory Note for the principal amount of \$1,150,000. Cash utilization for the quarter ended March 31, 2009 was \$3,768,000.

*Net Sales and Gross Profit*

Solutions-based net sales from continuing operations were \$5,280,000 for the quarter ended March 31, 2010 resulting from our Stones River Companies, LLC ( SRC ) subsidiary, which was acquired on December 31, 2009.

Product-based net sales from continuing operations were \$3,077,000 for the quarter ended March 31, 2010; an increase of \$554,000 compared to the quarter ended March 31, 2009. The increase resulted from a \$497,000 increase in government related product-based net sales, as well as by a \$135,000 increase in product-based net sales by our United Kingdom subsidiary.

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Gross profit was \$1,395,000 for the quarter ended March 31, 2010; an increase of \$1,167,000 compared to the quarter ended March 31, 2009. The gross profit margin as a percentage of sales increased to 16.7% for the first quarter of 2010 as compared to 9.1% for the first quarter of 2009.

Global economic conditions within all of our legacy markets, and particularly within the housing and new construction markets, deteriorated at a pace faster than our cost reduction initiatives could offset. Through September 2009, we maintained two manufacturing and assembly facilities for our North American operations which resulted in overall lower gross profitability on a net sales per dollar basis. In a continuing effort to reduce the fixed overhead of the company, and in conjunction with the strategic transition into a turnkey energy-efficient lighting services solutions company, we relocated 100% of the North American manufacturing and assembly operation into our lower cost Mexican contract manufacturing facility. Furthermore, we eliminated our Solon, Ohio distribution services operation during the quarter ended March 31, 2010. Lastly, we continue to negotiate with our Solon facility landlord to develop a mutually beneficial early termination of our lease agreement in that facility.

*Research and development*

Net research and development expenses decreased 65.0% to \$55,000 for the quarter ended March 31, 2010 as compared to \$156,000 for the quarter ended March 31, 2009. Our gross research and development expenses are reduced on a proportional performance basis under DARPA Small Business Innovation Research ( SBIR ) development contracts. In 2007, SBIR contracts were signed totaling \$1,500,000 to be reimbursed over a two-year recovery period. During 2009, additional SBIR contracts were signed totaling \$1,707,000 to be reimbursed through July 2010. At March 31, 2010, \$1,222,000 remained as unrecognized reductions of gross research and development expenses. The gross research and development spending along with credits from government contracts is shown in the table:

|  | <b>Three months ended<br/>March 31,</b> |             |
|--|---|-------------|
|  | <b>2010</b>                             | <b>2009</b> |
| Gross research and development expenses                        | \$ 316                                  | \$ 330      |
| Deduct: incurred and accrued credits from government contracts | (261)                                   | (174)       |
| Net research and development expenses                          | \$ 55                                   | \$ 156      |

*Sales and marketing*

Sales and marketing expenses increased 4.7% to \$1,619,000 for the quarter ended March 31, 2010 as compared to \$1,546,000 for the quarter ended March 31, 2009. The increase is primarily due to sales and marketing expenses related to SRC of \$269,000. Excluding the SRC related expenses, sales and marketing expenses decreased 12.7% to \$1,350,000, primarily due to decreased salaries and benefits, as well as management's continuing efforts to reduce costs.

*General and administrative*

General and administrative expenses increased \$415,000 to \$1,679,000 for the quarter ended March 31, 2010 as compared to \$1,264,000 quarter ended March 31, 2009. The increase is primarily due to general and administrative expenses related to SRC of \$338,000. Included in the general and administrative expenses related to SRC is a non-cash charge of \$268,000 for the amortization of SRC's intangible assets. Excluding the SRC related expenses, general and administrative expenses increased 6.1% to \$1,341,000, primarily due to increased professional service fees.

*Revaluation of equity instruments*

We recognized a non-cash charge of \$1,421,000 related to the revaluation of warrants to purchase shares of our common stock acquired by The Quercus Trust in our March 2008 equity financing. Please refer to Note 12 of our Condensed Consolidated Financial Statements ( financial statements ) for discussion of this transaction.

*Restructuring Expenses*

We recognized restructuring expenses of \$26,000 for the quarter ended March 31, 2010 associated with relocating our manufacturing equipment and operations. We incurred no restructuring expense during the first quarter of 2009.



**Table of Contents***Other Income and Expenses*

We had interest income of \$2,000 and interest expense of \$101,000 for the quarter ended March 31, 2010. Interest income consists of interest earned on deposits. Interest expense is for interest on our long-term borrowings, as well as for the contingent consideration and market price fee included in the acquisition of SRC. Please refer to Note 3 of our financial statements for discussion of this contingent consideration and market price fee. We had interest income of \$4,000 and interest expense of \$24,000 for the quarter ended March 31, 2009.

*Discontinued Operations*

As part of our strategy of evaluating the viability of our non-core businesses and our aggressive pursuit of capital funding, we determined that our German subsidiary was not directly aligned with our objective to become a leading provider of turnkey, comprehensive energy-efficient lighting solutions. Therefore, in the third quarter of 2009, we committed to a plan to sell our German subsidiary, LBM Lichtleit-Fasertechnik ( LBM ).

In December 2009, we completed the sale of our ownership in LBM for \$225,000 comprised of cash and a promissory note. Furthermore, we will receive an earn out equal to ten percent ( 10% ) of post-acquisition, pre-amortization, pre-tax profit for a period of 24 months commencing January 2010. As part of this transaction, the purchaser assumed all rights to both tangible and intangible assets as well as all of the liabilities of LBM.

Net sales from discontinued operations were \$265,000 for the quarter ended March 31, 2009. Net loss from discontinued operations was \$302,000 for the quarter ended March 31, 2009.

We have reported the business described above as discontinued operations for all periods presented. Please refer to Note 4 of our financial statements for discussion concerning discontinued operations.

*Net loss*

We recorded a net loss of \$3,570,000 for the quarter ended March 31, 2010, a 17.4% increase from the net loss of \$3,041,000 for the quarter ended March 31, 2009.

**Liquidity and Capital Resources***Cash and Cash Equivalents*

At March 31, 2010, our cash and cash equivalents were \$1,810,000 as compared to \$1,062,000 at December 31, 2009, a net cash increase of \$748,000 for the quarter ended March 31, 2010. This compares to a net cash decrease of \$3,768,000 for quarter ended March 31, 2009.

*Cash (Used in) Provided by Operating Activities*

Net cash used in operating activities of continuing operations primarily consists of net loss adjusted by non-cash items, including depreciation, amortization, and stock-based compensation, as well as the effect of changes in working capital. Cash decreased during the quarter ended March 31, 2010, by a net loss of \$3,570,000, compared to a net loss of \$3,041,000 for the quarter ended March 31, 2009. After adjustments, net cash used in operating activities of continuing operations was \$438,000 for the quarter ended March 31, 2010 compared to a net cash usage of \$4,041,000 for the quarter ended March 31, 2009.

Net cash provided by operating activities of discontinued operations primarily consists of net loss adjusted by non-cash items, including depreciation, as well as the effect of changes in working capital. Cash decreased during the quarter ended March 31, 2009, by a net loss of \$302,000 for the quarter ended March 31, 2009. After adjustments, net cash provided by operating activities of discontinued operations was \$444,000 for the quarter ended March 31, 2009.

*Cash Used in Investing Activities*

Net cash used in investing activities of continuing operations was \$16,000 for the quarter ended March 31, 2010, a decrease of 80.2% compared to a net cash usage of \$81,000 for the quarter ended March 31, 2009. During both periods, cash was used for the acquisition of fixed assets.

Net cash used in investing activities of discontinued operations was \$2,000 for the quarter ended March 31, 2009 for the acquisition of fixed assets.

**Table of Contents***Cash Provided by (Used in) Financing Activities*

Net cash provided by financing activities of continuing operations was \$1,205,000 for the quarter ended March 31, 2010. Cash provided was primarily due to the selling of a Secured Subordinated Promissory Note for the principal amount of \$1,150,000. Please refer to Note 7 of our Condensed Consolidated Financial Statements ( financial statements ) for discussion of this transaction. For the quarter ended March 31, 2009, financing activities neither provided nor used cash.

Net cash used in financing activities of discontinued operations was \$132,000 for the quarter ended March 31, 2009. This cash usage was due to payment on line of credit and long-term borrowings.

*Long-Term Borrowings*

Effective October 15, 2008, we entered into a one year credit agreement with Silicon Valley Bank ( SVB ) incorporating a \$4,000,000 revolving line of credit which replaced all existing facilities including the United States term loans. This new line of credit included a \$1,500,000 sub-limit for cash management products, letters of credit and foreign currency exchange. Under this agreement, all domestic existing term loans and revolving credit lines were repaid and funded by this new borrowing arrangement. Borrowings under this agreement were collateralized by our assets, including intellectual property, and bore interest at the SVB Prime Rate plus 1%. We were required to maintain 85% of our cash and cash equivalents in operating and investment accounts with SVB and were also required to comply with certain covenant requirements, including a tangible net worth covenant. The amount of borrowings available to the company was the lesser of \$4,000,000 or the sum of up to 75% of eligible accounts receivable, as defined by the agreement, and 50% of our cash balance in deposit at SVB, capped at \$1,500,000.

At December 31, 2008, we were not in compliance with the tangible net worth covenant requirement and such condition continued throughout 2009. As such, we entered into a series of loan modification and forbearance agreements ( agreements ) with effective dates ranging from January 31, 2009 through November 17, 2009. In conjunction with these agreements, the terms of our credit facility were revised culminating in a reduction to our revolving line of credit to \$1,300,000 with a maturity date of October 15, 2009 and a change in the rates of interest charged throughout 2009 in the range of SVB Prime Rate plus 1.5% to 3.00%. Under this revised credit facility, we were required to maintain all of our cash and cash equivalents in operating and investment accounts with SVB and its affiliates and were also required to continue compliance with certain covenant requirements, including the tangible net worth covenant. During the third quarter of 2009, SVB informed the company that it did not intend to renew our revolving line of credit when it was set to expire on October 15, 2009. Ultimately, we were able to extend the maturity date of this credit facility to December 31, 2009 at which time we liquidated the outstanding balance of \$253,000 on the line of credit. We have yet not replaced this credit facility but we are actively pursuing other potential financial resources to replace and/or compensate for the loss of the line of credit.

On May 27, 2009, we entered into an unsecured Promissory Note ( Note ) with The Quercus Trust ( The Trust ) in the amount of \$70,000. Under the terms of this Note, we are obligated to pay The Trust the principal sum of the Note and interest accruing at a yearly rate of 1.00% in one lump sum payment on or before June 1, 2109. We received these funds on June 9, 2009.

On December 29, 2009 and in conjunction with the acquisition of SRC, we entered into Letter of Credit Agreements ( LOC s ) with John Davenport, President of our company, and with The Trust, for \$250,000 and \$300,000, respectively. These LOC s have terms of 24 months and bear interest at a rate of 12.5% on the face amount. The LOC s are collateralized by a percentage of the capital stock of Crescent Lighting Ltd. ( CLL ) which in turn is based on CLL s net worth as of November 30, 2009 and is subordinated to the senior indebtedness of the company and CLL. In addition, subject to approval by shareholders at the next annual meeting, we will issue five-year, detachable penny warrants (\$.01 per share) to purchase common stock at a rate of 0.5 warrants per dollar of the face amount of the LOC. In conjunction with the acquisition of SRC on December 31, 2009, we entered into an agreement with TLC Investments, LLC ( TLC ), whereby a convertible promissory note ( Convertible Note ) was issued for the principal amount of \$500,000. This Convertible Note bears interest at the Wall Street Journal Prime Rate plus two percent (2%), which along with the principal, is due and payable on June 30, 2013 ( maturity date ). Additionally, TLC has the right to convert the principal of the Convertible Note, in whole, into 500,000 shares of our common stock at any time during the period commencing on June 30, 2010 and through the maturity date. Additionally, as a provision to the

Convertible Note, if the reported closing price of a share of common stock of the company shall not be equal to or greater than \$2.00 for at least twenty (20) trading days between June 30, 2010 and June 30, 2013, we shall pay TLC an additional fee of \$500,000 on the maturity date.

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On March 30, 2010, we entered into an agreement with EF Energy Partners LLC, an Ohio limited liability company ( EF Energy ), under which it sold to EF Energy a Secured Subordinated Promissory Note ( Subordinated Note ) for the principal amount of \$1,150,000. We secured the full amount of this financing with a pledge of our United States gross accounts receivable and selected capital equipment. This Subordinated Note bears interest at a rate of 12.5%, which is payable quarterly, in arrears, commencing September 30, 2010. The entire outstanding principal balance of this Subordinated Note, together with all accrued interest thereon, is due and payable on March 30, 2013. Additionally, we issued to the eight investors in EF Energy five-year, detachable penny warrants to purchase shares of our common stock at a rate of 0.2 warrants per dollar of financing, or 230,000 warrants, with an expiration date of March 30, 2015. We are not related to EF Energy.

Through our United Kingdom subsidiary, we maintain a British pounds sterling-denominated bank overdraft facility with Lloyds Bank Plc, in the amount of \$379,000, based on the exchange rate at March 31, 2010. There were no borrowings against this facility as of March 31, 2010 or December 31, 2009. This facility is renewed annually on January 1. The interest rate on the facility was 2.75% at March 31, 2010, and December 31, 2009.

### *Liquidity*

We have incurred losses attributable to operational performance which has led to negative cash flows. Although management believes that it has addressed many of the legacy issues that have historically burdened our financial performance, we still face challenges in order to reach profitability. In order for our company to attain profitability and growth, we will need to successfully address these challenges, including the continuation of cost reductions throughout our organization, execution of our marketing and sales plans for our new turnkey energy-efficient lighting solutions business, continued evaluation and divestiture of non-core business product lines, and continued improvements in our supply chain performance.

Although we are optimistic about obtaining the funding necessary for our company to continue as a going concern, there can be no assurances that this objective will be successful. We are currently aggressively pursuing the following external funding sources:

- obtain financing and/or grants available through federal, state, and/or local governmental agencies,

- obtain financing from various financial institutions,

- obtain financing from non-traditional investment capital organizations,

- potential sale or divestiture of one or more operating units, and

- obtain funding from the sale of our common stock or other equity instruments.

Obtaining financing through the above-mentioned mechanisms contains risks, including:

- government stimulus and/or grant money is not allocated to us despite our focus on the design, development, and manufacturing of energy efficient lighting systems,

- loans or other debt instruments may have terms and/or conditions, such as interest rate, restrictive covenants, and control or revocation provisions, which are not acceptable to management or our Board of Directors,

- the current global economic crisis combined with our current financial condition may prevent us from being able to obtain any debt financing,

- financing may not be available for parties interested in pursuing the acquisition of one or more of our operating units, and

- additional equity financing may not be available to us in the current economic environment and could lead to further dilution of shareholder value for current shareholders of record.

## **Critical Accounting Policies**



The preparation of our financial statements requires that we make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingencies, and the reported amounts of net sales and expenses in the financial statements. Material differences may result in the amount and timing of net sales and expenses if different judgments or different estimates were utilized. Critical accounting policies, judgments, and estimates which we believe have the most significant impact on our financial statements include allowances for doubtful accounts, returns, warranties, valuation of inventories, and stock-based compensation. For the detailed discussion of the application of policies critical to our business operations, see our Annual Report on Form 10-K for the year ended December 31, 2009.

**Table of Contents****Recent Accounting Pronouncements**

In January, 2010, the FASB issued Accounting Standards Update ( ASU ) 2010-02, *Consolidation (Topic 810) Accounting and Reporting for Decreases in Ownership of a Subsidiary – A Scope Clarification*. ASU 2010-02 clarifies the scope of the decrease in ownership provisions of Subtopic 810 and expands disclosure requirements about deconsolidation of a subsidiary or de-recognition of a group of assets. ASU 2010-02 is effective beginning in the first interim of annual reporting period ending on or after December 15, 2009. The adoption of ASU 2010-02-02 did not have an impact on our consolidated financial statements.

In October, 2009, the FASB issued ASU 2009-013, *Revenue Recognition (Topic 605) – Multiple-Deliverable Revenue Arrangements*. ASU 2009-13 revises certain accounting for revenue arrangements with multiple deliverables. In particular, when vendor specific objective evidence or third-party evidence for deliverables in an arrangement cannot be determined, ASU 2009-13 allows use of a best estimate of the selling price to allocate the arrangement consideration among them. ASU 2009-13 is effective for the first quarter of 2011, with early adoption permitted. We do not expect that the adoption of ASU 2009-13 will have a material impact on our consolidated financial statements.

In August, 2009, the FASB issued ASU 2009-05, an amendment to Accounting Standards Codification ( ASC ) 820-10, *Fair Value Measurements and Disclosures – Overall* for measuring liabilities at fair value. ASU 2009-05 provides clarification that in certain circumstances in which a quoted price in an active market for the identical liability is not available, a reporting entity is required to measure fair value using certain other valuation techniques. The guidance provided in this ASU is effective for the first reporting period beginning after issuance. This ASU had no impact on our consolidated financial statements.

In June, 2009, the FASB issued ASU 2009-01, *Generally Accepted Accounting Principles (Topic 105)* which amends the FASB ASC for the issuance of FASB Statement No. 168 – *The FASB Accounting Standards Codification on the Hierarchy of Generally Accepted Accounting Principles* . This statement establishes the FASB Accounting Standards Codification as the source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities in the preparation of financial statements in conformity with GAAP. This statement is effective for financial statements issued for interim and annual periods ending after September 15, 2009.

In December, 2007, the FASB issued ASC Topic 805, *Business Combinations*. The pronouncement requires the acquiring entity in a business combination to recognize only the assets acquired and liabilities assumed in a transaction (e.g., acquisition costs must be expensed when incurred), establishes the fair value at the date of acquisition as the initial measurement for all assets acquired and liabilities assumed, and requires expanded disclosures. ASC 805 is in effect for fiscal years beginning after December 15, 2008 (January 1, 2009, for our company). The adoption of ASC 805 did not have a material impact on our consolidated financial statements.

In December, 2007, the FASB issued ASC Topic 810, *Non-controlling Interests in Consolidated Financial Statements, an Amendment of ARB No. 51*. The pronouncement requires all entities to report non-controlling (minority) interests in subsidiaries as a component of shareholders' equity. ASC 810 is in effect for fiscal years beginning after December 15, 2008 (January 1, 2009, for our company). The adoption of ASC 810 did not have a material impact on our consolidated financial statements.

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

As of March 31, 2010, we had British pounds sterling-denominated cash valued at \$1,000 held in the United Kingdom, based on the exchange rate at March 31, 2010. The balances for cash held in the United Kingdom are subject to exchange rate risk. We have a policy of maintaining cash balances in local currency unless an amount of cash is occasionally transferred in order to repay inter-company debts.

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**ITEM 4. CONTROLS AND PROCEDURES**

*(a) Evaluation of disclosure controls and procedures*

We maintain disclosure controls and procedures, as such term is defined in Rule 13a-15(e) under the Securities Exchange Act of 1934 (the Exchange Act ), that are designed to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in Securities and Exchange Commission rules and forms and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating our disclosure controls and procedures, management recognized that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the disclosure controls and procedures are met. Our disclosure controls and procedures have been designed to meet, and management believes that they meet, reasonable assurance standards. Additionally, in designing disclosure controls and procedures, our management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. Any design of disclosure controls and procedures also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

Based on their evaluation as of the end of the period covered by this Quarterly Report on Form 10-Q, our Chief Executive Officer and Chief Financial Officer have concluded that, subject to the limitations noted above, our disclosure controls and procedures were effective to ensure that material information relating to us, including our consolidated subsidiaries, is made known to them by others within those entities, particularly during the period in which this Quarterly Report on Form 10-Q was being prepared.

*(b) Changes in internal control over financial reporting*

There was no change in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) identified in connection with the evaluation during our last fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**Table of Contents****PART II OTHER INFORMATION****ITEM 1. LEGAL PROCEEDINGS**

On January 29, 2010, a competitor and former supplier filed a complaint against our company in the Court of Chancery of the State of Delaware, alleging that the company has misused proprietary trade secrets, breached a contract, and engaged in deceptive trade practices relating to one of our lighting products. The complaint seeks injunctive relief and damages. We have answered the complaint and filed a counterclaim for breach of contract. We strongly deny any impropriety, believe that the complaint is without merit, and intend to vigorously defend ourselves. In the opinion of management, this lawsuit should not have an adverse effect on our financial condition, cash flows, or results of operations.

We are not currently engaged in any other litigation and do not anticipate becoming involved in any in the foreseeable future.

**ITEM 1A. RISK FACTORS**

Other than the below risk factor, there are no significant changes in risk factors from our Annual Report on Form 10-K for the year ended December 31, 2009.

*We have not been in compliance with the continued listing requirements of the NASDAQ Global Market.*

From time to time during the fourth quarter of 2009 and early in the first quarter of 2010, we have not met the NASDAQ Global Market ( NASDAQ ) continued listing requirements that call for the maintenance of a minimum bid price of our common stock of \$1.00 per share and minimum shareholders equity of \$10,000,000. We received formal notices of non-compliance from NASDAQ. Although we regained compliance with NASDAQ continued listing requirements on those occasions, there is a continuing risk that we could again become non-compliant with the listing requirements. In this regard, our shareholders equity as of the end of the first quarter has fallen below the minimum shareholder equity requirement. We are preparing a remedial plan to regain compliance. If the minimum bid price of our common stock should fall below \$1.00 for an extended period of time in the future, we will be required to take remedial action on it as well. If we are unable to maintain the minimum listing price of our common stock, or regain and maintain minimum shareholders equity, and if our common stock becomes subject to being delisted from trading on the NASDAQ Global Market, we could transfer trading in our common stock to the NASDAQ Capital Market or other exchange which could potentially result in a loss of trading liquidity.

**ITEM 5. OTHER INFORMATION**

On May 12, 2010, we notified the NASDAQ by telephone that the company s shareholder equity as shown in its Condensed Consolidated Balance Sheet as of March 31, 2010 was \$9,727,000, which is less than the minimum \$10,000,000 required by NASDAQ Rule 5450(b)(1)(A) (the Rule ). We are preparing a plan to regain compliance with the Rule that will be submitted to the NASDAQ Listing Department ( Listing Department ). While we have not yet received a notification of deficiency from the Listing Department, we expect to receive one within the next few days and anticipate that the notification letter will permit us 45 days to submit a compliance plan and, if the plan is acceptable, an additional 135 days to regain compliance with the Rule.

**ITEM 6. EXHIBITS**

| <b>Exhibit<br/>Number</b> | <b>Description</b>  |
|---------------------------|---|
| 10.1                      | Form of Management Continuity Agreement for Executive Officers.   |
| 31.1                      | Rule 13a-14(a) Certification of Chief Executive Officer.  |
| 31.2                      | Rule 13a-14(a) Certification of Chief Financial Officer.  |
| 32.1                      | Statement of Chief Executive Officer under Section 906 of the Sarbanes-Oxley Act of 2003 (18 U.S.C. §1350). |
| 32.2                      |   |

Statement of Chief Executive Officer under Section 906 of the Sarbanes-Oxley Act of 2003 (18 U.S.C. §1350).

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**SIGNATURES**

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

ENERGY FOCUS, INC.

Date: May 13, 2010

By: /s/ Joseph G. Kaveski  
Joseph G. Kaveski  
Chief Executive Officer

By: /s/ Nicholas G. Berchtold  
Nicholas G. Berchtold  
Chief Financial Officer  
(Principal Financial and Accounting  
Officer)

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