

POWER SOLUTIONS INTERNATIONAL, INC.

Form 10-Q

November 12, 2013

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**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

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

**For the Quarterly Period Ended: September 30, 2013**

**OR**

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

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

**Commission File Number: 001-35944**

**Power Solutions International, Inc.**

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

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

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

**201 Mittel Drive**

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

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

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

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

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller Reporting Company

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

As of November 4, 2013, there were 10,479,811 outstanding shares of Common Stock, par value \$0.001, of the registrant.

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**POWER SOLUTIONS INTERNATIONAL, INC.**

**QUARTER ENDED SEPTEMBER 30, 2013**

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**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements**

POWER SOLUTIONS INTERNATIONAL, INC.

## CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

(Dollar amounts in thousands, except per share amounts)	September 30, 2013	December 31, 2012
<b>ASSETS</b>		
Current assets		
Cash	\$ 8,332	\$ 543
Accounts receivable, net	39,217	37,480
Inventories, net	49,524	39,968
Prepaid expenses and other current assets	3,230	1,910
Deferred income taxes	2,176	2,176
Total current assets	102,479	82,077
Property, plant & equipment, net	11,338	7,145
Other noncurrent assets	1,703	1,543
<b>TOTAL ASSETS</b>	<b>\$ 115,520</b>	<b>\$ 90,765</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities		
Accounts payable	\$ 23,977	\$ 26,579
Income taxes payable		1,074
Accrued liabilities	7,084	5,011
Total current liabilities	31,061	32,664
LONG-TERM OBLIGATIONS		
Revolving line of credit	12,299	30,942
Deferred income taxes	136	136
Private placement warrants	20,120	3,666
Other noncurrent liabilities	583	623
<b>TOTAL LIABILITIES</b>	<b>64,199</b>	<b>68,031</b>
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS EQUITY		

Series A convertible preferred stock \$0.001 par value. Authorized: 114,000 shares. Issued and outstanding: -0- shares at September 30, 2013 and December 31, 2012.

Common stock \$0.001 par value. Authorized: 50,000,000 shares. Issued: 11,310,736 and 9,909,212 shares at September 30, 2013 and December 31, 2012, respectively. Outstanding: 10,479,811 and 9,078,287 shares at September 30, 2013 and December 31, 2012, respectively.

	11	10
Additional paid-in-capital	54,456	10,862
Retained earnings	1,104	16,112
Treasury stock, at cost, 830,925 shares at September 30, 2013 and December 31, 2012.	(4,250)	(4,250)
<b>TOTAL STOCKHOLDERS EQUITY</b>	<b>51,321</b>	<b>22,734</b>
<b>TOTAL LIABILITIES AND STOCKHOLDERS EQUITY</b>	<b>\$ 115,520</b>	<b>\$ 90,765</b>

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

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POWER SOLUTIONS INTERNATIONAL, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

(Dollar amounts in thousands, except per share amounts)	Three months ended September 30, 2013		Three months ended September 30, 2012	
	2013	2012	2013	2012
Net sales	\$ 64,628	\$ 51,703	\$ 176,342	\$ 149,890
Cost of sales	52,256	43,293	143,617	124,419
Gross profit	12,372	8,410	32,725	25,471
Operating expenses:				
Research & development and engineering	3,250	2,010	7,310	5,545
Selling and service	1,841	1,315	5,810	4,600
General and administrative	3,159	2,212	8,563	6,024
Total operating expense	8,250	5,537	21,683	16,169
Operating income	4,122	2,873	11,042	9,302
Other expense (income):				
Interest expense	135	249	570	766
Loss on debt extinguishment			270	
Private placement warrant expense (income)	12,605	(199)	21,658	(656)
Other (income) expense, net	(19)		(36)	94
Total other expense	12,721	50	22,462	204
(Loss) income before income taxes	(8,599)	2,823	(11,420)	9,098
Income tax provision	1,382	977	3,588	3,141
Net (loss) income	\$ (9,981)	\$ 1,846	\$ (15,008)	\$ 5,957
Weighted-average common shares outstanding:				
Basic	10,266,176	9,068,024	9,536,687	9,065,699
Diluted	10,266,176	9,068,024	9,536,687	9,065,699
(Loss) earnings per share basic				
Common shares	\$ (0.97)	\$ 0.20	\$ (1.57)	\$ 0.66
(Loss) earnings per share diluted				
Common shares	\$ (0.97)	\$ 0.20	\$ (1.57)	\$ 0.66

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



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POWER SOLUTIONS INTERNATIONAL, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Nine months ended September 30, 2013	Nine months ended September 30, 2012
(Dollar amounts in thousands)		
Cash flows from operating activities		
Net (loss) income	\$ (15,008)	\$ 5,957
Adjustments to reconcile net (loss) income to net cash (used in) provided by operating activities:		
Depreciation and amortization	1,144	748
Deferred income taxes		(308)
Share-based compensation expense	931	267
(Decrease) increase in accounts receivable allowances	(4)	57
Increase (decrease) in valuation of private placement warrants liability	21,658	(656)
Loss on disposal of assets	14	95
Loss on debt extinguishment	270	
(Increase) decrease in operating assets:		
Accounts receivable	(1,733)	(2,285)
Inventories	(9,556)	(11,158)
Prepaid expenses and other assets	58	(91)
Increase (decrease) in operating liabilities:		
Accounts payable	(3,698)	4,878
Accrued liabilities	2,073	(425)
Income taxes payable	(2,126)	165
Other noncurrent liabilities	(40)	113
Net cash used in operating activities	(6,017)	(2,643)
Cash flows from investing activities		
Purchases of property, plant and equipment	(4,322)	(2,900)
Investment in joint venture	(500)	
Net cash used in investing activities	(4,822)	(2,900)
Cash flows from financing activities		
Decrease in cash overdraft		(3,780)
Proceeds from stock offering	36,750	
Initial proceeds from borrowings under revolving line of credit	38,995	
Advances from revolving line of credit noncurrent obligation	59,907	49,156
Repayments of revolving line of credit noncurrent obligation	(78,600)	(43,358)
Repayment of prior revolving line of credit	(38,945)	



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Net change in revolving line of credit current obligation		4,249	
Payments on long-term debt and capital lease obligations		(21)	
Proceeds from exercise of private placement warrants	3,865		178
Payment of withholding taxes for net settlement of share-based awards	(2,063)		
Excess tax benefit from exercise of share-based awards	1,642		
Cash paid for financing and transaction fees	(2,923)		(226)
Net cash provided by financing activities	18,628		6,198
Net change in cash	7,789		655
Cash at beginning of period	543		
Cash at end of period	\$ 8,332	\$	655
Supplemental disclosures of cash flow information			
Cash paid for interest	\$ 567	\$	666
Cash paid for income taxes	4,074		3,290
Supplemental disclosure of non-cash transactions			
Unpaid property, plant and equipment	\$ 998	\$	815
Fair value of private placement warrants exercised	5,204		52
Unpaid financing and transaction fees	98		

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

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POWER SOLUTIONS INTERNATIONAL, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

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

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

***Description of the company***

Power Solutions International, Inc., a Delaware corporation, is the successor in a migratory merger to Power Solutions International, Inc., a Nevada corporation ( Power Solutions International and PSI refer to Power Solutions International, Inc., a Nevada corporation, prior to the consummation of the migratory merger, and Power Solutions International, Inc., a Delaware corporation, following the consummation of the migratory merger).

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

The W Group was the accounting acquiror in the reverse recapitalization with Format, Inc. Accordingly, with respect to the period prior to the reverse recapitalization, it is The W Group s historical financial position and results of operations that are presented in the unaudited condensed consolidated financial statements, with The W Group s historical equity restated to reflect the originally issued and outstanding equity of Format, plus the equity issued by Power Solutions International, pursuant to the reverse recapitalization.

Unless the context otherwise requires, the Company refers to The W Group prior to the closing of the reverse recapitalization on April 29, 2011, and Power Solutions International, Inc. as successor to the business of The W Group, following the completion of the reverse recapitalization.

Refer to Note 4, Reverse recapitalization of The W Group, private placement, reverse split and migratory merger, for further description of these transactions.

***Nature of business operations***

The Company is a global producer and distributor of a broad range of high performance, certified low emission, power systems for original equipment manufacturers of off-highway industrial equipment ( industrial OEMs ). The Company s customers include companies that are large, industry-leading and/or multinational organizations, and the Company is a sole source provider of alternative fuel power systems for most of its customers. The Company s products and services are sold predominantly to customers throughout North America, as well as, to customers located throughout Asia and Europe. The Company operates as one business and geographic segment.

The Company s power systems are highly engineered, comprehensive systems which, through its technologically sophisticated development and manufacturing processes, including its in-house design, prototyping, testing and engineering capabilities and its analysis and determination of the specific components to be integrated into a given

power system (driven in large part by emission standards and cost restrictions required, or desired, to be met), allow the Company to provide to its customers power systems customized to meet specific industrial OEM application requirements, other technical specifications of customers, and requirements imposed by environmental regulatory bodies. The Company's power system configurations range from a basic engine integrated with appropriate fuel system components to completely packaged power systems that include any combination of cooling systems, electronic systems, air intake systems, fuel systems, housings, power takeoff systems, exhaust systems, hydraulic systems, enclosures, brackets, hoses, tubes and other assembled componentry. The Company purchases engines from third party suppliers and has recently begun producing an internally-designed engine, all of which engines are then integrated into the Company's power systems. Additionally, the Company has begun designing and developing other engines in-house. Of the other components that the Company integrates into its power systems, a substantial portion consist of internally designed components and components for which the Company coordinates significant design efforts with third party suppliers, with the remainder consisting largely of parts that are sourced off-the-shelf from third party suppliers. Some of the key components (including purchased engines) embody proprietary intellectual property of the Company's suppliers. As a result of its design and manufacturing capabilities, the Company is able to provide to its customers a comprehensive power system which can be incorporated, using a single part number, directly into a customer's specified application. Capitalizing on its expertise in developing and manufacturing emission-certified power systems and its access to the latest power system technologies, the Company believes that it is able to provide complete green power systems to industrial OEMs at a low cost and with fast design turnaround. In addition to the certified products described above, the Company sells diesel and non-certified power systems and aftermarket components.

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### **2. Basis of presentation**

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

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

These unaudited condensed consolidated financial statements should be read in conjunction with, and have been prepared in conformity with the accounting principles reflected in, the consolidated financial statements and related notes included in PSI s Annual Report on Form 10-K for the fiscal year ended December 31, 2012. As these financial statements have been prepared pursuant to the rules and regulations of the SEC, certain information and disclosures normally included in the financial statements and related notes prepared in accordance with GAAP have been condensed or omitted.

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

The unaudited condensed consolidated financial statements include the accounts of Power Solutions International, Inc., and its direct and indirect wholly-owned subsidiaries, The W Group, Inc., Power Production, Inc., Power Great Lakes, Inc., Power Solutions, Inc., Power Global Solutions, Inc., Auto Manufacturing, Inc., Torque Power Source Parts, Inc., XISync, LLC, PSI International, LLC, and Power Properties, L.L.C. Collectively, these entities produce and distribute off-highway industrial engines and provide aftermarket support for the industrial engine market. All significant intercompany balances and transactions have been eliminated in the consolidation.

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

The Company s significant accounting policies as of December 31, 2012 are described in the Company s Annual Report on Form 10-K, filed with the Securities and Exchange Commission on March 12, 2013. There have been no material changes with respect to the Company s significant accounting policies subsequent to December 31, 2012.

In order to provide further description related to its policy on revenue recognition, the Company has outlined its policy below:

#### ***Revenue recognition***

The Company recognizes revenue upon transfer of title and risk of loss to the customer, which is typically when products are shipped, provided there is persuasive evidence of an arrangement, the sales price is fixed or determinable and management believes collectability is reasonably assured.

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

The Company evaluates the pronouncements of authoritative accounting organizations, including the Financial Accounting Standards Board (FASB), to determine the impact of new pronouncements on GAAP and the Company. There were no new accounting pronouncements that have been issued or adopted during the three months ended September 30, 2013, that are expected to have a significant effect on the Company s unaudited condensed consolidated financial statements.

#### **4. Reverse recapitalization of The W Group, private placement, reverse split and migratory merger**

On April 29, 2011, Power Solutions International, Inc. (formerly known as Format, Inc.) completed a reverse acquisition transaction ( Reverse Recapitalization ) in which PSI Merger Sub, Inc., a Delaware corporation that was newly-created as a wholly-owned subsidiary of Power Solutions International, Inc., merged with and into The W Group. The W Group remained as the surviving corporation of the reverse acquisition transaction and became a wholly-owned subsidiary of Power Solutions International, Inc. Pursuant to an agreement and plan of merger, all of the outstanding shares of common stock of The W Group held by the three stockholders of The W Group at the closing of the reverse acquisition transaction converted into, and Power Solutions International, Inc. issued to the three stockholders of The W Group, an aggregate of 10,000,000 shares of common stock and 95,960.90289 shares of Series A Convertible Preferred Stock (both share amounts prior to the Reverse Split defined below).

In accordance with ASC 805, *Business Combinations*, The W Group was considered the accounting acquiror for accounting purposes, and accounted for the transaction as a reverse recapitalization because (1) The W Group's former stockholders received the greater portion of the voting rights in the combined entity, (2) The W Group's senior management represented all of the senior

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management of the combined entity and (3) immediately prior to the transaction, Format, Inc., was a company with nominal operations and assets. Consequently, the assets and liabilities and the historical operations that are reflected in Power Solutions International, Inc.'s unaudited condensed consolidated financial statements are those of The W Group and have been recorded at the historical cost basis of The W Group, with a recapitalization adjustment to report the issued equity of PSI.

The results of operations of Format, Inc. have not been included in the unaudited condensed consolidated statement of operations from the date of the Reverse Recapitalization, April 29, 2011, because Format had nominal operations and assets, which consisted mostly of cash immediately prior to consummation of the Reverse Recapitalization transaction. In accordance with the accounting for an entity with nominal operations and assets under a reverse recapitalization transaction, the net income and equity of Format immediately prior to the Reverse Recapitalization were reclassified to preferred equity. The related party obligations owed by Format immediately prior to the Reverse Recapitalization were settled through the terms of a repurchase agreement, while the remaining obligations were settled with the available cash on Format Inc.'s balance sheet. Immediately prior to the reverse acquisition transaction, Format had assets with a net book value of \$5,000 which were written off in connection with the transaction.

Concurrent with the closing of the Reverse Recapitalization, Power Solutions International, Inc. and The W Group entered into a purchase agreement ( Private Placement ) whereby Power Solutions International, Inc. completed the sale of an aggregate of 18,000 shares of PSI preferred stock together with warrants ( Private Placement Warrants ) representing the right to purchase an aggregate of 24,000,007 shares of PSI common stock (share amount prior to the Reverse Split (as defined below)), subject to certain limitations on exercise. The shares of PSI preferred stock issued in the Private Placement were initially convertible into an aggregate of 48,000,007 shares of PSI common stock (share amount prior to the Reverse Split), subject to certain limitations. In consideration, Power Solutions International, Inc. and The W Group received proceeds of \$18.0 million before transaction fees, costs and expenses of approximately \$5.1 million in connection with the Reverse Recapitalization and Private Placement.

In connection with the Private Placement, the Company also issued to Roth Capital Partners, LLC ( Roth ) a warrant ( Roth Warrant ) to purchase initially 3,360,000 shares of PSI common stock (share amount prior to the Reverse Split), subject to certain limitations on exercise set forth in the Roth Warrant. On September 1, 2011, the Roth Warrant was exercised.

In connection with, and prior to the consummation of, the Reverse Recapitalization, the board of directors of Format approved a 1-for-32 reverse stock split of issued and outstanding shares of the Company's common stock ( Reverse Split ), immediately following the effectiveness of which each 32 issued and outstanding shares of the Company's common stock would automatically convert into one share of Company common stock. Any stockholder of the Company that would otherwise be entitled to a fraction of a share of the Company's common stock (after aggregating all fractional shares of the Company's common stock to be received by such holder) as a result of the Reverse Split, would receive an additional share of the Company's common stock (i.e., the aggregate number of shares of the Company's common stock of a stockholder resulting from the Reverse Split would be rounded up to the nearest whole number).

Further, in connection with the Reverse Recapitalization and the Private Placement, the board of directors of Format approved a migratory merger ( Migratory Merger ) of the Company with and into a Delaware corporation that was newly-created as a wholly-owned subsidiary of the Company, which Migratory Merger would be effected for the purpose of changing the Company's jurisdiction of incorporation from Nevada to Delaware. The parties agreed that the Reverse Split would be effected through the consummation of the Migratory Merger, whereby each 32 shares of the Company's common stock would be converted into one share of common stock of the surviving entity in the Migratory Merger. The consummation of the Migratory Merger would constitute the Reverse Split for all purposes, as

contemplated by the transaction documents entered into in connection with the consummation of the Reverse Recapitalization and the Private Placement. The consummation by the Company of the Migratory Merger, including the Reverse Split to be effected thereby, was subject to the approval of the Company's stockholders.

The Migratory Merger and Reverse Split were approved by the stockholders at a special meeting of the Company's stockholders held on August 25, 2011, and the Migratory Merger and the Reverse Split were effective on August 26, 2011. The Reverse Split did not affect the number of authorized shares of common stock of the Company or the par value per share of the Company's common stock. Immediately following the effectiveness of the Reverse Split, each issued and outstanding share of Company preferred stock automatically converted into a number of shares of Company common stock equal to \$1,000 divided by the conversion price then in effect.

The impact of the above transactions on the Company's issued capital is further described in Note 11, Stockholders equity.

## **5. Earnings per share**

The Company computes earnings (loss) per share by applying the guidance stated in ASC 260, *Earnings per Share*, to determine the net income (loss) available per share of its common stock. Prior to the conversion of the shares of Company preferred stock to Company common stock as described in Note 4, Reverse recapitalization of The W Group, private placement, reverse split and migratory merger, earnings per share was calculated using the two-class method because the convertible preferred shares participated in any undistributed earnings

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with the common stockholders, specifically, on a one-to-one, as-if converted basis, without giving effect to the limitations on conversion of the preferred stock. Thus, under the two-class method, earnings allocated to preferred shares were based upon the proportion of the as-if converted preferred shares to the combined total of common shares, plus the as-if converted shares. Basic and diluted EPS under the two-class method were then calculated as earnings allocated to common shares divided by the weighted average of the actual common shares outstanding during the reporting period after giving effect to the adjustment for the Reverse Split.

Though the Company did not pay dividends prior to the Reverse Split, because the preferred stock granted the right to participate in undistributed earnings with Company common stock, it was considered a participating security, and the Company applied the two-class method to calculate per share amounts for distributed and undistributed earnings required under ASC 260-10-45, until all of the shares of preferred stock were converted into shares of Company common stock. Upon the effectiveness of the Reverse Split on August 26, 2011, all shares of the Company's preferred stock automatically converted into shares of the Company's common stock. Effective upon, and at all times since, the conversion of the Company preferred stock to Company common stock, the treasury stock method has been used to compute earnings (loss) per share.

***Computation of dilutive common shares***

The Company utilizes the treasury stock method described in ASC 260-10-55 to determine the number of treasury shares assumed to be purchased from the proceeds of warrant exercises, with any residual shares representing the incremental common shares to be issued and included in diluted EPS. As of September 30, 2013, the Company's Private Placement Warrants, stock appreciation rights (SAR as described in Note 12, 2012 Incentive compensation Plan) and restricted stock (as described in Note 12, 2012 Incentive compensation Plan) were evaluated for their potentially dilutive effect under the treasury stock method. Due to the loss reported in the unaudited condensed consolidated statements of operating results, any potentially issuable shares of Company common stock associated with the Private Placement Warrants, SAR and restricted stock granted are not included in the dilutive EPS calculation for the three and nine months ended September 30, 2013. These potential shares were excluded from the diluted EPS calculation because they have an anti-dilutive effect under the treasury stock method.

For the three and nine months ended September 30, 2012, the Company's Private Placement Warrants were evaluated for their potentially dilutive effect using the treasury stock method. Due to the Company's limited trading volume during this period, the Company estimated the average fair value of its common shares using the estimated fair value derived in the periodic valuation of its Private Placement Warrants liability as of September 30, 2012, June 30, 2012, March 31, 2012 and December 31, 2011. Based upon an average estimated fair value of \$11.71 per share of the Company's common stock for the nine months ended September 30, 2012 and an exercise price of \$13.00 per share, all of the potentially issuable shares of common stock were excluded from the diluted EPS calculation because these potential shares would have an anti-dilutive effect under the treasury stock method. For the three and nine months ended September 30, 2012, the Company's SAR was also evaluated for its potentially dilutive effect using the treasury stock method. Based on the Company's estimated average fair value noted above and the SAR strike price, as well as certain other requirements as defined in the stock appreciation rights award agreement, the SAR was not dilutive to the Company's earnings per share during the period from date of grant to September 30, 2012. Accordingly, all potentially issuable shares of Company common stock associated with the SAR were excluded from the diluted EPS calculation. See Note 12, 2012 Incentive compensation plan, for the details associated with the aforementioned SAR grant.

During the three and nine months ended September 30, 2013, a portion of the Private Placement Warrants were exercised, resulting in the issuance of 88,167 and 297,334 shares of the Company's common stock, respectively.



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The computations of basic and diluted (loss) earnings per share for the three and nine months ended September 30, 2013 and 2012, respectively, were as follows:

	Three months ended September 30,		Nine months ended September 30,	
	2013	2012	2013	2012
<b><u>Numerator:</u></b>				
Net (loss) income	\$ (9,981)	\$ 1,846	\$ (15,008)	\$ 5,957
<b><u>Denominator:</u></b>				
Weighted average common shares outstanding-basic	10,266,176	9,068,024	9,536,687	9,065,699
Diluted effect of common stock equivalents				
Weighted average common shares outstanding-diluted	10,266,176	9,068,024	9,536,687	9,065,699
<b>(Loss) earnings per share of common stock basic and diluted</b>				
(Loss) earnings per share of common stock basic	\$ (0.97)	\$ 0.20	\$ (1.57)	\$ 0.66
(Loss) earnings per share of common stock diluted	\$ (0.97)	\$ 0.20	\$ (1.57)	\$ 0.66

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Inventories consist primarily of engines and parts. Engines are valued at the lower of cost, plus estimated freight-in, as determined by specific serial number identification, or market value. Parts are valued at the lower of cost (first-in, first-out) or market value. When necessary, the Company writes down inventory for an estimated amount equal to the difference between the cost of the inventory and the estimated realizable value. Additionally, an inventory reserve is provided for based upon the Company's estimation of future demand for the quantity of inventory on hand. In determining an estimate of future demand, multiple factors are taken into consideration, including (i) customer purchase orders and customer forecasted demand; (ii) historical sales/usage for each inventory item; and (iii) utilization within a current or anticipated future power system.

Inventory consisted of the following as of:

	September 30, 2013	December 31, 2012
Raw material	\$ 47,147	\$ 36,006
Finished goods	2,377	3,962
<b>Total</b>	<b>\$ 49,524</b>	<b>\$ 39,968</b>

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

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

	September 30, 2013	December 31, 2012
Land	\$ 260	\$ 260
Buildings and improvements	3,935	3,882
Office furniture and equipment	2,547	2,172
Tooling and equipment	5,903	5,505
Transportation equipment	212	223
Construction in progress	4,845	594
<b>Property, plant and equipment, at cost</b>	<b>17,702</b>	<b>12,636</b>
Accumulated depreciation	(6,364)	(5,491)
<b>Property, plant and equipment, net</b>	<b>\$ 11,338</b>	<b>\$ 7,145</b>

**8. Fair value of financial instruments**

As of September 30, 2013, and December 31, 2012, the Company measured its financial assets and liabilities under the amended ASC Topic 820, *Fair Value Measurements and Disclosures of the Accounting Standards Codification*, which defines fair value as the price that would be received to sell an asset or paid to transfer a liability (i.e., exit price) in an orderly transaction between market participants at the measurement date. It also establishes a three-level valuation hierarchy for disclosures of fair value measurement as follows:

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

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

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

***Private placement warrants liability***

As of September 30, 2013, and December 31, 2012, the Company's Private Placement Warrants were measured at fair value under ASC Topic 820. The Company's liability for the Private Placement Warrants is measured at fair value based on unobservable inputs, and thus is considered a Level 3 financial instrument. The Company analyzes financial instruments with features of both liabilities and equity under ASC 480, *Distinguishing Liabilities from Equity*, and ASC 815, *Derivatives and Hedging*.

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As of September 30, 2013, and December 31, 2012, the Company estimated the fair value of its Private Placement Warrants with a publicly traded stock pricing approach using the Black-Scholes option pricing model. The inputs of the Black-Scholes option pricing model included the following as of:

	September 30, 2013	December 31, 2012
Market value of the Company's common stock	\$ 59.12	\$ 16.18
Exercise price	\$ 13.00	\$ 13.00
Risk-free interest rate	0.50%	0.42%
Estimated price volatility	42.50%	45.00%
Marketability discount		15.00%
Contractual term	2.58 years	3.33 years
Dividend yield		

The market value of the Company's common stock was based on its closing price on September 30, 2013, and December 31, 2012, the date of each valuation. The volatility factors noted above represented the upper end of the range of implied volatility of publicly traded call options of benchmark companies. In the third quarter of 2013, the Company achieved a significant increase in its share price and daily average trading volume and additional Private Placement Warrants were exercised. Additionally, as described further under Note 11, "Stockholders' equity", the Company closed an underwritten public offering of its common stock, which significantly increased the Company's public float. In consideration of these factors, the Company no longer believes the Private Placement Warrants to be burdened by a lack of marketability. Accordingly, the warrant valuation as of September 30, 2013, was not discounted. As of December 31, 2012, the warrant valuation was discounted by 15%, reflecting the fact that the Private Placement Warrants were not directly traded and, at the time, were burdened by a lack of marketability. If all other assumptions were held constant, the recorded liability of the Private Placement Warrants would increase or decrease by approximately \$2.0 million due to a 10% change in the value of these warrants based on the Black-Scholes option pricing model.

The following table summarizes fair value measurement by level as of September 30, 2013, for the Company's level 3 financial liability measured at fair value on a recurring basis:

	Level 1	Level 2	Level 3
Private placement warrants liability			\$ 20,120

The following table summarizes fair value measurements by level as of December 31, 2012, for the Company's level 3 financial liability measured at fair value on a recurring basis:

	Level 1	Level 2	Level 3
Private placement warrants liability			\$ 3,666

The following table summarizes the change in the estimated fair value of the Company's Level 3 financial instrument as of September 30, 2013:

Balance at December 31, 2012	\$ 3,666
Fair value of private placement warrants exercised	(5,204)
Increase in the value of private placement warrants	21,658
Balance at September 30, 2013	\$ 20,120

For the three and nine months ended September 30, 2013, the Company recognized an expense of \$12,605,000 and \$21,658,000, respectively, due to an increase in the estimated fair value of the Company's Private Placement Warrants. For the three and nine months ended September 30, 2012, the Company recognized income of \$199,000 and \$656,000, respectively, due to a decrease in the estimated fair value of the Company's Private Placement Warrants. These expenses (income) were recorded as Private placement warrant expense (income) on the Company's unaudited condensed consolidated statements of operations for the respective periods.

***Financial assets and liabilities not measured at fair value***

As of September 30, 2013, and December 31, 2012, the Company's revolving line of credit (including accrued interest recorded under accrued liabilities) recorded on the unaudited condensed consolidated balance sheets was carried at cost. The carrying value of the revolving line of credit approximates fair value because the interest rates fluctuate with market interest rates or the fixed rates approximate current rates offered to the Company for debt with similar terms and maturities, and the Company's credit profile has not changed significantly since the origination of these financial liabilities. Under ASC Topic 825, *Financial Instruments*, these financial liabilities are defined as Level 2 in the three-level valuation hierarchy, as the inputs to their valuation are market observable.

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On April 29, 2011, in connection with the closing of the Reverse Recapitalization, The W Group and Power Solutions International, Inc. entered into a loan and security agreement ( Harris Agreement ) with BMO Harris Bank N.A. ( BMO Bank ), which replaced the existing loan and security agreement that The W Group had with a senior lender.

The Harris Agreement, prior to its March 20, 2012 amendment, provided for borrowings up to \$35.0 million under a revolving line of credit and was scheduled to mature on April 29, 2014. The Harris Agreement was collateralized by substantially all of the Company s assets. The Company was required to meet certain financial covenants, including a minimum monthly fixed charge coverage ratio and a limitation on annual capital expenditures. The Harris Agreement contained customary covenants and restrictions, including agreements to provide financial information, comply with laws, pay taxes and maintain insurance, restrictions on the incurrence of certain indebtedness, guarantees and liens, restrictions on mergers, acquisitions and certain dispositions of assets, and restrictions on the payment of dividends and distributions. In addition, the Harris Agreement required cash accounts to be held with BMO Bank. Historically, the Company s financing arrangements, including the Harris Agreement, required that cash received be applied against the Company s revolving line of credit. Accordingly, the Company did not maintain cash on its consolidated balance sheet during the term of the Harris Agreement and the loan and security agreement immediately preceding the Harris Agreement, but instead funded its operations through borrowings under its revolving line of credit.

Under the Harris Agreement, prior to its amendment on March 20, 2012: (a) the Company was a party to the Harris Agreement and pledged all of its shares of The W Group to BMO Bank as collateral for the revolving line of credit; (b) there were no term loans; (c) the revolving line of credit bore interest at BMO Bank s prime rate plus an applicable margin ranging from 0% to 0.50%; or, at the Company s option, all or a portion of the revolving line of credit could have been designated to bear interest at LIBOR plus an applicable margin ranging from 2.00% to 2.50%; (d) the Company had a limitation on annual capital expenditures; and (e) a fixed charge coverage ratio was included, except that this fixed charge coverage ratio excluded certain historical debt service costs and certain other one-time expenses (each as defined in the Harris Agreement).

On March 20, 2012, the loan and security agreement with BMO Bank was amended (the Harris Agreement, as so amended, the Amended Harris Agreement I ) to increase the total credit facility from \$35.0 million to \$50.0 million and to extend the maturity date to March 20, 2017. Under the terms of the Amended Harris Agreement I: (a) the revolving line of credit bore interest at BMO Bank s prime rate plus an applicable margin ranging from 0% to 0.50%; or, at the Company s option, all or a portion of the revolving line of credit could have been designated to bear interest at LIBOR plus an applicable margin ranging from 1.75% to 2.25%; (b) the unused revolving line fee was reduced to 0.25%; and (c) the Company was only required to report its compliance with the fixed charge coverage ratio for any month when the Company s Excess Availability, (as defined in the Amended Harris Agreement I), was less than the Liquidity Threshold. The Liquidity Threshold was defined in the Amended Harris Agreement I as the greater of (i) \$7.5 million or (ii) 12.5% of the total credit facility of \$50.0 million, as may have been reduced from time to time pursuant to the terms of the Amended Harris Agreement I. When required to report its compliance with the fixed charge coverage ratio, the Company would have had to continue to report its compliance with the fixed charge coverage ratio until it had exceeded the Liquidity Threshold for 60 consecutive days. Additionally, under the Amended Harris Agreement I, cash balances were no longer automatically swept by BMO Bank, and, as a result, from time to time, the Company carried cash balances on its consolidated balance sheet since the date of the Amended Harris Agreement I.

On November 8, 2012, the loan and security agreement with BMO Bank was further amended (the Harris Agreement, as so amended, Amended Harris Agreement II ). The Amended Harris Agreement II increased the Company s thresholds for certain transactions, allowing the Company to: (i) make acquisitions up to an aggregate of \$2.0 million,

(ii) enter into joint ventures up to an aggregate of \$2.0 million, up from \$500,000, and (iii) make annual capital expenditures up to an aggregate of \$8.0 million, up from \$4.0 million. These thresholds were subject to certain limitations as set forth in the Amended Harris Agreement II.

On June 28, 2013, the Company entered into a credit agreement with Wells Fargo Bank, National Association, (the Wells Credit Agreement ) which replaced the Amended Harris Agreement II with BMO Bank. The Wells Credit Agreement enables the Company to borrow under a revolving line of credit which is secured by substantially all of the Company's tangible and intangible assets (other than real property). The Wells Credit Agreement (a) provides an initial maximum \$75.0 million revolving line of credit to the Company, which, at the Company's request and subject to the terms of the Wells Credit Agreement, may be increased up to \$100.0 million during the term of the Wells Credit Agreement; (b) bears interest at the Wells Fargo Bank's prime rate plus an applicable margin ranging from 0% to 0.50%; or at the Company's option, all or a portion of the revolving line of credit can be designated to bear interest at LIBOR plus an applicable margin ranging from 1.50% to 2.00%; (c) has an unused line fee of 0.25% and (d) requires the Company to report its fixed charge coverage ratio, when its Excess Availability (as defined in the Wells Credit Agreement) is less than the Threshold Amount (as defined in the Wells Credit Agreement), for a period of 60 consecutive days, until the Company's availability is greater than or equal to the Threshold Amount. The Threshold Amount is defined in the Wells Credit Agreement as the greater of (i) \$9,375,000 or (ii) 12.5% of the maximum revolver amount of \$75.0 million or as it may be increased during the term of the Wells Credit Agreement up to \$100.0 million.

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Under the Wells Credit Agreement, the amount that the Company may borrow is limited to the lesser of the maximum available amount and borrowing base. The borrowing base is calculated as a percentage of the Company's eligible accounts receivable and eligible inventory (as defined in the Wells Credit Agreement). The Company is required to meet certain financial covenants, including a minimum monthly fixed charge coverage ratio of not less than 1.0 to 1.0, the testing of which commences on the last day of the month prior to the date the Company's Excess Availability (as defined in the Wells Credit Agreement) is less than the Threshold Amount and continuing for a period of 60 consecutive days, until the Company's availability is greater than or equal to the Threshold Amount. The Wells Credit Agreement also contains customary covenants and restrictions applicable to the Company, including agreements to provide financial information, comply with laws, pay taxes and maintain insurance, restrictions on the incurrence of certain indebtedness, guarantees and liens, restrictions on mergers, acquisitions and certain dispositions of assets, and restrictions on the payment of dividends and distributions. In addition, the Wells Credit Agreement requires the Company's cash accounts to be held with Wells Fargo Bank subject to an interim period during which the Company's cash accounts and activities are transitioned from BMO Bank to Wells Fargo Bank. The Credit Agreement is scheduled to mature on June 28, 2018.

In connection with the refinancing, the Company recognized a \$270,000 loss on extinguishment of debt for the unamortized deferred financing costs related to the BMO Bank agreement, in the nine months ended September 30, 2013.

As of September 30, 2013, \$4.3 million of the Company's outstanding borrowings under its revolving line of credit bore interest at the prime rate, which equaled 3.25% with the applicable margin included. The remaining outstanding balance of \$8.0 million as of September 30, 2013, had been designated to bear interest at the LIBOR rate, plus an applicable margin, which equaled 1.68%. The unused and available revolving line of credit balance was \$49.4 million at September 30, 2013.

As of December 31, 2012, \$5.9 million of the Company's outstanding borrowings under its revolving line of credit bore interest at the prime rate, which equaled 3.25% with the applicable margin included. The remaining outstanding balance of \$25.0 million as of December 31, 2012, had been designated to bear interest at the LIBOR rate, plus an applicable margin which equaled 1.96%. The unused and available revolving line of credit balance was \$19.1 million at December 31, 2012.

**10. Income taxes**

At the end of each interim period, the Company applies its estimated annual effective tax rate ( ETR ) to its interim earnings before considering the tax effect of any discrete items. The Company also records the tax impact of certain unusual or infrequently occurring items, including the effects of changes in valuation allowances and tax laws or rates, in the interim period in which they occur. Any penalties and/or interest incurred in connection with the payment of the Company's income tax obligations are classified within general and administrative expenses and interest expense, respectively.

The computation of the estimated annual ETR for each interim period requires certain estimates and significant judgments, including, but not limited to, the expected operating income for the year, projections of the proportion of income earned and taxed in state jurisdictions, estimates of permanent and temporary differences, and the likelihood of recovering deferred tax assets generated in the current year. The accounting estimates used to compute the provision for income taxes may change as new events occur, additional information is obtained, or the tax environment changes. For the 2013 fiscal year, the Company's estimated annual ETR is 37%, which excludes (i) the impact of the 2012 federal research tax credit which was enacted into law on January 2, 2013, and may not be retroactively applied to the prior year under generally accepted accounting principles, (ii) the impact of changes in the



valuation of the Private Placement Warrants, which amounts are excluded from the calculation of taxable income, and (iii) adjustments recorded in 2013 arising from differences between the Company's income tax provision as calculated on its income tax returns filed in 2013 for the year ended December 31, 2012 and the amounts provided in 2012 as recorded for financial statement purposes. Given the subjectivity and volatility of the valuation of the Private Placement Warrants, it is not possible to project the impact of the change in the Private Placement Warrants in the computation of the Company's estimated annual ETR. As a result, the Company's reported ETR will differ from the estimated annual ETR due to the changes in the valuation of the Private Placement Warrants in the periods in which such changes occur.

For the nine months ended September 30, 2013, the Company reported a pre-tax loss. The pre-tax loss was attributable to the expense recognized from a change in the valuation of the Private Placement Warrants during the period, which amount, as noted above, is permanently excluded from the computation of taxable income. Due to a reported pre-tax loss on the results of operations, an actual income tax rate is not a meaningful calculation for the nine months ended September 30, 2013. The income tax rate was 34.5% in the nine months ended September 30, 2012.

Excluding the impact of the changes in the valuation of the private placement warrants on results of operations, the calculated income tax rates would have been 35.0% and 37.2% in the nine months ended September 30, 2013 and 2012, respectively. The actual rate of 35.0% differs from the ETR of 37.0% in the nine months ended September 30, 2013, due to a favorable adjustment recorded arising from the difference between the Company's income tax provision as calculated on its income tax returns filed in 2013 for the year ended December 31, 2012, and the amounts provided in 2012 as recorded for financial statement purposes.

**Table of Contents****11. Stockholders equity*****Underwritten public offering***

On July 16, 2013, the Company closed an underwritten public offering of 2,005,000 shares of its common stock at a price to the public of \$35.00 per share. The Company sold 1,050,000 shares of its common stock, and certain selling stockholders, sold 955,000 shares of common stock in the offering. The proceeds to the Company, net of the underwriter's fees and expenses, were \$34,530,000 before deducting offering expenses of approximately \$514,000 payable by the Company. The Company did not receive any proceeds from the sale of the shares by the selling stockholders. The Company used \$25.0 million of the net proceeds to repay outstanding borrowings under the Company's revolving line of credit.

The following table presents the changes in the Company's stockholders' equity in the nine months ended September 30, 2013, giving effect to the Company's common stock issued in the above described underwritten public offering, stock compensation activity and warrant exercises:

	Common stock		Additional	Retained	Treasury	Total
	Number of	Amount	paid-in capital	earnings	stock	stockholders
	shares		Amount	Amount	Amount	equity
						Amount
Balance at December 31, 2012	9,078,287	\$ 10	\$ 10,862	\$ 16,112	\$ (4,250)	\$ 22,734
Net (loss) income				(15,008)		(15,008)
Proceeds from stock offering	1,050,000	1	36,749			36,750
Transaction expenses			(2,734)			(2,734)
Share-based compensation expense			931			931
Payment of withholding taxes for net settlement of share-based awards			(2,063)			(2,063)
Excess tax benefit from exercise of share-based awards			1,642			1,642
Fair value proceeds in excess of par value of common stock issued through the exercise of private placement warrants			9,069			9,069
Balance at September 30, 2013	10,479,811	\$ 11	\$ 54,456	\$ 1,104	\$ (4,250)	\$ 51,321

The Company's common stock issued in the recent underwritten public offering and Private Placement Warrants issued are described further below. The Company's common stock outstanding presented in the table above as of September 30, 2013, includes common stock issued upon the exercise of Private Placement Warrants in the nine months ended September 30, 2013 (refer to Note 5, Earnings per share, for a further description of these transactions), and Company common stock issued upon exercise of the vested portion of the SAR granted to the Company's Chief Operating Officer (refer to SAR exercise, below for a further description of this transaction).

***Common stock***

Each holder of a share of the Company's common stock is entitled to one vote per share held on each matter to be considered by holders of the Company's common stock. Holders of the Company's common stock are entitled to receive ratably such dividends, if any, as may be declared by the Company's board of directors. The Company's current policy is to retain earnings for operations and growth. Upon any liquidation, dissolution or winding-up of the Company, the holders of the Company's common stock are entitled to share ratably in all assets available for distribution, after payment of, or provision for, all liabilities and the preferences of any then outstanding shares of Company preferred stock. The holders of the Company's common stock have no preemptive, subscription, redemption or conversion rights.

***Private placement warrants***

Each investor in the Private Placement as described in Note 4, Reverse recapitalization of The W Group, private placement, reverse split and migratory merger, received a number of Private Placement Warrants equal to one-half the number of shares of the Company's common stock issuable upon conversion of the shares of the Company's preferred stock purchased by such investor. At issuance, the Private Placement Warrants represented the right to purchase a total of 750,002 shares of the Company's common stock at an exercise price of \$13.00 per share, as adjusted for the Reverse Split, subject to further adjustment for non-cash dividends, distributions, stock splits or other reorganizations or reclassifications of the Company's common stock. The Private Placement Warrants are also subject to full ratchet anti-dilution protection whereby, upon the issuance (or deemed issuance) of shares of the Company's common stock at a price below the then-current exercise price of the Private Placement Warrants, subject to specified exceptions, the exercise price of the Private Placement Warrants will be reduced to the effective price of the Company's common stock so issued (or deemed to be issued). The Private Placement Warrants will expire on April 29, 2016.

At any time beginning six months after the closing of the Private Placement at which the Company is required to register the shares issuable upon exercise of the Private Placement Warrants pursuant to the registration rights agreement entered into in connection with the Private Placement, but such shares may not be freely sold to the public, the Private Placement Warrants may be cashlessly exercised by their holders. In such circumstances, the warrant holders may cashlessly exercise the Private Placement Warrants by causing the Company to withhold

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a number of shares of its common stock otherwise issuable upon such exercise having a value, based upon the market price of the Company's common stock (such market price as defined in the purchase agreement for the Private Placement), equal to the aggregate exercise price associated with such exercise. In other words, in such circumstances, the exercise of the Private Placement Warrants will occur without any cash being paid by the holders of the Private Placement Warrants. Because the shares issuable upon exercise of the Private Placement Warrants are currently available for resale pursuant to effective registration statements filed by the Company with the SEC, the Private Placement Warrants may not be cashlessly exercised at this time. The Private Placement Warrants further include a requirement that, from and after the effective date of the Reverse Split, the Company will keep reserved out of the authorized and unissued shares of its common stock sufficient shares to provide for the exercise of the Private Placement Warrants.

The Company's Private Placement Warrants are accounted for as a liability, in accordance with ASC 480-10-25-14, *Distinguishing Liabilities from Equity*. ASC 480-10-25-14 states that, if an entity must or could settle an instrument by issuing a variable number of its own shares, and, as in this case, the obligation's monetary value is based solely or predominantly on variations in the fair value of the company's equity shares, but moves in the opposite direction, then the obligation to issue shares is to be recorded as a liability at the inception of the arrangement, and is adjusted with subsequent changes in the fair value of the underlying stock. The effect of the change in value of the obligation is reflected as Private placement warrant expense (income) in the Company's unaudited condensed consolidated statement of operations.

As of September 30, 2013, and December 31, 2012, respectively, 438,918 shares and 736,252 shares of Company common stock, remained reserved for the exercise of the Private Placement Warrants, in accordance with the terms of the purchase agreement for the Private Placement.

***SAR exercise***

The Company granted a SAR to the Company's Chief Operating Officer (Grantee) on June 6, 2012 as further described in Note 12, 2012 Incentive compensation plan. On August 15, 2013, the Grantee exercised the SAR with respect to 181,291 shares of common stock, which was the then vested portion of the SAR. Upon such exercise, the Company initially issued 96,504 shares of the Company's common stock. Under the terms of the plan, at the option of the Grantee, the Company then withheld 42,314 of the shares issued to satisfy his income tax obligations. The cash equivalent of the shares withheld was \$2,063,000, representing the income tax withholding obligation. The payment of the income tax withholding obligation was recorded as a reduction in additional paid-in-capital as of September 30, 2013.

In connection with this exercise, the excess of the underlying value of the common stock issued over the amount recognized as compensation expense in the Company's financial statements is a cost that is deductible for income tax purposes. As such, the Company realized an income tax benefit of \$1,642,000 for this incremental amount which was recorded as a reduction in the Company's income tax liability and an increase in additional paid-in-capital as of September 30, 2013.

Refer to the table above under the heading, Underwritten public offering, for tabular presentation of these transactions.

***Treasury stock***

The Company and Gary S. Winemaster, the Company's Chief Executive Officer and President, and Chairman of the Board of Directors of the Company, entered into a Stock Purchase Agreement, pursuant to which, on October 31, 2011, the Company purchased from Mr. Winemaster 830,925 shares of Company common stock for \$4.25 million, or

\$5.11 per share. These shares were returned to the Company's treasury as authorized and issued, but not outstanding, shares of common stock of the Company.

***Registration rights agreement***

In connection with the Private Placement, the Company entered into a Registration Rights Agreement (the "Private Placement Registration Rights Agreement") with the investors in the Private Placement and Roth Capital Partners, LLC, pursuant to which it agreed to file a registration statement on Form S-1, with the SEC, covering the resale of Registrable Securities (as defined below) (which includes the shares of the Company's common stock that were issuable upon conversion of shares of the Company's preferred stock originally issued in the Private Placement and shares of the Company's common stock issuable upon exercise of the Private Placement Warrants and shares of the Company's common stock that were issuable upon exercise of the Roth Warrant), on or before the date which is 30 days after the closing date of the Private Placement, and to use its commercially reasonable efforts to have such registration statement declared effective by the SEC as soon as practicable. The Company further agreed, within 30 days after it becomes eligible to use a registration statement on Form S-3 to register the Registrable Securities for resale, to file a registration statement on Form S-3 covering the Registrable Securities. On June 27, 2013, within 30 days after the Company became eligible

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to use a registration statement on Form S-3, in accordance with the Private Placement Registration Rights Agreement, it filed a registration statement on Form S-3 (as a post-effective amendment to the registration statement on Form S-1) covering the Registrable Securities, which was declared effective on June 27, 2013.

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

Pursuant to the Private Placement Registration Rights Agreement, the holders of Registrable Securities are also entitled to certain piggyback registration rights if the Registrable Securities are not covered by one or more effective registration statements. As of September 30, 2013, and as of the time of the closing of the public offering on July 16, 2013, all of the Registrable Securities were covered by an effective registration statement. Registrable Securities, as contemplated by the Private Placement Registration Rights Agreement, means certain shares of the Company's common stock, including those shares that were issuable upon conversion of shares of Company preferred stock issued in the Private Placement and shares of the Company's common stock issuable upon exercise of the Private Placement Warrants and the shares of the Company's common stock that were issued upon exercise of the Roth Warrant; provided, that, any such share shall cease to be a Registrable Security upon (A) sale pursuant to the registration statement or Rule 144 under the Securities Act, (B) such share becoming eligible for sale without restriction by the selling securityholder holding such security pursuant to Rule 144 under the Securities Act or (C) such share otherwise becoming eligible for sale without restriction pursuant to Section 4(1) of the Securities Act, provided that, any restrictive legend on any certificate or other instrument representing such shares has been removed or there has been delivered to the transfer agent for such shares irrevocable documentation (including any necessary legal opinion) to the effect that, upon submission by the applicable selling securityholder of the certificate or instrument representing such security, any such restrictive legend shall be removed.

In addition, at any time beginning six months after the closing of the Private Placement at which the Company was required to register the shares issuable upon exercise of the Private Placement Warrants, but such shares may not be freely sold to the public, the warrants may be cashlessly exercised by the holders thereof. In such circumstances, the warrant holders may cashlessly exercise the Private Placement Warrants by causing the Company to withhold a number of shares of its common stock otherwise issuable upon such exercise having a value, based upon the market price (such market price as defined in the purchase agreement for the Private Placement) of the Company's common stock, equal to the aggregate exercise price associated with such exercise. In other words, in such circumstances, the exercise of the Private Placement Warrants will occur without any cash being paid by the holders of the Private Placement Warrants to the Company. Because the shares issuable upon exercise of the Private Placement Warrants are currently available for resale pursuant to effective registration statements filed by the Company with the SEC, the Private Placement Warrants may not be cashlessly exercised as of September 30, 2013.

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

The Company had a commitment to file a registration statement on Form S-1 with the SEC as described above. If a registration statement was not filed with the SEC on or prior to the date which was 30 days after the closing date of the Private Placement, or if (1) a registration statement covering the Registrable Securities was not declared effective by the SEC prior to the earlier of (A) five business days after the SEC informed the Company that no review of such registration statement would be made or that the SEC had no further comments on such registration statement, or (B) the 120th day after the closing of the Private Placement, or (2) after a registration statement had been declared effective by the SEC, sales could not be made pursuant to such registration statement for any reason, but excluding any period for which the use of any prospectus included in a registration statement has been suspended if and so long as certain conditions exist (which period may not be for more than 20 consecutive days or for a total of more than 45 days in any 12-month period), then the Company would have been required to pay amounts representing liquidated damages to each of the investors. Specifically, in any such case the Company would have been required to pay each investor 1.5% of the aggregate amount invested by such investor for each 30-day period (or pro rata for any portion thereof) following the date by which such registration statement should have been filed with the SEC or been declared effective, or was unavailable, as applicable. Thus, liquidated damages to investors could have amounted to approximately \$0.3 million every 30 days. The terms of the Private Placement Registration Rights Agreement did not specify a maximum potential amount of liquidated damages and settlement alternatives were not provided. As the payment of liquidated damages did not appear probable at inception of the Private Placement, and remained so as of the date

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that any subsequent financial statements were issued, the Company did not record any contingent liability as an allocation of the gross proceeds from the Private Placement, nor subsequently, as an expense in accordance with ASC 450-20, *Loss Contingencies*. A registration statement covering the Registrable Securities was declared effective on August 26, 2011 by the SEC, which resolved the contingency regarding the registration statement being declared effective.

The Company had a commitment to file a registration statement on Form S-3 with the SEC as described above. If a registration statement on Form S-3 was not filed with the SEC within 30 days after the Company became eligible to use a registration statement on Form S-3, then the Company would have been required to pay amounts representing liquidated damages to each of the investors. Specifically, in any such case the Company would have been required to pay each investor 1.5% of the aggregate purchase price paid by such investor that was attributable to those Registrable Securities that remained unsold at that time each 30-day period (or pro rata for any portion thereof) following the date by which such registration statement should have been filed with the SEC. The terms of the Private Placement Registration Rights Agreement did not specify a maximum potential amount of liquidated damages and settlement alternatives were not provided. As the payment of liquidated damages did not appear probable at inception of the Private Placement, and remained so as of the date that any subsequent financial statements were issued, the Company did not record any contingent liability as an allocation of the gross proceeds from the Private Placement, nor subsequently, as an expense in accordance with ASC 450-20, *Loss Contingencies*. A registration statement on Form S-3 (as a post-effective amendment to the registration statement on Form S-1) covering the Registrable Securities was filed with the SEC on June 27, 2013, which resolved the contingency regarding the registration statement on Form S-3 being filed with the SEC.

**12. 2012 Incentive compensation plan**

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

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

Under the 2012 Plan, 830,925 shares of the Company's common stock were initially made available for awards pursuant to the 2012 Plan. On July 31, 2013, the Board of Directors of the Company, upon recommendation of the Compensation Committee, adopted an amendment to the 2012 Plan to increase the number of shares of common stock available for issuance under the 2012 Plan by 700,000 shares. This amendment was approved by a majority of the Company's stockholders at the Company's annual meeting of stockholders held on August 28, 2013. Of the Company's 1,530,925 shares reserved for awards under the 2012 Plan, 543,872 shares were originally underlying a SAR award granted to the Company's Chief Operating Officer on June 6, 2012 and 146,161 shares of restricted stock have been granted to date to eligible employees (both of which are further described below). As of September 30, 2013, the Company had 840,892 shares of common stock available for future issuance under the 2012 Plan.

***SAR award agreement***



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

The SAR granted to the Grantee vests and becomes exercisable ratably on each of the first three anniversaries of the SAR Grant Date (graded vesting). In addition, the SAR did not become exercisable until the date that was the last of any seven Valuation Dates (as defined in the SAR Award Agreement) within any period of ten or fewer consecutive Valuation Dates that commenced after the grant date and prior to the expiration date on each of which the market value per share of Company common stock is at least \$22.07. This market condition was met during the nine months ended September 30, 2013.

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

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The SAR is accounted for as equity, in accordance with ASC 718, *Compensation – Stock Compensation*. ASC 718-10-25-11 states that options or similar instruments on shares shall be classified as liabilities if either the underlying shares are classified as liabilities or the entity can be required under any circumstance to settle the option or similar instrument by transferring cash or other assets. The Company's underlying shares are classified as equity, and under the terms of the SAR Award Agreement, the Company must settle the exercised portion of the SAR in shares of the Company's common stock. As such, the Company has accounted for the SAR as equity.

As of the SAR Grant Date, the fair value of the SAR was estimated using the Black-Scholes option pricing model. The inputs of the Black-Scholes option pricing model included the fair value of the Company's common stock, exercise price, risk-free interest rate, estimated price volatility, term and dividend yield.

Due to the limited trading activity in the Company's common stock at the date of issuance of the SAR, the fair value of the Company's common stock was established through multiple valuation techniques, including (a) the income approach in the form of the discounted cash flow method and (b) the market approach in the form of (i) the guideline public company method and (ii) the merger and acquisition method. The technique used in estimating equity associated solely with the SAR was the Option Pricing Method.

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

ASC Topic 718, *Compensation – Stock Compensation*, was utilized in order to estimate the fair value of the SAR. The term fair value has been defined in Note 8, Fair value of financial instruments. ASC Topic 718 requires an entity to measure the cost of employee services received in exchange for an award of equity instruments based on the fair value of the award as of the grant date. That cost is then recognized over the period during which an employee is required to provide service in exchange for the award. ASC 718-10-55-72 provides that, if vesting (or exercisability) of an award is based on satisfying both a market condition and a performance or service condition and it is probable that the performance or service condition will be satisfied, the initial estimate of the service period is the longest of the explicit, implicit or derived service period. The Company has computed compensation expense by applying the guidance stated in ASC 718, on a straight-line basis over the requisite service period for each separately vesting portion of the award as if the award was, in-substance, multiple awards (graded vesting attribution method). Since, as noted above, the SAR granted by the Company includes both a market and service condition, the Company used the longest of the periods to define its requisite service period in each separately vesting portion or tranche. To determine the derived service period associated with the SAR's market condition, the Company performed a Monte Carlo analysis in order to estimate the likely timeframe until the Company's public equivalent value would exceed its aggregate exercise price over a period of seven days within a period of 10 or fewer trading days (i.e. the value at which the per share value of the Company's equity exceeds \$22.07). Based on the results of this analysis, the derived service period associated with the SAR's market condition was determined to be 1.78 years. Thus, compensation expense for the first tranche was computed on a straight-line basis over the derived service period of 1.78 years. The second and third tranches were computed on a straight-line basis over the explicit service period. During the second quarter of 2013, due to the fact that the market condition was achieved earlier than the estimated derived service period of 1.78 years (and the fact that the normal service period had been achieved), the Company was required to

accelerate the recognition of \$241,000 of compensation expense that equated to the remainder of the first tranche of expense.

During the three months ended September 30, 2013, the Grantee exercised the vested portion of his SAR. The impact of this transaction on the Company's issued capital is described in Note 11, Stockholders' equity.

In the three and nine months ended September 30, 2013, the Company recognized \$126,000 and \$783,000, respectively, of expense for the SAR granted. The nine month expense included an additional \$156,000 of accelerated SAR expense incurred due to the market condition described above having been achieved earlier than the estimated derived service period (also described above). In the three and nine months ended September 30, 2012, the Company recognized \$211,000 and \$267,000, of expense for the SAR. As of September 30, 2013, there was \$541,000 of total unrecognized compensation expense related to the SAR granted under the Plan. The Company expects the SAR expense to continue to be recognized over approximately the next twenty-one months.

***Restricted stock award agreement***

On June 17, 2013, (the June Restricted Stock Grant Date), the Compensation Committee of the Board of Directors approved, and the Company granted, 138,328 shares of Company restricted stock (Restricted Stock) to various employees pursuant to the 2012 Plan and subject to a Restricted Stock Award Agreement (Restricted Stock Award Agreement). The fair value of the Restricted Stock was \$36.00 on the June Restricted Stock Grant Date.

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On August 28, and August 29, 2013, the Compensation Committee of the Board of Directors approved, and the Company granted, 3,000 shares and 4,833 shares, respectively, of Restricted Stock to certain employees pursuant to the 2012 Plan and subject to a Restricted Stock Award Agreement. The fair value of the Restricted Stock was \$51.91 and \$52.28 on August 28, 2013, and August 29, 2013, respectively.

These shares of Restricted Stock vest in various increments and periods over a maximum of ten years from the date the stock was granted as defined under the applicable Restricted Stock Award Agreement. In the three and nine months ended September 30, 2013, the Company recognized approximately \$131,000 and \$149,000, respectively, of compensation expense in connection with the Restricted Stock granted under the 2012 Plan. As of September 30, 2013, there was approximately \$5,239,000 of total unrecognized compensation expense related to the Restricted Stock granted under the 2012 Plan. The total Restricted Stock expense is expected to be approximately \$5,388,000, and the weighted-average period over which total unrecognized compensation cost is expected to be recognized is approximately 9 years.

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

The Private Placement Registration Rights Agreement provides, among other things, that if, after such registration statement has been declared effective by the SEC, sales cannot be made pursuant to such registration statement for any reason, but excluding any period for which the use of any prospectus included in a registration statement has been suspended if and so long as certain conditions exist (which period may not be for more than 20 consecutive days or for a total of more than 45 days in any 12-month period), then the Company is required to pay amounts representing liquidated damages to each of the investors, on the same basis as the liquidated damages the Company could have been required to pay in connection with the initial registration statement filed pursuant to the Private Placement Registration Rights Agreement. See also note 11, Stockholders Equity for a discussion of a contingency related to the filing of a registration statement on Form S-3.

The Company is involved in various legal proceedings from time to time arising in the normal course of doing business. The Company is required to record a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated; however, based upon a review of information currently available to the Company regarding the potential impact of negotiations, settlements, rulings, advice of legal counsel and other information and events pertaining to the legal proceedings in which the Company is currently involved, the resolution of these legal proceedings, either individually or in the aggregate, is not expected to have a material effect on the Company's consolidated results of operations, financial condition or cash flows.

On December 7, 2012, the Company signed an agreement to enter into a joint venture with another entity for the purpose of manufacturing, assembling and selling certain engines into the Asian market. The production facility is scheduled to be completed by the end of 2013. In connection with this agreement, the Company has committed up to \$1.2 million toward the joint venture. On July 5, 2013, the Company made an initial contribution of \$500,000 to the start-up of the joint venture.

### **14. Related party purchase and sale transaction**

Thomas Somodi, who previously served as the Company's Chief Operating Officer and Chief Financial Officer, entered into with The W Group (i) a subscription agreement, dated as of April 16, 2005, as amended by the amendment to the subscription agreement, effective January 1, 2008, and (ii) an employment agreement dated as of April 16, 2005, as amended by the amendment to the employment agreement, effective January 1, 2008. Pursuant to the subscription agreement entered into with Mr. Somodi, Mr. Somodi acquired shares of The W Group which represented 10% of the issued and outstanding shares of common stock of The W Group as of the date of such

agreement and immediately prior to the closing of the Reverse Recapitalization, and the subscription agreement provided that, upon any issuance or change in the structure of capital stock, The W Group would make an equitable adjustment to the shares held by Mr. Somodi so that Mr. Somodi would maintain an interest equal to 10% of the fully-diluted capital stock of The W Group. The subscription agreement further provided (i) Mr. Somodi with the right to require The W Group to purchase his shares, and (ii) The W Group with the right to require Mr. Somodi to sell his shares to The W Group, upon The W Group's achievement of certain thresholds relating to the valuation of The W Group. Also, Mr. Somodi agreed to sell his shares, if requested by The W Group, to a third party in connection with the sale of The W Group.

On April 28, 2011, Gary Winemaster, Chief Executive Officer, and Mr. Somodi entered into a purchase and sale agreement which was subsequently amended on October 31, 2011, as described below, whereby Mr. Winemaster agreed to purchase all of Mr. Somodi's shares of preferred and common stock in The W Group, which shares converted into an aggregate of 830,925 shares of Company common stock upon the consummation of the Reverse Recapitalization, as adjusted for the Reverse Split as described in Note 4 Reverse recapitalization of The W Group, private placement, reverse split and migratory merger.

On October 31, 2011, Mr. Winemaster and Mr. Somodi amended the purchase and sale agreement to provide that Mr. Winemaster would purchase the 830,925 shares of the Company's common stock then held by Mr. Somodi at an initial closing upon delivery by Mr. Winemaster of \$4.25 million, by delivery of a full-recourse promissory note therefore, and to modify the terms upon which

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Mr. Winemaster was required to transfer shares of the Company's common stock to Mr. Somodi upon the Company's achievement of certain common stock value thresholds set forth in the purchase and sale agreement as follows: (a) an aggregate of 112,530 shares of Company common stock within 90 days of such time as the value per share of the Company's common stock was at least \$22.2162; (b) an additional aggregate of 135,036 shares of Company common stock within 90 days of such time as the value per share of the Company's common stock was at least \$27.7717; and (c) an additional aggregate of 90,024 shares of the Company's common stock within 90 days of such time as the value per share of the Company's common stock was at least \$33.3244. All share and per share numbers in the foregoing provisions were subject to adjustment for stock splits, stock dividends, stock combinations and similar events.

Messrs. Winemaster and Somodi consummated the sale of the 830,925 shares of Company common stock from Mr. Somodi to Mr. Winemaster pursuant to the terms of the purchase and sale agreement, as amended, on October 31, 2011, and, thereafter on October 31, 2011, pursuant to the terms of a purchase agreement between the Company and Mr. Winemaster, the Company purchased the 830,925 shares of the Company's common stock from Mr. Winemaster in exchange for delivery by the Company to Mr. Winemaster of \$4.25 million, representing a price per share of \$5.11. The promissory note delivered by Mr. Winemaster to Mr. Somodi in exchange for the shares at the closing of the transactions contemplated by the purchase and sale agreement, as amended, was paid in full by Mr. Winemaster on October 31, 2011. Promptly following the purchase of the shares by the Company from Mr. Winemaster pursuant to the terms of the purchase agreement, the shares were returned to the Company's treasury as authorized and issued, but not outstanding, shares of Company common stock.

Pursuant to the terms of the purchase and sale agreement, as amended, Mr. Winemaster had the right to elect to make a payment to Mr. Somodi equal to the product of the number of shares Mr. Winemaster would otherwise be required to deliver to Mr. Somodi upon achievement of a common stock value threshold, multiplied by the applicable threshold price. The first common stock value threshold was achieved on or about March 27, 2013, the second common stock value threshold was achieved on or about May 7, 2013, and the third common stock value threshold was achieved on or about May 28, 2013. On June 24, 2013, Mr. Somodi transferred to the Company his right to receive shares or a cash payment from Mr. Winemaster as a result of the achievement of the first common stock value threshold, in exchange for a cash payment by the Company to Mr. Somodi of \$2.5 million. Mr. Winemaster contemporaneously paid the Company \$2.5 million in full satisfaction of Mr. Winemaster's obligations to the Company as a result of the achievement of the first common stock value threshold. On August 5, 2013, Mr. Somodi again transferred to the Company his right to receive shares or a cash payment from Mr. Winemaster as a result of the achievement of the second common stock value threshold, in exchange for a cash payment by the Company to Mr. Somodi of \$3.75 million. Mr. Winemaster contemporaneously paid the Company \$3.75 million in full satisfaction of Mr. Winemaster's obligations to the Company as a result of the achievement of the second common stock value threshold. On August 26, 2013, Mr. Somodi transferred to the Company his right to receive shares or a cash payment from Mr. Winemaster as a result of the achievement of the third common stock value threshold, in exchange for a cash payment by the Company to Mr. Somodi of \$3.0 million. Mr. Winemaster contemporaneously paid the Company \$3.0 million in full satisfaction of Mr. Winemaster's obligations to the Company as a result of the achievement of the third common stock value threshold. These transactions were all approved by the Audit Committee prior to being entered into and consummated.

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

*The following discussion and analysis should be read in conjunction with our unaudited condensed consolidated financial statements and the related notes included in this report and our audited consolidated financial statements and the related notes for the fiscal year ended December 31, 2012, and the related management's discussion and analysis of financial condition and results of operations, contained in our annual report on Form 10-K for the fiscal year ended December 31, 2012, filed with the Securities and Exchange Commission on March 12, 2013 (our 2012 Annual Report). References to we, us, our and our company refer to Power Solutions International, Inc. and its subsidiaries.*

*The discussion and analysis below includes forward-looking statements about our business, financial condition and results of operations, including discussions about management's expectations for our business. These statements represent projections, beliefs and expectations based on current circumstances and conditions and are in light of recent events and trends, and you should not construe these statements either as assurances of performance or as promises of a given course of action. Instead, various known and unknown factors are likely to cause our actual performance and management's actions to vary, and the results of these variances may be both material and adverse. In evaluating such statements, you should carefully consider the various factors identified in this report and our 2012 Annual Report which could cause actual results to differ materially from those expressed in, or implied by, any forward-looking statements, including those factors set forth under the heading Cautionary Note Regarding Forward-Looking Statements at the end of this Item 2 in this Quarterly Report on Form 10-Q.*

#### **Overview**

#### **Organization**

We design, manufacture, distribute and support power systems for industrial OEMs across a broad range of industries including stationary electricity power generation, oil and gas, material handling, aerial work platforms, industrial sweepers, arbor, welding, airport ground support, turf, agricultural, construction and irrigation. Our engineering personnel design and test power system solutions and components supporting those solutions. Our major engine suppliers include Perkins/Caterpillar, General Motors, and Doosan, and we source components from a variety of domestic and global suppliers. We operate as one business and geographic segment. Accordingly, the following discussion is based upon this presentation.

#### *Net sales*

We generate revenues and cash primarily from the sale of off-highway industrial power systems and aftermarket parts to industrial OEMs. Our products are sold globally. Net sales are derived from gross sales less sales returns and or sales discounts.

#### *Cost of sales*

We manufacture and assemble our products at our facilities in Wood Dale, Illinois. The most significant component of our cost of sales is the engine cost. The remainder of our cost of sales primarily includes the cost of additional materials utilized in our finished goods, labor, freight, depreciation and other inventoriable costs such as allocated overhead.

#### *Operating expenses*

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

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



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

### *Other expense (income)*

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

### **Factors affecting comparability**

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

#### *Private placement warrants*

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

#### *Stock-based and other executive compensation*

In the latter part of the second quarter of 2012, our Compensation Committee of the Board of Directors approved, and we granted a stock appreciation rights award to our Chief Operating Officer. As a result, we have incurred non-cash, stock-based compensation expense for the full nine months ended September 30, 2013, as compared to approximately four months of such expense for the same period in 2012. Further, as explained below, the recognition of the expense for the stock appreciation rights was accelerated in 2013 as a result of achieving certain market conditions earlier than originally contemplated in the initial assumptions used to determine the expense and related recognition period for those stock appreciation rights.

Our Compensation Committee of the Board of Directors approved, and we have granted restricted stock awards to certain employees under the 2012 Incentive Stock Plan of the Company. As a result, we have incurred additional non-cash, stock-based compensation expense in the three and nine month periods ended September 30, 2013 that was not present in 2012. We may consider making additional share-based awards to our directors, officers and other employees and possibly to consultants, and if we do, we will incur additional non-cash, stock-based compensation expenses in future periods.

On July 31, 2013, our Board, upon recommendation of the Compensation Committee, adopted an amendment to increase the number of shares of common stock available for issuance under the 2012 Incentive Plan by 700,000 shares, which amendment was approved by our stockholders on August 28, 2013.

#### *Loss on debt extinguishment*

We recognized a loss on debt extinguishment of \$270,000 in the nine months ended September 30, 2013, due to the write-off of remaining unamortized loan fees associated with our prior credit facility. This item was not present in 2012.

*Underwritten public offering*

On July 16, 2013, we closed an underwritten public offering of 2,005,000 shares of our common stock at a price to the public of \$35.00 per share. We sold 1,050,000 shares of our common stock, and certain selling stockholders sold 955,000 shares of common stock, in the offering. We received proceeds, net of the underwriter's fees and expenses, of approximately \$34,530,000 before deducting offering expenses of approximately \$514,000 that has been payable or is payable by us. We did not receive any proceeds from the sale of the shares by the selling stockholders. We used \$25.0 million of the net proceeds to repay outstanding borrowings under our revolving line of credit.

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**Table of Contents***Events affecting sales and profitability comparisons*

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

**Results of operations*****Three months ended September 30, 2013 compared with three months ended September 30, 2012****Net sales*

Our net sales increased \$12,925,000 (25.0%) to \$64,628,000 for the three months ended September 30, 2013, compared to \$51,703,000 in the three months ended September 30, 2012, of which an increase in sales unit volume (as opposed to price increases) accounted for approximately \$12.4 million of the period over period increase. Our power systems and related sales increased approximately \$11.0 million and parts sales accounted for the remaining increase. The sales increase was primarily due to strong growth in power generation sales, driven in large part by increased demand for our larger power systems.

*Gross profit*

Our gross profit increased \$3,962,000 (47.1%) to \$12,372,000 for the three months ended September 30, 2013, from \$8,410,000 in the three months ended September 30, 2012. Our gross profit increased primarily due to the previously discussed increase in sales. Gross margin increased to 19.1% for the three months ended September 30, 2013, compared to 16.3% for the same period in 2012, primarily due to a product mix shift to larger power systems.

*Research & development and engineering*

Research & development and engineering expense increased \$1,240,000 (61.7%) to \$3,250,000 in the three months ended September 30, 2013, as compared to \$2,010,000 in 2012. We incurred expenses connected with our professional engineers, materials used in the development of new products and applications, and amounts paid to third parties for contract services associated with our research and development activities. Compensation and benefits increased \$804,000 in the three months ended September 30, 2013 as compared to the same period in 2012 as we added staff to support product development activities, including development activities associated with pursuing on-road applications for our products. Consulting and professional fees increased \$278,000 in the three months ended September 30, 2013 as compared to the same period in 2012 and was due to third-party resources used by us to support our in-house engineering staff as needed from time to time. Other research & development and engineering expenses increased an aggregate of \$158,000 in the three months ended September 30, 2013, as compared to the same period in 2012, principally related to the recognition of deferred emission expenses and other costs directly associated

with engineering. As a percentage of net sales, research & development and engineering expenses increased to 5.0% for the three months ended September 30, 2013, compared to 3.9% for the same period in 2012.

*Selling and service expense*

Selling and service expenses increased \$526,000 (40.0%) to \$1,841,000 for the three months ended September 30, 2013, from \$1,315,000 in the three months ended September 30, 2012. Wages and benefits increased \$384,000 in the three months ended September 30, 2013, as compared to the same period in 2012 in support of the achievement of our sales. Expenses increased across multiple categories in support of our higher sales unit volume, none of which was individually significant. As a percentage of net sales, selling and service expenses increased to 2.8% in 2013 compared to 2.5% for the same period in 2012.

*General and administrative expense*

General and administrative expenses increased \$947,000 (42.8%) to \$3,159,000 for the three months ended September 30, 2013, from \$2,212,000 in 2012. Wages and benefits increased \$525,000 in the three months ended September 30, 2013 as compared to the same period in 2012. The increase was attributable to the addition of staff to support our growth and expenses incurred in connection with our incentive

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and performance compensation programs. Accounting and legal fees increased \$459,000 in the three months ended September 30, 2013 as compared to the same period in 2012 and related to costs incurred in connection with the Sarbanes-Oxley Act and professional fees incurred in connection with our 401(k) plan. NASDAQ listing fees, investor relations expenses, SEC related costs, franchise taxes and other similar costs increased \$198,000 in the three months ended September 30, 2013, as compared to the same period in 2012. These increases were partially offset by a \$403,000 decrease in relocation expenses incurred in the three months ended September 30, 2012 in connection with the relocation of our production, warehousing, and administrative offices into newly built-out facilities in 2012. The remaining net increase in general and administrative expenses supported our continued growth period over period. As a percentage of net sales, general and administrative expenses increased to 4.9% in the three months ended September 30, 2013, from 4.3% for the same period in 2012.

*Other expense (income)*

Interest expense decreased \$114,000 (45.8%) to \$135,000 in the three months ended September 30, 2013, as compared to \$249,000 in 2012. The decrease in interest expense was primarily attributable to a decrease in borrowings on our revolving line of credit. As previously stated, in July 2013, we completed a public offering of our stock and used \$25,000,000 of the net proceeds to reduce borrowings on our revolving line of credit. As a result our average borrowings on our revolving line of credit outstanding decreased \$11.2 million or approximately 38% during the three months ended September 30, 2013, as compared to the same period in 2012. Our weighted average borrowing rate on our bank debt decreased slightly to 2.00% in the three months ended September 30, 2013 from 2.22% for the same period in 2012. Holding all other variables constant, we believe that for the full year of 2013 our effective interest rate will remain relatively unchanged from 2012.

Private placement warrant expense was \$12,605,000 in the three months ended September 30, 2013, as compared to income of \$199,000 in the three months ended September 30, 2012. This increase was attributable to a change in the estimated fair value of our private placement warrants. The change in estimated fair value of the private placement warrants was primarily attributable to an increase in the trading price of our common stock period over period.

*Income tax expense*

Our income tax expense increased \$405,000 to \$1,382,000 in the three months ended September 30, 2013, as compared to \$977,000 for the same period in 2012. We have estimated an interim effective income tax rate of 37% for 2013, excluding, (i) the 2012 federal research tax credit, (ii) the impact of any change in the valuation of the private placement warrants, and (iii) adjustments recorded in 2013 arising from differences between our income tax provision as calculated on our income tax returns filed in 2013 for the year ended December 31, 2012, and the provision recognized in 2012 as recorded for financial statement purposes.

The change in the valuation of our private placement warrants is a non-taxable transaction. Given the subjectivity and volatility of the valuation of the private placement warrants, we are unable to estimate the annual impact of the change in the private placement warrants and the corresponding effect on our effective tax rate for the full year. Accordingly, we include the effect of the change in the valuation of the private placement warrants, when known, in the period in which it occurs. For the three months ended September 30, 2013, we reported a pre-tax loss. The pre-tax loss was attributable to the expense recognized from a change in the valuation of the Private Placement Warrants during the period, which amount, as noted above, is permanently excluded from the computation of taxable income. Due to the reported pre-tax loss on the results of operations, an actual income tax rate is not a meaningful calculation for the three months ended September 30, 2013. The income tax rate was 34.6% in the three months ended September 30, 2012.

Excluding the impact of the changes in the valuation of the private placement warrants on results of operations, the calculated income tax rates would have been 34.5% and 37.2% in the three months ended September 30, 2013 and 2012, respectively. The actual rate of 34.5% differs from the 2013 ETR of 37.0%, due to a favorable adjustment recorded arising from the difference between our income tax provision as calculated on our income tax returns filed in 2013 for the year ended December 31, 2012, and the amounts provided in 2012 as recorded for financial statement purposes.

***Nine months ended September 30, 2013 compared with the nine months ended September 30, 2012***

*Net sales*

Our net sales increased \$26,452,000 (17.6%) to \$176,342,000 in the nine months ended September 30, 2013 compared to \$149,890,000 for the same period in 2012, of which power system sales accounted for \$22.4 million of the increase, with the remaining increase attributable to sales of aftermarket parts. Sales unit volume (as opposed to price increases) accounted for \$24.4 million of the increase in the nine months ended September 30, 2013, as compared to the same period in 2012.

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**Table of Contents***Gross profit*

Our gross profit increased \$7,254,000 (28.5%) to \$32,725,000 for the nine months ended September 30, 2013, from \$25,471,000 in the comparable period in 2012. Our gross profit increased primarily due to the previously discussed increase in sales unit volumes. As a percentage of net sales, gross margin was 18.6% for the nine months ended September 30, 2013, compared to 17.0% in the same period in 2012. The higher gross margin in the nine months ended September 30, 2013, as compared to the same period in 2012 was attributable to a product mix shift to larger power systems.

*Research & development and engineering*

Research and development and engineering expense increased \$1,765,000 (31.8%) to \$7,310,000 in the nine months ended September 30, 2013, as compared to \$5,545,000 for the same period in 2012. Wages and benefits increased \$1,300,000 as we increased headcount in connection with our engineering development and support activities, including development activities associated with pursuing on-road applications for our products. Consulting and professional fees increased \$277,000 in the nine months ended September 30, 2013, as compared to the same period in 2012 and was due to third-party resources used by us to support our in-house engineering staff as needed from time to time. Recognition of deferred emission certification expenses and on-going certification expenses applicable to EPA and CARB certified engines increased \$235,000 and was principally due to the increase in sales period over period. Offsetting these increases was a \$398,000 decrease in materials and related costs incurred for product design and application engineering. The remaining increase in other research & development and engineering expenses in the nine months ended September 30, 2013, as compared to the same period in 2012, principally related to supplies, expendable items and travel costs in support of our research and development and engineering activities. As a percentage of net sales, research & development and engineering expenses were 4.1% in the nine months ended September 30, 2013 as compared to 3.7% for the same period in 2012.

*Selling and service*

Selling and service expenses increased \$1,210,000 (26.3%) to \$5,810,000 in the nine month period ended September 30, 2013, from \$4,600,000 in the comparable period of 2012. Wages and benefits increased \$580,000 in the nine month period ended September 30, 2013, as compared to the same period in 2012, in support of the achievement of our sales increase. Warranty expenses increased \$249,000 on higher sales activity in the nine months ended September 30, 2013, as compared to the same period in 2012. Travel and related expenses increased \$140,000 and trade show and other promotional expenses also increased in support of our higher sales activity. As a percentage of net sales, selling and service expenses increased to 3.3% in the nine months ended September 30, 2013, compared to 3.1% for the same period in 2012.

*General and administrative*

General and administrative expenses increased \$2,539,000 (42.1%) to \$8,563,000 in the nine months ended September 30, 2013, from \$6,024,000 in the comparable period of 2012. Wages and benefits increased \$1,637,000 in the nine months ended September 30, 2013 as compared to the same period in 2012. The increase was attributable to the addition of staff to support our growth and expenses incurred in connection with our incentive and performance compensation programs. In particular, \$516,000 was attributable to an increase in the compensation expense associated with the stock appreciation right granted to our Chief Operating Officer in June 2012. This additional expense arose from (i) a full nine month s expense in 2013 as compared to four months in 2012 and (ii) \$156,000 of accelerated stock compensation expense arising as a result of the achievement of the market condition earlier than projected in the stock appreciation right assumptions made at the time the stock appreciation right was granted.

NASDAQ listing fees, investor relations expenses, SEC related costs, franchise taxes and other similar costs increased \$449,000 in the nine months ended September 30, 2013 as compared to the same period in 2012. In addition, accounting and legal expenses increased \$406,000 a portion of which was attributable to the additional testing required under Sarbanes-Oxley to which we are subject in 2013. We also incurred approximately \$225,000 of additional IT and human resources expenses to support our staff as we grow our business. These increases were offset by a \$423,000 reduction in relocation expenses incurred in 2012 when we moved to newly built-out facilities as previously described. The remaining net increase in general and administrative expenses supported our continued growth period over period. As a percentage of net sales, general and administrative expenses increased to 4.9% in the nine months ended September 30, 2013, from 4.0% for the same period in 2012.

*Other (income) expense*

Interest expense decreased \$196,000 (25.6%) to \$570,000 in the nine months ended September 30, 2013, as compared to \$766,000 for the same period in 2012. The decrease in interest expense was primarily attributable to a \$1.3 million, or 4.6%, decrease in average borrowings outstanding in the nine months ended September 30, 2013 as compared to the same period in 2012, which decrease was due to the aforementioned paydown of our revolving line of credit arising from proceeds received in a public offering of our common stock that was completed in July 2013. In addition, our weighted average borrowing rate on our bank debt from decreased to 2.21% in the nine months ended September 30, 2013, from 2.43% for the same period in 2012.



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We recognized a loss on debt extinguishment of \$270,000 in the nine months ended September 30, 2013, due to the write-off of remaining unamortized loan fees associated with our prior credit facility. The remaining unamortized loan fees were required to be expensed when we replaced our credit facility effective June 28, 2013, and repaid the balance outstanding under our prior credit agreement. See *Liquidity and Capital Resources* *Credit Agreements* below for further discussion regarding the refinancing of our prior credit facility with a new lender.

Private placement warrant expense was \$21,658,000 in the nine months ended September 30, 2013, as compared to income of \$656,000 for the same period in 2012. The change in estimated fair value of the private placement warrants was primarily attributable to an increase in the trading price of our common stock period over period.

*Income tax expense*

Our income tax expense increased \$447,000 to \$3,588,000 in the nine months ended September 30, 2013, as compared to \$3,141,000 for the same period in 2012. Our income tax expense in the nine months ended September 30, 2013, included a \$100,000 benefit for the federal research tax credit expected to be realized for the year ended December 31, 2012. Such amount was recorded in the first quarter of 2013 and not during 2012 because the enactment of the legislation providing the federal research tax credits for 2012 was not signed into law until January 2, 2013, and generally accepted accounting principles prohibit retroactive application of tax law changes. As described above, our interim effective income tax rate for 2013 is 37% excluding (i) the 2012 federal research tax credit, (ii) the impact of any change in the valuation of the private placement warrants, and (iii) adjustments recorded in 2013 arising from differences between our income tax provision as calculated on our income tax returns filed in 2013 for the year ended December 31, 2012 and the amounts provided in 2012 as recorded for financial statement purposes. For the nine months ended September 30, 2013, we reported a pre-tax loss. The pre-tax loss was attributable to the expense recognized from a change in the valuation of the Private Placement Warrants during the period, which amount, as noted above, is permanently excluded from the computation of taxable income. Due to a reported pre-tax loss on the results of operations, an actual income tax rate is not a meaningful calculation in the nine months ended September 30, 2013. The income tax rate was 34.5% in the nine months ended September 30, 2012.

Excluding the impact of the changes in the valuation of the private placement warrants on results of operations, the calculated income tax rates would have been 35.0% and 37.2% in the nine months ended September 30, 2013 and 2012, respectively. The actual rate of 35.0% differs from the ETR of 37.0% in the nine months ended September 30, 2013, due to a favorable adjustment recorded arising from the difference between the Company's income tax provision as calculated on its income tax returns filed in 2013 for the year ended December 31, 2012, and the amounts provided in 2012 as recorded for financial statement purposes.

**Liquidity and capital resources**

Our cash requirements are dependent upon a variety of factors, foremost of which is the execution of our strategic plan. We expect to continue to devote substantial capital resources to running our business. Our primary sources of liquidity have been and continue to be cash flows from operations, principally collections of customer accounts receivable and borrowing capacity under our credit facility. On June 28, 2013, we replaced our existing \$50.0 million credit facility with BMO Harris Bank N.A. with a \$75.0 million credit facility with Wells Fargo Bank, National Association. Our new and prior credit facilities are described further below under *Credit agreements*. On July 16, 2013, we completed a public offering in which we sold 1,050,000 shares of our common stock at \$35.00 per share that resulted in net proceeds to us of approximately \$34.1 million after underwriters' fees and expenses associated with the sale of these shares. We used \$25.0 million of our net proceeds to reduce the outstanding balance on our revolving line of credit, and the remaining proceeds will be used for working capital and other general corporate purposes, which may include capital expenditures and acquisitions.

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

As of September 30, 2013, we had working capital of \$71,418,000 compared to \$49,413,000 as of December 31, 2012. Our working capital increase of \$22,005,000 was primarily attributable to (i) a \$7,789,000 increase in cash arising from the net proceeds of the public offering of our common stock (after the repayment of \$25.0 million of our outstanding borrowings under our revolving line of credit) that we completed in July 2013, and (ii) a \$9,556,000 increase in our inventory principally resulting from continued growth in our business. The remaining change in working capital resulted from an increase of \$1,737,000 from higher trade receivables and a \$2,602,000 reduction in accounts payable.

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A limited number of our customers have payment terms which may extend up to 150 days. As of September 30, 2013, and December 31, 2012, our trade receivables included \$8.1 million and \$7.3 million of trade receivables which represented aggregate customer account balances subject to these terms. Of these amounts, \$4.0 million and \$3.3 million at September 30, 2013, and December 31, 2012, respectively, represented the portion of the balance outstanding with these extended trade terms. Under our revolving line of credit, which funds our working capital as needed, these receivables represent eligible collateral on the same basis as our other trade receivables and remain eligible as collateral upon which we may borrow up to their extended due date of 150 days.

***Cash flows for the nine months ended September 30, 2013******Operating activities***

Net income and changes in working capital are the primary drivers of our cash flows from operations. For the nine months ended September 30, 2013, we used \$6,017,000 to fund our operations. We had a reported net loss of \$15,008,000, which, after adjustment for non-cash items of \$24,013,000, resulted in net cash generated of \$9,005,000 before considering changes in our operating assets and liabilities. Our non-cash adjustments in the nine months ended September 30, 2013, primarily included expenses of (i) \$21,658,000 arising from a change in the valuation of our private placement warrants, (ii) \$1,144,000 of depreciation and amortization expense and (iii) \$931,000 of share-based compensation expense. Non-cash adjustments also included \$270,000 arising from the loss on debt extinguishment arising from the write-off of unamortized loan financing fees as a result of the replacement of our prior credit facility with BMO Harris Bank, N.A.

Cash generated of \$9,005,000 from operations, adjusted for non-cash expenses, was offset by \$15,022,000 of cash used in working capital activities in the nine months ended September 30, 2013, principally arising from the higher level of sales activity period over period. Our inventories increased \$9,556,000 as we built up our inventory to support current and future period sales. In addition, our current obligations, consisting of trade accounts payable and accrued liabilities netted, decreased \$1,625,000 as a result of payments to suppliers, and our income taxes payable also decreased \$2,126,000 resulting from the payment of our estimated income tax obligations. Also trade receivables outstanding increased \$1,733,000 as a result of an increase in sales period over period.

***Investing activities***

Net cash used in investing activities was \$4,822,000 in the nine months ended September 30, 2013, of which \$4,322,000 related primarily to the acquisition of tooling and equipment and related costs used in the production of our products, and \$500,000 related to our investment in a joint venture in China. In December 2012, we entered into a joint venture with MAT Holdings, Inc. for the purpose of manufacturing, assembling and selling certain engines into the Asian market. The joint venture agreement initially provides for an investment of \$1.2 million from each joint venture partner. We made the initial \$500,000 investment in the joint venture during the nine months ended September 30, 2013.

***Financing activities***

We generated approximately \$18,628,000 of cash from financing activities for the nine months ended September 30, 2013.

We generated \$36,750,000 of proceeds, prior to applicable transaction fees (classified in Cash paid for financing and transaction fees in our condensed consolidated statement of cash flows), from the completion of a public offering of our common stock in July 2013, and we generated \$3,865,000 of cash from the exercise of private placement warrants

by our investors. We also realized an income tax benefit of \$1,642,000 from compensation costs deductible only for income tax purposes and arising from the issuance of our common stock under our 2012 Incentive Stock Plan.

We replaced our existing credit facility with BMO Harris Bank, N.A. on June 28, 2013 with another credit facility from Wells Fargo Bank, National Association, as more fully discussed in Credit agreements below. We repaid \$38,945,000 representing the outstanding principal balance on the BMO Harris Bank, N.A. facility through an initial advance from the Wells Fargo Bank, National Association, facility of \$38,995,000. We incurred financing fees in connection with our new credit facility, which are included in Cash paid for financing and transaction fees in our condensed consolidated statement of cash flows.

Partially offsetting the cash generated were net repayments under our credit facilities of \$18,693,000 in the nine months ended September 30, 2013 principally due to a \$25,000,000 paydown of our revolving line of credit from a portion of the proceeds generated from the public offering discussed above. In addition, we used \$2,063,000 as payment of withholding taxes on behalf of our Chief Operating Officer in connection with his exercise of a portion of the SAR, and we withheld shares upon such exercise to satisfy his withholding tax obligations.

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**Table of Contents*****Cash flows for the nine months ended September 30, 2012******Operating activities***

For the nine months ended September 30, 2012, we used \$2,643,000 in cash to fund our operations. We generated cash flow from net income of \$5,957,000. Non-cash adjustments increased operating cash flow by approximately \$203,000. Non-cash adjustments included changes in the valuation of our private placement warrants liability, depreciation and amortization, deferred income taxes, non-cash losses on the disposal of fixed assets, share-based compensation expense and changes in the valuation of accounts receivable allowances. In addition to the cash generated from net income, we generated cash of \$4,878,000 due to an increase in accounts payable arising from the timing of payments to our suppliers.

These increases to cash generated by operations were offset by an \$11,158,000 increase in our inventories, as we elected to take significant positions in certain engines in connection with our sales activities, and we also increased our component purchases in support of our sales activities for 2012. Cash from operations was also used as a result of a \$2,285,000 increase in accounts receivable due to an increase in our sales unit volume for which receivables were yet uncollected. Other cash used in operating activities was \$238,000, none of which was individually significant.

***Investing activities***

Net cash used in investing activities of \$2,900,000 for the nine months ended September 30, 2012, related primarily to the acquisition of property, equipment and other assets.

***Financing activities***

We generated \$6,198,000 of cash from financing activities for the nine months ended September 30, 2012. We generated \$10,047,000 of cash from net advances on our revolving line of credit, which was partially offset by a \$3,780,000 reduction in a cash overdraft and other net cash outflows of \$69,000, none of which was individually significant.

***Credit agreements******Wells Fargo Bank, National Association credit agreement***

On June 28, 2013, we entered into a credit agreement with Wells Fargo Bank, National Association, which replaced our credit agreement with BMO Harris Bank N.A. The Wells Fargo Bank Credit Agreement enables us to borrow under a revolving line of credit which is secured by substantially all of our tangible and intangible assets (other than real property). The Wells Fargo Credit Agreement (a) provides an initial maximum \$75.0 million revolving line of credit to us, which, at our request and subject to the terms of the Wells Fargo Bank Credit Agreement, may be increased up to \$100.0 million during the term of the Wells Fargo Bank Credit Agreement; (b) bears interest at the Wells Fargo Bank's prime rate plus an applicable margin ranging from 0% to 0.50%; or at our option, all or a portion of the revolving line of credit can be designated to bear interest at LIBOR plus an applicable margin ranging from 1.50% to 2.00%; (c) has an unused line fee of 0.25%; and (d) requires us to report our fixed charge coverage ratio when our excess availability as defined in the Wells Fargo Bank Credit Agreement is less than the threshold amount, (as defined in the Wells Fargo Bank Credit Agreement) for a period of 60 consecutive days until our availability is greater than or equal to the threshold amount. The threshold amount is defined in the Wells Fargo Bank Credit Agreement as the greater of (i) \$9,375,000 or (ii) 12.5% of the maximum revolver amount of \$75.0 million or as it may be increased during the term of the Wells Fargo Bank Credit Agreement up to \$100.0 million.

Under the Wells Fargo Bank Credit Agreement, the amount that we may borrow is limited to the lesser of the maximum available amount and our borrowing base. The borrowing base is calculated as a percentage of our eligible accounts receivable and eligible inventory (as defined in the Wells Fargo Bank Credit Agreement). We are required to meet certain financial covenants, including a minimum monthly fixed charge coverage ratio of not less than 1.0 to 1.0, the testing of which commences on the last day of the month prior to the date our excess availability as defined in the Wells Fargo Bank Credit Agreement is less than the threshold amount and continuing for a period of 60 consecutive days, until our availability is greater than or equal to the threshold amount. The Wells Fargo Bank Credit Agreement also contains customary covenants and restrictions applicable to us, including agreements to provide financial information, comply with laws, pay taxes and maintain insurance, restrictions on the incurrence of certain indebtedness, guarantees and liens, restrictions on mergers, acquisitions and certain dispositions of assets, and restrictions on the payment of dividends and distributions. In addition, the Wells Fargo Bank Credit Agreement requires our cash accounts to be held with Wells Fargo Bank subject to an interim period during which our cash accounts and activities are transitioned from BMO Harris Bank N.A. to Wells Fargo Bank. The Credit Agreement is scheduled to mature on June 28, 2018.

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**Table of Contents***BMO Harris Bank N.A. credit agreement*

Prior to June 28, 2013, we had a credit facility with BMO Harris Bank N.A. that we had entered into on April 29, 2011. Our initial credit agreement with BMO Harris Bank N.A. provided for borrowings of up to \$35.0 million under a revolving line of credit, which revolving line of credit was scheduled to mature on April 29, 2014, and had a variable interest rate as described below. Borrowings under this credit agreement were collateralized by substantially all of our assets. Except as modified and discussed under the amended credit agreement with BMO Harris Bank N.A. below: (a) Power Solutions International, Inc. was a party to the credit agreement and pledged the equity interests of The W Group, Inc. and its subsidiaries to BMO Harris Bank N.A.; (b) there were no term loans; (c) the revolving line of credit bore interest at BMO Harris Bank N.A.'s prime rate plus an applicable margin ranging from 0% to 0.50% or, at our option, a portion of the revolving line of credit could have been designated to bear interest at LIBOR plus an applicable margin ranging from 2.00% to 2.50%; (d) there was a limit on annual capital expenditures; and (e) we were required to meet a minimum monthly fixed charge coverage ratio (as defined in the credit agreement) of not less than 1.10 to 1.0.

This credit agreement also contained customary covenants and restrictions applicable to us, including agreements to provide financial information, comply with laws, pay taxes and maintain insurance, restrictions on the incurrence of certain indebtedness, guarantees and liens, restrictions on mergers, acquisitions and certain dispositions of assets, and restrictions on the payment of dividends and distributions. In addition, the credit agreement required our cash accounts to be held with BMO Harris Bank N.A. Prior to the March 20, 2012 amendment of the credit facility, our cash balances were swept by BMO Harris Bank N.A. daily and applied against the outstanding balance on our revolving line of credit. As a result, we maintained a zero cash balance in our bank deposit accounts, and we borrowed on the revolving line of credit on a daily basis to fund our cash disbursements.

On March 20, 2012, the credit agreement with BMO Harris Bank N.A. was amended to increase the total credit facility from \$35.0 million to \$50.0 million and to extend the maturity date to March 20, 2017. Under the terms of the amended agreement: (a) the revolving line of credit bore interest at BMO Bank's prime rate plus an applicable margin ranging from 0% to 0.50%; or, at our option, all or a portion of the revolving line of credit could have been designated to bear interest at LIBOR plus an applicable margin ranging from 1.75% to 2.25%; (b) the unused revolving line fee was reduced to 0.25%; and (c) we were only required to report our compliance with the fixed charge coverage ratio for any month when our excess availability, as defined in the amended agreement, was less than the liquidity threshold. The liquidity threshold was defined as the greater of (i) \$7.5 million or (ii) 12.5% of the total credit facility of \$50.0 million, as may have been reduced from time to time pursuant to the terms of the amended agreement. When required to report our compliance with the fixed charge coverage ratio, we would have had to continue to report our compliance with the fixed charge coverage ratio until we had exceeded the liquidity threshold for 60 consecutive days. Additionally, under our amended agreement, cash balances were no longer automatically swept by BMO Harris Bank N.A., and, as a result, from time to time, we have carried cash balances on our consolidated balance sheet.

On November 8, 2012, the credit agreement with BMO Harris Bank N.A. was further amended to increase our thresholds for certain transactions, which allowed us to: (i) make acquisitions up to an aggregate of \$2.0 million, (ii) enter into joint ventures up to an aggregate of \$2.0 million, up from \$500,000, and (iii) make annual capital expenditures up to an aggregate of \$8.0 million, up from \$4.0 million. These thresholds were subject to certain limitations as set forth in the November 8, 2012 amended agreement.

*Outstanding borrowings under the credit agreements*

As of September 30, 2013, \$4.3 million of our outstanding borrowings under our revolving line of credit bore interest at the prime rate, which equaled 3.25% with the applicable margin included. The remaining balance, \$8.0 million, had

been designated to bear interest at the LIBOR rate, plus an applicable margin, which equaled an aggregate interest rate of 1.68%. The unused and available revolving line of credit balance was approximately \$49.4 million at September 30, 2013.

As of December 31, 2012, \$5.9 million of our outstanding borrowings under our revolving line of credit bore interest at the prime rate, which equaled 3.25% with the applicable margin included. The remaining outstanding balance as of December 31, 2012, of \$25.0 million had been designated to bear interest at the LIBOR rate, plus an applicable margin, which equaled an aggregate interest rate of 1.96%. The unused and available revolving line of credit balance was \$19.1 million at December 31, 2012.

#### **Off-balance sheet arrangements**

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

#### **Impact of recently issued accounting standards**

We evaluate the pronouncements of authoritative accounting organizations, including the FASB, to determine the impact of new pronouncements on GAAP and our unaudited condensed consolidated financial statements. There were no new accounting pronouncements that have been issued or adopted during the three months ended September 30, 2013, that we expect will have a significant effect on our unaudited condensed consolidated financial statements.



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**Cautionary Note Regarding Forward-Looking Statements**

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

A number of risks, uncertainties and other factors could cause our actual results, performance, financial condition, cash flows, prospects and opportunities to differ materially from those expressed in, or implied by, the forward-looking statements included in this report. These risks, uncertainties and other factors, many of which have been previously identified and described in greater detail under the heading Risk Factors in our 2012 Annual Report, include but are not limited to the following:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The loss of one or more key members of our senior management, or our inability to attract and retain qualified personnel could harm our business.

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

Failure or inability to meet our obligations under our current credit facility or any new credit facility could materially and adversely affect our business.

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

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

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

We could suffer warranty claims.

We could become subject to product liability claims.

Our telematics tool, MasterTrak, may not be successful.

We may have difficulty managing the expansion of our operations.

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

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

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

Our agreement to enter into a joint venture for the purpose of manufacturing, assembling and selling certain engines into the Asian market may not be successful.

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

We could be adversely affected by risks associated with acquisitions and joint ventures.

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

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

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

**Risks Related to the Shell Company**

We may have contingent liabilities related to Format, Inc.'s operations prior to the reverse recapitalization transaction of which we are not aware and for which we have not adequately provisioned.

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

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

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

A liquid and orderly trading market for our common stock may not develop, and the price of our stock may be volatile and may decline in value.

A significant number of shares of our common stock were registered for sale in 2011 and are eligible for sale. Future sales by us or our existing stockholders could depress the market price of our common stock.

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

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

If securities or industry analysts do not publish, or cease publishing, research or reports about us, our business or our market, or if they change their recommendations regarding our stock adversely, our stock price and trading volume could decline.

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

We have broad discretion in the use the net proceeds that we have received from our recent offering (or additional availability under our revolving line of credit resulting from the repayment of our outstanding borrowings thereunder with our proceeds from the offering) and may not use them in a manner in which our stockholders would consider appropriate.

A research report, which did not reflect our views, was published by one of our underwriters prior to the filing of our registration statement in connection with our public offering, which closed on July 16, 2013. We could be subject to potential liability as a result of the publication of this research report.

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

### **Item 4. Controls and Procedures Evaluation of Disclosure Controls and Procedures**

As of the end of the period covered by this report and pursuant to Rule 13a-15(b) of the Securities and Exchange Act of 1934 (the Exchange Act), our management, including the Chief Executive Officer and Chief Financial Officer, conducted an evaluation of the effectiveness and design of our disclosure controls and procedures (as that term is defined in Rule 13a-15(b) of the Exchange Act). Based upon that evaluation and due to the then current state of our remediation efforts related to the material weakness noted below, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were not effective, as of the end of the period covered under this report. As a result of this conclusion, post-closing procedures were performed to ensure that the unaudited condensed consolidated financial statements included in this report fairly represent, in all material aspects, our financial condition, results of operations and cash flows as of and for the period presented.

### **Material Weakness in Internal Control Over Financial Reporting Previously Disclosed**

As discussed in Item 9A of our Annual Report on Form 10-K for the year ended December 31, 2012, we identified a material weakness in the design and operation of our internal controls. The material weakness was related to the business systems software used in our aftermarket parts group. Users had access to add, delete, and modify data within this software and monitoring controls were not in place to adequately monitor transactions within the software. Users were also not assigned detailed security rights within the software. Management believes that this material weakness was not remediated in the period covered by this report.

In an effort to remediate this material weakness, we previously made the following changes to our internal control over financial reporting during the quarter ended June 30, 2013:

Assigned detailed security rights to all users of the business system software used in our aftermarket parts business; and

Implemented a database monitoring tool that allows management to monitor key fields and transactions within the system.

As of September 30, 2013, while management believes that significant progress has been made towards remediating the material weakness noted above, management believes that the monitoring controls implemented in the quarter ended June 30, 2013, have not been in place for a sufficient period of time to ensure remediation.

We are committed to a strong internal control environment and will continue to review the effectiveness of our internal control over financial reporting and disclosure controls and procedures. As we continue to evaluate and work to improve our internal control over financial reporting, management may determine additional measures are necessary.

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

There were no changes in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the quarter ended September 30, 2013, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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

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

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



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**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

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

**Item 6. Exhibits**

See Exhibit Index.

**SIGNATURES**

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

POWER SOLUTIONS INTERNATIONAL, INC.

Date: November 12, 2013

By: /s/ Daniel P. Gorey  
 Daniel P. Gorey  
 Chief Financial Officer  
 (Principal Financial and Accounting Officer)

**Exhibit Index**

<b>Exhibit</b>	<b>Description</b>
31.1	Certification of the Chief Executive Officer pursuant to Exchange Act Rule 13a-14(a).
31.2	Certification of the Chief Financial Officer pursuant to Exchange Act Rule 13a-14(a).
32.1	Certification of the Chief Executive Officer pursuant to Section 906 of the Sarbanes Oxley Act of 2002.
32.2	Certification of the Chief Financial Officer pursuant to Section 906 of the Sarbanes Oxley Act of 2002.
101.INS	XBRL Instance Document.
101.SCH	XBRL Taxonomy Extension Schema Document.
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document.
101.LAB	XBRL Taxonomy Extension Labels Linkbase Document.
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document.
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document.
	XBRL Taxonomy Extension Labels Linkbase Document.

