

Edgar Filing: PROTON ENERGY SYSTEMS INC - Form 10-Q

PROTON ENERGY SYSTEMS INC

Form 10-Q

November 13, 2001

-----  
-----  
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, 2001

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: 000-31533  
-----

PROTON ENERGY SYSTEMS, INC.  
(Exact name of registrant as specified in its charter)

Delaware 06-1461988  
(State or other jurisdiction (I.R.S. Employer  
of incorporation or organization) Identification Number)

50 Inwood Road, Rocky Hill, CT 06067  
(Address of registrant's principal executive office)

(860) 571-6533  
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports  
required to be filed by Sections 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 ☒ [X] No ☐ [ ]

The number of shares of common stock outstanding as of November 12, 2001 was  
33,219,576 with a par value of \$.01 per share.

-----  
-----  
PROTON ENERGY SYSTEMS, INC.

INDEX to FORM 10-Q

# Edgar Filing: PROTON ENERGY SYSTEMS INC - Form 10-Q

## PART I. FINANCIAL INFORMATION

### Item 1 --Financial Statements

Condensed Consolidated Balance Sheets--September 30, 2001 (unaudited)  
and December 31, 2000.....

Condensed Consolidated Statements of Operations--Three Month and Nine Month Periods  
ended September 30, 2001 (unaudited) and September 30, 2000 (unaudited) and Cumulative  
Amounts from Inception through September 30, 2001 (unaudited).....

Condensed Consolidated Statement of Changes in Stockholders' Equity (Deficit) from  
Inception through September 30, 2001 (unaudited).....

Condensed Consolidated Statements of Cash Flows--Nine-Month Periods ended September 30,  
2001 (unaudited) and September 30, 2000 (unaudited) and Cumulative Amounts from Inception  
through September 30, 2001 (unaudited).....

Notes to Condensed Consolidated Financial Statements.....

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

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

## PART II. OTHER INFORMATION

### Item 1 --Legal Proceedings.....

### Item 2 --Changes in Securities and Use of Proceeds.....

### Item 3 --Defaults upon Senior Securities.....

### Item 4 --Submission of Matters to a Vote of Security Holders.....

### Item 5 --Other Information.....

### Item 6 --Exhibits and Reports on Form 8-K.....

### Signatures.....

### Exhibit Index.....

## Part I--FINANCIAL INFORMATION

### ITEM 1. FINANCIAL STATEMENTS

PROTON ENERGY SYSTEMS, INC.  
(A DEVELOPMENT STAGE COMPANY)

# Edgar Filing: PROTON ENERGY SYSTEMS INC - Form 10-Q

## CONDENSED CONSOLIDATED BALANCE SHEETS

	September 30, 2001	December 31, 2000
	----- (Unaudited)	-----
ASSETS		
Current assets:		
Cash and cash equivalents.....	\$ 10,207,193	\$ 1,360,127
Marketable securities (Note 3).....	160,593,088	173,389,002
Inventories and deferred costs (Note 4).....	2,901,319	1,649,674
Other current assets.....	2,795,614	2,902,426
	-----	-----
Total current assets.....	176,497,214	179,301,229
	-----	-----
Fixed assets, net (Note 5).....	4,445,515	1,204,353
Other assets.....	98,591	246,889
	-----	-----
Total assets.....	\$181,041,320	\$180,752,471
	=====	=====
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable.....	\$ 292,077	\$ 185,733
Accrued expenses.....	360,314	435,598
Accrued compensation.....	506,867	507,250
Deferred revenue.....	1,361,859	1,035,302
Customer advances.....	175,556	156,549
Taxes payable.....	4,017	125,000
	-----	-----
Total current liabilities.....	2,700,690	2,445,432
	-----	-----
Commitments and contingencies (Note 9)		
Stockholders' equity (Note 7):		
Preferred stock, undesignated, \$.01 par value per share; 5,000,000 shares authorized, no shares issued or outstanding.....	--	--
Common stock, \$.01 par value; 100,000,000 shares authorized; 33,208,576 and 33,088,043 shares issued and outstanding, respectively.....	332,086	330,880
Additional paid-in capital.....	241,956,386	242,092,743
Unearned compensation.....	(1,618,257)	(2,374,361)
Accumulated other comprehensive gain (Note 3).....	2,703,421	289,000
Deficit accumulated during the development stage.....	(65,033,006)	(62,031,223)
	-----	-----
Total stockholders' equity.....	178,340,630	178,307,039
	-----	-----
Total liabilities and stockholders' equity.....	\$181,041,320	\$180,752,471
	=====	=====

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

# Edgar Filing: PROTON ENERGY SYSTEMS INC - Form 10-Q

(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,		For the period from 1 (August 1996) September 2
	2001	2000	2001	2000	
Contract revenue.....	\$ 303,496	\$ 350,125	\$ 710,448	\$ 537,256	\$ 2,
Product revenue.....	60,157	--	447,384	--	
Total revenues.....	363,653	350,125	1,157,832	537,256	2,
Costs and expenses:					
Costs of contract revenue.....	260,345	236,502	689,816	324,600	1,
Costs of production.....	321,612	14,917	1,136,540	130,853	1,
Research and development.....	1,810,437	891,229	4,289,584	2,077,692	12,
General and administrative.....	1,768,808	949,477	5,164,784	2,381,771	13,
Total costs and expenses.....	4,161,202	2,092,125	11,280,724	4,914,916	28,
Loss from operations.....	(3,797,549)	(1,742,000)	(10,122,892)	(4,377,660)	(25,
Interest income.....	2,117,184	727,726	7,007,639	1,409,582	11,
Gain on sale of marketable securities (Note 3).....	113,470	--	113,470	--	
Net loss.....	(1,566,895)	(1,014,274)	(3,001,783)	(2,968,078)	(14,
Deemed preferred dividends and accretion.....	--	(1,261,000)	--	(52,691,154)	(54,
Net loss attributable to common stockholders.....	\$ (1,566,895)	\$ (2,275,274)	\$ (3,001,783)	\$ (55,659,232)	\$ (68,
Basic and diluted net loss per share attributable to common stockholders.....	\$ (0.05)	\$ (1.18)	\$ (0.09)	\$ (29.16)	\$
Shares used in computing basic and diluted net loss per share attributable to common stockholders.....	33,186,840	1,920,772	33,141,397	1,908,566	8,

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

PROTON ENERGY SYSTEMS, INC.

(A DEVELOPMENT STAGE COMPANY)

CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN  
STOCKHOLDERS' EQUITY (DEFICIT)

Edgar Filing: PROTON ENERGY SYSTEMS INC - Form 10-Q

	Common Stock		Additional	Unearned	Accumulated
	Shares	Amount	Paid-In Capital	Compensation	Other Comprehensive Income
Initial capitalization.....	1,900,000	\$ 19,000	\$ --	\$ --	\$ --
Net loss.....					
Balance at December 31, 1996.....	1,900,000	19,000	--	--	--
Accretion.....	--	--	--	--	--
Net loss.....	--	--	--	--	--
Balance at December 31, 1997.....	1,900,000	19,000	--	--	--
Accretion.....	--	--	--	--	--
Net loss.....	--	--	--	--	--
Balance at December 31, 1998.....	1,900,000	19,000	--	--	--
Unearned compensation related to stock option grants.....	--	--	1,099,281	(1,099,281)	--
Amortization of unearned compensation.....	--	--	--	290,460	--
Accretion.....	--	--	(899,000)	--	--
Net loss.....	--	--	--	--	--
Balance at December 31, 1999.....	1,900,000	19,000	200,281	(808,821)	--
Issuance of common stock.....	8,051,950	80,519	125,768,765	--	--
Conversion of preferred stock into common stock.....	22,659,093	226,591	65,862,596	--	--
Issuance of common stock upon exercise of warrants.....	424,689	4,247	586,111	--	--
Issuance of common stock upon exercises of stock options...	52,311	523	8,483	--	--
Unearned compensation related to stock option grants.....	--	--	2,161,427	(2,161,427)	--
Amortization of unearned compensation.....	--	--	--	595,887	--
Deemed preferred dividends and accretion.....	--	--	47,457,155	--	--
Issuance of stock option awards....	--	--	47,925	--	--
Change in unrealized gain on marketable securities (Note 3)....	--	--	--	--	289,000
Net loss.....	--	--	--	--	--
Balance at December 31, 2000.....	33,088,043	330,880	242,092,743	(2,374,361)	289,000
Issuance of common stock (unaudited).....	9,609	96	51,659	--	--
Issuance of common stock upon exercises of stock options (unaudited).....	110,924	1,110	21,168	--	--
Unearned compensation (unaudited)..	--	--	(209,184)	209,184	--
Amortization of unearned compensation (unaudited).....	--	--	--	546,920	--
Change in unrealized gain on marketable securities (unaudited) (Note 3).....	--	--	--	--	2,414,421
Net loss (unaudited).....	--	--	--	--	--

# Edgar Filing: PROTON ENERGY SYSTEMS INC - Form 10-Q

Balance at September 30, 2001.....	33,208,576	\$332,086	\$241,956,386	\$(1,618,257)	\$2,703,421
	=====	=====	=====	=====	=====

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

5

## PROTON ENERGY SYSTEMS, INC. (A DEVELOPMENT STAGE COMPANY)

### CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

	Nine Months Ended September 30,		
	2001	2000	
	-----	-----	-----
Cash flows from operating activities:			
Net loss.....	\$ (3,001,783)	\$ (2,968,078)	\$ (14,000,000)
Adjustments to reconcile net loss to net cash used in operations:			
Depreciation and amortization.....	360,422	210,907	1,000,000
Amortization of premiums on securities.....	360,206	--	1,000,000
Non-cash stock-based expense.....	546,920	553,650	1,000,000
Changes in operating assets and liabilities:			
Inventories and deferred costs.....	(1,251,645)	(711,964)	(2,000,000)
Other current assets.....	106,812	(800,167)	(2,000,000)
Other assets.....	148,298	--	1,000,000
Accounts payable and accrued expenses.....	(90,306)	277,803	1,000,000
Deferred revenue and contract advances.....	345,564	491,401	1,000,000
Net cash used in operating activities.....	(2,475,512)	(2,946,448)	(14,000,000)
Cash flows from investing activities:			
Purchases of fixed assets.....	(3,601,584)	(475,993)	(5,000,000)
Purchases of marketable securities.....	(161,277,419)	(51,048,812)	(347,000,000)
Proceeds from maturities and sales of marketable securities.....	176,127,548	5,686,630	189,000,000
Net cash provided by (used in) investing activities.....	11,248,545	(45,838,175)	(163,000,000)
Cash flows from financing activities:			
Proceeds from sale of common stock, net.....	51,755	--	126,000,000
Proceeds from exercise of stock options.....	22,278	8,406	2,000,000
Proceeds from exercise of warrants.....	--	--	2,000,000
Proceeds from issuance of notes payable and warrants....	--	--	2,000,000
Proceeds from issuance of mandatorily redeemable convertible preferred stock and warrants.....	--	50,038,159	59,000,000

## Edgar Filing: PROTON ENERGY SYSTEMS INC - Form 10-Q

Payment of initial public offering costs.....	--	(370,726)	
	-----	-----	-----
Net cash provided by financing activities.....	74,033	49,675,839	188
	-----	-----	-----
Net increase in cash.....	8,847,066	891,216	10
Cash and cash equivalents at beginning of period.....	1,360,127	580,709	
	-----	-----	-----
Cash and cash equivalents at end of period.....	\$ 10,207,193	\$ 1,471,925	\$ 10
	=====	=====	=====

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

6

### PROTON ENERGY SYSTEMS, INC.

#### NOTES TO (UNAUDITED) CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

##### 1. NATURE OF OPERATIONS

Proton Energy Systems, Inc. (the "Company") was incorporated in Delaware on August 16, 1996 to design, develop and manufacture proton exchange membrane ("PEM") electrochemical products. The Company employs PEM electrochemical products in hydrogen generation and power generating and storage devices for use in a variety of commercial applications. The Company manufactures products for the domestic and international industrial gas market and operates in a single segment. The Company is considered a development stage company, as defined in Statement of Financial Accounting Standards ("SFAS") No. 7, "Accounting and Reporting by Development Stage Enterprises," because its principal operations have not yet commenced.

##### 2. BASIS OF PRESENTATION

In the third quarter of 2001, the Company established Technology Drive, LLC, a Connecticut limited liability company solely owned by the Company. Technology Drive, LLC holds title to approximately 44 acres of land in Wallingford, Connecticut, where the Company plans to construct its new headquarters and production facility. The condensed consolidated financial information includes the accounts of the Company and Technology Drive, LLC, after elimination of intercompany transactions.

The condensed consolidated financial information as of September 30, 2001, for the three-month and nine-month periods ended September 30, 2001 and 2000, and for the period from inception (August 16, 1996) through September 30, 2001 is unaudited. In the opinion of management, all adjustments, which consist solely of normal recurring adjustments, necessary to present fairly in accordance with generally accepted accounting principles, the financial position, results of operations and cash flows for all periods presented, have been made. The results of operations for the interim periods presented are not necessarily indicative of the results that may be expected for the full year.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. These condensed consolidated financial statements should be read in conjunction with the Company's audited financial statements and notes thereto included in the Company's Annual Report on Form 10-K filed on March 30, 2001.

Comprehensive Income (Loss)

## Edgar Filing: PROTON ENERGY SYSTEMS INC - Form 10-Q

Comprehensive income (loss) is defined as investments by owners and distributions to owners. The following table sets forth the components of comprehensive income:

	September 30,	
	2001	2000
	----- (unaudited)	----- (unaudited)
Net loss.....	\$ (3,001,783)	\$ (2,968,078)
Unrealized gains on marketable securities	2,414,421	--
	-----	-----
Total comprehensive loss.....	\$ (587,362)	\$ (2,968,078)
	=====	=====

### Reclassification

Certain amounts in the 2000 financial statements have been reclassified to conform with the 2001 presentation.

7

PROTON ENERGY SYSTEMS, INC.

NOTES TO (UNAUDITED) CONDENSED CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

### Recent Accounting Pronouncements

In July 2001, the Financial Accounting Standards Board issued SFAS 141, "Business Combinations" ("SFAS 141") and SFAS 142, "Goodwill and other Intangible Assets" ("SFAS 142"). SFAS 141 applies to all business combinations initiated after June 30, 2001, and requires these business combinations to be accounted for using the purchase method of accounting. SFAS 142 applies to all goodwill and intangibles acquired in a business combination. Under SFAS 142, all goodwill, including goodwill acquired before initial application of the standard, will not be amortized but will be tested for impairment within six months of adoption of the statement, and at least annually thereafter. Intangible assets other than goodwill will be amortized over their useful lives and reviewed for impairment in accordance with SFAS 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of." SFAS 142 is effective for fiscal years beginning after December 15, 2001, and must be adopted as of the beginning of a fiscal year. The adoption of these standards in 2002 is not expected to have a material impact on the Company's financial condition or results of operations.

### 3. MARKETABLE SECURITIES

The Company classifies its entire investment portfolio as available for sale as defined in SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities." As of September 30, 2001, the Company's investment portfolio consisted of U.S. government and agency securities held by two major banking institutions. The maturities of marketable securities are as follows:



# Edgar Filing: PROTON ENERGY SYSTEMS INC - Form 10-Q

	September 30, 2001	December 31, 2000
	-----	-----
(unaudited)		
Less than one year....	\$ 81,726,919	\$165,102,600
One to five years.....	78,866,169	8,286,402
	-----	-----
	\$160,593,088	\$173,389,002
	=====	=====

Securities are carried at fair value with the unrealized gains/losses reported as a separate component of stockholders' equity. Proceeds from the sale of a security in the third quarter of 2001 totaled \$15,546,432. The cost was determined using the specific identification method and the resulting realized gain was \$113,470. The unrealized gain from marketable securities was \$2,703,421 and \$289,000 at September 30, 2001 and December 31, 2000, respectively.

## 4. INVENTORIES AND DEFERRED COSTS

Inventories are stated at the lower of cost or market value. Cost is determined by the first-in, first-out method.

	September 30, 2001	December 31, 2000
	-----	-----
(unaudited)		
Raw materials.....	\$ 882,075	\$ 545,583
Work in process.....	695,114	133,315
Finished goods and deferred costs	1,324,130	970,776
	-----	-----
	\$2,901,319	\$1,649,674
	=====	=====

PROTON ENERGY SYSTEMS, INC.

NOTES TO (UNAUDITED) CONDENSED CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

## 5. FIXED ASSETS

	September 30, 2001	December 31, 2000
	-----	-----
(unaudited)		
Machinery and equipment.....	\$ 873,822	\$ 805,229
Leasehold improvements.....	373,308	280,705

## Edgar Filing: PROTON ENERGY SYSTEMS INC - Form 10-Q

Office furniture, fixtures and equipment	1,353,309	738,090
Construction in process.....	2,837,754	12,585
	-----	-----
	\$5,438,193	\$1,836,609
Less: accumulated depreciation.....	(992,678)	(632,256)
	-----	-----
	\$4,445,515	\$1,204,353
	=====	=====

Construction in process is primarily comprised of the land purchased for construction of the new facility and includes costs to prepare the land for construction.

### 6. LOSS PER SHARE

Net loss per share has been computed by dividing the net loss attributable to common stockholders by the weighted average common shares outstanding. No effect has been given to the exercise of common stock options, stock warrants, convertible notes and redeemable convertible preferred stock, since the effect would be antidilutive for all reporting periods.

### 7. CAPITAL STRUCTURE

In April 2000, the Company issued 14,306,901 shares of Series C Preferred Stock for \$3.50 per share for gross proceeds of approximately \$50 million. Concurrent with the issuance of the Series C Preferred Stock, the Company recorded a beneficial conversion charge. The beneficial conversion charge was calculated in accordance with EITF 98-5, "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios," and was the difference between the Series C Preferred Stock price and the deemed fair market value of the Company's common stock into which the Series C Preferred Stock was immediately convertible, limited to the total Series C Preferred Stock proceeds. Accordingly, a deemed preferred dividend of approximately \$50 million as of the issuance date has been recognized as a charge to accumulated deficit and net loss attributable to common stockholders, and as an increase to additional paid-in capital.

In October 2000, the Company completed an initial public offering. Upon closing the initial public offering, the outstanding shares of Series C Preferred Stock and all other outstanding Preferred Stock automatically converted into shares of Common Stock on a one-for-one basis.

### 8. STOCK OPTION GRANTS

During 1999 and 2000, the Company issued common stock options at less than the fair value of its common stock. The compensation expense for such options is amortized over the vesting periods of the related options. Accordingly, the Company recorded stock-based compensation expense of \$179,980 and \$184,000 for the three-month periods ended September 30, 2001 and September 30, 2000, respectively, and \$534,606 and \$405,000 for the nine-month periods ended September 30, 2001 and September 30, 2000, respectively.

### 9. COMMITMENTS AND CONTINGENCIES

In November 1999, the Company entered into an agreement with a distributor to develop, market and distribute hydrogen generators to be used solely in laboratory applications. This agreement grants the distributor

# Edgar Filing: PROTON ENERGY SYSTEMS INC - Form 10-Q

PROTON ENERGY SYSTEMS, INC.

NOTES TO (UNAUDITED) CONDENSED CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

worldwide exclusivity to the commercial sale of this product during the fifteen-year term of the contract as long as the distributor meets minimum purchases, as defined in the agreement. The Company retains the right to modify the contract once annually by providing six months notice. In the nine-month period ended September 30, 2001, the Company recorded a loss of \$251,000 under this contract. Any future loss recognition is contingent on the distributor placing additional orders and the Company's cost per unit exceeding the related sale price per unit.

In 2001, the Company entered into a 10-year agreement with STM Power, Inc. ("STM") for the exclusive supply of high-pressure hydrogen replenishment systems for Stirling Cycle Engines. Under an initial purchase order relating to this agreement, STM has agreed to provide \$395,000 for the product development and delivery of prototype hydrogen replenishment systems. At September 30, 2001, \$176,000 has been received and is recorded in customer advances.

## 10. RELATED PARTIES

In October 2001, the Company loaned \$275,000 to Walter W. Schroeder, the President of the Company and a director. The loan is for a term of two years and is payable, with interest at the prime rate (currently 5.5%), in monthly installments of \$10,000 each with a final payment of approximately \$64,000 at maturity. The loan agreement contains no penalty for early repayment.

In 2001, the Company entered into a contract with STM to develop and deliver hydrogen generators (see Note 9). Richard A. Aube, a member of the Company's Board of Directors, is also a member of STM's Board of Directors.

## 11. SUBSEQUENT EVENT

In October 2001, the Company entered into a cost plus fixed fee contract providing for payments of up to \$6.2 million with the Naval Research Laboratory for advanced fuel cell technology development. The contract contains two phases. Phase I, totaling up to \$3.2 million, consists of initial technology development. Phase II, totaling up to \$3.0 million, consists of prototype fabrication and testing.

## ITEM 2--MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion should be read in conjunction with the Financial Statements and Notes thereto appearing elsewhere in this Form 10-Q and with our Annual Report on Form 10-K filed for the fiscal year ended December 31, 2000. This Form 10-Q contains forward-looking statements that involve substantial risks and uncertainties. You can identify these statements by forward-looking words such as "anticipate," "believe," "could," "estimate," "expect," "intend," "may," "plan," "potential," "should," "will," and "would" or similar words. You should read statements that contain these words carefully because they discuss our future expectations and contain projections of our future results of operation or of our financial position or state other forward-looking information. However, there may be events in the future that we are unable to predict accurately or control. The factors in the section captioned "Certain Factors That May Affect Future Results," contained in our Annual Report on Form 10-K filed for the fiscal year ended December 31, 2000, and below in this Form 10-Q under the "Legal Proceedings" caption, provide examples of risks, uncertainties, and events that may cause our actual results to differ materially from the expectations we describe in our forward-looking statements.

## Edgar Filing: PROTON ENERGY SYSTEMS INC - Form 10-Q

### Overview

We were founded in 1996 to design, develop and manufacture PEM electrochemical products for commercial applications. Our proprietary PEM technology is incorporated in two families of products: hydrogen generators, of which we are currently manufacturing and delivering late-stage development models to customers, and regenerative fuel cell systems, which we are currently developing. Since our inception, we have funded our operations through private financings that raised approximately \$61.6 million, including \$50.1 million raised in a private financing in April 2000, and an initial public offering in October 2000 which raised net proceeds of approximately \$125.8 million.

10

### PROTON ENERGY SYSTEMS, INC.

We began delivering late-stage development models of our hydrogen generators to customers in 1999; revenue on such transactions has generally been deferred until the expiration of the product warranty period. In the future, product revenue will be recognized at the earlier of warranty expiration or when estimates of warranty obligations can be made. As of September 30, 2001, we have deferred revenue of approximately \$1.4 million related to the units we have delivered. In the future, we expect to derive the majority of our revenue from the sale of the hydrogen generator and regenerative fuel cell systems products we may develop.

We derive contract revenue from customer-sponsored research and development contracts related to our PEM technology. For those contracts that do not require us to meet specific obligations, we recognize contract revenue utilizing the percentage-of-completion method, which is based on the relationship of costs incurred to total estimated contract costs. For those contracts that require us to meet specified obligations, including delivery and acceptance obligations, amounts advanced to us pursuant to the contracts are recognized as contract liabilities until such obligations are met. Once the obligations are met, the amounts are recognized as contract revenue. From inception through September 30, 2001, we have recognized approximately \$2.3 million in contract revenue from research and development funding under arrangements with both government and private sources. Under these contracts, we have delivered HOGEN(R) hydrogen generators and demonstration regenerative fuel cell systems. At September 30, 2001, we currently have ongoing research and development projects with both NASA and the United States Department of Energy, or DOE. Our current NASA contract was completed in September 2001 and provided for total payments to us of approximately \$600,000, all of which has been recognized in revenue through September 30, 2001. The DOE contract extends to September 2002 and provides for payments to us of approximately \$1.3 million, of which we have recognized approximately \$778,000 in revenue through September 30, 2001.

We have generated cumulative losses since our inception, and as of September 30, 2001 our accumulated deficit was \$65.0 million, of which \$50.7 million is attributable to deemed preferred dividends and accretion and \$14.3 million is attributable to net losses since inception. We expect to continue to make significant investments in new product design and development for the foreseeable future. We expect to incur operating losses in 2001 and for the next several years and cannot predict when we will become profitable, if ever.

### Results of Operations

## Edgar Filing: PROTON ENERGY SYSTEMS INC - Form 10-Q

Comparison of the Three Months Ended September 30, 2001 and September 30, 2000

Contract revenue. Contract revenue decreased from \$350,000 for the three months ended September 30, 2000 to \$303,000 for the comparable period in 2001. The amount in the third quarter of 2001 relates to activity under our NASA contract as well as research and development activity related to Proton's HOGEN(R) hydrogen generator under the DOE contract. The decrease in 2001 relates to decreased activity under our NASA contract which was completed in September 2001. In the future, we expect contract revenue from government-sponsored research and development contracts to decrease as a percentage of total revenues as we begin to recognize increasing levels of revenue from product sales.

Product revenue. Product revenue increased from \$0 in the third quarter of 2000 to \$60,000 for the third quarter of 2001. The amount in 2001 relates to previously deferred revenue on products for which warranties have expired and from product rentals and spare part sales.

Costs of contract revenue. Costs of contract revenue increased from \$237,000 for the third quarter of 2000 to \$260,000 for the third quarter of 2001. The amount in 2001 and 2000 reflects costs incurred on our DOE and NASA contracts. The increase in 2001 is due to increased activity on our cost-sharing DOE contract coupled with lower average reimbursed billing rates.

11

### PROTON ENERGY SYSTEMS, INC.

Costs of production. Costs of production increased from \$15,000 for the third quarter of 2000 to \$322,000 for the third quarter of 2001. The amount in 2001 reflects costs associated with manufacturing and delivering our hydrogen generators which is in excess of the corresponding sales price as well as warranty costs on units in the field. In addition, cost of production also includes approximately \$43,000 of cost recognized concurrent with the recognition of revenue upon warranty expiration. To date, under our initial order, we have recognized costs in excess of our contracted sales price with Matheson Tri-Gas, Inc. in the amount of \$373,000. We expect to continue to incur costs in excess of our sales price under our contract with Matheson Tri-Gas, Inc. as we refine our production process.

Under the Matheson Tri-Gas contract, Matheson has the exclusive right to sell our hydrogen generators if it meets minimum purchase requirements specified in the contract. Because we have not yet completed development of commercial models of these units, no minimum purchase requirements are applicable to Matheson prior to December 31, 2001. For periods after December 31, 2001, the contract currently provides that Matheson must purchase 1,000 units per year if it wishes to maintain exclusivity; however, the Company and Matheson are currently in negotiation regarding quantity and price adjustments for 2002. Under the contract, we have the right to increase prices on the units once annually by providing six months notice, subject to either party's right to terminate the contract if agreement on price increases is not reached. We anticipate that the terms of the contract may be revised as commercial development is completed. Any future recognition of losses by us under this contract will depend on the number of orders placed by Matheson and the extent to which our cost per unit exceeds the sale price per unit.

Research and development expenses. Research and development expenses increased from \$891,000 for the third quarter of 2000 to \$1.8 million for the

## Edgar Filing: PROTON ENERGY SYSTEMS INC - Form 10-Q

third quarter of 2001. The increase was due to an increase in our research and development activities related to our PEM technology in our regenerative fuel cell systems and our hydrogen generators. These research and development activities primarily related to increased salaries and benefits for our growing research and development staff and materials to support our research and development projects. We expect our research and development expenses to continue to increase in the future.

General and administrative expenses. General and administrative expenses increased from \$949,000 for the third quarter of 2000 to \$1.8 million for the third quarter of 2001. This change primarily reflects an increase in salaries and benefits of \$351,000, as a result of an increase in employees, an increase in accounting and legal expenses of \$148,000, an increase of \$100,000 in educational and training related expenses, and an increase of \$77,000 for state minimum capital-based and franchise taxes.

Interest income, net. Interest income increased from \$728,000 for the third quarter of 2000 to \$2.1 million for the third quarter of 2001. The increase resulted from increased cash and marketable securities as a result of investing the proceeds from our initial public offering.

Comparison of the Nine Months Ended September 30, 2001 and September 30, 2000

Contract revenue. Contract revenue increased from \$537,000 for the nine months ended September 30, 2000 to \$710,000 for the comparable period in 2001. This increase was primarily due to research and development activity related to Proton's HOGEN(R) hydrogen generator under the DOE contract. In the future, we expect contract revenue from government-sponsored research and development contracts to decrease as a percentage of total revenues as we begin to recognize increasing levels of revenue from product sales.

Product revenue. Product revenue increased from \$0 in the first nine months of 2000 to \$447,000 for the comparable period of 2001. The amount in 2001 relates to previously deferred revenue on products for which warranties have expired and from product rentals and spare parts sales.

12

### PROTON ENERGY SYSTEMS, INC.

Costs of contract revenue. Costs of contract revenue increased from \$325,000 for the first nine months of 2000 to \$690,000 for the comparable period of 2001. The amount in 2000 reflects costs incurred on our DOE and NASA contracts. The amount in 2001 primarily reflects costs incurred under the DOE contract. The increase in 2001 is due to increased activity on our cost-sharing DOE contract coupled with lower average reimbursed billing rates.

Costs of production. Costs of production increased from \$131,000 for the first nine months of 2000 to \$1.1 million for the comparable period of 2001. The amounts in 2000 and 2001 reflect costs associated with manufacturing and delivering our hydrogen generators which is in excess of the corresponding sales price as well as warranty costs on units in the field. The increase in 2001 is a result of increased production activity. In addition, in 2001, cost of production includes approximately \$400,000 of cost recognized concurrent with the recognition of revenue upon warranty expiration as compared to \$0 for the first nine months of 2000.

Research and development expenses. Research and development expenses

## Edgar Filing: PROTON ENERGY SYSTEMS INC - Form 10-Q

increased from \$2.1 million for the first nine months of 2000 to \$4.3 million for the comparable period of 2001. The increase was due to an increase in our research and development activities related to our PEM technology in our regenerative fuel cell systems and our hydrogen generators. These research and development activities primarily related to increased salaries and benefits for our growing research and development staff and materials to support our research and development projects. We expect our research and development expenses to continue to increase in the future.

General and administrative expenses. General and administrative expenses increased from \$2.4 million for the first nine months of 2000 to \$5.2 million for the comparable period of 2001. This change primarily reflects an increase in salaries and benefits of \$1.2 million, as a result of an increase in employees, an increase in accounting and legal expenses of \$375,000, an increase of \$331,000 in investor relation and annual report related expenses, and an increase of \$282,000 for state minimum capital-based and franchise taxes.

Interest income, net. Interest income increased from \$1.4 million for the first nine months of 2000 to \$7.0 million for the comparable period of 2001. The increase resulted from increased cash and marketable securities as a result of investing the proceeds from the issuance of our Series C Convertible Preferred Stock and initial public offering.

### Liquidity and Capital Resources

Since our inception in August 1996 through September 2001, we have financed our operations through the series A, A-1, B, B-1 and C convertible preferred stock issuances and our initial public offering that, in total, raised approximately \$187.4 million. As of September 30, 2001, we had \$170.8 million in cash, cash equivalents and marketable securities.

Cash used in operating activities was \$2.5 million for the nine months ended September 30, 2001 and was primarily attributable to our net loss and increases in inventory and deferred costs, offset by increases in deferred revenue. Cash used in operating activities was \$2.9 million for the comparable 2000 period and was primarily attributable to our net loss and increases in inventory and other current assets, offset by increases in deferred revenue.

Cash provided by investing activities was \$11.2 million for the nine months ended September 30, 2001 and was primarily attributable to proceeds from the maturity of marketable securities offset by purchases of marketable securities and fixed assets. Cash used in investing activities was \$45.8 million for the nine months ended September 30, 2000 and was primarily attributable to purchases of marketable securities offset by maturities of marketable securities.

Cash provided by financing activities was \$49.7 million for the nine months ended September 30, 2000 resulting from the issuance of Series C Convertible Preferred Stock.

We anticipate that our cash and marketable securities on hand as of September 30, 2001 will be adequate to fund our operations, working capital and capital expenditure requirements for at least the next 12 months. We have purchased approximately 44 acres of land in Wallingford, CT to build our new

## Edgar Filing: PROTON ENERGY SYSTEMS INC - Form 10-Q

manufacturing facility. We currently anticipate relocating to our planned manufacturing facility in the next 12 months. We expect to invest approximately \$11--\$13 million over the next 9 to 12 months in connection with this facility. To date through September 30, 2001, we have invested approximately \$2.8 million in connection with the facility, primarily related to the land purchase and costs to prepare the land for construction. We are currently in negotiation with a major financial institution regarding financing for a significant portion of the facility construction. Over the next 12 months, we expect to continue to fund the production of our hydrogen generators and to continue our research and development activities on our regenerative fuel cell systems. We cannot assure you that we will not require additional financing to fund our operations or that, if required, any further financing will be available to us on acceptable terms, or at all. If sufficient funds are not available, we may be required to delay, reduce or eliminate some of our research and development or manufacturing programs. The terms of any additional financing may require us to relinquish rights to our technologies or potential products or other assets.

### ITEM 3. Quantitative and Qualitative Disclosures About Market Risk

We hold marketable securities consisting of U.S. government and agency securities that are held by two major banking institutions. We do not hold derivative financial instruments. Interest rate risk is the major price risk facing our investment portfolio. Such exposure can subject us to economic losses due to changes in the level or volatility of interest rates. Generally, as interest rates rise, prices for fixed income instruments will fall. As rates decline the inverse is true. We attempt to mitigate this risk by investing in high quality issues of short duration. We do not expect any material loss from our marketable securities investments and believe that our potential interest rate exposure is not material.

14

PROTON ENERGY SYSTEMS, INC.

## PART II.

### OTHER INFORMATION

#### ITEM 1. Legal Proceedings

Between July 3, 2001 and August 29, 2001, four purported class action lawsuits were filed in the United States District Court for the Southern District of New York against us and several of our officers and directors as well as against the underwriters who handled our September 28, 2000 initial public offering ("IPO") of common stock. All of the complaints were filed allegedly on behalf of persons who purchased the Company's common stock from September 28, 2000 through and including December 6, 2000. The complaints are similar, and allege violations of the Securities Act of 1933 and the Securities Exchange Act of 1934 primarily based on the assertion that there was undisclosed compensation received by the Company's underwriters in connection with our IPO. We expect that the actions will be consolidated into a single suit at some point in the future.

Although neither we nor the individual defendants have filed answers in any of these matters, we believe that the individual defendants and we have meritorious defenses to the claims made in the complaints and intend to contest the lawsuits vigorously. However, there can be no assurance that we will be successful, and an adverse resolution of the lawsuits could have a material



## Edgar Filing: PROTON ENERGY SYSTEMS INC - Form 10-Q

adverse effect on our financial position and results of operation in the period in which the lawsuits are resolved. We are not presently able to reasonably estimate potential losses, if any, related to the lawsuits. In addition, the costs to us of defending any litigation or other proceeding, even if resolved in our favor, could be substantial. Such litigation could also substantially divert the attention of our management and our resources in general. Uncertainties resulting from the initiation and continuation of any litigation or other proceedings could harm our ability to compete in marketplace.

### ITEM 2. Changes in Securities and Use of Proceeds

On October 4, 2000, we closed an initial public offering of our common stock. The effective date of the Securities Act registration statement for which the use of proceeds information is being disclosed was September 28, 2000, and the Commission file number assigned to the registration statement is 333-39748. After deducting underwriting discounts and commissions and offering expenses, our net proceeds from the offering were approximately \$125.8 million. The net proceeds have been allocated for general corporate purposes and capital expenditures, including purchase of equipment for and leasehold improvements to our planned manufacturing facility, and the possible acquisition of businesses, products or technologies that are complementary to our business. As of September 30, 2001, approximately \$8.1 million of the net proceeds of the offering had been used to fund operations and purchase fixed assets. The remaining net proceeds are invested in U.S. government securities and agencies. As of September 30, 2001, none of the proceeds were paid directly or indirectly to any director, officer or general partner of us or our associates, persons owning ten percent or more of any class of our equity securities, or an affiliate of us. Subsequent to September 30, 2001, the Company loaned \$275,000 to an officer and director of the Company.

### ITEM 3. Default upon Senior Securities

Not Applicable.

### ITEM 4. Submission of Matters to a Vote of Security Holders

Not Applicable.

15

PROTON ENERGY SYSTEMS, INC.

### ITEM 5. Other Information

Not Applicable.

### ITEM 6. Exhibits and Reports on Form 8-K

#### (a) Exhibits

10.17 Secured Promissory Note, dated October 4, 2001, between the Registrant and Walter W. Schroeder

#### (b) Reports on Form 8-K

None.

16

# Edgar Filing: PROTON ENERGY SYSTEMS INC - Form 10-Q

## 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.

PROTON ENERGY SYSTEMS, INC.  
(Registrant)

By: /S/ WALTER W. SCHROEDER

-----  
Walter W. Schroeder  
President and Chief Executive Officer

By: /S/ JOHN A. GLIDDEN

-----  
John A. Glidden  
Vice President of Finance  
(Principal Financial and Accounting Officer)

Date: November 13, 2001

17

## EXHIBIT INDEX

10.17 Secured Promissory Note, dated October 4, 2001, between the Registrant and Walter W. Schroe

18