

NATURAL GAS SERVICES GROUP INC
Form 10-K
March 09, 2018

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2017

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: 1-31398

NATURAL GAS SERVICES GROUP, INC.

(Exact Name of Registrant as Specified in its Charter)

Colorado

75-2811855

(State or other jurisdiction of incorporation or organization)

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

508 W. Wall St. Suite 550, Midland, Texas

79701

(Address of principal executive offices)

(Zip Code)

Registrant's telephone number, including area code:

(432) 262-2700

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

Title of each class

Name of each exchange on which registered

Common Stock, \$.01 par value

New York Stock Exchange

Securities registered pursuant to section 12(g) of the Act: None.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes No

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. Yes No

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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 definition of “accelerated filer and large accelerated filer” in Rule 12b-2 of the Exchange Act.

(Check one):

| | | | | |
|--|--|---|--|--|
| Large accelerated filer <input type="radio"/> | Accelerated filer <input checked="" type="checkbox"/> | Non-accelerated filer <input type="radio"/> | Smaller reporting company <input type="radio"/> | Emerging growth company <input type="radio"/> |
|--|--|---|--|--|

(Do not check if 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

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

The aggregate market value of voting and non-voting common equity held by non-affiliates of the Registrant as of June 30, 2017 was approximately \$321,493,471 based on the closing price of the common stock on that date on the New York Stock Exchange.

At March 2, 2018, there were 12,982,262 shares of the Registrant's common stock outstanding.

Documents Incorporated by Reference

Certain information called for in Items 10, 11, 12, 13 and 14 of Part III are incorporated by reference to the registrant's definitive proxy statement for the annual meeting of shareholders to be held on June 21, 2018.

FORM 10-K
 NATURAL GAS SERVICES GROUP, INC.
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SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-K contains certain forward-looking statements, within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, as amended, and information pertaining to us, our industry and the oil and natural gas industry that is based on the beliefs of our management, as well as assumptions made by and information currently available to our management. All statements, other than statements of historical facts contained in this Annual Report on Form 10-K, including statements regarding our future financial position, growth strategy, budgets, projected costs, plans and objectives of management for future operations, are forward-looking statements. We use the words “may,” “will,” “expect,” “anticipate,” “estimate,” “believe,” “continue,” “intend,” “plan,” “budget” and other similar words to identify forward-looking statements. You should read statements that contain these words carefully and should not place undue reliance on these statements because they discuss future expectations, contain projections of results of operations or of our financial condition and/or state other “forward-looking” information. We do not undertake any obligation to update or revise publicly any forward-looking statements. Although we believe our expectations reflected in these forward-looking statements are based on reasonable assumptions, no assurance can be given that these expectations or assumptions will prove to have been correct. Important factors that could cause actual results to differ materially from the expectations reflected in the forward-looking statements include, but are not limited to, the following factors and the other factors described in this Annual Report on Form 10-K under the caption “Risk Factors”:

- conditions in the oil and natural gas industry, including the supply and demand for natural gas and wide fluctuations and possible prolonged depression in the prices of oil and natural gas;
- economic challenges presently faced by our customers in the oil and natural gas business that, in turn, could adversely affect our sales, rentals and collectability of our accounts receivable;
- regulation or prohibition of new well completion techniques;
- competition among the various providers of compression services and products;
- changes in safety, health and environmental regulations;
- changes in economic or political conditions in the markets in which we operate;
- failure of our customers to continue to rent equipment after expiration of the primary rental term;
- the inherent risks associated with our operations, such as equipment defects, malfunctions and natural disasters;
- our inability to comply with covenants in our debt agreements and the decreased financial flexibility associated with our debt;
- future capital requirements and availability of financing;
- fabrication and manufacturing costs;
- general economic conditions;
- acts of terrorism; and
- fluctuations in interest rates.

We believe that it is important to communicate our expectations of future performance to our investors. However, events may occur in the future that we are unable to accurately predict or that we are unable to control. When considering our forward-looking statements, you should keep in mind the risk factors and other cautionary statements in this Annual Report on Form 10-K.

PART I

ITEM 1. BUSINESS

Unless the context otherwise requires, references in this Annual Report on Form 10-K to “Natural Gas Services Group,” the “Company,” “we,” “us,” “our” or “ours” refer to Natural Gas Services Group, Inc. Certain specialized terms used in describing our natural gas compressor business are defined in "Glossary of Industry Terms" on page 8.

The Company

We are a leading provider of small to medium horsepower compression equipment to the natural gas industry, with an emerging position in the large horsepower market. We focus primarily on the non-conventional natural gas and oil production business in the United States (such as coal bed methane, gas shale, tight gas and oil shales), which, according to data from the Energy Information Administration ("EIA"), is the single largest and fastest growing segment of U.S. hydrocarbon production. We manufacture, fabricate and rent natural gas compressors that enhance the production of natural gas wells and provide maintenance services for those compressors. In addition, we sell custom fabricated natural gas compressors to meet customer specifications dictated by well pressures, production characteristics and particular applications. We also manufacture and sell flare systems for oil and gas plant and production facilities.

The vast majority of our rental operations are in non-conventional natural gas and oil regions, which typically have lower initial reservoir pressures, lower production pressures and/or faster well decline rates. These areas usually require compression to be installed sooner and with greater frequency.

Natural gas compressors are used in a number of applications for the production and enhancement of gas wells and in gas transportation lines and processing plants. Compression equipment is often required to boost a well's production to economically viable levels and to enable gas to continue to flow in the pipeline to its destination.

Our revenue decreased to \$67.7 million from \$71.7 million for the year ended December 31, 2017 compared to the year ended December 31, 2016. Net income for the year ended December 31, 2017 increased to \$19.9 million (\$1.51 per diluted share), includes a net income tax benefit of approximately \$18.4 million due to a reduction in corporate income tax rates (see Note 7 to our Consolidated Financial Statements for further information), as compared to \$6.5 million (\$0.50 per diluted share) for the year ended December 31, 2016.

At December 31, 2017, current assets were \$108.2 million, which included \$69.2 million of cash and cash equivalents. Current liabilities were \$7.5 million, and the amount outstanding on our line of credit at December 31, 2017 was \$417,000. Our stockholders' equity as of December 31, 2017 was \$257.3 million.

See "Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations" for further financial information.

We were incorporated in Colorado on December 17, 1998 and maintain our principal offices at 508 W. Wall St., Suite 550, Midland, Texas 79701 and our telephone number is (432) 262-2700.

Overview and Outlook

The market for compression equipment and services is substantially dependent on the condition of the natural gas and oil industry. In particular, the willingness of natural gas and oil companies to make capital expenditures on exploration, drilling and production of natural gas and oil in the U.S. The level of activity and capital expenditures has generally been dependent upon the prevailing view of future gas and oil prices, which are influenced by numerous

factors, including the level of supply or demand for natural gas and oil and the impact on price of natural gas and oil, worldwide economic activity, interest rates and the cost of capital, environmental regulation, seasonal fluctuations and weather patterns. Natural gas and oil prices and the level of production activity have historically been characterized by significant volatility.

The steep decline in oil prices towards the end of 2014 resulted in capital budget cuts for many energy companies in 2015 and 2016. These budget reductions translated to fewer well completions and a softening of near-term demand for compression. In the latter half of 2017, we began to see an increase in oil prices and activity, and we anticipate a continuation of these increased prices and activity in E&P companies in 2018. See “Item 1 -- Business – Our Operating Units” and “Business – Backlog” for more information.

According to the U.S. Energy Information Administration (“EIA”), total consumption of oil in the United States increased 1.0% while natural gas decreased 1.1% for the twelve months ended November 2017 compared to the same period 2016. This follows a 0.3% and 1.6% increase in oil consumption and a 0.6% and 3.2% increase in natural gas consumption in the periods from 2015 to 2016 and 2014 to 2015, respectively. EIA expects total oil and natural gas consumption in the U.S. to increase in the U.S in 2018. While we anticipate long-term increased demand for oil and natural gas, we expect our business to continue to experience pressure on revenues in 2018 due to the delayed impact of an upturn on the compression business.

Long-Term Industry Trends

Natural gas prices historically have been volatile, and this volatility is expected to continue. Oil and natural gas are linked commodities with many drilling projects producing both products. The sustained oil price collapse that began towards the end of 2014 has made some of those drilling projects uneconomic. Uncertainty continues to exist as to the direction of future natural gas and near-term crude oil price and oil trends in the United States and worldwide. Over the last several years gas prices have not shown the resiliency that crude oil prices have typically shown. Now crude prices are beginning to show strength. We believe that natural gas is a more environmentally friendly source of energy which is likely to result in increases in demand over time. Being primarily a provider of services and equipment to natural gas producers, we are impacted by changes in natural gas, crude oil and condensate prices. Longer term natural gas prices will be determined by the supply and demand for natural gas as well as the prices of competing fuels, such as oil and coal. Prices for oil and natural gas will also be determined by the energy strategies of the world's top producing companies.

We believe part of the growth of the rental compression capacity in the U.S. market has been driven by the trend toward outsourcing by energy producers and processors. Renting does not require the purchaser to make large capital expenditures for new equipment or to obtain financing through a lending institution. This allows the customer's capital to be used for additional exploration and production of natural gas and oil. Balance sheet pressure associated with low energy prices could make renting an even more likely option, as overall producing activity begins to increase.

Notwithstanding the downturn in natural gas prices, we believe that there will continue to be a growing demand for natural gas, in the long-term. We expect long-term demand for our products and services will increase as prices recover as a result of:

- the increasing demand for energy, both domestically and abroad;
 - continued non-conventional gas exploration and production;
 - environmental considerations which provide strong incentives to use natural gas in place of other carbon fuels;
 - the cost savings of using natural gas rather than electricity for heat generation;
 - implementation of international environmental and conservation laws;
 - the aging of producing natural gas reserves worldwide;
 - the extensive supply of undeveloped non-conventional natural gas reserves;
 - the increased drilling for shale oil and its associated gas production; and
 - the use of our equipment for gas lift on oil wells.
- the increase in worldwide mobility of natural gas via LNG

Our Operating Units

We identify our operating units based upon major revenue sources as Gas Compressor Rental, Engineered Equipment Sales, Service and Maintenance and Corporate.

Gas Compressor Rental. Our rental business is primarily focused on non-conventional natural gas and oil production. We provide rental of small to medium horsepower compression equipment, with an emerging position in the large horsepower market, to customers under contracts typically having minimum initial terms of six to twenty four months. Historically, in our experience, most customers retain the equipment beyond the expiration of the initial term. At December 31, 2017, 32% of our rented compressors were under a lease term while the remainder were leased on a month-to-month basis. By outsourcing their compression needs, we believe our customers are able to increase their revenues by producing a higher volume of natural gas due to greater equipment run-time. Outsourcing also allows our customers to reduce their compressor downtime, operating and

maintenance costs and capital investments and more efficiently meet their changing compression needs. We maintain and service compressor equipment rented to our customers.

The size, type and geographic diversity of our rental fleet enables us to provide our customers with a range of compression units that can serve a wide variety of applications, and to select the correct equipment for the job, rather than the customer trying to fit the job to its own equipment. We base our gas compressor rental rates on several factors, including the cost and size of the equipment, the type and complexity of service desired by the customer, the length of contract and the inclusion of any other services desired, such as installation, transportation and daily operation.

As of December 31, 2017, we had 2,546 natural gas compressors in our rental fleet totaling 369,961 horsepower, as compared to 2,530 natural gas compressors totaling 362,408 horsepower at December 31, 2016. As of December 31, 2017, we had 1,259 natural gas compressors totaling 184,382 horsepower rented to 87 customers, compared to 1,298 natural gas compressors totaling 186,328 horsepower rented to 79 customers at December 31, 2016. As of December 31, 2017, the utilization rate of our rental fleet was 49.5% compared to 51.3% as of December 31, 2016.

Engineered Equipment Sales. This operating unit includes the following components:

Compressor fabrication. Fabrication involves the assembly of compressor components manufactured by us or other vendors into compressor units that are ready for rental or sale. In addition to fabricating compressors for our rental fleet, we engineer and fabricate natural gas compressors for sale to customers to meet their specifications based on well pressure, production characteristics and the particular applications for which compression is sought.

Compressor manufacturing. We design and manufacture our own proprietary line of reciprocating compressor frames, cylinders and parts known as our “CiP”, or Cylinder-in-Plane, product line. We use the finished components to fabricate compressor units for our rental fleet or for sale to customers. We also sell finished components to other fabricators.

Flare fabrication. We design, fabricate, sell, install and service flare stacks and related ignition and control devices for the onshore and offshore incineration of gas compounds such as hydrogen sulfide, carbon dioxide, natural gas and liquefied petroleum gases. Applications for this equipment are often environmentally and regulatory driven, and we believe we are a leading supplier to this market.

Parts sales and compressor rebuilds. To provide customer support for our compressor and flare sales businesses, we stock varying levels of replacement parts at our Midland, Texas facility and at field service locations. We also provide an exchange and rebuild program for screw compressors and maintain an inventory of new and used compressors to facilitate this part of our business.

Service and Maintenance. We service and maintain compressors owned by our customers on an “as needed” basis. Natural gas compressors require routine maintenance and periodic refurbishing to prolong their useful life. Routine maintenance includes physical and visual inspections and other parametric checks that indicate a change in the condition of the compressors. We perform wear-particle analysis on all packages and perform overhauls on a condition-based interval or a time-based schedule. Based on our past experience, these maintenance procedures maximize component life and unit availability and minimize downtime.

Business Strategy

During the downturn in the economy beginning in late 2014, our strategy has been to reduce expenses in line with the lower anticipated business activity, and fabricate compressor equipment only in direct response to market

requirements. As the industry recovery has been slow, we will continue with this strategy. See “Item 7 – Management’s Discussion and Analysis of Financial Condition and Results of Operations – Our Performance Trends and Outlook” for more information. Our long-term intentions to grow our revenue and profitability are based on the following business strategies:

Expand rental fleet. We intend to prudently increase the size of our rental fleet by fabricating compressor units in numbers that correspond to the growth of the market and in relation to market share gains we may experience. We believe our growth will continue to be primarily driven through our placement of small to medium horsepower wellhead natural gas compressors for non-conventional natural gas and oil production, with an emerging position in the large horsepower market.

Geographic expansion. We will continue to consolidate our operations in existing areas, as well as pursue focused expansion into new geographic regions as opportunities are identified. We presently provide our products and services

to a customer base of oil and natural gas exploration and production companies operating in Colorado, Kansas, Michigan, New Mexico, North Dakota, Ohio, Oklahoma, Pennsylvania, Texas, Utah, West Virginia and Wyoming.

Expand our 'secondary' product lines. In addition to our primary rental and engineered product business lines, we will emphasize the growth of our other products, e.g., flares, CiP compressor products and general compressor maintenance and repair services.

- Selectively pursue acquisitions. We will continue to evaluate potential acquisitions, joint ventures and other opportunities that could provide us with access to new markets or enhance our current market position.

Competitive Strengths

We believe our competitive strengths include:

Superior customer service. Our emphasis on the small to medium horsepower markets has enabled us to effectively meet the evolving needs of our customers. We believe these markets have been under-served by our larger competitors which, coupled with our personalized services and in-depth knowledge of our customers' operating needs and growth plans, have allowed us to enhance our relationships with existing customers as well as attract new customers. The size, type and geographic diversity of our rental fleet enable us to provide customers with a range of compression units that can serve a wide variety of applications. We are able to select the correct equipment for the job, rather than the customer trying to fit its application to our equipment.

Diversified product line. Our compressors are available as high and low pressure rotary screw and reciprocating packages. They are designed to meet a number of applications, including wellhead production, natural gas gathering, natural gas transmission, vapor recovery and gas and plunger lift. In addition, our compressors can be built to handle a variety of gas mixtures, including air, nitrogen, carbon dioxide, hydrogen sulfide and hydrocarbon gases. A diversified compression product line helps us compete by being able to satisfy widely varying pressure, volume and production conditions that customers encounter. Our "Flare King" product line provides flares and gas incineration devices to the industry for production maintenance and environmental compliance.

Purpose-built rental compressors. Our rental compressor packages have been designed and built to address the primary requirements of our customers in the producing regions in which we operate. Our units are compact in design and are easy, quick and inexpensive to move, install and start-up. Our control systems are technically advanced and allow the operator to start and stop our units remotely and/or in accordance with well conditions. We believe our rental fleet is also one of the newest.

Experienced management team. On average, each of our executive and operating team members has over 30 years of oilfield services industry experience. We believe our management team has successfully demonstrated its ability to grow our business during times of expansion and to manage through downturns.

Broad geographic presence. We presently provide our products and services to a customer base of oil and natural gas exploration and production companies operating in Colorado, Kansas, Michigan, New Mexico, North Dakota, Ohio, Oklahoma, Pennsylvania, Texas, Utah, West Virginia and Wyoming. Our footprint allows us to service many of the natural gas producing regions in the United States. We believe that operating in diverse geographic regions allows us better utilization of our compressors, minimal incremental expenses, operating synergies, volume-based purchasing, leveraged inventories and cross-trained personnel. We also sell engineered compression products to international customers.

Long-standing customer relationships. We have developed long-standing relationships providing compression equipment to many major and independent oil and natural gas companies. Our customers generally continue to rent our compressors after the expiration of the initial terms of our rental agreements, which we believe reflects their satisfaction with the reliability and performance of our services and products.

Major Customers

Sales and rental income to Occidental Permian, LTD. ("Oxy") and Devon Energy Production, Inc. ("Devon") for the year ended December 31, 2017 amounted to 20% and 15% of our revenue, respectively. Sales and rental income to Devon and Oxy for the year ended December 31, 2016 amounted to 21% and 19% of our revenue, respectively. Sales and rental income to Devon and Oxy for the year ended December 31, 2015 amounted to 21% and 10% of our revenue. No other single customer accounted for more than 10% of our revenues in 2017, 2016 or 2015.

Oxy amounted to 14% of our accounts receivables as of December 31, 2017. Oxy, APR Energy, LLC and BP America Inc. amounted to 15%, 15% and 14% of our accounts receivable as of December 31, 2016. No other customers amounted to more than 10% of our accounts receivable as of December 31, 2017 and 2016. The loss of any of the above customers could have a material adverse effect on our business, financial condition, results of operations and cash flows, depending upon the demand for our compressors at the time of such loss and our ability to attract new customers.

Sales and Marketing

Our sales force pursues the rental and sales market for compressors and flare equipment and other services in their respective territories. Additionally, our personnel coordinate with each other to develop relationships with customers who operate in multiple regions. Our sales and marketing strategy is focused on communication with current customers and potential customers through frequent direct contact, technical assistance, print literature, direct mail and referrals. Our sales and marketing personnel coordinate with our operations personnel in order to promptly respond to and address customer needs. Our overall sales and marketing efforts concentrate on demonstrating our commitment to enhancing the customer's cash flow through enhanced product design, fabrication, manufacturing, installation, customer service and support.

Competition

We have a number of competitors in the natural gas compression segment, some of which have greater financial resources. We believe that we compete effectively on the basis of price, customer service, including the ability to place personnel in remote locations, flexibility in meeting customer needs, and quality and reliability of our compressors and related services.

Compressor industry participants can achieve significant advantages through increased size and geographic breadth. As the number of rental compressors in our rental fleet increases, the number of sales, support, and maintenance personnel required and the minimum level of inventory do not increase proportionately.

Backlog

As of December 31, 2017, we had a sales backlog of approximately \$7.8 million compared to \$6.0 million as of December 31, 2016. We are scheduled to fulfill the backlog primarily in the first half of 2018. Sales backlog consists of firm customer orders for which a purchase or work order has been received, satisfactory credit or a financing arrangement exists, and delivery is scheduled. In addition, the major components of our compressors are acquired from suppliers through periodic purchase orders that in many instances require three or four months of lead time prior to delivery of the order.

Employees

As of December 31, 2017, we had 235 total employees, none of which are represented by a labor union. We believe we have good relations with our employees.

Liability and Other Insurance Coverage

Our equipment and services are provided to customers who are subject to hazards inherent in the oil and natural gas industry, such as blowouts, explosions, craterings, fires, and oil spills. We maintain liability insurance that we believe is customary in the industry and which includes environmental cleanup, but excludes product warranty insurance because the majority of components on our compressor unit are covered by the manufacturers. We also maintain

insurance with respect to our facilities. Based on our historical experience, we believe that our insurance coverage is adequate. However, there is a risk that our insurance may not be sufficient to cover any particular loss or that insurance may not cover all losses. In addition, insurance rates have in the past been subject to wide fluctuation, and changes in coverage could result in less coverage, increases in cost or higher deductibles and retentions.

Government Regulation

All of our operations and facilities are subject to numerous federal, state, foreign and local laws, rules and regulations related to various aspects of our business, including containment and disposal of hazardous materials, oilfield waste, other waste materials and acids.

To date, we have not been required to expend significant resources in order to satisfy applicable environmental laws and regulations. We do not anticipate any material capital expenditures for environmental control facilities or extraordinary

expenditures to comply with environmental rules and regulations in the foreseeable future. However, compliance costs under existing laws or under any new requirements could become material and we could incur liabilities for noncompliance.

Our business is generally affected by political developments and by federal, state, foreign and local laws and regulations, which relate to the oil and natural gas industry. The adoption of laws and regulations affecting the oil and natural gas industry for economic, environmental and other policy reasons could increase our costs and could have an adverse effect on our operations. The state and federal environmental laws and regulations that currently apply to our operations could become more stringent in the future.

We have utilized operating and disposal practices that were or are currently standard in the industry. However, materials such as solvents, thinner, waste paint, waste oil, wash down waters and sandblast material may have been disposed of or released in or under properties currently or formerly owned or operated by us or our predecessors. In addition, some of these properties have been operated by third parties over whom we have no control either as to such entities' treatment of materials or the manner in which such materials may have been disposed of or released.

The federal Comprehensive Environmental Response Compensation and Liability Act of 1980, commonly known as CERCLA, and comparable state statutes impose strict liability on:

- owners and operators of sites, and
- persons who disposed of or arranged for the disposal of "hazardous substances" found at sites.

Waste Management and Disposal

The federal Resource Conservation and Recovery Act ("RCRA") and analogous state laws and their implementing regulations govern the generation, transportation, treatment, storage and disposal of hazardous and non-hazardous solid wastes. During the course of our operations, we generate wastes (including, but not limited to, used oil, antifreeze, filters, paints, solvents and abrasive blasting materials) in quantities regulated under RCRA. The EPA and various state agencies have limited the approved methods of disposal for these types of wastes. CERCLA and analogous state laws and their implementing regulations impose strict, and under certain conditions, joint and several liability without regard to fault or the legality of the original conduct on classes of persons who are considered to be responsible for the release of a hazardous substance into the environment. These persons include current and past owners and operators of the facility or disposal site where the release occurred and any company that transported, disposed of, or arranged for the transport or disposal of the hazardous substances released at the site. Under CERCLA, such persons may be subject to joint and several liability for the costs of cleaning up the hazardous substances that have been released into the environment, for damages to natural resources and for the costs of certain health studies. In addition, where contamination may be present, it is not uncommon for neighboring landowners and other third parties to file claims for personal injury, property damage and recovery of response costs allegedly caused by hazardous substances or other pollutants released into the environment.

We currently own or lease, and in the past have owned or leased, a number of properties that have been used in support of our operations for a number of years. Although we have utilized operating and disposal practices that were standard in the industry at the time, hydrocarbons, hazardous substances, or other regulated wastes may have been disposed of or released on or under the properties owned or leased by us or on or under other locations where such materials have been taken for disposal by companies sub-contracted by us. In addition, some of these properties may have been previously owned or operated by third parties whose treatment and disposal or release of hydrocarbons, hazardous substances or other regulated wastes was not under our control. These properties and the materials released or disposed thereon may be subject to CERCLA, RCRA and analogous state laws. Under such laws, we could be required to remove or remediate historical property contamination, or to perform certain operations to prevent future

contamination. We are not currently under any order requiring that we undertake or pay for any cleanup activities. However, we cannot provide any assurance that we will not receive any such order in the future.

The Clean Water Act ("CWA") and the Oil Pollution Act of 1990 and implementing regulations govern:

the prevention of discharges, including oil and produced water spills, and liability for drainage into waters.

The CWA and analogous state laws impose restrictions and strict controls with respect to the discharge of pollutants, including spills and leaks of oil and other substances, into waters of the United States. The discharge of pollutants into regulated

waters and wetlands is prohibited, except in accordance with the terms of a permit issued by the EPA or an analogous state agency. The CWA also requires the development and implementation of spill prevention, control and countermeasures to help prevent the contamination of navigable waters in the event of a petroleum hydrocarbon spill or leak at hydrocarbon facilities. In addition, the CWA and analogous state laws require individual permits or coverage under general permits for discharges of storm water runoff from certain types of facilities. Federal and state regulatory agencies can impose administrative, civil and criminal penalties as well as other enforcement mechanisms for non-compliance with discharge permits or other requirements of the CWA and analogous state laws and regulations. Our compression operations do not generate process wastewaters that are discharged to waters of the U.S. However, the operations of our customers may generate such wastewaters subject to the CWA. While it is the responsibility of our customers to follow CWA regulations and obtain proper permits, violations of the CWA may indirectly impact our operations in a negative manner.

Air Emissions

Our operations are also subject to federal, state, and local regulations. The Clean Air Act and implementing regulations and comparable state laws and regulations regulate emissions of air pollutants from various industrial sources and also impose various monitoring and reporting requirements, including requirements related to emissions from certain stationary engines, such as those on our compressor units. These laws and regulations impose limits on the levels of various substances that may be emitted into the atmosphere from our compressor units and require us to meet more stringent air emission standards and install new emission control equipment on all of our engines built after July 1, 2008.

For instance, in 2010, the U.S. Environmental Protection Agency (“EPA”) published new regulations under the CAA to control emissions of hazardous air pollutants from existing stationary reciprocal internal combustion engines. In 2012, the EPA proposed amendments to the final rule in response to several petitions for reconsideration, which were finalized and became effective in 2013. The rule requires us to undertake certain expenditures and activities, including purchasing and installing emissions control equipment on certain compressor engines and/or purchasing certified engines from complaint manufacturers.

In recent years, the EPA has lowered the National Ambient Air Quality Standard (“NAAQs”) for several air pollutants. For example, in 2013, the EPA lowered the annual standard for fine particulate matter from 15 to 12 micrograms per cubic meter. In 2015, the EPA published the final rule strengthening the standards for ground level ozone, and the states are expected to establish revised attainment/non-attainment regions. State implementation of the revised NAAQS could result in stricter permitting requirements, delay or prohibit our customers’ ability to obtain such permits, and result in increased expenditures for pollution control equipment, which could negatively impact our customers’ operations by increasing the cost of additions to equipment, and negatively impact our business.

In 2012, the EPA finalized rules that establish new air emission controls for oil and natural gas production and natural gas processing operations. Specifically, the EPA’s rule package included New Source Performance Standards to address emissions of sulfur dioxide and volatile organic compounds (“VOCs”) and a separate set of emission standards to address hazardous air pollutants frequently associated with oil and natural gas production and processing activities. The rules established specific new requirements regarding emissions from compressors and controllers at natural gas processing plants, dehydrators, storage tanks and other production equipment as well as the first federal air standards for natural gas wells that are hydraulically fractured. The EPA has taken a number of steps to amend or expand on these regulations since 2012. For example, in June 2016, the EPA published New Source Performance Standards that require certain new, modified or reconstructed facilities in the oil and natural gas sector to reduce methane gas and VOC emissions. However, in a March 2017 executive order, President Trump directed the EPA to review the 2016 regulations and, if appropriate, to initiate a rulemaking to rescind or revise them consistent with the stated policy of promoting clean and safe development of the nation’s energy resources, while at the same time avoiding regulatory burdens that unnecessarily encumber energy production. On June 16, 2017, the EPA published a proposed rule to stay

for two years certain requirements of the 2016 regulations, including fugitive emission requirements.

We believe that our existing environmental control procedures are adequate and that we are in substantial compliance with environmental laws and regulations, and the phasing in of emission controls and other known regulatory requirements should not have a material adverse affect on our financial condition or operational results. However, it is possible that future developments, such as new or increasingly strict requirements and environmental laws and enforcement policies there under, could lead to material costs of environmental compliance by us. While we may be able to pass on the additional cost of complying with such laws to our customers, there can be no assurance that attempts to do so will be successful. Some risk of environmental liability and other costs are inherent in the nature of our business, however, and there can be no assurance that environmental costs will not rise.

To the extent that new laws or other governmental actions restrict the energy industry or impose additional environmental protection requirements that result in increased costs to the oil and gas industry, we could be adversely affected. We cannot

determine to what extent our future operations and earnings may be affected by new legislation, new regulations or changes in existing regulations.

Occupational Safety and Health

We are subject to the requirements of Occupational Safety and Health Administration ("OSHA") and comparable state statutes. These laws and the implementing regulations strictly govern the protection of the health and safety of employees. The OSHA hazard communication standard, the EPA community right-to-know regulations under Title III of CERCLA, and similar state statutes require that we maintain and/or disclose information about hazardous materials used or produced in our operations. We believe that we are in compliance with these applicable requirements and with other comparable laws.

Patents, Trademarks and Other Intellectual Property

We believe that the success of our business depends more on the technical competence, creativity and marketing abilities of our employees than on any individual patent, trademark, or copyright. Nevertheless, as part of our ongoing research, development and manufacturing activities, we may seek patents when appropriate on inventions concerning new products and product improvements. We do not own any unexpired patents. Although we continue to use technology that was previously covered by a patent and consider it useful in certain applications, we do not consider the expired patent to be material to our business as a whole.

Suppliers and Raw Materials

Fabrication of our rental compressors involves the purchase by us of engines, compressors, coolers and other components, and the assembly of these components on skids for delivery to customer locations. These major components of our compressors are acquired through periodic purchase orders placed with third-party suppliers on an "as needed" basis, which typically requires a three to four month lead time with delivery dates scheduled to coincide with our estimated production schedules. Although we do not have formal continuing supply contracts with any major supplier, we believe we have adequate alternative sources available. In the past, we have not experienced any sudden and dramatic increases in the prices of the major components for our compressors. However, the occurrence of such an event could have a material adverse effect on the results of our operations and financial condition, particularly if we are unable to increase our rental rates and sale prices proportionate to any such component price increases.

Available Information

We use our website as a channel of distribution for Company information. We make available free of charge on the Investor Relations section of our website (www.ngsgi.com) our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, and Current Reports on Form 8-K. We also make available through our website other reports filed with or furnished to the SEC under the Securities Exchange Act of 1934, as amended, including our proxy statements and reports filed by officers and directors under Section 16(a) of the Exchange Act, as well as our Code of Business Ethics and the charters to our various Committees of our Board of Directors. Paper copies of our filings are also available, without charge upon written request, at Natural Gas Services Group, Inc., 508 West Wall Street, Suite 550, Midland, Texas 79701. The information contained on our website is not part of this Report.

Glossary of Industry Terms

"CiP" - A branded, proprietary gas compressor product line designed, manufactured and packaged by the Company. The 'Cylinder in Plane' design results in a compact and vibration-free compressor unit that particularly lends itself to unconventional wellhead applications, air compression and compressed natural gas requirements.

"coal bed methane" – A natural gas generated during coal formation and provided from coal seams or adjacent sandstones.

"flare" – A tall stack equipped with burners used as a safety device at wellheads, refining facilities, gas processing plants, and chemical plants. Flares are used for the combustion and disposal of combustible gases. The gases are piped to a remote, usually elevated, location and burned in an open flame in the open air using a specially designed burner tip, auxiliary fuel, and steam or air. Combustible gases are flared most often due to emergency relief, overpressure, process upsets, startups, shutdowns, and other operational safety reasons. Natural gas that is uneconomical for sale is also flared. Often natural gas is flared as a result of the unavailability of a method for transporting such gas to markets.

"gas lift" – A production enhancement technique whereby natural gas is injected into an oil well to increase/improve the oil production.

"gas shale" – Fine grained rocks where the predominant gas storage mechanism is absorption and gas is stored in volumes that are potentially economic.

"oil shale" – Also referred to as tight oil, is petroleum that consists of light crude oil contained in petroleum-bearing formations of low-permeability, often shale or tight sandstone.

"reciprocating compressors" – A reciprocating compressor is a type of compressor which compresses vapor by using a piston in a cylinder and a back-and-forth motion.

"screw compressors" – A type of compressor used in low-pressure and vapor compression applications where two intermesh rotors create pockets of continuously decreasing volume, in which the gas is compressed and its pressure is increased.

"tight gas" – A gas bearing sandstone or carbonate matrix (which may or may not contain natural fractures) which exhibits a low-permeability (tight) reservoir.

ITEM 1A. RISK FACTORS

You should carefully consider the following risks associated with owning our common stock. Although the risks described below are the risks that we believe are material, they are not the only risks relating to our industry, our business and our common stock. Additional risks and uncertainties, including those that we have not yet identified or that we currently believe are immaterial, may also adversely affect our business, financial condition or results of operations.

Risks Associated With Our Industry

Adverse macroeconomic and business conditions may significantly and negatively affect our results of operations.

Economic conditions in the United States and abroad have, and will likely continue to, affect our revenue and profitability. The condition of domestic and global financial markets, continued low natural gas and oil prices, and the potential for disruption and illiquidity in the credit markets could have an adverse effect on our operating results and financial condition, and if sustained for an extended period, such adverse effects could become significant. Uncertainty and turmoil in the credit markets may negatively impact the ability of our customers to finance purchases of our products and services and could result in a decrease in, or cancellation of, orders included in our backlog or adversely affect the collectability of our receivables. If the availability of credit to our customers is reduced, they may reduce their drilling and production expenditures, thereby decreasing demand for our products and services, which could have a negative impact on our financial condition. A prolonged period of depressed prices for gas and oil would likely result in delays or cancellation of projects by our customers, reducing the demand for our products and services.

Decreased oil and natural gas prices and oil and gas industry expenditure levels adversely affect our revenue.

Our revenue is derived primarily from expenditures in the oil and natural gas industry, which, in turn, are based on budgets to explore for, develop and produce oil and natural gas. When these expenditures decline, as they have during

the past several years, our revenue will suffer. The industry's willingness to explore for, develop and produce oil and natural gas depends largely upon the prevailing view of future oil and natural gas prices. Prices for oil and natural gas historically have been, and are likely to continue to be, highly volatile. Many factors affect the supply and demand for oil and natural gas and, therefore, influence oil and natural gas prices, including:

- the level of oil and natural gas production;
- the level of oil and natural gas inventories;
- domestic and worldwide demand for oil and natural gas;
- the expected cost of developing new reserves;
- the cost of producing oil and natural gas;

- the level of drilling and completions activity;
- inclement weather;
- domestic and worldwide economic activity;
- regulatory and other federal and state requirements in the United States;
- the ability of the Organization of Petroleum Exporting Countries, national oil companies and other large producers to set and maintain production levels and prices for oil;
- political conditions in or affecting oil and natural gas producing countries;
- terrorist activities in the United States and elsewhere;
- the cost of developing alternate energy sources;
- environmental regulation; and
- tax policies.

Depending on the market prices of oil and natural gas, companies exploring for oil and natural gas may cancel or curtail their drilling programs, thereby reducing demand for our equipment and services. Our rental contracts are generally short-term, and oil and natural gas companies tend to respond quickly to upward or downward changes in prices. Any prolonged reduction in drilling and production activities historically has materially eroded both pricing and utilization rates for our equipment and services and adversely affects our financial results. As a result, we may suffer losses, be unable to make necessary capital expenditures and be unable to meet our financial obligations.

The intense competition in our industry could result in reduced profitability and loss of market share for us.

We compete with the oil and natural gas industry's largest equipment and service providers who have greater name recognition than we do. These companies also have substantially greater financial resources, larger operations and greater budgets for marketing, research and development than we do. They may be better able to compete because of their broader geographic dispersion and ability to take advantage of international opportunities, the greater number of compressors in their fleet or their product and service diversity. As a result, we could lose customers and market share to those competitors. These companies may also be better positioned than us to successfully endure downturns in the oil and natural gas industry.

Our operations may be adversely affected if our current competitors or new market entrants introduce new products or services with better prices, features, performance or other competitive characteristics than our products and services. Competitive pressures or other factors also may result in significant price competition that could harm our revenue and our business. Additionally, we may face competition in our efforts to acquire other businesses.

Our industry is highly cyclical, and our results of operations may be volatile.

Our industry is highly cyclical, with periods of high demand and high pricing followed by periods of low demand and low pricing. Periods of low demand intensify the competition in the industry and often result in rental equipment being idle for long periods of time. We have been required to enter into lower rate rental contracts in response to market conditions and our rentals and sales revenue have decreased as a result of such conditions. Due to the short-term nature of most of our rental contracts, changes in market conditions can quickly affect our business. As a result of the cyclical nature of our industry, we anticipate results of operations will be volatile in the future.

Increased regulation or ban of current fracturing techniques could reduce demand for our compressors.

From time to time, for example, legislation has been proposed in Congress to amend the federal Safe Drinking Water Act ("SDWA") to require federal permitting of hydraulic fracturing and the disclosure of chemicals used in the hydraulic fracturing process. Further, the EPA completed a study finding that hydraulic fracturing could potentially harm drinking water resources under adverse circumstances such as injection directly into groundwater or into

production wells lacking mechanical integrity. Further, legislation to amend the SDWA to repeal the exemption for hydraulic fracturing (except when diesel fuels are used) from the definition of “underground injection” and require federal permitting and regulatory control of hydraulic fracturing, as well as legislative proposals to require disclosure of the chemical constituents of the fluids used in the fracturing process, have been proposed in recent sessions of Congress. Several states and local jurisdictions also have adopted or are considering adopting regulations that could restrict or prohibit hydraulic fracturing in certain circumstances, impose more stringent operating standards and/or require the disclosure of the composition of hydraulic fracturing fluids.

More recently, federal and state governments have begun investigating whether the disposal of produced water into underground injection wells has caused increased seismic activity in certain areas. The results of these studies could lead federal and state governments and agencies to develop and implement additional regulations.

A ban of hydraulic fracturing would likely halt some projects, including unconventional projects, at least temporarily. Expanded regulations are likely to introduce a period of uncertainty as companies determine ways to proceed. Any curtailment could result in a reduction of demand for our compressors, potentially affecting both sales and rentals of our units.

We are subject to extensive environmental laws and regulations that could require us to take costly compliance actions that could harm our financial condition.

Our fabrication and maintenance operations are significantly affected by stringent and complex federal, state and local laws and regulations governing the discharge of substances into the environment or otherwise relating to environmental protection. In these operations, we generate and manage hazardous wastes such as solvents, thinner, waste paint, waste oil, wash down wastes, and sandblast material. We attempt to use generally accepted operating and disposal practices and, with respect to acquisitions, will attempt to identify and assess whether there is any environmental risk before completing an acquisition. Based on the nature of the industry, however, hydrocarbons or other wastes may have been disposed of or released on or under properties owned or leased by us or on or under other locations where such wastes have been taken for disposal. The waste on these properties may be subject to federal or state environmental laws that could require us to remove the wastes or remediate sites where they have been released. We could be exposed to liability for cleanup costs, natural resource and other damages as a result of our conduct or the conduct of, or conditions caused by, prior owners, lessees or other third parties. Environmental laws and regulations have changed in the past, and they are likely to change in the future. If current existing regulatory requirements or enforcement policies change, we may be required to make significant unanticipated capital and operating expenditures.

Any failure by us to comply with applicable environmental laws and regulations may result in governmental authorities taking actions against our business that could harm our operations and financial condition, including the: issuance of administrative, civil and criminal penalties; denial or revocation of permits or other authorizations; reduction or cessation in operations; and performance of site investigatory, remedial or other corrective actions.

Risks Associated With Our Company

As of December 31, 2017, a majority of our compressor rentals were for terms of six months or less which, if terminated or not renewed, would adversely impact our revenue and our ability to recover our initial equipment costs.

The length of our compressor rental agreements with our customers varies based on customer needs, equipment configurations and geographic area. In most cases, under currently prevailing rental rates, the initial rental periods are not long enough to enable us to fully recoup the average cost of acquiring or fabricating the equipment. We cannot be sure that a substantial number of our customers will continue to renew their rental agreements or that we will be able to re-rent the equipment to new customers or that any renewals or re-rentals will be at comparable rental rates. The inability to timely renew or re-rent a substantial portion of our compressor rental fleet has and will have a material adverse effect upon our business, financial condition, results of operations and cash flows.

We could be subject to substantial liability claims that could harm our financial condition.

Our products are used in production applications where an accident or a failure of a product can cause personal injury, loss of life, damage to property, equipment or the environment, or suspension of operations. While we maintain insurance coverage, we face the following risks under our insurance coverage:

- we may not be able to continue to obtain insurance on commercially reasonable terms;
- we may be faced with types of liabilities that will not be covered by our insurance, such as damages from significant product liabilities and from environmental contamination;
- the dollar amount of any liabilities may exceed our policy limits; and
- we do not maintain coverage against the risk of interruption of our business.

Any claims made under our policies will likely cause our premiums to increase. Any future damages caused by our products or services that are not covered by insurance, are in excess of policy limits or are subject to substantial deductibles, would reduce our earnings and our cash available for operations.

The loss of one or more of our current customers could adversely affect our results of operations.

Our business is dependent not only on securing new customers but also on maintaining current customers. We had two customers that accounted for an aggregate of approximately 35% of our revenue for the year ended December 31, 2017, and two customers that accounted for an aggregate of approximately 40% of our revenue for the year ended December 31, 2016. At December 31, 2017, one customer accounted for an aggregate of 14% of our accounts receivable. Unless we are able to retain our existing customers, or secure new customers if we lose one or more of our significant customers, our revenue and results of operations would be adversely affected. In addition, the default on payments by one or more of these significant customers may negatively impact our cash flow and current assets.

Loss of key members of our management could adversely affect our business.

In keeping with our streamlined approach to our business, our executive management team consists of three officers: our (i) Chief Executive Officer, (ii) Chief Financial Officer and (iii) Vice President of Technical Services. We depend on the continued employment and performance of these three key members of our executive management team. In particular, we are significantly reliant upon the leadership and guidance of Stephen C. Taylor, who has been our President, Chief Executive Officer and Board member since 2004. In addition to his management duties, Mr. Taylor has been instrumental in our communications and standing with the investment community. If any of our key executives resign or become unable to continue in his present role and is not adequately replaced, our business operations could be materially adversely affected. We do not carry any key-man insurance on any of our officers or directors.

The erosion of the financial condition of our customers could adversely affect our business.

Many of our customers finance their exploration and development activities through cash flow from operations, the incurrence of debt or the issuance of equity. During times when the oil or natural gas markets weaken, our customers are more likely to experience a downturn in their financial condition. Many of our customers' equity values and liquidity substantially declined during the most recent fall in oil and natural gas prices, and in some cases access to capital markets may be an unreliable source of financing for some customers. The combination of a reduction in cash flow resulting from declines in commodity prices, a reduction in borrowing bases under reserve-based credit facilities and the lack of availability of debt or equity financing may result in flat or moderate growth in our customers' spending for our products and services in 2018. For example, our customers could seek to preserve capital by canceling month-to-month contracts, canceling or delaying scheduled maintenance of their existing natural gas compression equipment or determining not to enter into any new natural gas compression service contracts or purchase new compression equipment.

We might be unable to employ qualified technical personnel, which could hamper our present operations or increase our costs.

Many of the compressors that we sell or rent are mechanically complex and often must perform in harsh conditions. We believe that our success depends upon our ability to employ and retain a sufficient number of technical personnel who have the ability to design, utilize, enhance and maintain these compressors. Our ability to expand our operations depends in part on our ability to increase our skilled labor force. The demand for skilled workers is high, and supply is limited. A significant increase in the wages paid by competing employers could result in a reduction of our skilled labor force or cause an increase in the wage rates that we must pay or both. If either of these events were to occur, our cost structure could increase and our operations and growth potential could be impaired.

We may require a substantial amount of capital to expand our compressor rental fleet and grow our business.

During 2018, the amount we will spend on capital expenditures related to rental compression equipment will be determined primarily by the activity of our customers. The amount and timing of any of these capital expenditures may vary depending on a variety of factors, including the level of activity in the oil and natural gas exploration and production industry and the presence of alternative uses for our capital, including any acquisitions that we may pursue.

Historically, we have funded our capital expenditures through cash flows from operations and borrowings under bank credit facilities. Although we believe that cash on hand, cash flows from our operations and/or bank borrowing from our line of credit will provide us with sufficient cash to fund our planned capital expenditures for 2018, we cannot assure you that these sources will be sufficient. We may require additional capital to fund any significant unanticipated capital expenditures, such as material acquisition. To the extent we would require any necessary capital, it may not be available to us when we need it or on acceptable terms. Our ability to raise additional capital will depend on the results of our operations and the status of various capital and industry markets at the time we seek such capital. Failure to generate sufficient cash flow, together with the absence of alternative sources of capital, could have a material adverse effect on our business, financial condition, results of operations or cash flow.

Of our \$30 million line of credit, we owe \$417,000 as of December 31, 2017. All outstanding principal and unpaid interest is due on December 31, 2020. Although we believe that we will be able to renew our existing line of credit, or obtain a new line of credit with another lender, we can provide no assurance that we will be successful in renewing our line of credit or obtaining a new line. In addition, any renewal of our existing line of credit or creation of a new line of credit may be on terms less favorable than our existing line. For instance, changes in the terms of a new line of credit may include, but not be limited to: a reduction in the borrowing amount, an increase in interest rate to be paid on borrowings under the line, or restrictive covenants that are more onerous than those on our existing line of credit.

Our debt levels may negatively impact our current and future financial stability.

Should we utilize our full debt capacity, growth beyond that point could be impacted. As of December 31, 2017, we had an aggregate of approximately \$417,000 of outstanding indebtedness, and accounts payable and accrued expenses of approximately \$7.3 million. As a result of our indebtedness at any given point in time, we might not have the ability to incur any substantial additional indebtedness. The level of our indebtedness could have several important effects on our future operations, including:

- our ability to obtain additional financing for working capital, acquisitions, capital expenditures and other purposes may be limited;
- a significant portion of our cash flow from operations may be dedicated to the payment of principal and interest on our debt, thereby reducing funds available for other purposes; and
- our leverage if increased to an unacceptable level, could make us more vulnerable to economic downturns.

If we are unable to service our debt, we will likely be forced to take remedial steps that are contrary to our business plan.

As of December 31, 2017, we had \$417,000 due under our Line of Credit agreement which allows us to borrow up to \$30.0 million provided we maintain certain collateral and borrowing base requirements. We believe that our current cash position

and the amount available under the current revolver are sufficient to meet our capital needs through 2018. However, if we were to materially increase our borrowings, it is possible that our business will not generate sufficient cash flow from operations to meet our debt service requirements and the payment of principal when due depending on the amount of borrowings on the agreement at any given time. If this were to occur, we may be forced to:

- sell assets at disadvantageous prices;
- obtain additional financing; or
- refinance all or a portion of our indebtedness on terms that may be less favorable to us.

Our current credit agreement contains covenants that limit our operating and financial flexibility and, if breached, could expose us to severe remedial provisions.

Under the terms of our credit agreement, we must:

- comply with a minimum leverage ratio;
- comply with a commitment coverage ratio;
- not exceed specified levels of debt; and
- comply with limits on asset sales.

Our ability to meet the financial ratios and tests under our credit agreement can be affected by events beyond our control, and we may not be able to satisfy those ratios and tests. A breach of any one of these covenants could permit the bank to accelerate

the debt so that it is immediately due and payable. If a breach occurred, no further borrowings would be available under our credit agreement. If we were unable to repay the debt, the bank could proceed against and foreclose on our assets, substantially all of which have been pledged as collateral to secure payment of our indebtedness.

If we fail to acquire or successfully integrate additional businesses, our growth may be limited and our results of operations may suffer.

As part of our business strategy, we evaluate potential acquisitions of other businesses or assets. However, there can be no assurance that we will be successful in consummating any such acquisitions. Successful acquisition of businesses or assets will depend on various factors, including, but not limited to, our ability to obtain financing and the competitive environment for acquisitions. In addition, we may not be able to successfully integrate any businesses or assets that we acquire in the future. The integration of acquired businesses is likely to be complex and time consuming and place a significant strain on management and may disrupt our business. We also may be adversely impacted by any unknown liabilities of acquired businesses, including environmental liabilities. We may encounter substantial difficulties, costs and delays involved in integrating common accounting, information and communication systems, operating procedures, internal controls and human resources practices, including incompatibility of business cultures and the loss of key employees and customers. These difficulties may reduce our ability to gain customers or retain existing customers, and may increase operating expenses, resulting in reduced revenues and income and a failure to realize the anticipated benefits of acquisitions.

Failure to effectively manage our growth and expansion could adversely affect our business and operating results and our internal controls.

We have significantly expanded our operations since our formation in 1998 and anticipate that our growth will continue if we are able to execute our strategy, subject to the supply and demand for oil and natural gas. Future growth may place significant strain on our management and other resources. To manage our future growth, we must be able to, among other things:

- accurately assess the number of additional officers and employees we will require and the areas in which they will be required;
- attract, hire and retain additional highly skilled and motivated officers and employees;
- train and manage our work force in a timely and effective manner;
- upgrade and expand our office infrastructure so that it is appropriate for our level of activity;
- and
- improve our financial and management controls, reporting systems and procedures.

Liability to customers under warranties and indemnification provisions may materially and adversely affect our earnings.

We provide warranties as to the proper operation and conformance to specifications of the equipment we manufacture. Our equipment is complex and often deployed in harsh environments. Failure of this equipment to operate properly or to meet specifications may increase our costs by requiring additional engineering resources and services, replacement of parts and equipment or monetary reimbursement to a customer. We have in the past received warranty claims and we expect to continue to receive them in the future. To the extent that we incur substantial warranty claims in any period, our reputation, our ability to obtain future business and our earnings could be materially and adversely affected.

Our rental and sales contracts provide for varying forms of indemnification from our customers and in most cases may require us to indemnify our customers. Under some of our rental and sales contracts, liability with respect to personnel

and property is customarily assigned on a “knock-for-knock” basis, which means that we and our customers assume liability for our respective personnel and property. However, in certain rental and sales contracts we assume liability for damage to our customer’s property and other third-party on the site resulting from our negligence. Since our products are used in production applications in the energy industry, expenses and liabilities in connection with accidents involving our products and services could be extensive and may exceed our insurance coverages.

Changes in accounting pronouncements or taxation rules or practices may adversely affect our financial results.

Changes in accounting pronouncements or taxation rules or practices can have a significant effect on our reported results. New accounting pronouncements and taxation rules can have a material impact on effective tax rates, results of operations, and our financial condition. On December 22, 2017, President Trump signed into law the statute commonly referred to as the Tax Cuts and Jobs Act (“2017 Tax Act”), which makes broad and complex changes to the U.S. tax code. As we collect and prepare necessary

data, and interpret the 2017 Tax Act and any additional guidance issued by the IRS or other standard-setting bodies, we may make adjustments to the provisional amounts in accordance with Staff Accounting Bulletin No. 118 (“SAB 118”), which provides SEC staff guidance for the application of ASC 740 in the reporting period in which the 2017 Tax Act was signed into law. This change could materially affect our financial position.

Our income taxes may change.

We are subject to income tax on a jurisdictional or legal entity basis and significant judgment is required in certain instances to allocate our taxable income to a jurisdiction and to determine the related income tax expense and benefits. Losses in one jurisdiction generally may not be used to offset profits in other jurisdictions. As a result, changes in the mix of our earnings (or losses) between jurisdictions, among other factors, could alter our overall effective income tax rate, possibly resulting in significant tax rate increases.

We are regularly audited by various tax authorities. Income tax audit assessments or changes in tax laws, regulations, or other interpretations may result in increased tax provisions which could materially affect our operating results in the period or periods in which such determinations are made or changes occur.

Failure to maintain effective internal controls could have a material adverse effect on our operations.

Section 404 of the Sarbanes-Oxley Act requires annual management assessments of the effectiveness of our internal control over financial reporting. If we fail to maintain effective internal controls, we may not be able to ensure that we can conclude on an ongoing basis that we have effective internal controls over financial reporting in accordance with Section 404 of the Sarbanes-Oxley Act. Moreover, effective internal controls are necessary for us to produce reliable financial reports and to help prevent financial fraud. If, as a result of deficiencies in our internal controls, we cannot provide reliable financial reports or prevent fraud, our business decision process may be adversely affected, our business and operating results could be harmed, investors could lose confidence in our reported financial information, and the price of our stock could decrease as a result.

A reduction in demand primarily for natural gas or prices for this commodity and credit markets could adversely affect our business.

Our results of operations depend upon the level of activity in the energy market, including natural gas development, production, processing and transportation. Oil and natural gas prices and the level of drilling and exploration activity can be volatile. For example, oil and natural gas exploration and development activity and the number of well completions typically decline when there is a significant reduction in oil and natural gas prices or significant instability in energy markets. As a result, the demand for our natural gas compression services could be adversely affected. A reduction in demand could also force us to reduce our pricing substantially. Additionally, our customers’ production from unconventional natural gas sources such as tight sands, shale and coal beds constitute the majority percentage of our business. Such unconventional sources are generally less economically feasible to produce in lower natural gas price environments. These factors could in turn negatively impact the demand for our products and services. A decline in demand for oil and natural gas or prices for those commodities and credit markets generally have a material adverse effect on our business, financial condition and results of operations.

The Company has witnessed the effects of the foregoing risks. Since the beginning of the steep decline in oil and gas prices in late 2014, the Company's revenues have declined approximately 30% from 2014 and its compressor utilization rate has declined from 76.0% at December 31, 2014 to 49.5% at December 31, 2017.

We are exposed to risks related to Computer systems failures or cyber security threats

In the conduct of our business we are dependent upon our computing systems and those of third parties to collect, store, transmit and process data used in our operational activities and to record, process and track financial transactions. If interruptions were to occur we would be unable to access these systems for a period of time and there is a risk of data loss. Data backup and storage measures are in place that would allow recovery in a time frame that we believe would not materially impact our ability to conduct business.

We are also subject to cyber security attacks and have taken steps to minimize the probability of an attack penetrating our systems. These include network security, virus protection, filtering software and intrusion protection measures. While an attack could potentially disrupt our activity, we do not house sensitive data that would affect the privacy of our customers, employees or business partners.

Risks Associated With Our Common Stock

The price of our common stock may fluctuate.

The trading price of our common stock and the price at which we may sell securities in the future are subject to substantial fluctuations in response to various factors, including our ability to successfully accomplish our business strategy, the trading volume of our stock, changes in governmental regulations, actual or anticipated variations in our quarterly or annual financial results, our involvement in litigation, general market conditions, the prices of oil and natural gas, announcements by us and our competitors, our liquidity, our ability to raise additional funds, and other events.

Future sales of our common stock could adversely affect our stock price.

Substantial sales of our common stock in the public market, or the perception by the market that those sales could occur, may lower our stock price or make it difficult for us to raise additional equity capital in the future. An aggregate of 15.25% of the outstanding shares of our common stock are owned by two institutional investors, each of which owns more than 5.0% of our outstanding shares as of March 5, 2018. Potential sales of large amounts of these shares in a short period of time by one or more of these significant investors could have a negative impact on our stock price. In addition, potential sales of our common stock by our directors and officers, who beneficially own approximately 6.0% of the outstanding shares of our common stock as of March 5, 2018, and because of the negative perception of sales by insiders, could also have a negative impact on our stock price.

We have a comparatively low number of shares of common stock outstanding and, therefore, our common stock may suffer from limited liquidity and its prices will likely be volatile and its value may be adversely affected.

Because of our relatively low number of outstanding shares of common stock, the trading price of our common stock will likely be subject to significant price fluctuations and limited liquidity. This may adversely affect the value of your investment. In addition, our common stock price could be subject to fluctuations in response to variations in quarterly operating results, changes in management, future announcements concerning us, general trends in the industry and other events or factors as well as those described above.

If we issue debt or equity securities, you may lose certain rights and be diluted.

If we raise funds in the future through the issuance of debt or equity securities, the securities issued may have rights and preferences and privileges senior to those of holders of our common stock, and the terms of the securities may impose restrictions on our operations or dilute your ownership in our Company.

If securities analysts downgrade our stock or cease coverage of us, the price of our stock could decline.

The trading market for our common stock relies in part on the research and reports that industry or financial analysts publish about us or our business. We do not control these analysts. Furthermore, there are many large, well-established, publicly traded companies active in our industry and market, which may mean that it is less likely that we will receive widespread analyst coverage. If one or more of the analysts who do cover us downgrade our stock, our stock price would likely decline rapidly. If one or more of these analysts cease coverage of our company, we could lose visibility in the market, which in turn could cause our stock price to decline.

We do not intend to pay, and have restrictions upon our ability to pay, dividends on our common stock.

We have not paid cash dividends in the past and do not intend to pay dividends on our common stock in the foreseeable future. Net income from our operations, if any, will be used for the development of our business, including capital expenditures, and to retire debt. In addition, our credit agreement contains restrictions on our ability to pay cash dividends on our common stock under certain circumstances.

Provisions contained in our governing documents could hinder a change in control of us.

Our articles of incorporation and bylaws contain provisions that may discourage acquisition bids and may limit the price investors are willing to pay for our common stock. Our articles of incorporation and bylaws provide that: directors are elected for three-year terms, with approximately one-third of the board of directors standing for election each year;

•cumulative voting is not allowed, which limits the ability of minority shareholders to elect any directors;
•the unanimous vote of the board of directors or the affirmative vote of the holders of not less than 80% of the votes
•entitled to be cast by the holders of all shares entitled to vote in the election of directors is required to change the size
•of the board of directors; and
•directors may be removed only for cause and only by the holders of not less than 80% of the votes entitled to be cast
•on the matter.

Our Board of Directors has the authority to issue up to five million shares of preferred stock. The Board of Directors can fix the terms of the preferred stock without any action on the part of our stockholders. The issuance of shares of preferred stock may delay or prevent a change in control transaction. In addition, preferred stock could be used in connection with the Board of Directors' adoption of a shareholders' rights plan (also known as a poison pill), which would make it much more difficult to effect a change in control of our Company through acquiring or controlling blocks of stock. Also, our directors and officers as a group will continue to beneficially own stock and although this is not a majority of our stock, it confers substantial voting power in the election of directors and management of our Company. This would make it difficult for other minority stockholders to effect a change in control or otherwise extend any significant control over our management. This may adversely affect the market price and interfere with the voting and other rights of our common stock.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

The table below describes the material facilities owned or leased by Natural Gas Services Group as of December 31, 2017:

| Location | Status | Square Feet | Uses |
|------------------------|------------------|-------------|---|
| Tulsa, Oklahoma | Owned and Leased | 91,780 | Compressor fabrication, rental and services |
| Midland, Texas | Owned | 70,000 | Compressor fabrication, rental and services |
| Lewiston, Michigan | Owned | 15,360 | Compressor fabrication, rental and services |
| Midland, Texas | Leased | 13,135 | Corporate offices |
| Bloomfield, New Mexico | Owned | 7,000 | Office and parts and services |
| Bridgeport, Texas | Leased | 4,500 | Office and parts and services |
| Midland, Texas | Owned | 4,100 | Parts and services |
| Godley, Texas | Leased | 5,000 | Parts and services |
| Vernal, Utah | Leased | 3,200 | Parts and services |
| Carrollton, Ohio | Leased | 2,600 | Parts and services |
| Loveland, Colorado | Leased | 2,400 | Parts and services |
| Wheeler, Texas | Leased | 2,160 | Parts and services |
| Grapevine, Texas | Leased | 800 | Sales |
| Midland, Texas | Owned | — | Corporate Office* |
| Total | | 222,035 | |

*In 2017, the Company purchased 3.059 acres in Midland, Texas for the location of its new corporate office. Construction for the new 45,000 sq ft building is under way, and expected to cost approximately \$12.0 million and complete in the first quarter of 2019.

We believe that our properties are generally well maintained and in good condition and adequate for our purposes.

ITEM 3. LEGAL PROCEEDINGS

From time to time, we are a party to various legal proceedings in the ordinary course of our business. While management is unable to predict the ultimate outcome of these actions, it believes that any ultimate liability arising from these actions will not have a material effect on our financial position, results of operations or cash flow. We are not currently a party to any bankruptcy, receivership, reorganization, adjustment or similar proceeding, and we are not aware of any threatened litigation.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Our common stock currently trades on the New York Stock Exchange under the symbol "NGS". The following table sets forth for the periods indicated the high and low sales prices for our common stock as reported for 2017 and 2016.

| 2017 | Low | High |
|----------------|---------|---------|
| First Quarter | \$24.50 | \$32.05 |
| Second Quarter | 22.85 | 28.80 |
| Third Quarter | 22.80 | 29.25 |
| Fourth Quarter | 24.35 | 29.05 |
| 2016 | Low | High |
| First Quarter | \$16.16 | \$22.41 |
| Second Quarter | 20.27 | 24.61 |
| Third Quarter | 22.18 | 26.00 |
| Fourth Quarter | 21.00 | 33.90 |

As of December 31, 2017 as reflected by our transfer agent records, we had 18 record holders of our common stock. This number does not include any beneficial owners for whom shares of common stock may be held in "nominee" or "street" name. On March 6, 2018, the last reported sale price of our common stock as reported by the New York Stock Exchange was \$26.45 per share.

The following graph shows a five year comparison of the cumulative total stockholder return on our common stock as compared to the cumulative total return of two other indexes: a custom composite index of the Philadelphia Oil Service Index and the Standard & Poor's 500 Composite Stock Price Index. These comparisons assume an initial investment of \$100 and the reinvestment of dividends.

The performance graph shall not be deemed incorporated by reference by any general statement incorporating by reference the Annual Report on Form 10-K into any filing under the Securities Act of 1933 or the Securities Exchange Act of 1934, except to the extent that we specifically incorporate this information by reference, and shall not otherwise be deemed filed under those Acts.

Dividends

To date, we have not declared or paid any dividends on our common stock. We currently do not anticipate paying a cash dividend on our common stock. Although we intend to retain our earnings, if any, to finance the growth of our business, our Board of Directors will have the discretion to declare and pay dividends in the future. Payment of dividends in the future will depend upon our earnings, capital requirements, and other factors, which our Board of Directors may deem relevant. Our credit agreement also contains restrictions on our paying dividends under certain circumstances.

Equity Compensation Plans

The following table summarizes certain information regarding our equity compensation plans as of December 31, 2017:

| Plan Category | (a) Number of Securities Issued or to be Issued Upon Exercise of Outstanding Options | (b) Weighted-average Issuance or Exercise Price of Outstanding Options | (c) Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column (a)) |
|---|--|---|--|
| Equity compensation plans approved by security holders: | | | |
| Stock Option Plan | 327,270 ⁽¹⁾ | \$ 20.21 | 313,169 |
| Restricted Stock / Unit Plan | 184,389 | \$ 25.32 | 162,770 |
| Total | 511,659 | | 475,939 |

(1) Total number of shares to be issued upon exercise of options granted to employees, officers, and directors under our 1998 Stock Option Plan.

Repurchase of Equity Securities

No repurchases of our securities were made by us or on our behalf by any “affiliated purchaser” during the year ended December 31, 2017.

Sale of Unregistered Securities

We made no sales of unregistered securities during the year ended December 31, 2017.

ITEM 6. SELECTED FINANCIAL DATA

In the table below, we provide you with selected historical financial data. We have derived this information from our audited financial statements for each of the years in the five-year period ended December 31, 2017. In the table we also present non-GAAP financial measures, Adjusted EBITDA and Adjusted Gross Margin, which we use in our business. These measures are not calculated or presented in accordance with GAAP. We explain these measures below and reconcile them to the most directly comparable financial measure calculated and presented in accordance with GAAP in "Non-GAAP Financial Measures." This information is only a summary and it is important that you read this information along with our audited financial statements and related notes and "Management's Discussion and Analysis of Financial Condition and Results of Operations" under Item 7 below, which discusses factors affecting the comparability of the information presented.

The selected financial information provided is not necessarily indicative of our future results of operations or financial performance.

| | Year Ended December 31, | | | | |
|--|--|----------|----------|------------|-----------|
| | 2017 | 2016 | 2015 | 2014 | 2013 |
| | (in thousands, except per share amounts) | | | | |
| STATEMENTS OF INCOME AND OTHER INFORMATION: | | | | | |
| Revenues | \$67,693 | \$71,654 | \$95,919 | \$96,974 | \$89,248 |
| Costs of revenues, exclusive of depreciation and amortization shown separately below | 34,743 | 31,872 | 42,655 | 43,147 | 40,943 |
| Loss on retirement of rental equipment | — | 545 | 4,370 | — | — |
| Depreciation and amortization | 21,302 | 21,796 | 22,758 | 21,507 | 18,144 |
| Selling, general and administrative expenses | 10,081 | 9,011 | 10,989 | 10,334 | 8,141 |
| Operating income | 1,567 | 8,430 | 15,147 | 21,986 | 22,020 |
| Total other income, net | 36 | 35 | 117 | 172 | 492 |
| Income before income taxes | 1,603 | 8,465 | 15,264 | 22,158 | 22,512 |
| Income tax (benefit) expense | (18,248) | 1,996 | 5,117 | 8,030 | 8,122 |
| Net income | \$19,851 | \$6,469 | \$10,147 | \$14,128 | \$14,390 |
| Net income per common share: | | | | | |
| Basic | \$1.55 | \$0.51 | \$0.81 | \$1.14 | \$1.17 |
| Diluted | \$1.51 | \$0.50 | \$0.79 | \$1.11 | \$1.15 |
| Weighted average shares of common stock outstanding: | | | | | |
| Basic | 12,831 | 12,702 | 12,567 | 12,434 | 12,324 |
| Diluted | 13,110 | 12,935 | 12,793 | 12,721 | 12,550 |
| Adjusted EBITDA ⁽¹⁾ | \$22,919 | \$30,814 | \$42,407 | \$43,675 | \$40,712 |
| Adjusted gross margin ⁽²⁾ | \$32,950 | \$39,782 | \$53,264 | \$53,827 | \$48,305 |
| Cash flows from: | | | | | |
| Operating Activities | \$17,452 | \$31,785 | \$41,566 | \$33,742 | \$40,039 |
| Investing Activities | (12,791) | (3,414) | (12,270) | (52,280) | (44,119) |
| Financing Activities | 453 | 191 | 55 | 276 | 437 |
| Net change in cash and cash equivalents | \$5,114 | \$28,562 | \$29,351 | \$(18,262) | \$(3,643) |
| | As of December 31, | | | | |
| | 2017 | 2016 | 2015 | 2014 | 2013 |
| BALANCE SHEET INFORMATION: | | | | | |
| | (in thousands) | | | | |
| Current assets | \$108,226 | \$95,359 | \$68,074 | \$49,631 | \$54,062 |
| Total assets | 298,310 | 293,524 | 285,553 | 282,712 | 256,589 |
| Long-term debt (including current portion) | 417 | 417 | 417 | 417 | 577 |
| Stockholders' equity | 257,319 | 232,954 | 223,981 | 210,587 | 192,737 |

(1) Adjusted EBITDA is defined, reconciled to net income and discussed immediately below under "Non-GAAP Financial Measures".

(2) Adjusted Gross Margin is defined, reconciled to operating income and discussed immediately below under "Non-GAAP Financial Measures".

Non-GAAP Financial Measures

Our definition and use of Adjusted EBITDA

“Adjusted EBITDA” is a non-GAAP financial measure that we define as earnings (net income) from operations before interest, taxes, loss on retirement of rental equipment, depreciation and amortization. This term, as used and defined by us, may not be comparable to similarly titled measures employed by other companies and is not a measure of performance calculated in accordance with GAAP. Adjusted EBITDA should not be considered in isolation or as a substitute for operating income, net income or loss, cash flows provided by operating, investing and financing activities, or other income or cash flow statement data prepared in accordance with GAAP. However, management believes Adjusted EBITDA is useful to an investor in evaluating our operating performance because:

- it is widely used by investors in the energy industry to measure a company’s operating performance without regard to items excluded from the calculation of Adjusted EBITDA, which can vary substantially from company to company depending upon accounting methods and book value of assets, capital structure and the method by which assets were acquired, among other factors;

- it helps investors to more meaningfully evaluate and compare the results of our operations from period to period by removing the impact of our capital structure and asset base from our operating structure; and

- it is used by our management for various purposes, including as a measure of operating performance, in presentations to our Board of Directors, as a basis for strategic planning and forecasting, and as a component for setting incentive compensation.

Adjusted EBITDA has limitations as an analytical tool, and you should not consider it in isolation, or as a substitute for analysis of our results as reported under generally accepted accounting principles. Some of these limitations are:

- Adjusted EBITDA does not reflect our cash expenditures, or future requirements for capital expenditures or contractual commitments;

- Adjusted EBITDA does not reflect changes in, or cash requirements for, our working capital needs;

- Adjusted EBITDA does not reflect the cash requirements necessary to service interest or principal payments on our debts; and

although depreciation and amortization are non-cash charges, the assets being depreciated and amortized will often have to be replaced in the future, and Adjusted EBITDA does not reflect any cash requirements for such replacements.

There are other material limitations to using Adjusted EBITDA as a measure of performance, including the inability to analyze the impact of certain recurring items that materially affect our net income or loss, and the lack of comparability of results of operations of different companies. Please read the table below under “Reconciliation” to see how Adjusted EBITDA reconciles to our net income, the most directly comparable GAAP financial measure.

Reconciliation

The following table reconciles our net income, the most directly comparable GAAP financial measure, to Adjusted EBITDA:

| | Year Ended December 31, | | | | |
|--|-------------------------|----------|----------|----------|----------|
| | 2017 | 2016 | 2015 | 2014 | 2013 |
| | (in thousands) | | | | |
| Net Income | \$19,851 | \$6,469 | \$10,147 | \$14,128 | \$14,390 |
| Interest expense | 14 | 8 | 15 | 10 | 56 |
| Income taxes (benefit) expense | (18,248) | 1,996 | 5,117 | 8,030 | 8,122 |
| Loss on retirement of rental equipment | — | 545 | 4,370 | — | — |
| Depreciation and amortization | 21,302 | 21,796 | 22,758 | 21,507 | 18,144 |
| Adjusted EBITDA | \$22,919 | \$30,814 | \$42,407 | \$43,675 | \$40,712 |

Our definition and use of Adjusted Gross Margin

We define “Adjusted Gross Margin” as total revenue less costs of revenues (excluding depreciation and amortization expense). Adjusted gross margin is included as a supplemental disclosure because it is a primary measure used by our management as it represents the results of revenue and costs (excluding depreciation and amortization expense), which are key components of our operations. Adjusted gross margin differs from gross profit, in that gross profit includes depreciation expense. We believe adjusted gross margin is important because it focuses on the current operating performance of our operations and excludes the impact of the prior historical costs of the assets acquired or constructed that are utilized in those operations, the indirect costs associated with our selling, general and administrative activities, the impact of our financing methods and income taxes. Depreciation expense does not accurately reflect the costs required to maintain and replenish the operational usage of our assets and therefore may not portray the costs from current operating activity. Rather, depreciation expense reflects the systematic allocation of historical property and equipment values over the estimated useful lives.

Adjusted gross margin has certain material limitations associated with its use as compared to operating income. These limitations are primarily due to the exclusion of certain expenses. Each of these excluded expenses is material to our results of operations. Because we use capital assets, depreciation expense is a necessary element of our costs and our ability to generate revenue and selling, general and administrative expense is a necessary cost to support our operations and required corporate activities. In order to compensate for these limitations, management uses this non-GAAP measure as a supplemental measure to other GAAP results to provide a more complete understanding of our performance.

As an indicator of our operating performance, adjusted gross margin should not be considered an alternative to, or more meaningful than, operating income as determined in accordance with GAAP. Our adjusted gross margin may not be comparable to a similarly titled measure of another company because other entities may not calculate adjusted gross margin in the same manner.

Reconciliation

The following table reconciles our operating income, the most directly comparable GAAP financial measure, to Adjusted Gross Margin:

| | Year Ended December 31, | | | | |
|--|-------------------------|------|------|------|------|
| | 2017 | 2016 | 2015 | 2014 | 2013 |

| | (in thousands) | | | | |
|---|----------------|----------|----------|----------|----------|
| Operating Income | \$1,567 | \$8,430 | \$15,147 | \$21,986 | \$22,020 |
| Depreciation and amortization | 21,302 | 21,796 | 22,758 | 21,507 | 18,144 |
| Selling, general, and administration expenses | 10,081 | 9,011 | 10,989 | 10,334 | 8,141 |
| Loss on retirement of rental equipment | — | 545 | 4,370 | — | — |
| Adjusted Gross Margin | \$32,950 | \$39,782 | \$53,264 | \$53,827 | \$48,305 |

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ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion is intended to assist you in understanding our financial position and results of operations for each of the years ended December 31, 2017, 2016 and 2015. You should read the following discussion and analysis in conjunction with our audited financial statements and the related notes.

The following discussion contains forward-looking statements. For a description of limitations inherent in forward-looking statements, see "Special Note Regarding Forward-Looking Statements" on page ii.

Overview

We fabricate, manufacture, rent and sell natural gas compressors and related equipment. Our primary focus is on the rental of natural gas compressors. Our rental contracts generally provide for initial terms of six to 24 months. After the initial term of our rental contracts, most of our customers have continued to rent our compressors on a month-to-month basis. Rental amounts include maintenance charges and are paid monthly in advance. As of December 31, 2017, we had 1,259 natural gas compressors totaling 184,382 horsepower rented to 87 customers, compared to 1,298 natural gas compressors totaling 186,328 horsepower rented to 79 customers at December 31, 2016. Of the 1,259 compressors rented at December 31, 2017, 853 were rented on a month-to-month basis.

We also fabricate natural gas compressors for sale to our customers, designing compressors to meet unique specifications dictated by well pressures, production characteristics and particular applications for which compression is sought. Fabrication of compressors involves the purchase by us of engines, compressors, coolers and other components, and then assembling these components on skids for delivery to customer locations. These major components of our compressors are acquired through periodic purchase orders placed with third-party suppliers on an "as needed" basis, which presently requires a three to four month lead time with delivery dates scheduled to coincide with our estimated production schedules. Although we do not have formal continuing supply contracts with any major supplier, we believe we have adequate alternative sources available. In the past, we have not experienced any sudden and dramatic increases in the prices of the major components for our compressors. However, the occurrence of such an event could have a material adverse effect on the results of our operations and financial condition, particularly if we were unable to increase our rental rates and sales prices proportionate to any such component price increases.

We also manufacture a proprietary line of compressor frames, cylinders and parts, known as our CiP (Cylinder-in-Plane) product line. We use finished CiP component products in the fabrication of compressor units for sale or rental by us or sell the finished component products to other compressor fabricators. We also design, fabricate, sell, install and service flare stacks and related ignition and control devices for onshore and offshore incineration of gas compounds such as hydrogen sulfide, carbon dioxide, natural gas and liquefied petroleum gases. To provide customer support for our compressor and flare sales businesses, we stock varying levels of replacement parts at our Midland, Texas facility and at field service locations. We also provide an exchange and rebuild program for screw compressors and maintain an inventory of new and used compressors to facilitate this business.

We provide service and maintenance to our non-rental customers under written maintenance contracts or on an as required basis in the absence of a service contract. Maintenance agreements typically have terms of six months to one year and require payment of a monthly fee.

The following table sets forth our revenues from each of our three operating categories for the periods presented:

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| | Year Ended December 31, | | |
|-------------------------|-------------------------|----------|----------|
| | 2017 | 2016 | 2015 |
| | (in thousands) | | |
| Rental | \$46,046 | \$56,717 | \$76,432 |
| Sales | 20,208 | 13,621 | 18,519 |
| Service and maintenance | 1,439 | 1,316 | 968 |
| Total | \$67,693 | \$71,654 | \$95,919 |

Our strategy for growth is focused on our compressor rental business. Margins, exclusive of depreciation and amortization, for our rental business historically run in the high 50% to low 60% range, while margins for the compressor sales business tend to be in the mid 20% range. If our rental business grows and contributes a larger percentage of our total revenues, we expect our overall company-wide margins, exclusive of depreciation and amortization, to improve over time.

The oil and natural gas equipment rental and services industry is cyclical in nature. The most critical factor in assessing the outlook for the industry is the worldwide supply and demand for natural gas and oil and the corresponding changes in commodity prices. As demand and prices increase, oil and natural gas producers increase their capital expenditures for drilling, development and production activities. Generally, the increased capital expenditures ultimately result in greater revenues and profits for service and equipment companies.

In general, we expect our overall business activity and revenues to track the level of activity in the natural gas industry, with changes in domestic natural gas production and consumption levels and prices more significantly affecting our business than changes in crude oil and condensate production and consumption levels and prices. We also believe that demand for compression services and products is driven by declining reservoir pressure in maturing natural gas producing fields and, more recently, by increased focus by producers on non-conventional natural gas production, such as coal bed methane, gas and oil shale and tight gas, which typically requires more compression than production from conventional natural gas reservoirs.

Demand for our products and services was relatively strong through most of 2014 due to increasing oil prices, in spite of continued low natural gas prices. Towards the end of 2014 crude oil prices collapsed and remained low through mid-2017, placing uncertainty on the growth in demand for our products and services.

For fiscal year 2018, our forecasted capital expenditures will be directly dependent upon our customers' compression requirements and are not anticipated to exceed our internally generated cash flows. Any required capital will be for additions to our compressor rental fleet and/or addition or replacement of service vehicles. We believe that cash on hand and cash flows from operations will be sufficient to satisfy our capital and liquidity requirements through 2018. If we require additional capital to fund any significant unanticipated expenditures, including any material acquisitions of other businesses, joint ventures or other opportunities, which exceed our current resources. To the extent needed, any such additional capital may not be available to us when we need it or on acceptable terms.

Notwithstanding the continued low energy price environment, we believe the long-term trend in our market is favorable.

Critical Accounting Policies and Practices

We have identified the policies below as critical to our business operations and the understanding of our results of operations. In the ordinary course of business, we have made a number of estimates and assumptions relating to the reporting of results of operations and financial condition in the preparation of our financial statements in conformity with accounting principles generally accepted in the United States. Actual results could differ significantly from those estimates under different assumptions and conditions. We believe that the following discussion addresses our most critical accounting policies, which are those that are most important to the portrayal of our financial condition and results of operations and require our most difficult, subjective, and complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain.

Our critical accounting policies are as follows:

- revenue recognition;

- estimating the allowance for doubtful accounts receivable;
- accounting for income taxes;
- valuation of long-lived and intangible assets and goodwill; and
- valuation of inventory.

Revenue Recognition

Revenue from the sales of custom and fabricated compressors and flare systems is recognized when title passes to the customer, the customer assumes risks and rewards of ownership, collectability is reasonably assured and delivery occurs as directed by our customer. Exchange and rebuild compressor revenue is recognized when both the replacement compressor has been delivered and the rebuild assessment has been completed. Revenue from compressor services is recognized upon providing services to the

customer. Maintenance agreement revenue is recognized as services are rendered. Rental revenue is recognized over the terms of the respective rental agreements. Deferred income represents payments received before a product is shipped. Revenue from the sale of rental units is included in sales revenue when equipment is shipped or title is transferred to the customer.

From time to time, upon the customer's written request, we recognize revenue when manufacturing is complete and the equipment is ready for shipment. At the customer's request, we will bill the customer upon completing all performance obligations, but before shipment. The customer will formally request we ship the equipment per their direction from our manufacturing facility at a later specified date and that we segregate the equipment from our finished goods, such that they are not available to fill other orders. Title of the equipment and risk of loss passes to the customer when the equipment is complete and ready for shipment, per the customer's agreement. At the transfer of title, all risks of ownership has passed to the customer on the manufactured items that have not yet been shipped. We have operated using bill and hold agreements with certain customers for many years, with consistent satisfactory results for both the customer and us. The credit terms on this agreement are consistent with the credit terms on all other sales. All risks of loss are shouldered by the customer, and there are no exceptions to the customer's commitment to accept and pay for these manufactured equipment. Revenues recognized at the completion of manufacturing in 2017 and 2016 were approximately \$4.6 million and \$5.6 million, respectively.

Allowance for Doubtful Accounts Receivable

We perform ongoing credit evaluations of our customers and adjust credit limits based upon payment history and the customer's current credit worthiness, as determined by our review of their current credit information. We continuously monitor collections and payments from our customers and maintain a provision for estimated credit losses based upon our historical experience and any specific customer collection issues that we have identified. While such credit losses have historically been within our expectations and the provisions established, we cannot guarantee that we will continue to experience the same credit loss rates that we have in the past. At December 31, 2017, one customer accounted for 14% of our accounts receivable, and at December 31, 2016, three customers accounted for approximately 15%, 15% and 14% of our accounts receivable. A significant change in the liquidity or financial position of these customers could have a material adverse impact on the collectability of our accounts receivable and our future operating results. At December 31, 2017 and 2016, our allowance for doubtful accounts balance was \$569,000 and \$597,000, respectively.

Accounting for Income Taxes

As part of the process of preparing our financial statements, we are required to estimate our federal income taxes as well as income taxes in each of the states in which we operate. This process involves us estimating our actual current tax exposure together with assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included in our consolidated balance sheet. We must then assess the likelihood that our deferred tax assets will be recovered from future taxable income and, to the extent we believe that recovery is not probable, we must establish a valuation allowance. To the extent we establish a valuation allowance or increase this allowance in a period, we must include an expense in the tax provision in the statement of operations.

Significant management judgment is required in determining our provision for income taxes, our deferred tax assets and liabilities and any valuation allowance recorded against our net deferred tax assets. We currently have no valuation allowance and fully expect to utilize all of our deferred tax assets.

On December 22, 2017, the U.S. government enacted comprehensive tax legislation commonly referred to as the Tax Cuts and Jobs Act (the "2017 Tax Act"), which makes broad and complex changes to the U.S. tax code. Certain income

tax effects of the 2017 Tax Act are reflected in the Company's financial results in accordance with Staff Accounting Bulletin No. 118 ("SAB 118"), which provides SEC staff guidance regarding the application of Accounting Standards Codification Topic 740 Income Taxes ("ASC 740"). See Note 7, "Income Taxes," to our Consolidated Financial Statements included here for further information on the financial statement impact of the 2017 Tax Act.

Valuation of Long-Lived and Intangible Assets and Goodwill

We assess the impairment of identifiable intangibles, long-lived assets and related goodwill annually or whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors we consider important which could trigger an impairment review include the following:

- significant underperformance relative to expected historical or projected future operating results;
- significant changes in the manner of our use of the acquired assets or the strategy for our overall business;

- significant negative industry or economic trends; and
- significant decline in the market value of our stock.

When we determine that the carrying value of intangibles, long-lived assets and related goodwill may not be recoverable based upon the existence of one or more of the above indicators of impairment, we measure any impairment based on a projected discounted cash flow method using a discount rate determined by our management to be commensurate with the risk inherent in our current business model.

We completed a review for impairment on our goodwill and indefinite-lived intangibles assets during the fourth quarter of 2017. Our analysis considered multiple qualitative factors to determine whether events and circumstances indicate that we more than likely than not experienced impairment to the stated value of goodwill. Our assessment included a review of changes in key company financial metrics, stock performance and other measures that are important to the company's success. The other measure included demand for our products and services, maintenance of customers and cost of producing our product. Based on the analysis we concluded that it is more likely than not that we have not incurred impairment and are not required to take further action. As a result, no impairment of goodwill or indefinite-lived intangibles was recorded during the year ended December 31, 2017. Future impairment tests could result in impairments of our intangible assets or goodwill.

Inventories

We value our total inventory (current and long-term) at the lower of the actual cost and net realizable value of the inventory. We regularly review inventory quantities on hand and record a provision for excess and obsolete inventory based primarily on our estimated forecast of product demand and production requirements. At December 31, 2017, an adjustment to the allowance of \$273,000 or 1% of inventory was made to remove obsolete inventory and bring inventory to current estimated net realizable value. This adjustment was the result of our obsolescence and lower cost and net realizable value which is conducted each year. We ended 2017 with an inventory allowance balance of \$15,000.

Our Performance Trends and Outlook

In anticipation of a slow recovery of natural gas and oil prices our customers are expected to be cautious in capital investments. We expect the overall activity levels will increase as we move through 2018. The expected slow increase in capital commitments and the inherent delay in demand for our products may result in modestly higher activity levels for 2018. In addition, we may continue to experience price pressure from our competitors until a more stable demand for products and services is established. We believe our fabrication business will likely reflect this level of activity in our production level through 2018. We believe growth in our rental operations business will also be moderated by this slow recovery.

Results of Operations

Year Ended December 31, 2017 Compared to the Year Ended December 31, 2016

The table below shows our revenues and percentage of total revenues for each of our product lines for the years ended December 31, 2017 and December 31, 2016.

| Revenue | |
|-------------------------|------|
| Year Ended December 31, | |
| 2017 | 2016 |

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(dollars in thousands)

| | | | | |
|-----------------------|----------|-------|----------|-------|
| Rental | \$46,046 | 68.0% | \$56,717 | 79.2% |
| Sales | 20,208 | 29.9% | 13,621 | 19.0% |
| Service & Maintenance | 1,439 | 2.1 % | 1,316 | 1.8 % |
| Total | \$67,693 | | \$71,654 | |

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Total revenue decreased to \$67.7 million from \$71.7 million, or 5.5%, for the year ended December 31, 2017, compared to 2016. This was the result of a 18.8% decrease in rental revenue offset by a 48.4% increase in sales revenue and a 9.3% increase in service and maintenance revenue.

Rental revenue decreased to \$46.0 million from \$56.7 million, or 18.8%, for the year ended December 31, 2017, compared to 2016. This decrease is due to reduced demand from the lower average oil and natural prices for the year ended December 31, 2017, resulting in units being returned. As of December 31, 2017, we had 2,546 natural gas compressors in our rental fleet totaling 369,961 horsepower, as compared to 2,530 natural gas compressors totaling 362,408 horsepower as of December 31, 2016. As of December 31, 2017, we had 1,259 natural gas compressors totaling 184,382 horsepower rented to 87 customers, compared to 1,298 natural gas compressors totaling 186,328 horsepower rented to 79 customers as of December 31, 2016. The rental fleet had a utilization of 49.5% as of December 31, 2017 as compared to 51.3% at December 31, 2016.

Sales revenue increased to \$20.2 million from \$13.6 million, or 48.4%, for the year ended December 31, 2017, compared to 2016. Our sales activity continues to reflect a demand from our customers' investments in non-conventional shale plays which require compression for producing natural gas. Due to lagging crude oil prices, along with economic uncertainty and continued tight credit markets, the energy industry continued to encounter reduced capital spending. While our strategy is to maintain our rental revenues so that they are a larger component of total revenue, we will continue to build and sell custom fabricated equipment. In support of this, we intend to cultivate new sales oriented customers and are actively pursuing small, medium and large reciprocating compressor fabrication projects, as well as, building rotary screw-type equipment of any size. Sales include: (1) compressor unit sales, (2) flare sales, (3) parts sales and (4) compressor rebuilds.

Operating income decreased to \$1.6 million from \$8.4 million, for the year ended December 31, 2017, compared to 2016. This decrease is attributed to a 18.8% drop in our rental revenue, due to the low oil and natural gas prices, resulting in the return of our units, as mentioned earlier.

During the fourth quarter of 2017, management performed a review of our rental compressor units and determined there were no units in our rental fleet which needed to be retired. In management's annual review performed in 2016, we determined that 63 units should be retired, with certain key components being re-utilized, representing total horsepower of 7,749. Based on this review, at December 31, 2016 we recorded a \$545,000 non-cash loss on the retirement of rental equipment to reduce the book value to approximately \$242,000, the estimated fair value of the key components being kept.

Selling, general, and administrative expenses increased to \$10.1 million for the year ended December 31, 2017, as compared to \$9.0 million for 2016. This 11.9% increase is primarily a result in an increase in stock compensation of \$1.7 million offset by a decrease in the executive incentive cash bonus of \$570,000.

Depreciation and amortization expense decreased to \$21.3 million from \$21.8 million, or 2.3%, for the year ended December 31, 2017, compared to 2016. The decrease is the result of fewer units being added to the fleet and older units becoming fully depreciated. We added only 20 units to our fleet over the past twelve months.

On December 22, 2017, the U.S. government enacted comprehensive tax legislation commonly referred to as the Tax Cuts and Jobs Act ("2017 Tax Act"), which makes broad and complex changes to the U.S. tax code. Certain income tax effects of the 2017 Tax Act are reflected in our financial results in accordance with SAB 118. SAB 118 provides SEC staff guidance regarding the application of Accounting Standards Codification Topic 740 ("ASC 740") Income Taxes, and the required disclosures due to the enactment of the 2017 Tax Act. The income tax effects of the 2017 Tax Act include a \$18.4 million income tax benefit related to the re-measurement of our deferred tax assets and liabilities at

the reduced rate of 21 percent. Refer to Note 7, "Income Taxes," in the Notes to the Consolidated Financial Statements for further information on the financial statement impact of the 2017 Tax Act.

Provision for income tax decreased to a benefit of \$18.2 million from \$2.0 million in expense for the year ended December 31, 2017 compared to 2016. This is a result of the \$18.4 million income tax benefit recorded in connection with the 2017 Tax Act, due to the re-measurement of our deferred tax assets and liabilities at the new federal statutory rate.

Year Ended December 31, 2016 Compared to the Year Ended December 31, 2015

The table below shows our revenue and percentage of total revenues for each of our product lines for the years ended December 31, 2016 and December 31, 2015.

| | Revenue | | | |
|-----------------------|-------------------------|-------|----------|-------|
| | Year Ended December 31, | | | |
| | 2016 | | 2015 | |
| | (dollars in thousands) | | | |
| Rental | \$56,717 | 79.2% | \$76,432 | 79.7% |
| Sales | 13,621 | 19.0% | 18,519 | 19.3% |
| Service & Maintenance | 1,316 | 1.8% | 968 | 1.0% |
| Total | \$71,654 | | \$95,919 | |

Total revenue decreased to \$71.7 million from \$95.9 million, or 25.3%, for the year ended December 31, 2016, compared to 2015. This was the result of a 25.8% decrease in rental revenue and a 26.4% decrease in sales revenue offset, partially, by a 36.0% increase in service and maintenance revenue.

Rental revenue decreased to \$56.7 million from \$76.4 million, or 25.8%, for the year ended December 31, 2016, compared to 2015. This decrease is due to reduced demand from the significant drop in oil and natural gas prices resulting in units being returned. As of December 31, 2016, we had 2,530 natural gas compressors in our rental fleet totaling 362,408 horsepower, as compared to 2,622 natural gas compressors totaling 372,482 horsepower as of December 31, 2015. As of December 31, 2016, we had 1,298 natural gas compressors totaling 186,328 horsepower rented to 79 customers, compared to 1,818 natural gas compressors totaling 256,204 horsepower rented to 84 customers as of December 31, 2015. The rental fleet had a utilization of 51.3% as of December 31, 2016 as compared to 69.3% at year end 2015.

Sales revenue decreased to \$13.6 million from \$18.5 million, or 26.4%, for the year ended December 31, 2016, compared to 2015. Our sales activity continues to reflect a softening of demand from our customers' investments in non-conventional shale plays which require compression for producing natural gas. Due to lagging crude oil prices, along with economic uncertainty and continued tight credit markets, the energy industry continues to encounter reduced capital spending. While our strategy is to maintain our rental revenues so that they are a larger component of total revenue, we will continue to build and sell custom fabricated equipment. In support of this, we intend to cultivate new sales oriented customers and are actively pursuing small, medium and large reciprocating compressor fabrication projects, as well as, building rotary screw-type equipment of any size. Sales include: (1) compressor unit sales, (2) flare sales, (3) parts sales and (4) compressor rebuilds.

Operating income decreased to \$8.4 million from \$15.1 million, for the year ended December 31, 2016, compared to 2015. This decrease is attributed to a 25.8% drop in our rental revenue, due to the significant drop in oil and natural gas prices, resulting in the return of our units, as mentioned earlier.

During the fourth quarter of 2016 management performed a review of our rental compressor units and determined that 63 units should be retired, with certain key components being re-utilized, representing total horsepower of 7,749. Based on this review, at December 31, 2016 we recorded a \$545,000 non-cash loss on the retirement of rental equipment to reduce the book value to approximately \$242,000, the estimated fair value of the key components being kept.

Selling, general, and administrative expenses decreased to \$9.0 million for the year ended December 31, 2016, as compared to \$11.0 million for 2015. This 18.0% decrease is primarily a result in a reduction in stock compensation of

\$1.0 million due to moving from a one year vesting period to a two vesting period for our 2016 restricted stock awards to our executive officers and a decrease in the executive incentive cash bonus of \$400,000.

Depreciation and amortization expense decreased to \$21.8 million from \$22.8 million, or 4.4%, for the year ended December 31, 2016, compared to 2015. The decrease in depreciation expense is driven by the 258 units we retired in 2015 that had a net book value of \$5.3 million, which was slightly offset by the full year of deprecation recognized on the 52 units added to our rental fleet in 2015 and the 18 units we added in 2016.

Provision for income tax decreased to \$2.0 million from \$5.1 million, or 61.0%. This is the result of the decrease in pre-tax income and effective tax rate, due to research and development credits taken in 2016. Our effective tax rate was 23.6% for 2016 and 33.5% for 2015.

Adjusted Gross Margin Year Ended December 31, 2017 Compared to the Year Ended December 31, 2016

The table below shows our adjusted gross margin and related percentages for each of our product lines for the years ended December 31, 2017 and December 31, 2016. Adjusted gross margin is the difference between revenue and cost of revenues, exclusive of depreciation and amortization expense.

| | Adjusted Gross Margin ⁽¹⁾ | | | |
|-----------------------|--------------------------------------|--------|-------------------------|--------|
| | Year Ended December 31, | | Year Ended December 31, | |
| | 2017 | | 2016 | |
| | (dollars in thousands) | | | |
| Rental | \$27,959 | 60.7 % | \$36,367 | 64.1 % |
| Sales | 3,922 | 19.4 % | 2,497 | 18.3 % |
| Service & Maintenance | 1,069 | 74.3 % | 918 | 69.8 % |
| Total | \$32,950 | 48.7 % | \$39,782 | 55.5 % |

(1) For a reconciliation of adjusted gross margin to its most directly comparable financial measure calculated and presented in accordance with GAAP, please read "Item 6. Selected Financial Data - Non-GAAP Financial Measures" in this Report.

The overall adjusted gross margin percentage dropped to 48.7% for the year ended December 31, 2017 compared to 55.5% for the year ended December 31, 2016, exclusive of depreciation and amortization. Our drop in gross margins is mainly due to the drop in rental revenue margins due to some pricing pressures from our customers. Rental margins decreased for the year ended December 31, 2017 compared to 2016 to 60.7% from 64.1%. Sales margin increased to 19.4% from 18.3% for the year ended 2017 compared to 2016. Third party service and maintenance margins increased to 74.3% from 69.8% for the year ended December 31, 2017 compared to 2016. Service and maintenance represents 2% of our revenue providing minimal impact on our overall adjusted gross margin.

Adjusted Gross Margin Year Ended December 31, 2016 Compared to the Year Ended December 31, 2015

The table below shows our adjusted gross margin and related percentages for each of our product lines for the years ended December 31, 2016 and December 31, 2015. Adjusted gross margin is the difference between revenue and cost of revenues, exclusive of depreciation and amortization expense.

| | Adjusted Gross Margin ⁽¹⁾ | | | |
|-----------------------|--------------------------------------|--------|-------------------------|--------|
| | Year Ended December 31, | | Year Ended December 31, | |
| | 2016 | | 2015 | |
| | (dollars in thousands) | | | |
| Rental | \$36,367 | 64.1 % | \$47,682 | 62.4 % |
| Sales | 2,497 | 18.3 % | 4,886 | 26.4 % |
| Service & Maintenance | 918 | 69.8 % | 696 | 71.9 % |
| Total | \$39,782 | 55.5 % | \$53,264 | 55.5 % |

(1) For a reconciliation of adjusted gross margin to its most directly comparable financial measure calculated and presented in accordance with GAAP, please read "Item 6. Selected Financial Data - Non-GAAP Financial Measures" in this Report.

The overall adjusted gross margin percentage remained steady at 55.5% for the twelve months ended December 31, 2016 and December 31, 2015, exclusive of depreciation and amortization. Our ability to maintain the percentage

during the depressed market is a result of the relatively higher margin rentals comprising a larger share of total revenue. Rental margins increased for the year ended December 31, 2016 compared to 2015 to 64.1% from 62.4%. Sales margin decreased to 18.3% from 26.4% for the year ended 2016 compared to 2015. Third party service and maintenance margins increased to 69.8% from 71.9% for the year ended December 31, 2016 compared to 2015. Service and maintenance represents 2% of our revenue providing minimal impact on our overall adjusted gross margin.

Liquidity and Capital Resources

Our working capital positions as of December 31, 2017 and 2016 are set forth below.

| | 2017 | 2016 |
|--------------------------------|----------------|----------|
| | (in thousands) | |
| Current Assets: | | |
| Cash and cash equivalents | \$69,208 | \$64,094 |
| Trade accounts receivable, net | 8,534 | 7,378 |
| Inventory, net | 26,224 | 21,433 |
| Prepaid income taxes | 3,443 | 1,482 |
| Prepaid expenses and other | 817 | 972 |
| Total current assets | 108,226 | 95,359 |
| Current Liabilities: | | |
| Line of credit | \$— | \$417 |
| Accounts payable | 4,162 | 971 |
| Accrued liabilities | 3,106 | 2,887 |
| Deferred income | 185 | 2,225 |
| Total current liabilities | 7,453 | 6,500 |
| Net working capital | \$100,773 | \$88,859 |

Historically, we have funded our operations through cash flows from operations and borrowings under bank credit facilities. In recent years, we have primarily funded our operations through cash flow from operations and, to a lesser extent, borrowings under our bank line of credit, which is described below. For the year ended December 31, 2017, we invested approximately \$13.5 million in equipment for our rental fleet service vehicles and land for our new corporate office. We financed this activity with cash on hand.

Cash flows

At December 31, 2017, we had cash and cash equivalents of \$69.2 million and working capital of \$100.8 million, and total debt of \$417,000 under our credit agreement, which is due in 2020. Our cash and cash equivalents increased from 2016 due to the continued hold on our capital program for non-contracted new compressor builds due to the continuing depressed oil and natural gas prices. We had positive net cash flow from operating activities of approximately \$17.5 million during 2017. This was primarily from net income of \$19.9 million and non-cash items of depreciation and amortization of \$21.3 million and \$4.0 million related to stock-based compensation, offset by a decrease in deferred income taxes of \$21.6 million and a decrease in cash flows related to working capital and other of \$6.1 million.

At December 31, 2016, we had cash and cash equivalents of \$64.1 million, working capital of \$88.9 million and total debt of \$417,000, under our line of credit which was due in 2017, and has subsequently been renewed. Our cash and cash equivalents increased from 2016 due to a the continued hold in our capital program which was the result of a decrease in compressor rentals due to the decrease in oil and natural gas prices. We had positive net cash flow from operating activities of approximately \$31.8 million during 2016. This was primarily from net income of \$6.5 million and non-cash items of depreciation and amortization of \$21.8 million, \$2.3 million related to stock-based compensation, a loss on retirement of rental fleet of \$545,000, a decrease in deferred income taxes of \$2.7 million and an increase in working capital of \$4.4 million.

Inventory increased to \$26.2 million as of the end of 2017, as compared to \$21.4 million as of the end of 2016. This increase is mainly due to purchases related to future jobs and the timing of jobs closing from work in progress to finished goods.

Contractual Obligations and Commitments

We have contractual obligations and commitments that affect our results of operations, financial condition and liquidity. The following table is a summary of our significant cash contractual obligations (in thousands):

| Cash Contractual Obligations | 2018 | 2019 | 2020 | 2021 | Thereafter | Total |
|------------------------------|-------|-------|-------|-------|------------|---------|
| Line of credit | \$— | \$— | \$417 | \$— | \$— | \$417 |
| Interest on line of credit | 17 | 17 | 17 | — | — | 51 |
| Purchase obligations | 300 | 300 | 300 | 300 | 266 | 1,466 |
| Other long term liabilities | — | — | — | — | 92 | 92 |
| Facilities and office leases | 484 | 122 | 9 | 1 | — | 616 |
| Total | \$801 | \$439 | \$743 | \$301 | \$358 | \$2,642 |

The Company also has a contractual obligation related to the construction of a new corporate office of \$12 million. Construction on the new office began in late 2017 and is expected to be completed in early 2019.

Senior Bank Borrowings

We have a senior secured revolving credit agreement the ("Amended Credit Agreement") with JP Morgan Chase Bank, N.A (the "Lender") with an aggregate commitment of \$30 million, subject to collateral availability. We also have a right to request from the Lender, on an uncommitted basis, an increase of up to \$20 million on the aggregate commitment (which could potentially increase the commitment amount to \$50 million). On August 31, 2017, we amended and renewed the Amended Credit Agreement, which was set to expire on December 31, 2017. The Credit Agreement Amendment extends the maturity date to December 31, 2020. No other material revisions were made to the credit facility. As of December 31, 2017, we owed \$417,000 on the line of credit under the Credit Agreement.

Borrowing Base. At any time before the maturity of the Amended Credit Agreement, we may draw, repay and re-borrow amounts available under the borrowing base up to the maximum aggregate availability discussed above. Generally, the borrowing base equals the sum of (a) 80% of our eligible accounts receivable plus (b) 50% of the book value of our eligible general inventory (not to exceed 50% of the commitment amount at the time) plus (c) 75% of the book value of our eligible equipment inventory. JPMorgan Chase Bank (the "Lender") may adjust the borrowing base components if material deviations in the collateral are discovered in future audits of the collateral.

Interest and Fees. Under the terms of the Amended Credit Agreement, we have the option of selecting the applicable variable rate for each revolving loan, or portion thereof, of either (a) LIBOR multiplied by the Statutory Reserve Rate (as defined in the Amended Credit Agreement), with respect to this rate, for Eurocurrency funding, plus the Applicable Margin ("LIBOR-based"), or (b) CB Floating Rate, which is the Lender's Prime Rate less the Applicable Margin; provided, however, that no more than three LIBOR-based borrowings under the agreement may be outstanding at any one time. For purposes of the LIBOR-based interest rate, the Applicable Margin is 1.50%. For purposes of the CB Floating Rate, the Applicable Margin is 1.25%. Accrued interest is payable monthly on outstanding principal amounts, provided that accrued interest on LIBOR-based loans is payable at the end of each interest period, but in no event less frequently than quarterly. In addition, fees and expenses are payable in connection with our requests for letters of credit (generally equal to the Applicable Margin for LIBOR-related borrowings multiplied by the face amount of the requested letter of credit) and administrative and legal costs.

Maturity. The maturity date of the Amended Credit Agreement is December 31, 2020, at which time all amounts borrowed under the agreement will be due and outstanding letters of credit must be cash collateralized. The agreement may be terminated early upon our request or the occurrence of an event of default.

Security. The obligations under the Amended Credit Agreement are secured by a first priority lien on all of our inventory and accounts and leases receivables, along with a first priority lien on a variable number of our leased compressor equipment the book value of must be maintained at a minimum of 2.00 to 1.00 commitment coverage ratio (such ratio being equal to (i) the amount of the borrowing base as of such date to (ii) the amount of the commitment as of such date.)

Covenants. The Amended Credit Agreement contains customary representations and warranties, as well as covenants which, among other things, limit our ability to incur additional indebtedness and liens; enter into transactions with affiliates; make acquisitions in excess of certain amounts; pay dividends; redeem or repurchase capital stock or senior notes; make investments or loans; make negative pledges; consolidate, merge or effect asset sales; or change the nature of our business.

Events of Default and Acceleration. The Amended Credit Agreement contains customary events of default for credit facilities of this size and type, and includes, without limitation, payment defaults; defaults in performance of covenants or other agreements contained in the transaction documents; inaccuracies in representations and warranties; certain defaults, termination events or similar events; certain defaults with respect to any other Company indebtedness in excess of \$50,000; certain bankruptcy or insolvency events; the rendering of certain judgments in excess of \$150,000; certain ERISA events; certain change in control events and the defectiveness of any liens under the secured revolving credit agreement. Obligations under the Amended Credit Agreement may be accelerated upon the occurrence of an event of default.

As of December 31, 2017, we were in compliance with all covenants in our Amended Credit Agreement. A default under our Amended Credit Agreement could trigger the acceleration of our bank debt so that it is immediately due and payable. Such default would have a material adverse effect on our liquidity, financial position and operations if we were to borrow a significant amount under facility.

Components of Our Principal Capital Expenditures

Capital expenditures for the three years ended December 31, 2017:

| Expenditure Category | 2017 | 2016 | 2015 |
|---|----------------|---------|----------|
| | (in thousands) | | |
| Rental equipment and property and equipment | \$13,489 | \$3,321 | \$12,459 |

The level of our expenditures will vary in future periods depending on energy market conditions and other related economic factors. Based upon existing economic and market conditions, we believe that our cash on hand, operating cash flow and available bank line of credit are adequate to fully fund our net capital expenditures requirements for 2018 and beyond. We also believe we have significant flexibility with respect to our financing alternatives and adjustment of our expenditure plans if circumstances warrant. We do not have any material continuing commitments related to our current operations that cannot be met with our cash on hand and our current line of credit.

Off-Balance Sheet Arrangements

From time-to-time, we enter into off-balance sheet arrangements and transactions that can give rise to off-balance sheet obligations. As of December 31, 2017, the off-balance sheet arrangements and transactions that we have entered into include operating lease agreements and purchase agreements. We do not believe that these arrangements are reasonably likely to materially affect our liquidity or availability of, or requirements for, capital resources.

We entered into a purchase agreement with a vendor in July 2008 pursuant to which we agreed to purchase up to \$4.8 million of our paint and coating requirements exclusively from the vendor. In connection with the execution of the agreement, the vendor paid us a \$300,000 fee which is considered to be a discount toward future purchases from the vendor. As of December 31, 2017, we had met \$3.3 million of this obligation. The \$300,000 payment we received is recorded as a long-term liability and will decrease as the purchase commitment is fulfilled. The long-term liability remaining as of December 31, 2017 was \$92,000.

Recently Issued Accounting Pronouncements

On February 25, 2016, the Financial Accounting Standards Board ("FASB") issued ASU No. 2016-02, Leases (Topic 842). Under the new guidance, a lessee will be required to recognize assets and liabilities for capital and operating leases with lease terms of more than 12 months. Additionally, this ASU will require disclosures to help investors and other financial statement users better understand the amount, timing, and uncertainty of cash flows arising from leases, including qualitative and quantitative requirements. For public business entities, the amendments are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years, with early adoption permitted. The new standard will be effective during our first quarter ending March 31, 2019. We are currently determining the impacts of the new standard on our consolidated financial statements and the additional applicable disclosure requirements.

On May 28, 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606). This update provides a five-step analysis on how an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. This guidance also requires more detailed disclosures to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. In August 2015, the FASB issued an accounting standards update for a one-year deferral of the revenue recognition standard's effective date for all entities, which changed the effectiveness to interim and annual reporting periods beginning after December 15, 2017. As a result, we adopted the guidance on January 1, 2018. The guidance offered two transition methods: a full retrospective approach to be applied to each prior reporting period presented or a modified retrospective approach where the cumulative effect of initially applying the standard is recognized at the date of initial application. We have selected the modified retrospective transition method. We have determined the impact of the new standard on our consolidated financial statements. Our approach included performing a detailed review of key contracts that are representative of our various revenue streams and comparing our historical accounting policies and practices to the new standard. Based upon our analysis, we have determined there will be no material financial impact upon adoption, but we will have a change in our disclosures under the new standard and have implemented new internal controls to ensure compliance under this new standard.

Environmental Regulations

Various federal, state and local laws and regulations covering the discharge of materials into the environment, or otherwise relating to protection of human safety and health and the environment, affect our operations and costs. Compliance with these laws and regulations could cause us to incur remediation or other corrective action costs or result in the assessment of administrative, civil and criminal penalties and the issuance of injunctions delaying or prohibiting operations. In addition, we have acquired certain properties and plant facilities from third parties whose actions with respect to the management and disposal or release of hydrocarbons or other wastes were not under our control. Under environmental laws and regulations, we could be required to remove or remediate wastes disposed of or released by prior owners. In addition, we could be responsible under environmental laws and regulations for properties and plant facilities we lease, but do not own. Compliance with such laws and regulations increases our overall cost of business, but has not had a material adverse effect on our operations or financial condition. It is not anticipated, based on current laws and regulations, that we will be required in the near future to expend amounts that are material in relation to our total expenditure budget in order to comply with environmental laws and regulations but such laws and regulations are frequently changed and we are unable to predict the ultimate cost of compliance. We also could incur costs related to the cleanup of sites to which we send equipment and for damages to natural resources or other claims related to releases of regulated substances at such sites.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

Commodity Risk

Our commodity risk exposure is the pricing applicable primarily to natural gas production and to lesser extent oil production. Realized commodity prices received for such production are primarily driven by the prevailing worldwide price for crude oil and spot prices applicable to natural gas. Depending on the market prices of oil and natural gas, companies exploring for such resources may cancel or curtail their drilling programs, thereby reducing demand for our equipment and services.

Financial Instruments and Debt Maturities

Our financial instruments consist of cash and cash equivalents, trade receivables, accounts payable and our line of credit. The carrying amounts of cash and cash equivalents, trade receivables, and accounts payable approximate fair

value because of the short-term nature of the instruments. The fair value of our bank borrowings approximate the carrying amounts as of December 31, 2017 and 2016, and were determined based upon interest rates currently available to us.

Customer Credit Risk

We are exposed to the risk of financial non-performance by our customers. Our ability to collect on rentals and sales to our customers is dependent on the liquidity of our customer base. To manage customer credit risk, we monitor credit ratings of our customers. Unless we are able to retain our existing customers, or secure new customers if we lose one or more of our significant customers, our revenue and results of operations would be adversely affected. At December 31, 2017, we had one customers that accounted for a total of approximately 14% of our accounts receivable.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Our audited financial statements and supplementary financial data are included in this Annual Report on Form 10-K beginning on page F-1.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

An evaluation was carried out under the supervision and with the participation of our management, including our President and Chief Executive Officer and our Vice President and Chief Financial Officer, of the effectiveness of the design of our “disclosure controls and procedures” (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended or, the “Exchange Act”) as of December 31, 2017, pursuant to Exchange Act Rule 13a-15. Based upon that evaluation, the President and Chief Executive Officer and our Principal Accounting Officer have concluded that our disclosure controls and procedures as of December 31, 2017, are effective to ensure that information required to be disclosed by us in the reports filed or submitted by us under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the SEC’s rules and forms and include controls and procedures designed to ensure that information required to be disclosed by us in such reports is accumulated and communicated to our management, including our principal executive and financial officers as appropriate to allow timely decisions regarding required disclosures. Due to the inherent limitations of control systems, not all misstatements may be detected. Those inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple errors or mistakes. Additionally, controls could be circumvented by the individual acts of some persons or by collusion of two or more people. Our controls and procedures can only provide reasonable, not absolute, assurance that the above objectives have been met.

Changes in Internal Control Over Financial Reporting

There were no changes in our internal control over financial reporting identified in connection with the evaluation required by paragraph (d) of Exchange Act Rules 13a-15 or 15d-15 that occurred during our last quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Management’s Report on Internal Control Over Financial Reporting

Our management, including the President and Chief Executive Officer and our Principal Accounting Officer, is responsible for establishing and maintaining adequate internal control over financial reporting, as defined in Rule 13a-15(f) and 15d-15(f) under the Exchange Act. Our internal control system is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Our internal control over financial reporting includes those policies and procedures that:

- pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of our assets;

provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America, and that our receipt and expenditures are being made only in accordance with authorizations of management and our Board of Directors; and provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on the financial statements.

All internal control systems, no matter how well designed, have inherent limitations. A system of internal control may become inadequate over time because of changes in conditions or deterioration in the degree of compliance with the policies or procedures. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

Our management assessed the effectiveness of our internal control over financial reporting as of December 31, 2017 using the criteria set forth by the Commission of Sponsoring Organizations of the Treadway Commission (COSO) in their Internal Control-Integrated Framework (2013). Based on this assessment, our management concluded that, as of December 31, 2017, our internal control over financial reporting was effective.

Pursuant to the Section 404 of the Sarbanes-Oxley Act of 2002, we have included a report of management's assessment of the effectiveness of our internal controls as part of this annual report on Form 10-K for the fiscal year December 31, 2017. BDO USA, LLP, our independent registered public accounting firm, has issued an attestation report dated March 9, 2018 on the effectiveness of internal control over financial reporting on page 36.

ITEM 9B. OTHER INFORMATION

None.

Report of Independent Registered Public Accounting Firm

Board of Directors and Stockholders
Natural Gas Services Group, Inc.
Midland, Texas

Opinion on Internal Control over Financial Reporting

We have audited Natural Gas Services Group, Inc.'s (the "Company") internal control over financial reporting as of December 31, 2017, based on criteria established in Internal Control - Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (the "COSO criteria"). In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2017, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"), the consolidated balance sheets of the Company and subsidiaries as of December 31, 2017 and 2016, the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2017, and the related notes, and our report dated March 9, 2018 expressed an unqualified opinion thereon.

Basis for Opinion

The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Item 9A, Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit of internal control over financial reporting in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

Definition and Limitations of Internal Control over Financial Reporting

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding

prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ BDO USA, LLP

Houston, Texas
March 9, 2018

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information required by this item is incorporated herein by reference to the sections “Election of Directors,” “Executive Officers,” “Corporate Governance” and “The Board of Directors and its Committees” in our definitive proxy statement which will be filed with the Securities and Exchange Commission within 120 days after December 31, 2017.

We have adopted a Code of Business Conduct and Ethics that applies to our directors, officers and employees. The Code of Business Conduct and Ethics is posted in the "Investor Relations" section of our website at www.ngsgi.com. The Code of Business Conduct and Ethics maybe obtained free of charge by writing to Natural Gas Services Group, Inc., Attn: Investor Relations, 508 W. Wall Street, Suite 550 Midland, Texas 79701.

ITEM 11. EXECUTIVE COMPENSATION

The information required by this item is incorporated herein by reference to the section “Executive Compensation” in our definitive proxy statement which will be filed with the Securities and Exchange Commission within 120 days after December 31, 2017.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information required by this item is incorporated herein by reference to the section “Principal Shareholders and Security Ownership of Management” in our definitive proxy statement which will be filed with the Securities and Exchange Commission within 120 days after December 31, 2017.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information required by this item is incorporated herein by reference to the sections “Related Person Transactions” and “Corporate Governance” in our definitive proxy statement which will be filed with the Securities and Exchange Commission within 120 days after December 31, 2017.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by this item is incorporated herein by reference to the section “Principal Accountant Fees and Services” in our definitive proxy statement which will be filed with the Securities and Exchange Commission within 120 days after December 31, 2017.

PART IV

ITEM 15. EXHIBITS AND CONSOLIDATED FINANCIAL STATEMENTS

The following documents are filed as part of this Annual Report on Form 10-K:

(a)(1) and (a)(2) Consolidated Financial Statements

For a list of Consolidated Financial Statements, see “Index to Consolidated Financial Statements” and incorporated herein by reference.

(a)(3) Exhibits

A list of exhibits to this Annual Report on Form 10-K is set forth below:

| Exhibit No. | Description |
|--------------|---|
| <u>3.1</u> | Articles of Incorporation, as amended (Incorporated by reference to Exhibit 3.1 of the 10-QSB filed and dated November 10, 2004). |
| <u>3.2</u> | Bylaws, as amended (Incorporated by reference to Exhibit 3.11 of the Registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission on June 21, 2016.) |
| <u>10.1</u> | Lease Agreement, dated January 9, 2018, between WNB Tower, LTD and Natural Gas Services Group, Inc. (Incorporated by reference to Exhibit 10.15 of the Registrant's Form 10-K for the fiscal year ended December 31, 2017 and filed with the Securities and Exchange Commission on March 9, 2018) |
| <u>10.2</u> | 2009 Restricted Stock/Unit Plan, as amended (Incorporated by reference to Exhibit 99.1 of the Registrant's Current Report on Form 8-K dated June 3, 2014 and filed with the Securities and Exchange Commission on June 6, 2014.) |
| <u>10.3</u> | Stock Option Plan, as amended and restated (Incorporated by reference to Exhibit 10.1 of the Registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission on June 21, 2016.) |
| <u>10.4</u> | Credit Agreement between Natural Gas Services Group, Inc. and JPMorgan Chase Bank, N.A., dated December 10, 2010 (Incorporated by reference to Exhibit 10.1 of the Registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission on November 24, 2014.) |
| <u>10.5</u> | Fifth Amendment of Credit Agreement between Natural Gas Services Group, Inc. and JPMorgan Chase Bank, N.A., dated August 31, 2017 (Incorporated by reference to Exhibit 10.2 of the Registrant's Current report on Form 8-K filed with the Securities and Exchange Commission on September 7, 2017.) |
| <u>10.6</u> | Security Agreement between Natural Gas Services Group, Inc. and JPMorgan Chase Bank, N.A., dated December 10, 2010 (Incorporated by reference to Exhibit 10.2 of the Registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission on December 16, 2011.) |
| <u>10.7</u> | Fourth Security Agreement between Natural Gas Services Group, Inc. and JPMorgan Chase Bank, N.A., dated August 31, 2017 (Incorporated by reference to Exhibit 10.1 of the Registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission on September 7, 2017.) |
| <u>10.8</u> | Promissory Note in the aggregate amount of \$30,000,000 issued to JPMorgan Chase Bank, N.A., dated August 31, 2017, in connection with the revolving credit line under the Credit Agreement with JPMorgan Chase Bank, N.A. (Incorporated by reference to Exhibit 10.3 of the Registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission on September 7, 2017.) |
| <u>10.9</u> | Amended and restated Employment Agreement dated April 27, 2015 between Natural Gas Services Group, Inc. and Stephen C. Taylor (Incorporated by reference to Exhibit 10.1 of the Registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission on April 29, 2015.) |
| <u>10.10</u> | |

The Executive Nonqualified Excess Plan Adoption Agreement, referred to as the Nonqualified Deferred Compensation Plan (Incorporated by reference to Exhibit 10.11 of the Registrant's Quarterly report on Form 10-Q filed with the Securities and Exchange Commission on May 6, 2016.)

- 10.11 Annual Incentive Bonus Plan (Incorporated by reference to Exhibit 10.1 of the Registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission on December 18, 2012.)
- *21.1 Subsidiaries of the registrant
- *23.1 Consent of BDO USA, LLP
- *31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- *31.2 Certification of Principal Accounting Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- *32.1 Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- *32.2 Certification of Principal Accounting Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 101.INS XBRL Instance Document
- 101.SCHXBRL Taxonomy Extension Schema Document
- 101.CALXBRL Taxonomy Extension Calculation Linkbase Document
- 101.DEF XBRL Taxonomy Extension Definition Linkbase Document
- 101.LABXBRL Taxonomy Extension Label Linkbase Document
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

* Filed herewith.

ITEM 16. FORM 10-K SUMMARY

None.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

NATURAL GAS SERVICES GROUP, INC.

Date: March 9, 2018 By: /s/ Stephen C. Taylor
 Stephen C. Taylor
 Chairman of the Board, President and Chief Executive Officer
 (Principal Executive Officer)

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated:

| Signature | Title | Date |
|--|--|------------------|
| /s/ Stephen C. Taylor Stephen C. Taylor | Chairman of the Board of Directors, Chief Executive Officer and President (Principal Executive Officer) | March 9, 2018 |
| /s/ G. Larry Lawrence G. Larry Lawrence | Vice President and Chief Financial Officer (Principal Accounting Officer) | March 9, 2018 |
| /s/ Charles G. Curtis Charles G. Curtis | Director | March 9, 2018 |
| /s/ William F. Hughes, Jr. William F. Hughes, Jr. | Director | March 9, 2018 |
| /s/ David L. Bradshaw David L. Bradshaw | Director | March 9, 2018 |
| /s/ John W. Chisholm John W. Chisholm | Director | March 9, 2018 |

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Report of Independent Registered Public Accounting Firm

Board of Directors and Stockholders

Natural Gas Services Group, Inc.

Midland, Texas

Opinion on the Consolidated Financial Statements

We have audited the accompanying consolidated balance sheets of Natural Gas Services Group, Inc. (the “Company”) and subsidiaries as of December 31, 2017 and 2016, the related consolidated statements of income, stockholders’ equity, and cash flows for each of the three years in the period ended December 31, 2017, and the related notes (collectively referred to as the “consolidated financial statements”). In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Company and subsidiaries at December 31, 2017 and 2016, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2017, in conformity with accounting principles generally accepted in the United States of America. We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (“PCAOB”), the Company’s internal control over financial reporting as of December 31, 2017, based on criteria established in Internal Control - Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”) and our report dated March 9, 2018 expressed an unqualified opinion thereon.

Basis for Opinion

These consolidated financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on the Company’s consolidated financial statements based on our audits. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud.

Our audits included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that our audits provide a reasonable basis for our opinion.

/s/ BDO USA, LLP

We have served as the Company's auditor since 2010.

Houston, Texas

March 9, 2018

NATURAL GAS SERVICES GROUP, INC.
CONSOLIDATED BALANCE SHEETS
(in thousands)

| | December 31, | |
|---|--------------|-----------|
| | 2017 | 2016 |
| ASSETS | | |
| Current Assets: | | |
| Cash and cash equivalents | \$69,208 | \$64,094 |
| Trade accounts receivable, net of allowance for doubtful accounts of \$569 and \$597, respectively | 8,534 | 7,378 |
| Inventory | 26,224 | 21,433 |
| Prepaid income taxes | 3,443 | 1,482 |
| Prepaid expenses and other | 817 | 972 |
| Total current assets | 108,226 | 95,359 |
| Long-Term Inventory, net of allowance for obsolescence of \$15 and \$15, respectively | 2,829 | 2,488 |
| Rental equipment, net of accumulated depreciation of \$145,851 and \$126,096, respectively | 167,099 | 175,972 |
| Property and equipment, net of accumulated depreciation of \$11,274 and \$11,267, respectively | 7,652 | 7,753 |
| Goodwill | 10,039 | 10,039 |
| Intangibles, net of accumulated amortization of \$1,632 and \$1,508, respectively | 1,526 | 1,651 |
| Other assets | 939 | 262 |
| Total assets | \$298,310 | \$293,524 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current Liabilities: | | |
| Line of credit | \$— | \$417 |
| Accounts payable | 4,162 | 971 |
| Accrued liabilities | 3,106 | 2,887 |
| Deferred income | 185 | 2,225 |
| Total current liabilities | 7,453 | 6,500 |
| Line of credit | 417 | — |
| Deferred income tax liability | 32,163 | 53,745 |
| Other long-term liabilities | 958 | 325 |
| Total liabilities | 40,991 | 60,570 |
| Commitments and contingencies (Note 11) | | |
| Stockholders' Equity: | | |
| Preferred stock, 5,000 shares authorized, no shares issued or outstanding | — | — |
| Common stock, 30,000 shares authorized, par value \$0.01; 12,880 and 12,764 shares issued and outstanding, respectively | 129 | 128 |
| Additional paid-in capital | 105,325 | 100,812 |
| Retained earnings | 151,865 | 132,014 |
| Total stockholders' equity | 257,319 | 232,954 |
| Total liabilities and stockholders' equity | \$298,310 | \$293,524 |

See accompanying notes to these consolidated financial statements.

NATURAL GAS SERVICES GROUP, INC.
CONSOLIDATED STATEMENTS OF INCOME
(in thousands, except earnings per share)

| | For the Years Ended December 31, | | |
|--|-------------------------------------|----------|----------|
| | 2017 | 2016 | 2015 |
| Revenue: | | | |
| Rental income | \$46,046 | \$56,717 | \$76,432 |
| Sales | 20,208 | 13,621 | 18,519 |
| Service and maintenance income | 1,439 | 1,316 | 968 |
| Total revenue | 67,693 | 71,654 | 95,919 |
| Operating costs and expenses: | | | |
| Cost of rentals, exclusive of depreciation stated separately below | 18,087 | 20,350 | 28,750 |
| Cost of sales, exclusive of depreciation stated separately below | 16,286 | 11,124 | 13,633 |
| Cost of service and maintenance, exclusive of depreciation stated separately below | 370 | 398 | 272 |
| Loss on retirement of rental equipment | — | 545 | 4,370 |
| Selling, general, and administrative expenses | 10,081 | 9,011 | 10,989 |
| Depreciation and amortization | 21,302 | 21,796 | 22,758 |
| Total operating costs and expenses | 66,126 | 63,224 | 80,772 |
| Operating income | 1,567 | 8,430 | 15,147 |
| Other income (expense): | | | |
| Interest expense | (14) | (8) | (15) |
| Other income | 50 | 43 | 132 |
| Total other income, net | 36 | 35 | 117 |
| Income before provision for income taxes | 1,603 | 8,465 | 15,264 |
| Provision for income taxes: | | | |
| Current | 3,334 | 4,709 | 6,963 |
| Deferred | (21,582) | (2,713) | (1,846) |
| Total income tax expense (benefit) | (18,248) | 1,996 | 5,117 |
| Net income | \$19,851 | \$6,469 | \$10,147 |
| Earnings per share: | | | |
| Basic | \$1.55 | \$0.51 | \$0.81 |
| Diluted | \$1.51 | \$0.50 | \$0.79 |
| Weighted average shares outstanding: | | | |
| Basic | 12,831 | 12,702 | 12,567 |
| Diluted | 13,110 | 12,935 | 12,793 |

See accompanying notes to these consolidated financial statements.

NATURAL GAS SERVICES GROUP, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(in thousands)

| | Preferred Stock Shares | Common Stock Shares | Common Stock Amount | Additional Paid-In Capital | Retained Earnings | Total Stockholders' Equity |
|--|------------------------------|------------------------|------------------------|----------------------------------|----------------------|----------------------------------|
| BALANCES, December 31, 2014 | — \$ | —12,466 | \$ 124 | \$95,065 | \$ 115,398 | \$ 210,587 |
| Exercise of common stock options | — | 66 | 1 | 775 | — | 776 |
| Compensation expense on common stock options | — | — | — | 601 | — | 601 |
| Issuance of restricted stock | — | 71 | — | — | — | — |
| Tax benefit of equity compensation | — | — | — | (379) | — | (379) |
| Compensation expense on restricted common stock | — | — | 1 | 2,943 | — | 2,944 |
| Taxes paid related to net shares settlement of equity awards | — | — | — | (695) | — | (695) |
| Net income | — | — | — | — | 10,147 | 10,147 |
| BALANCES, December 31, 2015 | — \$ | —12,603 | \$ 126 | \$98,310 | \$ 125,545 | \$ 223,981 |
| Exercise of common stock options | — | 62 | 1 | 1,041 | — | 1,042 |
| Compensation expense on common stock options | — | — | — | 506 | — | 506 |
| Issuance of restricted stock | — | 99 | — | — | — | — |
| Tax expense of equity compensation | — | — | — | 72 | — | 72 |
| Compensation expense on restricted common stock | — | — | 1 | 1,792 | — | 1,793 |
| Taxes paid related to net shares settlement of equity awards | — | — | — | (909) | — | (909) |
| Net income | — | — | — | — | 6,469 | 6,469 |
| BALANCES, December 31, 2016 | — \$ | —12,764 | \$ 128 | \$100,812 | \$ 132,014 | \$ 232,954 |
| Exercise of common stock options | — | 56 | — | 1,120 | — | 1,120 |
| Compensation expense on common stock options | — | — | — | 363 | — | 363 |
| Issuance of restricted stock | — | 60 | — | — | — | — |
| Compensation expense on restricted common stock | — | — | 1 | 3,674 | — | 3,675 |
| Taxes paid related to net shares settlement of equity awards | — | — | — | (644) | — | (644) |
| Net income | — | — | — | — | 19,851 | 19,851 |
| BALANCES, December 31, 2017 | — \$ | —12,880 | \$ 129 | \$ 105,325 | \$ 151,865 | \$ 257,319 |

See accompanying notes to these consolidated financial statements.

NATURAL GAS SERVICES GROUP, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

| | For the Years Ended December 31, | | |
|---|----------------------------------|---------------|---------------|
| | 2017 | 2016 | 2015 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | | |
| Net income | \$ 19,851 | \$ 6,469 | \$ 10,147 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Depreciation and amortization | 21,302 | 21,796 | 22,758 |
| Deferred taxes | (21,582) | (2,713) | (1,846) |
| Gain on disposal of assets | (87) | (86) | (179) |
| Loss on retirement of rental equipment | — | 545 | 4,370 |
| Bad debt allowance | 90 | 61 | 477 |
| Inventory allowance | 273 | 566 | 205 |
| Stock based compensation | 4,038 | 2,299 | 3,545 |
| Gain on company owned life insurance | (67) | (14) | — |
| Changes in assets (increase) decrease in: | | | |
| Trade accounts receivables | (1,246) | 1,668 | 824 |
| Inventory | (5,350) | 1,131 | 5,337 |
| Prepaid income taxes and prepaid expenses | (1,806) | (1,539) | 5,774 |
| Changes in liabilities increase (decrease) in: | | | |
| Accounts payable and accrued liabilities | 3,410 | (439) | (7,220) |
| Current income tax liability | — | — | (1,230) |
| Deferred income | (2,040) | 1,954 | (1,364) |
| Other | 666 | 159 | (32) |
| Tax benefit from equity compensation | — | (72) | — |
| NET CASH PROVIDED BY OPERATING ACTIVITIES | 17,452 | 31,785 | 41,566 |
| CASH FLOWS FROM INVESTING | | | |

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ACTIVITIES:

| | | | | | | |
|--|----------|---|---------|---|----------|---|
| Purchases of rental, property and equipment | (13,489) |) | (3,321) |) | (12,459) |) |
| Purchase of company owned life insurance | (620) |) | (194) |) | — |) |
| Proceeds from insurance claim | 1,231 |) | — |) | — |) |
| Proceeds from sale of property and equipment | 87 |) | 101 |) | 189 |) |
| NET CASH USED IN INVESTING ACTIVITIES | (12,791) |) | (3,414) |) | (12,270) |) |

CASH FLOWS FROM FINANCING

ACTIVITIES:

| | | | | | | |
|---|-------|---|-------|---|-------|---|
| Payments of other long-term liabilities | (23) |) | (14) |) | (26) |) |
| Proceeds from exercise of stock options | 1,120 |) | 1,042 |) | 776 |) |
| Tax benefit from equity compensation | — |) | 72 |) | — |) |
| Taxes paid related to net share settlement of equity awards | (644) |) | (909) |) | (695) |) |
| NET CASH PROVIDED BY FINANCING ACTIVITIES | 453 |) | 191 |) | 55 |) |

NET CHANGE IN CASH AND CASH EQUIVALENTS

| | | | | | | |
|--|-----------|---|-----------|---|-----------|---|
| NET CHANGE IN CASH AND CASH EQUIVALENTS | 5,114 |) | 28,562 |) | 29,351 |) |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD | 64,094 |) | 35,532 |) | 6,181 |) |
| CASH AND CASH EQUIVALENTS AT END OF PERIOD | \$ 69,208 |) | \$ 64,094 |) | \$ 35,532 |) |

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:

| | | | | | | |
|-------------------|----------|---|----------|---|----------|---|
| Interest paid | \$ 14 |) | \$ 8 |) | \$ 15 |) |
| Income taxes paid | \$ 3,725 |) | \$ 5,825 |) | \$ 6,530 |) |

NON-CASH TRANSACTIONS

| | | | | | | |
|---|-------|---|--------|---|----------|---|
| Transfer of rental equipment to inventory | \$ 55 |) | \$ 724 |) | \$ 2,309 |) |
| Transfer of inventory to property and equipment | \$ — |) | \$ — |) | \$ 1,624 |) |

See accompanying notes to these consolidated financial statements.

NATURAL GAS SERVICES GROUP INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Summary of Significant Accounting Policies

Organization and Principles of Consolidation

These notes apply to the consolidated financial statements of Natural Gas Services Group, Inc. (the "Company", "NGSG", "Natural Gas Services Group", "we" or "our") (a Colorado corporation). Natural Gas Services Group was formed on December 17, 1998 for the purposes of combining the operations of certain manufacturing, service and leasing entities. The accompanying consolidated financial statements include the accounts of the Company, its subsidiary, NGSB Properties, LLC and the rabbi trust associated with the Company's deferred compensation plan, see Note 5. All significant intercompany accounts and transactions for the periods presented have been eliminated in consolidation.

Nature of Operations

Natural Gas Services Group is a leading provider of small to medium horsepower compression equipment to the natural gas industry, with an emerging position in the large horsepower market. We focus primarily on the non-conventional natural gas and oil production business in the United States (such as coal bed methane, gas shale, tight gas and oil shale). We manufacture, fabricate and rent natural gas compressors that enhance the production of natural gas wells. NGSB provides maintenance services for its natural gas compressors. In addition, we sell custom fabricated natural gas compressors to meet customer specifications dictated by well pressures, production characteristics and particular applications. We also manufacture and sell flare systems for oil and natural gas plant and production facilities.

Use of Estimates

The preparation of our consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires our management to make estimates and assumptions that affect the amounts reported in these consolidated financial statements and accompanying notes. Actual results could differ from those estimates. Significant estimates include fixed asset lives, bad debt allowance and the allowance for inventory obsolescence. It is at least reasonably possible these estimates could be revised in the near term and the revisions could be material.

Cash Equivalents

For purposes of reporting cash flows, we consider all short-term investments with an original maturity of three months or less to be cash equivalents.

Accounts Receivable

Our trade receivables consist of customer obligations for the sale of compressors and flare systems due under normal trade terms, and operating leases for the use of our natural gas compressors. The receivables are not collateralized except as provided for under lease agreements. However, we typically require deposits of as much as 50% or use of progress payments for large custom sales contracts. We extend credit based on management's assessment of the customer's financial condition, receivable aging, customer disputes and general business and economic conditions. The allowance for doubtful accounts was \$569,000 and \$597,000 at December 31, 2017 and 2016, respectively. Management believes that the allowance is adequate; however, actual write-offs may exceed the recorded allowance.

Revenue Recognition

Revenue from the sales of custom and fabricated compressors, and flare systems is recognized when title passes to the customer, the customer assumes risks and rewards of ownership, collectability is reasonably assured and delivery occurs as directed by our customer. Exchange and rebuilt compressor revenue is recognized when both the replacement compressor has been delivered and the rebuild assessment has been completed. Revenue from compressor service and retrofitting services is recognized upon providing services to the customer. Maintenance agreement revenue is recognized as services are rendered. Rental revenue is recognized over the terms of the respective rental agreements. Deferred income represents payments received before a product is shipped. Revenue from the sale of rental units is included in sales revenue when equipment is shipped or title is transferred to the customer.

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From time to time, upon the customer's written request, we recognize revenue when manufacturing is complete and the equipment is ready for shipment. At the customer's request, we will bill the customer upon completing all performance obligations, but before shipment. The customer will formally request we ship the equipment per their direction from our manufacturing facility at a later specified date and that we segregate the equipment from our finished goods, such that they are not available to fill other orders. Title of the equipment and risk of loss passes to the customer when the equipment is complete and ready for shipment, per the customer's agreement. At the transfer of title, all risks of ownership has passed to the customer on the manufactured items that have not yet been shipped. We have operated using bill and hold agreements with certain customers for many years, with consistent satisfactory results for both the customer and us. The credit terms on this agreement are consistent with the credit terms on all other sales. All risks of loss are shouldered by the customer, and there are no exceptions to the customer's commitment to accept and pay for this manufactured equipment. Revenues recognized at the completion of manufacturing in 2017 and 2016 were approximately \$4.6 million and \$5.6 million, respectively.

Major Customers and Concentration of Credit Risk

Sales and rental income to Occidental Permian, LTD. ("Oxy") and Devon Energy Production, Inc. ("Devon") in 2017 amounted to 20% and 15% of revenue, respectively. Sales and rental income to Devon and Oxy in 2016 amounted to 21% and 19% of revenue, respectively. Sales and rental income to Devon and Oxy in 2015 amounted to 21% and 10% of revenue. No other single customer accounted for more than 10% of our revenues in 2017, 2016 or 2015. Oxy amounted to 14% of our accounts receivable as of December 31, 2017. Oxy, APR Energy, LLC and BP America Inc. amounted to 15%, 15% and 14%, respectively, of our accounts receivable as of December 31, 2016. No other customers amounted to more than 10% of our accounts receivable as of December 31, 2017 and 2016.

Inventory

Inventory (current and long-term) is valued at the lower of cost and net realizable value. The cost of inventories is determined by the weighted average method. A reserve is recorded against inventory balances for estimated obsolescence. This reserve is based on specific identification and historical experience and totaled \$15,000 and \$15,000 at December 31, 2017 and 2016, respectively. There were 7 newly completed compressor units at December 31, 2017 and December 31, 2016 available for sale or for use in our rental fleet. Our long-term inventory consists of raw materials that remain viable but that the Company does not expect to sell within the next year. At December 31, 2017 and 2016, inventory consisted of the following (in thousands):

| | 2017 | 2016 |
|---------------------------|----------|----------|
| Raw materials -current | \$22,813 | \$15,877 |
| Raw materials - long term | 2,829 | 2,488 |
| Finished Goods | 1,022 | 2,558 |
| Work in process | 2,389 | 2,998 |
| Total | \$29,053 | \$23,921 |

Rental Equipment and Property and Equipment

Rental equipment and property and equipment are recorded at cost less accumulated depreciation, except for work-in-progress on new rental equipment which is recorded at cost until it's complete and added to the fleet. At December 31 2017 and 2016, we had \$6.4 million and \$1.9 million in rental equipment work-in-progress, respectively. Depreciation is computed using the straight-line method over the estimated useful lives of the assets. Our rental equipment has an estimated useful life of 15 years, while our property and equipment has an estimate useful lives which range from three to thirty-nine years. The majority of our property and equipment, including rental

equipment, is a direct cost to generating revenue and the following table depicts the depreciation associated with each product line at December 31, 2017, 2016 and 2015 (in thousands):

| | 2017 | 2016 | 2015 |
|-----------------------|----------|----------|----------|
| Rentals | \$20,861 | \$21,325 | \$22,308 |
| Sales | 265 | 291 | 281 |
| Service & Maintenance | 21 | 25 | 16 |
| Total | \$21,147 | \$21,641 | \$22,605 |

We assess the impairment of rental equipment and property and equipment whenever events or changes in circumstances indicate that the net recorded amount may not be recoverable. The following factors could trigger an impairment review: significant

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underperformance relative to historical or projected future cash flows, significant adverse changes in the extent or manner in which asset is being used or its condition, significant negative industry trends or legislative changes prohibiting us from leasing our units or flares. An impairment loss is recognized if the future undiscounted cash flows associated with the asset and the estimated fair value of the asset are less than the asset's carrying value. We recognized no impairments in years ended December 31, 2017, 2016 or 2015.

Gains and losses resulting from sales and dispositions of property and equipment are included in current operations. Maintenance and repairs are charged to operations as incurred.

Goodwill

Goodwill represents the cost in excess of fair value of the identifiable net assets acquired. Goodwill is tested for impairment annually or whenever events indicate impairment may have occurred. Due to continued low oil and natural gas prices, we determined a triggering event occurred during each quarter and we performed a goodwill impairment test each quarter of 2017 and our annual goodwill impairment test was performed in the fourth quarter of 2017. We experienced no impairment of goodwill during the years ended December 31, 2017 or 2016.

Intangibles

At December 31, 2017, NGSG had intangible assets, which relate to developed technology and a trade name. The carrying amount net of accumulated amortization at December 31, 2017 and 2016 was \$1.5 million and \$1.7 million respectively. Developed technology is amortized on a straight-line basis with a useful life of 20 years, with a weighted average remaining life of approximately seven years as of December 31, 2017. Amortization expense recognized in each of the years ending December 31, 2017, 2016, and 2015 was \$125,000. Estimated amortization expense for the years 2018-2024 is \$125,000 per year. NGSG has an intangible asset with a gross carrying value of \$654,000 at December 31, 2017 related to the trade name of SCS which was acquired in our acquisition of Screw Compression Systems in January 2005. This asset is not being amortized as it has been deemed to have an indefinite life.

The following table represents the identified intangible assets by major asset class (in thousands):

| | | December 31, 2017 | | | December 31, 2016 | | |
|----------------------|---------------------|----------------------|--------------------------|----------------|----------------------|--------------------------|----------------|
| | Useful Life (years) | Gross Carrying Value | Accumulated Amortization | Net Book Value | Gross Carrying Value | Accumulated Amortization | Net Book Value |
| Developed Technology | 20 | \$2,505 | \$ 1,633 | \$872 | \$2,505 | \$ 1,508 | \$997 |
| Trade Name | Indefinite | 654 | — | 654 | 654 | — | 654 |
| Total | | \$3,159 | \$ 1,633 | \$1,526 | \$3,159 | \$ 1,508 | \$1,651 |

Our policy is to periodically review intangibles for impairment through an assessment of the estimated future cash flows related to such assets. In the event that assets are found to be carried at amounts in excess of estimated undiscounted future cash flows, then the assets will be adjusted for impairment to a level commensurate with a discounted cash flow analysis of the underlying assets. Based upon our analysis, we experienced no impairment of intangible assets during the years ended December 31, 2017 or 2016. Separately, we reviewed our indefinite life intangible for impairment with our goodwill impairment review, which we performed each quarter in 2017 due to a continued decline in our rental utilization and then annually in the fourth quarter of 2017. Based on this analysis, we experienced no impairment on our indefinite life intangible during the years ended December 31, 2017 or 2016.

Warranty

We accrue amounts for estimated warranty claims based upon current and historical product warranty costs and any other related information known. The warranty reserve was \$65,000 and \$103,000 for December 31, 2017 and 2016, respectively, and is included in accrued liabilities on the consolidated balance sheet.

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Financial Instruments and Concentrations of Credit Risk

We invest our cash primarily in deposits and money market funds with commercial banks. At times, cash balances at banks and financial institutions may exceed federally insured amounts.

Per Share Data

Basic earnings per common share is computed using the weighted average number of common shares outstanding during the period. Diluted earnings per common share is computed using the weighted average number of common stock and common stock equivalent shares outstanding during the period. There were anti-dilutive securities in 2017, 2016 and 2015.

The following table sets forth the computation of basic and diluted earnings per share (in thousands, except per share amounts):

| | Year Ended December | | |
|--|---------------------|---------|----------|
| | 31, | | |
| | 2017 | 2016 | 2015 |
| Numerator: | | | |
| Net income | \$19,851 | \$6,469 | \$10,147 |
| Denominator for basic net income per common share: | | | |
| Weighted average common shares outstanding | 12,831 | 12,702 | 12,567 |
| Denominator for diluted net income per share: | | | |
| Weighted average common shares outstanding | 12,831 | 12,702 | 12,567 |
| Dilutive effect of stock options and restricted shares | 279 | 233 | 226 |
| Diluted weighted average shares | 13,110 | 12,935 | 12,793 |
| Earnings per common share: | | | |
| Basic | \$1.55 | \$0.51 | \$0.81 |
| Diluted | \$1.51 | \$0.50 | \$0.79 |

In the year-ended December 31, 2017, options to purchase 83,917 shares of common stock with exercise prices ranging from \$28.15 to \$33.36 were not included in the computation of dilutive income per share, due to their anti-dilutive effect.

In the year-ended December 31, 2016, options to purchase 51,167 shares of common stock with exercise prices ranging from \$30.41 to \$33.36 were not included in the computation of dilutive income per share, due to their anti-dilutive effect.

In the year-ended December 31, 2015, options to purchase 107,500 shares of common stock with exercise prices ranging from \$22.90 to \$33.36 were not included in the computation of dilutive income per share, due to their anti-dilutive effect.

Income Taxes

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to temporary differences between the financial statement carrying amounts of assets and liabilities and their respective tax bases, and operating losses and tax credit carry-forwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled.

ASC Topic 740 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. In order to record any financial statement benefit, we are required to determine, based on technical merits of the position, whether it is more likely than not (a likelihood of more than 50 percent) that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes. If that step is satisfied, then we must measure the tax position to determine the amount of benefit to recognize in the financial statements. The tax position is measured at the largest amount of the benefit that is greater than 50 percent likely of being realized upon ultimate settlement. We have no uncertain tax positions as of December 31, 2017 or 2016.

Our policy regarding income tax interest and penalties is to expense those items as other expense.

On December 22, 2017, the U.S. government enacted comprehensive tax legislation commonly referred to as the Tax Cuts and Jobs Act (the “2017 Tax Act”), which makes broad and complex changes to the U.S. tax code. Certain income tax effects

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of the 2017 Tax Act are reflected in the Company's financial results in accordance with Staff Accounting Bulletin No. 118 ("SAB 118"), which provides SEC staff guidance regarding the application of Accounting Standards Codification Topic 740 Income Taxes ("ASC 740"). As we do not have all of the necessary information to analyze all income tax effects of the 2017 Tax Act, we will continue to evaluate tax reform and adjust the provisional amounts as additional information is obtained. We expect to complete our detailed analysis no later than the fourth quarter of 2018. See Note 7, "Income Taxes," for further information on the financial statement impact of the 2017 Tax Act.

Fair Value Measurement

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date under current market conditions. ASC Topic 820 established a fair value hierarchy, which requires an entity to maximize the use of observable inputs when measuring fair value. These inputs are categorized as follows:

Level 1- quoted prices in an active market for identical assets or liabilities;

Level 2- quoted prices in an active market for similar assets or liabilities, inputs other than quoted prices that are observable for similar assets or liabilities, inputs derived principally from or corroborated by observable market data by correlation or other means; and

Level 3- valuation methodology with unobservable inputs that are significant to the fair value measurement.

Management believes that the fair value of our cash and cash equivalents, trade receivables, accounts payable and line of credit at December 31, 2017 and 2016 approximate their carrying values due to the short-term nature of the instruments or the use of prevailing market interest rates.

Segments and Related Information

ASC 280-10-50, "Operating Segments", define the characteristics of an operating segment as a) being engaged in business activity from which it may earn revenue and incur expenses, b) being reviewed by the company's chief operating decision maker (CODM) for decisions about resources to be allocated and assess its performance and c) having discrete financial information. Although we indeed look at our products to analyze the nature of our revenue, other financial information, such as certain costs and expenses, net income and EBITDA are not captured or analyzed by these categories. Our CODM does not make resource allocation decisions or assess the performance of the business based on these categories, but rather in the aggregate. Based on this, management believes that it operates in one business segment.

In their analysis of product lines as potential operating segments, management also considered ASC 280-10-50-11, "Aggregation Criteria", which allows for the aggregation of operating segments if the segments have similar economic characteristics and if the segments are similar in each of the following areas:

- The nature of the products and services;
- The nature of the production processes;
- The type or class of customer for their products and services;
- The methods used to distribute their products or provide their services; and

- The nature of the regulatory environment, if applicable.

We are engaged in the business of designing and manufacturing compressors and flares. Our compressors and flares are sold and rented to our customers. In addition, we provide service and maintenance on compressors in our fleet and to third parties. These business activities are similar in all geographic areas. Our manufacturing process is essentially the same for the entire Company and is performed in house at our facilities in Midland, Texas and Tulsa, Oklahoma. Our customers primarily consist of entities in the business of producing natural gas. The maintenance and service of our products is consistent across the entire Company and is performed via an internal fleet of vehicles. The regulatory environment is similar in every jurisdiction in that the most impacting regulations and practices are the result of federal energy policy. In addition, the economic characteristics of each customer arrangement are similar in that we maintain policies at the corporate level.

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Recently Issued Accounting Pronouncements

On February 25, 2016, the Financial Accounting Standards Board ("FASB") issued ASU No. 2016-02, Leases (Topic 842). Under the new guidance, a lessee will be required to recognize assets and liabilities for capital and operating leases with lease terms of more than 12 months. Additionally, this ASU will require disclosures to help investors and other financial statement users better understand the amount, timing, and uncertainty of cash flows arising from leases, including qualitative and quantitative requirements. For public business entities, the amendments are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years, with early adoption permitted. The new standard will be effective during our first quarter ending March 31, 2019. We are currently determining the impacts of the new standard on our consolidated financial statements and the additional applicable disclosure requirements.

On May 28, 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606). This update provides a five-step analysis on how an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. This guidance also requires more detailed disclosures to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. In August 2015, the FASB issued an accounting standards update for a one-year deferral of the revenue recognition standard's effective date for all entities, which changed the effectiveness to interim and annual reporting periods beginning after December 15, 2017. As a result, we adopted the guidance on January 1, 2018. The guidance offered two transition methods: a full retrospective approach to be applied to each prior reporting period presented or a modified retrospective approach where the cumulative effect of initially applying the standard is recognized at the date of initial application. We have selected the modified retrospective transition method. We have determined the impact of the new standard on our consolidated financial statements. Our approach included performing a detailed review of key contracts that are representative of our various revenue streams and comparing our historical accounting policies and practices to the new standard. Based upon our analysis, we have determined there will be no material financial impact upon adoption, but we will have a change in our disclosures under the new standard and have implemented new internal controls to ensure compliance under this new standard.

Reclassification of Prior Period Balances

Certain reclassifications have been made to prior period amounts to conform to the current-year presentation. These reclassifications had no effect on the reported results of operations.

2. Rental Activity

We rent natural gas compressor packages to entities in the petroleum industry. These rental arrangements are classified as operating leases and generally have original terms of six months to twenty-four months and continue on a month-to-month basis thereafter. Depreciation expense for rental equipment was \$20.0 million, \$20.2 million and \$21.0 million for the years ended December 31, 2017, 2016 and 2015, respectively. Future minimum rent payments for arrangements not on a month-to-month basis at December 31, 2017 are as follows :

Years
Ending
December
31, (in

thousands)
2018 \$6,494
2019 976
2020 543
2021 542
2022 542
Total \$9,097

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3. Property and Equipment

Property and equipment consists of the following at December 31, 2017 and 2016 (in thousands):

| | Useful Lives (Years) | 2017 | 2016 |
|--------------------------------|----------------------|----------|----------|
| Land | — | \$1,290 | \$169 |
| Building | 39 | 6,116 | 6,856 |
| Leasehold improvements | 39 | 808 | 794 |
| Office equipment and furniture | 5 | 1,490 | 1,454 |
| Software | 5 | 573 | 573 |
| Machinery and equipment | 7 | 3,133 | 3,111 |
| Vehicles | 3 | 5,516 | 6,063 |
| Total | | 18,926 | 19,020 |
| Less accumulated depreciation | | (11,274) | (11,267) |
| Total | | \$7,652 | \$7,753 |

Depreciation expense for property and equipment was \$1.2 million, \$1.4 million and \$1.6 million for the year ended December 31, 2017, 2016 and 2015, respectively.

In 2017, the Midland fabrication facility suffered two separate damages, due to hailstorms. We did not incur a loss, as our insurance proceed fully cover the estimated cost for the repair. In accordance with ASC 605-40, we reduced the value of the building for these damages.

4. Retirement of Long-Lived Assets

During the annual review of our rental compressor units, management looks for any units that are not of the type, configuration, make or model that our customers are demanding or that were not cost efficient to refurbish, maintain and/or operate. We had no retirement from our rental fleet in 2017. From our review in 2016, we determined 63 units should be retired from our rental fleet with key components from those units being re-utilized in future unit builds and/or repairs. We performed an optimization review and recorded a \$545,000 loss on retirement of rental equipment to reduce the book value of each unit to the estimated fair value of approximately \$242,000 for key components being kept. As a result of our 2015 review, we retired 258 units from our rental fleet with key components from those units being re-utilized in future unit builds and/or repairs. Based on our optimization review we recorded a \$4.4 million loss on the retirement of rental equipment to reduce the book value of each unit to the estimated fair value of approximately \$967,000 for the key components being kept. These retirements are recorded in the consolidated income statement under loss on retirement of rental equipment.

5. Deferred Compensation Plans

Effective January 1, 2016, the Company established a non-qualified deferred compensation plan for executive officers, directors and certain eligible employees. The assets of the deferred compensation plan are held in a rabbi trust and are subject to additional risk of loss in the event of bankruptcy or insolvency of the Company. The plan allows for deferral up to 90% of a participant's base salary, bonus, commissions, director fees and restricted stock awards. A Company owned life insurance policy held in a rabbi trust is utilized as a source of funding for the plan. The cash surrender value of the life insurance policy is \$894,000 and \$207,000 as of December 31, 2017 and 2016, respectively, with a gain related to the policy of \$66,400 and \$13,900 reported in other income in our consolidated

income statement for the year ended December 31, 2017 and 2016, respectively.

For deferrals of base salary, bonus, commissions and director fees, settlement payments are made to participants in cash, either in a lump sum or in periodic installments. The deferred obligation to pay the deferred compensation and the deferred director fees is adjusted to reflect the positive or negative performance of investment measurement options selected by each participant and was \$866,000 and \$208,000 as of December 31, 2017 and 2016, respectively. The deferred obligation is included in other long-term liabilities in the consolidated balance sheet.

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For deferrals of restricted stock, the plan does not allow for diversification, therefore, distributions are paid in shares and the obligation is carried at grant value. As of December 31, 2017, a total of \$97,011 unvested restricted stock units have been deferred.

6. Credit Facility

We have a senior secured revolving credit agreement with JP Morgan Chase Bank, N.A (the "Amended Credit Agreement") aggregate commitment of \$30 million, subject to collateral availability. We also have a right to request from the Lender, on an uncommitted basis, an increase of up to \$20 million on the aggregate commitment (which could potentially increase the commitment amount to \$50 million). On August 31, 2017, we amended and renewed the Amended Credit Agreement, which was set to expire on December 31, 2017. The Credit Agreement Amendment extends the maturity date to December 31, 2020. No other material revisions were made to the credit facility.

Borrowing Base. At any time before the maturity of the Amended Credit Agreement, we may draw, repay and re-borrow amounts available under the borrowing base up to the maximum aggregate availability discussed above. Generally, the borrowing base equals the sum of (a) 80% of our eligible accounts receivable plus (b) 50% of the book value of our eligible general inventory (not to exceed 50% of the commitment amount at the time) plus (c) 75% of the book value of our eligible equipment inventory. JPMorgan Chase Bank (the "Lender") may adjust the borrowing base components if material deviations in the collateral are discovered in future audits of the collateral. We had \$29.5 million borrowing base availability at December 31, 2017 under the terms of our Amended Credit Agreement.

Interest and Fees. Under the terms of the Amended Credit Agreement, we have the option of selecting the applicable variable rate for each revolving loan, or portion thereof, of either (a) LIBOR multiplied by the Statutory Reserve Rate (as defined in the Amended Credit Agreement), with respect to this rate, for Eurocurrency funding, plus the Applicable Margin ("LIBOR-based"), or (b) CB Floating Rate, which is the Lender's Prime Rate less the Applicable Margin; provided, however, that no more than three LIBOR-based borrowings under the agreement may be outstanding at any one time. For purposes of the LIBOR-based interest rate, the Applicable Margin is 1.50%. For purposes of the CB Floating Rate, the Applicable Margin is 1.25%.

Accrued interest is payable monthly on outstanding principal amounts, provided that accrued interest on LIBOR-based loans is payable at the end of each interest period, but in no event less frequently than quarterly. In addition, fees and expenses are payable in connection with our requests for letters of credit (generally equal to the Applicable Margin for LIBOR-related borrowings multiplied by the face amount of the requested letter of credit) and administrative and legal costs.

Maturity . The maturity date of the Amended Credit Agreement is December 31, 2020, at which time all amounts borrowed under the agreement will be due and outstanding letters of credit must be cash collateralized. The agreement may be terminated early upon our request or the occurrence of an event of default.

Security. The obligations under the Amended Credit Agreement are secured by a first priority lien on all of our inventory and accounts and lease receivables, along with a first priority lien on a variable number of our leased compressor equipment the book value of must be maintained at a minimum of 2.00 to 1.00 commitment coverage ratio (such ratio being equal to (i) the amount of the borrowing base as of such date to (ii) the amount of the commitment as of such date.)

Covenants. The Amended Credit Agreement contains customary representations and warranties, as well as covenants which, among other things, limit our ability to incur additional indebtedness and liens; enter into transactions with affiliates; make acquisitions in excess of certain amounts; pay dividends; redeem or repurchase capital stock or senior

notes; make investments or loans; make negative pledges; consolidate, merge or effect asset sales; or change the nature of our business. In addition, we also have certain financial covenants that require us to maintain a leverage ratio less than or equal to 2.50 to 1.00 as of the last day of each fiscal quarter.

Events of Default and Acceleration. The Amended Credit Agreement contains customary events of default for credit facilities of this size and type, and includes, without limitation, payment defaults; defaults in performance of covenants or other agreements contained in the loan documents; inaccuracies in representations and warranties; certain defaults, termination events or similar events; certain defaults with respect to any other Company indebtedness in excess of \$50,000; certain bankruptcy or insolvency events; the rendering of certain judgments in excess of \$150,000; certain ERISA events; certain change in control events and the defectiveness of any liens under the secured revolving credit facility. Obligations under the Amended Credit Agreement may be accelerated upon the occurrence of an event of default.

As of December 31, 2017, we were in compliance with all covenants in our Amended Credit Agreement. A default under our Credit Agreement could trigger the acceleration of our bank debt so that it is immediately due and payable. Such default would likely limit our ability to access other credit. At December 31, 2017 our balance on the line of credit was \$417,000. Our weighted average interest rate for the year ended December 31, 2017 was 1.60%.

7. Income Taxes

The provision for income taxes for the years ended December 31, 2017, 2016 and 2015, consists of the following (in thousands):

| | 2017 | 2016 | 2015 |
|---------------------------|------------|----------|----------|
| Current provision: | | | |
| Federal | \$3,074 | \$4,280 | \$6,440 |
| State | 260 | 429 | 523 |
| Total current provision | 3,334 | 4,709 | 6,963 |
| Deferred provision: | | | |
| Federal benefit | (21,582) | (2,713) | (1,846) |
| Total deferred benefit | (21,582) | (2,713) | (1,846) |
| Total (benefit) provision | \$(18,248) | \$1,996 | \$5,117 |

On December 22, 2017, the U.S. government enacted the 2017 Tax Act. The 2017 Tax Act makes broad and complex changes to the U.S. tax code that affects the Company's 2017 financial results. The 2017 Tax Act also establishes new tax laws that will affect the Company's financial results after 2017, including a reduction in the U.S. federal corporate income tax rate from 35 percent to 21 percent; additional limitations on the deductibility of executive compensation; limitations on the deductibility of interest; and repeal of the domestic manufacturing deduction. As such, the Company recognized a \$18.4 income tax benefit related to the re-measurement of our deferred tax assets and liabilities in our 2017 financial statements in accordance with SAB 118, which provides SEC staff guidance for the application of ASC 740 in the reporting period in which the 2017 Tax Act was signed into law. As we do not have all of the necessary information to analyze all income tax effects of the 2017 Tax Act, we will continue to evaluate tax reform and adjust the provisional amounts as additional information is obtained. We expect to complete our detailed analysis no later than the fourth quarter of 2018.

The income tax effects of temporary differences that give rise to significant portions of deferred income tax assets and (liabilities) as of December 31, 2017 and 2016, are as follows (in thousands):

| | 2017 | 2016 |
|---------------------------------------|------------|------------|
| Deferred income tax assets: | | |
| Stock Compensation | \$843 | \$664 |
| Other | 201 | 84 |
| Total deferred income tax assets | \$1,044 | \$748 |
| Deferred income tax liabilities: | | |
| Property and equipment | \$(32,377) | (53,120) |
| Goodwill and other intangible assets | (604) | (973) |
| Other | (226) | (400) |
| Total deferred income tax liabilities | (33,207) | (54,493) |
| Net deferred income tax liabilities | \$(32,163) | \$(53,745) |

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The effective tax rate for the years ended December 31, 2017, 2016 and 2015, differs from the statutory rate as follows:

| | 2017 | 2016 | 2015 |
|---|-----------|----------|----------|
| Statutory rate | 34.0 | % 34.0 | % 34.0 |
| State and local taxes | 1.5 | % 1.6 | % 1.5 |
| Domestic production credit | (14.3) |)% (5.4) |)% (3.6) |
| Permanent stock differences | (13.4) |)% 0.3 | % 1.1 |
| Other | (1.5) |)% (6.9) |)% 0.5 |
| Effective rate prior to tax act | 6.3 | % 23.6 | % 33.5 |
| Deferred re-measurement for rate change | (1,144.4) | % — | % — |
| Effective rate | (1,138.1) | % 23.6 | % 33.5 |

Our policy regarding income tax interest and penalties is to expense those items as general and administrative expense. During the years ended December 31, 2017, 2016 and 2015, there were no significant income tax interest or penalty items in the statement of income.

We file income tax returns in the U.S. federal jurisdiction and various state jurisdictions. With few exceptions, we are no longer subject to U.S. federal or state income tax examination by tax authorities for years before 2013.

8. Other Long-term Liabilities

We entered into a purchase agreement with a vendor on July 30, 2008 pursuant to which we agreed to purchase up to \$4.8 million of our paint and coating requirements exclusively from the vendor. In connection with the execution of the agreement, the vendor paid us a \$300,000 fee which is considered to be a discount toward future purchases from the vendor. The \$300,000 payment we received is recorded as a long-term liability and will decrease as the purchase commitment is fulfilled. The long-term liability remaining for the purchase commitment was \$92,000 and \$115,000 as of December 31, 2017 and 2016, respectively.

9. Stockholders' Equity

Preferred Stock

We have a total of 5.0 million authorized preferred shares with rights and preferences as designated by the Board of Directors. As of December 31, 2017 and 2016, there were no issued or outstanding preferred shares.

10. Stock-Based Compensation

Restricted Stock/Units

On June 18, 2014, at our annual meeting of shareholders, our shareholders approved a proposed amendment to the 2009 Restricted Stock/Unit Plan (the "Plan") to add additional 500,000 shares of common stock to the Plan, thereby authorizing the issuance of up to 800,000 shares of common stock under the Plan. In accordance with the Company's employment agreement with Stephen Taylor, the Company's Chief Executive Officer, the Compensation Committee

reviewed his performance in determining the issuance of restricted common stock. Based on this review which included consideration of the Company's 2016 performance, Mr. Taylor, was awarded 70,464 restricted shares/units on February 14, 2017, which vest over three years, in equal installments beginning February 14, 2018. On March 23, 2017, the Compensation Committee awarded 20,000 restricted shares/units to each G. Larry Lawrence, our CFO, and James Hazlett, our Vice President of Technical Services. The restricted shares/units to Messrs. Hazlett and Lawrence vest over three years, in equal installments, beginning March 23, 2018. We also awarded and issued 15,968 shares of restricted common stock/units to our Board of Directors as partial payment for 2017 directors' fees. The restricted stock/units issued to our directors vests over one year, in quarterly installments, beginning March 31, 2018. Compensation expense related to the restricted shares/units was approximately \$3,675,000, \$1,793,000 and \$2,944,000 for the years ended December 31, 2017, 2016, and 2015, respectively. As of December 31, 2017, there was a total of approximately

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\$1,385,000 of unrecognized compensation expense related to the nonvested portion of these restricted shares/units. This expense is expected to be recognized over the next one year and a quarter. As of December 31, 2017, 162,770 shares were still available for issuance under the Plan.

A summary of all restricted stock/units activity as of December 31, 2015, 2016 and 2017 and changes during the years then ended are presented below.

| | Number of Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Life (years) | Aggregate Intrinsic Value (in thousands) |
|--------------------------------|------------------------|--|--|--|
| Outstanding, December 31, 2014 | 99,238 | \$ 28.22 | 9.00 | \$ 2,286 |
| Granted | 145,558 | \$ 19.17 | — | \$ 2,886 |
| Vested | (99,238) | \$ 28.22 | — | \$ 2,100 |
| Canceled/Forfeited | — | \$ — | — | \$ — |
| Outstanding, December 31, 2015 | 145,588 | \$ 19.17 | 9.12 | \$ 3,246 |
| Granted | 139,451 | \$ 21.34 | — | \$ 3,007 |
| Vested | (145,558) | \$ 19.17 | — | \$ 2,963 |
| Canceled/Forfeited | — | \$ — | — | \$ — |
| Outstanding, December 31, 2016 | 139,451 | \$ 21.34 | 9.13 | \$ 4,483 |
| Granted | 126,432 | 27.06 | — | 3,421 |
| Vested | (81,494) | 21.20 | — | 2,361 |
| Canceled/Forfeited | — | — | — | — |
| Outstanding, December 31, 2017 | 184,389 | \$ 25.32 | 8.83 | \$ 4,831 |

Stock Option Plan

Our Stock Option Plan which is stockholder approved, permits the granting of stock options to its employees for up to 550,000 shares of common stock. On June 16, 2009, at our annual meeting of shareholders, our shareholders approved to add an additional 200,000 shares of common stock to the Stock Option Plan. On June 16, 2016, at our annual meeting of shareholders, our shareholders approved a proposed amendment to the Stock Option Plan to add an additional 250,000 shares of common stock to the Stock Option Plan, thereby authorizing the issuance of up to 1.0 million shares of common stock under the Stock Option Plan. We believe that such awards better align the interests of our employees with our stockholders. Option awards are generally granted with an exercise price equal to the market price of our stock at the date of grant; those option awards generally vest based on three years of continuous service and have ten-year contractual terms. Certain option and share awards provide for accelerated vesting if there is a change in control of the Company (as defined in the Stock Option Plan). The last date that grants can be made under the Stock Option Plan is February 28, 2026. As of December 31, 2017, 313,169 shares were still available for issue under the Stock Option Plan.

The fair value of each option award is estimated on the date of grant using the Black-Scholes option valuation model that uses the assumptions noted in the following table. The risk-free rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant. The expected life of options granted is based on the vesting period and historical exercise and post-vesting employment termination behavior for similar grants. We use historical data to estimate option exercise and employee termination within the valuation model; separate groups of employees that have similar historical exercise behavior are considered separately for valuation purposes.

| Weighted average Black -Scholes fair value assumption during the years ended December 31, are as follows: | 2017 | 2015 |
|---|---------|---------|
| Risk free rate | 2.12 % | 1.56 % |
| Expected life | 6 years | 6 years |
| Expected volatility | 39.59 % | 45.07 % |
| Expected dividend yield | — | — |

There were no stock option grants made in 2016.

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A summary of all option activity as of December 31, 2015, 2016 and 2017 and changes during the years then ended are presented below:

| | Number of Shares | Weighted Average Grant Date Fair Value | Weighted Average Remaining Contractual Life (years) | Aggregate Intrinsic Value (in thousands) |
|--------------------------------|------------------|--|---|--|
| Outstanding, December 31, 2014 | 432,269 | \$ 17.55 | 4.89 | \$ 2,786 |
| Granted | 50,000 | \$ 22.90 | | |
| Exercised | (66,000) | \$ 11.76 | | 481 |
| Canceled/Forfeited | (1,500) | \$ 30.41 | | \$ — |
| Outstanding, December 31, 2015 | 414,769 | \$ 19.07 | 5.08 | \$ 1,814 |
| Granted | — | \$ — | | |
| Exercised | (62,083) | \$ 16.79 | | 625 |
| Canceled/Forfeited | (2,500) | \$ 22.90 | | — |
| Outstanding, December 31, 2016 | 350,186 | \$ 19.45 | 4.25 | \$ 4,453 |
| Granted | 32,750 | 28.15 | | |
| Exercised | (55,666) | 20.12 | | 446 |
| Outstanding, December 31, 2017 | 327,270 | \$ 20.21 | 4.28 | \$ 2,255 |
| Exercisable, December 31, 2017 | 278,689 | \$ 19.12 | 3.54 | \$ 2,203 |

The weighted average grant date fair value of options granted during the years 2017 and 2015 was \$11.93 and \$10.33, respectively. The total intrinsic value, or the difference between the exercise price and the market price on the date of exercise, of options exercised during the years ended December 31, 2017, 2016, and 2015 was approximately \$446,000, \$625,000, and \$481,000 respectively. Cash received from stock options exercised during the years ended December 31, 2017, 2016, and 2015 was approximately \$1,120,000, \$1,042,000, and \$776,000, respectively.

The following table summarizes information about our stock options outstanding at December 31,:

| Range of Exercise Prices | Options Outstanding | | | Options Exercisable | |
|--------------------------|---------------------|---|---------------------------------|---------------------|---------------------------------|
| | Shares | Weighted Average Remaining Contractual Life (years) | Weighted Average Exercise Price | Shares | Weighted Average Exercise Price |
| \$0.01-15.70 | 65,852 | 1.56 | \$ 9.82 | 65,852 | \$ 9.82 |
| \$15.71-17.81 | 72,750 | 1.79 | \$ 17.53 | 72,750 | \$ 17.53 |
| \$17.82-20.48 | 56,750 | 3.54 | \$ 19.36 | 56,750 | \$ 19.36 |
| \$20.49-33.36 | 131,918 | 7.34 | \$ 27.23 | 83,337 | \$ 27.70 |
| | 327,270 | 4.28 | \$ 20.21 | 278,689 | \$ 19.12 |

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The summary of the status of our unvested stock options as of December 31, 2017 and changes during the year then ended is presented below.

| | Shares | Weighted Average Grant Date Fair Value |
|-------------------------------|----------|--|
| Unvested stock options: | | |
| Unvested at December 31, 2016 | 50,833 | \$ 12.67 |
| Granted | 32,750 | \$ 11.93 |
| Vested | (35,002) | \$ 13.73 |
| Unvested at December 31, 2017 | 48,581 | \$ 11.41 |

We recognized stock compensation expense from stock options vesting of \$363,000, \$506,000, and \$601,000 for the years ended December 31, 2017, 2016 and 2015, respectively. As of December 31, 2017, there was approximately \$282,000 of total unamortized compensation cost related to unvested stock options. We expect to recognize such cost over a weighted-average period of 2.0 years.

11. Commitments and Contingencies

401(k) Plan

We offer a 401(k) Plan to all employees that have reached the age of eighteen and have completed six months of service. The participants may contribute up to 100% of their salary subject to IRS limitations. Employer contributions are subject to Board discretion and are subject to a vesting schedule of 20% each year after the first year and 100% after six years. We contributed \$301,000, \$295,000, and \$387,000 to the 401(k) Plan in 2017, 2016 and 2015, respectively.

Rented Facilities, Vehicles and Equipment

We lease certain of our facilities and equipment under operating leases with terms generally ranging from month-to-month to five years. Most leases contain renewal options. Remaining future minimum rental payments (excluding month to month) due under these leases are as follows:

| | |
|--|-------|
| Years Ending December 31, (in thousands) | |
| 2018 | \$484 |
| 2019 | 122 |
| 2020 | 9 |
| 2021 | 1 |
| Total | \$616 |

Rent expense under such leases was \$310,000, \$325,000, and \$375,000 for the years ended December 31, 2017, 2016 and 2015, respectively.

Legal Proceedings

From time to time, we are a party to various legal proceedings in the ordinary course of our business. While management is unable to predict the ultimate outcome of these actions, it believes that any ultimate liability arising from these actions will not have a material effect on our financial position, results of operations or cash flow. We are not currently a party to any bankruptcy, receivership, reorganization, adjustment or similar proceeding, and we are not aware of any other threatened litigation.

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12. Quarterly Financial Data (in thousands, except per share data) – Unaudited

| 2017 | Q1 | Q2 | Q3 | Q4 | Total |
|--------------------------------|----------|----------|----------|----------|----------|
| Total revenue | \$18,902 | \$16,218 | \$15,913 | \$16,660 | \$67,693 |
| Operating income | 343 | 414 | 593 | 217 | 1,567 |
| Net income ⁽¹⁾ | 252 | 375 | 522 | 18,702 | 19,851 |
| Net income per share - Basic | 0.02 | 0.03 | 0.04 | 1.46 | 1.55 |
| Net income per share - Diluted | 0.02 | 0.03 | 0.04 | 1.42 | 1.51 |

(1) The increase in fourth quarter net income is largely a result of the 2017 Tax Act, see Note 7.

| 2016 | Q1 | Q2 | Q3 | Q4 | Total |
|--------------------------------|----------|----------|----------|----------|----------|
| Total revenue | \$21,576 | \$17,194 | \$16,181 | \$16,703 | \$71,654 |
| Operating income | 3,767 | 1,873 | 1,823 | 967 | 8,430 |
| Net income | 2,541 | 1,259 | 1,509 | 1,160 | 6,469 |
| Net income per share - Basic | 0.20 | 0.10 | 0.12 | 0.09 | 0.51 |
| Net income per share - Diluted | 0.20 | 0.10 | 0.12 | 0.09 | 0.50 |

Amounts may not add due to rounding differences.

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