

NATURAL GAS SERVICES GROUP INC
Form 10-Q
November 06, 2015

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

FORM 10-Q

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

For the quarterly period ended September 30, 2015

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

(State or other jurisdiction of
incorporation or organization)

508 W. Wall St., Ste 550

Midland, Texas 79701

(Address of principal executive offices)

(432) 262-2700

(Registrant's telephone number, including area code)

75-2811855

(I.R.S. Employer
Identification 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 whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer", "accelerated filer", and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if 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

APPLICABLE ONLY TO CORPORATE ISSUERS

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class

November 4, 2015

Common Stock, \$0.01 par value

12,745,999

Part I - FINANCIAL INFORMATION

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PART I – FINANCIAL INFORMATION

Item 1. Financial Statements

NATURAL GAS SERVICES GROUP, INC.

CONDENSED BALANCE SHEETS

(in thousands, except per share amounts)

(unaudited)

| | September 30, 2015 | December 31, 2014 |
|---|-----------------------|----------------------|
| ASSETS | | |
| Current Assets: | | |
| Cash and cash equivalents | \$29,978 | \$6,181 |
| Trade accounts receivable, net of allowance for doubtful accounts of \$845 and \$507, respectively | 7,557 | 10,408 |
| Inventory, net | 28,085 | 32,624 |
| Prepaid income taxes | 3,776 | 6,242 |
| Prepaid expenses and other | 553 | 472 |
| Total current assets | 69,949 | 55,927 |
| Rental equipment, net of accumulated depreciation of \$108,229 and \$106,179, respectively | 196,951 | 208,292 |
| Property and equipment, net of accumulated depreciation of \$11,164 and \$10,830, respectively | 8,875 | 7,362 |
| Goodwill | 10,039 | 10,039 |
| Intangibles, net of accumulated amortization of \$1,351 and \$1,257, respectively | 1,808 | 1,902 |
| Other assets | 60 | 41 |
| Total assets | \$287,682 | \$283,563 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current Liabilities: | | |
| Accounts payable | \$1,459 | \$4,990 |
| Accrued liabilities | 2,950 | 6,624 |
| Current income tax liability | 6,328 | 851 |
| Deferred income | 989 | 1,635 |
| Total current liabilities | 11,726 | 14,100 |
| Line of credit, non-current portion | 417 | 417 |
| Deferred income tax liability | 55,675 | 58,304 |
| Other long-term liabilities | 135 | 155 |
| Total liabilities | 67,953 | 72,976 |
| Commitments and contingencies (Note 8) | | |
| Stockholders' Equity: | | |
| Preferred stock, 5,000 shares authorized, no shares issued or outstanding | — | — |
| Common stock, 30,000 shares authorized, par value \$0.01; 12,597 and 12,466 shares issued and outstanding, respectively | 126 | 124 |
| Additional paid-in capital | 97,335 | 95,065 |
| Retained earnings | 122,268 | 115,398 |
| Total stockholders' equity | 219,729 | 210,587 |
| Total liabilities and stockholders' equity | \$287,682 | \$283,563 |

See accompanying notes to these unaudited condensed financial statements.

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

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|-------------------------------------|----------|------------------------------------|----------|
| | 2015 | 2014 | 2015 | 2014 |
| Revenue: | | | | |
| Rental income | \$18,491 | \$20,177 | \$58,806 | \$58,431 |
| Sales, net | 2,468 | 5,218 | 10,672 | 10,831 |
| Service and maintenance income | 234 | 204 | 686 | 611 |
| Total revenue | 21,193 | 25,599 | 70,164 | 69,873 |
| Operating costs and expenses: | | | | |
| Cost of rentals, exclusive of depreciation stated separately below | 7,327 | 8,110 | 22,062 | 23,815 |
| Cost of sales, exclusive of depreciation stated separately below | 1,740 | 3,493 | 7,706 | 6,826 |
| Cost of service and maintenance, exclusive of depreciation and amortization stated separately below | 70 | 101 | 151 | 269 |
| Loss on retirement of rental equipment | (3 |) — | 4,370 | — |
| Selling, general, and administrative expense | 2,667 | 2,527 | 8,131 | 7,860 |
| Depreciation and amortization | 5,594 | 5,528 | 17,240 | 15,816 |
| Total operating costs and expenses | 17,395 | 19,759 | 59,660 | 54,586 |
| Operating income | 3,798 | 5,840 | 10,504 | 15,287 |
| Other income (expense): | | | | |
| Interest expense | (7 |) (4 |) (13 |) (9 |
| Other income | 20 | 131 | 67 | 183 |
| Total other income, net | 13 | 127 | 54 | 174 |
| Income before provision for income taxes | 3,811 | 5,967 | 10,558 | 15,461 |
| Provision for income taxes | 1,249 | 2,084 | 3,688 | 5,337 |
| Net income | \$2,562 | \$3,883 | \$6,870 | \$10,124 |
| Earnings per share: | | | | |
| Basic | \$0.20 | \$0.31 | \$0.55 | \$0.81 |
| Diluted | \$0.20 | \$0.30 | \$0.54 | \$0.80 |
| Weighted average shares outstanding: | | | | |
| Basic | 12,586 | 12,461 | 12,557 | 12,424 |
| Diluted | 12,801 | 12,740 | 12,783 | 12,728 |

See accompanying notes to these unaudited condensed financial statements.

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

| | Nine months ended September 30, | |
|---|------------------------------------|------------------|
| | 2015 | 2014 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | \$6,870 | \$10,124 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 17,240 | 15,816 |
| Deferred income taxes | (2,629 |) (226 |
| Stock based compensation | 2,616 | 2,438 |
| Bad debt allowance | 402 | — |
| Inventory allowance | 70 | 395 |
| Gain on sale of assets | (81 |) (159 |
| Loss on retirement of rental equipment | 4,370 | — |
| Changes in current assets and liabilities: | | |
| Trade accounts receivables | 2,449 | (2,762 |
| Inventory | 3,912 | (4,895 |
| Prepaid expenses | 2,287 | (3,024 |
| Accounts payable and accrued liabilities | (7,107 |) 2,785 |
| Current income tax liability | 5,086 | 5,290 |
| Deferred income | (646 |) 1,140 |
| Other | (19 |) (11 |
| Tax benefit from equity compensation | — | (414 |
| NET CASH PROVIDED BY OPERATING ACTIVITIES | 34,820 | 26,497 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchase of property and equipment | (11,163 |) (46,388 |
| Proceeds from sale of property and equipment | 113 | 239 |
| NET CASH USED IN INVESTING ACTIVITIES | (11,050 |) (46,149 |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Payments from other long-term liabilities, net | (20 |) (33 |
| Repayments of line of credit, net | — | (160 |
| Proceeds from exercise of stock options | 733 | 61 |
| Taxes paid related to net share settlement of equity awards | (686 |) — |
| Tax benefit from equity compensation | — | 414 |
| NET CASH PROVIDED BY FINANCING ACTIVITIES | 27 | 282 |
| NET CHANGE IN CASH AND CASH EQUIVALENTS | 23,797 | (19,370 |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD | 6,181 | 24,443 |
| CASH AND CASH EQUIVALENTS AT END OF PERIOD | \$29,978 | \$5,073 |
| SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION: | | |
| Interest paid | \$13 | \$9 |
| Income taxes paid | \$3,185 | \$4,968 |
| NON-CASH TRANSACTIONS | | |
| Transfer of rental equipment components to inventory | \$1,065 | \$— |
| Transfer from inventory to property and equipment | \$1,622 | \$53 |
| See accompanying notes to these unaudited condensed financial statements. | | |

Natural Gas Services Group, Inc.
Notes to Condensed Financial Statements
(unaudited)

(1) Basis of Presentation and Summary of Significant Accounting Policies

These notes apply to the unaudited condensed financial statements of Natural Gas Services Group, Inc. a Colorado corporation (the "Company", "NGSG", "Natural Gas Services Group", "we" or "our").

The accompanying unaudited condensed financial statements include all adjustments, consisting of only normal recurring adjustments, which are necessary to make our financial position at September 30, 2015 and the results of our operations for the three months and nine months ended September 30, 2015 and 2014 not misleading. As permitted by the rules and regulations of the Securities and Exchange Commission (SEC), the accompanying condensed financial statements do not include all disclosures normally required by generally accepted accounting principles in the United States of America (GAAP). These financial statements should be read in conjunction with the financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2014 on file with the SEC. In our opinion, the condensed financial statements are a fair presentation of the financial position, results of operations and cash flows for the periods presented.

The results of operations for the three and nine months ended September 30, 2015 are not necessarily indicative of the results of operations to be expected for the full fiscal year ending December 31, 2015.

Revenue Recognition

Revenue from the sales of custom and fabricated compressors, and flare systems is recognized upon shipment of the equipment to customers or when all conditions have been met and title is transferred to the 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 based upon the classification of the rental agreement. 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.

Fair Value of Financial Instruments

Our financial instruments consist principally of cash and cash equivalents, accounts receivable, accounts payable and our line of credit. Pursuant to ASC 820 (Accounting Standards Codification), the fair value of our cash equivalents is determined based on "Level 1" inputs, which consist of quoted prices in active markets for identical assets. We believe that the recorded values of all of our other financial instruments approximate their fair values because of their nature and relatively short maturity dates or durations.

Recently Issued Accounting Pronouncements

On May 28, 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-09, Revenue from Contracts with Customers (Topic 606), as part of a joint project with the International Accounting Standards Board (IASB) to clarify revenue-recognizing principles and develop a common revenue standard for U.S. GAAP and International Financial Reporting Standards (IFRS). ASU No. 2014-09 finalizes Proposed ASU Nos. 1820-100, 2011-230 and 2011-250 and is expected, among other things, to remove inconsistencies and weaknesses in revenue requirements and improve comparability of revenue recognition practices

across entities, industries, jurisdictions and capital markets. In particular, the amendments in this ASU will be added to the FASB Accounting Standards Codification (FASB ASC) as Topic 606, Revenue from Contracts with Customers, and will supersede the revenue recognition requirements in FASB ASC 605, Revenue Recognition, as well as some cost guidance in FASB ASC Subtopic 605-35, Revenue Recognition-Construction-Type and Production-Type Contracts. The core principle of this ASU is that 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. To achieve this core principle, the guidance provides that an entity should apply the following steps: (1) identify the contract(s) with a customer; (2) identify the performance obligation in the contract; (3) determine the transaction price; (4) allocate the transaction price to the performance obligations in the contract; and (5) recognize revenue when, or as, the entity satisfies a performance obligation. On July 9, 2015, the FASB approved the deferral of the effective date of ASU No. 2014-09, by one year. For public entities, the amendments are effective for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period, and early application is prohibited. Additionally, an entity should apply the amendments either

retrospectively to each prior reporting period presented or retrospectively with the cumulative effect of initially applying this ASU recognized at the date of initial application. If an entity elects the latter, transition method, then it must also provide the additional disclosures in reporting periods that include the date of initial application of (1) the amount by which each financial statement line item is affected in the current reporting period, as compared to the guidance that was in effect before the change, and (2) an explanation of the reasons for significant changes. The new standard will be effective during our first quarter ending March 31, 2018. We are currently evaluating the new standard to determine which reporting option allows us to report the most meaningful information and are still evaluating the potential impact this new standard may have on our financial statements.

On July 22, 2015, the FASB issued ASU No. 2015-11, Simplifying the Measurement of Inventory (Topic 330), which finalizes Proposed ASU No. 2014-210 of the same name, and responds to stakeholders' concerns that the guidance regarding the measurement of inventory is unnecessarily complex because there are several potential outcomes. In particular, the amendments in this ASU will be added to the FASB ASC under Topic 330, Inventory. The core principle of this ASU is that an entity should measure inventory at the lower of cost and net realizable value. Net realizable value is the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, retirement, and transportation. Subsequent measurement is unchanged for inventory measured using last-in, first-out (LIFO) or the retail inventory method. The amendments more closely align the measurement of inventory in GAAP with the measurement of inventory in IFRS. For public business entities, the amendments are effective for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years. The amendments should be applied prospectively with earlier application permitted as of the beginning of an interim or annual reporting period. The new standard will be effective during our first quarter ending March 31, 2017. We are currently evaluating the potential impact this new standard may have on our financial statements.

(2) Stock-Based Compensation

Stock Options:

A summary of option activity under our 1998 Stock Option Plan as of December 31, 2014, and changes during the nine months ended September 30, 2015 is presented below.

| | Number of Stock Options | Weighted Average Exercise Price | Weighted Average Remaining Contractual Life (years) | Aggregate Intrinsic Value (in thousands) |
|---------------------------------|-------------------------------|--|---|---|
| Outstanding, December 31, 2014 | 432,269 | \$ 17.55 | 10.10 | \$2,786 |
| Granted | 50,000 | 22.90 | | |
| Exercised | (63,500 |) 11.56 | | |
| Canceled/Forfeited | (1,500 |) 30.41 | | |
| Outstanding, September 30, 2015 | 417,269 | \$ 19.06 | 5.31 | \$954 |
| Exercisable, September 30, 2015 | 313,766 | \$ 17.10 | 4.12 | \$947 |

The following table summarizes information about our stock options outstanding at September 30, 2015:

| 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 | 94,852 | 3.48 | \$ 11.23 | 94,852 | \$ 11.23 |
| \$15.71-17.81 | 95,250 | 3.93 | 17.55 | 95,250 | 17.55 |
| \$17.82-20.48 | 119,667 | 4.52 | 19.58 | 106,167 | 19.69 |
| \$20.49-33.36 | 107,500 | 9.00 | 26.72 | 17,497 | 30.69 |
| | 417,269 | 5.31 | \$ 19.06 | 313,766 | \$ 17.10 |

The summary of the status of our unvested stock options as of December 31, 2014 and changes during the nine months ended September 30, 2015 is presented below.

| | Shares | Weighted Average Grant Date Fair Value |
|--------------------------------|---------|---|
| Unvested stock options: | | |
| Unvested at December 31, 2014 | 91,834 | \$14.19 |
| Granted | 50,000 | 10.33 |
| Vested | (36,831 |) 13.12 |
| Canceled/Forfeited | (1,500 |) 16.79 |
| Unvested at September 30, 2015 | 103,503 | \$12.66 |

As of September 30, 2015, there was \$868,663 of unrecognized compensation cost related to unvested options. Such cost is expected to be recognized over a weighted-average period of 1.8 years. Total compensation expense for stock

options was \$429,925 and \$297,522 for the nine months ended September 30, 2015 and 2014, respectively.

Restricted Stock:

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 2014 performance, Mr. Taylor, was awarded 83,590 restricted shares on January 16, 2015, which vest one year from the date of grant. On March 19, 2015, the Compensation Committee awarded 20,000 shares of restricted common stock to each of G. Larry Lawrence, our CFO, and James Hazlett, our Vice President of Technical Services. The restricted shares to Messrs. Hazlett and Lawrence vest one year from the grant date. We also awarded and issued 21,968 shares of restricted common stock to our Board of Directors as partial payment for 2015 directors' fees. The restricted stock issued to our directors vests over one year, in quarterly installments, beginning March 31, 2016. Total compensation expense related to restricted stock awards was \$2,186,330 and \$2,140,233 for the nine months ended September 30, 2015 and 2014, respectively. As of September 30, 2015, there was a total of \$1,211,952 of unrecognized compensation expense related to these shares which is expected to be recognized over the next fifteen months.

(3) Inventory

Our inventory, net of allowance for obsolescence of \$295,500 and \$225,000 at September 30, 2015 and December 31, 2014, respectively, consisted of the following amounts:

| | September 30, 2015 (in thousands) | December 31, 2014 |
|-----------------|--------------------------------------|-------------------|
| Raw materials | \$23,606 | \$25,984 |
| Work in process | 4,479 | 6,640 |
| | \$28,085 | \$32,624 |

During the nine months ended September 30, 2015 and 2014, there were no write-offs of obsolete inventory against the allowance for obsolescence.

(4) Retirement of Long-Lived Assets

As a result of a decline in market conditions during the first half of 2015, management reviewed our rental compressor units that were not of the type, configuration, make or model that our customers were demanding or that were not cost efficient to refurbish, maintain and operate. As a result of that review, we determined that 258 units representing total horsepower of 32,259 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 \$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. The retirement is recorded in the condensed income statement under loss on retirement of rental equipment.

(5) Credit Facility

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).

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. 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 September 30, 2015 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 1.50%. For the nine month period ended September 30, 2015, our weighted average interest rate was 1.45%.

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, 2017, 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 which 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 on a consolidated basis 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 September 30, 2015, 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 September 30, 2015 and December 31, 2014 our outstanding balance on the line of credit was \$417,000.

(6) Earnings per Share

The following table reconciles the numerators and denominators of the basic and diluted earnings per share computation(in thousands, except per share data).

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|-------------------------------------|---------|------------------------------------|----------|
| | 2015 | 2014 | 2015 | 2014 |
| Numerator: | | | | |
| Net income | \$2,562 | \$3,883 | \$6,870 | \$10,124 |
| Denominator for basic net income per common share: | | | | |
| Weighted average common shares outstanding | 12,586 | 12,461 | 12,557 | 12,424 |
| Denominator for diluted net income per share: | | | | |
| Weighted average common shares outstanding | 12,586 | 12,461 | 12,557 | 12,424 |
| Dilutive effect of stock options and restricted stock | 215 | 279 | 226 | 304 |
| Diluted weighted average shares | 12,801 | 12,740 | 12,783 | 12,728 |
| Earnings per common share: | | | | |
| Basic | \$0.20 | \$0.31 | \$0.55 | \$0.81 |
| Diluted | \$0.20 | \$0.30 | \$0.54 | \$0.80 |

In the three and nine months ended September 30, 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 antidilutive effect.

In the three and nine months ended September 30, 2014, options to purchase 55,000 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 antidilutive effect.

(7) Segment Information

ASC 280-10-50, "Operating Segments", defines 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 and crude oil. 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.

For the three months ended September 30, 2015 (in thousands):

| | Rental | Sales | Service & Maintenance | Retirement of Rental Equipment | Corporate | Total |
|--|----------|---------|-----------------------|--------------------------------|-----------|-----------|
| Revenue | \$18,491 | \$2,468 | \$234 | \$— | \$— | \$21,193 |
| Operating costs and expenses | 7,327 | 1,740 | 70 | (3 |) 8,261 | 17,395 |
| Other income, net | — | — | — | — | 13 | 13 |
| Income before provision for income taxes | \$11,164 | \$728 | \$164 | \$3 | \$(8,248 |) \$3,811 |

For the three months ended September 30, 2014 (in thousands):

| | Rental | Sales | Service & Maintenance | Corporate | Total |
|--|--------|-------|-----------------------|-----------|-------|
|--|--------|-------|-----------------------|-----------|-------|

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| | | | | | |
|--|----------|---------|--------|------------|----------|
| Revenue | \$20,177 | \$5,218 | \$ 204 | \$— | \$25,599 |
| Operating costs and expenses | 8,110 | 3,493 | 101 | 8,055 | 19,759 |
| Other income, net | — | — | — | 127 | 127 |
| Income before provision for income taxes | \$12,067 | \$1,725 | \$ 103 | \$(7,928) | \$5,967 |

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For the nine months ended September 30, 2015 (in thousands):

| | Rental | Sales | Service & Maintenance | Retirement of Rental Equipment | Corporate | Total |
|--|----------|----------|-----------------------|--------------------------------|------------|----------|
| Revenue | \$58,806 | \$10,672 | \$686 | \$— | \$— | \$70,164 |
| Operating costs and expenses | 22,062 | 7,706 | 151 | 4,370 | 25,371 | 59,660 |
| Other income, net | — | — | — | — | 54 | 54 |
| Income before provision for income taxes | \$36,744 | \$2,966 | \$535 | \$(4,370) | \$(25,317) | \$10,558 |

For the nine months ended September 30, 2014 (in thousands):

| | Rental | Sales | Service & Maintenance | Corporate | Total |
|--|----------|----------|-----------------------|------------|----------|
| Revenue | \$58,431 | \$10,831 | \$611 | \$— | \$69,873 |
| Operating costs and expenses | 23,815 | 6,826 | 269 | 23,676 | 54,586 |
| Other income, net | — | — | — | 174 | 174 |
| Income before provision for income taxes | \$34,616 | \$4,005 | \$342 | \$(23,502) | \$15,461 |

(8) Commitments and Contingencies

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 adverse effect on our financial position, results of operations or cash flow. We are not currently a party to any material legal proceedings, and we are not aware of any other threatened material litigation.

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

The discussion and analysis of our financial condition and results of operations are based on, and should be read in conjunction with, our condensed financial statements and the related notes included elsewhere in this report and in our Annual Report on Form 10-K for the year ended December 31, 2014 filed with the SEC.

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 are billed monthly in advance and include maintenance of the rented compressors. As of September 30, 2015, we had 1,922 natural gas compressors totaling 267,202 horsepower rented to 89 customers compared to 2,162 natural gas compressors totaling 298,764 horsepower rented to 98 customers at September 30, 2014.

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 our purchase of engines, compressors, coolers and other components, and our assembling of these components on skids for delivery to customer locations. The 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 two to three 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 customers under written maintenance contracts or on an as-required basis in the absence of a service contract. Maintenance agreements typically have terms of nine months to one year and require payment of a monthly fee.

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 crude 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 services 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. However, we have increased our rental and sales in the non-conventional shale plays which are more dependent on crude oil 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 coalbed methane, gas shales and tight gas, which typically requires more compression than production from conventional natural gas reservoirs.

Demand for our products and services have been historically strong. However, a decline in demand is experienced during periods of low crude oil and natural gas prices. Through 2013, signs of price recovery continued at a slow pace led by crude oil price. This led to opportunities in non-conventional shale plays. The economics of these shale plays are more dependent on oil prices. While shale plays continued to offer opportunities, natural gas prices have not surged. In late 2014, oil prices dropped significantly and have remained well below 2013 levels. The low price environment for both oil and natural gas has left demand for compression in conventional areas uncertain, and demand growth in non-conventional areas has declined.

Natural gas and oil prices continue at levels that do not encourage energy companies to invest capital in drilling projects. In addition, the domestic economy has not fully recovered. Notwithstanding the continuing uncertain economy and financial markets, we believe the long-term trend in our market is favorable. We believe this outlook is supported by our ability to withstand temporary disruptions and position the Company for the long term.

Results of Operations

Three months ended September 30, 2015, compared to the three months ended September 30, 2014.

The table below shows our revenues and percentage of total revenues of each of our product lines for the three months ended September 30, 2015 and 2014.

| | Revenue Three months ended September 30, (in thousands) | | | | | |
|-------------------------|--|----|---|----------|----|---|
| | 2015 | | | 2014 | | |
| Rental | \$18,491 | 87 | % | \$20,177 | 79 | % |
| Sales | 2,468 | 12 | % | 5,218 | 20 | % |
| Service and Maintenance | 234 | 1 | % | 204 | 1 | % |
| Total | \$21,193 | | | \$25,599 | | |

Total revenue decreased to \$21.2 million from \$25.6 million, or 17%, for the three months ended September 30, 2015, compared to the same period ended September 30, 2014. The \$4.4 million drop in revenue is due to a combination of rental units being returned and the inconsistent timing of unit sales.

Rental revenue decreased to \$18.5 million from \$20.2 million for the three months ended September 30, 2015, compared to the same period ended September 30, 2014. This decrease is due to the reduced demand from the drop in oil prices resulting in units being returned. We ended the quarter with 2,664 compressor packages in our rental fleet following the retirement of 258 units, as of June 30, 2015, down from 2,842 units at September 30, 2014. The rental fleet had a utilization of 72.1% as of September 30, 2015 compared to 76.1% utilization as of September 30, 2014. This drop in utilization is mainly the result of compressor rental units being returned. In the event that oil and natural gas prices increase, we should see an increase in the utilization of our fleet.

Sales revenue decreased to \$2.5 million from \$5.2 million for the three months ended September 30, 2015, compared to the same period ended September 30, 2014, respectively. This decrease is the result of the inconsistent timing of industry activity related to the completion of capital projects. We believe this timing is reflective of the typical sales cycle, resulting in inconsistent compressor units sales to third parties from our Tulsa and Midland operations. There was also a decrease in demand for flares during this comparative period.

Our overall operating income decreased \$2.0 million to \$3.8 from \$5.8 million, primarily due to a decrease in revenue. Operating margin percentage decreased to 18% from 23% for the three months ended September 30, 2015 and September 30, 2014, respectively. The operating margin decreased due the reduction in total revenue with a slight increase in costs.

Selling, general, and administrative expense increased to \$2.7 million from \$2.5 million, for the three months ended September 30, 2015, as compared to the same period ended September 30, 2014, due to increases in salaries and stock based compensation expense.

Depreciation and amortization expense increased to \$5.6 million for the three months ended September 30, 2015, compared to \$5.5 million for the period ended September 30, 2014. This was the result of new gas compressor rental units being added to the rental fleet from September 30, 2014 to September 30, 2015. We added a net of 80 compressors to our rental fleet during the twelve month period ending September 30, 2015, prior to the retirement of 258 units on June 30, 2015.

Provision for income tax was \$1.2 and \$2.1 million for the three months ended September 30, 2015 and September 30, 2014, respectively. The decrease in the provision is the result of a decrease in revenues, for the three months ended September 30, 2015 compared to the three months ended September 30, 2014.

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Nine months ended September 30, 2015, compared to the nine months ended September 30, 2014.

The table below shows our revenues and percentage of total revenues of each of our product lines for the nine months ended September 30, 2015 and 2014.

| | Revenue | | | | | |
|-------------------------|---|----|---|----------|----|---|
| | Nine months ended September 30, (in thousands) | | | | | |
| | 2015 | | | 2014 | | |
| Rental | \$58,806 | 84 | % | \$58,431 | 84 | % |
| Sales | 10,672 | 15 | % | 10,831 | 15 | % |
| Service and Maintenance | 686 | 1 | % | 611 | 1 | % |
| Total | \$70,164 | | | \$69,873 | | |

Total revenue increased to \$70.2 million from \$69.9 million, or 0.4%, for the nine months ended September 30, 2015, compared to the same period ended September 30, 2014. Comparing the nine months ended September 30, 2015 to the same period in 2014, rental revenue increased 1% and sales revenue decreased 1%.

Rental revenue increased slightly, to \$58.8 million from \$58.4 million for the nine months ended September 30, 2015, compared to the same period ended September 30, 2014. This increase is the result of the slower than expected decline in demand from the oil and natural gas industry, and the relatively higher rental rate of low to mid horsepower lift compression. We ended the quarter with 2,664 compressor packages in our rental fleet following the retirement of 258 units, at June 30, 2015, down from 2,842 units at September 30, 2014. The rental fleet had a utilization of 72.1%, as of September 30, 2015 compared to 76.1% utilization as of September 30, 2014. This utilization decrease mainly results from compressor returns. In the event that oil and natural gas prices increase, we should see incremental utilization of our fleet.

Sales revenue decreased slightly, to \$10.7 million from \$10.8 million for the nine months ended September 30, 2015, compared to the same period ended September 30, 2014. This decrease is the result of the inconsistent timing of industry activity related to capital projects. We believe this timing is reflective of the typical sales cycle, resulting in inconsistent compressor units sales to third parties from our Tulsa and Midland operations. There was also a decrease in demand for flares during this comparative period.

Our overall operating income decreased \$4.8 million to \$10.5 million from \$15.3 million, primarily due to the retirement of rental equipment, mentioned in Note 4 to the Condensed Financial Statements. Operating margin percentage remained steady at 21% and 22%, respectively, for the nine months ended September 30, 2015 (excluding the loss on retirement of rental fleet), compared to the same period ended September 30, 2014. The operating margin decreased due to a slight increase in costs.

As a result of a decline in market conditions, management reviewed our rental compressor units and determined that 258 units should be retired (with certain key components being re-utilized), representing total horsepower of 32,259. Based on this optimization review, at June 30, 2015, we recorded a \$4.4 million non-cash loss on the retirement of rental equipment for the six months ended June 30, 2015, to reduce the book value to approximately \$967,000, the estimated fair value of the key components being kept.

Selling, general, and administrative expense increased to \$8.1 million from \$7.9 million, for the nine months ended September 30, 2015, as compared to the same period ended September 30, 2014, due to increases in salaries and stock based compensation expense.

Depreciation and amortization expense increased to \$17.2 million for the nine months ended September 30, 2015, compared to \$15.8 million for the period ended September 30, 2014. This was the result of new gas compressor rental units being added to the rental fleet from September 30, 2014 to September 30, 2015. We added a net of 80 compressors to our rental fleet during the twelve month period ending September 30, 2015, prior to the retirement of 258 units on June 30, 2015.

Provision for income tax decreased to \$3.7 million from \$5.3 million, or 30.2%, and is the result of the decrease in taxable income and a change in effective tax rate between the two periods. The decrease in taxable income due to the rental fleet retirement, as mentioned in Note 4 to the Condensed Financial Statements, for the nine months ended September 30, 2015 compared to nine months ended September 30, 2014.

Liquidity and Capital Resources

Our working capital positions as of September 30, 2015 and December 31, 2014 are set forth below:

| | September 30, 2015 | December 31, 2014 |
|----------------------------------|-----------------------|----------------------|
| | (in thousands) | |
| Current Assets: | | |
| Cash and cash equivalents | \$29,978 | \$6,181 |
| Trade accounts receivable, net | 7,557 | 10,408 |
| Inventory, net | 28,085 | 32,624 |
| Prepaid income taxes | 3,776 | 6,242 |
| Prepaid expenses and other | 553 | 472 |
| Total current assets | 69,949 | 55,927 |
| Current Liabilities: | | |
| Accounts payable | 1,459 | 4,990 |
| Accrued liabilities | 2,950 | 6,624 |
| Current portion of tax liability | 6,328 | 851 |
| Deferred income | 989 | 1,635 |
| Total current liabilities | 11,726 | 14,100 |
| Total working capital | \$58,223 | \$41,827 |

For the nine months ended September 30, 2015, we invested \$11.2 million in equipment for our rental fleet and service vehicles. Even though we have idle rental equipment, at times we do not have the specific type of equipment that our customers require, therefore we have to build new equipment to satisfy their needs. We financed this activity with cash flow from operations and cash on hand.

Cash flows

At September 30, 2015, we had cash and cash equivalents of \$30.0 million compared to \$6.2 million at December 31, 2014. Our cash flow from operations of \$34.8 million was offset by capital expenditures of \$11.2 million, during the nine months ended September 30, 2015. We had working capital of \$58.2 million at September 30, 2015 compared to \$41.8 million at December 31, 2014. On September 30, 2015 and December 31, 2014, we had outstanding debt of \$417,000, which is all related to our line of credit and is classified as non-current. We had positive net cash flow from operating activities of \$34.8 million during the first nine months of 2015 compared to \$26.5 million for the first nine months of 2014. The cash flow from operations of \$34.8 million was primarily the result of the net income of \$6.9 million and the non-cash items of depreciation of \$17.2 million, \$2.6 million related to the expenses associated with stock options and restricted shares, a loss on retirement of rental fleet of \$4.4 million, a decrease in deferred income taxes of \$2.6 million and an increase in working capital of \$6.4 million.

Strategy

For the remainder of the fiscal year 2015 and into 2016, our overall plan is to continue monitoring and holding expenses in line with the anticipated level of activity, fabricate rental fleet equipment only in direct response to market requirements, emphasize marketing of our idle gas compressor units and limit bank borrowing in line with market conditions. For the remainder of 2015, our forecasted capital expenditures will be directly dependent upon our customers' compression requirements and are not anticipated to exceed our internally generated cash flows and cash on

hand. Any required capital will be for additions to our compressor rental fleet and/or addition or replacement of service vehicles. We believe that cash flows from operations and our line of credit will be sufficient to satisfy our capital and liquidity requirements for the foreseeable future. We may require additional capital to fund any unanticipated expenditures, including any acquisitions of other businesses, although that capital, beyond our line of credit, as discussed below may not be available to us when we need it or on acceptable terms.

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).

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. 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 September 30, 2015, 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 1.50%. For the nine month period ended September 30, 2015, our weighted average interest rate was 1.45%.

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, 2017, 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. In addition, we also have certain financial covenants that require us to maintain on a consolidated basis 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 September 30, 2015, 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 September 30, 2015, our balance on the line of credit was \$417,000.

Contractual Obligations and Commitments

We have contractual obligations and commitments that affect the results of operations, financial condition and liquidity. The following table is a summary of our significant cash contractual obligations as of September 30, 2015:

| Cash Contractual Obligations | Obligations Due in Period (in thousands) | | | | | Total |
|---|--|-------|---------|-------|------------|---------|
| | 2015 ⁽¹⁾ | 2016 | 2017 | 2018 | Thereafter | |
| Line of credit (secured) | \$— | \$— | \$417 | \$— | \$— | \$417 |
| Interest on line of credit ⁽²⁾ | 4 | 17 | 17 | — | — | 38 |
| Purchase obligations | 100 | 476 | 476 | 476 | 620 | 2,148 |
| Other long-term liabilities | — | — | — | — | 135 | 135 |
| Facilities and office leases | 77 | 284 | 260 | 126 | 15 | 762 |
| Total | \$181 | \$777 | \$1,170 | \$602 | \$770 | \$3,500 |

(1)For the three months remaining in 2015.

(2)Assumes an interest rate of 4.0% and no additional borrowings.

Critical Accounting Policies and Practices

There have been no changes in the critical accounting policies disclosed in the Company's Form 10-K for the year ended December 31, 2014.

Recently Issued Accounting Pronouncements

On May 28, 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-09, Revenue from Contracts with Customers (Topic 606), as part of a joint project with the International Accounting Standards Board (IASB) to clarify revenue-recognizing principles and develop a common revenue standard for U.S. GAAP and International Financial Reporting Standards (IFRS). ASU No. 2014-09 finalizes Proposed ASU Nos. 1820-100, 2011-230 and 2011-250 and is expected, among other things, to remove inconsistencies and weaknesses in revenue requirements and improve comparability of revenue recognition practices across entities, industries, jurisdictions and capital markets. In particular, the amendments in this ASU will be added to the FASB Accounting Standards Codification (FASB ASC) as Topic 606, Revenue from Contracts with Customers, and will supersede the revenue recognition requirements in FASB ASC 605, Revenue Recognition, as well as some cost guidance in FASB ASC Subtopic 605-35, Revenue Recognition-Construction-Type and Production-Type Contracts. The core principle of this ASU is that 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. To achieve this core principle, the guidance provides that an entity should apply the following steps: (1) identify the contract(s) with a customer; (2) identify the performance obligation in the contract; (3) determine the transaction price; (4) allocate the transaction price to the performance obligations in the contract; and (5) recognize revenue when, or as, the entity satisfies a performance obligation. On July 9, 2015, the FASB approved the deferral of the effective date of ASU No. 2014-09, by one year. For public entities, the amendments are effective for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period, and early application is prohibited. Additionally, an entity should apply the amendments either retrospectively to each prior reporting period presented or retrospectively with the cumulative effect of initially applying this ASU recognized at the date of initial application. If an entity elects the latter, transition method, then it must also provide the additional disclosures in reporting periods that include the date of initial application of (1) the amount by which each financial statement line item is affected in the current reporting period, as compared to the guidance that was in effect before the change, and (2) an explanation of the reasons for significant changes. The new standard will be effective during our first quarter ending March 31, 2018. We are currently evaluating the new

standard to determine which reporting option allows us to report the most meaningful information and are still evaluating the potential impact this new standard may have on our financial statements.

On July 22, 2015, the FASB issued ASU No. 2015-11, Simplifying the Measurement of Inventory (Topic 330), which finalizes Proposed ASU No. 2014-210 of the same name, and responds to stakeholders' concerns that the guidance regarding the measurement of inventory is unnecessarily complex because there are several potential outcomes. In particular, the amendments in this ASU will be added to the FASB ASC under Topic 330, Inventory. The core principle of this ASU is that an entity should measure inventory at the lower of cost and net realizable value. Net realizable value is the estimated selling prices in the ordinary

course of business, less reasonably predictable costs of completion, retirement, and transportation. Subsequent measurement is unchanged for inventory measured using last-in, first-out (LIFO) or the retail inventory method. The amendments more closely align the measurement of inventory in GAAP with the measurement of inventory in IFRS. For public business entities, the amendments are effective for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years. The amendments should be applied prospectively with earlier application permitted as of the beginning of an interim or annual reporting period. The new standard will be effective during our first quarter ending March 31, 2017. We are currently evaluating the potential impact this new standard may have on our financial statements.

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 September 30, 2015, 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, availability of, or requirements for, capital resources.

Special Note Regarding Forward-Looking Statements

Except for historical information contained herein, the statements in this report are forward-looking and made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements involve known and unknown risks and uncertainties, which may cause our actual results in future periods to differ materially from forecasted results. Those risks include, among other things, the loss of market share through competition or otherwise; the introduction of competing technologies by other companies; a prolonged, substantial reduction in oil and natural gas prices which could cause a decline in the demand for our products and services; and new governmental safety, health and environmental regulations which could require us to make significant capital expenditures. The forward-looking statements included in this Form 10-Q are only made as of the date of this report, and we undertake no obligation to publicly update such forward-looking statements to reflect subsequent events or circumstances. A discussion of these and other risk factors is included in our Annual Report on Form 10-K for the year ended December 31, 2014 filed with the SEC.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

There have been no changes in the market risks disclosed in the Company's Form 10-K for the year ended December 31, 2014.

Item 4. 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 Principal Accounting Officer, of the effectiveness of the design and of our "disclosure controls and procedures" (as such term is defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended or, the "Exchange Act") as of the end of the period covered by this report pursuant to Exchange Act Rule 13a-15. Based upon that evaluation, the President and Chief Executive Officer and our Vice President and Principal Accounting Officer have concluded that our disclosure controls and procedures as of the end of the period covered by this report were 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. These 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 the inherent limitations of control systems, not all misstatements or omissions 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 Controls.

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.

PART II – OTHER INFORMATION

Item 1. 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 adverse effect on our financial position, results of operations or cash flow. We are not currently a party to any material legal proceedings and we are not aware of any other threatened litigation.

Item 1A. Risk Factors

Please refer to and read “Risk Factors” in our Annual Report on Form 10-K for the fiscal year ended December 31, 2014 for a discussion of the risks associated with our Company and industry.

Item 6. Exhibits

The following exhibits are filed herewith or incorporated herein by reference, as indicated:

Exhibit No. Description

- | | |
|------|--|
| 3.1 | Articles of Incorporation, as amended (Incorporated by reference to Exhibit 3.1 of the 10-QSB filed and dated November 10, 2004) |
| 3.2 | Bylaws (Incorporated by reference to Exhibit 3.4 of the Registrant's Registration Statement on Form SB-2, No. 333-88314) |
| 4.1 | Non-Statutory Stock Option Agreement (Incorporated by reference to Exhibit 10.2 to Form 8-K filed with the SEC on August 30, 2005) |
| 4.2 | Form of Senior Indenture (Incorporated by reference to Exhibit 4.1 of the Registrant's Registration Statement on Form S-3 (No. 333-161346) and filed on August 14, 2009) |
| 10.1 | Lease Agreement, dated March 26, 2008, 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, 2008 and filed with the Securities and Exchange Commission on March 9, 2009) |
| 10.2 | 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.) |
| 10.3 | 1998 Stock Option Plan, as amended (Incorporated by reference to Exhibit 10.2 of the Registrant's Current Report on Form 8-K dated September 18, 2009 and filed with the Securities and Exchange Commission on September 18, 2009.) |
| 10.4 | Lease Agreement, dated December 11, 2008, between Klement-Wes Partnership, LTD and Natural Gas Services Group, Inc. and commencing on January 1, 2009 |
| 10.5 | 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.) |
| 10.6 | Third Amendment of Credit Agreement between Natural Gas Services Group, Inc. and JPMorgan Chase Bank, N.A., dated November 19, 2014 (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 January 9, 2012.) |
| 10.7 | 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.) |
| 10.8 | First Amendment of Security Agreement between Natural Gas Services Group, Inc. and JPMorgan Chase Bank, N.A., dated December 31, 2011 (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 January 9, 2012.) |

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10.9 Promissory Note in the aggregate amount of \$30,000,000 issued to JPMorgan Chase Bank, N.A., dated December 31, 2014, in connection with the revolving credit line under the Credit Agreement with JPMorgan Chase Bank, N.A. (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 November 24, 2014.)

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- 10.10 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.)
- *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
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- 101.SCH XBRL Taxonomy Extension Schema Document
- 101.CAL XBRL Taxonomy Extension Calculation Linkbase Document
- 101.DEF XBRL Taxonomy Extension Definition Linkbase Document
- 101.LAB XBRL Taxonomy Extension Label Linkbase Document
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

* Filed herewith.

SIGNATURES

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

NATURAL GAS SERVICES GROUP, INC.

/s/ Stephen C. Taylor
Stephen C. Taylor
President and Chief Executive Officer
(Principal Executive Officer)

/s/ G. Larry Lawrence
G. Larry Lawrence
Vice President and Chief Financial Officer
(Principal Accounting Officer)

November 6, 2015

INDEX TO EXHIBITS

The following exhibits are filed herewith or incorporated herein by reference, as indicated:

Exhibit No. Description

- 3.1 Articles of Incorporation, as amended (Incorporated by reference to Exhibit 3.1 of the 10-QSB filed and dated November 10, 2004)
- 3.2 Bylaws (Incorporated by reference to Exhibit 3.4 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
- 4.1 Non-Statutory Stock Option Agreement (Incorporated by reference to Exhibit 10.2 to Form 8-K filed with the SEC on August 30, 2005)
- 4.2 Form of Senior Indenture (Incorporated by reference to Exhibit 4.1 of the Registrant's Registration Statement on Form S-3 (No. 333-161346) and filed on August 14, 2009)
- 10.1 Lease Agreement, dated March 26, 2008, 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, 2008 and filed with the Securities and Exchange Commission on March 9, 2009)
- 10.2 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.)
- 10.3 1998 Stock Option Plan, as amended (Incorporated by reference to Exhibit 10.2 of the Registrant's Current Report on Form 8-K dated September 18, 2009 and filed with the Securities and Exchange Commission on September 18, 2009.)
- 10.4 Lease Agreement, dated December 11, 2008, between Klement-Wes Partnership, LTD and Natural Gas Services Group, Inc. and commencing on January 1, 2009
- 10.5 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.)
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