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

FORM 10-Q

<Table>
<C> <S>
(Mark One)
[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2001

OR

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

FOR THE TRANSITION PERIOD FROM TO

</Table>

COMMISSION FILE NUMBER: 001-15957

CAPSTONE TURBINE CORPORATION
(Exact name of Registrant as specified in its charter)

<Table>
<S> <C>
DELAWARE 95-4180883
(State or other jurisdiction of (I.R.S. Employer
incorporation or organization) Identification No.)
</Table>

21211 NORDHOFF STREET, CHATSWORTH, CALIFORNIA 91311
(Address of principal executive offices) (Zip code)

818-734-5300
(Registrant's telephone number including area code)

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 [X] No [ ]

APPLICABLE ONLY TO CORPORATE REGISTRANTS:

The number of shares outstanding of the registrant's common stock as of

October 31, 2001 was 77,033,993.

CAPSTONE TURBINE CORPORATION

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PART I -- FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

CAPSTONE TURBINE CORPORATION

CONSOLIDATED BALANCE SHEETS

<Table>
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	DECEMBER 31, 2000	SEPTEMBER 30, 2001
		(UNAUDITED)
<S>	<C>	<C>
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 236,947,000	$ 181,692,000
Accounts receivable, net of allowance for doubtful accounts of $85,000 at December 31, 2000 and $131,000 at September 30, 2001	3,664,000	7,561,000
Inventory	14,123,000	26,981,000
Prepaid expenses and other current assets	1,689,000	1,792,000
</Table>

Total current assets	256,423,000	218,026,000
Equipment and Leasehold Improvements:		
Machinery, equipment and furniture	13,664,000	22,347,000
Leasehold improvements	3,055,000	9,155,000
Molds and tooling	1,331,000	4,277,000
	18,050,000	35,779,000
Less accumulated depreciation and amortization	6,434,000	7,874,000
Total equipment and leasehold improvements	11,616,000	27,905,000
Deposits on fixed assets	6,649,000	1,977,000
Other assets	302,000	243,000
Intangible assets, net	27,028,000	23,308,000
Total	$ 302,018,000	$ 271,459,000
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	$ 4,728,000	$ 5,020,000
Accrued salaries and wages	1,135,000	1,156,000
Other accrued liabilities	1,282,000	3,193,000
Accrued warranty reserve	5,589,000	4,454,000
Deferred revenue	4,064,000	2,199,000
Current portion of capital lease obligations	1,497,000	1,281,000
Total current liabilities	18,295,000	17,303,000
Non-current Liabilities:		
Long-term portion of capital lease obligations	3,999,000	2,864,000
Other long-term liabilities	342,000	511,000
Total non-current liabilities	4,341,000	3,375,000
Commitments and Contingencies	--	--
Stockholders' Equity:		
Common stock, $.001 par value; 415,000,000 shares authorized; 75,771,303 and 77,014,259 shares issued and outstanding at December 31, 2000 and September 30, 2001, respectively	76,000	77,000
Additional paid-in capital	516,738,000	520,353,000
Accumulated deficit	(237,432,000)	(269,649,000)
Total stockholders' equity	279,382,000	250,781,000
Total	$ 302,018,000	$ 271,459,000

</Table>

See accompanying notes to financial statements.

CAPSTONE TURBINE CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)

<Table>
<Caption>

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
	2000	2001	2000	2001
<S>	<C>	<C>	<C>	<C>
Revenues	$ 6,197,000	$ 3,346,000	$ 16,029,000	$ 25,811,000
Cost of Goods Sold	7,278,000	5,468,000	20,658,000	27,033,000
Gross Loss	(1,081,000)	(2,122,000)	(4,629,000)	(1,222,000)

Operating Costs and Expenses:				
Research and development	*2,953,000*	*2,512,000*	*8,416,000*	*8,171,000*
Selling, general and administrative	*7,203,000*	*9,210,000*	*17,264,000*	*30,015,000*
Total operating costs and expenses	*10,156,000*	*11,722,000*	*25,680,000*	*38,186,000*
Loss from Operations	*(11,237,000)*	*(13,844,000)*	*(30,309,000)*	*(39,408,000)*
Interest Income	*3,385,000*	*1,485,000*	*6,007,000*	*7,611,000*
Interest Expense	*(197,000)*	*(137,000)*	*(733,000)*	*(457,000)*
Other Income (Expense)	*(32,000)*	*11,000*	*(31,000)*	*38,000*
Loss Before Income Taxes	*(8,081,000)*	*(12,485,000)*	*(25,066,000)*	*(32,216,000)*
Provision for Income Taxes			*1,000*	*1,000*
Net Loss	*(8,081,000)*	*(12,485,000)*	*(25,067,000)*	*(32,217,000)*
Preferred Stock Dividends, Accretion, and Repurchase			*(559,862,000)*	
Net Loss Attributable to Common Stockholders	*$ (8,081,000)*	*$(12,485,000)*	*$(584,929,000)*	*$(32,217,000)*
Weighted Average Common Shares Outstanding	*74,931,668*	*76,976,934*	*36,317,944*	*76,560,247*
Net Loss Per Share of Common Stock -- Basic and Diluted	*$ (0.11)*	*$ (0.16)*	*$ (16.11)*	*$ (0.42)*

</Table>

See accompanying notes to financial statements.

CAPSTONE TURBINE CORPORATION

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
NINE MONTHS ENDED SEPTEMBER 30, 2000 AND SEPTEMBER 30, 2001
(UNAUDITED)

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	COMMON STOCK				
	SHARES OUTSTANDING	*AMOUNT*	*ADDITIONAL PAID IN CAPITAL*	*ACCUMULATED DEFICIT*	*TOTAL*
<S>	*<C>*	*<C>*	*<C>*	*<C>*	*<C>*
BALANCE, DECEMBER 31, 1999	*2,377,826*	*$ 2,000*	*$ --*	*$(144,227,000)*	*$(144,225,000)*
Common stock warrants granted			*8,132,000*		*8,132,000*
Stock-based compensation			*1,239,000*		*1,239,000*
Exercise of stock options and warrants	*10,793,693*	*12,000*	*2,831,000*		*2,843,000*
Repurchase of preferred stock			*2,209,000*	*454,000*	*2,663,000*
Accretion of preferred stock			*(13,883,000)*	*(457,593,000)*	*(471,476,000)*
Dividends accrued for preferred stock				*(1,028,000)*	*(1,028,000)*
Beneficial conversion feature for Series G preferred stock				*(89,567,000)*	*(89,567,000)*
Dividends waived on preferred stock			*440,000*	*6,309,000*	*6,749,000*
Conversion of preferred stock	*51,312,037*	*51,000*	*341,296,000*	*479,645,000*	*820,992,000*
Issuance of common stock	*10,455,046*	*10,000*	*153,554,000*		*153,564,000*
Net loss				*(25,067,000)*	*(25,067,000)*
BALANCE, SEPTEMBER 30,					

2000	74,938,602	$75,000	$495,818,000	$(231,074,000)	$ 264,819,000
BALANCE, DECEMBER 31, 2000	75,771,303	$76,000	$516,738,000	$(237,432,000)	$ 279,382,000
Stock-based compensation			1,591,000		1,591,000
Exercise of stock options	1,242,956	1,000	2,134,000		2,135,000
Stock issuance costs			(110,000)		(110,000)
Net loss				(32,217,000)	(32,217,000)
BALANCE, SEPTEMBER 30, 2001	77,014,259	$77,000	$520,353,000	$(269,649,000)	$ 250,781,000

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See accompanying notes to financial statements.

CAPSTONE TURBINE CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

<Table>
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	NINE MONTHS ENDED SEPTEMBER 30,	
	2000	2001
<S>	<C>	<C>
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$(25,067,000)	$(32,217,000)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	4,847,000	7,489,000
Provision for doubtful accounts	74,000	
Loss on disposal of equipment	35,000	68,000
Non-employee stock compensation	60,000	361,000
Employee stock compensation	1,239,000	1,230,000
Changes in operating assets and liabilities:		
Accounts receivable	(959,000)	(3,921,000)
Prepaid expenses and other assets	447,000	(125,000)
Inventory	(2,173,000)	(12,858,000)
Accounts payable	2,853,000	292,000
Other accrued liabilities	(852,000)	2,102,000
Accrued warranty reserve	2,869,000	(1,136,000)
Deferred revenue	1,255,000	(1,865,000)
Net cash used in operating activities	(15,446,000)	(40,506,000)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Deposits and acquisition of equipment and leasehold improvements	(7,173,000)	(15,172,000)
Proceeds from sale of equipment	1,253,000	1,000
Intangible assets	(16,550,000)	(557,000)
Net cash used in investing activities	(22,470,000)	(15,728,000)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Repayment of capital lease obligations	(1,150,000)	(1,046,000)
Exercise of stock options and warrants	3,549,000	2,135,000
Net proceeds from issuance of common stock	153,572,000	
Stock issuance costs		(110,000)
Net proceeds from issuance of Series G preferred stock	120,362,000	
Repurchase of preferred stock	(15,492,000)	
Net cash provided by financing activities	260,841,000	979,000
Net Increase (Decrease) in Cash and Cash Equivalents	222,925,000	(55,255,000)
Cash and Cash Equivalents, Beginning of Period	6,858,000	236,947,000

Cash and Cash Equivalents, End of Period.....	$229,783,000	$181,692,000
Supplemental Disclosures of Cash Flow Information:		
Cash paid during the period for:		
Interest.....	$ 588,000	$ 457,000
Income taxes.....	$ 1,000	$ 1,000

</Table>

See accompanying notes to financial statements.

CAPSTONE TURBINE CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

1. BUSINESS AND ORGANIZATION

Business. Capstone Turbine Corporation (the "Company") develops, manufactures, and markets microturbine generator sets for use in stationary, vehicular, and other electrical distributed generation applications. The Company was organized in 1988 and has been commercially producing its microturbine generator since 1998. The Company has incurred significant operating losses since its inception. Management anticipates incurring additional losses until the Company can produce sufficient revenues to cover costs. To date, the Company has funded its activities primarily through private and public equity offerings.

Organization. In February 2001, the Company formed a wholly owned subsidiary, Capstone California Corporation, to provide direct sales of products to the California market.

Basis of Consolidation. The consolidated financial statements include the accounts of the parent company and its wholly owned subsidiary, after elimination of inter-company transactions.

2. BASIS OF PRESENTATION

The accompanying unaudited financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Regulation S-X promulgated under the Securities and Exchange Act of 1934, as amended. They do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. The balance sheet at December 31, 2000 was derived from audited financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2000. In the opinion of management the interim financial statements include all adjustments (consisting of normal recurring adjustments) necessary for a fair presentation of the financial condition, results of operations and cash flows for such periods. Results of operations for any interim period are not necessarily indicative of results for any other interim period or for the full year. These financial statements should be read in conjunction with the financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2000.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

New Accounting Pronouncement -- SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," is effective for all fiscal years beginning after June 15, 2000. SFAS 133, as amended, establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities. The Company adopted SFAS 133 effective January 1, 2001. The adoption of SFAS 133 did not have a significant impact on the financial position, results of operations, or cash flows of the Company.

During July 2001, SFAS No. 142, "Goodwill and Other Intangible Assets" was issued by the Financial Accounting Standards Board. SFAS 142 applies to all acquired intangible assets whether acquired singly, as part of a group, or in a business combination. SFAS 142 specifies that goodwill and indefinite lived intangible assets will no longer be amortized but instead will be subject to periodic impairment testing. Intangible assets with a determinable useful life will continue to be amortized over that period. The Company is required to implement SFAS 142 on January 1, 2002 and it has not determined the impact, if

any, that this statement will have on its consolidated financial position or results of operations.

In August 2001, the FASB issued a new pronouncement SFAS No. 144 "Accounting for the Impairment or Disposal of Long-Lived Assets". SFAS 144 addresses the financial accounting and reporting issues for the impairment or disposal of long-lived assets. This statement supersedes SFAS 121 but retains the fundamental provisions for (a) recognition/measurement of impairment of long-lived assets to be held and used and (b) measurement of long-lived assets to be disposed of by sales. It is effective for fiscal years beginning after

December 15, 2001, and interim periods within those fiscal years, with early application encouraged. We are currently evaluating the provisions of SFAS 144 and have not determined the impact, if any, that this statement will have on its consolidated financial position or results of operations.

4. SEGMENT REPORTING

The Company is considered to be a single operating segment in conformity with SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information." The business activities of the operating segment are the development, manufacture and sale of turbine generator sets. Following is the geographic revenue information:

<Table>
<Caption>

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
	2000	2001	2000	2001
<S>	<C>	<C>	<C>	<C>
North America	$4,009,000	$2,277,000	$10,261,000	$16,535,000
Asia	1,867,000	692,000	5,264,000	5,828,000
Europe	321,000	328,000	504,000	1,719,000
South America	--	16,000	--	989,000
Africa	--	33,000	--	740,000
Total	$6,197,000	$3,346,000	$16,029,000	$25,811,000

</Table>

5. INVENTORY

Inventory is stated at the lower of standard cost (which approximates actual cost on the first-in, first-out method) or market.

<Table>
<Caption>

	DECEMBER 31, 2000	SEPTEMBER 30, 2001
<S>	<C>	<C>
Raw materials	$10,133,000	$16,117,000
Work in process	3,354,000	3,165,000
Finished goods	636,000	7,699,000
Total	$14,123,000	$26,981,000

</Table>

6. STOCK-BASED COMPENSATION

During 1999 and 2000, the Company issued common stock options at less than the fair value of its common stock. Accordingly, the Company recorded stock-based compensation expense of $488,000 and $357,000 for the three-month period ended September 30, 2000 and 2001, and $1,239,000 and $1,230,000 for the nine-month period ended September 30, 2000 and 2001, respectively. Stock-based

compensation expense for the three-month period ended September 30, 2000 was included in cost of goods sold, research and development and selling, general, and administrative expenses in the amounts of $11,000, $89,000 and $388,000, respectively. Stock-based compensation expense for the three-month period ended September 30, 2001 was included in cost of goods sold, research and development, and selling, general, and administrative expenses in the amounts of $16,000, $77,000 and $264,000, respectively. Stock-based compensation expense for the nine-month period ended September 30, 2000 was included in cost of goods sold, research and development and selling, general, and administrative expenses in the amounts of $43,000, $233,000 and $963,000, respectively. Stock-based compensation expense for the nine-month period ended September 30, 2001 was included in cost of goods sold, research and development, and selling, general, and administrative expenses in the amounts of $50,000, $241,000 and $939,000, respectively.

As of September 30, 2001, the Company had $2.1 million in deferred stock compensation related to stock options, which will be recognized as stock-based compensation expense through 2004, as the amortization is based on the vesting period.

7. COMMITMENTS AND CONTINGENCIES

In August 2000, the Company entered into a Transition Agreement and Amended and Restated License Agreement with a supplier, requiring a total of $9.1 million in upfront payments. Under the terms of the Agreements, the Company acquired fixed assets and manufacturing technology, which provide the Company with the ability to manufacture components previously purchased from the supplier. In February 2001, the Company completed its upfront payments under the Agreements. The Company is required to pay a per unit royalty fee over a seventeen-year period.

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

The following discussion should be read in conjunction with the Financial Statements and Notes included in this Form 10-Q and Capstone's Annual Report on Form 10-K for the year ended December 31, 2000. When used in the following discussion, the words "believes", "anticipates", "intends", "expects" and similar expressions are intended to identify forward-looking statements. Such statements are subject to certain risks and uncertainties, which could cause actual results to differ materially from those projected. These risks include those identified under "Business Risks" in this Form 10-Q. Readers are cautioned not to place undue reliance on forward-looking statements, which speak only as of the date hereof. Forward-looking statements contained in this Form 10-Q speak only as of its date. We assume no obligation to update any of the forward-looking statements after the filing of this Form 10-Q to conform such statements to actual results or to changes in our expectations.

OVERVIEW

Capstone develops, manufactures and markets microturbine technology for use in stationary, combined heat and power generation, resource recovery, hybrid electric vehicle, and other power and heat applications in the multi-billion dollar market for distributed power generation. Our microturbines provide power at the site of consumption and to hybrid electric vehicles that combine a primary source battery with an auxiliary power source, such as a microturbine, to enhance performance. We believe the simple and flexible design of our microturbines will enable our distributors and end users to develop an increasingly broad range of applications to fit their particular power needs. Capstone expects its microturbines to provide the commercial power generation industry with clean, multifunctional, and scalable distributed power sources.

We began commercial sales of our units in 1998, targeting the emerging distributed generation industry that is being driven by fundamental changes in power requirements. We are currently focusing on our sales and marketing efforts, development of new products, acquisition of intellectual property

rights and manufacturing facility expansion, which will result in higher operating expenses. We intend to achieve long-run profitability through production efficiencies and economies of scale. In February 2001, we completed our upfront payments to acquire intellectual property from a former supplier. In June 2001, we started to manufacture recuperator cores at our new facility. We continue working to develop new, higher profit-margin products.

We sell complete microturbine units, subassemblies and components. Our microturbines can be fueled by various sources including natural gas, propane, sour gas, kerosene and diesel. We will continue investing significant resources to develop new products and enhancements, including enhancements that enable greater kilowatt power production, additional fuel capabilities and additional distributed power generation solutions such as co-generation applications.

We continue to generate operating losses and we expect to continue to sustain operating losses through at least fiscal year 2002. Our sales cycles vary by application and geographic region, and in many cases require long lead times between identifying customer needs and providing commercially available solutions. As a result of anticipated increases in our operating expenses resulting from our expansion and the difficulty in forecasting revenue levels, we expect our quarterly performance to fluctuate. We are also a young company and therefore period-to-period comparisons between years may not necessarily be meaningful.

RESULTS OF OPERATIONS

THREE MONTHS ENDED SEPTEMBER 30, 2001 COMPARED TO THREE MONTHS ENDED SEPTEMBER 30, 2000

Revenues. Revenues for the three months ended September 30, 2001 decreased $2.9 million to $3.3 million compared to $6.2 million for the three months ended September 30, 2000. During the three months ended September 30, 2001, we shipped 80 units, a decrease of 131 units from the 211 units we shipped in the three months ended September 30, 2000. During the three months ended September 30, 2001, we shipped 62 units of our 30-kilowatt products and 18 units of our 60-kilowatt products. During the three months

ended September 30, 2000, we shipped 210 units of our 30-kilowatt products and one unit of our 60-kilowatt products.

The decrease in revenues is attributable to several factors that contributed to the drop-off in demand in the third quarter of 2001 including the overall deterioration in economic conditions. Given the increased focus by companies to tighten their capital expenditures, we saw reluctance on the part of potentially large customers to make the investment required to achieve the benefits of our microturbines. In addition, the predicted energy shortages in California have not materialized. In the beginning of the year, widely-held expectations were that large portions of California would be subject to brownouts and rolling blackouts, motivating large numbers of businesses to adopt the clean, blackout protection capabilities of our microturbine systems. This scenario did not occur to the degree anticipated.

Gross Loss. Cost of goods sold includes direct material costs, assembly and testing, compensation and benefits, overhead allocations for facilities and administration, and warranty reserve charges. Our gross loss for the three months ended September 30, 2001 increased to $2.1 million compared to a gross loss of $1.1 million for the three months ended September 30, 2000. Gross loss as a percentage of revenue increased as production overhead costs were allocated over lesser volumes of production. Costs for replacement parts and systems are charged against our warranty reserve, which is accrued through charges to cost of goods sold. The warranty reserve charge decreased $811,000 to $240,000 for the three months ended September 30, 2001 from $1.1 million for the three months ended September 30, 2000 as estimated warranty costs have declined based on our actual warranty cost experience and lesser number of units sold in the three months ended September 30, 2001.

Research and Development Expenses. Research and development expenses include compensation, the engineering department overhead allocations for administration and facilities, and material costs associated with development. Research and development expenses were primarily for expanding the functionality of our 60-kilowatt family of products and for next generation products. Research

and development expenses for the three months ended September 30, 2001 decreased $0.5 million, or 17%, to $2.5 million compared to $3.0 million for the three months ended September 30, 2000. Research and development expenses for the three months ended September 30, 2001 are reported net of a $1 million benefit from cost sharing programs such as the Department of Energy Advanced Microturbine Program.

Selling, General, and Administrative Expenses. Selling, general, and administrative expenses include compensation and related expenses in support of our sales, marketing and general corporate functions, which include human resources, finance and accounting, information systems and legal services. Selling, general, and administrative expenses for the three months ended September 30, 2001 increased $2 million, or 28%, to $9.2 million compared to $7.2 million for the three months ended September 30, 2000. The Company continues to expand its selling and marketing efforts through increases in staff headcount and related overhead expenses, and we anticipate this trend to continue as we enter into new markets and develop new sales and marketing programs. In addition, legal expenses increased to support our patent pursuit efforts.

Interest Income. Interest income, net of interest expense for the three months ended September 30, 2001 decreased $1.8 million to $1.4 million compared to $3.2 million for the three months ended September 30, 2000. The decrease is primarily attributable to lower average investment balances and lower interest rates in the three months ended September 30, 2001.

NINE MONTHS ENDED SEPTEMBER 30, 2001 COMPARED TO NINE MONTHS ENDED SEPTEMBER 30, 2000

Revenues. Revenues for the nine months ended September 30, 2001 increased $9.8 million to $25.8 million compared to $16 million for the nine months ended September 30, 2000. The increase in revenues is attributable to greater sales to a larger customer base, which has resulted from expanding our marketing efforts. During the nine months ended September 30, 2001, we shipped 808 units, an increase of 260 units over the 548 units we shipped in the nine months ended September 30, 2000. During the nine months ended September 30, 2001, we shipped 715 units of our 30-kilowatt products and 93 units of our 60-kilowatt products. During the nine months ended September 30, 2000, we shipped 547 units of our 30-kilowatt products and one unit of our 60-kilowatt products.

Gross Loss. Cost of goods sold includes direct material costs, assembly and testing, compensation and benefits, overhead allocations for facilities and administration, and warranty reserve charges. Our gross loss for the nine months ended September 30, 2001 decreased to $1.2 million compared to $4.6 million for the nine months ended September 30, 2000. Gross loss as a percentage of revenue decreased as production overhead costs were allocated over larger volumes of production. Costs for replacement parts and systems are charged against our warranty reserve, which is accrued through charges to cost of goods sold. The warranty reserve charge decreased $2.5 million to $1.6 million for the nine months ended September 30, 2001 from $4.1 million for the nine months ended September 30, 2000 as estimated warranty costs have declined based on our actual warranty cost experience.

Research and Development Expenses. Research and development expenses include compensation, the engineering department overhead allocations for administration and facilities, and material costs associated with development. Research and development expenses were primarily for expanding the functionality of our 60-kilowatt family of products and for next generation products. Research and development expenses for the nine months ended September 30, 2001 decreased $0.2 million, or 3%, to $8.2 million compared to $8.4 million for the nine months ended September 30, 2000. Research and development expenses for the nine months ended September 30, 2001 are reported net of a $1.5 million benefit from cost sharing programs such as the Department of Energy Advanced Microturbine Program.

Selling, General, and Administrative Expenses. Selling, general, and administrative expenses include compensation and related expenses in support of our sales, marketing and general corporate functions, which include human resources, finance and accounting, information systems and legal services. Selling, general, and administrative expenses for the nine months ended September 30, 2001 increased $12.8 million, or 74%, to $30 million compared to $17.2 million for the nine months ended September 30, 2000. The Company

continues to expand its selling and marketing efforts through increases in staff headcount and related overhead expenses, and we anticipate this trend to continue as we enter into new markets and develop new sales and marketing programs. Of the increase, $2.9 million was attributable to pre-production costs associated with the Company's core manufacturing and $1.3 million to marketing rights amortization expense related to the repurchase of marketing rights from Fletcher Challenge Limited. Marketing rights amortization expense will continue through 2005, as the expense is being amortized over the original term of the contract. In addition, legal expenses increased to support our patent pursuit efforts.

Interest Income. Interest income, net of interest expense for the nine months ended September 30, 2001 increased $1.9 million to $7.1 million compared to $5.2 million for the nine months ended September 30, 2000. The increase is primarily attributable to higher average investment balances due to the funds received from the Series G preferred stock issuance in February 2000, our initial public offering in July 2000 and our secondary public offering in November 2000.

LIQUIDITY AND CAPITAL RESOURCES

Our cash requirements depend on many factors, including our product development activities, our product expansion and our commercialization efforts. We expect to continue to devote substantial capital resources to continue the development of our sales and marketing programs, to hire and train production staff and to expand our research and development activities. We believe that our current cash balance of $181.7 million is sufficient to fund operations at least through 2002.

Accounts receivable increased to $7.6 million as of September 30, 2001 compared to $3.7 million as of December 31, 2000. Accounts receivable included $1 million from Department of Energy, of which $0.7 million was collected subsequent to September 30, 2001. We also have about $0.6 million of receivables from two foreign customers, secured by irrevocable letters of credits. We do not anticipate any significant bad debt write-offs arising out of our receivables.

Inventory increased to $27 million as of September 30, 2001 compared to $14.1 million as of December 31, 2000, attributable to an inventory build-up due to slower-than-anticipated sales. Inventory included $7.7 million of finished microturbine systems ready for shipment.

Equipment and leasehold improvements, net of accumulated depreciation and amortization, increased to $27.9 million as of September 30, 2001 compared to $11.6 million as of December 31, 2000. The increase was primarily from leasehold improvements, tooling and equipment in our new facility in Van Nuys, California. Deposits on fixed assets decreased to $2 million as of September 30, 2001 compared to $6.6 million as of December 31, 2000 due to the application of down payments on fixed assets received during 2001.

Deferred revenue decreased to $2.2 million compared to $4.1 million as of December 31, 2000, attributable to application of deposits from customers on shipments during the nine months ended September 30, 2001.

Our net cash used in operating activities was $40.5 million for the nine months ended September 30, 2001 compared to $15.4 million for the nine months ended September 30, 2000. During the nine months ended September 30, 2001, cash used in operating activities included a $32.2 million Net Loss, a $12.9 million increase in inventory and $4.6 million increase in other operating assets and liabilities, less non cash operating activities of $9.2 million. Net cash used in investing activities was $15.7 million for the nine months ended September 30, 2001 compared to $22.5 million for the nine months ended September 30, 2000. Investing activities in 2001 primarily consisted of equipment and tooling purchases, intangible purchases and leasehold improvements associated with our recuperator core manufacturing and facility.

Our net cash provided by financing activities was $1 million for the nine months ended September 30, 2001 compared to $260.8 million for the nine months ended September 30, 2000. We have financed our operations and investing activities primarily through private and public equity issuances. The primary source of our cash and cash equivalents as of September 30, 2001 were provided by financing activities during 2000 from the issuance of Series G preferred

stock with net proceeds of $120.4 million, the issuance of common stock in our initial public offering with net proceeds of $153.6 million and the issuance of common stock in our secondary offering with net proceeds of $19.6 million.

We have invested proceeds from the issuances of securities to provide liquidity for operations and for capital preservation. In addition, we use capital lease commitments to sell and leaseback various fixed assets. During the nine months ended September 30, 2001, we repaid our capital lease obligations in the amount of $1.0 million. As of September 30, 2001, we had $4.1 million outstanding under various leases with Transamerica and $5,000 outstanding to other leasing institutions.

ITEM 3. QUALITATIVE AND QUANTITATIVE DISCLOSURES ABOUT MARKET RISK

We do not currently use derivative financial instruments that expose us to market risk.

FOREIGN CURRENCY

We currently develop products in the United States and market our products in North America, South America, Asia, Europe and Africa. As a result, factors such as changes in foreign currency exchange rates or weak economic conditions in foreign markets could affect our financial results. As all of our sales and supplies are currently made in U.S. Dollars, we do not utilize foreign exchange contracts to reduce our exposure to foreign currency fluctuations. In the future, as our customers and vendor bases expand, we anticipate that we will enter into transactions that are denominated in foreign currencies.

INTEREST

We have no long-term debt outstanding and do not use any derivative instruments.

INFLATION

We do not believe that inflation has had a material effect on our financial position or results of operations. However, we cannot predict the future effects of inflation, including interest rate fluctuations and market fluctuations.

IMPACT OF RECENTLY ISSUED ACCOUNTING STANDARDS

Statement of Financial Accounting Standards (SFAS) No. 133, Accounting for Derivative Instruments and Hedging Activities, is effective for all fiscal years beginning after June 15, 2000. SFAS 133, as amended, establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities. Under SFAS 133, certain contracts that were not formerly considered derivatives may now meet the definition of a derivative. The Company adopted SFAS 133 effective January 1, 2001. The adoption of SFAS 133 did not have a significant impact on the financial position, results of operations, or cash flows of the Company.

During July 2001, SFAS No. 142, "Goodwill and Other Intangible Assets" was issued by the Financial Accounting Standards Board. SFAS 142 applies to all acquired intangible assets whether acquired singly, as part of a group, or in a business combination. SFAS 142 specifies that goodwill and indefinite lived intangible assets will no longer be amortized but instead will be subject to periodic impairment testing. Intangible assets with a determinable useful life will continue to be amortized over that period. The Company is required to implement SFAS 142 on January 1, 2002 and it has not determined the impact, if any, that this statement will have on its consolidated financial position or results of operations.

In August 2001, the FASB issued a new pronouncement SFAS No. 144 "Accounting for the Impairment or Disposal of Long-Lived Assets". SFAS 144 addresses the financial accounting and reporting issues for the impairment or disposal of long-lived assets. This statement supersedes SFAS 121 but retains the fundamental provisions for (a) recognition/measurement of impairment of long-lived assets to be held and used and (b) measurement of long-lived assets to be disposed of by sales. It is effective for fiscal years beginning after December 15, 2001, and interim periods within those fiscal years, with early application encouraged. We are currently evaluating the provisions of SFAS 144

and have not determined the impact, if any, that this statement will have on its consolidated financial position or results of operations.

BUSINESS RISKS

This Form 10-Q and other public statements and announcements made by Capstone and its representatives from time to time contain or may contain forward-looking statements, as such term is defined in Section 27A of the Securities Act of 1933, as amended (the "Securities Act") and Section 21E of the Exchange Act of 1934, as amended (the "Exchange Act"), pertaining to, among other things, Capstone's future results of operations, research and development activities, including the development of our 60-kilowatt unit and our 125-kilowatt unit, sales expectations, sources for parts, federal, state and local regulations, and general business, industry and economic conditions applicable to Capstone. These statements are based largely on Capstone's current expectations and are subject to a number of risks and uncertainties. Actual results could differ materially from these forward-looking statements. Factors that can cause actual results to differ materially include, but are not limited to, those discussed below. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. The following factors should be considered in addition to the other information contained herein in evaluating Capstone and its business. Forward-looking statements contained in this Form 10-Q speak only as of its date. We assume no obligation to update any of the forward-looking statements after the filing of this Form 10-Q to conform such statements to actual results or to changes in our expectations.

WE HAVE A LIMITED OPERATING HISTORY CHARACTERIZED BY NET LOSSES, WE ANTICIPATE CONTINUED LOSSES THROUGH AT LEAST 2002 AND WE MAY NEVER BECOME PROFITABLE.

Since our inception in 1988, we have reported net losses for each year. Our net losses were $30.6 million in 1997, $33.1 million in 1998, $29.5 million in 1999, $31.4 million in 2000 and $32.2 million for the nine months ended September 30, 2001. We anticipate incurring additional net losses through at least 2002. Since inception through September 30, 2001, we have recorded cumulative losses of approximately $180 million. We have only been commercially producing Capstone MicroTurbines since December 1998 and have made only limited sales to date. Also, because we are in the early stages of selling our products, we have relatively few

customers. Even if we do achieve profitability, we may be unable to increase our sales and sustain or increase our profitability in the future.

A MASS MARKET FOR MICROTURBINES MAY NEVER DEVELOP OR MAY TAKE LONGER TO DEVELOP THAN WE ANTICIPATE, WHICH WOULD ADVERSELY IMPACT OUR REVENUES AND PROFITABILITY.

Our products represent an emerging market, and we do not know whether our targeted customers will accept our technology or will purchase our products in sufficient quantities to grow our business. If a mass market fails to develop or develops more slowly than we anticipate, we may be unable to recover the losses we have incurred to develop our products, we may be unable to meet our operational expenses and we may be unable to achieve profitability. The development of a mass market for our systems may be impacted by many factors which are out of our control, including:

- *the cost competitiveness of our microturbines;*
- *the future costs and availability of fuels used by our microturbines;*
- *consumer reluctance to try a new product;*
- *consumer perceptions of our microturbines' safety;*
- *regulatory requirements; and*
- *the emergence of newer, more competitive technologies and products.*

IF WE ARE UNABLE TO MANUFACTURE RECUPERATOR CORES INTERNALLY, OUR ASSEMBLY AND PRODUCTION OF MICROTURBINES MAY SUFFER DELAYS AND INTERRUPTIONS.

Solar Turbines Incorporated had been our sole supplier of recuperator cores, which are heat exchangers that preheat incoming air before it enters the combustion chamber and are an essential component of our microturbines. Solar is a wholly owned subsidiary of Caterpillar Inc. At present, we are not aware of any other suppliers that could produce these cores to our specifications within our time requirements. In September 2000, we exercised contractual rights to begin using Solar's intellectual property to manufacture recuperator cores. In June 2001, we started to manufacture recuperator cores. We cannot assure you that this transition from purchasing recuperator cores to manufacturing them ourselves will be without disruption. Also, we cannot assure you that Solar will honor the license agreement, that a court would enforce it, or that we will be able to meet our obligations under it. If we had to develop and produce our own recuperator cores without using Solar's intellectual property, we estimate it could take up to three years to begin production.

WE MAY NOT BE ABLE TO CONTROL OUR WARRANTY EXPOSURE AND OUR WARRANTY RESERVE MAY NOT BE SUFFICIENT TO MEET OUR WARRANTY EXPENSE, WHICH COULD IMPAIR OUR FINANCIAL CONDITION.

We sell our products with warranties. However, these warranties vary from product to product with respect to the time period covered and the extent of the warranty protection. Malfunctions of our product could expose us to significant warranty expenses. Because we are in the early stages of production and few of our products have completed a full warranty term, we cannot be certain that we have adequately determined our warranty exposure. Moreover, as we develop new configurations for our microturbines or as our customers place existing configurations in commercial use for long periods of time, we expect to experience product malfunctions that cause our products to fall substantially below our 98% availability target level. While our microturbines have often achieved this availability target when using high-pressure natural gas, we are still working to achieve this availability target across all of our units and for all fuel sources. While management believes that the recorded warranty reserve is reasonable, there can be no assurance that the reserve will be sufficient to cover our warranty expenses in the future. Although we attempt to reduce our risk of warranty claims through warranty disclaimers, we cannot assure you that our efforts will effectively limit our liability. Any significant incurrence of warranty expense could have a material adverse effect on our financial condition.

WE MAY NOT BE ABLE TO RETAIN KEY MANAGEMENT AND THE LOSS OF KEY MANAGEMENT COULD PREVENT EFFECTIVE IMPLEMENTATION OF OUR EXPANSION PLAN.

Our success depends in significant part upon the continued service of key management personnel, such as Dr. Ake Almgren, our Chief Executive Officer, Mr. Norman Chambers, our Chief Operating Officer, Mr. Jeffrey Watts, our Chief Financial Officer and Mr. William Treece, our Senior Vice President of Strategic Technology Development. Currently, the competition for qualified personnel is intense and we cannot assure you that we can retain our existing management team. The loss of Dr. Almgren, Mr. Chambers, Mr. Watts, Mr. Treece or any other key management personnel could materially adversely affect our operations.

WE MAY NOT BE ABLE TO HIRE AND RETAIN THE TECHNICAL PERSONNEL NECESSARY TO BUILD OUR PRODUCTS, WHICH COULD DELAY PRODUCT DEVELOPMENT AND LOWER PRODUCTION.

We have historically experienced, and expect to continue to experience, delays in filling technical positions. Competition is intense for qualified technical personnel, and in particular skilled engineers. As a result, we may not be able to hire and retain engineering personnel that we need. Our failure to do so could delay product development cycles, affect the quality of our products, reduce the number of microturbines we can produce and/or otherwise negatively affect our business.

IF WE DO NOT EFFECTIVELY IMPLEMENT OUR SALES AND MARKETING EXPANSION PROGRAM, OUR SALES WILL NOT GROW AND OUR PROFITABILITY WILL SUFFER.

We need to increase our internal sales and marketing staff in order to enhance our sales efforts. We cannot assure you that the expense of such internal expansion will not exceed the net revenues generated, or that our sales and marketing team will successfully compete against the more extensive and well-funded sales and marketing operations of our current and future

competitors. In addition, to grow our sales, we have begun to hire new management team members to provide more sales and marketing expertise. Since these management team members will not have a proven track record with us, we cannot assure you that they will be successful in overseeing their functional areas. Our inability to recruit, or our loss of, important sales and marketing personnel, or the inability of new sales personnel to effectively sell and market our microturbine system could materially adversely affect our business and results of operations.

Our sales during the third quarter of 2001 were less than we expected. These trends appear to be continuing into the fourth quarter. As a result, it is difficult for us to forecast the level of sales that may occur in the fourth quarter and, if sales during the latter part of the quarter do not once again substantially exceed the sales early in the quarter, we could experience a material shortfall relative to our expectations and targets.

THE CALIFORNIA ENERGY SITUATION MAY CHANGE AND NEGATIVELY IMPACT OUR SALES.

Problems associated with deregulation of the electric industry in California have resulted in intermittent service interruptions, significantly higher costs in some areas of the state and uncertainty regarding future regulation. To alleviate these problems, emergency procedures have been implemented in California to provide for expedited review and approval of the construction and operation of new power plants in California on favorable terms. Additional competition from these power plants or other power sources that may take advantage of favorable legislation as well as unforeseen changes in the California market could diminish the demand for our products. We cannot assure you that significant sales will arise from this potential market.

WORLD ECONOMIC FACTORS MAY CHANGE AND NEGATIVELY IMPACT OUR GROWTH AND SALES.

It is predicted that there will be a significant slowdown in growth in the U.S. economy for the remainder of 2001 and a portion of 2002. As a consequence of the September 11th terrorist attack on the U.S., and any extended U.S. recession or worldwide slowdown, we may not be able to expand our customer base and sales, which would negatively impact our results. As a result of the economic uncertainty, and a desire by companies to tighten capital expenditures, we have seen reluctance on the part of potentially large customers to buy our products. The economic uncertainty, along with fluctuations in energy prices and political disruptions or higher interest rates could result in weaker than anticipated business growth and worldwide sales of our products.

WE MAY NOT BE ABLE TO ESTABLISH STRATEGIC MARKETING RELATIONSHIPS, IN WHICH CASE OUR SALES WOULD NOT INCREASE AS EXPECTED.

We are in the early stages of developing our distribution network. In order to expand our customer base, we believe that we must enter into strategic marketing alliances or similar collaborative relationships, in which we ally ourselves with companies that have particular expertise in or more extensive access to desirable markets. Providing volume price discounts and other allowances along with significant costs incurred in customizing our products may reduce the potential profitability of these relationships. We may not be able to identify appropriate distributors on a timely basis, and we cannot assure you that the distributors with which we partner will focus adequate resources on selling our products or will be successful in selling them. In addition, we cannot assure you that we will be able to negotiate collaborative relationships on favorable terms or at all. The lack of success of our collaborators in marketing our products may adversely affect our financial condition and results of operations.

WE HAVE LIMITED EXPERIENCE IN INTERNATIONAL SALES AND MAY NOT SUCCEED IN GROWING OUR INTERNATIONAL SALES.

We have limited experience in international sales and will depend on our international marketing partners for these sales. Most of our marketing partnerships are recently created and, accordingly, may not achieve the results that we expect. If a dispute arises between us and any of our partners, we may not achieve our desired sales results and we may be delayed or completely fail to penetrate some international markets, and our revenue and operations could be materially adversely affected. Any inability to obtain foreign regulatory approvals or quality standard certifications on a timely basis could negatively impact our business and results of operations. Also, as we seek to expand into

the international markets, customers may have difficulty or be unable to integrate our products into their existing systems. As a result, our products may require redesign. In addition, we may be subject to a variety of other risks associated with international business, including:

- *delays in establishing international distribution channels;*
- *difficulties in collecting international accounts receivables;*
- *difficulties in complying with foreign regulatory and commercial requirements;*
- *increased costs associated with maintaining international marketing efforts;*
- *compliance with U.S. Department of Commerce export controls;*
- *increases in duty rates;*
- *the introduction of non-tariff trade barriers;*
- *fluctuations in currency exchange rates;*
- *political and economic instability; and*
- *difficulties in enforcement of intellectual property rights.*

THE 60-KILOWATT CAPSTONE MICROTURBINE MAY NOT REACH THE LEVEL OF SALES THAT WE ANTICIPATE OR IT MAY ERODE SALES OF OUR 30-KILOWATT UNIT.

The successful launch of our next generation 60-kilowatt microturbine, the Capstone 60, is very important to our market penetration strategy. Factors that could hinder the successful launch of our Capstone 60 microturbine include potential engineering, production or performance problems, including problems in developing the ability to operate on multiple fuels or in multiple modes of operation and an unstable supply or unsatisfactory quality of components from vendors. We cannot guarantee you that demand for our 60-kilowatt unit will develop or that if it does develop, that it will not diminish over time. It is also possible that production of the 60-kilowatt unit could replace or diminish the sales of our 30-kilowatt unit. If so, our results of operations would be adversely affected.

WE MAY BE UNABLE TO FUND OUR FUTURE OPERATING REQUIREMENTS, WHICH COULD FORCE US TO CURTAIL OUR OPERATIONS.

We are a capital-intensive company and may need additional financing to fund our operations. In 2000, our net cash used in operations was $23.8 million and our net cash used in investing activities totaled $26.9 million. For the nine months ended September 30, 2001, our net cash used in operations was $40.5 million and our net cash used in investing activities was $15.7 million. As of September 30, 2001, we had approximately $181.7 million in cash and cash equivalents on hand. Our future capital requirements will depend on many factors, including our ability to successfully market and sell our products. To the extent that the funds we now have on hand are insufficient to fund our future operating requirements, we will need to raise additional funds, through further public or private equity or debt financings. These financings may not be available or, if available, may be on terms that are not favorable to us and could result in further dilution to our stockholders. Downturns in worldwide capital markets may also impede our ability to raise additional capital on favorable terms or at all. If adequate capital were not available to us, we would likely be required to significantly curtail or possibly even cease our operations.

WE MAY NOT BE ABLE TO EFFECTIVELY PREDICT OR REACT TO RAPID TECHNOLOGICAL CHANGES THAT COULD RENDER OUR PRODUCTS OBSOLETE.

The market for our products is characterized by rapidly changing technologies, extensive research and new product introductions. We believe that our future success will depend in large part upon our ability to enhance our existing products and to develop, introduce and market new products. As a result, we expect to continue to make a significant investment in product

development. We have in the past experienced setbacks in the development of our products and our anticipated roll out of our products has accordingly been delayed. If we are unable to develop and introduce new products or enhancements to our existing products that satisfy customer needs and address technological changes in target markets in a timely manner, our products will become noncompetitive or obsolete.

WE MAY NOT BE ABLE TO EFFECTIVELY MANAGE OUR GROWTH OR IMPROVE OUR MANAGEMENT INFORMATION SYSTEMS, WHICH WOULD IMPAIR OUR PROFITABILITY.

If we are successful in executing our business plan, we will experience growth in our business that could place a significant strain on our management and other resources. Our ability to manage our growth will require us to continue to improve our operational, financial and management information systems, to implement new systems and to motivate and effectively manage our employees. We cannot assure you that our management will be able to effectively manage this growth.

WE MAY NOT EFFECTIVELY EXPAND OUR PRODUCTION CAPABILITIES, WHICH WOULD NEGATIVELY IMPACT OUR SALES.

We anticipate a significant increase in our business operations, which will require expansion of our internal and external production capabilities. We may experience delays or problems in our expected production expansion that could significantly impact our business. Several factors could delay or prevent our expected production expansion, including our:

- *inability to purchase parts or components in adequate quantities or sufficient quality;*
- *failure to increase our assembly and test operations;*
- *failure to hire and train additional personnel;*
- *failure to develop and implement manufacturing processes and equipment;*
- *inability to find and train proper partner companies in other countries with whom we can build product*
- *distribution, marketing, or development relationships;*

- *inability to manufacture recuperator cores on schedule, in quantities or with the quality that we require; and*
- *inability to acquire new space for additional production capacity.*

WE MAY NOT ACHIEVE PRODUCTION COST REDUCTIONS NECESSARY TO COMPETITIVELY PRICE OUR PRODUCT, WHICH WOULD IMPAIR OUR SALES.

We believe that we will need to reduce the unit production cost of our products over time to maintain our ability to offer competitively priced products. Our ability to achieve cost reductions will depend on our ability to develop low cost design enhancements that lower costs, to obtain necessary tooling and favorable vendor contracts, as well as to increase sales volumes so we can achieve economies of scale. We cannot assure you that we will be able to achieve any production cost reductions.

OUR SUPPLIERS AND MANUFACTURERS MAY NOT SUPPLY US WITH A SUFFICIENT AMOUNT OF COMPONENTS OR COMPONENTS OF ADEQUATE QUALITY, AND WE MAY NOT BE ABLE TO PRODUCE OUR PRODUCT.

Although we generally attempt to use standard parts and components for our products, some of our components are currently available only from a single source or from limited sources. Also, we cannot guarantee that any of the parts or components that we purchase will be of adequate quality or that the prices we pay for these parts or components will not increase. For example, there is currently an industry-wide shortage of several electronic components, some of which we use in our products. We may experience delays in production of our Capstone MicroTurbine if we fail to identify alternative vendors, or any parts supply is interrupted or reduced or there is a significant increase in production costs, each of which could materially adversely affect our business

and operations.

OUR PRODUCTS INVOLVE A LENGTHY SALES CYCLE AND WE MAY NOT ANTICIPATE SALES LEVELS APPROPRIATELY, WHICH COULD IMPAIR OUR PROFITABILITY.

The sale of our products typically involves a significant commitment of capital by customers, with the attendant delays frequently associated with large capital expenditures. We are targeting, in part, customers in the utility industry, which generally commit to a larger number of products when ordering and which have a lengthy process for approving capital expenditures. We have also targeted the hybrid electric vehicle market, which requires a significant amount of lead-time due to the implementation costs incurred. For these and other reasons, the sales cycle associated with our products is typically lengthy and subject to a number of significant risks over which we have little or no control. We expect to plan our production and inventory levels based on internal forecasts of customer demand, which is highly unpredictable and can fluctuate substantially.

If sales in any period fall significantly below anticipated levels, our financial condition and results of operations could suffer. In addition, our operating expenses are based on anticipated sales levels, and a high percentage of our expenses are generally fixed in the short term. As a result of these factors, a small fluctuation in timing of sales can cause operating results to vary from period to period.

WE FACE POTENTIALLY SIGNIFICANT FLUCTUATIONS IN OPERATING RESULTS, WHICH COULD IMPACT OUR STOCK PRICE.

A number of factors could affect our operating results and thereby impact our stock price, including:

- *the timing of the introduction or enhancement of products by us or our competitors;*
- *our reliance on a small number of customers;*
- *the size, timing and shipment of individual orders;*
- *market acceptance of new products;*
- *potential delays in production as a result of the commencement of our manufacturing of recuperator cores;*
- *customers delaying orders of our products because of the anticipated release of new products by us;*

- *changes in our operating expenses, the mix of products sold, or product pricing;*
- *the ability of our suppliers to deliver quality parts when we need them;*
- *development of our direct and indirect sales channels;*
- *loss of key personnel;*
- *political unrest or changes in the trade policies, tariffs or other regulations of countries in which we do business that could lower demand for our products; and*
- *changes in market prices for natural resources that could lower the desirability of our products.*

Because we are in the early stages of selling our products, with relatively few customers, we expect our order flow to continue to be uneven from period to period. Because a significant portion of our expenses is fixed, a small variation in the timing of recognition of revenue can cause significant variations in operating results from quarter to quarter.

POTENTIAL INTELLECTUAL PROPERTY, SHAREHOLDER OR OTHER LITIGATION MAY ADVERSELY IMPACT OUR BUSINESS.

Because of the nature of our business, we may face litigation relating to

intellectual property matters, labor matters, product liability and shareholder disputes. Our intellectual property is one of our principal assets. A negative outcome in a litigation relating to our intellectual property could have a material adverse effect on our business and operating results. An adverse judgment could negatively impact the price of our common stock and our ability to obtain future financing on favorable terms or at all. Any litigation could be costly, divert management attention or result in increased costs of doing business.

OUR COMPETITORS, WHO HAVE SIGNIFICANTLY GREATER RESOURCES THAN WE HAVE, MAY BE ABLE TO ADAPT MORE QUICKLY TO NEW OR EMERGING TECHNOLOGIES OR TO DEVOTE GREATER RESOURCES TO THE PROMOTION AND SALE OF THEIR PRODUCTS, AND WE MAY BE UNABLE TO COMPETE EFFECTIVELY.

Our competitors include several well-established companies that have substantially greater resources than we have and that benefit from larger economies of scale and worldwide presence. NREC (Ingersoll-Rand Company), and Elliot are domestically based competitors of Capstone who we believe have microturbines in various stages of development. NREC (Ingersoll-Rand Company) has announced that it expects to begin to commercially ship microturbine units in 2001. In addition to these domestic microturbine competitors, AB Volvo and ABB Ltd. have a joint venture in Europe, called Turbec, to develop a microturbine. A number of other major automotive and industrial companies have in-house microturbine development efforts, including Ishikawajima-Harima Heavy Industries, Mitsubishi Heavy Industries, Ltd. and Turbo Genset Inc. We believe that all of these companies will eventually have products that will compete with our microturbines. Some of our competitors are currently developing and testing microturbines which they expect to produce greater amounts of power than Capstone MicroTurbines, ranging from 75 kilowatts up to 350 kilowatts, and which may have longer useful lives than Capstone MicroTurbines. Capstone MicroTurbines also compete with other existing technologies, including the electric utility grid, reciprocating engines, fuel cells, and solar and wind powered systems. Many of the competitors producing these technologies also have greater resources than we have. For instance, reciprocating engines are produced by, among others, Caterpillar Inc., Interstate companies and Cummins Inc. We cannot assure you that the market for distributed power generation products will not ultimately be dominated by technologies other than ours.

Because of greater resources, some of our competitors may be able to adapt more quickly to new or emerging technologies and changes in customer requirements, or to devote greater resources to the promotion and sale of their products than we can. We believe that developing and maintaining a competitive advantage will require continued investment by us in product development, manufacturing capability and sales and marketing. We cannot assure you that we will have sufficient resources to make the necessary investments to do so. In addition, current and potential competitors have established or may in the future establish collaborative relationships among themselves or with third parties, including third parties with whom we have

strategic relationships. Accordingly, new competitors or alliances may emerge and rapidly acquire significant market share.

WE OPERATE IN A HIGHLY COMPETITIVE MARKET AND MAY NOT BE ABLE TO COMPETE EFFECTIVELY DUE TO FACTORS AFFECTING THE MARKET FOR OUR PRODUCTS.

The market for our products is highly competitive and is changing rapidly. We believe that the primary competitive factors affecting the market for our products include:

- *operating efficiency;*
- *reliability;*
- *product quality and performance;*
- *life cycle costs;*
- *development of new products and features;*
- *quality and experience of sales, marketing and service organizations;*

- availability and price of fuel;

- product price;

- emissions levels;

- name recognition; and

- quality of distribution channels.

Several of these factors are outside our control. We cannot assure you that we will be able to compete successfully in the future with respect to these or any other competitive factors.

UTILITY COMPANIES COULD PLACE BARRIERS TO OUR ENTRY INTO THE MARKETPLACE AND WE MAY NOT BE ABLE TO EFFECTIVELY SELL OUR PRODUCT.

Utility companies commonly charge fees to industrial customers for disconnecting from the grid, for using less electricity, or for having the capacity to use power from the grid for back-up purposes. These types of fees could increase the cost to our potential customers of using our systems and could make our systems less desirable, thereby harming our revenue and profitability.

WE DEPEND ON OUR INTELLECTUAL PROPERTY TO MAKE OUR PRODUCTS COMPETITIVE AND IF WE ARE UNABLE TO PROTECT OUR INTELLECTUAL PROPERTY, OUR BUSINESS WILL SUFFER.

We rely on a combination of patent, trade secret, copyright and trademark law, and nondisclosure agreements to establish and protect our intellectual property rights in our products. At September 30, 2001, we possessed 45 United States patents and 15 international patents and additional patents pending. In particular, we believe that our patents and patents pending for our air-bearing systems, digital power controller and our combustion systems are key to our business. We believe that, due to the rapid pace of technological innovation in turbine products, our ability to establish and maintain a position among the technology leaders in the industry depends on both our patents and other intellectual property and the skills of our development personnel. We cannot assure you that any patent, trademark, copyright or license owned or held by us will not be invalidated, circumvented or challenged, that the rights granted thereunder will provide competitive advantages to us or that any of our future patent applications will be issued with the scope of the claims asserted by us, if at all. Further, we cannot assure you that third parties or competitors will not develop technologies that are similar or superior to our technology, including our air bearing technology, duplicate our technology or design around our patents. Also, another party may be able to reverse engineer our technology and discover our intellectual property and trade secrets. We may be subject to or may initiate proceedings in the U.S. Patent and Trademark Office, which can require significant financial and management resources. In

addition, the laws of foreign countries in which our products are or may be developed, manufactured or sold may not protect our products and intellectual property rights to the same extent as the laws of the United States. Our inability to protect our intellectual property adequately could have a material adverse effect on our financial condition or results of operations.

IF WE ARE FOUND TO INFRINGE UPON THE INTELLECTUAL PROPERTY RIGHTS OF OTHERS, WE MAY NOT BE ABLE TO PRODUCE OUR PRODUCTS OR MAY HAVE TO ENTER INTO COSTLY LICENSE AGREEMENTS.

Third parties may claim infringement by us with respect to past, current or future proprietary rights. In particular, Honeywell (AlliedSignal), Sundstrand Corporation and Solar Turbines Incorporated have patents in areas related to our business and core technologies. Any infringement claim, whether meritorious or not, could be time-consuming, result in costly litigation or arbitration and diversion of technical and management personnel or require us to develop non-infringing technology or to enter into royalty or licensing agreements. Royalty or licensing agreements, if required, may not be available on terms acceptable to us, or at all, and could significantly harm our business and operating results. Litigation may also be necessary in the future to enforce our patent or other intellectual property rights, to protect our trade secrets and to determine the validity and scope of proprietary rights of others. For

example, in 1997, we were involved in a dispute with Honeywell (AlliedSignal) regarding various disputed intellectual property rights. We entered into a settlement agreement regarding these issues. These types of disputes could result in substantial costs and diversion of resources and could materially adversely affect our financial condition and results of operations.

WE OPERATE IN A HIGHLY REGULATED BUSINESS ENVIRONMENT AND CHANGES IN REGULATION COULD IMPOSE COSTS ON US OR MAKE OUR PRODUCTS LESS ECONOMICAL.

Our products are subject to federal, state, local and foreign laws and regulations, governing, among other things, emissions to air as well as laws relating to occupational health and safety. Regulatory agencies may impose special requirements for implementation and operation of our products (e.g. connection with the electric grid) or may significantly impact or even eliminate some of our target markets. We may incur material costs or liabilities in complying with government regulations. In addition, potentially significant expenditures could be required in order to comply with evolving environmental and health and safety laws, regulations and requirements that may be adopted or imposed in the future. Furthermore, our potential utility customers must comply with numerous laws and regulations. The deregulation of the utility industry may also create challenges for our marketing efforts. For example, as part of electric utility deregulation, federal, state and local governmental authorities may impose transitional charges or exit fees, which would make it less economical for some potential customers to switch to our products. Further, our ability to penetrate the Japanese market will depend on our receipt of approvals and changes to regulatory requirements surrounding power generation by Japan's Ministry of International Trade and Industry, or MITI. We can provide no assurances that we will be able to obtain these approvals and changes in a timely manner, or at all.

THE MARKET PRICE OF OUR COMMON STOCK IS HIGHLY VOLATILE AND MAY DECLINE REGARDLESS OF OUR OPERATING PERFORMANCE.

The market price of our common stock is highly volatile. Factors that could cause fluctuation in our stock price may include, among other things:

- *actual or anticipated variations in quarterly operating results;*
- *changes in financial estimates by securities analysts;*
- *conditions or trends in our industry;*
- *changes in the market valuations of other technology companies;*
- *the listing for trading of options on our common stock;*
- *announcements by us or our competitors of significant acquisitions, strategic partnerships, divestitures, joint ventures or other strategic initiatives;*

- *capital commitments;*
- *additions or departures of key personnel; and*
- *sales of common stock.*

Many of these factors are beyond our control. These factors may cause the market price of our common stock to decline, regardless of our operating performance.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

None

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

On July 5, 2000, we completed the initial public offering of our common stock. The shares of common stock sold in the offering were registered under the Securities Act on a Registration Statement on Form S-1/A (No. 333-33024). The

Securities and Exchange Commission declared the Registration Statement effective on June 28, 2000.

In our initial public offering, we sold an aggregate of 10,454,545 shares our common stock for net proceeds of approximately $153.6 million. Since our initial public offering, we have used from the general corporate funds, which includes proceeds from a previous offering of the Series G preferred stock, approximately $23 million to purchase tooling and manufacturing equipment, $11 million to repurchase marketing rights and $55 million to fund operating activities, including sales and marketing and research and development. As of September 30, 2001, remaining net proceeds from the offering were primarily held in cash equivalents. With the exception of marketing rights acquired from Fletcher Challenge Limited, none of the net proceeds of the offering were paid, directly or indirectly, to any director or officer of Capstone or any of their associates, or to persons owning ten percent or more of any class of our equity securities, or any affiliates.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None

ITEM 5. OTHER INFORMATION

None

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K:

(a) Index to Exhibits.

The following exhibits are incorporated by reference into this Form 10-Q:

None

(b) Reports on Form 8-K.

None

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.

CAPSTONE TURBINE CORPORATION

BY: /s/ JEFFREY WATTS

Jeffrey Watts,
Senior Vice President Finance and Administration and Chief Financial Officer

Date: November 13, 2001