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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**Form 10-Q**

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(Mark One)

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

For the quarterly period ended September 30, 2018

or

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

For the transition period from        to

Commission File Number: 001-15957

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**Capstone Turbine Corporation**

(Exact name of registrant as specified in its charter)

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

**95-4180883**  
(I.R.S. Employer  
Identification No.)

**16640 Stagg Street**  
**Van Nuys, California**  
(Address of principal executive offices)

**91406**  
(Zip Code)

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

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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 every Interactive Data File required to be submitted 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 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   
Non-accelerated filer

Accelerated filer   
Smaller reporting company   
Emerging growth company

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

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

The number of shares outstanding of the registrant's common stock as of November 2, 2018 was 68,415,345.

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**PART I — FINANCIAL INFORMATION**

**Item 1. Financial Statements**

**CAPSTONE TURBINE CORPORATION AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(In thousands, except share amounts)  
(Unaudited)

	September 30, 2018	March 31, 2018
<b>Assets</b>		
Current Assets:		
Cash and cash equivalents	\$ 12,303	\$ 14,408
Restricted cash	6,000	5,000
Accounts receivable, net of allowances of \$5,828 at September 30, 2018 and \$5,744 at March 31, 2018	16,531	15,968
Inventories, net	15,477	15,633
Prepaid expenses and other current assets	4,967	2,803
Total current assets	55,278	53,812
Property, plant and equipment, net	2,831	2,859
Non-current portion of inventories	1,109	1,041
Intangible assets, net	299	411
Other assets	3,125	250
Total assets	\$ 62,642	\$ 58,373
<b>Liabilities and Stockholders' Equity</b>		
Current Liabilities:		
Accounts payable and accrued expenses	\$ 14,055	\$ 13,503
Accrued salaries and wages	1,562	1,588
Accrued warranty reserve	2,242	1,682
Deferred revenue	5,497	6,596
Revolving credit facility	12,496	8,527
Current portion of notes payable and capital lease obligations	39	192
Total current liabilities	35,891	32,088
Deferred revenue - non-current	1,284	—
Long-term portion of notes payable and capital lease obligations	111	130
Other long-term liabilities	390	396
Total liabilities	37,676	32,614
Commitments and contingencies (Note 15)		
Stockholders' Equity:		
Preferred stock, \$.001 par value; 10,000,000 shares authorized; none issued	—	—
Common stock, \$.001 par value; 515,000,000 shares authorized, 67,817,994 shares issued and 67,607,817 shares outstanding at September 30, 2018; 57,062,598 shares issued and 56,916,646 shares outstanding at March 31, 2018	68	57
Additional paid-in capital	898,108	889,585
Accumulated deficit	(871,479)	(862,225)
Treasury stock, at cost; 210,177 shares at September 30, 2018 and 145,952 shares at March 31, 2018	(1,731)	(1,658)
Total stockholders' equity	24,966	25,759
Total liabilities and stockholders' equity	\$ 62,642	\$ 58,373

See accompanying notes to condensed consolidated financial statements.

**CAPSTONE TURBINE CORPORATION AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
**(In thousands, except per share data)**  
**(Unaudited)**

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2018</b>	<b>2017</b>	<b>2018</b>	<b>2017</b>
Revenue:				
Product, accessories and parts	\$18,627	\$16,005	\$35,712	\$31,496
Service	3,547	3,769	7,651	7,518
Total revenue	<u>22,174</u>	<u>19,774</u>	<u>43,363</u>	<u>39,014</u>
Cost of goods sold:				
Product, accessories and parts	16,945	13,549	32,575	27,586
Service	3,192	3,209	6,929	6,173
Total cost of goods sold	<u>20,137</u>	<u>16,758</u>	<u>39,504</u>	<u>33,759</u>
Gross margin	<u>2,037</u>	<u>3,016</u>	<u>3,859</u>	<u>5,255</u>
Operating expenses:				
Research and development	891	1,139	1,822	2,288
Selling, general and administrative	5,308	4,796	10,962	9,757
Total operating expenses	<u>6,199</u>	<u>5,935</u>	<u>12,784</u>	<u>12,045</u>
Loss from operations	(4,162)	(2,919)	(8,925)	(6,790)
Other income (expense)	(7)	14	(21)	4
Interest income	—	—	—	9
Interest expense	(186)	(98)	(304)	(319)
Change in warrant valuation	—	(657)	—	(657)
Loss before provision for income taxes	<u>(4,355)</u>	<u>(3,660)</u>	<u>(9,250)</u>	<u>(7,753)</u>
Provision for income taxes	2	7	5	7
Net loss	<u><u>\$(4,357)</u></u>	<u><u>\$(3,667)</u></u>	<u><u>\$(9,255)</u></u>	<u><u>\$(7,760)</u></u>
Net loss per common share—basic and diluted	<u>\$ (0.07)</u>	<u>\$ (0.09)</u>	<u>\$ (0.15)</u>	<u>\$ (0.18)</u>
Weighted average shares used to calculate basic and diluted net loss per common share	<u>65,065</u>	<u>42,941</u>	<u>63,422</u>	<u>42,606</u>

See accompanying notes to condensed consolidated financial statements.

**CAPSTONE TURBINE CORPORATION AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(In thousands)  
(Unaudited)

	<b>Six Months Ended</b>	
	<b>September 30,</b>	
	<b>2018</b>	<b>2017</b>
<b>Cash Flows from Operating Activities:</b>		
Net loss	\$ (9,255)	\$ (7,760)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	568	583
Amortization of deferred financing costs	85	133
Accounts receivable allowances	55	(22)
Inventory provision	408	590
Provision for warranty expenses	1,251	995
Loss on disposal of equipment	7	26
Stock-based compensation	451	307
Change in warrant valuation	—	657
Changes in operating assets and liabilities:		
Accounts receivable	(619)	3,778
Inventories	(320)	(2,360)
Prepaid expenses, other current assets and other assets	(5,135)	266
Accounts payable and accrued expenses	448	(790)
Accrued salaries and wages and long term liabilities	(32)	(7)
Accrued warranty reserve	(691)	(2,199)
Deferred revenue	184	(49)
Net cash used in operating activities	<u>(12,595)</u>	<u>(5,852)</u>
<b>Cash Flows from Investing Activities:</b>		
Expenditures for property and equipment	(316)	(521)
Net cash used in investing activities	<u>(316)</u>	<u>(521)</u>
<b>Cash Flows from Financing Activities:</b>		
Net proceeds from (repayments of) revolving credit facility	3,969	(1,958)
Repayment of notes payable and capital lease obligations	(173)	(183)
Cash used in employee stock-based transactions	(73)	(22)
Net proceeds from issuance of common stock and warrants	8,083	3,987
Net cash provided by financing activities	<u>11,806</u>	<u>1,824</u>
Net decrease in Cash, Cash Equivalents and Restricted Cash	(1,105)	(4,549)
Cash, Cash Equivalents and Restricted Cash, Beginning of Period	19,408	19,705
Cash, Cash Equivalents and Restricted Cash, End of Period	<u>\$ 18,303</u>	<u>\$ 15,156</u>
<b>Supplemental Disclosures of Cash Flow Information:</b>		
Cash paid during the period for:		
Interest	\$ 186	\$ 205
Income taxes	\$ 5	\$ 7
<b>Supplemental Disclosures of Non-Cash Information:</b>		
Acquisition of property and equipment through accounts payable	\$ 110	\$ 99

See accompanying notes to condensed consolidated financial statements.

**CAPSTONE TURBINE CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
(Unaudited)

## 1. Business and Organization

Capstone Turbine Corporation (the “Company”) develops, manufactures, markets and services microturbine technology solutions for use in stationary distributed power generation applications and distribution networks, including cogeneration (combined heat and power (“CHP”), integrated combined heat and power (“ICHP”), and combined cooling, heat and power (“CCHP”)), renewable energy, natural resources and critical power supply. In addition, the Company’s microturbines can be used as battery charging generators for hybrid electric vehicles and to provide power to a vessel’s electrical loads in marine applications. The Company’s microturbines can be interconnected to other distributed energy resources to form “microgrids” (also called “distribution networks”) located within a specific geographic area and provide power to a group of buildings. The Company also remanufactures microturbine engines and provides aftermarket parts and services. The Company was organized in 1988 and has been commercially producing its microturbine generators since 1998.

## 2. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (“generally accepted accounting principles” or “GAAP”) for interim financial information and the instructions to Form 10-Q and Regulation S-X promulgated under the Securities Exchange Act of 1934, as amended (the “Exchange Act”). They do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. The condensed consolidated balance sheet at March 31, 2018 was derived from audited consolidated financial statements included in the Company’s Annual Report on Form 10-K for the year ended March 31, 2018. In the opinion of management, the interim condensed consolidated financial statements include all adjustments (including 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 condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the Fiscal Year 2018. This Quarterly Report on Form 10-Q (this “Form 10-Q”) refers to the Company’s fiscal years ending March 31 as its “Fiscal” years.

**Significant Accounting Policies** Except for the accounting policy for revenue recognition that was updated, as set forth below, as a result of adopting Accounting Standards Update (“ASU”) No. 2014-09 (defined below), there have been no changes to the Company’s significant accounting policies described in the Annual Report on Form 10-K for the Fiscal Year 2018 filed with the SEC on June 7, 2018, that have had a material impact on the Company’s condensed consolidated financial statements and related notes.

**Cash, Cash Equivalents and Restricted Cash** The Company considers only those investments that are highly liquid and readily convertible to cash with original maturities of three months or less at date of purchase as cash equivalents. The Company maintains its cash and cash equivalents in highly rated financial institutions, and at times these balances exceed insurable amounts. Restricted cash represents the Company’s cash held by Western Alliance Bank through its Bridge Bank division (“Bridge Bank”) and as a condition of the two secured credit facilities (the “Bridge Bank Credit Agreements”) with Bridge Bank, the Company has restricted \$6.0 million of cash equivalents as additional security for the credit facility. The following table provides a reconciliation of cash, cash equivalents and restricted cash reported within the condensed consolidated balance sheets that sum to the total of the same amounts shown in the statements of cash flows.

	September 30, 2018	March 31, 2018
Cash and cash equivalents	\$ 12,303	\$ 14,408
Restricted cash	6,000	5,000
Total cash, cash equivalents and restricted cash	\$ 18,303	\$ 19,408

***Evaluation of Ability to Maintain Current Level of Operations*** In connection with preparing the consolidated financial statements for the second quarter of Fiscal 2019, management evaluated whether there were conditions and events, considered in the aggregate, that raised substantial doubt about the Company's ability to meet its obligations as they became due for the next twelve months from the date of issuance of its second quarter of Fiscal 2019 interim condensed consolidated financial statements. Management assessed that there were such conditions and events, including a history of recurring operating losses, negative cash flows from operating activities, the continued impact of the volatility of the global oil and gas markets, a strong U.S. dollar in certain markets making its products more expensive in such markets and ongoing global geopolitical tensions. The Company incurred a net loss of \$4.4 million and used cash in operating activities of \$6.6 million for the second quarter of Fiscal 2019. Cash used in operating activities includes payment of approximately \$3.0 million to Carrier Corporation ("Carrier") for a negotiated royalty settlement agreement. See Note 14—Other Current Liabilities for additional discussion on the negotiated royalty settlement agreement. The Company's working capital requirements during the second quarter of Fiscal 2019 were higher than management's expectations primarily the result of not recognizing revenue on certain service contracts because of the reassignment of those service contracts from Capstone's legacy California distributor to Cal Microturbine, which resulted in a higher than expected net loss. In addition, the Company's net loss was negatively impacted during the second quarter of Fiscal 2019 because of an increase in the Company's warranty provision as a result of a supplier defect identified during the first quarter of Fiscal 2019. As of September 30, 2018, the Company had cash, cash equivalents and restricted cash of \$18.3 million, and outstanding borrowings under its credit facility of \$12.5 million.

Management evaluated these conditions in relation to the Company's ability to meet its obligations as they become due. The Company's ability to continue current operations and to execute on management's plans is dependent on its ability to generate cash flows from operations. Management believes that the Company will continue to make progress on its path to profitability by continuing to maintain low operating expenses and develop its geographical and vertical markets. The Company may seek to raise funds by selling additional securities (through at-the-market offerings or otherwise) or by obtaining additional debt financing. There is no assurance that the Company will be able to obtain additional funds on commercially favorable terms or at all. If the Company raises additional funds by issuing additional equity or convertible debt securities, the fully diluted ownership percentages of existing stockholders will be reduced. In addition, any equity or debt securities that the Company would issue may have rights, preferences or privileges senior to those of the holders of its common stock.

Based on the Company's current operating plan, management anticipates that, given current working capital levels, current financial projections and the ability to borrow under its credit facility with Bridge Bank, the Company will be able to meet its financial obligations as they become due over the next twelve months from the date of issuance of its second quarter of Fiscal 2019 financial statements.

***Basis for Consolidation*** The consolidated financial statements include the accounts of the Company, Capstone Turbine International, Inc., its wholly owned subsidiary that was formed in June 2004 and Capstone Turbine Financial Services, LLC, its wholly owned subsidiary that was formed in October 2015, after elimination of inter-company transactions.

### **3. Recently Issued Accounting Standards**

#### *Adopted*

In May 2014, the Financial Accounting Standards Board ("FASB") issued ASU, 2014-09, Revenue from Contracts with Customers (Topic 606), ("ASU 2014-09"). ASU 2014-09 outlines a single, comprehensive model for accounting for revenue from contracts with customers and requires more detailed disclosure to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from such contracts. ASU 2014-09 provides a five-step analysis of transactions to determine when and how revenue is recognized. The core principle is that a company 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 and services. On April 1, 2018, the Company adopted ASU 2014-09 under the modified retrospective transition method. This method was applied to contracts that were not complete as of the date of initial application of ASU 2014-09.

During the three and six months ended September 30, 2018, the Company recognized revenue based on ASU 2014-09, however revenue for the three and six months ended September 30, 2017 was recognized based on Accounting Standards Codification, Topic 605, Revenue Recognition. See Note 13—Revenue Recognition for additional discussion of the impact of the adoption of ASU 2014-09.

*Not yet adopted*

On August 17, 2018, the SEC issued Release No. 33-10532, “Disclosure Update and Simplification”, (“Release No. 33-10532”) which amends certain redundant, duplicative, outdated, superseded or overlapping disclosure requirements. The amendments in this rule are intended to facilitate the disclosure of information to investors and to simplify compliance without significantly impacting the mix of information provided to investors. The amendments also expand the disclosure requirements regarding the analysis of stockholders’ equity for interim financial statements, in which entities will be required to present a reconciliation for each period for which a statement of comprehensive income is required to be filed. The final rule became effective on November 5, 2018, however the SEC announced that it would not object if a filer’s first presentation of the changes in stockholders’ equity were included in its Form 10-Q for the quarter that begins after the effective date of the amendments. The Company is currently evaluating the impact of Release No. 33-10532 on its consolidated financial position and results of operations.

On June 2018, the FASB issued ASU 2018-07, “Shared-Based Payment Arrangements with Nonemployees” (Topic 505), (“ASU 2018-07”). ASU 2018-07 simplifies the accounting for share-based payments granted to nonemployees for goods and services. Under ASU 2018-07, most of the guidance on such payments to nonemployees will be aligned with the requirements for share-based payments granted to employees. Under the ASU 2018-07, the measurement of equity-classified nonemployee share-based payments will be fixed on the grant date, as defined in ASC 718, and will use the term nonemployee vesting period, rather than requisite service period. The amendments in this update are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early adoption is permitted if financial statements have not yet been issued. The Company is currently evaluating the impact of ASU 2018-07 on its consolidated financial position and results of operations.

On December 22, 2017, the SEC issued guidance under Staff Accounting Bulletin No. 118, Income Tax Accounting Implications of the Tax Cuts and Jobs Act (“SAB 118”) directing taxpayers to consider the impact of the U.S. legislation as “provisional” when it does not have the necessary information available, prepared or analyzed (including computations) in reasonable detail to complete its accounting for the change in tax law. In accordance with SAB 118, our estimated income tax is considered provisional and the Company’s analysis is expected to be finalized by the end of the 2018 calendar year.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842), (“ASU 2016-02”). The purpose of ASU 2016-02 is to provide financial statement users a better understanding of the amount, timing, and uncertainty of cash flows arising from leases. The adoption of ASU 2016-02 will result in the recognition of a right-of-use asset and a lease liability for most operating leases. New disclosure requirements include qualitative and quantitative information about the amounts recorded in the financial statements. In September 2017, the FASB issued ASU 2017-13, Revenue Recognition (Topic 605), Revenue from Contracts with Customers (Topic 606), Leases (Topic 840), and Leases (Topic 842), which provides additional implementation guidance on the previously issued ASU 2016-02 Leases (Topic 842). ASU 2016-02 requires a lessee to recognize assets and liabilities on the balance sheet for leases with lease terms greater than 12 months. ASU 2016-02 is effective for fiscal years beginning after December 15, 2018. ASU 2016-02 requires a modified retrospective transition by means of a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year in which the guidance is effective with the option to elect certain practical expedients. Early adoption is permitted. The Company is currently evaluating the impact of ASU 2016-02 on its consolidated financial position and results of operations.

#### **4. Customer Concentrations and Accounts Receivable**

Sales to Horizon Power Systems (“Horizon”) and E-Finity Distributed Generation, LLC (“E-Finity”), two of the Company’s domestic distributors and Safwan Petroleum Technologies Company (“SPETCO International”), one of the Company’s Middle East and African distributors, accounted for 15%, 12% and 10%, respectively, of revenue for the three months ended September 30, 2018. Sales to Reliable Secure Power Systems, (“RSP”), Regatta Solutions, Inc. (“Regatta”) and E-Finity Distributed Generation, LLC (“E-Finity”), three of the Company’s domestic distributors, and Optimal Group Australia Pty Ltd, one of the Company’s Australian distributors and IBT Europe GmbH (“IBT”), one of



the Company's European distributors, accounted for 12%, 11%, 11%, 11% and 10%, respectively, of revenue for the three months ended September 30, 2017. For the six months ended September 30, 2018, E-Finity and Horizon, accounted for 11% and 10% of revenue, respectively. For the six months ended September 30, 2017, E-Finity, Horizon and Optimal accounted for 13%, 12% and 10% of revenue, respectively.

Additionally, E-Finity, Woojin Mechanical and Electrical Co., Ltd ("Woojin"), one of the Company's Asian distributors, Cal Microturbine ("Cal"), one of the Company's domestic distributors, Serba Dinamik Sdn Bhd ("Serba"), one of the Company's Malaysian distributors and Supernova Energy Services SAS, one of the Company's Columbian distributors ("Supernova") accounted for 12%, 12%, 11% and 10%, respectively, of net accounts receivable as of September 30, 2018. Serba, E-Finity, and Supernova accounted for 20%, 18% and 10%, respectively, of net accounts receivable as of March 31, 2018.

On October 13, 2017, the Company entered into an Accounts Receivable Assignment Agreement (the "Assignment Agreement") and Promissory Note (the "Note") with Turbine International, LLC ("TI").

Pursuant to the terms of the Assignment Agreement, the Company agreed to assign to TI the right, title and interest to receivables owed to the Company from BPC Engineering, its former Russian distributor ("BPC"), upon TI's payment to the Company of \$2.5 million in three payments by February 1, 2018. The Company received payments from TI of approximately \$1.0 million under the Assignment Agreement during Fiscal 2018, which was recorded as bad debt recovery. The receivables owed to the Company from BPC had a balance of \$5.2 million as of September 30, 2018, and this balance was fully reserved. As of September 30, 2018, the right, title and interest to the receivables owed to the Company from BPC had not been assigned to TI, as TI had not yet made all payments as required under the Assignment Agreement by February 1, 2018.

On October 13, 2017, the Company and Hispania Petroleum, S.A. (the "Guarantor") entered into a Guaranty Agreement (the "Guaranty Agreement") whereby the Guarantor guarantees TI's obligations under the Agreement and Note. However, due to the Company's limited business relationship with TI and the missed payments on the Assignment Agreement, the Company deferred recognition of the Assignment Agreement and Note until collectability is reasonably assured.

In connection with the terms of the Note, the Company granted TI the sole distribution rights for its products and services in the Russian oil and gas sector. As a result of this appointment, TI agreed to pay the Company \$3.8 million over a three-year period in 35 equal monthly installments starting in August 2018.

On June 5, 2018, the Company entered into an amendment to the Assignment Agreement (the "Amended Assignment Agreement") and the Note (the "Amended Note") with TI. Pursuant to the terms of the Amended Assignment Agreement, the right, title and interest to receivables owed to the Company from BPC will be contingent upon TI's payment to the Company of the remaining approximately \$1.5 million in five payments by September 20, 2019. During the first quarter of Fiscal 2019 no payment was due under these agreements. Under the terms of the Amended Note, TI agreed to pay the Company \$3.8 million over a three-year period in 13 equal quarterly installments starting in December 20, 2019.

The Company recorded a net bad debt expense of approximately \$0.1 million during each of the three and six months ended September 30, 2018, respectively. The Company recorded a net bad debt recovery of approximately \$9,000 and \$22,000 during the three and six months ended September 30, 2017, respectively.

As of March 31, 2015, the Company had an amount owed of approximately \$8.1 million by BPC. As of September 30, 2018, the Company collected cumulatively approximately \$1.8 million from BPC on their accounts receivable which has been previously reserved. The Company collected approximately \$0.1 million from TI during the three months ended September 30, 2018, under the terms of the Amended Assignment Agreement. The Company cumulatively collected approximately \$1.1 million from TI, under the terms of the Assignment Agreement and the Amended Assignment Agreement. The remaining balance of the fully reserved accounts receivable was \$5.2 million as of September 30, 2018.

## 5. Inventories

Inventories are valued at the lower of cost (determined on a first in first out (“FIFO”) basis) or net realizable value and consisted of the following as of September 30, 2018 and March 31, 2018 (in thousands):

	September 30, 2018	March 31, 2018
Raw materials	\$ 19,716	\$ 17,981
Work in process	30	111
Finished goods	1,449	4,076
Total	21,195	22,168
Less inventory reserve	(4,609)	(5,494)
Less non-current portion	(1,109)	(1,041)
Current portion	<u>\$ 15,477</u>	<u>\$ 15,633</u>

The non-current portion of inventories represents the portion of the inventories in excess of amounts expected to be sold or used in the next twelve months. The non-current inventories are primarily comprised of repair parts for older generation products that are still in operation but are not technologically compatible with current configurations. The weighted average age of the non-current portion of inventories on hand as of September 30, 2018 is 1.3 years. The Company expects to use the non-current portion of the inventories on hand as of September 30, 2018 over the periods presented in the following table (in thousands):

Expected Period of Use	Non- current Inventory Balance Expected to be Used
13 to 24 months	\$ 405
25 to 36 months	704
Total	<u>\$ 1,109</u>

## 6. Property, Plant and Equipment

Property, plant and equipment consisted of the following as of September 30, 2018 and March 31, 2018 (in thousands):

	September 30, 2018	March 31, 2018
Machinery, rental equipment, equipment, automobiles and furniture	\$ 15,295	\$ 15,481
Leasehold improvements	11,053	10,949
Molds and tooling	2,834	2,904
	29,182	29,334
Less, accumulated depreciation	(26,351)	(26,475)
Total property, plant and equipment, net	<u>\$ 2,831</u>	<u>\$ 2,859</u>

The Company regularly reassesses the useful lives of property and equipment and retires assets no longer in service. Depreciation expense for property and equipment was \$0.2 million and \$0.4 million for each of the three and six months ended September 30, 2018 and 2017, respectively.

## 7. Intangible Assets

Intangible assets consisted of the following as of September 30, 2018 and March 31, 2018 (in thousands):

	September 30, 2018			
	Weighted Average Amortization Period	Intangible Assets, Gross	Accumulated Amortization	Intangible Assets, Net
Manufacturing license	17 years	\$ 3,700	\$ 3,700	\$ —
Technology	10 years	2,240	1,941	299
Trade name & parts, service and TA100 customer relationships	1.2 to 5 years	1,766	1,766	—
Total		<u>\$ 7,706</u>	<u>\$ 7,407</u>	<u>\$ 299</u>

  

	March 31, 2018			
	Weighted Average Amortization Period	Intangible Assets, Gross	Accumulated Amortization	Intangible Assets, Net
Manufacturing license	17 years	\$ 3,700	\$ 3,700	\$ —
Technology	10 years	2,240	1,829	411
Trade name & parts, service and TA100 customer relationships	1.2 to 5 years	1,766	1,766	—
Total		<u>\$ 7,706</u>	<u>\$ 7,295</u>	<u>\$ 411</u>

Amortization expense for the intangible assets was \$0.1 million for each of the three and six months ended September 30, 2018 and 2017, respectively.

Expected future amortization expense of intangible assets as of September 30, 2018 is as follows (in thousands):

Year Ending March 31,	Amortization Expense
2019 (remainder of fiscal year)	112
2020	187
Total expected future amortization	<u>\$ 299</u>

The manufacturing license provides the Company with the ability to manufacture recuperator cores previously purchased from Solar Turbines Incorporated (“Solar”). The Company is required to pay a per-unit royalty fee over a seventeen-year period for cores manufactured and sold by the Company using the technology. Royalties of approximately \$10,000 and \$7,200 were earned by Solar for the three months ended September 30, 2018 and 2017, respectively. Royalties of approximately \$17,100 and \$13,700 were earned by Solar for the six months ended September 30, 2018 and 2017, respectively. Earned royalties of approximately \$10,000 and \$8,000 were unpaid as of September 30, 2018 and March 31, 2018, respectively, and are included in accounts payable and accrued expenses in the accompanying condensed consolidated balance sheets.

## 8. Stock-Based Compensation

The following table summarizes, by condensed consolidated statement of operations line item, stock-based compensation expense for the Company’s three and six months ended September 30, 2018 and 2017 (in thousands):

	Three Months Ended September 30,		Six Months Ended September 30,	
	2018	2017	2018	2017
Cost of goods sold	\$ 13	\$ 18	\$ 25	\$ 38
Research and development	6	5	13	12
Selling, general and administrative	205	130	413	257
Stock-based compensation expense	<u>\$ 224</u>	<u>\$ 153</u>	<u>\$ 451</u>	<u>\$ 307</u>

**Stock Plans**

**2000 Equity Incentive Plan and 2017 Equity Incentive Plan**

In June 2000, the Company adopted the 2000 Equity Incentive Plan (“2000 Plan”). The 2000 Plan provides for a total maximum aggregate number of shares which may be issued of 1,849,000 shares. In June 2017, the Company’s Board of Directors (the “Board”) adopted the Capstone Turbine Corporation 2017 Equity Incentive Plan (the “2017 Plan”) which was approved by the stockholders at the Company’s 2017 annual meeting of stockholders on August 31, 2017 (the “2017 Annual Meeting”). The 2017 Plan provides for awards of up to 3,000,000 shares of common stock. The 2017 Plan is administered by the Compensation Committee designated by the Board (the “Compensation Committee”). The Compensation Committee’s authority includes determining the number of incentive awards and vesting provisions. On June 5, 2018, the Company’s Board of Directors adopted an amendment of the 2017 Plan to increase the aggregate number of shares of common stock authorized for issuance under the 2017 Plan by 3,000,000 shares of common stock. The amendment of the 2017 Plan was approved by the Company’s stockholders at the 2018 annual meeting of stockholders on August 30, 2018.

*Stock Options*

The Company issued stock options under the 2000 Plan and issues stock options under the 2017 Plan to employees, non-employee directors and consultants that vest and become exercisable over a four-year period and expire 10 years after the grant date. The Company uses a Black-Scholes valuation model to estimate the fair value of the options at the grant date, and compensation cost is recorded on a straight-line basis over the vesting period. All options are subject to the following vesting provisions: one-fourth vest one year after the issuance date and 1/48th vest on the first day of each full month thereafter, so that all options will be vested on the first day of the 48th month after the grant date. Information relating to stock options for the Company’s six months ended September 30, 2018 is as follows:

	<u>Shares</u>	<u>Weighted-Average Exercise Price</u>	<u>Weighted-Average Remaining Contractual Term (in years)</u>	<u>Aggregate Intrinsic Value</u>
Options outstanding at March 31, 2018	212,392	\$ 20.71		
Granted	—	\$ —		
Exercised	—	\$ —		
Forfeited, cancelled or expired	(2,500)	\$ 55.20		
Options outstanding at September 30, 2018	<u>209,892</u>	<u>\$ 20.30</u>	<u>2.4</u>	<u>—</u>
Options fully vested at September 30, 2018 and those expected to vest beyond September 30, 2018	<u>209,892</u>	<u>\$ 20.30</u>	<u>2.4</u>	<u>—</u>
Options exercisable at September 30, 2018	<u>209,892</u>	<u>\$ 20.30</u>	<u>2.4</u>	<u>—</u>

*Black-Scholes Model Valuation Assumptions*

There were no stock options granted during either of the three or six months ended September 30, 2018 or 2017. There was no expense associated with stock options during the three or six months ended September 30, 2018. The Company recorded expense of approximately \$8,000 and \$17,000 associated with its stock options during the three and six months ended September 30, 2017, respectively. There were no unvested stock option awards as of September 30, 2018.

*Restricted Stock Units and Performance Restricted Stock Units*

The Company issued restricted stock units under the 2000 Plan and issues restricted stock units under the 2017 Plan to employees, non-employee directors and consultants. The restricted stock units are valued based on the closing price of the Company’s common stock on the date of issuance, and compensation cost is recorded on a straight-line basis over the vesting period. The restricted stock units vest over a period of two, three or four years. For restricted stock units with two year vesting, 100% vests on the second year anniversary. For restricted stock units with three year vesting, one-third vest annually beginning one year after the issuance date. For restricted stock units with four year vesting, one-

fourth vest annually beginning one year after the issuance date. The restricted stock units issued to non-employee directors vest one year after the issuance date. The following table outlines the restricted stock unit and performance restricted stock unit (“PRSU”) activity:

<b>Restricted Stock Units and Performance Restricted Stock Units</b>	<b>Shares</b>	<b>Weighted Average Grant Date Fair Value</b>
Nonvested restricted stock units outstanding at March 31, 2018	2,011,611	\$ 0.90
Granted	634,856	1.36
Vested and issued	(465,165)	0.88
Forfeited	(32,945)	0.86
Nonvested restricted stock units outstanding at September 30, 2018	<u>2,148,357</u>	<u>1.04</u>
Restricted stock units expected to vest beyond September 30, 2018	<u>2,148,334</u>	<u>\$ 1.04</u>

The following table provides additional information on restricted stock units for the Company’s three and six months ended September 30, 2018 and 2017:

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2018</b>	<b>2017</b>	<b>2018</b>	<b>2017</b>
Restricted stock compensation expense (in thousands)	\$ 224	\$ 144	\$ 451	\$ 287
Aggregate fair value of restricted stock units vested and issued (in thousands)	\$ 516	\$ 130	\$ 523	\$ 137
Weighted average grant date fair value of restricted stock units granted during the period	\$ 1.14	\$ 0.62	\$ 1.36	\$ 0.67

As of September 30, 2018, there was approximately \$1.8 million of total compensation cost related to unvested restricted stock units that is expected to be recognized as expense over a weighted average period of 2.1 years.

The Company adopted PRSU activity is included in the above restricted stock units tables. The PRSU Program has a two-year or three-year performance measurement period. The performance measurement period will begin on April 1 of the first fiscal year and end on March 31 of the second fiscal year or the third fiscal year. The program is intended to have overlapping performance measurement periods (e.g., a new three-year cycle begins each year on April 1), subject to Compensation Committee approval. At the end of each performance measurement period, the Compensation Committee will determine the achievement against the performance objectives.

During the six months ended September 30, 2018, the Company granted 147,327 PRSUs with three-year performance measurement period and the criteria measured by the Company’s free cash flow and aftermarket sales absorption. The target PRSU awards for each participant, will be paid upon achievement of the target level of performance for free cash flow and aftermarket sale absorption, taking into account the applicable weighting for the individual metric. Achievement of a performance goal at the threshold level will result in a payment that is 50% of the target PRSU award. Achievement of a performance goal at the maximum level will result in a payment that is 150% of the target PRSU award. The Compensation Committee will use an interpolation table that weights performance between levels for determining the portion of the Target PRSU that is earned. In addition, during the six months ended September 30, 2018, the Company granted 150,000 PRSUs to its President and Chief Executive officer with two-year performance measurement period and the criteria measured by the Company’s institutional ownership levels, Distributor Support System (“DSS program”) cash collections and Factory Protection Plan (“FPP”) gross margins. This equity award is 100% vesting in two years and based on predetermined equally weighted criteria. See Note 13—Revenue Recognition for additional discussion on DSS program.

The weighted average per share grant date fair value of PRSUs granted during the six months ended September 30, 2018 was \$1.59. However, based on the Company’s assessment as of September 30, 2018 that the PRSU threshold for the first performance measurement likely would not be met, the fair value of the PRSU awards were adjusted to zero and no compensation expense was recorded or recognized during the six months ended September 30, 2018. Any compensation expense will be recognized over the corresponding requisite service period and will be adjusted in subsequent reporting periods if the Company’s assessment of the probable level of achievement of the performance

goals change. The Company will continue to periodically assess the likelihood of the PRSU threshold being met until the end of the applicable performance period.

*Restricted Stock Awards*

The Company issued restricted stock awards under the 2000 Plan and issues restricted stock awards under the 2017 Plan to employees and non-employee directors. There were no restricted stock awards granted during the three and six months ended September 30, 2018. During the three and six months ended September 30, 2017 the Company granted stock awards to non-employee directors who elected to take payment of all or any part of the directors’ fees in stock in lieu of cash. The following table outlines the restricted stock award activity for the three and six months ended September 30, 2018 and 2017:

	Three Months Ended <u>September 30,</u> 2017	Six Months Ended <u>September 30,</u> 2017
Restricted stock awards compensation expense (in thousands)	\$ 1	\$ 3
Restricted stock awards granted	1,953	3,969
Weighted average grant date fair value of restricted stock awards granted during the period	\$ 0.64	\$ 0.63

For each term of the Board (beginning on the date of an annual meeting of stockholders and ending on the date immediately preceding the next annual meeting of stockholders), a non-employee director may elect to receive a stock award in lieu of all or any portion of their annual retainer or committee fee cash payment. The shares of stock were valued based on the closing price of the Company’s common stock on the date of grant.

*Employee Stock Purchase Plan*

In June 2000, the Company adopted the Employee Stock Purchase Plan (the “ESPP”). The ESPP provides for the granting of rights to purchase common stock to regular full and part-time employees or officers of the Company and its subsidiaries. In June 2017, the Board unanimously approved an amendment and restatement to the ESPP which was approved by the stockholders at the Company’s annual meeting of stockholders on August 31, 2017. Prior to the current amendment, 70,000 shares of the Company’s common stock had been reserved for issuance. As amended, the ESPP continued by its terms and the number of shares of the Company’s common stock available increased by 500,000 shares which reserved for issuance a total of 570,000 shares of common stock. Under the ESPP, shares of the Company’s common stock are issued upon exercise of the purchase rights. The ESPP will continue by its terms through June 30, 2020, unless terminated sooner.

**Stockholder Rights Plan**

On May 6, 2016, the Company entered into a rights agreement (the “NOL Rights Agreement”) with Broadridge Financial Solutions, Inc. successor-in-interest to Computershare Inc., as rights agent. In connection with the NOL Rights Agreement, the Company’s Board authorized and declared a dividend distribution of one preferred stock purchase right (a “Right”) for each share of the Company’s common stock authorized and outstanding. Each Right entitles the registered holder to purchase from the Company a unit consisting of one one-thousandth of a share of Series B Junior Participating Preferred Stock, par value \$0.001 per share, at a purchase price of \$8.76 per unit, subject to adjustment. The description and terms of the Rights are set forth in the NOL Rights Agreement.

The purpose of the NOL Rights Agreement is to diminish the risk that the Company’s ability to use its net operating losses and certain other tax assets (collectively, “Tax Benefits”) to reduce potential future federal income tax obligations would become subject to limitations by reason of the Company’s experiencing an “ownership change,” as defined in Section 382 of the Internal Revenue Code of 1986. A company generally experiences such an ownership change if the percentage of its stock owned by its “5-percent shareholders,” as defined in Section 382 of the Internal Revenue Code of 1986, increases by more than 50 percentage points over a rolling three-year period. The NOL Rights Agreement is designed to reduce the likelihood that the Company will experience an ownership change under Section 382 of the Internal Revenue Code of 1986 by (i) discouraging any person or group from becoming a 4.99% shareholder and (ii) discouraging any existing 4.99% shareholder from acquiring additional shares of the Company’s stock.

The Rights will not be exercisable until the earlier to occur of (i) the close of business on the tenth business day after a public announcement or filing that a person has, or group of affiliated or associated persons or persons acting in concert have, become an “Acquiring Person,” which is defined as a person or group of affiliated or associated persons or persons acting in concert who, at any time after the date of the NOL Rights Agreement, have acquired, or obtained the right to acquire, beneficial ownership of 4.99% or more of the Company’s outstanding shares of common stock, subject to certain exceptions or (ii) the close of business on the tenth business day after the commencement of, or announcement of an intention to commence, a tender offer or exchange offer the consummation of which would result in any person becoming an Acquiring Person (the earlier of such dates being called the “Distribution Date”). Certain synthetic interests in securities created by derivative positions, whether or not such interests are considered to be ownership of the underlying common stock or are reportable for purposes of Regulation 13D of the Exchange Act, are treated as beneficial ownership of the number of shares of common stock equivalent to the economic exposure created by the derivative position, to the extent actual shares of the common stock are directly or indirectly held by counterparties to the derivatives contracts.

The Rights, which are not exercisable until the Distribution Date, will expire prior to the earliest of (i) May 6, 2019 or such later day as may be established by the Board prior to the expiration of the Rights, provided that the extension is submitted to the Company’s stockholders for ratification at the next annual meeting of stockholders of the Company succeeding such extension; (ii) the time at which the Rights are redeemed pursuant to the NOL Rights Agreement; (iii) the time at which the Rights are exchanged pursuant to the NOL Rights Agreement; (iv) the time at which the Rights are terminated upon the occurrence of certain transactions; (v) the close of business on the first day after the 2017 Annual Meeting of stockholders, if approval by the stockholders of the Company of the NOL Rights Agreement has not been obtained on or prior to the close of business on the first day after the 2017 Annual Meeting of stockholders; (vi) the close of business on the effective date of the repeal of Section 382 of the Internal Revenue Code of 1986, if the Board of Directors determines that the NOL Rights Agreement is no longer necessary or desirable for the preservation of Tax Benefits; and (vii) the close of business on the first day of a taxable year of the Company to which the Board determines that no Tax Benefits are available to be carried forward.

Each share of Series B Junior Participating Preferred Stock will be entitled, when, as and if declared, to a preferential per share quarterly dividend payment equal to the greater of (i) \$1.00 per share or (ii) an amount equal to 1,000 times the dividend declared per share of common stock. Each share of Series B Junior Participating Preferred Stock will entitle the holder thereof to 1,000 votes on all matters submitted to a vote of the stockholders of the Company. In the event of any merger, consolidation or other transaction in which shares of common stock are converted or exchanged, each share of Series B Junior Participating Preferred Stock will be entitled to receive 1,000 times the amount received per one share of common stock.

At the 2017 Annual Meeting, the stockholders approved the NOL Rights Agreement.

## **9. Offerings of Common Stock and Warrants and At-the-Market Offering Program**

On June 7, 2018, the Company entered into a sales agreement with H.C. Wainwright & Co., LLC with respect to an at-the-market offering program pursuant to which the Company may offer and sell, from time to time at its sole discretion, shares of its common stock, having an aggregate offering price of up to \$25.0 million. The Company will set the parameters for sales of the shares, including the number to be sold, the time period during which sales are requested to be made, any limitation on the number that may be sold in one trading day and any minimum price below which sales may not be made. During the three months ended September 30, 2018, the Company issued 3.0 million shares of the Company’s common stock under this at-the-market offering program and the net proceeds to the Company from the sale of the Company’s common stock were approximately \$3.1 million after deducting commissions paid of approximately \$0.1 million. During the six months ended September 30, 2018, the Company issued 3.7 million shares of the Company’s common stock under the at-the-market offering program and the net proceeds to the Company from the sale of the Company’s common stock were approximately \$4.1 million after deducting commissions paid of approximately \$0.1 million. As of September 30, 2018, approximately \$20.7 million remained available for issuance with respect to this at-the-market offering program.

On April 13, 2018, a warrant holder exercised its rights to the warrant agreement to exercise on a cashless basis 5,760,000 Series A warrants at an exercise price of \$0.60 per share under the warrant agreement. In accordance with terms of the warrant agreement, after taking into account the shares withheld to satisfy the cashless exercise option, the Company issued 3,806,243 shares of common stock.

As of September 30, 2018, there were 2,718,750 Series A warrants outstanding and there are no Series B warrants outstanding. Of the total Series A warrants outstanding, 2,178,750 Series A warrants were issued with an exercise price of \$2.55 per share, and have an expiration date of October 25, 2021, and 540,000 Series A warrants were issued with an exercise price of \$0.60 per share, and have an expiration date of April 22, 2021.

Effective August 28, 2015, the Company entered into a sales agreement with Cowen and Company, LLC with respect to an at-the-market offering program pursuant to which the Company offered and sold, from time to time at its sole discretion, shares of its common stock, having an aggregate offering price of up to \$30.0 million. During the six months ended September 30, 2018, the Company issued 2.8 million shares of the Company's common stock under this at-the-market offering program and the net proceeds to the Company from the sale of the Company's common stock were approximately \$4.0 million after deducting commissions paid of approximately \$0.1 million. As of September 30, 2018, 26.0 million shares of the Company's common stock were cumulatively sold pursuant to the at-the-market offering program and the net proceeds to the Company from the sale of the common stock were approximately \$28.6 million after deducting commissions paid of approximately \$0.8 million. This at-the-market offering program expired on May 29, 2018.

## 10. Fair Value Measurements

The FASB has established a framework for measuring fair value using generally accepted accounting principles. That framework provides a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (level 1 measurements) and the lowest priority to unobservable inputs (level 3 measurements). The three levels of the fair value hierarchy are described as follows:

*Level 1.* Inputs to the valuation methodology are unadjusted quoted prices for identical assets or liabilities in active markets.

*Level 2.* Inputs to the valuation methodology include:

- Quoted prices for similar assets or liabilities in active markets
- Quoted prices for identical or similar assets or liabilities in inactive markets
- Inputs other than quoted prices that are observable for the asset or liability
- Inputs that are derived principally from or corroborated by observable market data by correlation or other means

If the asset or liability has a specified (contractual) term, the level 2 input must be observable for substantially the full term of the asset or liability.

*Level 3.* Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

The asset or liability's fair value measurement level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. Valuation techniques used must maximize the use of observable inputs and minimize the use of unobservable inputs.

The table below presents our assets and liabilities that are measured at fair value on a recurring basis at September 30, 2018 and are categorized using the fair value hierarchy (in thousands):



**Fair Value Measurements at September 30, 2018**

	<b>Total</b>	<b>Quoted Prices in Active Markets for Identical Assets (Level 1)</b>	<b>Significant Other Observable Inputs (Level 2)</b>	<b>Significant Unobservable Inputs (Level 3)</b>
Restricted cash	\$6,000	\$ 6,000	\$ —	\$ —

The table below presents our assets and liabilities that are measured at fair value on a recurring basis at March 31, 2018 and are categorized using the fair value hierarchy (in thousands):

**Fair Value Measurements at March 31, 2018**

	<b>Total</b>	<b>Quoted Prices in Active Markets for Identical Assets (Level 1)</b>	<b>Significant Other Observable Inputs (Level 2)</b>	<b>Significant Unobservable Inputs (Level 3)</b>
Restricted cash	\$ 5,000	\$ 5,000	\$ —	\$ —

*Basis for Valuation*

The carrying values reported in the consolidated balance sheets for cash and cash equivalents, restricted cash, accounts receivable and accounts payable approximate fair values because of the immediate or short-term maturities of these financial instruments. As the Company's obligations under the Credit Facility are based on adjustable market rates reflective of what would currently be available to the Company, the Company has determined that the carrying value approximates the fair value. The carrying values and estimated fair values of these obligations are as follows (in thousands):

	<b>As of</b>		<b>As of</b>	
	<b>September 30, 2018</b>	<b>March 31, 2018</b>	<b>September 30, 2018</b>	<b>March 31, 2018</b>
	<b>Carrying Value</b>	<b>Estimated Fair Value</b>	<b>Carrying Value</b>	<b>Estimated Fair Value</b>
Obligations under the credit facility	\$12,496	\$ 12,496	\$ 8,527	\$ 8,527

**11. Revolving Credit Facility**

**Former Credit Facility** The Company maintained two Credit and Security Agreements, as amended, with Wells Fargo, which provided the Company with a line of credit of up to \$20.0 million in the aggregate. Interest expense related the former credit facility with Wells Fargo during the six months ended September 30, 2017 was \$0.2 million, which includes \$0.1 million in amortization of deferred financing costs.

**New Credit Facility** The Company maintains Bridge Bank Credit Agreements with Western Alliance Bank through Bridge Bank, with credit support provided by the Export-Import Bank of the United States through its working capital guarantee program. Under the terms of the Bridge Bank Credit Agreements, the Company may borrow up to \$15.0 million on a revolving basis depending on, among other factors, the amount of its eligible inventory and accounts receivable. The Bridge Bank Credit Agreements will terminate in accordance with their terms on June 2, 2021.

On June 1, 2018, the Company entered into a letter agreement (the "Letter Agreement") with Bridge Bank. The Letter Agreement extended the maturity date under the Company's Bridge Bank Credit Agreements from June 2, 2019 to June 2, 2021. The Letter Agreement increased the line of credit to an amount up to \$15.0 million from \$12.0 million. Additionally, the Letter Agreement reduced the per annum interest rate from prime rate plus 1.50 percent to prime rate plus 1.00 percent; the facility fee from 0.625% to 0.5%, and the cash collateral held at Bridge Bank from 42% to 40%, which is \$6.0 million of the \$15.0 million facility, as well as no fee for early termination.

Total borrowings, letter of credit obligations and the then aggregate committed amount of cash management services under the Bridge Bank Credit Agreements may not exceed 85% of the sum of unrestricted cash and the amount of cash collateral held at Bridge Bank. As a condition of the Bridge Bank Credit Agreements, the Company has restricted \$6.0 million of cash equivalents as additional security for the credit facility. Borrowings under the Bridge

Bank Credit Agreements will bear per annum interest at the prime rate plus 1.0 percent, subject to increase during the occurrence of an event of default. Obligations under the Bridge Bank Credit Agreements are secured by all of the Company's assets, including intellectual property and general intangibles. The Company has incurred \$0.4 million in origination fees. These fees have been recorded under the caption "Prepaid expenses and other current assets" in the accompanying condensed consolidated balance sheets and will be amortized to interest expense through June 2021. As of September 30, 2018, \$12.5 million in borrowings were outstanding and approximately \$2.5 million borrowings were available under the credit facility. Interest expense related to the new credit facility during the three months ended September 30, 2018 was \$0.2 million, which includes \$46,900 in amortization of deferred financing costs. Interest expense related to the new credit facility during the three months ended September 30, 2017 was \$0.1 million, which includes \$28,000 in amortization of deferred financing costs. Interest expense related to the new credit facility during the six months ended September 30, 2018 was \$0.3 million, which includes \$0.1 million in amortization of deferred financing costs. Interest expense related to the new credit facility during the six months ended September 30, 2017 was \$0.2 million, which includes \$46,000 in amortization of deferred financing costs. The Company's borrowing rate was 6.3% at September 30, 2018.

The Bridge Bank Credit Agreements include affirmative covenants as well as negative covenants that prohibit a variety of actions without Bridge Bank's consent, including covenants that limit the Company's ability to (a) incur or guarantee debt, (b) create liens, (c) enter into any merger, recapitalization or similar transaction or purchase all or substantially all of the assets or stock of another entity or (d) sell, assign, transfer or otherwise dispose of the Company's assets.

The financial covenants of the domestic credit agreement with Bridge Bank (the "Domestic Facility"), which is included in the Bridge Bank Credit Agreements, requires the Company not to exceed specified levels of losses relative to its financial model and the outstanding line of credit advances may not exceed 85% of the sum of unrestricted cash and the amount of cash collateral held at Bridge Bank. The Domestic Facility also defines an event of default to include a material adverse effect on the Company's business. An event of default for this or any other reason, if not waived, could have a material adverse effect on the Company. As of September 30, 2018 we were in compliance with the covenants contained in the Bridge Bank Credit Agreements for Fiscal 2019.

## 12. Accrued Warranty Reserve

The Company provides for the estimated costs of warranties at the time revenue is recognized. The specific terms and conditions of those warranties vary depending upon the microturbine product sold and the geography of sale. The Company's product warranties generally start from the delivery date and continue for up to twenty-four months. Factors that affect the Company's warranty obligation include product failure rates, anticipated hours of product operations and costs of repair or replacement in correcting product failures. These factors are estimates that may change based on new information that becomes available each period. Similarly, the Company also accrues the estimated costs to address reliability repairs on products no longer in warranty when, in the Company's judgment, and in accordance with a specific plan developed by the Company, it is prudent to provide such repairs. The Company assesses the adequacy of recorded warranty liabilities quarterly and makes adjustments to the liability as necessary. When the Company has sufficient evidence that product changes are altering the historical failure occurrence rates, the impact of such changes is then taken into account in estimating future warranty liabilities. Changes in accrued warranty reserve during the six months ended September 30, 2018 are as follows (in thousands):

Balance, beginning of the period	\$1,682
Standard warranty provision	1,251
Accrual related to reliability repair programs	—
Deductions for warranty claims	(691)
Balance, end of the period	<u>\$2,242</u>

### 13. Revenue Recognition

On April 1, 2018, the Company adopted the new revenue standard ASU 2014-09 and applied it to all contracts using the modified retrospective method. The Company determined there was no change in applying the new revenue standard, therefore no adjustment to the opening balance of accumulated deficit was needed.

The Company derives its revenues primarily from system sales, service contracts and professional services. Revenues are recognized when control of the systems and services is transferred to the Company's customers in an amount that reflects the consideration it expects to be entitled to in exchange for those services.

The Company determines revenue recognition through the following steps:

- Identification of the contract, or contracts, with a customer
- Identification of the performance obligations in the contract
- Determination of the transaction price
- Allocation of the transaction price to the performance obligations in the contract
- Recognition of revenue when, or as, the Company satisfies a performance obligation

The Company recognizes revenue when performance obligations identified under the terms of contracts with its customers are satisfied, which generally occurs, for systems, upon the transfer of control in accordance with the contractual terms and conditions of the sale. The majority of the Company's revenue associated with systems is recognized at a point in time when the system is shipped to the customer. Revenue from service contracts and post-shipment performance obligations is recognized when or as those obligations are satisfied. The Company primarily offers assurance-type standard warranties that do not represent separate performance obligations and will separately offer and price extended warranties that are separate performance obligations for which the associated revenue is recognized over-time based on the extended warranty period. The Company records amounts billed to customers for reimbursement of shipping and handling costs within revenue. Shipping and handling costs associated with outbound freight after control over a system has transferred to a customer are accounted for as fulfillment costs and are included in cost of goods sold. Sales taxes and other usage-based taxes are excluded from revenue.

Comprehensive Factory Protection Plan ("FPP") service contracts require payment at the beginning of the contract period. Advance payments are not considered a significant financing component as they are typically received less than one year before the related performance obligations are satisfied. These payments are treated as a contract liability and are classified in deferred revenue in the Condensed Consolidated Balance Sheet. Once control transfers to the customer and the Company meets the revenue recognition criteria, the deferred revenue is recognized in the Condensed Consolidated Statement of Income. The deferred revenue relating to the annual maintenance service contracts is recognized in the Condensed Consolidated Statement of Income on a straight line basis over the expected term of the contract.

#### **Significant Judgments - Contracts with Multiple Performance Obligations**

The Company enters into contracts with its customers that often include promises to transfer multiple products, parts, accessories, FPP and services. A performance obligation is a promise in a contract with a customer to transfer products or services that are distinct. Determining whether products and services are distinct performance obligations that should be accounted for separately or combined as one unit of accounting may require significant judgment.

Products, parts and accessories are distinct as such services are often sold separately. In determining whether FPP and service contracts are distinct, the Company considers the following factors for each FPP and services agreement: availability of the services from other vendors, the nature of the services, the timing of when the services contract was signed in comparison to the product delivery date and the contractual dependence of the product on the

customer’s satisfaction with the professional services work. To date, the Company has concluded that all of the FPP and services contracts included in contracts with multiple performance obligations are distinct.

The Company allocates the transaction price to each performance obligation on a relative standalone selling price (“SSP”) basis. The SSP is the price at which the Company would sell a promised product or service separately to a customer. Judgment is required to determine the SSP for each distinct performance obligation.

The Company determines SSP by considering its overall pricing objectives and market conditions. Significant pricing practices taken into consideration include the Company’s discounting practices, the size and volume of the Company’s transactions, the customer demographic, the geographic area where systems and services are sold, price lists, its go-to-market strategy, historical sales and contract prices. The determination of SSP is made through consultation with and approval by the Company’s management, taking into consideration the go-to-market strategy. As the Company’s go-to-market strategies evolve, the Company may modify its pricing practices in the future, which could result in changes to SSP.

In certain cases, the Company is able to establish SSP based on observable prices of products or services sold separately in comparable circumstances to similar customers. The Company uses a single amount to estimate SSP when it has observable prices.

If SSP is not directly observable, for example when pricing is highly variable, the Company uses a range of SSP. The Company determines the SSP range using information that may include market conditions or other observable inputs. The Company typically has more than one SSP for individual products and services due to the stratification of those products and services by customer size and geography.

The following table presents disaggregated revenue by business group for the three and six months ended September 30, 2018 (in thousands):

	<b>Three Months Ended</b>	<b>Six Months Ended</b>
	<b>September 30, 2018</b>	<b>September 30, 2018</b>
Microturbine Products	\$ 14,876	\$ 28,509
Accessories and Parts	3,751	7,203
Total Product, Accessories and Parts	18,627	35,712
Service	3,547	7,651
Total Revenue	<u>\$ 22,174</u>	<u>\$ 43,363</u>

Following is the geographic revenue information based on the primary operating location of the Company’s customers for the three and six months ended September 30, 2018 (in thousands):

	<b>Three Months Ended</b>	<b>Six Months Ended</b>
	<b>September 30, 2018</b>	<b>September 30, 2018</b>
United States	\$ 10,938	\$ 21,812
Mexico	1,186	1,795
All other North America	151	267
Total North America	12,275	23,874
Europe	3,689	6,651
United Kingdom	648	2,559
Columbia	43	2,659
Asia	2,212	3,066
Australia	512	1,365
Kuwait	2,161	2,161
All other	634	1,028
Total Revenue	<u>\$ 22,174</u>	<u>\$ 43,363</u>

## Contract Balances

Our contract liabilities consist of advance payments for systems as well as deferred revenue on service obligations and extended warranties. The current portion of deferred revenue is included in current liabilities under deferred revenue and the non-current portion of deferred revenue is included in other non-current liabilities in the Condensed Consolidated Balance Sheet.

As of September 30, 2018 the balance of deferred revenue was approximately \$6.8 million compared to \$6.6 million as of March 31, 2018. This overall increase in the balance of deferred revenue of \$0.2 million during the six months ended September 30, 2018 was comprised of an increase in deferred revenue attributable to FPP contracts of \$1.1 million, offset by decreases in deferred revenue attributable to the Distributor Support System (“DSS program”) of \$0.5 million and deferred revenue attributable to deposits of \$0.4 million. Changes in deferred revenue during the six months ended September 30, 2018 are as follows (in thousands):

FPP Balance, beginning of the period	\$ 3,549
FPP Billings	8,087
FPP Revenue recognized	<u>(7,078)</u>
Balance attributed to FPP contracts	<u>4,558</u>
DSS program	626
Deposits	<u>1,597</u>
Deferred revenue balance, end of the period	<u>\$ 6,781</u>

Deferred revenue attributed to FPP contracts represents the unearned portion of the billed agreements. FPP agreements are generally paid quarterly in advance with revenue recognized on a straight line basis over the contract period. The DSS program began January 1, 2018 and service revenue derived from the DSS program began in March 2018 and is recognized on a pro rata basis as the distributors purchase our products. Deferred revenue attributed to deposits are primarily non-refundable cash payments from distributors for future orders.

As of September 30, 2018, approximately \$4.6 million of revenue is expected to be recognized from remaining performance obligations for FPP service contracts. The Company expects to recognize revenue on approximately \$3.3 million of these remaining performance obligations over the next 12 months, with the balance recognized thereafter. Revenue from remaining performance obligations for professional services contracts as of September 30, 2018 was not material.

## Unsatisfied Performance Obligations

The Company has elected the practical expedient to disclose only the value of unsatisfied performance obligations for contracts with an original expected length greater than one year. The majority of the Company’s revenues resulted from sales of inventoried systems with short periods of manufacture and delivery and thus are excluded from this disclosure.

## Practical Expedients

We apply a practical expedient to expense costs as incurred for costs to obtain a contract when the amortization period would have been one year or less. These costs are recorded within sales and marketing expenses.

## 14. Other Current Liabilities

The Company is a party to a Development and License Agreement with Carrier Corporation (“Carrier”) regarding the payment of royalties on the sale of each of the Company’s 200 kilowatt (“C200”) microturbines. On July 25, 2018, the Company and Carrier entered into a Second Amendment to the Development and License Agreement (“Second Amendment”) whereby the Company agreed to pay Carrier approximately \$3.0 million to conclude the Company’s current royalty obligation under the Development and License Agreement, dated as of September 4, 2007, as amended (“Development Agreement”) and release the Company from any future royalty payment obligations. The Second Amendment also removed non-compete provisions from the Development Agreement, allowing the Company to

design market or sell its C200 System in conjunction with any energy system and compete with Carrier products in the CCHP market. Carrier earned zero and \$0.2 million in royalties for C200 and C1000 Series system sales during the three and six months ended September 30, 2018, respectively. Carrier earned \$0.2 million and \$0.5 million in royalties for C200 and C1000 Series system sales during the three and six months ended September 30, 2017, respectively. Earned royalties of approximately \$0.2 million were unpaid as of March 31, 2018, and are included in accrued expenses in the accompanying condensed consolidated balance sheets.

On September 19, 2018, the Company paid in full the negotiated royalty settlement of \$3.0 million to Carrier, and as such, there is no further royalty obligation to Carrier. The prepaid royalty of \$3.0 million has been recorded under the captions “Prepaid expenses and other current assets” and “Other assets” in the accompanying condensed consolidated balance sheets and will be amortized in the accompanying condensed consolidated statement of operations over a 15-year amortization period through September 2033 using an effective royalty rate. The effective royalty rate is calculated as the prepaid royalty settlement divided by total projected C200 System units over the 15-year amortization period. On a quarterly basis, the Company will perform a re-forecast of C200 System unit shipments, to see if a change needs to be made to the effective royalty rate. Accordingly, if the Company’s future projections change, its effective royalty rates would change, which could affect the amount and timing of royalty expense the Company recognizes. If impairment exists, then the prepaid royalty asset could be written down to fair value. Prepaid royalties are classified as current assets to the extent that such amounts will be recognized in the Company’s condensed consolidated statements of operations within the next 12 months. The current and long-term portions of prepaid royalties, included in other current assets and other assets, respectively, consisted of (in thousands):

	September 30, 2018
Other current assets	\$ 124
Other assets	2,828
Royalty-related assets	<u>\$ 2,952</u>

## 15. Commitments and Contingencies

### Purchase Commitments

As of September 30, 2018, the Company had firm commitments to purchase inventories of approximately \$37.1 million through Fiscal 2020. Certain inventory delivery dates and related payments are not firmly scheduled; therefore, amounts under these firm purchase commitments will be payable upon the receipt of the related inventories.

### Lease Commitments

The Company leases offices and manufacturing facilities under various non-cancelable operating leases expiring at various times through Fiscal 2025. All of the leases require the Company to pay maintenance, insurance and property taxes. The lease agreements for primary office and manufacturing facilities provide for rent escalation over the lease term and renewal options for five-year periods. Rent expense is recognized on a straight-line basis over the term of the lease. The difference between rent expense recorded and the amount paid is credited or charged to deferred rent, which is included in other long-term liabilities in the accompanying balance sheets. The balance of deferred rent was approximately \$0.4 million as of September 30, 2018 and March 31, 2018, respectively. Rent expense was approximately \$0.6 million during each of the three months ended September 30, 2018 and 2017. Rent expense was approximately \$1.2 million and \$1.1 million during the six months ended September 30, 2018 and 2017, respectively.

### Other Commitments

The Company has agreements with certain of its distributors requiring that if the Company renders parts obsolete in inventories the distributors own and hold in support of their obligations to serve fielded microturbines, then the Company is required to replace the affected stock at no cost to the distributors. While the Company has never incurred costs or obligations for these types of replacements, it is possible that future changes in the Company’s product technology could result and yield costs to the Company if significant amounts of inventory are held at distributors. As of September 30, 2018, no significant inventories were held at distributors.

## **Legal Matters**

### *Federal Securities Class Action*

Two putative securities class action complaints were filed against the Company and certain of its current and former officers in the United States District Court for the Central District of California under the following captions: David Kinney, etc. v. Capstone Turbine, et al., No. 2:15-CV-08914 on November 16, 2015 (the “Kinney Complaint”) and Kevin M. Grooms, etc. v. Capstone Turbine, et al., No. 2:15-CV-09155 on November 25, 2015 (the “Grooms Complaint”).

The putative class in the Kinney Complaint was comprised of all purchasers of the Company’s securities between November 7, 2013 and November 5, 2015. The Kinney Complaint alleges material misrepresentations and omissions in public statements regarding BPC and the likelihood that BPC would not be able to fulfill many legal and financial obligations to the Company. The Kinney Complaint also alleges that the Company’s financial statements were not appropriately adjusted in light of this situation and were not maintained in accordance with GAAP, and that the Company lacked adequate internal controls over accounting. The Kinney Complaint alleges that these public statements and accounting irregularities constituted violations by all named defendants of Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder, as well as violations of Section 20(a) of the Exchange Act by the individual defendants. The Grooms Complaint makes allegations and claims that are substantially identical to those in the Kinney Complaint, and both complaints seek compensatory damages of an undisclosed amount. On January 16, 2016, several shareholders filed motions to consolidate the Kinney and Grooms actions and for appointment as lead plaintiff. On February 29, 2016, the Court granted the motions to consolidate, and appointed a lead plaintiff. On May 6, 2016, a Consolidated Amended Complaint with allegations and claims substantially identical to those of the Kinney Complaint was filed in the consolidated action. The putative class period in the Consolidated Amended Complaint is June 12, 2014 to November 5, 2015. Defendants filed a motion to dismiss the Consolidated Amended Complaint on June 17, 2016. On March 10, 2017, the Court issued an order granting Defendants’ motion to dismiss in its entirety with leave to amend. Plaintiffs filed an amended complaint on April 28, 2017. On February 9, 2018, the Court issued an Order denying Defendants’ motion to dismiss. On March 30, 2018, Defendants filed an answer to the Consolidated Amended Complaint. On May 17, 2018, the Court issued a scheduling order setting a trial date of March 17, 2020. On June 26, 2018, the Court entered an order vacating all deadlines through the end of October 2018 and temporarily staying formal discovery and other proceedings to allow the parties time to conduct a mediation. The parties participated in mediation on September 24, 2018. The mediation did not result in a settlement. The Company has not recorded any liability as of September 30, 2018 since any potential loss is not probable or reasonably estimable given the current status of the proceedings.

### *Federal Individual Securities Action*

An individual securities complaint was filed against us, our Chief Executive Officer, and additional unidentified defendants in the United States District Court for the Central District of California under the following caption: FiveT Investment Management LTD, et al., v. Capstone Turbine, et al., No. 2:18-CV-03512 on April 25, 2018. The lawsuit alleges material misrepresentations and omissions regarding our revenue, sales, and operations because of alleged improper revenue recognition and backlog calculations related to BPC. The lawsuit alleged that these statements constituted violations by all named defendants of Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder, as well as violations of Section 20(a) of the Exchange Act by the individual defendants. The complaint also asserted claims against all named defendants for fraud, negligent misrepresentation, violations of California Civil Code sections 1709 and 1710, and California Corporations Code sections 25400 and 25401. Additionally, the complaint asserted a cause of action against the individual defendants for breach of fiduciary duty. It demanded compensatory damages for the amount of damages allegedly suffered, pre-judgment and post-judgment interest, and fees.

On June 29, 2018, the plaintiffs filed an Amended Complaint for Common Law Fraud and Negligent Misrepresentation. The Amended Complaint asserts claims for common law fraud and negligent misrepresentation, against the Company, Mr. Jamison, and unidentified individual defendants. The Amended Complaint demands damages in an unspecified amount, plus pre-judgment and post-judgment interest and fees. Defendants filed their answer to the Amended Complaint on August 17, 2018. The parties participated in a mediation on September 24, 2018. The mediation did not result in a settlement. On October 12, 2018, the plaintiffs filed a motion for leave to amend their complaint, seeking to reinstate the cause of action for violation of California Civil Code section 25401. The motion is scheduled for hearing on November 30, 2018. The Company has not recorded any liability as of September 30, 2018 since any potential loss is not probable or reasonably estimable given the current status of the proceedings.

*State Derivative Lawsuits — California*

On February 18, 2016, a purported shareholder derivative action was filed in Los Angeles Superior Court in the State of California against the Company and certain of its current and former officers and directors under the following caption: *Stesiak v. Jamison, et al.*, No. BC610782. The lawsuit alleges that certain of the Company's current and former officers and directors knew or should have known that BPC would be unable to fulfill its obligations to the Company, but allowed the Company to make false and misleading statements regarding BPC and the Company's financial condition. The complaint also alleges that the defendants failed to timely adjust the Company's account receivables and backlog to reflect BPC's inability to pay the Company. The complaint asserts causes of action for breach of fiduciary duty and unjust enrichment. It demands damages for the amount of damage sustained by the Company as a result of the individual defendants' alleged breach of fiduciary duties and unjust enrichment, that the Company institute corporate governance reforms, and disgorgement from the individual defendants. On May 5, 2016, the parties filed a stipulation and proposed order seeking to stay this action until such time as the defendants' motion(s) to dismiss the federal securities class action are either granted with prejudice or denied in whole or in part. On May 10, 2016, the Court entered that proposed order. On March 9, 2018, following the Court's order denying Defendants' motion to dismiss in the federal securities class action, the parties filed a stipulation and proposed order seeking to stay this action until the close of fact discovery in the federal securities class action. On March 20, 2018, the Court entered that proposed order. A status conference is scheduled for January 22, 2019.

On June 8, 2016, a purported shareholder derivative action entitled *Velma Kilpatrick v. Simon, et al.*, No. BC623167, was filed in Los Angeles Superior Court in the State of California against the Company and certain of its current and former officers and directors. The complaint alleges that certain of the Company's current and former officers and directors knew or should have known that BPC would be unable to fulfill its obligations to the Company, but allowed the Company to make false and misleading statements regarding BPC and the Company's financial condition. The complaint also alleges that the defendants failed to timely adjust the Company's account receivables and backlog to reflect BPC's inability to pay the Company. The complaint asserts causes of action for breach of fiduciary duty. It demands damages for the amount of damage sustained by the Company as a result of the individual defendants' alleged breach of fiduciary duties, and that the Company institute corporate governance reforms. On August 23, 2016, the parties filed a stipulation and proposed order seeking to stay this action until such time as the defendants' motion(s) to dismiss the federal securities class action are either granted with prejudice or denied in whole or in part. On March 9, 2018, following the Court's order denying Defendants' motion to dismiss in the federal securities class action, the parties filed a stipulation and proposed order seeking to stay this action until the close of fact discovery in the federal securities class action. On March 20, 2018, the Court entered that proposed order. A status conference is scheduled for January 2, 2019.

The parties in both of the above state derivative lawsuits participated in a mediation held on September 24, 2018. Settlement negotiations are ongoing.

*Federal Derivative Lawsuits*

On March 7, 2016, a purported shareholder derivative action was filed in the United States District Court for the Central District of California against the Company and certain of its current and former officers and directors under the following caption: *Haber v. Jamison, et al.*, No. CV16-01569-DMG (RAOx). The lawsuit alleges that certain of the Company's current and former officers and directors knew or should have known that BPC would be unable to fulfill its obligations to the Company, but allowed the Company to make false and misleading statements regarding BPC and the Company's financial condition. The complaint asserts a cause of action for breach of fiduciary duty. It demands damages for the amount of damage sustained by the Company as a result of the individual defendants' alleged breach of fiduciary duties, and equitable relief, including that the Company institute appropriate corporate governance reforms. On May 11, 2016, the parties filed a stipulation and proposed order seeking to stay this action until such time as the defendants' motion(s) to dismiss the federal securities class action are either granted with prejudice or denied in whole or in part. On May 13, 2016, the Court entered that proposed order.

On July 12, 2016 and July 18, 2016, respectively, two additional purported shareholder derivative actions were filed in the United States District Court for the Central District of California against the Company and certain of its current and former officers and directors, under the caption *Tuttle v. Atkinson, et al.*, No. CV16-05127, and *Boll v. Jamison, et al.*, No. CV16-5282, respectively. The lawsuits allege that certain of the Company's current and former officers and directors knew or should have known that BPC would be unable to fulfill its obligations to the Company,



but allowed the Company to make false and misleading statements regarding BPC and the Company's financial condition. The Tuttle complaint asserts causes of action for breach of fiduciary duty, gross mismanagement, and unjust enrichment, and the Boll complaint asserts causes of action for breach of fiduciary duty, unjust enrichment, abuse of control, gross mismanagement, and waste of corporate assets. Both complaints demand damages sustained by the Company as a result of the individual defendants' alleged breaches of fiduciary duties, and equitable relief, including that the Company institute appropriate corporate governance reforms. The federal derivative actions were stayed until such time as the defendants' motion(s) to dismiss the federal securities class action are either granted with prejudice or denied in whole or in part. On March 9, 2018, following the Court's order denying Defendants' motion to dismiss in the federal securities class action, the parties filed a stipulation and proposed order seeking to stay this action until the close of fact discovery in the federal securities class action. On March 13, 2018, the Court granted the parties' stipulation.

The parties in the above federal derivative lawsuits participated in a mediation held on September 24, 2018. Settlement negotiations are ongoing.

*Capstone Turbine Corporation v. Regatta Solutions, Inc.*

On August 14, 2018, the Company initiated arbitration proceedings against its former distributor, Regatta Solutions, Inc. ("Regatta"), and additional unidentified defendants with the American Arbitration Association under the following caption: Capstone Turbine Corp. v. Regatta Solutions, Inc., Case No. 01-18-0003-0860 ("Capstone-Regatta Arbitration"). The Company has alleged claims against Regatta for breach of contract and unjust enrichment relating to an agreement to wind down relations following the mutual non-renewal of the distributor agreement between the parties. As remedies for these claims, the Company is seeking compensatory, consequential, and punitive damages, along with declaratory relief and attorney's fees, interest and costs.

On October 18, 2018, Regatta filed its answer and cross-claims in the Capstone-Regatta Arbitration. In its cross-claims, Regatta has asserted claims for breach of contract, intentional interference with prospective economic advantage, fraud, and intentional interference with contractual relation relating to the agreement to wind down relations and purported sales efforts by the Company's distributor in California. As remedies for these alleged claims, Regatta is seeking no less than \$1.5 million in general and compensatory damages, along with punitive and exemplary damages, as well as attorney's fees and costs. The Company's answer to the cross-claims is due to be filed on November 7, 2018.

On October 18, 2018, Regatta also filed claims in the Superior Court of the State of California, County of Orange, alleging two counts of fraud, and one count of interference with contractual obligations individually against Mr. James Crouse, Executive Vice President of Sales for the Company arising out of the same allegations relating to the agreement to wind down relations and purported sales efforts by the Company's distributor in California. As remedies for these alleged claims, Regatta is seeking no less than \$1.5 million in general and compensatory damages, along with punitive and exemplary damages, as well as attorney's fees and costs. The case was filed under the caption Regatta Solutions, Inc., v. Jim Crouse, et. al., Case No. 30-2018-01026571-CU-FR-CJC. The Company has not recorded any liability as of September 30, 2018 since any potential loss is not probable or reasonably estimable given the current status of the proceedings.

*Capstone Turbine Corporation v. Energy Systems, Inc.*

On August 17, 2018 the Company initiated arbitration proceedings against its former distributor, Energy Systems of Caribbean, Inc. ("Energy Systems") by seeking declaratory relief that its action in terminating the distributorship was justified under the law. The claim was filed with the American Arbitration Association under the following caption: Capstone Turbine Corp. v. Energy Systems of Caribbean, Inc., Case No. 01-18-0003-1307. As remedies for these claims, the Company is seeking declaratory relief and attorney's fees, interest and costs.

On August 22, 2018, Energy Systems filed a claim against the Company in Puerto Rico alleging Breach of Distribution Contract under Law No. 75 of June 24, 1964, as amended, 10 l.p.r.a. §§ 278-278. The case was filed under the caption Energy Systems of Caribbean, Inc., v. Capstone Turbine Corporation, CIVIL NO. SJ2018cv06543 (904). As remedies for these alleged claims, Energy Systems seeks actual damages, injunctive relief, attorney's fees and costs. This matter was subsequently removed to the United States District Court for the District of Puerto Rico based on diversity jurisdiction (Case No. 3:18-cv-01611). The parties have since stipulated to a stay of both the federal litigation and arbitration so that the parties may pursue settlement. The Company has not recorded any liability as of September 30, 2018 since any potential loss is not probable or reasonably estimable given the current status of the proceedings.

## **16. Net Loss Per Common Share**

Basic loss per share of common stock is computed using the weighted average number of common shares outstanding for the period. Diluted loss per share is computed without consideration to potentially dilutive instruments because the Company incurred losses in the three months ended September 30, 2018 which would make these instruments anti-dilutive. As of September 30, 2018 and 2017, the number of anti-dilutive stock options and restricted stock units excluded from diluted net loss per common share computations was approximately 2.4 million and 0.9 million, respectively. As of September 30, 2018, the number of PRSUs subject to performance conditions which have not been satisfied have been excluded from diluted net loss per common share computations was approximately 0.3 million. There were no PRSUs outstanding as of September 30, 2017. As of September 30, 2018 and 2017, the number of warrants excluded from diluted net loss per common share computations was approximately 2.7 million and 10.4 million, respectively.

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

The following discussion should be read in conjunction with the condensed consolidated financial statements and notes included in this Form 10-Q and in our Annual Report on Form 10-K for Fiscal 2018. When used in this Form 10-Q, and 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 under Risk Factors in our Annual Report on Form 10-K for Fiscal 2018 and in other reports we file with the Securities and Exchange Commission (“SEC”). Readers are cautioned not to place undue reliance on forward-looking statements, which speak only as of the date hereof. We assume no obligation to update any of the forward-looking statements contained herein after the filing of this Form 10-Q to conform such statements to actual results or changes in expectations except as may be required by law. All dollar amounts are approximate.

### **Overview**

We are the market leader in microturbines based on the number of microturbines sold. Generally, power purchased from the electric utility grid is less costly than power produced by distributed generation technologies. Utilities may also charge fees to interconnect to their power grids. However, we can provide economic benefits to end users in instances where the waste heat from our microturbine has value (combined heat and power (“CHP”) and combined cooling, heat and power (“CCHP”)), where fuel costs are low (renewable energy/renewable fuels), where the costs of connecting to the grid may be high or impractical (such as remote power applications), where reliability and power quality are of critical importance, or in situations where peak shaving could be economically advantageous because of highly variable electricity prices. Our microturbines can be interconnected to other distributed energy resources to form “microgrids” (also called “distribution networks”) located within a specific geographic area and provide power to a group of buildings. Because our microturbines can provide a reliable source of power and can operate on multiple fuel sources, management believes they offer a level of flexibility not currently offered by other technologies such as reciprocating engines.

Our goals for Fiscal 2019 are to achieve EBITDA breakeven; significantly grow gross margin and revenue for our accessories, parts and service; strengthen our core market verticals, while diversifying into additional market verticals and geographies; and drive towards 100% aftermarket sales absorption. During the second quarter Fiscal 2019 our net loss increased by 19% to \$4.4 million and our basic and diluted loss per share improved by 22% to \$0.07 compared to \$3.7 million and \$0.09, respectively, in the same period of the previous year. The increase in the net loss during the second quarter of Fiscal 2019 was primarily the result of not recognizing revenue on certain service contracts because of the reassignment of those service contracts from Capstone's legacy California distributor to Cal Microturbine. In addition, our net loss was negatively impacted because of an increase in our warranty provision during the second quarter of Fiscal 2019 as a result of a supplier defect identified during the first quarter of Fiscal 2019. The improvement in the net loss per share during the second quarter of Fiscal 2019 was primarily the result of an increase in weighted average shares outstanding to 65.1 million for the second quarter of Fiscal 2019 from 42.9 million for the second quarter of Fiscal 2018. Total revenue increased 12% during the second quarter of Fiscal 2019 primarily because of an increase in revenue from the United States and Canada and Middle East and Africa geographic markets compared to the same period last year. The first half of Fiscal 2019 was characterized by a growth of 11% in our total revenue, strengthening of the natural resources market while diversifying into Latin America, Russia and Middle East and Africa, compared to the first half of Fiscal 2018. Additionally, though the U.S. dollar has somewhat weakened against other currencies, it still continues to be an issue in select markets as the strong dollar makes our products more expensive in those markets as we sell in U.S. dollars.

Our products continue to gain interest in all six of the major vertical markets (energy efficiency, renewable energy, natural resources, critical power supply, microgrid and transportation). In the energy efficiency market, we continue to expand our market presence in hotels, office buildings, hospitals, retail and industrial applications globally. The renewable energy market is fueled by landfill gas, biodiesel, and biogas from sources such as food processing, agricultural waste and livestock manure. Our product sales in the oil and gas and other natural resources market is driven by our microturbines' reliability, emissions profile and ease of installation. Given the volatility of the oil and gas market, our business strategy is to target projects within the energy efficiency and renewal energy markets. However, we experienced growth in the natural resources market during the second quarter of Fiscal 2019, which we believe was primarily because oil prices continued to be above \$60.00 per barrel. Although we have experienced an improvement in revenue during the second quarter of Fiscal 2019 primarily because of a rebound in oil prices, we continue to be

impacted by the volatility of the global oil and gas markets and the ongoing global geopolitical tensions. We also continue to see interest in critical power supply applications as customers want solutions that can handle both primary and backup power.

We continue to focus on improving our products based on customer input, building brand awareness and new channels to market by developing a diversified network of strategic distribution partners. Our focus is on products and solutions that provide near term opportunities to drive repeatable business rather than discrete projects for niche markets. In addition, management closely monitors operating expenses and strives to improve manufacturing efficiencies while simultaneously lowering direct material costs and increasing average selling prices. The key drivers to our success are revenue growth, higher average selling prices, lower direct material costs, positive new order flow and reduced cash usage.

An overview of our direction, targets and key initiatives are as follows:

1. **Focus on Vertical Markets** Within the distributed generation markets that we serve, we focus on vertical markets that we identify as having the greatest near-term potential. In our primary products and applications (energy efficiency, renewable energy, natural resources, critical power supply, microgrid and transportation products), we identify specific targeted vertical market segments. Within each of these segments, we identify what we believe to be the critical factors to success and base our plans on those factors. Given the volatility of the oil and gas market, we have refocused our business strategy to target projects within the energy efficiency, renewable energy and microgrid markets.

The following table summarizes our product shipments by vertical markets:

	Three Months Ended		Six Months Ended	
	September 30,		September 30,	
	2018	2017	2018	2017
Energy efficiency	53%	66%	40%	61%
Natural resources	44%	15%	51%	27%
Renewable energy	3%	19%	6%	12%
Microgrid	—	—	3%	—

*Energy Efficiency—CHP/CCHP*

Energy efficiency refers to the proper utilization of both electrical and thermal energies in the power production process. In such applications, our microturbines are able to maximize the availability of usable energy to provide a significant economic advantage to customers while reducing their onsite emissions. CHP and CCHP can improve site economics by capturing the waste heat created from a single combustion process to increase the efficiency of the total system, from approximately 30 percent to 80 percent or more. Compared with more traditional, independent generation sources, the increase in operational efficiency also reduces greenhouse gas emissions through the displacement of other separate systems, which can also reduce operating costs.

*Natural Resources—Oil, Natural Gas, Shale Gas & Mining*

Our microturbines are installed in the natural resource market for use in both onshore and offshore applications, including oil and gas exploration, production, and at compression and transmission sites as a highly efficient and reliable source of power. In some cases, these oil and gas or mining operations have no electric utility grid and rely solely on power generated onsite. There are numerous locations, on a global scale, where the drilling, production, compression and transportation of natural resources and other extraction and production processes create fuel byproducts, which are traditionally burned or released into the atmosphere. Our microturbines can turn these fuel byproducts - flare gas, or associated gas, into a useable fuel to provide prime power to these sites.

*Renewable Energy*

There is a growing transition to renewable energy sources and technologies happening on a global scale. Our microturbines run efficiently on renewable fuels such as methane and other biogases from landfills, wastewater

treatment facilities and other small biogas applications like food processing plants, livestock farms and agricultural waste operations. Microturbines can burn these renewable fuels with minimal emissions, thereby, and in some cases, avoiding the imposition of penalties incurred for pollution while simultaneously producing electricity from this “free” fuel source for use at the site or in the surrounding areas. Our microturbines have demonstrated effectiveness in these smaller applications and may outperform conventional combustion engines in some situations, including when the gas contains a high amount of sulfur.

#### *Critical Power Supply*

Because of the potentially catastrophic consequences of system failure, momentary or otherwise, certain high demand power users, including high technology, health care and information systems facilities require higher levels of reliability in their power generation service. To meet these customer requirements, traditional solutions utilize UPS to protect critical loads from power disturbances along with back-up diesel generators for extended outages. We offer an alternative solution that can both meet customer reliability requirements and reduce operating costs. We have seen continued development in the critical market segment as it relates to health care facilities.

#### *Microgrid*

Microgrid is a group of interconnected loads and distributed energy resources that act as a single controllable energy entity with respect to the grid. Distributed energy resources typically include other dual-mode microturbines, reciprocating engines, solar photovoltaic (PV), wind turbine, fuel cells and battery storage. Microgrids can be connected to larger electricity grids; however, in the event of a widespread outage, the microgrid will disconnect from the main grid and continue to operate independently to maintain the electricity supply to the homes and businesses that are connected to the microgrid’s electricity network. Our microturbines have the ability to meet the needs of microgrid end-users by lowering their overall cost to operate and by providing a versatile dispatchable technology that is fuel flexible and scalable enough to fit a wide variety of applications. We have seen continued development in the microgrid market segment.

#### *Transportation*

Our technology is also used in hybrid electric vehicle (“HEV”) applications. Our customers have applied our products in HEV applications such as transit buses and Class 7 and 8 work trucks. In these applications, the microturbine acts as an onboard battery charger to recharge the battery system as needed. The benefits of microturbine-powered HEV hybrids include extended range, fuel economy gains, quieter operation, reduced emissions and higher reliability when compared with traditional internal combustion engines.

Our technology is also used in marine applications. Our customers have applied our products in the commercial vessel and luxury yacht market segments. The application for our marine products is for use as a ship auxiliary engine. In this application, the microturbines provide power to the vessel’s electrical loads and, in some cases, the vessel is able to utilize the exhaust energy to increase the overall efficiency of the application, thereby reducing overall fuel consumption and emissions. Another feasible application is similar to our HEV application where the vessel is driven by an electric propulsion system and the microturbine serves as an on board range extender. Transportation is a developing market segment for us. In Fiscal 2018, transportation products were only for customer demonstrations.

#### *Backlog*

Net product orders were approximately \$19.4 million and \$5.8 million for the three months ended September 30, 2018 and 2017, respectively. Ending backlog was approximately \$78.4 million at September 30, 2018 compared to \$110.9 million at September 30, 2017. Book-to-bill ratio was 0.7:1 and 0.5:1 for the three months ended September 30, 2018 and 2017, respectively. Book-to-bill ratio is the ratio of new orders we received to units shipped and billed during a period.

During the first quarter of Fiscal 2019 we removed from product backlog orders related to Regatta Solutions, our former California distributor (“Regatta”) for approximately \$3.8 million. This removal was the result of the

reassignment of the California sales territory to Cal Microturbine, our new exclusive distribution partner in California.

On October 13, 2017, we entered into an Accounts Receivable Assignment Agreement (the "Assignment Agreement") and Promissory Note (the "Note") with Turbine International, LLC ("TI").

Pursuant to the terms of the Assignment Agreement, we agreed to assign to TI the right, title and interest to receivables owed to us from BPC Engineering, our former Russian distributor ("BPC"), upon TI's payment to us of \$2.5 million in three payments by February 1, 2018. We received payments from TI of approximately \$1.0 million under the Assignment Agreement during Fiscal 2018 which was recorded as bad debt recovery. The receivables owed to us from BPC had a balance of \$5.3 million as of March 31, 2018, and this balance was fully reserved. As of March 31, 2018, the right, title and interest to the accounts receivables owed to us from BPC had not been assigned to TI, as TI had not yet made all payments as required under the Assignment Agreement by February 1, 2018.

In connection with the terms of the Note, we granted TI the sole distribution rights for our products and services in the Russian oil and gas sector. As a result of this appointment, TI agreed to pay us \$3.8 million over a three-year period in 35 equal monthly installments starting in August 2018.

On October 13, 2017, we and Hispania Petroleum, S.A. (the "Guarantor"), entered into a Guaranty Agreement (the "Guaranty Agreement") whereby the Guarantor guarantees TI's obligations under the Agreement and Note. However, due to our limited business relationship with TI and the missed payments on the Assignment Agreement, we deferred recognition of the Assignment Agreement and Note until collectability is reasonably assured.

On June 5, 2018, we entered into an amendment to the Assignment Agreement (the "Amended Assignment Agreement") and the Note (the "Amended Note") with TI. Pursuant to the terms of the Amended Assignment Agreement, the right, title and interest to receivables owed to us from BPC will be contingent upon TI's payment to us of the remaining approximately \$1.5 million in five payments by September 20, 2019. During the first quarter of Fiscal 2019 no payment was due under these agreements. Under the terms of the Amended Note, TI agreed to pay us \$3.8 million over a three-year period in 13 equal quarterly installments starting in December 20, 2019.

Due to the above amendments, during the three months ended March 31, 2018 we removed product orders related to BPC from backlog for approximately \$7.2 million. This removal was the result of product pricing that we no longer would honor. Additionally, during the three months ended September 30, 2018 we removed product orders related to BPC from backlog for approximately \$10.6 million. This removal was the result of our continuous review of BPC related backlog with TI which resulted in us no longer honoring the product pricing. After removal of the foregoing orders, the remaining backlog related to BPC as of September 30, 2018 comprises up to approximately 39% of our total backlog. This remaining backlog related to BPC continues to be reviewed with TI and the other new distributors in the region, and they have the right to request delivery of those backlog orders if the associated projects proceed. Nonetheless, the remaining backlog related to BPC may be negatively impacted.

A portion of our backlog is concentrated in the international oil and gas market which may impact the overall timing of shipments or the conversion of backlog to revenue. The timing of the backlog is based on the requirement date indicated by our customers. However, based on historical experience, management expects that a significant portion of our backlog may not be shipped within the next 18 months. Additionally, the timing of shipments is subject to change based on several variables (including customer deposits, payments, availability of credit and customer delivery schedule changes), most of which are not in our control and can affect the timing of our revenue. As a result, management believes the book-to-bill ratio demonstrates the current demand for our products in the given period.

2. ***Sales and Distribution Channels*** We seek out distributors that have business experience and capabilities to support our growth plans in our targeted markets. A significant portion of our revenue is derived from sales to distributors who resell our products to end users. We have a total of 104 distributors, Original Equipment Manufacturers ("OEMs") and national accounts. In the United States and Canada, we currently have 25

distributors, OEMs and national accounts. Outside of the United States and Canada, we currently have 79 distributors, OEMs and national accounts. We continue to refine our distribution channels to address our specific targeted markets.

Effective January 1, 2018, we launched our Distributor Support System (“DSS program”) to provide additional support for distributor business development activities, customer lead generation, brand awareness and tailored marketing services for each of our major geography and market vertical. This new program is funded by our distributors and was developed to provide improved worldwide distributor training, sales efficiency, website development, company branding and provide funding for increased strategic marketing activities. See Note 13—Revenue Recognition for additional discussion of revenue recognition for this program.

3. **Service** We provide service primarily through our global distribution network. Together with our global distribution network, we offer a comprehensive FPP for a fixed annual fee to perform regularly scheduled and unscheduled maintenance as needed. We provide factory and on-site training to certify all personnel that are allowed to perform service on our microturbines. FPPs are generally paid quarterly in advance.

Our FPP backlog as of September 30, 2018 was approximately \$73.8 million, which represents the value of the contractual agreement for FPP services that has not been earned and extends through Fiscal 2031. Our FPP backlog as of March 31, 2018 was approximately \$75.6 million. Our FPP backlog as of September 30, 2017 was approximately \$74.7 million. Additionally, we offer new and remanufactured parts through our global distribution network.

4. **Product Robustness and Life Cycle Maintenance Costs** We continue to invest in enhancements that relate to high performance and high reliability. An important element of our continued innovation and product strategy is to focus on the engineering of our product hardware and electronics to make them work together more effectively and deliver improved microturbine performance, reliability and low maintenance cost to our customers.
5. **New Product Development** Our new product development is targeted specifically to meet the needs of our selected vertical markets. We expect that our existing product platforms, the C30, C65, C200 and C1000 Series microturbines, will be our foundational product lines for the foreseeable future. Our research and development project portfolio is centered on enhancing the features of these base products.

During the three months ended September 30, 2018 we received funding from the Department of Energy Technology Commercialization to refine Argonne National Laboratory’s (“Argonne”) high-efficiency, fast-charging and fast-discharging thermal energy-storage system (“TESS”) for use in CHP systems. The new Capstone CHP system will incorporate Argonne’s high-efficiency, fast-charging, and fast-discharging thermal energy system for waste heat recovery and reuse in projects that require process heat and industrial manufacturing environments. This new project focuses on integrating Argonne’s TESS into a C200 CHP system, specifically, using thermal modeling and simulations to optimize system design; fabricating and integrating the TESS into the C200 system; testing the performance of the integrated TESS-C200 CHP system and conducting both a technology and economic analysis to establish performance and cost benefits of the new integrated microturbine and thermal battery solution.

Our product development activities during Fiscal 2018 included the completion of the new family of PowerSync controllers used for Capstone microturbines. We also improved our C65 heat recovery module and launched a new cleanable severe environment air filtration system for our line of microturbine products. In addition, our product development activities during Fiscal 2018 included research in the certification for our C200S microturbine by Underwriters Laboratories Inc. (UL) to the latest UL 1741 interconnection standards that became effective in 2016.

We are also developing a more efficient microturbine CHP system with the support of the Department of Energy, which awarded us a grant of \$5.0 million in support of this development program, of which \$4.2 million was allocated to us and was used through September 30, 2015. We successfully completed

the first phase of the development program on September 30, 2015 and achieved 270 kW with a prototype C250 microturbine in our development test lab. Management intends to continue with the next phase of development and commercialization after we achieve profitability. In Fiscal 2018, we completed the second phase of long-



term endurance test. The next phase will be to continue development of the C250 product architecture as well as the associated power electronics and software controls required for successful commercialization.

6. **Cost and Core Competencies** We believe that the core competencies of our products are air bearing technology, advanced combustion technology and sophisticated power electronics to form efficient and ultra-low emission electricity and cooling and heat production systems. Our core intellectual property is contained within our air bearing technology. We continue to review avenues for cost reduction by sourcing to the best value supply chain option. In order to utilize manufacturing facilities and technology more effectively, we are focused on continuous improvements in manufacturing processes. Additionally, considerable effort is being directed to manufacturing cost reduction through process improvement, product design, advanced manufacturing technology, supply management and logistics. Management expects to be able to leverage our costs as product volumes increase.

Our manufacturing designs include the use of conventional technology, which has been proven in high volume automotive and turbocharger production for many years. Many components used in the manufacture of our products are readily fabricated from commonly available raw materials or off the shelf items available from multiple supply sources; however, certain items are custom made to meet our specifications that require longer lead time. We believe that in most cases, adequate capacity exists at our suppliers and that alternative sources of supply are available or could be developed within a reasonable period of time. However, single source suppliers with long lead times may be more challenging to transition to another supplier. We have an ongoing program to develop alternative back up suppliers for sole source parts wherever possible, however this has been challenging with low production volumes and increased pricing. We regularly reassess the adequacy and abilities of our suppliers to meet our future needs. During the fourth quarter of Fiscal 2018, we received notification from one of our single source suppliers that they were at maximum capacity and would require prepayment and a significant increase in the price of multiple components in order to fulfill our supply requirements for Fiscal 2019. Due to their capacity issues, it is uncertain if we will experience an interruption in parts from this supplier or be able to fully offset or recover any resulting component price increases. This could impact margins or sales in future quarters. During the first quarter of Fiscal 2019 we issued a prepayment of approximately \$2.2 million to this single source supplier.

We believe that effective execution in each of these key areas will be necessary to leverage Capstone's promising technology and early market leadership into achieving positive cash flow with growing market presence and improving financial performance. Based on our recent progress and assuming achievement of targeted cost reductions and product mix, pricing and performance and our increasing accessories, parts and service revenue with improved gross margins, our financial model indicates that we will achieve positive cash flow when we generate \$25 million in quarterly revenue with a 20% gross margin. We expect to have costs increase in certain areas in Fiscal 2019, including sales and marketing, which if not offset by an increase in revenue, would reduce margins and profitability as we have limited ability to further reduce costs.

During the third quarter of Fiscal 2018, we consolidated our operations and offices into our Van Nuys location and we believe that our production capacity is approximately 2,000 units per year, depending on product mix. We believe we will be able to support this production capacity level by adding additional shifts, which would increase working capital requirements, and making some additional capital expenditures when necessary.

### **Critical Accounting Policies and Estimates**

The preparation of our condensed consolidated financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses. Management believes the most complex and sensitive judgments, because of their significance to the condensed consolidated financial statements, result primarily from the need to make estimates about the effects of matters that are inherently uncertain. Actual results could differ from management's estimates. Management believes the critical accounting policies listed below affect our more significant accounting judgments and estimates used in the preparation of the condensed consolidated financial statements. These policies are described in greater detail in our Annual Report on Form 10-K for Fiscal 2017 and continue to include the following areas:

- Impairment of long-lived assets, including intangible assets with finite lives;



- Inventory write-downs and classification of inventories;
- Estimates of warranty obligations;
- Accounts receivable allowances;
- Deferred tax assets and valuation allowance; and
- Stock-based compensation expense.

Except for the accounting policy for revenue recognition that was updated, as set forth above, as a result of adopting Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers (Topic 606), there have been no changes to our significant accounting policies described in the Annual Report on Form 10-K for the Fiscal Year 2018 filed with the SEC on June 7, 2018, that have had a material impact on our condensed consolidated financial statements and related notes.

## Results of Operations

### *Three Months Ended September 30, 2018 and 2017*

The following table summarizes our revenue by geographic markets (amounts in millions):

	<b>Three Months Ended September 30,</b>	
	<b>2018</b>	<b>2017</b>
	<b>Revenue</b>	<b>Revenue</b>
United States and Canada	\$ 11.1	\$ 9.2
Europe and Russia	4.4	4.5
Latin America	1.8	1.4
Asia and Australia	2.7	3.6
Middle East and Africa	2.2	1.1
Total	<u>\$ 22.2</u>	<u>\$ 19.8</u>

**Revenue** Revenue for the three months ended September 30, 2018 increased \$2.4 million, or 12%, to \$22.2 million from \$19.8 million for the three months ended September 30, 2017. The change in revenue for the three months ended September 30, 2018 compared to the three months ended September 30, 2017 included increases in revenue of \$1.9 million from the United States and Canadian markets, \$1.1 million from the Middle East and African markets and \$0.4 million from the Latin American market. These overall increases in revenue were offset by decreases in revenue of \$0.9 million from the Asian and Australian markets and \$0.1 million from the European and Russian markets. The increase in revenue in the United States and Canadian markets during the three months ended September 30, 2018 compared to the same period last year was primarily because the natural resources and energy efficiency vertical markets continue to improve. The increase in revenue in the Middle East and African markets was primarily the result of our continued investment in key growth initiatives in those markets. However, our revenue in the Middle East and African markets continues to be negatively impacted by the volatility of the global oil and gas markets and ongoing geopolitical tensions in these regions. The increase in revenue in the Latin American market was primarily because of an increase in C200 and C1000 Signature Series systems shipments during the three months ended September 30, 2018 compared to the same period last year. The decrease in revenue in the Asian and Australian markets was primarily because of a decrease in accessories and parts shipments during three months ended September 30, 2018 compared to the same period last year. The decrease in revenue in the European and Russian markets was primarily because of a decrease in product shipments into the European energy efficiency and renewable energy vertical markets. Our revenue in the European and Russian markets continues to be negatively impacted by the ongoing geopolitical tensions and a strong U.S. dollar in certain markets making our products more expensive in such markets.

The following table summarizes our revenue (revenue amounts in millions):

	Three Months Ended September 30,					
	2018			2017		
	Revenue	Megawatts	Units	Revenue	Megawatts	Units
Microturbine Product	\$ 14.9	15.9	82	\$ 12.2	11.3	68
Accessories and Parts	3.8			3.8		
Service	3.5			3.8		
Total Accessories, Parts and Service	7.3			7.6		
Total	\$ 22.2			\$ 19.8		

For the three months ended September 30, 2018, revenue from microturbine products increased \$2.7 million, or 22%, to \$14.9 million from \$12.2 million for the three months ended September 30, 2017. The increase in revenue and megawatts shipped was primarily because of a favorable shift in product mix, as we sold a higher number of our C1000 Series systems, offset by a decrease in revenue per megawatt shipped during the three months ended September 30, 2018 compared to the same period last year. Megawatts shipped was 15.9 megawatts and 11.3 megawatts during the three months ended September 30, 2018 and 2017, respectively. Average revenue per megawatt shipped was approximately \$0.9 million and \$1.1 million during the three months ended September 30, 2018 and 2017, respectively. Average revenue per megawatt decreased as a result of a shipment of 2.0 megawatts of remanufactured systems during the second quarter of Fiscal 2019. These systems had a much lower selling price than the new systems. The timing of shipments is subject to change based on several variables (including customer deposits, payments, availability of credit and delivery schedule changes), most of which are not within our control and can affect the timing of our revenue.

Revenue from our accessories and parts was \$3.8 million for each of the three months ended September 30, 2018 and 2017, respectively.

Service revenue for the three months ended September 30, 2018 decreased \$0.3 million, or 8%, to \$3.5 million from \$3.8 million for the three months ended September 30, 2017. The decrease in service revenue was primarily the result of not recognizing revenue on certain service contracts because of the reassignment of those service contracts from Capstone's legacy California distributor to Cal Microturbine. This decrease was offset by an increase in revenue from our Distributor Support System ("DSS program"). Effective January 1, 2018 we launched our DSS program to provide additional support for distributor business development activities, customer lead generation, brand awareness and tailored marketing services for each of our major geography and market vertical. This new program is funded by our distributors and was developed to provide improved worldwide distributor training, sales efficiency, website development, company branding and provide funding for increased strategic marketing activities. Earned revenue from our DSS program for the three months ended September 30, 2018 was \$0.3 million and included under the caption "Service revenue" in the accompanying condensed consolidated statements of operations.

Sales to Horizon Power Systems ("Horizon"), one of our domestic distributors, E-Finity Distributed Generation, LLC ("E-Finity"), one of our domestic distributors and Safwan Petroleum Technologies Company ("SPETCO International"), one of our Middle East and African distributors, accounted for 15%, 12% and 10%, respectively, of revenue for the three months ended September 30, 2018. Sales to Reliable Secure Power Systems, ("RSP"), Regatta Solutions, Inc. ("Regatta") and E-Finity Distributed Generation, LLC ("E-Finity"), three of the Company's domestic distributors, and Optimal Group Australia Pty Ltd, one of the Company's Australian distributors and IBT Europe GmbH ("IBT"), one of the Company's European distributors, accounted for 12%, 11%, 11%, 11% and 10%, respectively, of revenue for the three months ended September 30, 2017.

**Gross Margin** Cost of goods sold includes direct material costs, production and service center labor and overhead, inventory charges and provision for estimated product warranty expenses. The gross margin was \$2.0 million, or 9% of revenue, for the three months ended September 30, 2018 compared to a gross margin of \$3.0 million, or 15% of revenue, for the three months ended September 30, 2017. The decrease in gross margin of \$1.0 million during the three months ended September 30, 2018 compared to the three months ended September 30, 2017 was primarily because of incremental warranty expense of \$0.6 million, a \$0.4 million decrease in our direct material costs margin and higher production and service center labor and overhead expense of \$0.2 million, offset by lower royalty expense of \$0.2 million. In addition to consolidating our manufacturing processes into our Van Nuys location, management continues to

implement initiatives to improve gross margin in Fiscal 2019 by further reducing manufacturing overhead and direct material costs, and improving product performance as we work to achieve profitability.

Warranty expense is a combination of a standard warranty provision recorded at the time revenue is recognized and changes, if any, in estimates for reliability repair programs. Reliability repair programs are based upon estimates that are recorded in the period that new information becomes available, including design changes, cost of repair and product enhancements, which can include both in-warranty and out-of-warranty systems. The increase in warranty expense of \$0.6 million during the three months ended September 30, 2018 compared to the three months ended September 30, 2017 was primarily because of an increase in the standard warranty provision as a result of a supplier defect identified during the first quarter of Fiscal 2019. Management expects warranty expense in Fiscal 2019 to be higher than in Fiscal 2018 primarily because of an increase in the standard warranty provision.

Direct material costs margin decreased \$0.4 million during the three months ended September 30, 2018 compared to the three months ended September 30, 2017 primarily as a result of an increase in FPP expenses associated with higher than normal levels of unscheduled maintenance activities and lower selling price of two C1000 refurbished systems.

Production and service center labor and overhead expense increased \$0.2 million during the three months ended September 30, 2018 compared to the three months ended September 30, 2017 primarily because of an increase in overhead allocated to finished goods inventory of \$0.4 million, offset by a decrease in salaries expense of \$0.2 million.

On July 25, 2018, we and Carrier entered into a Second Amendment to the Development and License Agreement (“Second Amendment”) whereby we agreed to pay Carrier approximately \$3.0 million to conclude our current royalty obligation under the Development and License Agreement, dated as of September 4, 2007, as amended (“Development Agreement”) and release us from any future royalty payment obligations. The Second Amendment also removed non-compete provisions from the Development Agreement, allowing us to design, market or sell our C200 System in conjunction with any energy system and compete with Carrier products in the CCHP market. On September 19, 2018, we paid in full the negotiated royalty settlement of \$3.0 million to Carrier, and as such, there is no further royalty obligation to Carrier. The prepaid royalty of \$3.0 million has been recorded under the caption “Prepaid expenses and other current assets” in the accompanying condensed consolidated balance sheets and will be amortized in the accompanying condensed consolidated statement of operations over a 15-year amortization period through September 2033 using an effective royalty rate. The effective royalty rate is calculated as the prepaid royalty settlement divided by total projected C200 System units over the 15-year amortization period. Royalty expense decreased \$0.2 million during the three months ended September 30, 2018 compared to the three months ended September 30, 2017 primarily because we concluded our royalty obligation under the Development Agreement.

The following table summarizes our gross margin (in millions except percentages):

	<b>Three Months Ended</b>	
	<b>September 30,</b>	
	<b>2018</b>	<b>2017</b>
<b>Gross Margin</b>		
Product	\$ 0.3	\$ 0.9
As a percentage of product revenue	2 %	7 %
Accessories, parts and service	\$ 1.7	\$ 2.1
As a percentage of accessories, parts and service revenue	24 %	28 %
Total Gross Margin	<u>\$ 2.0</u>	<u>\$ 3.0</u>
As a percentage of total revenue	9 %	15 %

The decrease in product gross margin during the three months ended September 30, 2018 compared to the three months ended September 30, 2017 was primarily because of an increase in warranty expense, lower selling price of two C1000 refurbished systems, an increase in direct material costs and an increase in overhead allocated to finished goods inventory. Accessories, parts and service gross margin decreased during the three months ended September 30, 2018 compared to the three months ended September 30, 2017 primarily because of lower than expected service revenue, resulting from reassignment of certain long-term factory protection plan contracts from our legacy California distributor

to Cal Microturbine and higher than normal levels of unscheduled maintenance activities primarily because of a supplier defect identified during the first quarter of Fiscal 2019.

**Research and Development (“R&D”) Expenses** R&D expenses for the three months ended September 30, 2018 decreased \$0.2 million, or 18%, to \$0.9 million from \$1.1 million in the three months ended September 30, 2017. The overall decrease in R&D expenses of approximately \$0.2 million resulted from a decrease in salaries expense of approximately \$0.3 million, offset by an increase in supplies expense of \$0.1 million. Management expects R&D expenses in Fiscal 2019 to be slightly higher than in Fiscal 2018 as a result of ongoing product development costs.

**Selling, General, and Administrative (“SG&A”) Expenses** SG&A expenses for the three months ended September 30, 2018 increased \$0.5 million, or 10%, to \$5.3 million from \$4.8 million for the three months ended September 30, 2017. The net increase in SG&A expenses was comprised of increases of approximately \$0.2 million in allocated costs for shared-services facilities expense, \$0.2 million in professional services expense, including legal expenses and \$0.1 million in marketing expense. Excluding the one-time Leadership Incentive Program and bad debt recovery recorded in Fiscal 2018, management expects SG&A expenses in Fiscal 2019 to be slightly higher than in Fiscal 2018 primarily as a result of increases in salaries expense, marketing expense, allocated costs for shared-services facilities expense and professional services, including legal and shareholder expenses.

**Interest Expense** Interest expense was \$0.2 million and \$0.1 million during the three months ended September 30, 2018 and 2017, respectively. As of September 30, 2018, we had total debt of \$12.5 million outstanding under the Bridge Bank credit facility.

**Six Months Ended September 30, 2018 and 2017**

The following table summarizes our revenue by geographic markets (amounts in millions):

	<b>Six Months Ended</b>	
	<b>September 30,</b>	
	<b>2018</b>	<b>2017</b>
	<b>Revenue</b>	<b>Revenue</b>
United States and Canada	\$ 22.1	\$ 19.6
Europe and Russia	9.3	7.1
Latin America	5.4	2.9
Asia and Australia	4.4	6.4
Middle East and Africa	2.2	3.0
Total	<u>\$ 43.4</u>	<u>\$ 39.0</u>

**Revenue** Revenue for the six months ended September 30, 2018 increased \$4.4 million, or 11%, to \$43.4 million from \$39.0 million for the six months ended September 30, 2017. The change in revenue for the six months ended September 30, 2018 compared to the six months ended September 30, 2017 included increases in revenue of \$2.5 million from the United States and Canadian markets, \$2.5 million from the Latin American market and \$2.2 million from the European and Russian markets. These increases in revenue were offset by decreases in revenue of \$2.0 million from the Asian and Australian markets and \$0.8 million from the Middle East and African markets. The increase in revenue in the United States and Canadian markets during the six months ended September 30, 2018 compared to the same period the previous year was primarily because of higher accessories, parts and service revenue and product shipments into the natural resources vertical market continues to improve on our C30 and C1000 Signature Series. The increase in revenue in the Latin American market was primarily because of an increase in C200 and C1000 Signature Series systems shipments during the six months ended September 30, 2018 compared to the same period last year. The increase in revenue in the European and Russian markets was primarily because the European energy efficiency and renewable energy vertical markets continue to improve. Our revenue in the European and Russian markets continues to be negatively impacted by the ongoing geopolitical tensions and a strong U.S. dollar in certain markets making our products more expensive in such markets. The decrease in revenue in the Middle East and African markets was primarily the result of the shift in certain customers’ project timelines compared to the same period last year. Our revenue in the Middle East and African markets continues to be negatively impacted by the volatility of the global oil and gas markets and ongoing geopolitical tensions in these regions. The decrease in revenue in the Asian and Australian markets was primarily because of decreases in accessories and parts revenue and product shipments into the energy efficiency and renewable energy vertical markets during the six months ended September 30, 2018 compared to the same period last year.

The following table summarizes our revenue (revenue amounts in millions):

	Six Months Ended September 30,					
	2018			2017		
	Revenue	Megawatts	Units	Revenue	Megawatts	Units
Microturbine Product	\$ 28.5	28.8	140	\$ 24.8	23.4	120
Accessories and Parts	7.2			6.7		
Service	7.7			7.5		
Total Accessories, Parts and Service	14.9			14.2		
Total	\$ 43.4			\$ 39.0		

For the six months ended September 30, 2018, revenue from microturbine products increased \$3.7 million, or 15%, to \$28.5 million from \$24.8 million for the six months ended September 30, 2017. The increase in revenue and megawatts shipped was primarily because of a favorable shift in product mix, as we sold a higher number of our C1000 Series systems, offset by a decrease in revenue per megawatt shipped during the six months ended September 30, 2018 compared to the same period last year. Megawatts shipped during the six months ended September 30, 2018 increased 5.4 megawatts, or 23%, to 28.8 megawatts from 23.4 megawatts during the six months ended September 30, 2017. Average revenue per megawatt shipped was approximately \$1.0 million and \$1.1 million during the six months ended September 30, 2018 and 2017, respectively. Average revenue per megawatt decreased as a result of the shipment of 2.0 megawatts of remanufactured systems during the second quarter of Fiscal 2019. These systems had a much lower selling price than the new systems. The timing of shipments is subject to change based on several variables (including customer deposits, payments, availability of credit and delivery schedule changes), most of which are not within our control and can affect the timing of our revenue.

For the six months ended September 30, 2018, revenue from our accessories and parts increased \$0.5 million, or 7%, to \$7.2 million from \$6.7 million for the six months ended September 30, 2017. The increase in revenue from accessories and parts was primarily because of delivery of certain large parts orders, offset by lower accessories shipments of our Organic Rankine Cycle (“ORC”) systems.

Service revenue for the six months ended September 30, 2018 increased \$0.2 million, or 3%, to \$7.7 million from \$7.5 million for the six months ended September 30, 2017. The increase in service revenue was primarily because of revenue from our new DSS program, offset by a decrease in service revenue. The decrease in service revenue was primarily the result of not recognizing revenue on certain service contracts because of the reassignment of those service contracts from Capstone’s legacy California distributor to Cal Microturbine. Earned revenue from our DSS program for the six months ended September 30, 2018 was \$0.5 million and included under the caption “Service revenue” in the accompanying condensed consolidated statements of operations.

For the six months ended September 30, 2018, E-Finity and Horizon, accounted for 11% and 10% of revenue, respectively. For the six months ended September 30, 2017, E-Finity, Horizon and Optimal accounted for 13%, 12% and 10% of revenue, respectively.

**Gross Margin** Cost of goods sold includes direct material costs, production and service center labor and overhead, inventory charges and provision for estimated product warranty expenses. The gross margin was approximately \$3.9 million, or 9% of revenue, for the six months ended September 30, 2018 compared to a gross margin of \$5.2 million, or 13% of revenue, for the six months ended September 30, 2017. The decrease in gross margin of \$1.3 million during the six months ended September 30, 2018 compared to the six months ended September 30, 2017 was primarily because of a \$0.7 million decrease in our direct material costs margin, higher production and service center labor and overhead expense of \$0.7 million and incremental warranty expense of \$0.2 million, offset by lower royalty expense of \$0.2 million and inventory charges of \$0.1 million. In addition to consolidating our manufacturing processes into our Van Nuys location, management continues to implement initiatives to improve gross margin in Fiscal 2019 by further reducing manufacturing overhead and direct material costs, and improving product performance as we work to achieve profitability.

Direct material costs margin decreased \$0.7 million during the six months ended September 30, 2018 compared to the six months ended September 30, 2017 primarily as a result of an increase in FPP expenses associated with higher

than normal levels of scheduled and unscheduled maintenance activities and lower selling price of two C1000 refurbished systems.

Production and service center labor and overhead expense increased \$0.7 million during the six months ended September 30, 2018 compared to the six months ended September 30, 2017 primarily because of increases of approximately \$0.5 million in overhead allocated to finished goods inventory, \$0.4 million in consulting expense and \$0.1 million in supplies expense, offset by decreases of \$0.2 million in salaries expense and \$0.1 million in facilities expense.

The increase in warranty expense of \$0.2 million during the six months ended September 30, 2018 compared to the six months ended September 30, 2017 was primarily because of an increase in our warranty provision as a result of a supplier defect identified during the first quarter of Fiscal 2019. Management expects warranty expense in Fiscal 2019 to be higher than in Fiscal 2018 primarily because of an increase in the standard warranty provision.

On July 25, 2018, we and Carrier entered into a Second Amendment whereby we agreed to pay Carrier approximately \$3.0 million to conclude our current royalty obligation under the Development Agreement and release us from any future royalty payment obligations. The Second Amendment also removed non-compete provisions from the Development Agreement, allowing us to design, market or sell our C200 System in conjunction with any energy system and compete with Carrier products in the CCHP market. On September 19, 2018, we paid in full the negotiated royalty settlement of \$3.0 million to Carrier, and as such, there is no further royalty obligation to Carrier. The prepaid royalty of \$3.0 million has been recorded under the captions “Prepaid expenses and other current assets” and “Other assets” in the accompanying condensed consolidated balance sheets and will be amortized in the accompanying condensed consolidated statement of operations over a 15-year amortization period through September 2033 using an effective royalty rate. The effective royalty rate is calculated as the prepaid royalty settlement divided by total projected C200 System units over the 15-year amortization period. Royalty expense decreased \$0.2 million during the six months ended September 30, 2018 compared to the six months ended September 30, 2017 primarily because we concluded our royalty obligation under the Development Agreement.

Inventory charges decreased \$0.1 million during the six months ended September 30, 2018 compared to the six months ended September 30, 2017 primarily as the result of a decrease in scrap material.

The following table summarizes our gross margin (in millions except percentages):

	<b>Six Months Ended September 30,</b>	
	<b>2018</b>	<b>2017</b>
<b>Gross Margin</b>		
Product	\$ 0.4	\$ 0.9
As a percentage of product revenue	1 %	4 %
Accessories, parts and service	\$ 3.5	\$ 4.3
As a percentage of accessories, parts and service revenue	23 %	30 %
Total Gross Margin	<u>\$ 3.9</u>	<u>\$ 5.2</u>
As a percentage of total revenue	9 %	13 %

The decrease in product gross margin during the six months ended September 30, 2018 compared to the six months ended September 30, 2017 was primarily because of an increase in warranty expense, lower selling price of two C1000 refurbished systems and an increase in direct material costs. In addition, the decrease in product gross margin was because of an increase expense associated with overhead allocated to finished goods inventory. Accessories, parts and service gross margin decreased during the six months ended September 30, 2018 compared to the six months ended September 30, 2017 primarily the result of not recognizing revenue on certain service contracts because of the reassignment of those service contracts from Capstone’s legacy California distributor to Cal Microturbine. In addition, the accessories, parts and service margin decreased because of higher than normal levels of scheduled and unscheduled maintenance activities primarily as a result of a supplier defect identified during the first quarter of Fiscal 2019.



**R&D Expenses** R&D expenses for the six months ended September 30, 2018 decreased \$0.5 million, or 22%, to \$1.8 million from \$2.3 million in the six months ended September 30, 2017. The overall decrease in R&D expenses of approximately \$0.5 million resulted primarily from a decrease in salaries expense during the six months ended September 30, 2018 compared to the same period last year. Management expects R&D expenses in Fiscal 2019 to be slightly higher than in Fiscal 2018 as a result of ongoing product development costs.

**SG&A Expenses** SG&A expenses for the six months ended September 30, 2018 increased \$1.1 million, or 11%, to \$10.9 million from \$9.8 million for the six months ended September 30, 2017. The net increase in SG&A expenses was comprised of increases of approximately \$0.3 million in allocated costs for shared-services facilities expense, \$0.3 million in marketing expense, \$0.2 million in salaries expense, \$0.2 million in professional services expense, including legal expenses and \$0.1 million in consulting expense. Excluding the one-time Leadership Incentive Program and bad debt recovery recorded in Fiscal 2018, management expects SG&A expenses in Fiscal 2019 to be slightly higher than in Fiscal 2018 primarily as a result of increases in salaries expense, marketing expense, allocated costs for shared-services facilities expense and professional services, including legal and shareholder expenses.

**Interest Expense** Interest expense was \$0.3 million during each of the six months ended September 30, 2018 and 2017. As of September 30, 2018, we had total debt of \$12.5 million outstanding under the credit facility.

### Liquidity and Capital Resources

Our cash requirements depend on many factors, including the execution of our plan. We expect to continue to devote substantial capital resources to running our business and implementing the strategic changes summarized herein. Our planned capital expenditures for the year ending March 31, 2019 include approximately \$1.0 million for plant and equipment costs related to manufacturing and operations. However, management expects to spend more than planned primarily as a result of deploying several of our microturbines under our microturbine rental program. We have invested our cash in institutional funds that invest in high quality short term money market instruments to provide liquidity for operations and for capital preservation.

Our cash, cash equivalents and restricted cash balances decreased \$1.1 million during the six months ended September 30, 2018, compared to a decrease of \$4.5 million during the six months ended September 30, 2017. The increase in cash, cash equivalents and restricted cash during the six months ended September 30, 2018 compared to the same period last year was because of higher cash generated from financing activities primarily from the issuance of common stock through the at-the-money offering program as described below.

**Operating Activities** During the six months ended September 30, 2018, we used \$12.6 million in cash in our operating activities, which consisted of a net loss for the period of \$9.2 million and cash used for working capital of \$6.2 million, offset by non-cash adjustments (primarily warranty provision, accounts receivable allowances, depreciation and amortization, stock based compensation and inventory provision) of \$2.8 million. During the six months ended September 30, 2017, we used \$5.9 million in cash in our operating activities, which consisted of a net loss for the period of \$7.8 million and cash used for working capital of \$1.4 million, offset by non-cash adjustments of \$3.3 million.

The following is a summary of the significant sources (uses) of cash from operating activities (amounts in thousands):

	<b>Six Months Ended September 30,</b>	
	<b>2018</b>	<b>2017</b>
Net loss	\$ (9,255)	\$ (7,760)
Non-cash operating activities(1)	2,825	3,269
Changes in operating assets and liabilities:		
Accounts receivable	(619)	3,778
Inventories	(320)	(2,360)
Accounts payable and accrued expenses	448	(790)
Other changes in operating assets and liabilities	(5,674)	(1,989)
Net cash used in operating activities	<u>\$ (12,595)</u>	<u>\$ (5,852)</u>

(1) Represents change in warrant valuation, warranty provision, depreciation and amortization, stock-based compensation expense, inventory provision and accounts receivable allowances.

The change in non-cash operating activities during the six months ended September 30, 2018 compared to the same period the previous fiscal year was primarily because of the provision for warranty expenses during the six months ended September 30, 2018 primarily as a result of a supplier defect identified during the first quarter of Fiscal 2019. The change in accounts receivable during the six months ended September 30, 2018 was primarily the due to delayed collection from certain customers, compared to a decrease in accounts receivable during the six months ended September 30, 2017, which was primarily the result of higher revenue in the fourth quarter of Fiscal 2017. The change in inventory was primarily the result of an increase in raw materials offset by a reduction in finished goods during the six months ended September 30, 2018 compared to an increase in finished goods during the six months ended September 30, 2017. The change in accounts payable and accrued expenses was primarily the result of the level of inventory receipts and timing of payments made by us during the six months ended September 30, 2018 compared to the same period the previous fiscal year. The change in other operating assets and liabilities during the six months ended September 30, 2018 was primarily because of a negotiated royalty settlement to Carrier and a supplier prepayment obligation, each described below. The change in other operating assets and liabilities during the six months ended September 30, 2017 was primarily the result of warranty payments for the proactive retrofit of certain non-Signature Series C200 microturbines and this warranty program was completed during the three months ended December 31, 2017.

On July 25, 2018, we and Carrier entered into a Second Amendment whereby we agreed to pay Carrier approximately \$3.0 million to conclude our current royalty obligation under the Development Agreement and release us from any future royalty payment obligations. The Second Amendment also removed non-compete provisions from the Development Agreement, allowing us to design, market or sell our C200 System in conjunction with any energy system and compete with Carrier products in the CCHP market. On September 19, 2018, we paid in full the negotiated royalty settlement agreement of \$3.0 million to Carrier, as such there is no further royalty obligation to Carrier.

During the three months ended March 31, 2018, we received notification from one of our single source suppliers that they were at maximum capacity and would require prepayment and a significant increase in the price of multiple components in order to fulfill our supply requirements for Fiscal 2019. During the six months ended September 30, 2018 we issued a prepayment of approximately \$2.2 million to this single source supplier.

**Investing Activities** Net cash used in investing activities of \$0.3 million and \$0.5 million during the six months ended September 30, 2018 and 2017, respectively, relates primarily to the acquisition of fixed assets and leasehold improvements made to our Van Nuys location, respectively. During the fiscal year ended March 31, 2018, we consolidated our operations and offices into our Van Nuys, California location from our Chatsworth, California location.

**Financing Activities** During the six months ended September 30, 2018, we generated approximately \$11.8 million in financing activities compared to cash generated during the six months ended September 30, 2017 of approximately \$1.8 million. The funds generated from financing activities during the six months ended September 30, 2018 were primarily the result of proceeds from the at-the-market offering program described below and net proceeds from our credit facility, offset by repayment of notes payable and capital lease obligations. The funds generated from financing activities during the six months ended September 30, 2017 were primarily the result of proceeds from the at-the-market offering program, offset by net repayments under the credit facility and the repayment of notes payable and capital lease obligations.

On June 7, 2018, we entered into a sales agreement with H.C. Wainwright & Co., LLC with respect to an at-the-market offering program pursuant to which we may offer and sell, from time to time at our sole discretion, shares of our common stock, having an aggregate offering price of up to \$25.0 million. We will set the parameters for sales of the shares, including the number to be sold, the time period during which sales are requested to be made, any limitation on the number that may be sold in one trading day and any minimum price below which sales may not be made. During the three months ended September 30, 2018, we issued 3.0 million shares of our common stock under this at-the-market offering program and the net proceeds to us from the sale of our common stock were approximately \$3.1 million after deducting commissions paid of approximately \$0.1 million. During the six months ended September 30, 2018, we issued 3.7 million shares of our common stock under this at-the-market offering program and the net proceeds to us from the sale of our common stock were approximately \$4.1 million after deducting commissions paid of approximately \$0.1 million. As of September 30, 2018, approximately \$20.7 million remained available for issuance with respect to this at-the-market offering program.

On April 13, 2018, a warrant holder exercised its rights to the warrant agreement to exercise on a cashless basis 5,760,000 Series A warrants at an exercise price of \$0.60 per share under the warrant agreement. In accordance with terms of the warrant agreement, after taking into account the shares withheld to satisfy the cashless exercise option, the Company issued 3,806,243 shares of common stock.

Effective August 28, 2015, we entered into a sales agreement with Cowen and Company, LLC with respect to an at-the-market offering program pursuant to which we offered and sold, from time to time at our sole discretion, shares of our common stock, having an aggregate offering price of up to \$30.0 million. During the six months ended September 30, 2018, we issued 2.8 million shares of our common stock under the at-the-market offering program and the net proceeds to us from the sale of our common stock were approximately \$4.0 million after deducting commissions paid of approximately \$0.1 million. As of September 30, 2018, 26.0 million shares of our common stock were cumulatively sold pursuant to the at-the-market offering program and the net proceeds to us from the sale of the common stock were approximately \$28.6 million after deducting commissions paid of approximately \$0.8 million. This at-the-market offering program expired on May 29, 2018.

There were no stock options exercised during the six months ended September 30, 2018 and 2017, respectively. Repurchases of shares of our common stock for employee taxes due on vesting of restricted stock units, net of employee stock purchases, resulted in approximately \$73,000 and \$22,000 of net cash used during the six months ended September 30, 2018 and 2017, respectively.

**Credit Facility** The Company maintains Bridge Bank Credit Agreements with Western Alliance Bank through Bridge Bank, with credit support provided by the Export-Import Bank of the United States through its working capital guarantee program. Under the terms of the Bridge Bank Credit Agreements, the Company may borrow up to \$15.0 million on a revolving basis depending on, among other factors, the amount of its eligible inventory and accounts receivable. The Bridge Bank Credit Agreements will terminate in accordance with their terms on June 2, 2021.

On June 1, 2018, the Company entered into a letter agreement (the “Letter Agreement”) with Bridge Bank. The Letter Agreement extended the maturity date under the Company’s Bridge Bank Credit Agreements from June 2, 2019 to June 2, 2021. The Letter Agreement increased the line of credit to an amount up to \$15.0 million from \$12.0 million. Additionally, the Letter Agreement reduced the per annum interest rate from prime rate plus 1.50 percent to 1.00 percent; the facility fee from 0.625% to 0.5%, and the cash collateral held at Bridge Bank from 42% to 40%, which is \$6.0 million of the \$15.0 million facility, as well as no fee for early termination.

Total borrowings, letter of credit obligations and the then aggregate committed amount of cash management services under the Bridge Bank Credit Agreements may not exceed 85% of the sum of unrestricted cash and the amount of cash collateral held at Bridge Bank. As a condition of the Bridge Bank Credit Agreements, the Company has restricted \$6.0 million of cash equivalents as additional security for the credit facility. Borrowings under the Bridge Bank Credit Agreements will bear per annum interest at the prime rate plus 1.0 percent, subject to increase during the occurrence of an event of default. Obligations under the Bridge Bank Credit Agreements are secured by all of the Company’s assets, including intellectual property and general intangibles.

The Bridge Bank Credit Agreements include affirmative covenants as well as negative covenants that prohibit a variety of actions without Bridge Bank’s consent, including covenants that limit the Company’s ability to (a) incur or guarantee debt, (b) create liens, (c) enter into any merger, recapitalization or similar transaction or purchase all or substantially all of the assets or stock of another entity or (d) sell, assign, transfer or otherwise dispose of the Company’s assets.

The financial covenants of the domestic credit agreement with Bridge Bank (the “Domestic Facility”), which is included in the Bridge Bank Credit Agreements, requires the Company not to exceed specified levels of losses relative to its financial model and the outstanding line of credit advances may not exceed 85% of the sum of unrestricted cash and the amount of cash collateral held at Bridge Bank. The Domestic Facility also defines an event of default to include a material adverse effect on the Company’s business. An event of default for this or any other reason, if not waived, could have a material adverse effect on the Company. As of September 30, 2018 we were in compliance with the covenants contained in the Bridge Bank Credit Agreements for Fiscal 2019.

**Working Capital** Cash used for working capital was \$6.2 million during the six months ended September 30, 2018, an increase of \$4.8 million from the cash used for working capital of \$1.4 million during the six months ended

September 30, 2017. We attribute the increase in our working capital requirements primarily because of \$3.0 million negotiated royalty settlement agreement payment to Carrier, \$2.2 million in prepayments to one of our single source suppliers that notified us that they were at maximum capacity and would require prepayment and a significant increase in the price of multiple components in order to fulfill our supply requirements for Fiscal 2019, and a pay down of accrued expenses of \$1.0 million with respect to our one-time leadership incentive program compensation.

***Evaluation of Ability to Maintain Current Level of Operations*** In connection with preparing the consolidated financial statements for the second quarter of Fiscal 2019, management evaluated whether there were conditions and events, considered in the aggregate, that raised substantial doubt about our ability to meet our obligations as they became due for the next twelve months from the date of issuance of our first quarter of Fiscal 2019 financial statements. Management assessed that there were such conditions and events, including a history of recurring operating losses, negative cash flows from operating activities, the continued negative impact by the volatility of the global oil and gas markets, a strong U.S. dollar in certain markets making our products more expensive in such markets and ongoing global geopolitical tensions. We incurred a net loss of \$4.4 million and used cash in operating activities of \$6.6 million for the second quarter of Fiscal 2019. Cash used in operating activities includes a payment of approximately \$3.0 million to Carrier for a negotiated royalty settlement agreement. See Note 14—Other Current Liabilities for additional discussion on the negotiated royalty settlement agreement. Our working capital requirements during the second quarter of Fiscal 2019 were higher than management’s expectations primarily the result of not recognizing revenue on certain service contracts because of the reassignment of those service contracts from Capstone’s legacy California distributor to Cal Microturbine, which resulted in a higher than expected net loss. In addition, our net loss was negatively impacted during the second quarter of Fiscal 2019 because of an increase in our warranty provision as a result of a supplier defect identified during the first quarter of Fiscal 2019. As of September 30, 2018, we had cash, cash equivalents and restricted cash of \$18.3 million, and outstanding borrowings under our credit facility of \$12.5 million.

As of September 30, 2018, we had cash, cash equivalents and restricted cash of \$18.3 million, and outstanding borrowings under our credit facility of \$12.5 million.

Management evaluated these conditions in relation to our ability to meet our obligations as they become due. Our ability to continue current operations and to execute on management’s plan is dependent on our ability to generate cash flows from operations. Management believes that we will continue to make progress on our path to profitability by continuing to maintain low operating expenses and develop our geographical and vertical markets. We may seek to raise funds by selling additional securities (through at-the-market offering or otherwise) or by obtaining additional debt financing. There is no assurance that we will be able to obtain additional funds on commercially favorable terms or at all. If we raise additional funds by issuing additional equity or convertible debt securities, the fully diluted ownership percentages of existing stockholders will be reduced. In addition, any equity or debt securities that we would issue may have rights, preferences or privileges senior to those of the holders of our common stock.

Based on our current operating plan, management anticipates that, given current working capital levels, current financial projections, the ability to borrow under our credit facility and the funds raised by selling additional securities through the at-the-market offering as of the date of issuance of our second quarter of Fiscal 2019 financial statements, we will be able to meet our financial obligations as they become due over the next twelve months from the date of issuance of our first quarter of Fiscal 2019 financial statements.

Depending on the timing of our future sales and collection of related receivables, managing inventory costs and the timing of inventory purchases and deliveries required to fulfill the backlog, our future capital requirements may vary materially from those now planned. The amount of capital that we will need in the future will require us to achieve significantly increased sales volume which is dependent on many factors, including:

- the market acceptance of our products and services;
- our business, product and capital expenditure plans;
- capital improvements to new and existing facilities;
- our competitors’ response to our products and services;
- our relationships with customers, distributors, dealers and project resellers; and

- our customers' ability to afford and/or finance our products.

Our accounts receivable balance, net of allowances, was \$16.5 million and \$16.0 million as of September 30, 2018 and March 31, 2018, respectively. Days sales outstanding in accounts receivable, ("DSO"), increased by 7 days to 68 days as of September 30, 2018 compared to 61 days as of September 30, 2017. The increase in our DSO was primarily because of a delay in a specific customer accounts receivable. We recorded a net bad debt expense of approximately \$0.1 million during the six months ended September 30, 2018. We recorded a net bad debt recovery of approximately \$22,000 during the six months ended September 30, 2017.

No assurance can be given that future bad debt expense will not increase above current operating levels. Increased bad debt expense or delays in collecting accounts receivable could have a material adverse effect on cash flows and results of operations. In addition, our ability to access the capital markets may be severely restricted or made very expensive at a time when we need, or would like, to do so, which could have a material adverse impact on our liquidity and financial resources. Certain industries in which our customers do business and certain geographic areas have been and could continue to be adversely affected by the previously referenced economic and geopolitical considerations.

### **New Accounting Pronouncements**

#### *Adopted*

In May 2014, the Financial Accounting Standards Board ("FASB") issued ASU, 2014-09, Revenue from Contracts with Customers (Topic 606), ("ASU 2014-09"). ASU 2014-09 outlines a single, comprehensive model for accounting for revenue from contracts with customers and requires more detailed disclosure to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from such contracts. ASU 2014-09 provides a five-step analysis of transactions to determine when and how revenue is recognized. The core principle is that a company 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 and services. On April 1, 2018, we adopted ASU 2014-09 under the modified retrospective transition method. This method was applied to contracts that were not complete as of the date of initial application of ASU 2014-09.

During the first quarter of Fiscal 2019, we recognized revenue based on ASU 2014-09, however revenue for the first quarter of Fiscal 2018 was recognized based on Accounting Standards Codification, Topic 605, Revenue Recognition. See Note 13—Revenue Recognition for additional discussion of the impact of the adoption of ASU 2014-09.

#### *Not yet adopted*

On August 17, 2018, the SEC issued Release No. 33-10532, "Disclosure Update and Simplification", ("Release No. 33-10532") which amends certain redundant, duplicative, outdated, superseded or overlapping disclosure requirements. The amendments in this rule are intended to facilitate the disclosure of information to investors and to simplify compliance without significantly impacting the mix of information provided to investors. The amendments also expand the disclosure requirements regarding the analysis of stockholders' equity for interim financial statements, in which entities will be required to present a reconciliation for each period for which a statement of comprehensive income is required to be filed. The final rule became effective on November 5, 2018, however the SEC announced that it would not object if a filer's first presentation of the changes in stockholders' equity were included in its Form 10-Q for the quarter that begins after the effective date of the amendments. We are currently evaluating the impact of Release No. 33-10532 on our consolidated financial position and results of operations.

On June 2018, the FASB issued ASU 2018-07, "Shared-Based Payment Arrangements with Nonemployees" (Topic 505), ("ASU 2018-07"). ASU 2018-07 simplifies the accounting for share-based payments granted to nonemployees for goods and services. Under ASU 2018-07, most of the guidance on such payments to nonemployees will be aligned with the requirements for share-based payments granted to employees. Under the ASU 2018-07, the measurement of equity-classified nonemployee share-based payments will be fixed on the grant date, as defined in ASC 718, and will use the term nonemployee vesting period, rather than requisite service period. The amendments in this update are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal

years. Early adoption is permitted if financial statements have not yet been issued. We are currently evaluating the impact of ASU 2018-07 on our consolidated financial position and results of operations.

On December 22, 2017, the SEC issued guidance under Staff Accounting Bulletin No. 118, Income Tax Accounting Implications of the Tax Cuts and Jobs Act (“SAB 118”) directing taxpayers to consider the impact of the U.S. legislation as “provisional” when it does not have the necessary information available, prepared or analyzed (including computations) in reasonable detail to complete its accounting for the change in tax law. In accordance with SAB 118, our estimated income tax is considered provisional and our analysis is expected to be finalized by the end of the 2018 calendar year.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842), (“ASU 2016-02”). The purpose of ASU 2016-02 is to provide financial statement users a better understanding of the amount, timing, and uncertainty of cash flows arising from leases. The adoption of ASU 2016-02 will result in the recognition of a right-of-use asset and a lease liability for most operating leases. New disclosure requirements include qualitative and quantitative information about the amounts recorded in the financial statements. In September 2017, the FASB issued ASU 2017-13, Revenue Recognition (Topic 605), Revenue from Contracts with Customers (Topic 606), Leases (Topic 840), and Leases (Topic 842), which provides additional implementation guidance on the previously issued ASU 2016-02 Leases (Topic 842). ASU 2016-02 requires a lessee to recognize assets and liabilities on the balance sheet for leases with lease terms greater than 12 months. ASU 2016-02 is effective for fiscal years beginning after December 15, 2018. ASU 2016-02 requires a modified retrospective transition by means of a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year in which the guidance is effective with the option to elect certain practical expedients. Early adoption is permitted. We are currently evaluating the impact of ASU 2016-02 on our consolidated financial position and results of operations.

#### **Off-Balance Sheet Arrangements**

We did not have during the periods presented, and we do not currently have, any off balance sheet arrangements, as defined under SEC rules.

#### **Item 3. *Quantitative and Qualitative Disclosures About Market Risk***

No material changes have occurred in our quantitative and qualitative market risk disclosure as presented in our Annual Report on Form 10-K for Fiscal 2018.

#### **Item 4. **Controls and Procedures****

##### ***Evaluation of Disclosure Controls and Procedures***

Under the supervision and with the participation of our management, including the Chief Executive Officer and Chief Financial Officer, we have evaluated the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the “Exchange Act”), as of the end of the period covered by this report. Based upon that evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that, as of the end of the period covered by this report, our disclosure controls and procedures are effective. The term “disclosure controls and procedures” means controls and other procedures of ours that are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within required time periods. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

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

Effective April 1, 2018, we adopted ASU 2014-09. While ASU 2014-09 is expected to have an immaterial impact on our ongoing revenue and net income, it will require management to make significant judgments and estimates. As a result, we implemented changes to our internal control environment related to revenue recognition for the first quarter of Fiscal 2019. These changes include updated accounting policies affected by ASU 2014-09, reviewing internal

controls over financial reporting and updating related to ASU 2014-09 as necessary, expanded data gathering to comply with the additional disclosure requirements, training of individuals responsible for implementation of, and continuing compliance with, ASU 2014-09, as well as ongoing contract review requirements.

There was no change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during our most recently completed fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## **PART II — OTHER INFORMATION**

### **Item 1. Legal Proceedings**

#### *Federal Securities Class Action*

Two putative securities class action complaints were filed against us and certain of our current and former officers in the United States District Court for the Central District of California under the following captions: David Kinney, etc. v. Capstone Turbine, et al., No. 2:15-CV-08914 on November 16, 2015 (the “Kinney Complaint”) and Kevin M. Grooms, etc. v. Capstone Turbine, et al., No. 2:15-CV-09155 on November 25, 2015 (the “Grooms Complaint”).

The putative class in the Kinney Complaint was comprised of all purchasers of our securities between November 7, 2013 and November 5, 2015. The Kinney Complaint alleges material misrepresentations and omissions in public statements regarding BPC and the likelihood that BPC would not be able to fulfill many legal and financial obligations to us. The Kinney Complaint also alleges that our financial statements were not appropriately adjusted in light of this situation and were not maintained in accordance with GAAP, and that we lacked adequate internal controls over accounting. The Kinney Complaint alleges that these public statements and accounting irregularities constituted violations by all named defendants of Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder, as well as violations of Section 20(a) of the Exchange Act by the individual defendants. The Grooms Complaint makes allegations and claims that are substantially identical to those in the Kinney Complaint, and both complaints seek compensatory damages of an undisclosed amount. On January 16, 2016, several shareholders filed motions to consolidate the Kinney and Grooms actions and for appointment as lead plaintiff. On February 29, 2016, the Court granted the motions to consolidate, and appointed a lead plaintiff. On May 6, 2016, a Consolidated Amended Complaint with allegations and claims substantially identical to those of the Kinney Complaint was filed in the consolidated action. The putative class period in the Consolidated Amended Complaint is June 12, 2014 to November 5, 2015. Defendants filed a motion to dismiss the Consolidated Amended Complaint on June 17, 2016. On March 10, 2017, the Court issued an order granting Defendants’ motion to dismiss in its entirety with leave to amend. Plaintiffs filed an amended complaint on April 28, 2017. Defendants’ motion to dismiss was filed June 2, 2017. Plaintiffs filed their opposition to the motion to dismiss on July 7, 2017, and Defendants filed their reply in support of the motion to dismiss on July 28, 2017. The court vacated the hearing that was scheduled for August 18, 2017. On February 9, 2018, the Court issued an Order denying Defendants’ motion to dismiss. On March 30, 2018, Defendants filed an answer to the Consolidated Amended Complaint. On May 17, 2018, the Court issued a scheduling order setting a trial date of March 17, 2020. On June 26, 2018, the Court entered an order vacating all deadlines through the end of October 2018 and temporarily staying formal discovery and other proceedings to allow the parties time to conduct a mediation. The parties participated in mediation on September 24, 2018. The mediation did not result in a settlement. We have not recorded any liability as of September 30, 2018 since any potential loss is not probable or reasonably estimable given the current status of the proceedings.

#### *Federal Individual Securities Action*

An individual securities complaint was filed against us, our Chief Executive Officer, and additional unidentified defendants in the United States District Court for the Central District of California under the following caption: FiveT Investment Management LTD, et al., v. Capstone Turbine, et al., No. 2:18-CV-03512 on April 25, 2018. The lawsuit alleges material misrepresentations and omissions regarding our revenue, sales, and operations because of alleged improper revenue recognition and backlog calculations related to BPC. The lawsuit alleged that these statements constituted violations by all named defendants of Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder, as well as violations of Section 20(a) of the Exchange Act by the individual defendants. The complaint also asserted claims

against all named defendants for fraud, negligent misrepresentation, violations of California Civil Code sections 1709 and 1710, and California Corporations Code sections 25400 and 25401. Additionally, the complaint asserted a cause of action against the individual defendants for breach of fiduciary duty. It demanded compensatory damages for the amount of damages allegedly suffered, pre-judgment and post-judgment interest, and fees.

On June 29, 2018, the plaintiffs filed an Amended Complaint for Common Law Fraud and Negligent Misrepresentation. The Amended Complaint asserts claims for common law fraud and negligent misrepresentation, against the Company, Mr. Jamison, and unidentified individual defendants. The Amended Complaint demands damages in an unspecified amount, plus pre-judgment and post-judgment interest and fees. Defendants filed their answer to the Amended Complaint on August 17, 2018. Defendants filed their answer to the Amended Complaint on August 17, 2018. The parties participated in a mediation on September 24, 2018. The mediation did not result in a settlement. On October 12, 2018, the plaintiffs filed a motion for leave to amend their complaint, seeking to reinstate the cause of action for violation of California Civil Code section 25401. The motion is scheduled for hearing on November 30, 2018. We have not recorded any liability as of September 30, 2018 since any potential loss is not probable or reasonably estimable given the current status of the proceedings.

#### *State Derivative Lawsuits — California*

On February 18, 2016, a purported shareholder derivative action was filed in Los Angeles Superior Court in the State of California against us and certain of our current and former officers and directors under the following caption: *Stesiak v. Jamison, et al.*, No. BC610782. The lawsuit alleges that certain of our current and former officers and directors knew or should have known that BPC would be unable to fulfill its obligations to us, but allowed us to make false and misleading statements regarding BPC and our financial condition. The complaint also alleges that the defendants failed to timely adjust our account receivables and backlog to reflect BPC's inability to pay us. The complaint asserts causes of action for breach of fiduciary duty and unjust enrichment. It demands damages for the amount of damage sustained by us as a result of the individual defendants' alleged breach of fiduciary duties and unjust enrichment, that we institute corporate governance reforms, and disgorgement from the individual defendants. On May 5, 2016, the parties filed a stipulation and proposed order seeking to stay this action until such time as the defendants' motion(s) to dismiss the federal securities class action are either granted with prejudice or denied in whole or in part. On May 10, 2016, the Court entered that proposed order. On March 9, 2018, following the Court's order denying Defendants' motion to dismiss in the federal securities class action, the parties filed a stipulation and proposed order seeking to stay this action until the close of fact discovery in the federal securities class action. On March 20, 2018, the Court entered that proposed order. A status conference is scheduled for January 22, 2019.

On June 8, 2016, a purported shareholder derivative action entitled *Velma Kilpatrick v. Simon, et al.*, No. BC623167, was filed in Los Angeles Superior Court in the State of California against us and certain of our current and former officers and directors. The complaint alleges that certain of our current and former officers and directors knew or should have known that BPC would be unable to fulfill its obligations to us, but allowed us to make false and misleading statements regarding BPC and our financial condition. The complaint also alleges that the defendants failed to timely adjust our account receivables and backlog to reflect BPC's inability to pay us. The complaint asserts causes of action for breach of fiduciary duty. It demands damages for the amount of damage sustained by us as a result of the individual defendants' alleged breach of fiduciary duties, and that we institute corporate governance reforms. On August 23, 2016, the parties filed a stipulation and proposed order seeking to stay this action until such time as the defendants' motion(s) to dismiss the federal securities class action are either granted with prejudice or denied in whole or in part. On March 9, 2018, following the Court's order denying Defendants' motion to dismiss in the federal securities class action, the parties filed a stipulation and proposed order seeking to stay this action until the close of fact discovery in the federal securities class action. On March 20, 2018 the Court entered that proposed order. A status conference is scheduled for January 2, 2019.

The parties in both of the above state derivative lawsuits participated in a mediation held on September 24, 2018. Settlement negotiations are ongoing.

#### *Federal Derivative Lawsuits*

On March 7, 2016, a purported shareholder derivative action was filed in the United States District Court for the Central District of California against us and certain of our current and former officers and directors under the following caption: *Haber v. Jamison, et al.*, No. CV16-01569-DMG (RAOx). The lawsuit alleges that certain of our



current and former officers and directors knew or should have known that BPC would be unable to fulfill its obligations to us, but allowed us to make false and misleading statements regarding BPC and our financial condition. The complaint asserts a cause of action for breach of fiduciary duty. It demands damages for the amount of damage sustained by us as a result of the individual defendants' alleged breach of fiduciary duties, and equitable relief, including that we institute appropriate corporate governance reforms. On May 11, 2016, the parties filed a stipulation and proposed order seeking to stay this action until such time as the defendants' motion(s) to dismiss the federal securities class action are either granted with prejudice or denied in whole or in part. On May 13, 2016, the Court entered that proposed order.

On July 12, 2016 and July 18, 2016, respectively, two additional purported shareholder derivative actions were filed in the United States District Court for the Central District of California against us and certain of our current and former officers and directors, under the caption *Tuttle v. Atkinson, et al.*, No. CV16-05127, and *Boll v. Jamison, et al.*, No. CV16-5282, respectively. The lawsuits allege that certain of our current and former officers and directors knew or should have known that BPC would be unable to fulfill its obligations to us, but allowed us to make false and misleading statements regarding BPC and our financial condition. The Tuttle complaint asserts causes of action for breach of fiduciary duty, gross mismanagement, and unjust enrichment, and the Boll complaint asserts causes of action for breach of fiduciary duty, unjust enrichment, abuse of control, gross mismanagement, and waste of corporate assets. Both complaints demand damages sustained by us as a result of the individual defendants' alleged breaches of fiduciary duties, and equitable relief, including that we institute appropriate corporate governance reforms. The federal derivative actions were stayed until such time as the defendants' motion(s) to dismiss the federal securities class action are either granted with prejudice or denied in whole or in part. On March 9, 2018, following the Court's order denying Defendants' motion to dismiss in the federal securities class action, the parties filed a stipulation and proposed order seeking to stay this action until the close of fact discovery in the federal securities class action. On March 13, 2018, the Court granted the parties' stipulation.

The parties in both of the above state derivative lawsuits participated in a mediation on September 24, 2018. Settlement negotiations are ongoing.

*Capstone Turbine Corporation v. Regatta Solutions, Inc.*

On August 14, 2018, we initiated arbitration proceedings against our former distributor, Regatta Solutions, Inc. ("Regatta"), and additional unidentified defendants with the American Arbitration Association under the following caption: *Capstone Turbine Corp. v. Regatta Solutions, Inc.*, Case No. 01-18-0003-0860 ("Capstone-Regatta Arbitration"). We have alleged claims against Regatta for breach of contract and unjust enrichment relating to an agreement to wind down relations following the mutual non-renewal of the distributor agreement between the parties. As remedies for these claims, we are seeking compensatory, consequential, and punitive damages, along with declaratory relief and attorney's fees, interest and costs.

On October 18, 2018, Regatta filed its answer and cross-claims in the Capstone-Regatta Arbitration. In its cross-claims, Regatta has asserted claims for breach of contract, intentional interference with prospective economic advantage, fraud, and intentional interference with contractual relation relating to the agreement to wind down relations and purported sales efforts by our distributor in California. As remedies for these alleged claims, Regatta is seeking no less than \$1.5 million in general and compensatory damages, along with punitive and exemplary damages, as well as attorney's fees and costs. Our answer to the cross-claims is due to be filed on November 7, 2018.

On October 18, 2018, Regatta also filed claims in the Superior Court of the State of California, County of Orange, alleging two counts of fraud, and one count of interference with contractual obligations individually against Mr. James Crouse, Executive Vice President of Sales for us arising out of the same allegations relating to the agreement to wind down relations and purported sales efforts by our distributor in California. As remedies for these alleged claims, Regatta is seeking no less than \$1.5 million in general and compensatory damages, along with punitive and exemplary damages, as well as attorney's fees and costs. The case was filed under the caption *Regatta Solutions, Inc., v. Jim Crouse, et. al.*, Case No. 30-2018-01026571-CU-FR-CJC. We have not recorded any liability as of September 30, 2018 since any potential loss is not probable or reasonably estimable given the current status of the proceedings.

*Capstone Turbine Corporation v. Energy Systems, Inc.*

On August 17, 2018 Capstone initiated arbitration proceedings against its former distributor, Energy Systems of Caribbean, Inc. ("Energy Systems") by seeking declaratory relief that its action in terminating the distributorship was

justified under the law. The claim was filed with the American Arbitration Association under the following caption: Capstone Turbine Corp. v. Energy Systems of Caribbean, Inc., Case No. 01-18-0003-1307. As remedies for these claims, we are seeking declaratory relief and attorney's fees, interest and costs.

On August 22, 2018, Energy Systems filed a claim against us in Puerto Rico alleging Breach of Distribution Contract under Law No. 75 of June 24, 1964, as amended, 10 l.p.r.a. §§ 278-278. The case was filed under the caption Energy Systems of Caribbean, Inc., v. Capstone Turbine Corporation, CIVIL NO. SJ2018cv06543 (904). As remedies for these alleged claims, Energy Systems seeks actual damages, injunctive relief, attorney's fees and costs. This matter was subsequently removed to the United States District Court for the District of Puerto Rico based on diversity jurisdiction (Case No. 3:18-cv-01611). The parties have since stipulated to a stay of both the federal litigation and arbitration so that the parties may pursue settlement. We have not recorded any liability as of September 30, 2018 since any potential loss is not probable or reasonably estimable given the current status of the proceedings.

**Item 1A. Risk Factors**

There have been no material changes to the risk factors disclosed in our Annual Report on Form 10-K for Fiscal 2018 except for the revision of the risk factors set forth below:

***If any of our distributor relationships is not successful, we may terminate or choose not to renew the related distributor agreement, which may result in interference with the wind down of the relationship or the transition of end-user service agreements, and could potentially negatively impact our distribution channel or result in litigation costs or other expenses.***

Successfully managing our distribution channel in an effort to reach various potential customer segments for our products and services is a complex process. Each of our distributors is a strategically placed independent partner that provides for marketing and selling of our products and services on our behalf. If our distribution relationships are not successful, we may lose sales opportunities, customers, and revenues. Our agreements with our distribution partners require them to comply with performance conditions that are subject to interpretation, which could result in disagreements. At any given time, we may be in disputes with one or more distribution partners. Any such dispute could result in lengthy and costly litigation, even if the outcome is ultimately in our favor. We cannot predict the outcome of any arbitration or litigation, the effect of any negative judgment against us or the amount of any settlement that we may enter into with such distribution partners. A contractual dispute with a distribution partner may result in our or our distribution partner seeking to terminate the related distribution agreement, even if such termination would be wrongful, which could harm our business, or interfere with a previously agreed wind down of the relationship or transition of end-user service agreements. Any prolonged disruptions of our distribution channels that results from the termination of one or more of our distributions or our failure to renew our distribution agreements with our desired distributors, could negatively affect our ability to effectively sell our products and would materially and adversely affect our business, financial condition, results of operations and prospects.

***We have effected reductions in our operating costs and, as a result, our ability to cut costs further and sustain our business initiatives may be limited.***

Beginning in April 2015, we have implemented various initiatives to reduce operating costs across all functions of the Company and focus our business efforts on our most promising near-term product opportunities. As a result of these cost-cutting initiatives, we may have a more limited ability to further reduce costs to increase our liquidity should such measures become necessary. Any further reductions may have a materially negative impact on our business.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

None

**Item 3. Defaults Upon Senior Securities**

None

**Item 4. *Mine Safety Disclosures***

Not applicable

**Item 5. *Other Information***

None

**Item 6. Exhibits**

<b>Exhibit Number</b>	<b>Description</b>
3.1	<a href="#">Second Amended and Restated Certificate of Incorporation of Capstone Turbine Corporation</a> (a)
3.2	<a href="#">Certificate of Amendment to the Second Amended and Restated Certificate of Incorporation of Capstone Turbine Corporation, dated August 30, 2012</a> (b)
3.3	<a href="#">Certificate of Amendment to the Second Amended and Restated Certificate of Incorporation of Capstone Turbine Corporation, filed November 6, 2015</a> (c)
3.4	<a href="#">Fourth Amended and Restated Bylaws of Capstone Turbine Corporation</a> (d)
4.1	<a href="#">Form of Senior Indenture by and between Capstone Turbine Corporation and Computershare Trust Company, N.A., Trustee</a> (e)
4.2	<a href="#">Form of Subordinated Indenture by and between Capstone Turbine Corporation and Computershare Trust Company, N.A., Trustee</a> (e)
10.1	<a href="#">Form of Change in Control Agreement</a> (f)
10.2	<a href="#">First Amendment to the Accounts Receivable Agreement and Promissory Note between Capstone Turbine Corporation and Turbine International, LLC, dated June 5, 2018</a> (g)
10.3	<a href="#">At The Market Offering Agreement, dated June 7, 2018, between Capstone Turbine Corporation and H.C. Wainwright &amp; Co., LLC</a> (h)
10.4	<a href="#">Second Amendment to The Development and License Agreement between Capstone Turbine Corporation and Carrier Corporation, dated July 25, 2018, effective September 4, 2007</a> (i)
10.5	<a href="#">First Amendment to Business Financing Agreement between Capstone Turbine Corporation and Western Alliance Bank, N.A. dated June 1, 2018</a> (g)
31.1	<a href="#">Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes—Oxley Act of 2002</a>
31.2	<a href="#">Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes—Oxley Act of 2002</a>
32	<a href="#">Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes—Oxley Act of 2002</a>
101.INS	XBRL Instance Document
101.SCH	XBRL Schema Document
101.CAL	XBRL Calculation Linkbase Document
101.LAB	XBRL Label Linkbase Document
101.PRE	XBRL Presentation Linkbase Document
101.DEF	XBRL Definition Linkbase Document

(a) Incorporated by reference to Capstone Turbine Corporation’s Registration Statement on Form S-1/A, dated May 8, 2000 (File No. 333-33024)

(b) Incorporated by reference to Appendix B to Capstone Turbine Corporation’s Definitive Proxy Statement, filed on July 17, 2012 (File No. 001-15957)

(c) Incorporated by reference to Capstone Turbine Corporation’s Current Report on Form 8-K, filed on November 6, 2015 (File No. 001-15957)

(d) Incorporated by reference to Capstone Turbine Corporation’s Current Report on Form 8-K, filed on September 1, 2017 (File No. 001-15957)

(e) Incorporated by reference to Capstone Turbine Corporation’s Current Report on Form S-3 on filed on June 7, 2018 (File No. 333-225503)

(f) Incorporated by reference to Capstone Turbine Corporation’s Current Report on Form 8-K, filed on June 11, 2018 (File No. 001-15957)

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- (g) Incorporated by reference to Capstone Turbine Corporation's Current Report on Form 10-K, filed on June 7, 2018 (File No. 001-15957)
- (h) Incorporated by reference to Capstone Turbine Corporation's Current Report on Form 8-K, filed on June 7, 2018 (File No. 001-15957)
- (i) Incorporated by reference to Capstone Turbine Corporation's Current Report on Form 8-K, filed on June 7, 2018 (File No. 001-15957)









**CERTIFICATION OF THE CHIEF EXECUTIVE OFFICER AND THE CHIEF FINANCIAL OFFICER**

In connection with the quarterly report of Capstone Turbine Corporation (the "Company") on Form 10-Q for the quarter ended September 30, 2018, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), Darren R. Jamison, as Chief Executive Officer of the Company, and Jayme L. Brooks, as Chief Financial Officer of the Company, each hereby certifies, pursuant to 18 U.S.C. Sec. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

By:                   /s/ DARREN R. JAMISON                    
                  Darren R. Jamison  
                  President and Chief Executive Officer

By:                   /s/ JAYME L. BROOKS                    
                  Jayme L. Brooks  
                  Chief Financial Officer

Date: November 6, 2018