

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

Form 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended December 31, 2019

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

Capstone Turbine Corporation

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of
incorporation or organization)

**16640 Stagg Street
Van Nuys, California**

(Address of principal executive offices)

95-4180883

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

91406

(Zip Code)

818-734-5300

(Registrant's telephone number, including area code)

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

Title of each class	Trading Symbol(s)	Name of exchange on which registered
Common Stock, par value \$.001 per share Series B Junior Participating Preferred Stock Purchase Rights	CPST	NASDAQ Capital Market

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, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer Non-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 February 6, 2020 was 9,117,918.

**CAPSTONE TURBINE CORPORATION
INDEX**

	<u>Page Number</u>
<u>PART I — FINANCIAL INFORMATION</u>	
<u>Item 1. Financial Statements (Unaudited)</u>	3
<u>Condensed Consolidated Balance Sheets as of December 31, 2019 and March 31, 2019</u>	3
<u>Condensed Consolidated Statements of Operations for the Three and Nine Months Ended December 31, 2019 and 2018</u>	4
<u>Condensed Consolidated Statements of Stockholders' Equity for the Three and Nine Months Ended December 31, 2019 and 2018</u>	5
<u>Condensed Consolidated Statements of Cash Flows for the Nine Months Ended December 31, 2019 and 2018</u>	6
<u>Notes to Condensed Consolidated Financial Statements</u>	7
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	29
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	46
<u>Item 4. Controls and Procedures</u>	46
<u>PART II — OTHER INFORMATION</u>	
<u>Item 1. Legal Proceedings</u>	46
<u>Item 1A. Risk Factors</u>	50
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	50
<u>Item 3. Defaults Upon Senior Securities</u>	50
<u>Item 4. Mine Safety Disclosures</u>	50
<u>Item 5. Other Information</u>	50
<u>Item 6. Exhibits</u>	51
<u>Signatures</u>	52

PART I — FINANCIAL INFORMATION

Item 1. Financial Statements

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

	December 31, 2019	March 31, 2019
Assets		
Current Assets:		
Cash and cash equivalents	\$ 16,730	\$ 29,727
Accounts receivable, net of allowances of \$267 at December 31, 2019 and \$5,298 at March 31, 2019	19,821	16,222
Inventories, net	20,855	20,343
Prepaid expenses and other current assets	3,904	3,818
Total current assets	<u>61,310</u>	<u>70,110</u>
Property, plant, equipment and rental assets, net	7,744	5,291
Non-current portion of inventories	1,229	1,403
Intangible assets, net	19	187
Other assets	8,363	2,972
Total assets	<u>\$ 78,665</u>	<u>\$ 79,963</u>
Liabilities and Stockholders' Equity		
Current Liabilities:		
Accounts payable and accrued expenses	\$ 19,351	\$ 16,638
Accrued salaries and wages	1,403	1,637
Accrued warranty reserve	2,134	2,614
Deferred revenue	4,941	7,167
Current portion of notes payable and lease obligations	471	31
Total current liabilities	<u>28,300</u>	<u>28,087</u>
Deferred revenue - non-current	1,120	1,069
Term note payable, net	27,657	27,099
Long-term portion of notes payable and lease obligations	5,205	212
Other long-term liabilities	—	342
Total liabilities	<u>62,282</u>	<u>56,809</u>
Commitments and contingencies (Note 15)		
Stockholders' Equity:		
Preferred stock, \$.001 par value; 1,000,000 shares authorized; none issued	—	—
Common stock, \$.001 par value; 51,500,000 shares authorized, 8,841,634 shares issued and 8,804,910 shares outstanding at December 31, 2019; 7,216,910 shares issued and 7,190,671 shares outstanding at March 31, 2019	9	7
Additional paid-in capital	912,097	903,803
Accumulated deficit	(893,907)	(878,884)
Treasury stock, at cost; 36,724 shares at December 31, 2019 and 26,239 shares at March 31, 2019	(1,816)	(1,772)
Total stockholders' equity	<u>16,383</u>	<u>23,154</u>
Total liabilities and stockholders' equity	<u>\$ 78,665</u>	<u>\$ 79,963</u>

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)

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2019	2018	2019	2018
Revenue:				
Product, accessories and parts	\$ 12,010	\$ 13,310	\$ 42,070	\$ 49,022
Service	5,373	4,720	15,296	12,371
Total revenue	<u>17,383</u>	<u>18,030</u>	<u>57,366</u>	<u>61,393</u>
Cost of goods sold:				
Product, accessories and parts	10,815	12,534	36,506	45,109
Service	3,940	3,256	12,286	10,185
Total cost of goods sold	<u>14,755</u>	<u>15,790</u>	<u>48,792</u>	<u>55,294</u>
Gross margin	<u>2,628</u>	<u>2,240</u>	<u>8,574</u>	<u>6,099</u>
Operating expenses:				
Research and development	972	891	2,811	2,713
Selling, general and administrative	5,280	4,574	17,015	15,535
Total operating expenses	<u>6,252</u>	<u>5,465</u>	<u>19,826</u>	<u>18,248</u>
Loss from operations	<u>(3,624)</u>	<u>(3,225)</u>	<u>(11,252)</u>	<u>(12,149)</u>
Other income (expense)	6	(23)	165	(44)
Interest expense	<u>(1,289)</u>	<u>(202)</u>	<u>(3,853)</u>	<u>(506)</u>
Loss before provision for income taxes	<u>(4,907)</u>	<u>(3,450)</u>	<u>(14,940)</u>	<u>(12,699)</u>
Provision for income taxes	—	—	8	5
Net loss	<u>(4,907)</u>	<u>(3,450)</u>	<u>(14,948)</u>	<u>(12,704)</u>
Less: Deemed dividend on purchase warrant for common shares	—	—	75	—
Net loss attributable to common stockholders	<u>\$ (4,907)</u>	<u>\$ (3,450)</u>	<u>\$ (15,023)</u>	<u>\$ (12,704)</u>
Net loss per common share attributable to common stockholders—basic and diluted	<u>\$ (0.59)</u>	<u>\$ (0.50)</u>	<u>\$ (1.94)</u>	<u>\$ (1.94)</u>
Weighted average shares used to calculate basic and diluted net loss per common share attributable to common stockholders	<u>8,367</u>	<u>6,955</u>	<u>7,730</u>	<u>6,547</u>

See accompanying notes to condensed consolidated financial statements.

CAPSTONE TURBINE CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(In thousands, except per share data)
(Unaudited)

	Common Stock		Additional	Accumulated	Treasury Stock		Total
	Shares	Amount	Paid-in Capital	Deficit	Shares	Amount	Stockholders' Equity
Balance, March 31, 2019	7,216,910	\$ 7	\$ 903,803	\$ (878,884)	26,239	\$ (1,772)	\$ 23,154
Purchase of treasury stock	—	—	—	—	78	—	—
Vested restricted stock awards	229	—	—	—	—	—	—
Stock-based compensation	—	—	262	—	—	—	262
Issuance of common stock, net of issuance costs	143,387	1	1,221	—	—	—	1,222
Net loss	—	—	—	(5,593)	—	—	(5,593)
Balance, June 30, 2019	7,360,526	\$ 8	\$ 905,286	\$ (884,477)	26,317	\$ (1,772)	\$ 19,045
Purchase of treasury stock	—	—	—	—	3,987	(26)	(26)
Vested restricted stock awards	1,250	—	26	—	—	—	26
Stock-based compensation	—	—	104	—	—	—	104
Exercise of stock options and employee stock purchases	522	—	3	—	—	—	3
Stock awards to Board of Directors	26,315	—	(24)	—	—	—	(24)
Issuance of common stock, net of issuance costs	616,443	—	4,815	—	—	—	4,815
Deemed dividend on purchase warrant for common shares	—	—	75	(75)	—	—	—
Net loss	—	—	—	(4,448)	—	—	(4,448)
Balance, September 30, 2019	8,005,056	\$ 8	\$ 910,285	\$ (889,000)	30,304	(1,798)	19,495
Purchase of treasury stock	—	—	—	—	6,420	(18)	(18)
Vested restricted stock awards	19,961	—	17	—	—	—	17
Stock-based compensation	—	—	303	—	—	—	303
Issuance of common stock, net of issuance costs	376,617	—	1,201	—	—	—	1,201
Warrants exercised	440,000	1	—	—	—	—	1
Change in warrants valuation	—	—	291	—	—	—	291
Net loss	—	—	—	(4,907)	—	—	(4,907)
Balance, December 31, 2019	8,841,634	\$ 9	\$ 912,097	\$ (893,907)	36,724	\$ (1,816)	\$ 16,383

	Common Stock		Additional	Accumulated	Treasury Stock		Total
	Shares	Amount	Paid-in Capital	Deficit	Shares	Amount	Stockholders' Equity
Balance, March 31, 2018	5,706,260	\$ 57	\$ 889,585	\$ (862,224)	14,596	\$ (1,658)	\$ 25,760
Purchase of treasury stock	—	—	—	—	168	(3)	(3)
Vested restricted stock awards	469	—	3	—	—	—	3
Stock-based compensation	—	—	227	—	—	—	227
Warrants exercised	346,691	3	4,967	—	—	—	4,970
Issuance of common stock, net of issuance costs	380,621	4	(4)	—	—	—	—
Net loss	—	—	—	(4,898)	—	—	(4,898)
Balance, June 30, 2018	6,434,041	\$ 64	\$ 894,778	\$ (867,122)	14,764	\$ (1,661)	\$ 26,059
Purchase of treasury stock	—	—	—	—	6,254	(70)	(70)
Vested restricted stock awards	330	—	70	—	—	—	70
Stock-based compensation	—	—	224	—	—	—	224
Exercise of stock options and employee stock purchases	102	—	1	—	—	—	1
Stock awards to Board of Directors	45,719	—	(70)	—	—	—	(70)
Issuance of common stock, net of issuance costs	301,608	4	3,105	—	—	—	3,109
Net loss	—	—	—	(4,357)	—	—	(4,357)
Balance, September 30, 2018	6,781,800	\$ 68	\$ 898,108	\$ (871,479)	21,018	(1,731)	24,966
Purchase of treasury stock	—	—	—	—	3	—	—
Vested restricted stock awards	12,090	—	—	—	—	—	—
Stock-based compensation	—	—	292	—	—	—	292
Issuance of common stock, net of issuance costs	386,458	4	2,862	—	—	—	2,866
Net loss	—	—	—	(3,450)	—	—	(3,450)
Balance, December 31, 2018	7,180,348	\$ 72	\$ 901,262	\$ (874,929)	21,021	\$ (1,731)	\$ 24,674

See accompanying notes to condensed consolidated financial statements

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

	Nine Months Ended	
	December 31,	
	2019	2018
Cash Flows from Operating Activities:		
Net loss	\$ (14,948)	\$ (12,704)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	1,223	957
Amortization of financing costs and discounts	850	132
Amortization of right-of-use assets	779	—
(Reduction) in accounts receivable allowances	(77)	(345)
Inventory provision	489	617
Provision for warranty expenses	459	1,921
(Gain) loss on disposal of equipment	(13)	7
Stock-based compensation	669	743
Changes in operating assets and liabilities:		
Accounts receivable	(3,522)	3,088
Inventories	(827)	(3,401)
Prepaid expenses, other current assets and other assets	591	(3,821)
Accounts payable and accrued expenses	1,956	2,185
Accrued salaries and wages and long term liabilities	(234)	(258)
Accrued warranty reserve	(939)	(1,034)
Deferred revenue	(2,176)	(684)
Net cash used in operating activities	<u>(15,720)</u>	<u>(12,597)</u>
Cash Flows from Investing Activities:		
Expenditures for property, equipment and rental assets	(3,900)	(3,070)
Net cash used in investing activities	<u>(3,900)</u>	<u>(3,070)</u>
Cash Flows from Financing Activities:		
Net proceeds from revolving credit facility	—	2,209
Repayment of notes payable and lease obligations	(593)	(144)
Cash used in employee stock-based transactions	(44)	(73)
Net proceeds from issuance of common stock and warrants	7,260	10,948
Net cash provided by financing activities	<u>6,623</u>	<u>12,940</u>
Net increase (decrease) in Cash, Cash Equivalents and Restricted Cash	<u>(12,997)</u>	<u>(2,727)</u>
Cash, Cash Equivalents and Restricted Cash, Beginning of Year	<u>29,727</u>	<u>19,408</u>
Cash, Cash Equivalents and Restricted Cash, End of Year	<u>\$ 16,730</u>	<u>\$ 16,681</u>
Supplemental Disclosures of Cash Flow Information:		
Cash paid during the period for:		
Interest	\$ 2,625	\$ 343
Income taxes	\$ 15	\$ 5
Supplemental Disclosures of Non-Cash Information:		
Acquisition of property and equipment through accounts payable	\$ 7	\$ —
Renewal of insurance contracts which was financed by notes payable	\$ —	\$ 260
Deemed dividend	\$ 75	\$ —

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 and distribution networks applications, including energy efficient cogeneration combined heat and power (“CHP”), integrated combined heat and power (“ICHP”), and combined cooling, heat and power (“CCHP”), as well as renewable energy, natural resources and critical power supply applications. Microturbines allow customers to produce power on-site in parallel with the electric grid or stand-alone when no utility grid is available. Several technologies are used to provide “on-site power generation” (also called “distributed generation”) such as reciprocating engines, solar photovoltaic power (“PV”), wind turbines and fuel cells. 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. In addition, the Company’s microturbines have been used as battery charging generators for hybrid electric vehicles and to provide power to a vessel’s electrical loads in marine applications. We sell microturbine units, components and accessories, as well as offer long-term microturbine rentals. We also remanufacture microturbine engines and provide new and remanufactured aftermarket spare parts, accessories, services, and comprehensive long-term service contracts for up to 20 years. 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, 2019 was derived from audited consolidated financial statements included in the Company’s Annual Report on Form 10-K for the year ended March 31, 2019. 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 2019. 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 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 2019 filed with the SEC on June 11, 2019, that have had a material impact on the Company’s condensed consolidated financial statements and related notes, except for the accounting policy for lease recognition as a result of the adoption of Accounting Standards Update (“ASU”) No. 2016-02, as discussed in Note 3—Recently Issued Accounting Standards.

Reverse Stock Split At the annual meeting of stockholders of the Company held on August 29, 2019, the Company’s stockholders approved an amendment to our Second Amended and Restated Certificate of Incorporation (the “Amendment”) to effect a reverse stock split of our common stock at a ratio in the range of one-for-five (1:5) to one-for-ten (1:10). Pursuant to such authority granted by the stockholders, the Company’s board of directors approved a one-for-ten (1:10) reverse stock split (the “Reverse Stock Split”) of the common stock and the filing of the Amendment. The certificate was filed with the Secretary of State of Delaware, effective on October 21, 2019 and the Reverse Stock Split became effective as of that date as filed with the SEC under the Securities and Exchange Act. Accordingly, all references to numbers of common shares, including the number of common shares on an as-if-converted basis, per-share data and share prices and exercise prices in the accompanying condensed consolidated financial statements have been adjusted to reflect the reverse stock split on a retroactive basis.

Evaluation of Ability to Maintain Current Level of Operations In connection with preparing the condensed consolidated financial statements for the nine months ended December 31, 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 third quarter of Fiscal 2020 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 \$14.9 million and used cash in operating activities of \$15.7 million for the nine months ended December 31, 2019. The Company's working capital requirements during the nine months ended December 31, 2019 were higher than management's expectations, which included higher accounts receivable due to delayed collections and higher inventory. The Company's net loss expanded during the nine months ended December 31, 2019 compared to the same period the previous year primarily because of higher interest expense and higher selling, general and administrative expense, partially offset by higher gross margins from our accessories, parts and service business. As of December 31, 2019, the Company had cash and cash equivalents of \$16.7 million, and outstanding debt of \$30.0 million (see Note 11 – Term Note Payable for further discussion of the outstanding debt).

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). 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, the fully diluted ownership percentages of existing stockholders will be reduced. In addition, any equity 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 funds received under the note purchase agreement, 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 our third quarter of Fiscal 2020 financial statements.

Basis for Consolidation The condensed 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 Pronouncements

Adopted

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. On April 1, 2019, the Company adopted this standard. See Note 16—Leases for additional discussion of the impact of the adoption of ASU 2016-02.

In June 2018, the FASB issued ASU 2018-07, "Share-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 adopted ASU 2018-07 on April 1, 2019 and it did not have a material impact on the Company's condensed consolidated financial statements.

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 adopted Release No. 33-10532 on April 1, 2019 and it did not have a material impact on the Company's financial disclosures.

4. Customer Concentrations and Accounts Receivable

Sales to Optimal Group Australia Pty Ltd, one of the Company's Australian distributors, accounted for 11% of revenue for the three months ended December 31, 2019. Sales to E-Finity Distributed Generation, LLC ("E-Finity") and Cal Microturbine ("CAL"), two of the Company's domestic distributors and DTC Soluciones Inmobiliarias S.A. de C.V., one of the Company's Mexican distributors ("DTC"), accounted for 14%, 13% and 13%, respectively, of revenue for the three months ended December 31, 2018. For the nine months ended December 31, 2019 and 2018, E-Finity accounted for 12% of revenue.

Additionally, E-Finity accounted for 12% of net accounts receivable as of December 31, 2019. Reliable Secure Power Systems, ("RSP"), one of the Company's domestic distributors and E-Finity, accounted for 14% and 10%, respectively, of net accounts receivable as of March 31, 2019.

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.

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 was contingent upon TI's payment to the Company of the remaining approximately \$1.5 million in five payments by September 20, 2019. 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 on December 20, 2019. The payments of \$0.4 million, \$0.3 million, and \$0.3 million, due March 20, 2019, June 20, 2019, and September 20, 2019, respectively, under the Amended Assignment

Agreement, have not been received at the time of this filing. In September 2019, the Company sent TI a notice to cure default with a deadline of October 31, 2019. TI failed to cure the noticed default and the Company has since terminated TI's distributor agreement. As a result, the BPC accounts receivable and related accounts receivable reserve of \$4.8 million were written off.

The Company recorded a net bad debt recovery of \$0.1 million during the nine months ended December 31, 2019. No bad debt recovery or expense was recorded in the three months ended December 31, 2019. The Company recorded a net bad debt recovery of approximately \$0.4 million and \$0.3 million during the three and nine months ended December 31, 2018, respectively.

As of March 31, 2015, the Company had an amount owed of approximately \$8.1 million by BPC. As of September 30, 2019, the Company cumulatively collected approximately \$1.8 million from BPC on their accounts receivable, which has been previously reserved. The Company cumulatively collected approximately \$1.5 million from TI, under the terms of the Assignment Agreement and the Amended Assignment Agreement. The BPC accounts receivable and related accounts receivable reserve of \$4.8 million were written off as of December 31, 2019.

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 December 31, 2019 and March 31, 2019 (in thousands):

	December 31, 2019	March 31, 2019
Raw materials	\$ 22,628	\$ 24,426
Work in process	603	—
Finished goods	1,742	1,207
Total	24,973	25,633
Less inventory reserve	(2,889)	(3,887)
Less non-current portion	(1,229)	(1,403)
Current portion	\$ 20,855	\$ 20,343

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 December 31, 2019 is 1.2 years. The Company expects to use the non-current portion of the inventories on hand as of December 31, 2019 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	\$ 647
25 to 36 months	582
Total	\$ 1,229

6. Property, Plant, Equipment and Rental Assets

Property, plant, equipment and rental assets consisted of the following as of December 31, 2019 and March 31, 2019 (in thousands):

	December 31, 2019	March 31, 2019
Machinery, equipment, automobiles and furniture	\$ 15,728	\$ 15,344
Leasehold improvements	11,114	11,074
Molds and tooling	3,099	2,893
Rental assets	5,502	2,818
	35,443	32,129
Less, accumulated depreciation	(27,699)	(26,838)
Total property, plant, equipment and rental assets, net	\$ 7,744	\$ 5,291

During the third quarter of Fiscal 2020, the Company deployed approximately \$0.7 million of its C1000 Signature Series systems (0.8 megawatts “MW”) under its long-term rental program, bringing the total rental fleet to 7.0 MWs. During the nine months ended December 31, 2019, the Company deployed approximately \$2.7 million of its C1000 Signature Series systems under its long-term rental program.

The Company regularly reassesses the useful lives of property and equipment and retires assets no longer in service. Depreciation expense for property, equipment and rental assets was \$0.3 million each for the three months ended December 31, 2019 and 2018. Depreciation expense for property, equipment and rental assets was \$1.0 million and \$0.8 million for the nine months ended December 31, 2019 and 2018, respectively.

7. Intangible Assets

Intangible assets consisted of the following as of December 31, 2019 and March 31, 2019 (in thousands):

	December 31, 2019			
	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	2,221	19
Trade name & parts, service and TA100 customer relationships	1.2 to 5 years	1,766	1,766	—
Total		\$ 7,706	\$ 7,687	\$ 19

	March 31, 2019			
	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	2,053	187
Trade name & parts, service and TA100 customer relationships	1.2 to 5 years	1,766	1,766	—
Total		\$ 7,706	\$ 7,519	\$ 187

Amortization expense for the intangible assets was \$0.1 million and \$0.2 million for each of the three and nine months ended December 31, 2019 and 2018, respectively.

Expected future amortization expense of intangible assets as of December 31, 2019 is as follows (in thousands):

Year Ending March 31,	Amortization Expense
2020 (remainder of fiscal year)	\$ 19
Total expected future amortization	\$ 19

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 \$6,200 and \$8,100 were earned by Solar for the three months ended December 31, 2019 and 2018, respectively. Royalties of approximately \$22,600 and \$25,200 were earned by Solar for the nine months ended December 31, 2019 and 2018, respectively. Earned royalties of approximately \$48,700 and \$26,100 were unpaid as of December 31, 2019 and March 31, 2019, 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 nine months ended December 31, 2019 and 2018 (in thousands):

	Three Months Ended		Nine Months Ended	
	December 31,		December 31,	
	2019	2018	2019	2018
Cost of goods sold	\$ 17	\$ 13	\$ 52	\$ 38
Research and development	12	8	33	21
Selling, general and administrative	274	271	584	684
Stock-based compensation expense	<u>\$ 303</u>	<u>\$ 292</u>	<u>\$ 669</u>	<u>\$ 743</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 184,900 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 300,000 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 300,000 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.

On August 29, 2019, at the Company's 2019 annual meeting, the Registrant's stockholders approved another amendment to the 2017 Plan to increase the aggregate number of shares authorized for issuance under the 2017 Plan by 300,000 shares to 900,000 shares of common stock. As of December 31, 2019, there were 510,993 shares available for future grants under the 2017 Plan.

Stock Options

The Company issued stock options under the 2000 Plan and can issue 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 nine months ended December 31, 2019 is as follows:

	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value
Options outstanding at March 31, 2019	17,499	\$ 209.36		
Granted	—	\$ —		
Exercised	—	\$ —		
Forfeited, cancelled or expired	(6,250)	\$ 198.21		
Options outstanding at December 31, 2019	<u>11,249</u>	<u>\$ 215.56</u>	<u>2.3</u>	<u>—</u>
Options fully vested at December 31, 2019 and those expected to vest beyond December 31, 2019	11,249	\$ 215.56	2.3	—
Options exercisable at December 31, 2019	<u>11,249</u>	<u>\$ 215.56</u>	<u>2.3</u>	<u>—</u>

Black-Scholes Model Valuation Assumptions

There were no stock options granted during either of the three or nine months ended December 31, 2019 or 2018. There was no expense associated with stock options during the three or nine months ended December 31, 2019 or 2018. There were no unvested stock option awards as of December 31, 2019.

Restricted Stock Units and Performance Restricted Stock Units

The Company issued restricted stock units under the 2000 Plan and issued 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:

Restricted Stock Units and Performance Restricted Stock Units	Shares	Weighted Average Grant Date Fair Value
Nonvested restricted stock units outstanding at March 31, 2019	221,778	\$ 10.20
Granted	149,370	5.95
Vested and issued	(47,753)	10.91
Forfeited	(52,022)	8.34
Nonvested restricted stock units outstanding at December 31, 2019	<u>271,373</u>	<u>8.10</u>
Restricted stock units expected to vest beyond December 31, 2019	<u>271,373</u>	<u>\$ 8.10</u>

The following table provides additional information on restricted stock units and performance restricted stock units for the Company's three and nine months ended December 31, 2019 and 2018:

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2019	2018	2019	2018
Restricted stock compensation expense (in thousands)	\$ 303	\$ 292	\$ 669	\$ 743
Aggregate fair value of restricted stock units vested and issued (in thousands)	\$ 54	\$ 91	\$ 235	\$ 614
Weighted average grant date fair value of restricted stock units granted during the period	\$ 3.21	\$ 8.20	\$ 5.95	\$ 11.60

As of December 31, 2019, there was approximately \$1.1 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 1.3 years.

The Company's 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 nine months ended December 31, 2019, the Company granted 30,139 PRSUs with a three-year performance measurement period and the criteria measured by the Company's cash flow from operations and aftermarket sales absorption. The target PRSU awards for each participant, will be paid upon achievement of the target level of performance for cash flow from operations 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.

The weighted average per share grant date fair value of PRSUs granted during the nine months ended December 31, 2019 was \$8.90. Based on the Company's assessment as of December 31, 2019, the threshold for one of the performance measurements on the 2-year vesting PRSU was met and as a result we recorded compensation expense of approximately \$0.1 million during the three months ended December 31, 2019. Such compensation expense is 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 changes. 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 to employees and non-employee directors. There were no restricted stock awards granted during the three and nine months ended December 31, 2019 or 2018. No expense was recorded associated with its restricted stock awards during the three and nine months ended December 31, 2019 or 2018.

For each term of the Board of Directors (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, 7,000 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 50,000 shares which reserved for issuance a total of 57,000 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. The maximum amount that an employee can contribute during a purchase right period is \$25,000 or 15% of the employee's regular compensation. Under the ESPP, the exercise price of a purchase right is 95% of the fair market value of such shares on the last day of the purchase right period. The fair market value of the stock is its closing price as reported on the Nasdaq Capital Market on the day in question. During the nine months ended December 31, 2019, the Company issued a total of 522 shares of stock to regular full and part-time employees or officers of the Company who elected to participate in the ESPP. As of December 31, 2019, there were 48,838 shares available for future grant under the ESPP.

Stockholder Rights Plan

On May 6, 2019, the Company's Board of Directors (the "Board"), declared a dividend of one right (a "New Right") for each of the Company's issued and outstanding shares of common stock, \$0.001 par value per share ("Common Stock"). The dividend was paid to the stockholders of record at the close of business on May 16, 2019 (the "Record Date"). Each New Right entitles the registered holder, subject to the terms of the NOL Rights Agreement (as defined below), to purchase from the Company one one-thousandth of a share of the Company's Series B Junior Participating Preferred Stock (the "Preferred Stock") at a price of \$5.22 (the "Exercise Price"), subject to certain adjustments. The description and terms of the New Rights are set forth in the Rights Agreement dated as of May 6, 2019 (the "NOL Rights Agreement") between the Company and Broadridge Financial Solutions, Inc., as Rights Agent (the "Rights Agent").

The NOL Rights Agreement replaces the Company's Rights Agreement, dated May 6, 2016, by and between the Company and Broadridge Financial Solutions, Inc., as successor-in-interest to Computershare Inc., as rights agent (the "Original Rights Agreement"). The Original Rights Agreement, and the rights thereunder to purchase fractional

shares of Preferred Stock, expired at 5:00 p.m., New York City time, on May 6, 2019 and the NOL Rights Agreement was entered into immediately thereafter.

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, as amended (the "Tax Code"). 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 Tax Code, 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 Tax Code by (i) discouraging any person or group from becoming a 4.9% shareholder and (ii) discouraging any existing 4.9% shareholder from acquiring additional shares of the Company's stock.

The New 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 have, become an "Acquiring Person," which is defined as a person or group of affiliated or associated persons who, at any time after the date of the NOL Rights Agreement, have acquired, or obtained the right to acquire, beneficial ownership of 4.9% 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 Securities 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.

With respect to certificates representing shares of Common Stock outstanding as of the Record Date, until the Distribution Date, the New Rights will be evidenced by such certificates for shares of Common Stock registered in the names of the holders thereof, and not by separate Rights Certificates, as described further below. With respect to book entry shares of Common Stock outstanding as of the Record Date, until the Distribution Date, the New Rights will be evidenced by the balances indicated in the book entry account system of the transfer agent for the Common Stock. Until the earlier of the Distribution Date and the Expiration Date, as described below, the transfer of any shares of Common Stock outstanding on the Record Date will also constitute the transfer of the New Rights associated with such shares of Common Stock. As soon as practicable after the Distribution Date, separate certificates evidencing the New Rights ("Right Certificates") will be mailed to holders of record of the Common Stock as of the close of business on the Distribution Date, and such Right Certificates alone will evidence the New Rights.

The New Rights, which are not exercisable until the Distribution Date, will expire prior to the earliest of (i) May 6, 2022 or such later day as may be established by the Board prior to the expiration of the New 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 New Rights are redeemed pursuant to the NOL Rights Agreement; (iii) the time at which the New Rights are exchanged pursuant to the NOL Rights Agreement; (iv) the time at which the New Rights are terminated upon the occurrence of certain transactions; (v) the close of business on the effective date of the repeal of Section 382 of the Tax Code, if the Board determines that the NOL Rights Agreement is no longer necessary or desirable for the preservation of Tax Benefits; and (vi) 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, (the earliest of (i), (ii), (iii), (iv), (v), (vi) and (vi) is referred to as the "Expiration Date").

Each share of 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 aggregate quarterly dividend declared per share of Common Stock since the immediately preceding quarterly dividend payment date for the Common Stock (or, with respect to the first quarterly dividend payment on the Common Stock, since the first issuance of the Preferred Stock). Each share of 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 Preferred Stock will be entitled to receive 1,000 times the amount received per one share of Common Stock.

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

At-the-market offerings

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 nine months ended December 31, 2018, the Company issued 0.3 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 December 31, 2018, 2.6 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.

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 December 31, 2019, the Company issued approximately 0.4 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 \$1.2 million after deducting commissions paid of approximately \$41,400. During the nine months ended December 31, 2019, the Company issued 0.6 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 \$2.7 million after deducting commissions paid of approximately \$0.1 million. As of December 31, 2019, approximately \$15.0 million remained available for issuance with respect to this at-the-market offering program.

Warrants

On April 13, 2018, a warrant holder exercised its rights to the warrant agreement to exercise on a cashless basis 576,000 Series A warrants at an exercise price of \$6.00 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 380,625 shares of common stock.

As of December 31, 2019, there were 271,875 Series A warrants outstanding and there are no Series B warrants outstanding. Of the total Series A warrants outstanding, 217,875 Series A warrants were issued with an exercise price of \$25.50 per share of common stock, and have an expiration date of October 25, 2021, and 54,000 Series A warrants with anti-dilution provisions were issued with an initial exercise price of \$13.40 per share of common stock, and have an expiration date of April 22, 2021. As of December 31, 2019, because of the anti-dilution provisions, these warrants had an adjusted exercise price of \$3.05 per share of common stock.

On February 4, 2019, the Company sold to Goldman Sachs & Co. LLC (the "Holder"), a Purchase Warrant for Common Shares (the "Warrant") pursuant to which the Holder may purchase shares of the Company's common stock, par value \$0.001 per share (the "Common Shares") in an aggregate amount of up to 404,634 shares (the "Warrant Shares"). The Warrant was sold to the Holder at a purchase price of \$150,000, in a private placement exempt from registration under the Securities Act. The Warrant may be exercised by the Holder at any time after August 4, 2019 at an exercise price equal to \$8.86 and will expire on February 4, 2024. The Warrant contains standard adjustment provisions in the event of additional stock issuances below the exercise price of the warrant, stock splits, combinations, rights offerings and similar transactions. The value of the Warrant was \$2.3 million, and has been classified as an equity instrument in additional paid in capital in our consolidated balance sheets. The Company's common stock and warrant transactions during the second quarter of Fiscal 2020 triggered certain anti-dilution provisions in the warrants outstanding. As a result, the Company issued an additional 29,654 warrants and recorded a deemed dividend amounting to \$74,989.

On December 9, 2019, the Company entered into an Amendment No. 1 to the Purchase Warrant for Common shares (the "Amendment No. 1") with Special Situations Investing Group II, LLC (as successor in interest to Goldman Sachs & Co. LLC) (the "Warrant Holder") that amends the Warrant. The Amendment No. 1 amends the first paragraph

of the Warrant to increase the number of Warrant Shares issuable under the Warrant (on a post-reverse split basis) and to decrease the exercise price from \$8.86 per share (on a post-reverse split basis) to \$3.80 per share (the “Per Share Warrant Exercise Price”). The Amendment No. 1 also amends Section 2.1 of the Warrant such that the Per Share Anti-Dilution Price is equal to the Per Share Warrant Exercise Price. As a result of the decrease in exercise price, we recorded the change in valuation of \$0.3 million as additional debt discount with a corresponding entry to additional paid in capital in the condensed consolidated balance sheets as of December 31, 2019.

On September 4, 2019, the Company entered into a Securities Purchase Agreement (the “Securities Purchase Agreement”) with certain institutional and accredited investors pursuant to which the Company agreed to issue and sell in a registered direct offering (the “Registered Direct Offering”) an aggregate of 580,000 shares of our common stock, par value \$0.001 per share at a negotiated purchase price of \$5.00 per share, and pre-funded warrants to purchase up to an aggregate of 440,000 shares of our common stock at a negotiated purchase price of \$5.00 per Pre-Funded Warrant, for aggregate gross proceeds of approximately \$5.1 million (580,000 shares of our common stock plus 440,000 pre-funded warrants at a \$5.00 per share purchase price), before deducting placement agent fees and other offering expenses. Net proceeds from the offering were \$4.6 million. The offering closed on September 9, 2019. On October 24, 2019, a warrant holder exercised its rights to the warrant agreement to exercise on a cash basis 440,000 pre-funded warrants at an exercise price of \$0.001 per share under the warrant agreement.

In a concurrent private placement, we agreed to issue to the purchasers warrants to purchase 765,000 shares of Common Stock, which represent 75% of the number of shares of Common Stock and shares underlying the Pre-Funded Warrants purchased in the Registered Direct Offering, pursuant to the Securities Purchase Agreement. The Common Warrants will be exercisable for shares of Common Stock at an initial exercise price of \$6.12 per share for a period of five years, starting on April 2, 2020 and expiring on April 2, 2025.

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.

Basis for Valuation

The carrying values reported in the condensed consolidated balance sheets for cash and cash equivalents, accounts receivable and accounts payable approximate fair values because of the immediate or short-term maturities of these financial instruments. The term note payable has been recorded net of a discount based on the fair value of the associated warrant and capitalized debt issuance costs. The carrying values and estimated fair values of these obligations are as follows (in thousands):

	As of December 31, 2019		As of March 31, 2019	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
Term note payable	\$ 27,657	\$ 30,000	\$ 27,099	\$ 30,000

11. Term Note Payable

On February 4, 2019 (the “Closing Date”), we entered into a Note Purchase Agreement (as amended, the “Note Purchase Agreement”), by and among us, certain subsidiaries of us party thereto as guarantors, Goldman Sachs Specialty Lending Holdings, Inc. and any other purchasers party thereto from time to time (collectively, the “Purchaser”). Under the Note Purchase Agreement, we sold to the Purchaser \$30.0 million aggregate principal amount of senior secured notes (the “Notes”), which bear interest at a rate of 13.0% per annum and payable quarterly on March 31, June 30, September 30 and December 31 of each year until maturity. The entire principal amount of the Notes is due and payable on February 4, 2022 (the “Maturity Date”). The Notes do not amortize and the entire principal balance is due in a single payment on the Maturity Date. As of December 31, 2019, \$30.0 million in borrowings were outstanding under the three-year term note.

Obligations under the Note Purchase Agreement are secured by all of our assets, including intellectual property and general intangibles. The Note Purchase Agreement contains customary covenants, including, among others, covenants that restrict our ability to incur debt, grant liens, make certain investments and acquisitions, pay dividends, repurchase equity interests, repay certain debt, amend certain contracts, enter into affiliate transactions and asset sales or make certain equity issuances (including equity issuances that would cause an ownership change within the meaning of Section 382 of the Internal Revenue Code), and covenants that require us to, among other things, provide annual, quarterly and monthly financial statements, together with related compliance certificates, maintain its property in good repair, maintain insurance and comply with applicable laws.

On December 9, 2019, the Company entered into a Second Amendment (the “Second Amendment”) to the Note Purchase Agreement. Under the Second Amendment, the Parties agreed to amend Section 6.21 of the Note Purchase Agreement to increase the Section 382 Ownership Shift threshold to not exceed 40.0%.

The financial covenants of the Note Purchase Agreement require the Company not to exceed specified levels of Adjusted EBITDA losses relative to its financial model, beginning with the fiscal quarter ending September 30, 2020. Additionally, we shall not permit our minimum consolidated liquidity, which consists of our cash and cash equivalents, to be less than \$12.0 million through February 4, 2020, and \$9.0 million thereafter. As of December 31, 2019, the Company was in compliance with the covenants contained in the Note Purchase Agreement.

The three-year term note has been recorded net of a discount based on the fair value of the associated common stock warrants and debt issuance costs totaling \$2.3 million. Amortization of the debt discount and debt issuance costs was \$0.3 million and \$0.9 million for the three and nine months ended December 31, 2019, respectively, based on an effective interest rate, and has been recorded as interest expense in the condensed consolidated statements of operations.

Interest expense related to the term note payable during the three months ended December 31, 2019 was \$1.3 million, which includes \$0.3 million in amortization of debt issuance costs. Interest expense during the nine months ended December 31, 2019 was \$3.9 million, which includes \$0.9 million in amortization of debt issuance costs.

When we entered into the Note Purchase Agreement the existing credit facility with Bridge Bank was paid in full. As such, there was no interest expense related to the credit facility during the nine months ended December 31, 2019. Interest expense related to the credit facility during the three and nine months ended December 31, 2018 was \$0.2 million and \$0.5 million, which includes \$46,900 and \$0.1 million in amortization of debt issuance costs, respectively.

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 nine months ended December 31, 2019 are as follows (in thousands):

Balance, beginning of the period	\$ 2,614
Standard warranty provision	459
Deductions for warranty claims	(939)
Balance, end of the period	<u>\$ 2,134</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 Sheets. 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 Operations. The deferred revenue relating to the annual maintenance service

contracts is recognized in the Condensed Consolidated Statement of Operations 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 nine months ended December 31, 2019 (in thousands):

	<u>Three Months Ended</u>	<u>Nine Months Ended</u>
	<u>December 31, 2019</u>	<u>December 31, 2019</u>
Microturbine Products	\$ 7,923	\$ 30,024
Accessories and Parts	4,087	12,046
Total Product, Accessories and Parts	12,010	42,070
Service	5,373	15,296
Total Revenue	\$ 17,383	\$ 57,366

Following is the geographic revenue information based on the primary operating location of the Company's customers for the three and nine months ended December 31, 2019 (in thousands):

	<u>Three Months Ended</u> <u>December 31, 2019</u>	<u>Nine Months Ended</u> <u>December 31, 2019</u>
United States	\$ 7,030	\$ 24,497
Mexico	358	1,841
All other North America	41	793
Total North America	<u>7,429</u>	<u>27,131</u>
Russia	1,182	3,467
All other Europe	4,060	11,077
Total Europe	<u>5,242</u>	<u>14,544</u>
Asia	1,162	3,611
Australia	1,867	4,005
All other	1,683	8,075
Total Revenue	<u>\$ 17,383</u>	<u>\$ 57,366</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 December 31, 2019, the balance of deferred revenue was approximately \$6.1 million compared to \$8.2 million as of March 31, 2019. This overall decrease in the balance of deferred revenue of \$2.1 million during the nine months ended December 31, 2019 was comprised of decreases in deferred revenue attributable to deposits of \$0.8 million and deferred revenue attributable to the Distributor Support System ("DSS program") of \$1.7 million, these decreases were offset by an increase in deferred revenue attributable to FPP contracts of \$0.4 million. Changes in deferred revenue during the nine months ended December 31, 2019 are as follows (in thousands):

FPP Balance, beginning of the period	\$ 4,881
FPP Billings	12,595
FPP Revenue recognized	<u>(12,206)</u>
Balance attributed to FPP contracts	5,270
Deposits	791
Deferred revenue balance, end of the period	<u>\$ 6,061</u>

Deferred revenue attributed to FPP contracts represents the unearned portion of our contracts. FPP contracts are generally paid quarterly in advance with revenue recognized on a straight line basis over the contract period. Deposits are primarily non-refundable cash payments from distributors for future orders.

As of December 31, 2019, approximately \$5.3 million of revenue is expected to be recognized from remaining performance obligations for FPP contracts. The Company expects to recognize revenue on approximately \$4.2 million of these remaining performance obligations over the next 12 months and the balance of \$1.1 million will be recognized thereafter. Revenue from remaining performance obligations for professional services contracts as of December 31, 2019 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.

As of December 31, 2019, the FPP backlog was approximately \$83.7 million, which represents the value of the contractual agreement for FPP services that has not been earned and extends through Fiscal 2034.

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 Assets

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. During the three months ended September 30, 2013, we reached our repayment threshold level and the fixed rate royalty was reduced by 50%. 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 nine months ended December 31, 2019 and 2018, respectively. There were no unpaid, earned royalties as of December 31, 2019.

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. A 15-year amortization period is the minimum expected life cycle of the current generation of product. 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):

	December 31, 2019	
Other current assets	\$	124
Other assets		2,679
Royalty-related assets	\$	2,803

15. Commitments and Contingencies

Purchase Commitments

As of December 31, 2019, the Company had firm commitments to purchase inventories of approximately \$27.7 million through Fiscal 2022. 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

See Note 16—Leases.

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.

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 Kinney Complaint alleged 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 alleged 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 alleged 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 made allegations and claims that were substantially identical to those in the Kinney Complaint, and both complaints sought 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 was 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, which did not result in a settlement. On November 16, 2018, after further settlement discussions, the parties advised the Court that they had reached an agreement in principle to settle the action in its entirety. The agreement in principle was subject to several conditions, including the execution of a stipulation of settlement that was satisfactory to all parties, and preliminary and final approval from the court, among other things. Plaintiffs filed a motion seeking preliminary approval of the proposed settlement on April 12, 2019, and filed supplementary declarations in support of the motion on May 2, 2019. Preliminary approval of the settlement was granted on May 17, 2019. On September 24, 2019, lead counsel filed a motion for attorneys' fees and reimbursement of litigation expenses. On October 25, 2019, plaintiffs filed a motion for final approval of the settlement. On November 15, 2019, the Court issued an order approving the settlement and the payment of attorneys' fees, litigation expenses, and class representative payments, and entering final judgment in the action. The Company's insurance carrier funded the settlement amount. The Company has not recorded any liability as of December 31, 2019 since the settlement amount is not considered material as it was funded by its insurance carrier.

Federal Individual Securities Action

An individual securities complaint was filed against the Company, its 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 alleged material misrepresentations and omissions regarding the Company's 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 asserted claims for common law fraud and negligent misrepresentation, against the Company, Mr. Jamison, and unidentified individual defendants. The Amended Complaint demanded 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. On November 29, 2018, the Court granted plaintiffs' motion for leave to amend and plaintiffs filed their Second Amended Complaint, which asserted claims for common law fraud, negligent misrepresentation, and violation of California Civil Code section 25401 against the Company, Mr. Jamison, and unidentified individual defendants. On December 20, 2018, defendants filed their answer to the Second Amended Complaint. On June 6, 2019, the parties reached a confidential settlement of the action and the suit was dismissed with prejudice on July 1, 2019. The Company has not recorded any liability as of December 31, 2019 as its insurance carrier funded the settlement amount.

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 previously scheduled for December 17, 2019 is now scheduled for February 14, 2020.

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 previously scheduled for December 17, 2019 is now scheduled for February 14, 2020.

The parties in both of the above state derivative lawsuits participated in a mediation held on September 24, 2018. On May 6, 2019, the parties reached an agreement in principle regarding corporate governance reforms to be implemented in settlement of the action. The parties have not yet formalized a settlement, however, which is subject to several conditions, including the execution of a stipulation of settlement that is satisfactory to all parties, negotiation regarding an award of attorney fees, and preliminary and final approval from the court, among other things. Settlement discussions are ongoing. The Company has not recorded any liability as of December 31, 2019 as its insurance carrier will fund the settlement amount.

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. On May 6, 2019, the parties reached an agreement in principle regarding corporate governance reforms to be implemented in settlement of the action. The parties have not yet formalized a settlement, however, which is subject to several conditions, including the execution of a stipulation of settlement that is satisfactory to all parties, negotiation regarding an award of attorney fees, and preliminary and final approval from the court, among other things. Settlement discussions are ongoing. The Company has not recorded any liability as of December 31, 2019 as its insurance carrier will fund the settlement amount.

Capstone Turbine Corporation v. Regatta Solutions, Inc.

On August 23, 2018, the Company initiated arbitration proceedings against its former distributor, Regatta Solutions, Inc. ("Regatta"), with the American Arbitration Association ("AAA"), under the following caption: Capstone Turbine Corp. v. Regatta Solutions, Inc., Case No. 01-18-0003-0860 (the "Capstone-Regatta Arbitration"). The Company has alleged claims against Regatta for breach of contract and unjust enrichment relating to the parties' prior distributor relationship, which terminated at the end of March of 2018, and the related wind-down 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 relations, relating to the parties' agreement to wind-down relations and Regatta's purported sales efforts 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 has filed and served an answering statement denying Regatta's counterclaims and asserting several affirmative defenses.

Also on October 18, 2018, Regatta filed a lawsuit in the Superior Court of the State of California, County of Orange, alleging two counts of fraud, and one count of interference with contractual relations, individually against Mr.

James Crouse, then Executive Vice President of Sales for the Company, arising out of the same allegations made in Regatta's counterclaim. As remedies for these alleged claims, Regatta again sought 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. On December 14, 2018, Regatta stipulated and agreed to arbitrate its claims against Mr. James Crouse and dismissed him from the Superior Court action.

On January 16, 2019, the parties participated in a mediation that did not resolve the dispute. The parties continued their settlement discussions and held a follow-on mediation on April 24, 2019 at which point the parties came to a resolution of the matter. Following initial compliance with the settlement terms, Regatta has since breached its obligations thereunder and Capstone is now engaged in efforts to enforce the settlement agreement, including participating in further dispute resolution proceedings. The Company and Regatta continue to negotiate a resolution to the remaining dispute. The settlement did not have a material impact on the Company's condensed consolidated financial statements.

16. Leases

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842), to require lessees to recognize most leases on the balance sheet, while recognition on the statement of operations will remain similar to current lease accounting. The ASU requires lessees to recognize a liability for lease obligations, which represents the discounted obligation to make future lease payments, and a corresponding right-of-use (ROU) asset on the balance sheet. The guidance requires disclosure of key information about leasing arrangements that is intended to give financial statement users the ability to assess the amount, timing and potential uncertainty of cash flows related to leases. The ASU also eliminates real estate-specific provisions and modifies certain aspects of lessor accounting.

The Company adopted the new standard on April 1, 2019 using the modified retrospective approach. The Company has elected to apply the transition method that allows companies to continue applying the guidance under the lease standard in effect at that time in the comparative periods presented in the consolidated financial statements and recognize a cumulative-effect adjustment to the opening balance of retained earnings on the date of adoption. The Company also elected the "package of practical expedients"; which permits us not to reassess under the new standard our prior conclusions about lease identification, lease classification and initial direct costs; the use of hindsight in order to calculate the lease term of existing assets; the use of the portfolio approach on similar assets; and has elected not to separate lease and non-lease assets.

Results for reporting periods beginning after April 1, 2019 are presented under the new standard, while prior period amounts are not adjusted and continue to be reported under the accounting standards in effect for the prior period. Upon adoption of the new lease standard, on April 1, 2019, the Company recorded approximately \$5.5 million of right-of-use assets, adjusted for the reclassification of deferred rent and lease incentive of approximately \$0.3 million, and \$5.8 million of operating lease liabilities, within the Company's condensed consolidated balance sheets upon adoption. The adoption of this standard did not have an impact on the Company's condensed consolidated statement of operations or cash flows and did not result in a cumulative catch-up adjustment to the opening balance of retained earnings. Financed leases are not material to the Company's condensed consolidated financial statements and are therefore not included in the disclosures.

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. Lease expense is recognized on a straight-line basis over the term of the lease.

The components of lease expense were as follows for the Company's three and nine months ended December 31, 2019 (in thousands):

	Three Months Ended December 31, 2019	Nine Months Ended December 31, 2019
Operating lease cost	\$ 268	\$ 1,264

Rental expense for operating leases classified under the previous accounting standard, Accounting Standards Codification (“ASC”) Topic 840, for the three and nine months ended December 31, 2018 was approximately \$0.6 million and \$1.7 million, respectively.

Supplemental balance sheet information related to the leases was as follows (in thousands):

Operating Leases	December 31, 2019
Operating lease right-of-use assets	\$ 5,209
Total operating lease right-of-use assets	\$ 5,209
Operating lease liability, current	\$ 438
Operating lease liability, non-current	5,051
Total operating lease liabilities	\$ 5,489

The Company records its right-of-use assets within other assets (non-current) and its operating lease liabilities within current and long-term portion of notes payable and lease obligations.

Supplemental cash flow information related to the leases was as follows (in thousands):

	Nine Months Ended December 31, 2019
Cash paid for amounts included in the measurement of lease liabilities	
Operating cash flows from operating leases	\$ 1,326

Other supplemental operating lease information consists of the following:

Weighted average remaining lease life	8 years
Weighted average discount rate	13%

Maturities of operating lease liabilities as of December 31, 2019 were as follows (in thousands):

Year Ending March 31,	Operating Leases
2020 (remainder of fiscal year)	\$ 317
2021	1,116
2022	1,099
2023	1,125
2024	1,153
2025	1,043
Thereafter	3,002
Total lease payments	\$ 8,855
Less: imputed interest	(3,366)
Present value of operating lease liabilities	\$ 5,489

17. 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 December 31, 2019 which would make these instruments anti-dilutive. As of December 31, 2019 and 2018, the number of anti-dilutive stock options and restricted stock units excluded from diluted net loss per common share computations was approximately 0.3 million and 0.3 million, respectively. As of December 31, 2019 and 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 30,000. As of December 31, 2019 and 2018, the number of warrants excluded from diluted net loss per common share computations was approximately 1.5 million and 0.3 million, respectively.

18. Subsequent Events

The Company has evaluated all subsequent events through the filing date of this Form 10-Q with the SEC, to ensure that this filing includes appropriate disclosure of events both recognized in the financial statements as of December 31, 2019, and events which occurred subsequently but were not recognized in the financial statements. There were no subsequent events which required recognition, adjustment to or disclosure in the financial statements.

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 2019. 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 2019 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 2020 are to improve cash flow, working capital, and our balance sheet; grow revenue through accelerating global product sales; diversify into additional market verticals and geographies; and increase aftermarket sales absorption. During the third quarter of Fiscal 2020 our net loss was \$4.9 million and our basic and diluted loss per share was \$0.59 compared to \$3.5 million and \$0.50, respectively, in the same period of the previous year. Product revenue was lower primarily due to weakening in the United States natural resources market. We build to a fixed number of production slots for our microturbines each quarter and during the third quarter of Fiscal 2020, we allocated two C1000 Signature Series systems production slots to our long-term rental program, resulting in lower product revenue. Additionally, although the U.S. dollar has somewhat weakened against other currencies, it 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. Total service revenue increased approximately 14% during the third quarter of Fiscal 2020 primarily attributable to increases in revenue from our FPP service contracts and new long-term rental program compared to the same period last year. The increase in FPP service revenue was primarily the result of not recognizing revenue in the third quarter of Fiscal 2019 on certain reassigned FPP service contracts. The increase in operating expense was primarily attributable to higher marketing and labor costs. On February 4, 2019, we entered into a \$30.0 million three-year term note with Goldman Sachs to replace the existing \$15.0 million revolving credit facility with Bridge Bank, which resulted in higher interest expense during the third quarter of Fiscal 2020 as compared to the same period last year.

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. We also continue to see interest in critical power supply applications as customers want solutions that can handle both primary and backup power. Transportation is a developing market segment for us and currently transportation products were only for customer demonstrations.

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 December 31,		Nine Months Ended December 31,	
	2019	2018	2019	2018
Energy efficiency	54%	40%	54%	40%
Natural resources	22%	42%	31%	48%
Renewable energy	24%	12%	15%	8%
Microgrid	—	6%	—	4%

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 which we believe provides a significant economic advantage to our 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 exploration, production, compression and transmission sites as a highly efficient and reliable source of prime 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 oil and gas 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 power to these remote oil and gas 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, as the sulfur can contaminate combustion engines lube oil leading to equipment breakdowns and higher lifecycle costs.

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. The majority of microturbine based distributed generation installations have powered through hurricanes with little or no downtime. To meet these customer requirements, traditional solutions utilize Uninterruptible Power Supplies (“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

A microgrid is a group of interconnected loads and distributed energy resources that acts 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.

Transportation

Our technology also can be 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 and reduced emissions when compared with traditional internal combustion engines. Internal combustion diesel engine manufacturers have been challenged for the last several years to develop technology improvements, prior to aftertreatment that reduce emissions to levels specified by the EPA and CARB 2007 and 2010 standards. Many manufacturers are incorporating aftertreatment that increases upfront equipment costs, vehicle weight and life cycle costs, which may reduce overall engine efficiency.

Additionally, 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 generator set. 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, 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 battery charger and range extender. Our marine customers use both liquid fueled and natural gas microturbine products. Liquefied natural gas (“LNG”) is in its early stages as a marine fuel, and the number of vessels powered by LNG is forecasted to double every two years over the next decade. Vessel owners can receive the same benefits as users of stationary products: low emissions with no exhaust aftertreatment, long maintenance intervals, high reliability, low noise and no vibration. Transportation is a developing market segment for us. In Fiscal 2019, transportation products were only for customer demonstrations.

Backlog

Net product orders were approximately negative \$6.2 million and \$8.6 million for the three months ended December 31, 2019 and 2018, respectively. At December 31, 2019, net product orders were negative due to the removal of BPC backlog of \$15.8 million as discussed further below. Ending backlog was approximately \$45.6 million at December 31, 2019 compared to \$76.3 million at December 31, 2018. The gross book-to-bill ratio was 1.2:1 and 1.3:1 for the three months ended December 31, 2019 and 2018, respectively. Book-to-bill ratio is the ratio of new orders we received to units shipped and billed during a period.

During the second quarter of Fiscal 2020, we removed from product backlog orders related to Green Energy Sustainable Solutions, Inc. (“GESS”) of approximately \$10.6 million. This removal was the result of Capstone’s findings following further review of GESS’s ability to meet its obligations under their national account agreement.

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.

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 was contingent upon TI’s payment to us of the remaining approximately \$1.5 million in five payments by September 20, 2019. The payments of \$0.4 million, \$0.3 million, and \$0.3 million due March 20, 2019, June 20, 2019, and September 20, 2019, respectively, under the Amended Assignment Agreement, have not been received at the time of this filing. 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 on December 20, 2019. In September 2019, we sent TI a notice to cure default with a deadline of October 31, 2019. TI failed to cure the noticed default and we have since terminated TI’s distributor agreement. As a result, the BPC accounts receivable and related accounts receivable reserve of \$4.8 million were written off as of December 31, 2019.

As a result of 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, for Fiscal 2019, we removed product orders related to BPC from backlog for approximately \$20.7 million. During the three months ended June 30, 2019 we removed approximately \$4.6 million. These removals were the result of our continuous review of BPC related backlog with TI which resulted in us no longer honoring the product pricing. Due to the cancellation of our distributor agreement with TI, we removed product orders related to BPC from backlog for approximately \$15.8 million

during the three months ended December 31, 2019. There are no remaining backlog related to BPC as of December 31, 2019.

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 required delivery dates requested by our customers. 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 69 distributors, Original Equipment Manufacturers (“OEMs”) and national accounts. In the United States and Canada, we currently have 15 distributors, OEMs and national accounts. Outside of the United States and Canada, we currently have 54 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 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 December 31, 2019 was approximately \$83.7 million, which represents the value of the contractual agreement for FPP services that has not been earned and extends through Fiscal 2034. Our FPP backlog as of December 31, 2018 was approximately \$72.8 million, which represents the value of the contractual agreement for FPP services that has not been earned and extends through Fiscal 2031.

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 Fiscal 2019, we received support 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 TESS 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 2019 included the successful launch of the new family of PowerSync controllers used for Capstone microturbines. We also continued development and testing of a new self-cleanable severe environment air filtration system for our Signature Series line of microturbine products. Capstone has also embarked upon a project to modernize electronics to today's standards, providing common functionality and enabling long term support. In addition, our product development activities during Fiscal 2019 included certification of our C65, C200S, and C1000S series microturbines to the latest UL 1741 interconnection standards.

We are also developing a more efficient microturbine CHP system with the support of the DOE, 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. 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 first quarter of Fiscal 2019, we identified a defect in one of the component parts for microturbine systems from one of our single source suppliers. As a result of this defect we have identified several new suppliers with greater engineering expertise and robust quality management systems. The transition is complex, lengthy and may result in an interruption in our manufacturing process. An interruption in our manufacturing process for this component part would adversely impact our results of operations. The efforts to qualify and dual source these components was completed in the fourth quarter of Fiscal 2019.

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. As of December 31, 2019, there were gradual improvement trends in the capacity issues at the supplier. A new supplier has been identified and has been fully qualified and is now working towards increasing its capacity and is expected to meet our production volumes during Fiscal 2020.

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 25% gross margin. We expect to have costs and operating expenses increase in certain areas in Fiscal 2020, 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 2019 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.

Results of Operations

Three Months Ended December 31, 2019 and 2018

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

	Three Months Ended December	
	31,	
	2019	2018
	Revenue	Revenue
United States and Canada	\$ 7.1	\$ 9.6
Europe and Russia	5.2	3.0
Latin America	1.9	2.8
Asia and Australia	3.0	2.6
Middle East and Africa	0.2	—
Total	<u>\$ 17.4</u>	<u>\$ 18.0</u>

Revenue Revenue for the three months ended December 31, 2019 decreased \$0.6 million, or 3%, to \$17.4 million from \$18.0 million for the three months ended December 31, 2018. The change in revenue for the three months ended December 31, 2019 compared to the three months ended December 31, 2018 included decreases in revenue of \$2.5 million from the United States and Canadian markets and \$0.9 million from the Latin American markets. These overall decreases in revenue were offset by increases in revenue of \$2.2 million from the Europe and Russian markets, \$0.4 million from the Asian and Australian markets, and \$0.2 million from the Middle East and African markets. The decrease in revenue in the United States and Canadian markets was primarily because of a decline in product revenue in

the United States natural resources market vertical. Additionally, we deployed a 0.8 megawatt C1000 Signature Series system under our long-term rental program. The increase in revenue in the Europe and Russian markets was primarily the result of our continued investment in key growth initiatives in the Energy Efficiency market vertical in those markets. The decrease in revenue in the Latin American markets was primarily because of a decrease in product shipments compared to the same period last year. The increase in revenue in the Asian and Australian markets and Middle East and African markets was primarily of higher accessories, parts and service sales compared to the same period last year.

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

	Three Months Ended December 31,					
	2019			2018		
	Revenue	Megawatts	Units	Revenue	Megawatts	Units
Microturbine Product	\$ 7.9	8.1	50	\$ 10.1	10.3	66
Accessories and Parts	4.1			3.2		
Service	5.4			4.7		
Total Accessories, Parts and Service	9.5			7.9		
Total	\$ 17.4			\$ 18.0		

For the three months ended December 31, 2019, revenue from microturbine products decreased \$2.2 million, or 22%, to \$7.9 million from \$10.1 million for the three months ended December 31, 2018. The decrease in revenue and megawatts shipped was primarily because of a decrease in product volume due to weakness in the United States natural resources market vertical and because we deployed a 0.8 megawatt C1000 Signature Series system under our long-term rental program during the three months ended December 31, 2019. Megawatts shipped was 8.1 megawatts and 10.3 megawatts during the three months ended December 31, 2019 and 2018, respectively. Average revenue per megawatt shipped was approximately \$1.0 million during the three months ended December 31, 2019 and 2018. 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 three months ended December 31, 2019, revenue from our accessories and parts increased \$0.9 million, or 28%, to \$4.1 million from \$3.2 million for the three months ended December 31, 2018. The increase in revenue from accessories and parts was primarily due to parts from higher powerhead and engine shipments during the three months ended December 31, 2019 compared to the prior year.

Service revenue for the three months ended December 31, 2019 increased \$0.7 million, or 15%, to \$5.4 million from \$4.7 million for the three months ended December 31, 2018. The increase in service revenue was due to increases in revenue from our new long-term rental program, new FPP service agreements, and the result of not recognizing revenue on certain FPP service contracts because of the reassignment of those service contracts during the same period last year. Effective January 1, 2018 we launched our DSS program to provide additional support for distributor business development, 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 December 31, 2019 and 2018 was \$0.7 million for each period and has been included under the caption "Service revenue" in the accompanying condensed consolidated statements of operations.

Sales to Optimal Group Australia Pty Ltd, one of our Australian distributors, accounted for 11% of revenue for the three months ended December 31, 2019. Sales to E-Finity Distributed Generation, LLC ("E-Finity") and Cal Microturbine ("CAL"), two of our domestic distributors and DTC Soluciones Inmobiliarias S.A. de C.V., one of the Company's Mexican distributors ("DTC"), accounted for 14%, 13% and 13%, respectively, of revenue for the three months ended December 31, 2018.

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 \$2.6 million, or 15% of revenue, for the three months ended December 31, 2019 compared to a gross margin of \$2.2 million, or 12% of revenue, for the three months ended December 31, 2018. The increase in gross margin of \$0.4 million during the three months ended December 31, 2019 compared to the three months ended December 31, 2018 was primarily due to

decreases in warranty expense of \$0.7 million, and production and service center labor and overhead expense decreases of \$0.4 million, partially offset by a \$0.7 million decrease in our direct material costs margin. Management continues to implement initiatives to improve gross margin in Fiscal 2020 by further reducing manufacturing overhead and direct material costs, and improving product performance as we work to achieve profitability.

Direct material costs margin, calculated as total revenue less our direct material costs, decreased \$0.7 million during the three months ended December 31, 2019 compared to the three months ended December 31, 2018 primarily because of lower product margin due to volume, partially offset by higher service margins.

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 decrease in warranty expense of \$0.7 million during the three months ended December 31, 2019 compared to the three months ended December 31, 2018 was primarily because of a higher than normal standard warranty provision in the nine months ended December 31, 2018 due to the supplier defect identified during the prior year period. Management expects warranty expense in Fiscal 2020 to be lower than Fiscal 2019 primarily because of the higher standard warranty provision in Fiscal 2019 due to a supplier defect identified during the first quarter of Fiscal 2019.

Production and service center labor and overhead expense decreased \$0.4 million during the three months ended December 31, 2019 compared to the three months ended December 31, 2018 primarily because of \$0.1 million in overhead allocated to finished goods inventory, decreases of \$0.1 million in labor costs, \$0.1 million in consulting expense and \$0.1 million in supplies.

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 increased \$8,000, to \$30,000 during the three months ended December 31, 2019 compared to \$38,000 during the three months ended December 31, 2018.

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

	Three Months Ended December 31,	
	2019	2018
Gross Margin		
Product	\$ (0.5)	\$ (0.6)
As a percentage of product revenue	(7)%	(6)%
Accessories, parts and service	\$ 3.1	\$ 2.8
As a percentage of accessories, parts and service revenue	28 %	36 %
Total Gross Margin	<u>\$ 2.6</u>	<u>\$ 2.2</u>
As a percentage of total revenue	15 %	12 %

Product gross margin increased \$0.1 million during the three months ended December 31, 2019 compared to the three months ended December 31, 2018. Accessories, parts and service gross margin increased during the three months ended December 31, 2019 compared to the three months ended December 31, 2018 primarily because of higher service revenue resulting from our long-term rental program.

Research and Development (“R&D”) Expenses R&D expenses for the three months ended December 31, 2019 increased \$0.1 million, or 11%, to \$1.0 million from \$0.9 million for the three months ended December 31, 2018. Management expects R&D expenses in Fiscal 2020 to be slightly higher than in Fiscal 2019 as a result of ongoing product development costs.

Selling, General, and Administrative (“SG&A”) Expenses SG&A expenses for the three months ended December 31, 2019 increased \$0.7 million, or 15%, to \$5.3 million from \$4.6 million for the three months ended December 31, 2018. The net increase in SG&A expenses was comprised of a decrease of approximately \$0.4 million in bad debt recovery, and increases of approximately \$0.1 million in marketing costs because of additional funding from the DSS program, \$0.1 million in consulting expense and \$0.1 million in legal, accounting and shareholder expense, compared to the same period last year. Management expects SG&A expenses in Fiscal 2020 to be higher than in Fiscal 2019 primarily as a result of increases in salaries expense, marketing expense, and professional services, including legal and accounting expenses.

Interest Expense Interest expense increased \$1.1 million to \$1.3 million during the three months ended December 31, 2019 from \$0.2 million for the three months ended December 31, 2018. Interest expense increased because of higher debt outstanding and a higher interest rate. On February 4, 2019, we entered into a \$30.0 million three-year term note with Goldman Sachs to replace the existing \$15.0 million revolving credit facility with Bridge Bank. See Liquidity and Capital Resources—Three-year Term Note below for additional discussion on our three-year term note with Goldman Sachs.

Nine Months Ended December 31, 2019 and 2018

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

	Nine Months Ended December 31,	
	2019	2018
	Revenue	Revenue
United States and Canada	\$ 25.3	\$ 31.7
Europe and Russia	14.6	12.2
Latin America	7.9	8.2
Asia and Australia	7.6	7.0
Middle East and Africa	2.0	2.3
Total	<u>\$ 57.4</u>	<u>\$ 61.4</u>

Revenue Revenue for the nine months ended December 31, 2019 decreased \$4.0 million, or 7%, to \$57.4 million from \$61.4 million for the nine months ended December 31, 2018. The change in revenue for the nine months ended December 31, 2019 compared to the nine months ended December 31, 2018 included decreases in revenue of \$6.4 million from the United States and Canadian markets, \$0.3 million from the Middle East and African markets and \$0.3 million from the Latin American markets. These overall decreases in revenue were offset by increases in revenue of \$2.4 million from the European and Russian markets and \$0.6 million from the Asia and Australian markets. The decrease in revenue in the United States and Canadian markets during the nine months ended December 31, 2019 compared to the same period last year was primarily because of a decrease in product volume due to weakness in the natural resources market vertical. Additionally, we deployed 3.4 megawatts C1000 Signature Series systems under our long-term rental program and a 0.6 megawatt system as a customer demo unit. The decrease in revenue in the Middle East and African markets was primarily the result of the ongoing geopolitical tensions in these regions and continues to be negatively impacted by the volatility of the global oil and gas markets. The decrease in revenue in the Latin American markets was primarily because of the decrease of product shipments. The increase in revenue in the European and Russian markets was primarily because of an increase in product shipments in the energy efficiency market vertical, as well as an increase in accessories and parts shipments during the nine months ended December 31, 2019 compared to the same period last year. The increase in revenue in the Asian and Australian markets was primarily because of an increase in system shipments into the natural resources market vertical during the nine months ended December 31, 2019 compared to the same period last year.

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

	Nine Months Ended December 31,					
	2019			2018		
	Revenue	Megawatts	Units	Revenue	Megawatts	Units
Microturbine Product	\$ 30.0	29.8	179	\$ 38.6	39.2	206
Accessories and Parts	12.1			10.5		
Service	15.3			12.3		
Total Accessories, Parts and Service	27.4			22.8		
Total	\$ 57.4			\$ 61.4		

For the nine months ended December 31, 2019, revenue from microturbine products decreased \$8.6 million, or 22%, to \$30.0 million from \$38.6 million for the nine months ended December 31, 2018. The decrease in revenue and megawatts shipped was primarily because of a decrease in volume, as well as the deployment of 3.4 megawatts C1000 Signature Series systems under our factory rental program, and a 0.6 megawatt system deployed as a customer demo unit during the nine months ended December 31, 2019 compared to no rental or demo units the same period last year. Also contributing to the decrease was weakness in the natural resources market vertical. Megawatts shipped during the nine months ended December 31, 2019 decreased 9.4 megawatts, or 24%, to 29.8 megawatts from 39.2 megawatts during the nine months ended December 31, 2018. Average revenue per megawatt shipped was approximately \$1.0 million during the nine months ended December 31, 2019 and 2018, respectively. 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 nine months ended December 31, 2019, revenue from our accessories and parts increased \$1.6 million, or 15%, to \$12.1 million from \$10.5 million for the nine months ended December 31, 2018. The increase in revenue from accessories and parts was primarily due to parts from higher powerhead and engine shipments.

Service revenue for the nine months ended December 31, 2019 increased \$3.0 million, or 24%, to \$15.3 million from \$12.3 million for the nine months ended December 31, 2018. The increase in service revenue was due to increases in revenue from new FPP service contracts and revenue from our long-term rental program, and lower than expected service revenue resulting from reassignment of certain FPP contracts during the same period last year. Earned revenue from our DSS program for the nine months ended December 31, 2019 and 2018 was \$1.2 million for each period and has been included under the caption "Service revenue" in the accompanying condensed consolidated statements of operations.

E-Finity accounted for 12% of our revenue for the nine months ended December 31, 2019 and 2018.

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 \$8.6 million, or 15% of revenue, for the nine months ended December 31, 2019 compared to a gross margin of \$6.1 million, or 10% of revenue, for the nine months ended December 31, 2018. The increase in gross margin of \$2.5 million during the nine months ended December 31, 2019 compared to the nine months ended December 31, 2018 was primarily because of decreases in warranty expense of \$1.5 million, production and service center labor and overhead expense of \$1.1 million and royalty expense of \$0.2, partially offset by a \$0.3 million decrease in our direct material costs margin. Management continues to implement initiatives to improve gross margin in Fiscal 2020 by further reducing manufacturing overhead and direct material costs, and improving product performance as we work to achieve profitability.

Direct material costs margin decreased \$0.3 million during the nine months ended December 31, 2019 compared to the nine months ended December 31, 2018 due to a decrease in product margin from lower volume, partially offset by higher service margin.

Production and service center labor and overhead expense decreased \$1.1 million during the nine months ended December 31, 2019 compared to the nine months ended December 31, 2018 primarily because of decreases of approximately \$0.5 million in overhead allocated to finished goods inventory, \$0.3 million in labor costs, \$0.2 million in consulting expense, \$0.2 million in supplies, offset by an increase of \$0.1 million in facilities expense.

The decrease in warranty expense of \$1.5 million during the nine months ended December 31, 2019 compared to the nine months ended December 31, 2018 was primarily because of a higher than normal standard warranty provision in the nine months ended December 31, 2018 due to the supplier defect identified during the nine months ended December 31, 2018. Management expects warranty expense in Fiscal 2020 to be lower than Fiscal 2019 primarily because of the higher standard warranty provision in Fiscal 2019 due to a supplier defect identified during the first quarter of Fiscal 2019.

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 nine months ended December 31, 2019 compared to the nine months ended December 31, 2018 primarily because we concluded our royalty obligation under the Development Agreement during Fiscal 2019.

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

	Nine Months Ended December 31,	
	2019	2018
Gross Margin		
Product	\$ (0.1)	\$ (0.2)
As a percentage of product revenue	0%	(1)%
Accessories, parts and service	\$ 8.7	\$ 6.3
As a percentage of accessories, parts and service revenue	31 %	28 %
Total Gross Margin	<u>\$ 8.6</u>	<u>\$ 6.1</u>
As a percentage of total revenue	15 %	10 %

Product gross margin increased \$0.1 million during the nine months ended December 31, 2019 compared to the nine months ended December 31, 2018. Accessories, parts and service gross margin increased during the nine months ended December 31, 2019 compared to the nine months ended December 31, 2018 primarily because of increases in revenue from our long-term rental program and FPP service agreements. The increase in FPP service revenue was primarily the result of not recognizing revenue during Fiscal 2019 on certain reassigned FPP service contracts.

R&D Expenses R&D expenses for the nine months ended December 31, 2019 increased \$0.1 million, or 3%, to \$2.8 million from \$2.7 million for the nine months ended December 31, 2018. Management expects expenses in Fiscal 2020 to be slightly higher than in Fiscal 2019 as a result of ongoing product development costs.

SG&A Expenses SG&A expenses for the nine months ended December 31, 2019 increased \$1.5 million, or 1%, to \$17.0 million from \$15.5 million for the nine months ended December 31, 2018. The net increase in SG&A expenses was comprised of a decrease of approximately \$0.3 million in bad debt recovery, and increases of approximately \$0.7 million in marketing expense, \$0.3 million in salaries expense, including non-cash stock based compensation expense, \$0.2 million in shareholder costs, and \$0.2 million in allocated costs for shared-services facilities expense. These increases were partially offset by a decrease of approximately \$0.2 million in supplies and travel during the nine months ended December 31, 2019 compared to the same period last year. Management expects SG&A expenses in Fiscal 2020 to be higher than in Fiscal 2019 primarily as a result of increases in salaries expense, marketing expense, and professional services, including legal and accounting expenses.

Interest Expense Interest expense increased \$3.3 million to \$3.9 million during the nine months ended December 31, 2019 from \$0.5 million for the nine months ended December 31, 2018. Interest expense increased because

of higher debt outstanding and a higher interest rate. On February 4, 2019, we entered into a \$30.0 million three-year term note with Goldman Sachs to replace the existing \$15.0 million revolving credit facility with Bridge Bank. See Liquidity and Capital Resources—Three-year Term Note below for additional discussion on our three-year term note with Goldman Sachs.

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, 2020 include approximately \$1.0 million for plant and equipment costs related to manufacturing and operations, and approximately \$3.0 million for systems under our factory rental program. During the nine months ended December 31, 2019, we deployed approximately \$2.7 million of our C1000 Signature Series systems under our factory 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 and cash equivalents balances decreased \$13.0 million during the nine months ended December 31, 2019, compared to a decrease of \$2.7 million during the nine months ended December 31, 2018. The decrease in cash and cash equivalents during the nine months ended December 31, 2019 compared to the same period last year was primarily the result of higher cash used in operating activities and cash used for rental assets, as well as lower cash generated from the issuance of common stock through the at-the-money offering program, partially offset by the September 2019 registered direct offering described below.

Operating Activities During the nine months ended December 31, 2019, we used \$15.7 million in cash in our operating activities, which consisted of a net loss for the period of \$14.9 million and cash used for working capital of \$5.2 million, offset by non-cash adjustments (primarily warranty provision, accounts receivable allowance, depreciation and amortization, stock based compensation and inventory provision) of \$4.4 million. During the nine months ended December 31, 2018, we used \$12.6 million in cash in our operating activities, which consisted of a net loss for the period of \$12.7 million and cash used for working capital of \$3.9 million, offset by non-cash adjustments (primarily warranty provision, accounts receivable allowances, depreciation and amortization, stock based compensation and inventory provision) of \$4.0 million. The following is a summary of the significant sources (uses) of cash from operating activities (amounts in thousands):

	Nine Months Ended December 31,	
	2019	2018
Net loss	\$ (14,948)	\$ (12,704)
Non-cash operating activities(1)	4,379	4,032
Changes in operating assets and liabilities:		
Accounts receivable	(3,522)	3,088
Inventories	(827)	(3,401)
Accounts payable and accrued expenses	1,956	2,185
Prepaid expenses, other current assets and other assets	591	(3,821)
Other changes in operating assets and liabilities	(3,349)	(1,976)
Net cash used in operating activities	<u>\$ (15,720)</u>	<u>\$ (12,597)</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 nine months ended December 31, 2019 compared to the same period the previous year was primarily because of the amortization of debt issuance costs from the Goldman Sachs term note payable. The change in accounts receivable during the nine months ended December 31, 2019 was primarily due to delayed collection from certain customers, compared to the same period the previous year. The change in inventory was primarily the result of a decrease in raw materials offset by an increase in finished goods during the nine months ended December 31, 2019 compared to an increase in raw materials offset by a reduction in finished goods during the nine months ended December 31, 2018. The change in accounts payable and accrued expenses was primarily the result of the timing of payments made by us during the nine months ended December 31, 2019 compared to the same period the previous fiscal year. The change in prepaid expenses, other current assets and other assets during the nine

months ended December 31, 2019, was primarily because of a supplier prepayment obligation in the nine months ended December 31, 2018, described below, and a marketing demonstration unit accounted for as a deferred marketing cost in the nine months ended December 31, 2019. The change in other operating assets and liabilities during the nine months ended December 31, 2019 was primarily the result of decrease in deferred revenue attributable to deposits.

Investing Activities During the nine months ended December 31, 2019, we used cash of \$3.9 million in investing activities compared to \$3.1 million during the nine months ended December 31, 2018. The increase was primarily due to the deployment of rental units and the acquisition of fixed assets and leasehold improvements made to our Van Nuys location.

Financing Activities During the nine months ended December 31, 2019, we generated cash of approximately \$6.6 million from financing activities compared to cash generated during the nine months ended December 31, 2018 of approximately \$12.9 million. The funds generated from financing activities during the nine months ended December 31, 2019 were primarily the result of proceeds from the September 2019 registered direct offering and proceeds from the at-the-market offering program described below, offset by repayment of notes payable and capital lease obligations. The funds generated from financing activities during the nine months ended December 31, 2018 were primarily the result of proceeds from the at-the-market offering program described below and net borrowings under the credit facility, offset by repayment of notes payable and capital lease obligations.

At-the-market offerings

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 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 nine months ended December 31, 2018, the Company issued 0.3 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 June 30, 2018, 2.6 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.

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 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 December 31, 2019, we issued approximately 0.4 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 \$1.2 million after deducting commissions paid of approximately \$41,400. During the nine months ended December 31, 2019, we issued 0.6 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 \$2.7 million after deducting commissions paid of approximately \$0.1 million. As of December 31, 2019, approximately \$15.0 million remained available for issuance with respect to this at-the-market offering program.

Warrants

On April 13, 2018, a warrant holder exercised its rights to the warrant agreement to exercise on a cashless basis 576,000 Series A warrants at an exercise price of \$6.00 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 380,625 shares of common stock.

As of December 31, 2019, there were 271,875 Series A warrants outstanding and there are no Series B warrants outstanding. Of the total Series A warrants outstanding, 217,875 Series A warrants were issued with an exercise price of \$25.50 per share of common stock, and have an expiration date of October 25, 2021, and 54,000 Series A warrants with anti-dilution provisions were issued with an initial exercise price of \$13.40 per share of common stock, and have an expiration date of April 22, 2021. As of December 31, 2019, because of the anti-dilution provisions, these warrants had an adjusted exercise price of \$3.05 per share of common stock.

On February 4, 2019, we sold to Goldman Sachs & Co. LLC (the “Holder”), a Purchase Warrant for Common Shares (the “Warrant”) pursuant to which the Holder may purchase shares of the Company’s common stock, par value \$0.001 per share (the “Common Shares”) in an aggregate amount of up to 404,634 shares (the “Warrant Shares”). The Warrant was sold to the Holder at a purchase price of \$150,000, in a private placement exempt from registration under the Securities Act. The Warrant may be exercised by the Holder at any time after August 4, 2019 at an exercise price equal to \$8.86 and will expire on February 4, 2024. The Warrant contains standard adjustment provisions in the event of additional stock issuances below the exercise price of the warrant, stock splits, combinations, rights offerings and similar transactions. The value of the Warrant was \$2.3 million, and has been classified as an equity instrument in additional paid in capital in our consolidated balance sheets. Our common stock and warrant transactions during second quarter of Fiscal 2020 triggered certain anti-dilution provisions in the warrants outstanding, resulting in an additional 29,654 warrants issued, which were treated as a deemed dividend in the amount of \$74,989.

On December 9, 2019, we entered into Amendment No. 1 to the Purchase Warrant for Common shares (the “Amendment No. 1”) with Special Situations Investing Group II, LLC (as successor in interest to Goldman Sachs & Co. LLC) (the “Warrant Holder”) that amends the Warrant. The Amendment No. 1 amends the first paragraph of the Warrant to increase the number of Warrant Shares issuable under the Warrant (on a post-reverse split basis) and to decrease the exercise price from \$8.86 per share (on a post-reverse split basis) to \$3.80 per share (the “Per Share Warrant Exercise Price”). The Amendment No. 1 also amends Section 2.1 of the Warrant such that the Per Share Anti-Dilution Price is equal to the Per Share Warrant Exercise Price.

On September 4, 2019, we entered into a Securities Purchase Agreement (the “Securities Purchase Agreement”) with certain institutional and accredited investors pursuant to which we agreed to issue and sell in a registered direct offering (the “Registered Direct Offering”) an aggregate of 580,000 shares of our common stock, par value \$0.001 per share at a negotiated purchase price of \$5.00 per share, and pre-funded warrants to purchase up to an aggregate of 440,000 shares of our common stock at a negotiated purchase price of \$5.00 per Pre-Funded Warrant, for aggregate gross proceeds of approximately \$5.1 million (580,000 shares of our common stock plus 440,000 pre-funded warrants at a \$5.00 per share purchase price), before deducting placement agent fees and other offering expenses. Net proceeds from the offering were \$4.6 million. The offering closed on September 9, 2019. On October 24, 2019, a warrant holder exercised its rights to the warrant agreement to exercise on a cash basis 440,000 pre-funded warrants at an exercise price of \$0.001 per share under the warrant agreement.

In a concurrent private placement, we agreed to issue to the purchasers warrants to purchase 765,000 shares of Common Stock, which represent 75% of the number of shares of Common Stock and shares underlying the Pre-Funded Warrants purchased in the Registered Direct Offering, pursuant to the Securities Purchase Agreement. The Common Warrants will be exercisable for shares of Common Stock at an initial exercise price of \$6.12 per share for a period of five years, starting on April 2, 2020 and expiring on April 2, 2025.

There were no stock options exercised during the nine months ended December 31, 2019 and 2018, 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 \$44,000 and \$73,000 of net cash used during the nine months ended December 31, 2019 and 2018, respectively.

Former Credit Facility Upon closing with the Purchaser and Goldman Sachs Specialty Lending Holdings, Inc., our existing credit facilities with Bridge Bank were paid off in full.

Three-year Term Note On February 4, 2019 (the “Closing Date”), we entered into a Note Purchase Agreement (as amended, the “Note Purchase Agreement”), by and among us, certain subsidiaries of us as guarantors, Goldman Sachs Specialty Lending Holdings, Inc. and any other purchasers party thereto from time to time (collectively, the “Purchaser”) and Goldman Sachs Specialty Lending Holdings, Inc., as collateral agent, in connection with the sale of senior secured notes of us in a private placement exempt from registration under the Securities Act of 1933, as amended. Under the Note Purchase Agreement, we sold to the Purchaser \$30.0 million aggregate principal amount of senior secured notes (the “Notes”), which bear interest at a rate of 13.0% per annum, computed on the basis of a 360-day year composed of twelve 30-day months, and payable quarterly on March 31, June 30, September 30 and December 31 of each year until maturity. The first interest payment on the Notes was on March 31, 2019. The entire principal amount of the Notes is due and payable on February 4, 2022 (the “Maturity Date”). The Notes do not amortize and the entire principal balance is due in a single payment on the Maturity Date. As of March 31, 2019, \$30.0 million in borrowings were outstanding under the three-year term note. Under the three-year term note with Goldman Sachs we are not

permitted to allow our cash and cash equivalents to be less than \$12.0 million through the first anniversary date of February 4, 2020, and \$9.0 million thereafter. On December 9, 2019, we entered into a Second Amendment (the “Second Amendment”) to the Note Purchase Agreement. Under the Second Amendment, Section 6.21 of the Note Purchase Agreement was amended to increase the Section 382 Ownership Shift threshold to not exceed 40.0%. In addition to the Note Purchase Agreement, on February 4, 2019, the Company sold the Warrant pursuant to which the Holder may purchase shares of the Company’s Common Shares of the Warrant Shares. The Warrant was sold to the Holder at a purchase price of \$150,000, in a private placement exempt from registration under the Securities Act. The Warrant may be exercised by the Holder at any time after August 4, 2019 at an exercise price equal to \$8.86 and will expire on February 4, 2024. The Warrant contains standard adjustment provisions in the event of additional stock issuances below the exercise price of the warrant, stock splits, combinations, rights offerings and similar transactions. The value of the Warrant was \$2.3 million, and has been classified as an equity instrument in additional paid in capital in our consolidated balance sheets. Our common stock and warrant transactions during second quarter of Fiscal 2020 triggered certain anti-dilution provisions in the warrants outstanding, resulting in an additional 29,654 warrants issued, which were treated as a deemed dividend in the amount of \$74,989. On December 9, 2019, the Company entered into Amendment No. 1 with the Warrant Holder that amends the Warrant. The Amendment No. 1 amends the first paragraph of the Warrant to increase the number of Warrant Shares issuable under the Warrant (on a post-reverse split basis) and to decrease the exercise price from \$8.86 per share (on a post-reverse split basis) to Per Share Warrant Exercise Price. The Amendment No. 1 also amends Section 2.1 of the Warrant such that the Per Share Anti-Dilution Price is equal to the Per Share Warrant Exercise Price.

Working Capital and Other Operating Assets and Liabilities Cash used for working capital was \$5.2 million during the nine months ended December 31, 2019, an increase of \$1.3 million from the cash used for working capital of \$3.9 million during the nine months ended December 31, 2018. We attribute the increase in our working capital requirements during the nine months ended December 31, 2019 compared to December 31, 2018 primarily to an increase in cash used for accounts receivable due to delayed collection from certain customers. These increases in cash used for working capital and other operating assets and liabilities were partially offset by an increase in accounts payable payments and a marketing demonstration unit accounted for as a deferred marketing cost during the nine months ended December 31, 2019 compared to the same period last year.

Evaluation of Ability to Maintain Current Level of Operations In connection with preparing the condensed consolidated financial statements for the nine months ended December 31, 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 third quarter of Fiscal 2020 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 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 \$14.9 million and used cash in operating activities of \$15.7 million for the nine months ended December 31, 2019. Our working capital requirements during the nine months ended December 31, 2019 were higher than management’s expectations, which included higher accounts receivable due to delayed collections and higher inventory. Our net loss expanded during the nine months ended December 31, 2019 compared to the same period the previous year primarily because of higher interest expense and higher selling, general and administrative expense, partially offset by higher gross margins from our accessories, parts and service business. As of December 31, 2019, we had cash and cash equivalents of \$16.7 million, and outstanding debt of \$30.0 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). 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, the fully diluted ownership percentages of existing stockholders will be reduced. In addition, any equity 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 and the term note payable with Goldman Sachs, 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 third quarter of Fiscal 2020 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 \$19.8 million and \$16.2 million as of December 31, 2019 and March 31, 2019, respectively. Days sales outstanding in accounts receivable, ("DSO"), increased by 36 days to 104 days as of December 31, 2019 compared to 68 days as of December 31, 2018. The increase in our DSO was primarily because of delays in collections of certain customer accounts receivable. We recorded net bad debt recoveries of approximately \$0.1 and \$0.3 million during the nine months ended December 31, 2019 and 2018, respectively.

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 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 adopted ASU 2018-07 on April 1, 2019 and it did not have a material impact on our condensed consolidated financial statements.

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 adopted ASU 2016-02 on April 1, 2019. See Note 16—Leases for additional discussion of the impact of the adoption of ASU 2016-02.

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 adopted Release No. 33-10532 on April 1, 2019 and it did not have a material impact on our financial disclosures.

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 2019.

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

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 Kinney Complaint alleged 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 alleged 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 alleged 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 made allegations and claims that were substantially identical to those in the Kinney Complaint, and both complaints sought 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 was 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, which did not result in a settlement. On November 16, 2018, after further settlement discussions, the parties advised the Court that they had reached an agreement in principle to settle the action in its entirety. The agreement in principle was subject to several conditions, including the execution of a stipulation of settlement that was satisfactory to all parties, and preliminary and final approval from the court, among other things. Plaintiffs filed a motion seeking preliminary approval of the proposed settlement on April 12, 2019, and filed supplementary declarations in support of the motion on May 2, 2019. Preliminary approval of the settlement was granted on May 17, 2019. On September 24, 2019, our lead counsel filed a motion for attorneys’ fees and reimbursement of litigation expenses. On October 25, 2019, plaintiffs filed a motion for final approval of the settlement. On November 15, 2019, the Court issued an order approving the settlement and the payment of attorneys’ fees, litigation expenses, and class representative payments, and entering final judgment in the action. Our insurance carrier funded the settlement amount. We have not recorded any liability as of December 31, 2019 since the settlement amount is not considered material as it was funded by our insurance carrier.

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 alleged 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 asserted claims for common law fraud and negligent misrepresentation, against the Company, Mr. Jamison, and unidentified individual defendants. The Amended Complaint demanded 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. On November 29, 2018, the Court granted plaintiffs' motion for leave to amend and plaintiffs filed their Second Amended Complaint, which asserted claims for common law fraud, negligent misrepresentation, and violation of California Civil Code section 25401 against the Company, Mr. Jamison, and unidentified individual defendants. On December 20, 2018, defendants filed their answer to the Second Amended Complaint. On June 6, 2019, the parties reached a confidential settlement of the action and the suit was dismissed with prejudice on July 1, 2019. We have not recorded any liability as of December 31, 2019 as our insurance carrier funded the settlement amount.

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 previously scheduled for December 17, 2019 is now scheduled for February 14, 2020.

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 previously scheduled for December 17, 2019 is now scheduled for February 14, 2020.

The parties in both of the above state derivative lawsuits participated in a mediation held on September 24, 2018. On May 6, 2019, the parties reached an agreement in principle regarding corporate governance reforms to be implemented in settlement of the action. The parties have not yet formalized a settlement, however, which is subject to several conditions, including the execution of a stipulation of settlement that is satisfactory to all parties, negotiation regarding an award of attorney fees, and preliminary and final approval from the court, among other things. Settlement discussions are ongoing. We have not recorded any liability as of December 31, 2019 as our insurance carrier will fund the settlement amount.

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 the above federal derivative lawsuits participated in a mediation held on September 24, 2018. On May 6, 2019, the parties reached an agreement in principle regarding corporate governance reforms to be implemented in settlement of the action. The parties have not yet formalized a settlement, however, which is subject to several conditions, including the execution of a stipulation of settlement that is satisfactory to all parties, negotiation regarding an award of attorney fees, and preliminary and final approval from the court, among other things. Settlement discussions are ongoing. We have not recorded any liability as of December 31, 2019 as our insurance carrier will fund the settlement amount.

Capstone Turbine Corporation v. Regatta Solutions, Inc.

On August 23, 2018, we initiated arbitration proceedings against its former distributor, Regatta Solutions, Inc. ("Regatta"), with the American Arbitration Association ("AAA"), under the following caption: Capstone Turbine Corp. v. Regatta Solutions, Inc., Case No. 01-18-0003-0860 (the "Capstone-Regatta Arbitration"). We have alleged claims against Regatta for breach of contract and unjust enrichment relating to the parties' prior distributor relationship, which terminated at the end of March of 2018, and the related wind-down 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 relations, relating to the parties' agreement to wind-down relations and Regatta's purported sales efforts 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. We have filed and served an answering statement denying Regatta's counterclaims and asserting several affirmative defenses.

Also on October 18, 2018, Regatta filed a lawsuit in the Superior Court of the State of California, County of Orange, alleging two counts of fraud, and one count of interference with contractual relations, individually against Mr. James Crouse, then Executive Vice President of Sales for the Company, arising out of the same allegations made in Regatta's counterclaim. As remedies for these alleged claims, Regatta again sought 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. On December 14, 2018, Regatta stipulated and agreed to arbitrate its claims against Mr. James Crouse and dismissed him from the Superior Court action.

On January 16, 2019, the parties participated in a mediation that did not resolve the dispute. The parties continued their settlement discussions and held a follow-on mediation on April 24, 2019 at which point the parties came to a resolution of the matter. Following initial compliance with the settlement terms, Regatta has since breached its obligations thereunder and Capstone is now engaged in efforts to enforce the settlement agreement, including participating in further dispute resolution proceedings. We continue to negotiate a resolution with Regatta to the remaining dispute. The settlement did not have a material impact on our condensed consolidated financial statements.

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 2019 except for the revision of the risk factors set forth below:

Our operations are vulnerable to interruption by fire, earthquake and other events beyond our control.

Our operations are vulnerable to interruption by fire, earthquake and other events beyond our control. Our executive offices, manufacturing facility, and auxiliary inventory storage facility are located in southern California. Because the southern California area is located in an earthquake-sensitive and high-risk fire area, we are particularly susceptible to the risk of damage to, or total destruction of, our facilities in southern California and the surrounding transportation infrastructure, which could affect our ability to make and transport our products. Any evacuations, power outages or safety issues related to fires or other natural disasters affecting our employees could also adversely impact our business. If an earthquake, fire or other natural disaster occurs at or near our facilities, our business, financial condition, operating results and cash flow could be materially adversely affected.

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

None

Item 3. Defaults Upon Senior Securities

None

Item 4. Mine Safety Disclosure

Not applicable

Item 5. Other Information

None

Item 6. Exhibits

Exhibit Number	Description
3.1	Second Amended and Restated Certificate of Incorporation of Capstone Turbine Corporation (a)
3.2	Certificate of Amendment to the Second Amended and Restated Certificate of Incorporation of Capstone Turbine Corporation, dated August 30, 2012 (b)
3.3	Certificate of Amendment to the Second Amended and Restated Certificate of Incorporation of Capstone Turbine Corporation, filed November 6, 2015 (c)
3.4	Certificate of Amendment to the Second Amended and Restated Certificate of Incorporation of Capstone Turbine Corporation, filed October 21, 2019 (d)
3.5	Fourth Amended and Restated Bylaws of Capstone Turbine Corporation (e)
4.1	Second Amendment to the Note Purchase Agreement, dated as of December 9, 2019, by and among Capstone Turbine Corporation, certain subsidiaries of the company and Goldman Sachs Specialty Lending Group L.P. (a successor in interest to Goldman Sachs Specialty Lending Holdings, Inc.) (f)
4.2	Amendment No. 1 to the Purchase Warrant for Common Shares issued in favor of Special Situations Investing Group II, LLC (a successor in interest to Goldman Sachs & Co. LLC), dated December 9, 2019(f)
31.1	Certification of Chief Executive Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Financial Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32	Certification of Chief Executive Officer and Chief Financial Officer 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
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 October 21, 2019 (File No. 001-15957)
 - (e) Incorporated by reference to Capstone Turbine Corporation’s Current Report on Form 8-K, filed on September 1, 2017 (File No. 001-15957)
 - (f) Incorporated by reference to Capstone Turbine Corporation’s Current Report on Form 8-K, filed on December 9, 2019 (File No. 001-15957)

CERTIFICATION OF THE CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER

PURSUANT TO 18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the quarterly report of Capstone Turbine Corporation (the "Company") on Form 10-Q for the quarter ended December 31, 2019, 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 Frederick S. Hencken III, 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
(Principal Executive Officer)

By: _____
/s/ FREDERICK S. HENCKEN III
Frederick S. Hencken III
Chief Financial Officer
(Principal Financial Officer)

Date: February 6, 2020
