

# ETI ALPHADIRECT MANAGEMENT SERIES

APRIL 28, 2017

## IN FOCUS: CAPSTONE TURBINE'S GLOBAL MARKET STRATEGY AND GEOGRAPHICAL DIVERSIFICATION

This issue focuses on Capstone Turbine (CPST), the distributed power megatrend and its global market strategy and geographical diversification.



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## THE ETI ALPHADIRECT INSIGHT

We believe that the international markets will continue to present significant growth opportunities with increasing demand for cleaner energy and the distributed power generation megatrend. We expect emerging markets such as Africa, Asia, and the Middle East will be important long-term growth drivers for Capstone and the broader Energy Tech industry. We believe Capstone's long-term growth strategy is well-placed and provides diversification as well as tapping key areas of growth. Importantly, Capstone's global initiative includes the aftermarket service component, which we view as a critical driver to reach long-term profitability goals. Although emerging markets can be difficult to navigate, we believe the company is developing a solid local distribution network as well managing risk, including receivables. In this piece, we engage in a number of key parts of the company's strategy and opportunity.

### CPST Business Snapshot

**HQ:** Chatsworth, California  
**Nasdaq Ticker:** CPST (NASDAQ)  
**Full Time Employees:** 173  
**Stock Price:** \$0.77\*  
**Market Cap:** \$27.15M\*  
**Website:** [www.capstoneturbine.com](http://www.capstoneturbine.com)  
\*As of April 20, 2017



### About EnergyTech Investor

EnergyTech Investor, LLC (ETI) is a strategic advisory and independent research firm that delivers innovative investor intelligence programs, investor relations expertise and new investor outreach strategies to companies across the Energy Conversion and Industrial Technology sectors. ETI's mission is to generate insightful and credible information flow between companies and their investors through a broad portfolio of investor intelligence products that helps investors clearly understand the issues impacting a company and their stock price including strategic direction, technology and industry dynamics. EnergyTech Investor was founded by Wall Street veteran and research analyst, Shawn Severson, after seeing a fundamental shift in the investment industry that resulted in less fundamental research conducted on small cap companies and a significant decline in information available to the average investor. ETI's mission is to bridge that information gap and deliver solutions to both companies and investors.

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## Participants

**Mr. Darren Jamison**  
**Chief Executive Officer and President**  
**Capstone Turbine Corp.**

Mr. Jamison joined Capstone in December 2006 as President and Chief Executive Officer and has been a director since December 2006. Mr. Jamison joined Capstone from Northern Power Systems, Inc., a company that designs, manufactures and sells wind turbines into the global marketplace, where he served as President and Chief Operating Officer and Executive Vice President of Operations. Prior to joining Northern Power Systems, Inc., Mr. Jamison was Vice President and General Manager of Distributed Energy Solutions for Stewart & Stevenson Services, Inc., a leading designer, manufacturer and marketer of specialized engine-driven power generation equipment to the oil and gas, renewable and energy efficiency markets. He holds a Bachelor of Arts degree in Business Administration and Finance from Seattle University.

**Mr. Shawn Severson**  
**Founder & CEO**  
**EnergyTech Investor, LLC**

Mr. Severson is the founding partner and CEO of EnergyTech Investor, LLC. He has over 20 years of experience as a senior research analyst covering the technology and cleantech industries. Prior to founding ETI he lead the Energy, Environmental and Industrial Technologies practice at the Blueshirt Group, a leading growth company investor relations firm. He was frequently ranked as a top research analyst including one of the Wall Street Journal's "Best on the Street" stock pickers and multiple awards as Stamine's top three stock pickers.

## ABOUT CAPSTONE TURBINE CORP.

Capstone Turbine Corporation is the world's leading developer and manufacturer of clean-and-green microturbine power generation systems and was first to market with its high-efficiency air bearing turbine technology. Capstone has shipped thousands of microturbines to customers worldwide. These innovative and award-winning systems have logged millions of documented runtime operating hours and are compliant with current and future emissions regulations.

With over 86 distributors worldwide, Capstone's low-emission microturbines serve multiple vertical markets with industry-leading reliability and efficiency. Capstone offers a comprehensive product lineup, providing scalable solutions from 30kW to 30MW. Capstone microturbines can also operate on a variety of gaseous or liquid fuels and are the ideal solution for today's distributed generation needs.

Capstone is a member of the U.S. Environmental Protection Agency's Combined Heat and Power Partnership which is committed to improving the efficiency of the nation's energy infrastructure and reducing emissions of pollutants and greenhouse gases. A UL-Certified ISO 9001:2015 and ISO 14001:2015 company, Capstone is headquartered in the Los Angeles area with sales and/or service centers in the United States, Latin America, Europe, Middle East and Asia.

**Shawn Severson:** Darren, thank you for taking the time to speak with us today. Last time that we spoke we discussed Capstone's growing aftermarket business and service opportunity and today our focus is going to be on Capstone's global market and geographical diversification strategy. Let's begin with an overview of your current revenue mix by geography, so investors have perspective on the business today.

**Darren Jamison:** Sure, Shawn, and thank you. I think one of the advantages of Capstone as a company is that we continue to diversify not only our market verticals but also our geographies. Our geographical diversification continues to improve and change over time, which we see as one of our strategic strengths. Historically speaking, we were very U.S. and Europe-centric, and if you look today, especially at our pipeline of potential opportunities, which is a little more than a billion dollars, the U.S. is still our biggest market. Our second biggest market, from a potential opportunity standpoint is Africa and the Middle East, which is a substantial change from where we have been in the past. Our third biggest market for potential opportunities going forward is Mexico and Latin America followed by Asia, excluding China. Europe has dropped all the way down to our fifth largest opportunity, followed by China and Russia. So, we have seen significant shifts over the last couple of years, and a lot has changed as well with the development of our CHP specific product and the shift away from being predominantly an oil and gas company or business.

**Shawn Severson:** So, if we go back a couple of years and look at the geographic mix, just how U.S. centric vs. international was the business?

**Darren Jamison:** We used to be about a 50/50 split between international and U.S. and have been as high as 70 percent international. Our international business obviously varies on a quarter by quarter basis, and as our larger products become a bigger part of our business, our sales can be a little lumpier quarter to quarter. However, if you look at our present pipeline of opportunities, current orders, and pending orders, it looks very much like how you would want your 401K to look. It is a well-diversified pie with multiple markets and geographies, and we are not heavily concentrated in any one area. If you look at other companies in the cleantech space, they are either very heavily focused in China or Korea internationally, or focused in Connecticut or California domestically. They are driven by markets within large subsidies. We are selling in virtually all 50 states in the U.S. and in 73 countries around the world, and as we develop more CHP, oil and gas, and renewable projects globally, we will have a much more diversified portfolio of customers which is a good thing for any business.

**Shawn Severson:** I know you touched on it a bit earlier, but let's go back to the geographies that you think offer the most potential for Capstone, and can you help investors really understand where we should be focused on in terms of new opportunities by geography?

**Darren Jamison:** If you look near-term, the U.S. continues to be a very good geography for us together with Canada and Mexico. Mexico's power rates continue to go up and natural gas prices continue to go down, much like in the U.S. Canada is also developing into a nice market for us as well as Europe. Europe is not very dynamic at the

moment, but parts of Eastern Europe are becoming more interesting. Another very dynamic market is Australia, with oil and gas opportunities as well as growing CHP opportunities. Additionally, we are seeing a lot of applications in island areas and other remote locations. Specifically, Indonesia and Malaysia have been developing markets for us, but we believe the biggest regions going forward are definitely going to be Africa, Asia, and the Middle East.

We are starting to sell products in the Middle East and we just recently shipped an order to West Africa. We're probably in four African countries today and just a couple of countries in the Middle East. As we focus our efforts, we expect to continue to expand and grow substantially in these areas of the world. If you look at various energy studies, they show that anywhere from 50 to 65 percent of global electricity consumed by 2020 will be in Asia, Africa, and the Middle East, which are developing areas that are underutilized today from an electrical generation standpoint. This is especially true in Africa, where because much of the population is without access to electricity, it doesn't make sense to put in large scale power plants. However, it does make sense to put in independent small-scale power generation sources, such as microgrids, directly into a village, in which case Capstone is a perfect fit for that type of application.

**Shawn Severson:** Thanks, Darren. I know investors want to address the issue of Russia. Can you just explain what happened there and help investors gain a better perspective of the Russia situation?

**Darren Jamison:** Russia is a big piece of our history. It's all over the news today with our new administration, so it's an area that has a

lot of geopolitical activity. Russia has been a very good market of ours for a long time, and we have over 1,400 units currently running in the country today. In Russia, we do both oil and gas and CHP. Russia, as you know, has inexpensive natural gas as well as large oil reserves, which makes it a great market for Capstone. However, managing the geopolitical tensions in Russia has been challenging for businesses. When Mr. Putin invaded Ukraine, we saw sanctions back and forth from both Europe and the U.S., but more importantly, we saw sanctions back from Russia against U.S. products. Those sanctions from Russia against the U.S. were the most challenging for Capstone and ultimately impacted our business. Also, the drop in the Russian ruble against the U.S. dollar ended up hurting us because it meant that our distributor was buying the product from us at one price and getting paid a much lower price from their customers. The ruble has since stabilized, and we've been patiently working with our Russian distributor. We saw a sharp decrease in our Russian business, but it has come back online, and we've been shipping products consistently over the last couple of quarters. Our Russian distributor is slowly paying down their Capstone receivables, and we fully expect to collect that receivable over the next couple of years. More importantly, we diversified our risks in that area and added five new distributors. With the additional distributors in Russia and the CIS states, we can better manage our presence in the region. We will continue to collect the receivables owed, but also ship product to that territory and take care of those customers that already have a large installed base of microturbines.

**Shawn Severson:** Thank you, Darren. That leads me to bring up another question I have concerning the risks to receivables



abroad. Clearly, there are great growth opportunities in these emerging markets, but how do you handle the receivable risk when you're looking at emerging markets such as Russia or Africa, for example?

**Darren Jamison:** Almost everything we do in Africa and the Middle East today is with an LC, or letter of credit. As our distributors continue to grow and mature, we will consider opening lines of credit for them. What we learned with Russia is that even our largest distributors – ones that have conducted over a hundred million dollars in business with us – have had their ability to pay impacted by geopolitical events. I've seen volatile changes in currency exchange rates as well. With that being said, based on our historical collections, we believe our risk in collecting receivables is extremely low. If I think of the approximate 800 million dollars of revenue since I've been CEO, we've truly only failed to collect a couple of million dollars. Our distributors are in the business of being dedicated Capstone distributors. The only time they don't pay is if they literally go out of business. We can have geopolitical headwinds that can cause a project to go sideways, and sometimes they struggle to pay their bills, but we do put reserves in place if we don't have clear sight into the collection. At the end of the day, we are very effective at collecting those dollars.

**Shawn Severson:** Going back to the sales effort internationally, the U.S. has a very strong distribution network, and we've talked about that before and how you leverage that as a business. How is your sales network outside the U.S., and do you still use the distributor model, or is there a different approach to the effort internationally?

**Darren Jamison:** We still use the same distributor model. If you look at the more mature companies in our space, such as Caterpillar, their distributor model is a hundred years old. It is third generation and very mature worldwide. GE and all the big industrial manufacturing companies have very mature networks as well. If you look at Capstone, our distribution model is only ten years old for the most part in the U.S., but in some of these developing countries, it is less than two years old. We have 86 distributors worldwide in 73 countries, and we have approximately 759 dedicated distributor employees. However, the maturation of our distributors and the experience level vary greatly. Our U.S. distribution channel is generally more mature as they have been working with us for approximately ten years. Consequently, our more mature U.S. distribution channel doesn't require as many resources in terms of support as some of our newer distributors that are located within Latin America and parts of the Middle East and Africa. These regions need some extra attention on how to apply and service the products and rapidly move up the learning curve. Thus, we have concentrated our efforts on our distributor training and helping them with the sales process. For example, we train each distributor to use our Customer Relationship Management (CRM) tool to improve their management of the sales and marketing activities related to Capstone's product line.

**Shawn Severson:** You touched on it a bit by talking about the line of credit regarding receivables with distributors and customers abroad. How does the financing mechanism work internationally versus in the U.S.?

**Darren Jamison:** Internationally we have Ex-Im financing which is a U.S. government program. In general the Ex-Im financing pro-

gram works well for us. We use it both in our Wells Fargo credit line when we borrow against international receivables, and our distributors use it to finance projects. There are other in-country financing and leasing opportunities as well, but Ex-Im financing is probably our most valuable tool as far as international sales goes. When we do sell on letters of credit, we look for European or U.S. banks that meet Wells Fargo's criteria and are larger and more reputable.

**Shawn Severson:** Let's take a step back and talk about growth internationally versus the U.S. Are there different drivers internationally versus what we know drives it in the U.S., or in other developed countries?

**Darren Jamison:** I think you're seeing both similarities and differences. I think the similarities you're seeing include the fact that more people are looking toward distributed generation. The typical utility model is somewhat broken because it's expensive as well as inflexible and people are looking to control their energy needs much like people control their computer or telephone needs, or other commodities that they buy. We're seeing energy as one of the bigger business spends. The ability to manage that wisely and find a partner that will help share that risk is what people are looking for nowadays. I think this is a global trend and what you're seeing are lower fuel costs worldwide, whether its natural gas, propane or diesel – you're seeing lower fuel costs across the board and increasing utility rates.

The fact of the matter is you're not seeing utility rates drop at the same level as those fuels. But as utility rates stay high and fuel costs get lower, the "spark spread" increases and makes the economic payback much better. Though the biggest thing we're

seeing internationally is more the electrification of rural areas, upgrading unreliable power systems, power plants and substations. In addition, we're seeing a lot of governments outside the U.S. subsidize their electric rates. As governments lose their ability or desire to subsidize electric rates, they pull out of that subsidy process, which leads to a 15, 20 or 30 percent increase in electric rates – creating a very substantial and dramatic change for customers. However, these large increases in electric rates force customers to take action. When they see their electric rates go up dramatically in a short period of time, they start to look at distributed generation as a viable solution. In summary, I think there are a lot of similarities in the drivers today, but there will be more differences going forward.

**Shawn Severson:** Over the years I've seen a lot of companies move into emerging markets. Let's talk about China specifically. One of the challenges has always been the higher up-front cost of new technologies even though over the total life-cycle there are clear advantages to using alternative technologies, such as microturbines. Are you finding that there is a shift in this idea, and are customers in areas like China more open to the idea of understanding the total cost of ownership versus looking at the cheapest solution only up-front?

**Darren Jamison:** I would love to say that this is the case. China and India both talk about energy resiliency, reliability, buying quality products and improving air quality. However, their purchasing patterns don't match what they say. Even though it is improving, it's doing so at a very slow pace. I think it's going to take some actual populous movement by people that are tired of getting sick from poor air quality and water pollution to

move governments to be more serious about clean energy. We are seeing slight movements, but it's very slow. Asia, China and India, in particular, have talked about it for a long time but have been slow to react. I think what we're seeing is that Africa, the Middle East, and countries like Australia, Indonesia, and Malaysia are moving much quicker. These regions are frankly a little more receptive to buying a quality product and looking at total life-cycle cost. I think that China and India will lag for the next couple of years. Now, when they begin to focus more of their attention on their countries' pollution issues and are willing to pay a small premium, those markets are going to be huge. As we anticipate these markets to move slowly, we will aim for much better performing regions like Africa, Asia, the Middle East, and countries like Australia, Indonesia and Malaysia.

**Shawn Severson:** Let's move on to the aftermarket strategy on a global basis. Service contracts are a key part of Capstone's strategy, and we've talked about it in our previous piece. How does this apply to international business?

**Darren Jamison:** One of the benefits of our aftermarket business is that it is global and steadily growing. Even with the challenges we may face to sell more, our service business is growing at 20 percent a year, and it is expected to accelerate as product sales further increase. We use the same model globally as we do here in the U.S. which means that we could hypothetically grow our aftermarket service business tenfold next quarter without adding a single person to Capstone's workforce. It's an incredibly scalable model as we do not perform hands-on maintenance of machines ourselves, but we train our distributors by giving

them the tools, training and spare parts availability. They can sell our five and nine-year Factory Protection Plans (FPP) or spare parts, making it a great area of growth. We believe our margins will continue to expand, especially in the back half of this year, with robust margins coming from our aftermarket service business.

**Shawn Severson:** So, should we expect a different attach rate in international versus domestic sales in terms of service contracts?

**Darren Jamison:** No, the attachment rate is driven by a function of market vertical mix and geographies. We're seeing very high attachment rates in CHP globally and lower attachment rates on oil and gas just because of the nature of the two markets. I don't think that the actual geographies should change that much. If you look at Australia, almost 100 percent of their Capstone products are under FPP, and we've done very well in some other areas like Europe. This week we're increasing our spare parts pricing and then putting out special discounts for factory protection plans. We'll continue to help customers make the right decision by offering lower cost factory protection plans and higher-priced a la carte, buy-parts-as-you-go programs. We want our customers to be partners with us for 20 years or longer. We also want to share in that life-cycle risk and benefit as our goal is to continue to make a more robust product line and save our customers more money in the process.

**Shawn Severson:** I think we already addressed this, but I wanted to come back to it in a more direct manner. As international sales grow, what is the overall impact on margins? We assume that the attach rate and service agreements are there but is there any reason to think that pricing and

margin would be different in a country like Indonesia versus a sale in California?

**Darren Jamison:** There's no doubt that the strong dollar plays a role. We do more discounting outside the U.S. on our standard list prices than we do within the U.S. As the dollar strengthens against other currencies, the pressure increases and our products become more expensive. You'll see heavier discounting on international sales than on domestic sales. With that being said, we're working hard to lower the direct material cost of our product and improve our margins to where we can better afford the discounts and continue growing the business. At the end of the day, we need our products to be affordable for the customer, and we want to drive good projects with good economics all throughout the world. If that means we have to discount in Indonesia or discount in India or China, then so be it – we want to make sure that we deploy our products globally.

**Shawn Severson:** Great. Lastly, I see that you recently added a new Board Member, Yon Yoon Jordan. What is the strategy behind that and what does it do for Capstone going forward?

**Darren Jamison:** We have had very little Board turnover in the 10+ years since I joined the company, and over the last 18 months we've looked to refresh the Board. I'm a firm believer in Board refresh. As the company

grows and matures and changes, bringing in different executives with different skill sets and backgrounds is helpful for me and helpful for investors. We've actually had three Directors come off the board in the last two years. John Jagers came off first, who was one of our longest tenured Directors, then Darrell Wilk last summer, and most recently, Richard Atkinson. We added Paul DeWeese this past August, who is an oil and gas expert with heavy customer service and aftermarket service background, and Yon Yoon Jordan just joined last week. She's more of an expert in cost controls, financing, M&A activities and licensing. She's also very experienced in the cleantech space. She's on the Board of Maxwell and some other big companies that I consider as operators in a similar universe to us. She is intelligent, a strong financial player and has a diverse approach. Paul DeWeese also brings to the Board strong aftermarket and oil and gas experience. As we continue to refresh the Board over time, we'll look to bring on individuals with different skill sets and backgrounds that are relevant and active in the industry.

**Shawn Severson:** Great. Thank you, Darren. I look forward to speaking to you again in the near future.

**Darren Jamison:** Excellent. Thank you, Shawn.



## SHAWN SEVERSON FOUNDER AND CEO

Mr. Severson founded EnergyTech Investor in 2016 after seeing a significant communication and information gap developing between small and micro-cap companies and the financial community. Mr. Severson has over 20 years of experience as a senior research analyst covering the technology and cleantech industries. Previously, he was Managing Director at the Blueshirt Group where he was the head of the Energy, Environmental and Industrial Technologies practice. Prior to the Blueshirt Group, Mr. Severson was at JMP Securities where he was a Senior Equity Research Analyst and Managing Director of the firm's Energy, Environmental & Industrial Technologies research team. Before joining JMP, he held senior positions at ThinkEquity, Robert W. Baird (London) and Raymond James. He began his career as an Equity Research Associate at Kemper Securities. He was frequently ranked as a top research analyst including one of the Wall Street Journal's "Best on the Street" stock pickers and multiple awards as Starmine's top three stock pickers.



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