ETI ALPHADIRECT MANAGEMENT SERIES

AUGUST 4, 2017

IN FOCUS: CAPSTONE TURBINE AND ITS STRATEGIC COST REDUCTION INITIATIVES AND PROGRAMS

This report focuses on Capstone Turbine (CPST), its strategic cost reduction program and the opportunities and challenges operating a growth company during a cost-cutting initiative.

Source: www.energytechinvestor.com

THE ETI ALPHADIRECT INSIGHT

During fiscal 2016, Capstone faced a significant short-term shift from high-growth mode into strong and challenging macroeconomic headwinds. The company had to adjust its model quickly and declare a "war on costs" by rapidly cutting costs and streamlining the business. With a stated final business model goal of $5.5M in quarterly expenses, Capstone has managed to cut its operating expenses by 42% during an 18-month period and is within $700k of its target run-rate. This type of strategic adjustment can present a number of challenges, but we believe this is a critical move by the company. Investors are intensely focused on the company reaching breakeven levels and we believe this can now be accomplished at a much lower revenue level than under the company's previous model. The numbers confirm that Capstone has managed its cost reduction initiative well, but there are additional cost-cutting opportunities the company is capitalizing on. Today, Capstone is driving revenue growth from its Signature Series products, improving the product mix by moving away from oil and gas and focusing more on the service portion of the business, as well as lowering operating expenses on multiple levels. We expect all of these factors will help to improve margins as well. As Capstone moves into fiscal 2018, there is still work to be done, but we believe reaccelerating revenue growth will be critical over the next 18 months and, when combined with the lower operating expense margin, the company should be well-positioned to reach overall profitability and cash flow objectives.

CPST Business Snapshot

HQ: Chatsworth, California
Nasdaq Ticker: CPST (NASDAQ)
Full Time Employees: 173
Stock Price: $0.625*
Market Cap: $26.25M*
Website: www.capstoneturbine.com
As of August 2, 2017

About EnergyTech Investor

EnergyTech Investor, LLC (ETI) is an independent research and Investor Intelligence firm that creates and implements digital content and programs to help investors better understand a company's key drivers including industry dynamics, technology, strategy, outlook and risks as well as the impact they could have on the stock price. EnergyTech Investor's expertise encompasses a variety of sectors including Clean Transportation, Emerging EnergyTech, Energy Services, Smart Buildings, Solar, Water Value Chain and Industrial. EnergyTech Investor was founded by Wall Street veteran and research analyst, Shawn Severson, after seeing a significant shift in the investment industry that resulted in less fundamental research conducted on small cap companies and a significant decline in information available to all investors. ETI's mission is to bridge that information gap and engage companies and investors in a way that opens information flow and analytical insights.

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Participants

Mr. Darren Jamison
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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
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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 Starmine'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 96 distributors and Original Equipment Manufacturers ("OEMs") 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: Thank you for taking the time to speak with us today. The last time we spoke, we analyzed Capstone's global market and geographical diversification plan. Today's focus will be on strategic cost-cutting programs, the opportunities and challenges you are facing and where investors should be focused going forward. To begin, it would be helpful if you could provide some historical perspective to your initiative.

Darren Jamison: Sure, Shawn, thank you. If you look back to when I joined the company in fiscal 2007, we had about $21 million in revenue that year. We went through a high-growth period and saw some significant growth rates from 2008 all the way through fiscal 2015. As we entered fiscal 2016, we started to see macroeconomic headwinds and realized that it was the right time to reduce costs within the company and streamline the organization. In the first quarter of 2016, we made the decision to cut our operating expenses by approximately 35%, and approximately 18 months later in Q3 of fiscal 2017, we not only achieved that goal but exceeded it as we had actually reduced our operating expenses by 42%. In that 18-month period, we essentially went from about $10 million in quarterly operating expenses to about $6 million.

Shawn Severson: Being cash-flow positive is a critical milestone for investors and we often hear the question, "Why didn't the company implement this cost-cutting strategy earlier?" Help us understand what brought this to the forefront of Capstone's business strategy.

Darren Jamison: Sure, I get that question a lot and it's a valid one. We really had several reasons why we did not start the cost-cutting sooner. First, as I said when I joined the company in fiscal 2007, we were in a major strategic growth phase and experienced year-over-year compounded annual growth rates of about 30% from fiscal 2007-2014. As I mentioned, we took the business from about $21 million annually to a high-water mark of about $133 million. It is very challenging to be in a heavy growth mode and try to cut costs in the business. We then looked at the business projections going forward and realized that we were moving from a high-growth mode into strong macroeconomic headwinds. It was then that we knew it was the right time to focus on reducing costs and streamlining the business, even after recently launching the C1000 Signature Series to address what customers wanted in the energy efficiency or CHP market. Also, we had developed our distributor network and it was mature enough to start transferring costs from Capstone to our distribution partners. To put it another way, you really can't prune a sapling. It needs to become a tree before you start cutting back branches, and so the business had to reach a critical mass and be mature enough for us to go back in and start cutting and transferring operating expenses. When you look at the cost reductions we made, they were in areas such as sales and marketing where we had moved the operating expense over to our distribution channel, and in engineering where we were able to reduce headcount due to the fact that we had already launched the key new products we needed. On the services side of the business, we moved service personnel from Capstone into the distribution channel and they took over the aftermarket support of the product.

Shawn Severson: Thanks, Darren. We know that there are generally three ways to drive profitability: more revenue, a better mix and lower costs. Obviously, goals are achieved through a combination of all three, but from a 30,000-foot view, can you give us a brief summary of your thoughts on these factors and how they pertain to Capstone today?

Darren Jamison: You are absolutely correct. We are employing all three of these strategies to help us become profitable as quickly as possible. We are driving renewed revenue growth through our Signature Series products, which are heavily concentrated on the energy efficiency market. Emphasis is placed on expanding our service offering, which is also benefitting from our renewed focus on CHP. Furthermore, we expect to drive future growth through our Capstone Energy Finance JV business as that comes online and starts contributing to the top-line. Regarding mix, we are moving toward more long-term factory protection plan, or FPP, service contracts, which have higher margins with recurring revenue. The good news is the shift away from oil and gas to energy efficiency generally yields higher service contract attachment rates, as CHP customers typically do not have the indigenous personnel or expertise to do the maintenance like our oil and gas customers. Lastly, as we have discussed before, we have been cutting our development efforts and reducing our marketing and service expenses by moving a lot of that work into our distribution channel. If you look at it from a 30,000-foot standpoint, we are increasing our focus on growing the top-line through our new Signature Series product line as well as Capstone Energy Finance. We are improving our mix by focusing more on the service part of the business and lowering our operating expenses from $10 million a quarter to $6 million a quarter today with a path to get down to about $5.5 million a quarter. If you compare that with other companies that are in the cleantech space, whether they are fuel cell companies, ultra-caps or other technologies, all of their quarterly operating expenses are $10-15 million a quarter and we are definitely industry leading within our space once we get down closer to $5 million.

Shawn Severson: What are some of the successes you have had since beginning your cost-cutting initiatives and can you give us some specific metrics?

Darren Jamison: I am very proud of our team and the work we have done since I joined the company. Reducing your operating expenses by 40% is like losing 40% of your body weight. It is not easy to accomplish without starving yourself. In order for us to accomplish this, we had to be very strategic. We have had to work really hard to do it responsibly and thoughtfully to get our operating expenses down to that level, and as I said, we had to have very challenging conversations with our distribution partners to have them pick up more of the load on the sales and marketing side and on the service side. It is the same with our employees as we have gone through three reductions in force and made difficult decisions when it came to what engineering programs we were going to implement and how we were going to prioritize the business going forward. In general, we just have to be very thoughtful about how money is spent. As you know, the other area we focused on was non-personnel related expenses. We carefully looked at all external expenses and decided that nothing was off-limits when it came to reducing costs. Everything from the boardroom to our coffee service, all the way to our auditors, SEC counsel, tax providers and any other area where we could reduce our expenses, we did. The biggest expenses that have yet to be fully realized are the consolidation of both our facilities into one facility, which we are currently in the progress of doing. Once completed, the consolidation will save us over $1.5 million a year.

Shawn Severson: You previously stated the last time we spoke that Capstone has declared a war on costs. What are some of the challenges you have faced to date with this cost reduction initiative and what areas have you not been able to execute on as planned along with details on how you plan to work through them in order to achieve the company's strategic goals?

Darren Jamison: We are definitely at war with costs and again there are no sacred cows. As I said, we have gone after everything from the boardroom all the way down to the shop floor. We have not only met our goal of 35% in cost reductions, we then exceeded it, so we are very happy about that, but we are not done. We will continue to look at all areas to streamline the business.

It has been both very challenging and very stressful. I have been a growth CEO over my career and not a cost-cutting CEO. In cutting costs I have had to use my sales skills, starting from when I talked to the board about going down a couple of directors and having more board meetings telephonically instead of in person. We have had difficult conversations with our distributors and employees and even with our vendors as we look to reduce costs everywhere that we can. However, we are not done and we still need to complete the consolidation of both our facilities into one. We will have to make sure that we work with everybody to make the move to one facility as smooth as possible because the last thing we want to do is negatively affect our distributors, or more importantly, our customers. We want them to see the same level of service and support from Capstone as they have always expected and received. All of this is challenging to do and you have to do it thoughtfully and in a certain sequence. We have also reduced our costs by changing our outside auditors, tax providers, compensation consultants, SEC counsel and even changed our banking relationship. We did all that in a very short amount of time, so it can be stressful on the organization to have to deal with that many new providers and new relationships.

Shawn Severson: Let's talk specifically about the gross margin for a moment. It has been volatile in recent quarters. Can you give us some color on the gross margin trends throughout fiscal 2017 and what you anticipate going forward?

Darren Jamison: Yes, it has definitely been volatile. We have had to work on cleaning up some field reliability issues, so we took a one-time charge to warranty expense a couple of quarters ago that was fairly significant. Obviously, when you launch a new product – our Signature Series – you are going to experience some challenges on the cost side given the fact that you are now buying new components and parts, not to mention the fact that volumes have yet to ramp up. So, I think to your point, we have had volatile margins, but you should also notice that our cash burn before equity raises has dropped considerably from over $7 million back in Q2 to $3.5 million in Q3 to generating cash in the last quarter of fiscal 2017. Therefore, even though we have been challenged some on the margins, we have done a great job with working capital and our operating expenses, and are actually lowering our cash burn on a quarter-by-quarter basis despite soft margins. You will, however, see margins improve as the field issues wind down and we execute on our Signature Series cost reduction strategy. Also, as the service business continues to become a bigger part of our mix, margins should normalize in the back half of our current fiscal year and then hopefully hit our target goals of low 20s within three or four quarters.

Shawn Severson: Staying along the lines of gross profit, how important is revenue growth to that margin target of fiscal 2018 and beyond?

Darren Jamison: We have fairly fixed operating expenses and although we have dramatically cut them, our facilities, operating personnel and leases are fixed, so revenue growth really helps leverage those fixed costs. Therefore, continuing to grow revenue and gain market share is very critical and we definitely want to get back into the high-growth mode we enjoyed for seven or eight years before the macroeconomic headwinds. As we move forward, I think the quality of revenue is important as well. Revenue growth with low margins and with non-recurring customers that do not purchase service contracts is not the healthiest or most ideal type of revenue for Capstone. Ideally, we would like to see revenue from Fortune 100 companies that are going to purchase more products once they realize how well our microturbine solutions work. We want to sell our accessories and long-term factory protection plans, so we are moving to more of a bundled solution approach, pursuing customers with a fully wrapped Capstone microturbine solution that incorporates a Capstone microturbine, Capstone accessories and a Capstone factory protection plan as a prepaid bundled solution. In doing this, we are giving them better economics in the deal, but we are also getting all the cash up front, tying in the accessories and long-term service business. That is much healthier revenue than what we have had with some of our traditional oil and gas customers in the past.

Shawn Severson: As of your last quarterly announcement your operating expenses quarterly run rate was $6.2 million. You have a stated final business model goal of $5.5 million in quarterly expenses, which leaves a gap of about $700,000 today. Can you help us understand what some of the lower hanging fruit might be versus what you think is most challenging to achieve, and in addition, can you give us some thoughts on a timeline for your goals?

Darren Jamison: As we cut our operating expenses by 42% we are out of lower hanging fruit; we are more into lower hanging branches. If you look at our fourth quarter of fiscal 2017, about $6.2 million had included about $300,000 of one-time expenses. So, the number should really be about $5.9 million going forward without one-time expenses. Then we still have the savings from our outside service providers that is yet to be fully realized and will take us down another couple hundred thousand. That will bring us down to $5.7 million, and more importantly, there is the consolidation of both our facilities, which as I mentioned earlier, we are in the process of doing. To date, we have already moved the manufacturing floor from our headquarters in Chatsworth over to our Van Nuys facility and are now in the process of moving engineering and the rest of our employees. The move will save us about $1.5 million annually and get us below the $5.5 million stated target. At the end of the day, we should be north of a 45% reduction in total operating expenses. We may even get close to 50%, but really the target is to get below that $5.5 million number.

Shawn Severson: We have seen many companies over the years struggle with the growth versus cost challenges and we touched on that a bit. How do you try to balance that fact with Capstone because it is clearly still a growth company and you have to spend to grow?

Darren Jamison: I think any good company has to be able to do both. I think the challenge is, when do you grow and when do you manage expenses. When you have strong macroeconomic tailwinds as we had with high oil prices and a weak dollar, we really grew the business and focused on market penetration. As we saw macroeconomic headwinds appear with tensions in Russia, the subsequent sanctions on Russia, the strong dollar and falling oil prices, we really had to turn and focus internally on our operations and make sure we could streamline our business. Hence the business is kind of an ebb and flow; you spend money when you have the tailwinds and you get as much market share as you can but when you get headwinds, you focus on cutting the business and concentrate on any inefficiencies that resulted from those high-growth periods. We are very focused on our working capital and all the things on the balance sheet that we can control. We have made the business much leaner and more efficient, but as growth opportunities come up, we are going to leverage them and begin to invest money back into our sales and marketing department and probably speed up some product development once we have those tailwinds behind us again. When it comes down to it, it is really about being able to make each adjustment strategically and at the right time.

Shawn Severson: Expanding on my prior question a bit. How do you plan to reduce the overall costs, maintain quality and keep customers satisfied? How do you guarantee that this cost-cutting effort will not affect existing or future customers, which can be difficult to do in a heavy cost-cutting environment?

Darren Jamison: It is definitely a challenge. You can cut to the point where you reduce customer satisfaction and have your sales go down and then you cut some more and you get into sort of a 'death spiral'. We definitely want to avoid that! If you look at how we interact with our customers, they really have not seen any drops in service levels or support. The change in how service work is being performed is hardly noticeable as this is now being done by our distributors. Where we had done much of the service work directly in the past and had our own technicians; those technicians now work for our distribution partners and the distribution channel is providing that work. So, like in other areas, it has been more of a shift of cost from Capstone to our distribution channel. As far as product development, we have slowed down and refocused our product development efforts. Most customers still see the new Signature Series products, new fuel capabilities, new controls and new accessories. Capstone Product Development might not be developing new products at the same rate as it was prior, but we are utilizing this time to fine-tune our current products in and out of the field. Regarding the providers we use, our customers do not really mind. They know we use great service companies like Marcum for our auditing services, but at the end of the day, most customers are not concerned with those details. They are not concerned with who our SEC legal counsel is or that we have shifted our banking relationship from Wells Fargo to Bridge Bank. Most of the changes we have made in external providers will save us money, but they are typically invisible to our customers. We have really focused on not cutting our overall internal quality and stuck to delivering a truly great product. I can comfortably say that we have made the appropriate changes without reducing customer service levels in any way.

Shawn Severson: As you know, a major part of the strategy to reach profitability and expand margins is to increase both service and spare parts revenue. Can you remind us how and why this is an important factor to investors and what you are doing to grow this part of the business specifically?

Darren Jamison: Yes, I would say that the one thing that investors are really missing about the Capstone story is that there has been a tectonic shift in our business that the casual investor might overlook. As we continue to move away from being heavily focused on the oil and gas market to focusing more on the energy efficiency market, we become more diversified as a company. More importantly, the energy efficiency customers are buying our long-term service contracts at a much higher rate than, let's say, the typical oil and gas customer. Even though our revenue has declined over the last two years, our service business has grown between 13-14% annually, and as our revenue picks back up, our service business is on track to grow even faster. This should have a significant impact on helping us to increase margins. Today, our accessories, parts and service business is approximately a 30% margin business. We can see it hitting 50% as the new Signature Series products get into the market and we start putting the more robust units under long-term service agreements. We made over 70 design improvements to make the new product more robust than the older R series C200 and C1000 products. As the service business grows on the back of the new CHP energy efficiency mix, from about $5 million a quarter where it was, to approximately $7 million today and towards $10 million in the near future, we should be able to get to a 50% margin. Simple math says you are generating about $5 million in contribution margin quarterly from your recurring accessories, parts and service business alone. If our operating expenses are $5.5 million or less, we are essentially at break even on our aftermarket service business before the benefit of product sales. That is a huge tectonic change from where we were two years ago. Two years ago, our service business was approximately 15% margin on $5 million of quarterly revenue and so we had to sell $35 million in product every quarter to cover our $10 million in operating expense. Under the new target business model, we would hardly have to sell any product at all to break even. Therefore, we have a much more robust, viable and almost recession-proof business as we execute our new improved and diversified business plan.

Shawn Severson: Thank you, Darren. Lastly, I would like to talk a bit about the role that the financing solution for projects has on your goal. Will it simply be to drive product revenue or are there other factors that we should consider in a potential business model?

Darren Jamison: There are two other factors besides top-line revenue. Yes, it should grow our top-line revenue, estimating about 10-15% annually when mature, but the other important factor is that it is a valuable sales tool, to be able to say to a customer that you have a great project with a three and a half to four-year payback. So, if you are not sure about the technology or do not want to pull the trigger or do not have the capital dollars to allocate toward it, we can do the project for you. The other critically important aspect is that all Capstone Energy Finance projects will be sold with long-term factory protection plans, to which we have already discussed the benefit of our mix and margins.

Shawn Severson: Thank you for your time, Darren.

Darren Jamison: Thank you, Shawn.

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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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