

ETI ALPHADIRECT MANAGEMENT SERIES

MARCH 15, 2017

IN FOCUS: CAPSTONE'S AFTERMARKET SERVICE OPPORTUNITY DRIVING GROWTH AND MARGIN EXPANSION.

This issue focuses on Capstone's (CPST) aftermarket business opportunity and related growth drivers and margin expansion.



Source: www.capstoneturbine.com

THE ETI ALPHADIRECT INSIGHT

As Capstone drives to reach profitability, the aftermarket continues to play an important role in achieving this objective. Specifically, aftermarket service contracts will help drive margin expansion as these contracts generally carry attractive margins relative to equipment sales alone. As the service contract attach rates increase, the favorable mix should help to drive overall expansion for the company. This is especially critical for markets such as CHP/energy efficiency and renewable energy, where service contracts are more relevant vs. other markets such as the oil and gas sector. Customers in the oil and gas sector have stronger technical knowledge with internal maintenance resources, often due to stringent reliability and safety requirements. Other markets, however, lack the expertise and technical personnel and the growing demand to manage maintenance is creating a significant opportunity for Capstone.

CPST Business Snapshot

HQ: Chatsworth, California

Nasdaq Ticker: CPST (NASDAQ)

Full Time Employees: 173

Stock Price: \$0.73*

Market Cap: \$27.29*

Website: www.capstoneturbine.com

*As of March 14, 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 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 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: First, I would like to thank you, Darren, for taking the time to speak with us again today. The last time that we spoke, we discussed Capstone as the leader in microturbine technology and the distributed power megatrend. Today our focus will be on the growing aftermarket business and service opportunity. For investors still new to Capstone, can you start by giving us a brief overview of Capstone's core market and applications?

Darren Jamison: Absolutely. Capstone is a high efficiency, clean energy, power generation technology. Although we operate in several markets, we focus primarily on three core markets. Our largest market today is what we call combined heat and power ("CHP") and combined cooling, heat and power ("CCHP"), which for Capstone makes up the energy efficiency market. The energy efficiency market consists of office buildings, hotels, healthcare facilities, and universities as well as commercial and industrial customers who are looking to lower their operational energy expense. Our next biggest market is oil and gas for onshore and offshore drilling operations, pipelines, compression stations and cathodic protection, which is frequently used in the shale industry and offshore platforms. Our third market is what we call renewable energy. Renewable energy for Capstone means farm digesters, landfills, solid waste and wastewater treatment plants - essentially any biogas that you can get from organic materials or green waste that can be used in our microturbine systems. We also serve in smaller markets such as transportation and some marine.

Shawn Severson: Thank you, Darren. So, let's move on to today's topic. Could you start by giving us an introduction to your aftermarket support and service organization?

Darren Jamison: Yes. The aftermarket business is an important part of our product offerings, especially as our fleet continues to grow. To date, we have shipped approximately 9,000 units worldwide spanning across 73 countries. As our fleet of microturbines expands and matures, our aftermarket sector becomes a more important part of our business, one that will be more robust and profitable with each passing quarter. We are a bit different than other power generation technologies. Traditional technologies tend to have dozens if not several hundred moving parts, while Capstone only has one. For example, traditional technologies like internal combustion engines are your classic razor that you read about in business school, where they sell the razor at a lower cost and make their money on the aftermarket blade refills. We are very different – we are the electric razor – and as a result, we do away with a lot of the traditional maintenance, like oil changes, belts, hoses, spark plugs, valve adjustments and so forth. At Capstone we are really selling lifecycle cost guarantees as opposed to long term pay-as-you-go parts replacement and service agreements.

Shawn Severson: Can you talk about the factory protection plan (FPP) and its different features and options? For example, the protection against unscheduled maintenance repairs, minimizing downtime, etc.?

Darren Jamison: What's different about our aftermarket service offerings is that most technologies offer customers a one-year warranty and then they offer very limited or very short-term maintenance agreements where they only perform the scheduled maintenance listed in the operations manual. As I mentioned, we are different because we only have one moving part, digital controls,

and power electronics, and we are an inverter-based technology like the solar industry. Capstone offers standard five- and nine-year factory protection plans, which mean that lifecycle costs are basically guaranteed and backed by the factory. What that means to the customer is that for any scheduled or unscheduled maintenance that needs to be performed on the unit, we will cover the maintenance repair via our local distributor under our comprehensive factory protection program. Regardless of where you are in the world, our factory trained authorized distributors will complete the maintenance work for our customers in a timely and professional manner. Our distributors will then bill us directly for the repair - not the customer. The FPP contracts are paid in advance by our customers, either quarterly or annually. This is, in some ways, similar to that of an insurance policy and just like your car insurance or your home insurance, for example, if you don't pay for your policy and you have a claim, you are not covered. So, it's important that our customers purchase a protection plan upfront in order to avoid any lapse in coverage, should they ever need it.

Shawn Severson: Can you explain why and how your plan is different from other service plans and contracts currently available on the market today?

Darren Jamison: Yes, our plan is different very much like our products are different compared to the more traditional internal combustion engines, which are a virtual concert of moving parts consisting of pistons, valves, cylinders, hoses, antifreeze, grease, motor oil, auxiliary equipment, batteries and other components. These parts need scheduled maintenance and often experience unscheduled failures at the most inopportune times. The "engine guys" typically like to sell

the product at the lowest cost and make all their money in the aftermarket when the customer has the lowest leverage. Again, let's refer back to the razor theory where they make their money from the aftermarket parts - the blade refills. As an example, Caterpillar probably does it better than anybody else in the world. They will get you a spare part within 24 hours regardless of your location. That is excellent, but unfortunately, you are also spending money on these spare parts, and there is often a reason you need to get the spare parts within 24 hours. Capstone's technology is different: we have patented air bearings, we have one moving part. We only change the air filter about once a year, our injectors about every two and a half years and we do a top-end overhaul at five years. Since there are so few actual maintenance events, it feels more like a lifecycle guarantee or even a long-term partnership where we, Capstone, will stand by the product, unlike anybody else in the industry. Currently, there is nobody else offering a standard nine-year comprehensive all-inclusive service program with no questions asked like we do.



Source: www.capstoneturbine.com

Shawn Severson: Thank you, Darren. Can you expand on your customer base and the applications where your aftermarket strategy is most effective?

Darren Jamison: Yes, we are working hard to make our aftermarket strategy more effective, but the energy efficiency segment is where we receive the highest attachment rate. Obviously, if you're a hotel, a hospital or an industrial customer, you don't have local, highly-trained staff to do maintenance on this type of high-tech equipment. If you have staff assigned to this kind of high-tech maintenance, you usually only have one person, and that person already has a lot on their plate. So, we receive a very high attachment rate for energy efficiency and CHP projects. In some geographical areas like New York, the Mid-Atlantic and California, I believe we are almost up to 100 percent energy efficiency attachment rate, which is certainly our goal.

In renewable energy, the attachment rate is not as high as in energy efficiency because you have waste water treatment plants and municipal landfills that normally do a lot of their maintenance work themselves. However, if you are a brewery, a farm digester or other similar application, you are more likely to buy the long-term service agreement that Capstone offers.

The most challenging sector is by far oil and gas, which has the lowest attachment rate. This sector tends to have local personnel that are highly trained individuals that prefer to monitor their systems with onsite experts. In addition to that, they are also very critical of safety and other reliability issues and prefer to have their own repair technician's onsite 24/7. As a part of our efforts to expand and grow within this sector, we have launched a

long-term warranty program in order to sell extended warranties or manufacturer's warranties rather than selling long-term service agreements. We launched this warranty program recently and believe that it will help improve the aftermarket attachment rate within the oil and gas side of the business.

Shawn Severson: Could you discuss what is driving growth in the aftermarket business and the long-term service contract backlog? Also, what can Capstone do to get higher close rates on the units sold?

Darren Jamison: In our case, the drivers that determine growth in our aftermarket business are two-fold. One, our distributors are getting better at explaining the many benefits and selling the factory protection plan. In the beginning, they were very focused on just selling the product, but now they realize that selling an aftermarket protection plan or the extended warranty is critical to their profitability and repeat orders. These services keep the distributors very close to the customer. In addition, as the product continues to improve over time, everybody makes more money, which in turn makes everybody happy. I think distributors are waking up to the value that it adds to their own business and their franchise as a long-term recurring revenue stream. It is good for everybody – it's good for Capstone, good for the distributor and good for the customer. Two, for Capstone, it's about getting the attachment rates up, focusing on the key markets and getting to the customers early in the sales process. It's very challenging to get a customer to sign a long-term service agreement if the units have already been installed and running for three years and without a single failure. Getting to the customer at the time of sale or after the manufacturer's warranty expires at the latest

are the two most critical times to get customers into a long-term maintenance partnership.



Source: www.capstoneturbine.com

Shawn Severson: Help us understand the aftermarket business' impact on margins and also the percentage of revenue it represents today.

Darren Jamison: We have seen our backlog, especially for the FPP business, grow in the last three years from about \$35 million to \$77 million, and it's continuing to accelerate despite some of the headwinds we have experienced on the unit demand side. Because these are five-year/nine-year contracts, they are not rolling off the books as quickly as we are adding them. Every quarter our FPP backlogs are increasing regardless of whether our sales are going up or down during that quarter. This is absolutely crucial for us. The margins are improving as the product improves and the latest Signature Series version of our C1000 product had 83 discrete improvements, both in performance and reliability. As product performance improves, the lifecycle cost improves and as these are firm

fixed contracts, it's a win-win for everyone. Today, we are at about 35 percent gross margin, but with the launch of the new Signature Series, we anticipate that within the next 18 months, we should be pushing 50 percent gross margin. It is significant to go from 35 percent gross margin to 50 percent gross margin, and this kind of revenue growth is helping us on both ends.

Shawn Severson: Help us understand the role your aftermarket business plays in achieving your goal of cash flow breakeven and just how critical it is to achieve this inflection point.

Darren Jamison: Absolutely, that is actually the most important question of them all. In our last earnings call, I presented a new slide that I thought would be beneficial to our investors that outlined our previous, new and future quarterly business models. I think it is extremely important and believe that so many people may have missed the significant tectonic shift in our business. We have gone from an R&D company to a product company, and now to a product company with a very robust aftermarket service business. In the past, in order to achieve breakeven as a product company, we had to sell about \$35 million in product each and every quarter. Today, as a product company with a growing robust aftermarket business we're pushing \$10 million in aftermarket service revenue, and those margins are improving, as I mentioned on the earnings call, and with our lower cost structure, we only need to sell about \$15 million of product a quarter. This is an incredibly huge paradigm shift, going from selling and shipping \$35 million in product a quarter to breakeven, to only \$15 million a quarter is a game changer. It is simply riding on the back of two things: The accessory FPP sales and the lower operating

expenses, which are part of our key strategic plan. As we move forward, we can get to what I call 100 percent absorption. When I was working for Stewart & Stevenson, this was a key business model for us, and we are employing the very same strategy here at Capstone. 100 percent absorption means that you eventually get to the point where your aftermarket parts and service business is robust enough to cover all of your operating expenses on both a quarterly and annual basis; just on aftermarket parts and FPP service revenue. Therefore, you are essentially recession-proof, and all product margins during the quarter drop straight to the bottom line. It is a great business model and one we are striving to get to as quickly as possible.

Shawn Severson: Can you briefly discuss the attachment rate with each new unit sold? What is the most common reason for clients to resist the factory protection plan?

Darren Jamison: Unfortunately, we don't disclose that in detail because it varies so much, but for several reasons. It varies across each market and on how confident and capable the distributor is. As I mentioned, for our more mature distributors, like E-Finity Distributed Generation, Regatta Solutions, and RSP Systems, the attachment rates are extremely high. However, other newer or less mature distributors are still more focused on new product sales, and they don't quite understand the value of the aftermarket sales programs just yet. As a result, the attachment rates vary widely by each distributor and their maturation as well as the market verticals in which they operate. With that said, energy efficiency, oil and gas, and renewable energy all have different attachment rates. Overall, we are doing several things that are somewhat proprietary to help increase the attachment rates. Similar to when you rent a car,

and they make sure that you sign your name four times on the rental contract when you do not opt for the rental car insurance. We are making sure that our customers fully understand that if they self-insure with our product, they are going to shoulder that risk alone instead of becoming our long-term aftermarket partner. We are making sure that they understand the value of the FPP and extended warranty plans we offer and that we can guarantee them very competitive lifecycle costs, and ultimately take the risk out of the equation. Nine years is a long time for us to take that kind of risk, especially in today's world, but we strive to provide our customers with that kind of satisfaction and long-term peace of mind.



Source: www.capstoneturbine.com

Shawn Severson: Lastly, what are some upcoming milestones or targets that investors should look for?

Darren Jamison: I would say that as it relates to our aftermarket business, there are three main targets. First, you should look closely at our accessories, parts and FPP revenue as it continues to grow quarter over quarter. Our total non-product related revenue should reach those key \$10 million quarterly numbers or \$40 million a year very soon. We are pushing about \$8 million per quarter today and are growing each quarter. When we get to that \$10 million mark, it will drive the profitability model to get Capstone to breakeven as quickly as possible. Second, while margins in FPP long-term service contracts are at approximately 35 percent today, they should be driven up to 50 percent within the next 18 months. We can actually go higher than 50 percent as more Signature Series products enter the field. However, I do believe that 50

percent is a significant milestone and also very similar to other mature, world-class service organizations. The third target is to look for our FPP backlog to surpass our product backlog. Today, our FPP long-term service contract backlog is about \$77 million, and our product backlog is over \$100 million. As I mentioned before, our FPP service backlog is growing every quarter regardless of new product sales and shipments, so you should see service and sales numbers flip. It may be a close race between the two for a while, but as oil and gas continues to come back online and as we penetrate new geographic markets, we will look forward to seeing both our product and service backlogs grow in leaps and bounds.

Shawn Severson: Thank you very much for your time, Darren. We look forward to another conversation with you soon.

Darren Jamison: 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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