CAPSTONE TURBINE Corp
Form 10-Q
February 10, 2014
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended December 31, 2013

or

o **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)	**95-4180883** (I.R.S. Employer Identification No.)
21211 Nordhoff Street, **Chatsworth, California** (Address of principal executive offices)	**91311** (Zip Code)

818-734-5300

(Registrant s telephone number, including area code)

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 x No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer o	Accelerated filer x
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

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

The number of shares outstanding of the registrant s common stock as of January 31, 2014 was 310,128,393.

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PART I FINANCIAL INFORMATION

Item 1. *Financial Statements*

CAPSTONE TURBINE CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except share amounts)
(Unaudited)

	December 31, 2013	March 31, 2013
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 31,571	$ 38,817
Accounts receivable, net of allowance for doubtful accounts of $2,126 at December 31, 2013 and $2,142 at March 31, 2013	22,046	17,941
Inventories	22,086	18,513
Prepaid expenses and other current assets	2,588	2,588
Total current assets	78,291	77,859
Property, plant and equipment, net	3,095	3,543
Non-current portion of inventories	2,995	3,252
Intangible assets, net	1,912	2,313
Other assets	308	371
Total	$ 86,601	$ 87,338
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Accounts payable and accrued expenses	$ 28,975	$ 24,121
Accrued salaries and wages	1,533	1,721
Accrued warranty reserve	2,765	2,299
Deferred revenue	2,645	3,089
Revolving credit facility	13,204	13,476
Current portion of notes payable and capital lease obligations	612	361
Warrant liability		10
Total current liabilities	49,734	45,077
Long-term portion of notes payable and capital lease obligations	238	233
Other long-term liabilities	91	142
Commitments and contingencies (Note 15)		
Stockholders Equity:		
Preferred stock, $.001 par value; 10,000,000 shares authorized; none issued		
Common stock, $.001 par value; 515,000,000 shares authorized, 311,136,986 shares issued and 309,993,712 shares outstanding at December 31, 2013; 305,661,276 shares issued and 304,622,573 shares outstanding at March 31, 2013	311	306
Additional paid-in capital	804,407	796,767
Accumulated deficit	(766,850)	(753,975)
	(1,330)	(1,212)

Treasury stock, at cost; 1,143,274 shares at December 31, 2013 and 1,038,703 shares at March 31, 2013				
Total stockholders equity		36,538		41,886
Total	$	86,601	$	87,338

See accompanying notes to condensed consolidated financial statements.

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CAPSTONE TURBINE CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share data)
(Unaudited)

	Three Months Ended December 31, 2013	Three Months Ended December 31, 2012	Nine Months Ended December 31, 2013	Nine Months Ended December 31, 2012
Revenue	$ 37,003	$ 33,257	$ 96,667	$ 92,187
Cost of goods sold	29,668	28,639	81,117	82,794
Gross margin	7,335	4,618	15,550	9,393
Operating expenses:				
Research and development	2,267	2,188	6,558	6,805
Selling, general and administrative	6,991	6,816	21,200	20,692
Total operating expenses	9,258	9,004	27,758	27,497
Loss from operations	(1,923)	(4,386)	(12,208)	(18,104)
Other (expense) income	(2)		(22)	26
Interest expense	(176)	(205)	(538)	(524)
Change in fair value of warrant liability		304	10	755
Loss before income taxes	(2,101)	(4,287)	(12,758)	(17,847)
Provision for income taxes	88	190	117	586
Net loss	$ (2,189)	$ (4,477)	$ (12,875)	$ (18,433)
Net loss per common share basic and diluted	$ (0.01)	$ (0.01)	$ (0.04)	$ (0.06)
Weighted average shares used to calculate net loss per common share	308,407	304,418	306,044	301,376

See accompanying notes to condensed consolidated financial statements.

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CAPSTONE TURBINE CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Nine Months Ended December 31, 2013		Nine Months Ended December 31, 2012	
Cash Flows from Operating Activities:				
Net loss	$	(12,875)	$	(18,433)
Adjustments to reconcile net loss to net cash used in operating activities:				
Depreciation and amortization		1,806		2,208
Amortization of deferred financing costs		167		92
Provision for allowance for doubtful accounts		193		518
Inventory provision		826		926
Provision for warranty expenses		3,377		4,438
Loss on disposal of equipment				2
Stock-based compensation		1,664		1,177
Change in fair value of warrant liability		(10)		(755)
Changes in operating assets and liabilities:				
Accounts receivable		(4,298)		(1,240)
Inventories		(4,142)		(4,084)
Prepaid expenses and other current assets		371		(193)
Accounts payable and accrued expenses		4,854		1,573
Accrued salaries and wages and long term liabilities		(239)		290
Accrued warranty reserve		(2,911)		(3,554)
Deferred revenue		(444)		3,560
Net cash used in operating activities		(11,661)		(13,475)
Cash Flows from Investing Activities:				
Expenditures for property and equipment		(783)		(876)
Net cash used in investing activities		(783)		(876)
Cash Flows from Financing Activities:				
Net (repayments of) proceeds from revolving credit facility		(272)		2,390
Repayment of notes payable and capital lease obligations		(393)		(309)
Net cash used in employee stock-based transactions		(91)		(29)
Proceeds from exercise of common stock warrants		5,954		4,260
Net cash provided by financing activities		5,198		6,312
Net decrease in Cash and Cash Equivalents		(7,246)		(8,039)
Cash and Cash Equivalents, Beginning of Period		38,817		49,952
Cash and Cash Equivalents, End of Period	$	31,571	$	41,913
Supplemental Disclosures of Cash Flow Information:				
Cash paid during the period for:				
Interest	$	380	$	440
Income taxes	$	72	$	586
Supplemental Disclosures of Non-Cash Information:				

Included in accounts payable at December 31, 2013 and 2012, is $10 thousand and $16 thousand of accrued purchases of property and equipment, respectively.

During the nine months ended December 31, 2013 and 2012, the Company incurred $491 thousand and $476 thousand, respectively, in connection with the renewal of insurance contracts, which was financed by notes payable.

During the nine months ended December 31, 2013, the Company incurred $158 thousand of capital expenditures that were funded by capital lease borrowings. There were no capital expenditures funded by capital lease borrowings during the nine months ended December 31, 2012.

See accompanying notes to condensed consolidated financial statements.

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CAPSTONE TURBINE CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Business and Organization

Capstone Turbine Corporation (Capstone or the Company) develops, manufactures, markets and services microturbine technology solutions for use in stationary distributed power generation applications, including cogeneration (combined heat and power (CHP), integrated combined heat and power (ICHP), and combined cooling, heat and power (CCHP)), renewable energy, natural resources and critical power supply. In addition, the Company s microturbines can be used as battery charging generators for hybrid electric vehicle applications. The Company was organized in 1988 and has been producing its microturbine generators commercially since 1998.

The Company has incurred significant operating losses since its inception. Management anticipates incurring additional losses until the Company can produce sufficient revenue to cover its operating costs. To date, the Company has funded its activities primarily through private and public equity offerings.

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 GAAP for complete financial statements. The condensed consolidated balance sheet at March 31, 2013 was derived from audited financial statements included in the Company s Annual Report on Form 10-K for the year ended March 31, 2013. In the opinion of management, the interim condensed consolidated financial statements include all adjustments (consisting of 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 year ended March 31, 2013. 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.

The consolidated financial statements have been prepared assuming the Company will continue as a going concern, which contemplates the realization of assets and satisfaction of liabilities in the normal course of business. The Company s loss from operations for the third quarter of Fiscal 2014 and 2013 was $1.9 million and $4.4 million, respectively. Management believes the Company s net loss from operations will continue to decrease as the Company makes overall progress on its path to profitability. The Company s cash and cash equivalents as of December 31, 2013 and March 31, 2013 were $31.6 million and $38.8 million, respectively.

Management believes that existing cash and cash equivalents are sufficient to meet the Company s anticipated cash needs for working capital and capital expenditures for at least the next twelve months; however, if the Company s anticipated cash needs change, it is possible that the Company may need to raise additional capital. The Company may seek to raise funds by selling additional securities to the public or to selected investors or by obtaining additional debt financing. There is no assurance that the Company will be able to obtain additional funds on commercially favorable terms or at all. If the Company raises additional funds by issuing additional equity or convertible debt securities, the fully diluted ownership percentages of existing stockholders will be reduced. In addition, any equity or debt securities that the Company would issue may have rights, preferences or privileges senior to those of the holders of its common stock. The Company s Credit and Security Agreements (the Agreements) with Wells Fargo Bank, National Association (Wells Fargo) will terminate in accordance with their terms on September 30, 2014. The Company expects to renew the Agreements with Wells Fargo prior to their termination, but there is no assurance that the Agreements will be renewed. Please see Note 11 Revolving Credit Facility for further discussion of the Agreements with Wells Fargo.

The condensed consolidated financial statements include the accounts of the Company, Capstone Turbine Singapore, Pte. Ltd., its wholly owned subsidiary that was formed in February 2011, and Capstone Turbine International, Inc., its wholly owned subsidiary that was formed in June 2004, after elimination of inter-company transactions.

3. Recently Issued Accounting Standards

In July 2013, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2013-11, Income Taxes (Topic 740) Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a

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Similar Tax Loss, or a Tax Credit Carryforward Exists. ASU 2013-11 defines the criteria as to when an unrecognized tax benefit should be presented as a liability and when it should be netted against a deferred tax asset on the face of the balance sheet. ASU 2013-11 is effective for fiscal years beginning after December 15, 2013. The Company does not believe that the adoption of the provisions of ASU 2013-11 will have a material impact on its consolidated financial position or results of operations.

In February 2013, FASB issued ASU 2013-02, Comprehensive Income (Topic 220), Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income, effective for annual and interim reporting periods beginning after December 15, 2012. The new accounting rules require all U.S. public companies to report the effect of items reclassified out of accumulated other comprehensive income on the respective line items of net income, net of tax, either on the face of the financial statements where net income is presented or in a tabular format in the notes to the financial statements. The Company adopted this updated guidance with no impact on its consolidated financial position or results of operations.

4. Customer Concentrations and Accounts Receivable

Sales to E-Finity Distributed Generation, LLC (E-Finity), Horizon Power Systems (Horizon) and Regatta Solutions, Inc. (Regatta), three of the Company s domestic distributors, accounted for 18%, 16% and 11%, respectively, of revenue for the three months ended December 31, 2013. Sales to Horizon and BPC Engineering (BPC), one of the Company s Russian distributors, accounted for 20% and 11%, respectively, of revenue for the three months ended December 31, 2012. E-Finity, BPC and Horizon accounted for 21%, 14% and 13% of revenue, respectively, for the nine months ended December 31, 2013. For the nine months ended December 31, 2012, Horizon and BPC accounted for 28% and 13% of revenue, respectively.

Additionally, BPC, E-Finity and ADA Engineering Co., Ltd, the Company s Vietnamese distributor, accounted for 24%, 22% and 11%, respectively, of net accounts receivable as of December 31, 2013. BPC and Regatta accounted for 35% and 11%, respectively, of net accounts receivable as of March 31, 2013.

5. Inventories

Inventories are valued at a first in first out (FIFO) basis and lower of cost or market and consisted of the following as of December 31, 2013 and March 31, 2013 (in thousands):

	December 31, 2013	March 31, 2013
Raw materials	$ 23,656	$ 20,198
Finished goods	1,425	1,567
Total	25,081	21,765
Less non-current portion	(2,995)	(3,252)
Current portion	$ 22,086	$ 18,513

The non-current portion of inventories represents that 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 product configurations. The weighted average age of the non-current portion of inventories on hand as of December 31, 2013 is 1.8 years. The Company expects to use the non-current portion of the inventories on hand as of December 31, 2013, over the periods presented in the following table (in thousands):

Expected Period of Use	**Non-current Inventory Balance**
13 to 24 months	$ 2,279
25 to 36 months	461
37 to 48 months	255
Total	$ 2,995

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6. Property, Plant and Equipment

The Company recorded depreciation expense of $0.4 million and $1.4 million for the three and nine months ended December 31, 2013, respectively. The Company recorded depreciation expense of $0.6 million and $1.8 million for the three and nine months ended December 31, 2012, respectively. Property, plant and equipment consisted of the following as of December 31, 2013 and March 31, 2013 (in thousands):

	December 31, 2013	March 31, 2013
Machinery, rental equipment, equipment, automobiles and furniture	$ 21,365	$ 20,649
Leasehold improvements	9,728	9,708
Molds and tooling	5,111	4,933
	36,204	35,290
Less accumulated depreciation	(33,109)	(31,747)
Total property, plant and equipment, net	$ 3,095	$ 3,543

7. Intangible Assets

The Company recorded amortization expense of $0.1 million and $0.4 million for the three and nine months ended December 31, 2013, respectively. Intangible assets consisted of the following as of December 31, 2013 (in thousands):

	December 31, 2013			
	Weighted Average Amortization Period	Intangible Assets, Gross	Accumulated Amortization	Intangible Assets, Net
Manufacturing license	17 years	$ 3,700	$ 3,524	$ 176
Technology	10 years	2,240	877	1,363
Parts and service customer relationships	5 years	1,080	846	234
TA100 customer relationships	2 years	617	617	
Backlog	Various	490	351	139
Trade name	1.2 years	69	69	
Total		$ 8,196	$ 6,284	$ 1,912

The Company recorded amortization expense of $0.1 million and $0.4 million for the three and nine months ended December 31, 2012, respectively. Intangible assets consisted of the following as of March 31, 2013 (in thousands):

	March 31, 2013			
	Weighted Average Amortization Period	Intangible Assets, Gross	Accumulated Amortization	Intangible Assets, Net
Manufacturing license	17 years	$ 3,700	$ 3,487	$ 213

Technology	10 years	2,240	709	1,531
Parts and service customer relationships	5 years	1,080	684	396
TA100 customer relationships	2 years	617	617	
Backlog	Various	490	317	173
Trade name	1.2 years	69	69	
Total		$ 8,196	$ 5,883	$ 2,313

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Expected future amortization expense of intangible assets as of December 31, 2013 is as follows:

	Amortization Expense (In thousands)
2014 (remainder of fiscal year)	$ 180
2015	533
2016	273
2017	273
2018	242
Thereafter	411
Total expected future amortization	$ 1,912

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 $15,000 and $19,500 were earned by Solar for the three months ended December 31, 2013 and 2012, respectively. Royalties of approximately $62,300 and $52,100 were earned by Solar for the nine months ended December 31, 2013 and 2012, respectively. Earned royalties of approximately $15,000 and $24,600 were unpaid as of December 31, 2013 and March 31, 2013, 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 stock-based compensation expense as it is associated with each of the operations line items listed below (in thousands):

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2013	2012	2013	2012
Cost of goods sold	$ 13	$ 23	$ 34	$ 76
Research and development	73	91	490	240
Selling, general and administrative	395	367	1,140	861
Stock-based compensation expense	$ 481	$ 481	$ 1,664	$ 1,177

Stock Plans

2000 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 27,980,000 shares.

As of December 31, 2013, the Company had outstanding 3,550,000 non-qualified common stock options issued outside of the 2000 Plan. The Company granted 250,000 of these stock options during the second quarter of Fiscal 2013, 250,000 of these stock options during the first quarter of Fiscal 2012 and 3,050,000 of the options prior to Fiscal 2008 as inducement grants to new officers and employees of the Company, with exercise prices equal to the fair market value of the Company s common stock on the grant date. Included in the 3,550,000 options were 2,000,000 options granted to the Company s President and Chief Executive Officer, 850,000 options granted to the Company s Executive Vice President of Sales and Marketing, 250,000 options granted to the Company s Senior Vice President of Program Management, 250,000 options granted to the Company s Senior Vice President of Customer Service and 200,000 options granted to the Company s former Senior Vice President of Human Resources. Additionally, as of December 31, 2013, the Company had outstanding 46,875 restricted stock units issued outside of the 2000 Plan. These restricted stock units were issued during the second quarter of Fiscal 2013 as an inducement grant to the Company s Senior Vice President of Customer Service. Although the options and restricted stock units were not granted under the 2000 Plan, they are governed by terms and conditions identical to those under the 2000 Plan. 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. All outstanding options have a contractual term of ten years. The restricted stock units vest in equal installments over a period of four years. Information relating to all outstanding stock options, except for rights associated with the Amended and Restated 2000 Employee Stock Purchase Plan, is as follows:

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	Shares	Weighted Average Exercise Price	Weighted-Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value
Options outstanding at March 31, 2013	11,791,765	$ 1.33		
Granted	1,665,200	0.93		
Exercised	(13,022)	1.01		
Forfeited, cancelled or expired	(107,830)	1.15		
Options outstanding at December 31, 2013	13,336,113	$ 1.29	5.37	$ 2,695,890
Options fully vested at December 31, 2013 and those expected to vest beyond December 31, 2013	13,103,969	$ 1.29	5.31	$ 2,620,410
Options exercisable at December 31, 2013	10,059,889	$ 1.36	4.27	$ 1,737,651

The weighted average per share grant date fair value of options granted during the nine months ended December 31, 2013 and 2012 was $0.93 and $1.01, respectively. The weighted average per share grant date fair value of options exercised during the three and nine months ended December 31, 2013 was $1.01. The total intrinsic value of options exercised during each of the three and nine months ended December 31, 2013 was approximately $10,000. There were no options exercised during each of the three or nine months ended December 31, 2012. The Company recorded expense of approximately $0.2 million and $0.3 million associated with its stock options during the three months ended December 31, 2013 and 2012, respectively. The Company recorded expense of approximately $0.9 million and $0.7 million associated with its stock options during the nine months ended December 31, 2013 and 2012, respectively. As of December 31, 2013, there was approximately $1.9 million of total compensation cost related to unvested stock option awards that is expected to be recognized as expense over a weighted average period of 2.7 years.

There were no options granted during the three months ended December 31, 2013 and 2012. The Company calculated the estimated fair value of each stock option granted during the nine months ended December 31, 2012 and 2013 on the date of grant using the Black-Scholes option-pricing model and the following weighted-average assumptions:

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2013	2012	2013	2012
Risk-free interest rates	%	%	0.9%	0.8%
Expected lives (in years)			5.7	5.7
Dividend yield	%	%	%	%
Expected volatility	%	%	77.3%	79.8%

The Company s computation of expected volatility for the nine months ended December 31, 2013 and 2012 was based on historical volatility. The expected life, or term, of options granted is derived from historical exercise behavior and represents the period of time that stock option awards are expected to be outstanding. Management has selected a risk-free rate based on the implied yield available on U.S. Treasury Securities with a maturity equivalent to the options expected terms. Stock-based compensation expense is based on awards that are ultimately expected to vest and accordingly, stock-based compensation recognized in the three and nine months ended December 31, 2013 and 2012 has been reduced by estimated forfeitures.

The following table outlines the restricted stock unit activity:

	Shares		Weighted Average Grant-Date Fair Value
Unvested restricted stock units outstanding at March 31, 2013	1,467,096	$	1.10
Granted	1,295,418		1.06
Vested and issued	(651,908)		1.06
Forfeited	(85,171)		1.09
Unvested restricted stock units outstanding at December 31, 2013	2,025,435	$	1.09
Restricted stock units expected to vest beyond December 31, 2013	1,836,615	$	1.09

The restricted stock units were 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 related compensation expense recognized has been reduced by estimated forfeitures. The Company s estimate of forfeitures is based on historical forfeitures.

The weighted average per share grant date fair value of restricted stock granted during the three months ended December 31, 2013 and 2012 was approximately $1.27 and $1.03, respectively. The weighted average per share grant date fair value of restricted stock granted during the nine months ended December 31, 2013 and 2012 was approximately $1.06 and $0.98, respectively. The total fair value of restricted stock units vested and issued by the Company during the three months ended December 31, 2013 and 2012 was approximately $33,000 and $0.2 million, respectively. The total fair value of restricted stock units vested and issued by the Company during the nine months ended December 31, 2013 and 2012 was approximately $0.8 million and $0.5 million, respectively. The Company recorded expense of approximately $0.3 million and $0.2 million associated with its restricted stock awards and units during the three months ended December 31, 2013 and 2012, respectively. The Company recorded expense of approximately $0.8 million and $0.5 million associated with its restricted stock awards and units during the nine months ended December 31, 2013 and 2012, respectively. As of December 31, 2013, there was approximately $1.6 million of total compensation cost related to unvested restricted stock units that is expected to be recognized as expense over a weighted average period of 2.6 years.

During the three months ended December 31, 2013 and 2012, the Company issued a total of 25,316 and 29,993 shares of stock, respectively, to non-employee directors who elected to take payment of all or any part of the directors fees in stock in lieu of cash. During the nine months ended December 31, 2013 and 2012, the Company issued a total of 73,478 and 74,200 shares of stock, respectively, to non-employee directors who elected to take payment of all or any part of the directors fees in stock in lieu of cash. The weighted average per share grant date fair value of shares of stock issued during the three months ended December 31, 2013 and 2012 was $1.16 and $0.95, respectively. The weighted average per share grant date fair value of shares of stock issued during the nine months ended December 31, 2013 and 2012 was $1.18 and $0.98, respectively.

Stockholder Rights Plan

The Company has entered into a rights agreement (as amended, the Rights Agreement) with Computershare, Inc. successor in interest to Mellon Investor Services LLC, as rights agent. In connection with the Rights Agreement, the Company s board of directors authorized and declared a dividend distribution of one preferred stock purchase right for each authorized and outstanding share of the Company s common stock. Each right entitles the registered holder to purchase from the Company a unit consisting of one one-hundredth of a share of Series A Junior Participating Preferred Stock, par value $0.001 per share, at a purchase price of $10.00 per unit, subject to adjustment. The description and terms of the rights are set forth in the Rights Agreement. Initially, the rights are attached to all common stock certificates representing shares then outstanding, and no separate rights certificates are distributed. Subject to certain exceptions specified in the Rights Agreement, the rights will separate from the common stock and will be exercisable upon the earlier of (i) 10 days following a public announcement that a person or group of affiliated or associated persons has acquired, or obtained the right to acquire, beneficial ownership of 20% or more of the outstanding shares of common stock, other than as a result of repurchases of stock by the Company or certain inadvertent actions by institutional or certain other stockholders, or (ii) 10 days (or such later date as the Company s Board of Directors shall determine) following the commencement of a tender offer or exchange offer (other than certain permitted offers described in the Rights Agreement) that would result in a person or group beneficially owning 20% or more of the outstanding shares of the Company s common stock. On June 9, 2011, the Company s Board of Directors unanimously approved a second amendment to the Rights Agreement, which was approved by the stockholders in August 2011. The second amendment adds an additional sunset provision, which provides that the Rights Agreement will expire on the 30th day after the 2014 annual meeting of stockholders unless continuation of the Rights Agreement is approved by the stockholders at that meeting. The second amendment also provides for an update to the definition of Beneficial Owner to include derivative interests in the calculation of a stockholder s ownership. In addition, the second amendment clarifies the manner in which the exchange provision of the Rights Agreement shall be effected. The rights are intended to protect the Company s stockholders in the event of an unfair or coercive offer to acquire the Company. Management believes the rights, however, should not affect any prospective offeror willing to make an offer at a fair price and otherwise in the best interests of the Company and its stockholders, as determined by the Board of Directors. Also, management believes the rights should also not interfere with any merger or other business combination approved by the Board of Directors.

9. Underwritten and Registered Direct Placements of Common Stock

Effective March 5, 2012, the Company completed a registered direct placement in which it sold 22.6 million shares of the Company s common stock, par value $.001 per share, and warrants to purchase 22.6 million shares of common stock with an initial exercise price of $1.55 per share, at a price of $1.11 per unit (the 2012 Warrants). Each unit consisted of one share of common stock and a warrant to purchase one share of common stock. The March 2012 sale resulted in net proceeds of approximately $23.1 million net of direct incremental costs of approximately $1.9 million. In addition, the Company obtained

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the right to require investors in the offering to purchase up to an aggregate maximum of 19.0 million additional shares of common stock from the Company (the Put Options) during two option exercise periods, the first such option exercise period beginning September 10, 2012 and the second such option exercise period beginning March 4, 2013. Each Put Option was subject to certain conditions which reduced the number of shares that could be sold or eliminate the Put Option. These conditions included a minimum volume-weighted average price (VWAP) and a minimum average trading volume of the Company s common shares during the 30 trading days prior to the exercise of the Put Option.

On September 18, 2012, the Company entered into an Investor Agreement with one of the investors in the 2012 registered direct offering pursuant to which the investor agreed to (i) waive the condition precedent to the Company s exercise of the Put Option requiring the arithmetic average of the average daily trading volumes during the measurement period set forth in the subscription agreement between the Company and the investor and on the exercise date be not less than 1.75 million shares and (ii) amend the subscription agreement to provide that the purchase price of the additional shares during the first exercise period would be discounted pursuant to a formula that resulted in a purchase price for the first exercise period of $0.94 per share. Additionally, pursuant to the Investor Agreement, the Company agreed to amend the exercise price of the 2012 Warrants originally issued to the investor to $1.26. The exercise of the first Put Option resulted in net proceeds of $4.2 million. On February 21, 2013, the Company entered into a letter agreement (each a Letter Agreement and, collectively, the Letter Agreements) with each of the investors in the 2012 registered direct offering. Pursuant to the Letter Agreements, the parties evidenced their mutual agreement that the Company would not exercise any portion of the second Put Option. The Company chose not to exercise the second of the two Put Options because of its improved cash position at the time and its desire to avoid stockholder dilution. On October 31, 2013, an unsolicited exercise of 2012 Warrants to purchase 4.7 million shares resulted in proceeds of approximately $6.0 million. Effective October 31, 2013, all remaining outstanding 2012 Warrants expired.

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 need to maximize the use of observable inputs and minimize the use of unobservable inputs.

The table below presents assets and liabilities that are measured at fair value on a recurring basis at December 31, 2013 and are categorized using the fair value hierarchy (in thousands):

		Fair Value Measurements at December 31, 2013		
	Total	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
Cash Equivalents	$ 16,737	$ 16,737	$	$

Cash equivalents include cash held in money market and U.S. treasury funds at December 31, 2013.

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The table below presents our assets and liabilities that are measured at fair value on a recurring basis during the fiscal year ended March 31, 2013 and are categorized using the fair value hierarchy (in thousands):

	Total	Fair Value Measurements at March 31, 2013 Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash Equivalents	$ 27,742	$ 27,742	$	$
Warrant Liability	$ (10)	$	$	$ (10)

Basis for Valuation

The carrying values reported in the 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. As the Company s obligations under the revolving credit facility are based on adjustable market interest rates, the Company has determined that the carrying value approximates the fair value. The carrying values and estimated fair values of these obligations are as follows (in thousands):

	As of December 31, 2013		As of March 31, 2013	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
Obligations under the credit facility	$ 13,204	$ 13,204	$ 13,476	$ 13,476

The fair value of the Company s warrant liability recorded in the Company s financial statements as of March 31, 2013 was determined using the Monte Carlo simulation valuation method and the quoted price of the Company s common stock in an active market, a Level 3 measurement. Volatility was based on the actual market activity of the Company s stock. The expected life was based on the remaining contractual term of the warrants and the risk free interest rate is based on the implied yield available on U.S. Treasury Securities with a maturity equivalent to the warrants expected life. The Company s use of different estimates and assumptions could produce different financial results.

From time to time, the Company has sold common stock warrants that are derivative instruments. The Company does not enter into speculative derivative agreements and does not enter into derivative agreements for the purpose of hedging risks.

As discussed above, the Company adopted authoritative guidance issued by the FASB on contracts in an entity s own equity that requires the common stock warrants to be classified as liabilities at their estimated fair value with changes in fair value at each reporting date recognized in the statement of operations.

11. Revolving Credit Facility

The Company maintains the Agreements with Wells Fargo, which provide the Company with a line of credit of up to $15.0 million in the aggregate (the Credit Facility). The amount actually available to the Company may be less and may vary from time to time depending on, among other factors, the amount of its eligible inventory and accounts receivable. As security for the payment and performance of the Credit Facility, the Company granted a security interest in favor of Wells Fargo in substantially all of the assets of the Company. The Agreements will terminate in accordance with their terms on September 30, 2014 unless terminated sooner.

The Agreements include affirmative covenants as well as negative covenants that prohibit a variety of actions without Wells Fargo s consent, including covenants that limit the Company s ability to (a) incur or guarantee debt, (b) create liens, (c) enter into any merger, recapitalization or similar transaction or purchase all or substantially all of the assets or stock of another entity, (d) pay dividends on, or purchase, acquire, redeem or retire shares of, the Company s capital stock, (e) sell, assign, transfer or otherwise dispose of all or substantially all of the Company s assets, (f) change the Company s accounting method or (g) enter into a different line of business. Furthermore, the Agreements contain financial covenants, including (a) a requirement not to exceed specified levels of losses, (b) a requirement to maintain a substantial minimum cash balance relative to the outstanding line of credit advances. The minimum cash balance requirement was $18.4 million as of December 31, 2013, and (c) limitations on the Company s annual capital expenditures. The Agreements also define an event of default to include a material adverse effect on the Company s business, as determined by Wells Fargo. An event of default for this or any other reason, if not waived, would have a material adverse effect on the Company.

The Company has pledged its accounts receivable, inventories, equipment, patents and other assets as collateral for the Credit Facility, which would be subject to seizure by Wells Fargo if the Company were in default under the Agreements and unable to repay the indebtedness. Wells Fargo also has the option to terminate the Agreements or accelerate the indebtedness during a period of noncompliance. On June 7, 2013, the Company entered into an amendment to the Agreements which set the

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financial covenants for Fiscal 2014. As of December 31, 2013 the Company determined that it was not in compliance with the financial covenant contained in the amended Agreements regarding the Company s net income for the nine months ended December 31, 2013. On January 31, 2014, the Company received from Wells Fargo a waiver of the Company s noncompliance with the financial covenant regarding its net income for the nine months ended December 31, 2013. Based on the Company s current forecasts and following the waiver of noncompliance described above, the Company believes it will maintain compliance with the covenants contained in the amended Agreements for the remainder of the term of the Agreements. If an additional subsequent covenant violation were to occur, the Company would attempt to negotiate a waiver of compliance from Wells Fargo.

The Company is required to maintain a Wells Fargo collection account for cash receipts on all of its accounts receivable. These amounts are immediately applied to reduce the outstanding amount on the Credit Facility. The floating rate for line of credit advances is the sum of daily three month London Inter Bank Offer Rate (LIBOR), which interest rate shall change whenever daily three month LIBOR changes, plus applicable margin. Based on the revolving nature of the Company s borrowings and payments, the Company classifies all outstanding amounts as current liabilities. The applicable margin varies based on net income and the minimum interest floor is set at $66,000 each calendar quarter. The Company s borrowing rate at December 31, 2013 and March 31, 2013 was 4.0% and 5.4%, respectively.

The Company incurred $0.1 million in origination fees in connection with a September 2011 amendment to the Agreements that increased borrowing capacity and extended the maturity date of the Credit Facility. These fees were capitalized and are being amortized to interest expense through September 2014. The Company is also required to pay an annual unused line fee of one-quarter of one percent of the daily average of the maximum line amount and 1.5% interest with respect to each letter of credit issued by Wells Fargo. These amounts, if any, are also recorded as interest expense by the Company. As of December 31, 2013 and March 31, 2013, $13.2 million and $13.5 million in borrowings were outstanding, respectively, under the Credit Facility. Interest expense related to the Credit Facility during the three months ended December 31, 2013 was $0.2 million, which includes $0.1 million in amortization of deferred financing costs. Interest expense related to the Credit Facility during the three months ended December 31, 2012 was $0.2 million, which includes $0.1 million in amortization of deferred financing costs. Interest expense related to the Credit Facility during the nine months ended December 31, 2013 was $0.5 million, which includes $0.2 million in amortization of deferred financing costs. Interest expense related to the Credit Facility during the nine months ended December 31, 2012 was $0.6 million, which includes $0.1 million in amortization of deferred financing costs.

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 product sold, the location of the sale and the length of extended warranties sold. The Company s product warranties generally start from the delivery date and continue for up to 18 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 related to addressing reliability repairs on products covered under standard warranty and for products no longer in warranty when, in the Company s judgment, 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 taken into account in estimating future warranty liabilities.

Changes in accrued warranty reserve during the nine months ended December 31, 2013 are as follows (in thousands):

Balance, beginning of the period	$	2,299

Standard warranty provision		2,323
Changes for accrual related to reliability repair programs		1,054
Deductions for warranty claims		(2,911)
Balance, end of the period	$	2,765

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13. Deferred Revenue

Changes in deferred revenue are as follows during the nine months ended December 31, 2013 (in thousands):

FPP Balance, beginning of the period	$	1,412
FPP Billings		5,635
FPP Revenue recognized		(5,142)
Balance attributed to FPP contracts		1,905
Deposits		740
Deferred revenue balance, end of the period	$	2,645

Comprehensive Factory Protection Plan (FPP) deferred revenue represents the unearned portion of our agreements. FPP agreements 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.

14. Other Current Liabilities

In September 2007, the Company entered into a Development and License Agreement (the Development Agreement) with UTC Power Corporation (UTCP), a division of United Technologies Corporation. The Development Agreement engaged UTCP to fund and support the Company s continued development and commercialization of the Company s 200 kilowatt (C200) microturbine. Pursuant to the terms of the Development Agreement, UTCP contributed $12.0 million in cash and approximately $0.8 million of in-kind services toward the Company s efforts to develop the C200. In return, the Company agreed to pay UTCP an ongoing royalty of 10% of the sales price of the C200 sold to customers other than UTCP until the aggregate of UTCP s cash and in-kind services investment was recovered and, thereafter, the royalty would be reduced to 5% of the sales price. In August 2009, the Development Agreement was assigned by UTCP to Carrier Corporation (Carrier).

On January 14, 2011, the Company entered into an amendment to the Development Agreement with Carrier that amended the royalty payment from a certain percentage of the sales prices to a predetermined fixed rate for each microturbine system covered by the amendment. The fixed rate royalty was reduced during the three months ended September 30, 2013 by 50% because the repayment of Carrier s cash and in-kind services investment was completed. Carrier earned $0.6 million and $0.9 million in royalties for C200 and C1000 Series system sales during the three months ended December 31, 2013 and 2012, respectively. Carrier earned $2.2 million and $2.9 million in royalties for C200 and C1000 system sales during the nine months ended December 31, 2013 and 2012, respectively. Earned royalties of $0.6 million and $1.4 million were unpaid as of December 31, 2013 and March 31, 2013, respectively, and are included in accounts payable and accrued expenses in the accompanying condensed consolidated balance sheets.

15. Commitments and Contingencies

Purchase Commitments

As of December 31, 2013, the Company had firm commitments to purchase inventories of approximately $40.2 million through Fiscal 2015. Certain inventory delivery dates and related payments are not firmly scheduled; therefore, amounts under these firm purchase commitments will be payable upon the receipt of the related inventories.

Lease Commitments

The Company leases offices and manufacturing facilities under various non-cancelable operating leases expiring at various times through the fiscal year ending March 31, 2018. All of the leases require the Company to pay maintenance, insurance and property taxes. The lease agreements for primary office and manufacturing facilities provide for rent escalation over the lease term and renewal options for five-year periods. Rent expense is recognized on a straight-line basis over the term of the lease. The difference between rent expense recorded and the amount paid is credited or charged to deferred rent, which is included in other long-term liabilities in the accompanying balance sheets. The balance of deferred rent was approximately $0.1 million as of December 31, 2013 and March 31, 2013, respectively. Rent expense was approximately $0.6 million and $0.5 million during the three months ended December 31, 2013 and 2012, respectively. Rent expense was approximately $1.7 million and $1.6 million during the nine months ended December 31, 2013 and 2012, respectively.

Other Commitments

In September 2010, the Company was awarded a grant from the U.S. Department of Energy (DOE) for the research, development and testing of a more efficient microturbine CHP system. Part of the improved efficiency will come from an improved microturbine design, with a projected electrical efficiency of 42% and power output of 370 kW. The project is estimated to cost approximately $15.0 million. The DOE will contribute $5.0 million toward the project, and the Company will incur approximately $12.4 million in research and development expense. The contract is over a five-year period and will be completed by September 2015. The Company billed the DOE under the contract for this project a cumulative amount of $3.3 million through December 31, 2013.

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In November 2009, the Company was awarded a grant from the DOE for the research, development and testing of a more fuel flexible microturbine capable of operating on a wider variety of biofuels. This program concluded in August 2013 and the Company billed the DOE a cumulative amount of $1.4 million under this contract.

The Company has agreements with some of its distributors requiring it to replace stocked parts if the Company renders parts obsolete in inventories the distributors own and hold in support of their obligations to serve fielded microturbines without charge 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 by distributors. As of December 31, 2013 and March 31, 2013, no significant inventories were held at distributors.

Legal Matters

From time to time, the Company may become subject to certain legal proceedings, claims and litigation arising in the ordinary course of business. In the opinion of management, the Company is not currently a party to any material legal proceedings, nor is the Company aware of any pending or threatened litigation that would have a material effect on the Company s operating results, cash flows, financial position or results of operations should such litigation be resolved unfavorably.

16. Net Income (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, 2013 which would make these instruments anti-dilutive. As of December 31, 2013 and 2012, the number of anti-dilutive stock options and restricted stock units excluded from diluted net loss per common share computations was approximately 15.4 million and 13.2 million, respectively. As of December 31, 2013, the Company did not have any warrants outstanding. As of December 31, 2012, the number of warrants excluded from diluted net loss per common share computations was approximately 26.5 million.

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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 the year ended March 31, 2013. 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 2013 and in other reports we file with the SEC. Readers are cautioned not to place undue reliance on forward-looking statements, which speak only as of the date hereof. All dollar amounts are approximate.

Overview

Capstone is the market leader in microturbines based on the number of microturbines sold. During the third quarter of Fiscal 2014, we decreased our net loss by 51% to $2.2 million compared to the same period last year and held our net loss per share to $0.01. We continue to remain focused on improving our gross margin. Our gross margin was 20% for the third quarter of Fiscal 2014, which represents an increase of over 600 basis points from our gross margin of 14% for the third quarter of Fiscal 2013. Management believes that our ongoing efforts in manufacturing cost reduction and product robustness were the primary reasons for our gross margin and net loss improvement during the third quarter of Fiscal 2014 compared to the third quarter of the prior year. The first nine months of Fiscal 2014 were characterized by overall higher sales volume for our microturbine products led by the natural resources vertical market. In addition, the European market is showing signs of improvement with an increase in revenue of 34%, primarily from Russia, compared to the same period last year. During the first nine months of Fiscal 2014, warranty expense for C200 and C1000 Series systems declined compared to the first nine months of Fiscal 2013. Management expects per unit warranty rates for C200 and C1000 Series systems to decline during Fiscal 2014 as reliability repair programs are completed and the products mature.

Capstone products continue to gain interest in all five of the major vertical markets (energy efficiency, renewable energy, natural resources, critical power/power security and mobile products). 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 continues to be a significant portion of our business as we ship products around the globe for applications fueled by landfill gas, biodiesel, biogas such as food processing and agricultural waste, referred to as green waste, and cow, pig and chicken manure. Our C1000 Series microturbine continues to drive our near term business success in the oil and gas and other natural resource markets as we gain product acceptance in U.S. shale plays and Russian oil fields. Our critical power and power security initial installations are performing well, and we continue to focus efforts on gaining market share in this segment. Capstone s mobile products market, which utilizes microturbines for the marine and electric vehicle industry, is gaining interest as liquid natural gas becomes more readily available as a transportation fuel and as emission regulations continue to be tightened on the diesel engine industry.

To support our opportunities to grow in our targeted markets, we continue to enhance the reliability and performance of our products by regularly developing new processes and enhancing training to assist those who apply, install and use our products.

An overview of our direction, targets and key initiatives 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 and mobile 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.

Energy Efficiency CHP/CCHP

Energy efficiency maximizes the use of energy produced by the microturbines, reduces emissions compared with traditional power generation and enhances the economic advantage to customers. Energy efficiency applications use both the heat and electric energy produced in the power generation process. Using the heat and electricity created from a single combustion process increases the efficiency of the system from approximately 30% to 75% or more. The increased operating efficiency reduces overall greenhouse gas emissions compared with traditional independent sources such as power generation and local thermal generation and, through displacement of other separate systems, can reduce variable production costs.

Renewable Energy

Our microturbines can use renewable methane gases from landfills, wastewater treatment facilities and other biogas applications such as food processing and agricultural waste, referred to as green waste, and cow, pig and chicken manure. Capstone s microturbines can burn these renewable waste gases with minimal emissions, thereby, in some

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cases, avoiding the imposition of penalties incurred for pollution while simultaneously producing electricity from this free renewable fuel for use at the site or in the surrounding area. Capstone s microturbines have demonstrated effectiveness in these applications and outperform conventional combustion engines in a number of situations, including when the gas contains a high amount of sulfur.

Natural Resources Oil, Natural Gas, Shale Gas & Mining

On a worldwide basis, there are thousands of locations where the drilling, production, compression and transportation of natural resources and other extraction and production processes create fuel byproducts, which traditionally have been released or burned into the atmosphere. Our microturbines are installed in the natural resource market to be used in oil and gas exploration, production, compression and transmission sites both onshore and offshore as a highly reliable critical source of power generation. In addition, our microturbines can use flare gas as a fuel to provide prime power. Typically these oil and gas or mining operations have no access to an electric utility grid and rely solely on Capstone s microturbines for a reliable low emission power supply.

Critical Power Supply

Because of the potentially catastrophic consequences of even momentary system failure, certain power users, such as high technology and information systems companies, require particularly high levels of reliability in their power service. Management believes that Capstone s critical power supply offerings are the world s only microturbine powered Uninterruptible Power Source solutions that can offer clean, IT-grade power produced from microturbines, the utility or a combination of both.

Mobile Products Hybrid Electric Vehicles

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

Mobile Products Marine

Our technology is also used in marine applications. Our customers have applied our products in the commercial vessel and luxury yacht markets. The most immediate market for our marine products is for use as ship auxiliaries. 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. The other application is similar to our HEV application where the vessel is driven by an electric propulsion system and the microturbine serves as an onboard range extender.

Backlog

During the three months ended December 31, 2013, we booked total orders of $40.5 million for 109 units, or 46.0 megawatts, compared to $21.7 million for 137 units, or 22.4 megawatts, during the three months ended December 31, 2012. We shipped 162 units with an aggregate of 28.7 megawatts, generating microturbine product revenue of $29.9 million during the three months ended December 31, 2013 compared to 166 units with an aggregate of 26.1 megawatts, generating microturbine product revenue of $26.3 million during the three months ended December 31, 2012. Total backlog as of December 31, 2013 increased $23.9 million, or 18%, to $160.4 million from $136.5 million as of December 31, 2012. As of December 31, 2013, we had 722 units, or 178.4 megawatts, in total backlog compared to 646 units, or 152.0 megawatts, at the same date last year. The timing of the backlog is based on the requirement date indicated by our customers. However, based on historical experience, management expects that a significant portion of our backlog may not be shipped within the next twelve months. 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. Our actual product shipments during the three months ended December 31, 2013 were: 59% for use in natural resources applications, 19% for use in energy efficiency applications, 3% for use in renewable energy applications and 19% for use in other applications (including critical power supply and mobile products).

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The following table summarizes our backlog:

	As of December 31,			
	2013		2012	
	Megawatts	Units	Megawatts	Units
C30	3.2	106	3.2	106
C65	27.2	419	21.2	327
TA100	1.9	19	2.3	23
C200	3.8	19	12.2	61
C600	9.0	15	8.4	14
C800	8.0	10	6.4	8
C1000	124.0	124	97.0	97
Waste heat recovery generator	1.3	10	1.3	10
Total Backlog	178.4	722	152.0	646

2. ***Sales and Distribution Channels*** We seek out distributors that have business experience and capabilities to support our growth plans in our targeted markets. We have a total of 99 distributors and Original Equipment Manufacturers (OEMs). In North America, we currently have 32 distributors and OEMs. Internationally, outside of North America, we currently have 67 distributors and OEMs. We continue to refine the distribution channels to address our specific targeted markets.

3. ***Service*** We provide service primarily through our global distribution network and offer new and remanufactured parts as well as a comprehensive FPP. Through our global distribution network, we offer a comprehensive FPP for a fixed annual fee to perform regularly scheduled and unscheduled maintenance as needed. In January 2011, we expanded the FPP to include total microturbine plant operations if required by the end use customer. Capstone provides factory and onsite 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, 2013 was $45.2 million, which represents the value of the contractual agreements for FPP services that has not been earned and extends through Fiscal 2029.

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, TA100, 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. We are currently focusing efforts on enhancing our products to improve reliability, reduce direct material costs, and be compliant with the new stringent European power grid requirements. We are also developing a more efficient microturbine CHP system with the DOE. The first phase of the development program has successfully achieved 270 kW with a prototype C250 engine. Capstone plans to continue development of the engine as well as power electronics and software controls required for successful commercialization. The second phase of the program is expected to incorporate further engine efficiency improvements, resulting in a product with a projected electrical efficiency of 42% and targeted power output of 370 kW. The DOE awarded us a grant of $5.0 million in support of this development program.

6. ***Cost and Core Competencies*** We believe that the core competencies of Capstone 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.

Management believes 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, our financial model anticipates that we will achieve positive cash flow when we ship approximately 200 units in a quarter, dependent on an

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assumed product mix. Management believes our manufacturing facilities located in Chatsworth and Van Nuys, California have a combined production capacity of approximately 2,000 units per year, depending on product mix. Excluding working capital requirements, management believes we can expand our combined production capacity to approximately 4,000 units per year, depending on product mix, with approximately $10.0 to $15.0 million of capital expenditures. We have not committed to this expansion nor identified a source for its funding.

Critical Accounting Policies and Estimates

The preparation of our 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 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 consolidated financial statements. These policies (except as noted below) are described in greater detail in our Annual Report on Form 10-K for Fiscal 2013 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;
- Allowance for doubtful accounts;
- Deferred tax assets and valuation allowance;
- Stock-based compensation expense;
- Loss contingencies; and
- Fair value of financial instruments.

Results of Operations

Three Months Ended December 31, 2013 and 2012

Revenue - Revenue for the three months ended December 31, 2013 increased $3.7 million, or 11%, to $37.0 million from $33.3 million for the three months ended December 31, 2012. The change in revenue for the three months ended December 31, 2013 compared to the three months ended December 31, 2012 included increases in revenue of $2.6 million from the North American market, $1.1 million from the African market, $0.9 million from the South American market and $0.5 million from the European market. The increase in the North American market was primarily because of a change in product mix of microturbine units shipped in this market during the three months ended December 31, 2013 compared to the same period last year. The increase in the African market was primarily the result of further market adoption of our products in this market. The increase in the European market was primarily related to higher sales into the Russian natural resources vertical market. This overall increase in revenue was offset by decreases in revenue of $1.0 million from the Australian market and $0.4 million from the Asian market. The decrease in the Australian market was primarily a result of a shift in certain customers project timelines compared to the same period last year. The decrease in the Asian market was primarily the result of a change in product mix of microturbine units shipped during the three months ended December 31, 2013 compared to the same period last year.

Megawatts shipped and revenue per unit during the three months ended December 31, 2013 increased as a result of higher sales volume of our C65 microturbine and C1000 Series product line. For the three months ended December 31, 2013, revenue from microturbine products increased $3.6 million, or 14%, to $29.9 million from $26.3 million for the three months ended December 31, 2012. Microturbine megawatts shipped during the three months ended December 31, 2013 increased 2.6 megawatts to 28.7 megawatts from 26.1 megawatts for the three months ended December 31, 2012. Microturbine units shipped during the three months ended December 31, 2013 decreased by four units to 162 units from 166 units for the three months ended December 31, 2012. Average revenue per unit increased for the three months ended December 31, 2013 to approximately $184,000 compared to approximately $158,000 per unit for the three months ended December 31, 2012.

For the three months ended December 31, 2013, revenue from our accessories, parts and service increased $0.1 million, or 1%, to $7.1 million from $7.0 million for the three months ended December 31, 2012. The increase in revenue resulted primarily from higher FPP contract enrollment and sales of microturbine parts offset by lower sales of microturbine service work.

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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. Therefore, we evaluate historical revenue in conjunction with backlog to anticipate the growth trend of our revenue.

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

	Three Months Ended December 31,					
	2013			2012		
	Revenue	Megawatts	Units	Revenue	Megawatts	Units
C30	$ 1.0	0.6	19	$ 2.5	1.6	54
C65	7.7	6.8	105	5.3	4.8	73
TA100	0.1	0.1	1	1.1	0.5	5
C200	5.0	3.6	18	2.6	2.6	13
C600	1.1	1.2	2	5.3	5.4	9
C800	2.3	2.4	3	3.1	3.2	4
C1000	12.7	14.0	14	6.4	8.0	8
Total from Microturbine Products	$ 29.9	28.7	162	$ 26.3	26.1	166
Accessories, Parts and Service	7.1			7.0		
Total	$ 37.0	28.7	162	$ 33.3	26.1	166

Sales to E-Finity Distributed Generation, LLC (E-Finity), Horizon Power Systems (Horizon) and Regatta Solutions, Inc. (Regatta), three of the Company s domestic distributors, accounted for 18%, 16% and 11%, respectively, of revenue for the three months ended December 31, 2013. Sales to Horizon, one of the Company s domestic distributors, and BPC Engineering (BPC), one of the Company s Russian distributors, accounted for 20% and 11%, respectively of revenue for the three months ended December 31, 2012.

Gross Margin Cost of goods sold includes direct material costs, production and service center labor and overhead, inventory provision and provision for estimated product warranty expenses. The gross margin was $7.3 million, or 20% of revenue, for the three months ended December 31, 2013 compared to a gross margin of $4.6 million, or 14% of revenue, for the three months ended December 31, 2012. The increase of $2.7 million in gross margin was primarily related to a $2.2 million improvement resulting from change in product mix of our microturbine products and lower direct material cost during the three months ended December 31, 2013. In addition, our royalty expense decreased $0.4 million and warranty expense decreased $0.1 million during the three months ended December 31, 2013 compared to the prior year. Management continues to implement initiatives to address warranty expense and to further reduce direct material costs as we work to achieve profitability.

Warranty expense is a combination of a standard warranty provision recorded at the time revenue is recognized and changes, if any, in estimates for reliability repair programs. Reliability repair programs are based upon estimates that are recorded in the period that new information becomes available, including design changes, cost of repair and product enhancements, which can include both in-warranty and out-of-warranty systems. The decrease in warranty expense of $0.1 million reflects a decrease in reliability repair programs, offset by an increase in the per unit standard warranty provision as a result of sales mix and higher volume of units under warranty during the three months ended December 31, 2013 compared to the prior year. Management expects per unit warranty rates for C200 and C1000 Series systems to decline as reliability repair programs are completed and these products mature.

Royalty expense decreased $0.4 million during the three months ended December 31, 2013 compared to the three months ended December 31, 2012 as a result of a reduction in the predetermined fixed rate royalty offset by higher volume of covered microturbine systems. We pay a predetermined fixed rate royalty for each microturbine system covered by our Development and License Agreement with Carrier. The fixed rate royalty was reduced by 50% because of the contractual reduction during the three months ended September 30, 2013.

Research and Development (R&D) Expenses - R&D expenses include compensation, engineering department expenses, overhead allocations for administration and facilities, and materials costs associated with development. R&D expenses for the three months ended December 31, 2013 increased $0.1 million, or 5%, to $2.3 million from $2.2 million for the three months ended December 31, 2012. R&D expenses are reported net of benefits from cost-sharing programs, such as DOE grants. The overall increase in R&D expenses of $0.1 million resulted primarily from an increase in supplies expense of $0.1 million. There were approximately $0.4 million of cost-sharing benefits for the three months ended December 31, 2013 and $0.3 million of such benefits for the three months ended December 31, 2012. Cost-sharing programs vary from period to period depending on the phase of the programs. At the end of the third quarter of Fiscal 2014, management expects R&D expenses in Fiscal 2014 to be slightly higher than in Fiscal 2013 as we continue new product development, product robustness and direct material cost reduction initiatives.

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Selling, General, and Administrative (SG&A) Expenses - SG&A expenses for the three months ended December 31, 2013 increased $0.2 million, or 3%, to $7.0 million from $6.8 million for the three months ended December 31, 2012. The net increase in SG&A expenses was comprised of increases of $0.2 million in travel expense and $0.1 million in bad debt expense, offset by a decrease of $0.1 million in marketing expense. At the end of the third quarter of Fiscal 2014, management expects SG&A expenses in Fiscal 2014 to be slightly higher than in Fiscal 2013 as we focus on continuous improvement in customer service levels and investment in software and hardware technology to support the growing business.

Interest Expense - Interest expense for each of the three months ended December 31, 2013 and 2012 was approximately $0.2 million. Interest expense is primarily incurred from the average balances outstanding under the Credit Facility (as defined below). As of December 31, 2013, we had total debt of $13.2 million outstanding under the Credit Facility.

Change in Fair Value of Warrant Liability Effective September 23, 2013, warrants to purchase approximately 4.0 million shares of common stock that were issued in connection with the September 23, 2008 registered direct placement expired, and the liability associated with the warrants was reversed. This reversal of the warrant liability had no impact on our cash balances. The change in fair value of the warrant liability was a benefit of $0.3 million for the three months ended December 31, 2012. The change in fair value of warrant liability for the three months ended December 31, 2012 was a result of warrant exercises and revaluing the warrant liability based on the Monte-Carlo simulation valuation model which is affected primarily by the quoted price of the Company s common stock in an active market. This revaluation of the warrant liability had no impact on our cash balances.

Income Taxes - Income tax expense for the three months ended December 31, 2013 was $0.1 million. Income tax expense for the three months ended December 31, 2012 was $0.2 million. The decrease in income tax expense was primarily related to microturbine service activity in Mexico.

Nine Months Ended December 31, 2013 and 2012

Revenue - Revenue for the nine months ended December 31, 2013 increased $4.5 million, or 5%, to $96.7 million from $92.2 million for the nine months ended December 31, 2012. The change in revenue for the nine months ended December 31, 2013 compared to the nine months ended December 31, 2012 included increases in revenue of $7.0 million from the European market, $1.1 million from the African market, $0.8 million from the Australian market and $0.5 million from the Asian market. The increase in the European market was primarily related to increased sales into the Russian natural resources vertical market. The increase in the African market was primarily the result of further market adoption of our products in this market. The increases in the Asian and Australian markets were primarily because of a change in product mix of microturbine units shipped in these markets during the nine months ended December 31, 2013 compared to the same period last year. This overall increase in revenue was offset by decreases in revenue of $4.2 million from the North American market and $0.7 million from the South American market. The decreases in the North American and South American markets were primarily as a result of a shift in certain customers project timelines compared to the same period last year.

Megawatts shipped and microturbine units shipped during the nine months ended December 31, 2013 increased as a result of overall higher sales volume for our microturbine products. For the nine months ended December 31, 2013, revenue from microturbine products increased $5.2 million, or 7%, to $78.8 million from $73.6 million for the nine months ended December 31, 2012. Microturbine megawatts shipped during the nine months ended December 31, 2013 increased 2.6 megawatts to 77.7 megawatts from 75.1 megawatts for the nine months ended December 31, 2012. Microturbine units shipped during the nine months ended December 31, 2013 increased 64 units to 499 units from 435 units for the nine months ended December 31, 2012. Average revenue per unit decreased for the nine months ended December 31, 2013 to approximately $158,000 compared to approximately $169,000 per unit for the nine months ended December 31, 2012. The decrease in average revenue per unit was primarily the result of a change in mix of C1000 Series systems and more C30 and C65 microturbines shipped during the nine months ended December 31, 2013 compared to the same period last year.

For the nine months ended December 31, 2013, revenue from our accessories, parts and service decreased $0.7 million, or 4%, to $17.9 million from $18.6 million for the nine months ended December 31, 2012. The decrease in revenue resulted primarily from lower sales of microturbine service work, partially offset by higher sales of microturbine parts and FPP contract enrollment.

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. Therefore, we evaluate historical revenue in conjunction with backlog to anticipate the growth trend of our revenue.

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

	Nine Months Ended December 31,					
	2013			2012		
	Revenue	Megawatts	Units	Revenue	Megawatts	Units
C30	$ 5.2	3.5	115	$ 4.8	3.2	106
C65	20.2	17.7	274	16.1	14.5	224
TA100	0.5	0.4	4	1.5	0.8	8
C200	13.0	10.8	54	8.3	7.6	38
C600	5.1	5.4	9	11.9	12.0	20
C800	7.9	8.8	11	4.6	4.8	6
C1000	26.7	31.0	31	26.3	32.0	32
Waste heat recovery generator	0.2	0.1	1			
Unit upgrades				0.1	0.2	1
Total from Microturbine Products	$ 78.8	77.7	499	$ 73.6	75.1	435
Accessories, Parts and Service	17.9			18.6		
Total	$ 96.7	77.7	499	$ 92.2	75.1	435

Sales to E-Finity, BPC and Horizon accounted for 21%, 14% and 13% of revenue, respectively, for the nine months ended December 31, 2013. For the nine months ended December 31, 2012, Horizon and BPC accounted for 28% and 13% of revenue, respectively.

Gross Margin - The gross margin was $15.6 million, or 16% of revenue, for the nine months ended December 31, 2013 compared to a gross margin of $9.4 million, or 10% of revenue, for the nine months ended December 31, 2012. The increase of $6.2 million in gross margin was the result of a $4.1 million improvement realized from overall higher sales volume of our microturbine products and lower direct material costs during the nine months ended December 31, 2013. In addition, there were decreases in our warranty expense of $1.1 million, royalty expense of $0.7 million, inventory provision of $0.2 million and production and service center labor and overhead expenses of $0.1 million during the nine months ended December 31, 2013 compared to the prior year. Management continues to implement initiatives to address warranty expense and to further reduce direct material costs as we work to achieve profitability.

Warranty expense is a combination of a standard warranty provision recorded at the time revenue is recognized and changes, if any, in estimates for reliability repair programs. Reliability repair programs are based upon estimates that are recorded in the period that new information becomes available, including design changes, cost of repair and product enhancements, which can include both in-warranty and out-of-warranty systems. The decrease in warranty expense of $1.1 million reflects a decrease in reliability repair programs, offset by an increase in the per unit standard warranty provision as a result of sales mix and higher volume of units under warranty during the nine months ended December 31, 2013 compared to the prior year. Management expects per unit warranty rates for C200 and C1000 Series systems to decline as reliability repair programs are completed and these products mature.

Royalty expense decreased $0.7 million during the nine months ended December 31, 2013 compared to the nine months ended December 31, 2012 as a result of a reduction in the predetermined fixed rate royalty offset by higher volume of covered microturbine systems. We pay a predetermined fixed rate royalty for each microturbine system covered by our Development and License Agreement with Carrier. The fixed rate royalty was reduced by 50% because of the contractual reduction during the three months ended September 30, 2013.

Inventory provision decreased $0.2 million during the nine months ended December 31, 2013 compared to the nine months ended December 31, 2012 primarily as the result of physical inventory adjustments and reserve for excess and obsolete inventory.

Production and service center labor and overhead expense decreased $0.1 million during the nine months ended December 31, 2013 compared to the nine months ended December 31, 2012 primarily as the result of a decrease in travel expense, partially offset by an increase in salaries expense.

Research and Development Expenses - R&D expenses for the nine months ended December 31, 2013 decreased $0.2 million, or 3%, to $6.6 million from $6.8 million for the nine months ended December 31, 2012. R&D expenses are reported net of benefits from cost-sharing programs, such as DOE grants. The overall decrease in R&D expenses of $0.2 million resulted from a decrease in supplies of $0.3 million, offset by increased salaries of $0.1 million. There were approximately $1.1 million of cost-sharing benefits for the nine months ended December 31, 2013 and $1.2 million of such benefits for the nine months ended December 31, 2012. Cost-sharing programs vary from period to period depending on the phase of the programs. At the end of the third quarter of Fiscal 2014, management expects R&D expenses in Fiscal 2014 to be slightly higher than in Fiscal 2013 as we continue new product development, product robustness and direct material cost reduction initiatives.

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Selling, General, and Administrative Expenses - SG&A expenses for the nine months ended December 31, 2013 increased $0.5 million, or 2%, to $21.2 million from $20.7 million for the nine months ended December 31, 2012. The net increase in SG&A expenses was comprised of increases of $1.0 million in salaries expense, $0.2 million in supplies expense and $0.2 million in consulting expense, offset by decreases of $0.6 million in marketing expense and $0.3 million in bad debt expense. At the end of the third quarter of Fiscal 2014, management expects SG&A expenses in Fiscal 2014 to be slightly higher than in Fiscal 2013 as we focus on continuous improvement in customer service levels and investment in software and hardware technology to support the growing business.

Interest Expense - Interest expense for each of the nine months ended December 31, 2013 and 2012 was approximately $0.5 million. Interest expense is primarily from the average balances outstanding under the Credit Facility. As of December 31, 2013, we had total debt of $13.2 million outstanding under the Credit Facility.

Change in Fair Value of Warrant Liability - Effective September 23, 2013, warrants to purchase approximately 4.0 million shares of common stock that were issued in connection with the September 23, 2008 registered direct placement expired, and the liability associated with the warrants was reversed. This reversal of the warrant liability had no impact on our cash balances. The reversal of the warrant liability was a benefit of approximately $10,000 for the nine months ended December 31, 2013. The change in fair value of the warrant liability was a benefit of $0.8 million for the nine months ended December 31, 2012. The change in fair value of warrant liability during the nine months ended December 31, 2012 was a result of warrant exercises and revaluing the warrant liability based on the Monte-Carlo simulation valuation model which is impacted primarily by the quoted price of the Company s common stock in an active market. This revaluation of the warrant liability had no impact on our cash balances.

Income Taxes - Income tax expense for the nine months ended December 31, 2013 was $0.1 million. Income tax expense for the nine months ended December 31, 2012 was $0.6 million. The decrease in income tax expense was primarily related to microturbine service activity in Mexico.

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 creating the strategic changes summarized herein. Our planned capital expenditures for the year ending March 31, 2014 include approximately $2.0 million for plant and equipment costs related to manufacturing and operations. Management expects to spend less than planned as a result of a change in timing of capital expenditures for new product development and the replacement of older equipment. 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 equivalent balances decreased $7.2 million during the nine months ended December 31, 2013, compared to a decrease of $8.0 million during the nine months ended December 31, 2012. The overall improvement in cash during the nine months ended December 31, 2013 compared to the nine months ended December 31, 2012 was primarily the result of a reduction of cash used in operating activities.

Operating Activities - During the nine months ended December 31, 2013, we used $11.7 million in cash in our operating activities, which consisted of a net loss for the period of $12.9 million and cash used for working capital of $6.8 million, offset by non-cash adjustments (primarily warranty provision, depreciation and amortization, stock based compensation and inventory provision) of $8.0 million. During the nine months ended December 31, 2012, operating cash usage was $13.5 million, which consisted of a net loss for the period of $18.4 million and cash used for working capital of $3.7 million, offset by non-cash adjustments of $8.6 million.

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

	Nine Months Ended December 31, 2013		Nine Months Ended December 31, 2012	
Net loss	$	(12,875)	$	(18,433)
Non-cash operating activities (1)		8,023		8,606
Changes in operating assets and liabilities:				
Accounts receivable		(4,298)		(1,240)
Inventories		(4,142)		(4,084)
Accounts payable and accrued expenses		4,854		1,573
Other changes in operating assets and liabilities		(3,223)		103
Net cash used in operating activities	$	(11,661)	$	(13,475)

(1) Represents warranty provision, depreciation and amortization, stock-based compensation expense, change in fair value of warrant liability, inventory provision and provisions for doubtful accounts.

The decrease in cash used in operating activities during the nine months ended December 31, 2013 compared to the nine months ended December 31, 2012 was primarily related to an improvement in net loss, offset by reduction in cash from customer deposits.

Investing Activities - Net cash used in investing activities of $0.8 million and $0.9 million during the nine months ended December 31, 2013 and 2012, respectively, relates primarily to the acquisition of fixed assets.

Financing Activities During the nine months ended December 31, 2013, we generated $5.2 million from financing activities compared to cash generated during the nine months ended December 31, 2012 of $6.3 million. The funds generated from financing activities during the nine months ended December 31, 2013 were primarily the result of the exercise of warrants, described below yielding $6.0 million in cash offset by additional repayments under the Credit Facility. During the nine months ended December 31, 2012 the funds generated from financing activities were primarily from the proceeds related to exercise of the Put Option described below and additional borrowings under the Credit Facility.

Effective March 5, 2012, the Company completed a registered direct placement in which it sold 22.6 million shares of the Company s common stock, par value $.001 per share, and warrants to purchase 22.6 million shares of common stock with an initial exercise price of $1.55 per share, at a price of $1.11 per unit. Each unit consisted of one share of common stock and a warrant to purchase one share of common stock. The warrants expired on October 31, 2013. In addition, the Company obtained the right to require investors in the offering to purchase up to an aggregate maximum of 19.0 million additional shares of common stock from the Company (the Put Options) during two option exercise periods, the first such option exercise period beginning September 10, 2012 and the second such option exercise period beginning March 4, 2013. Each Put Option was subject to certain conditions which could reduce the number of shares that could be sold or eliminate the Put Option. These conditions included a minimum volume-weighted average price (VWAP) and a minimum average trading volume of the Company s common shares during the 30 trading days prior to the exercise of the Put Option. The March 2012 sale resulted in gross proceeds of approximately $25.0 million and proceeds net of direct incremental costs of approximately $23.1 million.

On September 18, 2012, the Company entered into an Investor Agreement with one of the investors in the 2012 registered direct offering pursuant to which the investor agreed to (i) waive the condition precedent to the Company s exercise of the Put Option requiring the arithmetic average of the average daily trading volumes during the measurement period set forth in the subscription agreement between the Company and the investor and on the exercise date be not less than 1.75 million shares and (ii) amend the subscription agreement to provide that the purchase price of the additional shares during the first exercise period shall be an 8% discount to the lesser of the closing bid price of the Company s common stock on September 18, 2012, and the VWAP measurement for the ten trading days ending on September 18, 2012. Additionally, pursuant to the Investor Agreement, the Company agreed to amend the exercise price of the warrant originally issued to $1.26. The exercise of the Put Option resulted in net proceeds of $4.2 million. On February 21, 2013, the Company entered into a letter agreement (each a Letter Agreement and, collectively, the Letter Agreements) with each of the investors in the 2012 registered direct offering. Pursuant to the Letter Agreements, the parties evidenced their mutual agreement that the Company would not exercise any portion of the second Put Option. The Company chose not to exercise the second of the two Put Options because of its improved cash position at the time and its desire to avoid stockholder dilution. On October 31, 2013, an unsolicited exercise of 2012 Warrants to purchase 4.7 million shares resulted in proceeds of approximately $6.0 million. Effective October 31, 2013, all remaining outstanding 2012 Warrants expired.

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Employee stock purchases, net of repurchases of shares of our common stock for employee taxes due on vesting of restricted stock units, resulted in approximately $0.1 million of net cash used during the nine months ended December 31, 2013, compared with $29,000 of net cash used during the nine months ended December 31, 2012.

We maintain two Credit and Security Agreements, as amended (the Agreements), with Wells Fargo, which provide the Company with a line of credit of up to $15.0 million in the aggregate (the Credit Facility). The amount actually available to us may be less and may vary from time to time depending on, among other factors, the amount of eligible inventory and accounts receivable. As security for the payment and performance of the Credit Facility, we granted a security interest in favor of Wells Fargo in substantially all of our assets. As of December 31, 2013 and March 31, 2013, $13.2 million and $13.5 million in borrowings were outstanding, respectively, under the Credit Facility.

The Agreements include affirmative covenants as well as negative covenants that prohibit a variety of actions without Wells Fargo s consent, including covenants that limit our ability to (a) incur or guarantee debt, (b) create liens, (c) enter into any merger, recapitalization or similar transaction or purchase all or substantially all of the assets or stock of another entity, (d) pay dividends on, or purchase, acquire, redeem or retire shares of, our capital stock, (e) sell, assign, transfer or otherwise dispose of all or substantially all of our assets, (f) change our accounting method or (g) enter into a different line of business. Furthermore, the Agreements contain financial covenants, including (a) a requirement not to exceed specified levels of losses, (b) a requirement to maintain a substantial minimum monthly cash balance to outstanding line of credit advances based upon the Company s financial performance, and (c) limitations on our annual capital expenditures.

The Company has pledged its accounts receivables, inventories, equipment, patents and other assets as collateral for the Credit Facility, which would be subject to seizure by Wells Fargo if the Company were in default under the Agreements and unable to repay the indebtedness. Wells Fargo also has the option to terminate the Agreements or accelerate the indebtedness during a period of noncompliance. On June 7, 2013, we entered into an amendment to the Agreements which set the financial covenants for Fiscal 2014. As of December 31, 2013, we determined that we were not in compliance with the financial covenant contained in the amended Agreements regarding our net income for the nine months ended December 31, 2013. On January 31, 2014, we received from Wells Fargo a waiver of noncompliance with the financial covenant regarding our net income for the nine months ended December 31, 2013. Based on our current forecasts and following the waiver of noncompliance described above, management believes that we will maintain compliance with the covenants contained in the amended Agreements for the remainder of the term of the Agreements. If an additional subsequent covenant violation were to occur, management would attempt to negotiate a waiver of compliance from Wells Fargo.

Except for scheduled payments made on operating leases during the nine months ended December 31, 2013, there have been no material changes in our remaining commitments under non-cancelable operating leases disclosed in our Annual Report on Form 10-K for Fiscal 2013.

Management believes that existing cash and cash equivalents are sufficient to meet our anticipated cash needs for working capital and capital expenditures for at least the next twelve months; however, if our anticipated cash needs change, we may need to raise additional capital in the future. We could seek to raise funds by selling additional securities to the public or to selected investors, or by obtaining additional debt financing. There is no assurance that we will be able to obtain additional funds on commercially favorable terms, or at all. If the Company raises additional funds by issuing additional equity or convertible debt securities, the fully diluted ownership percentages of existing stockholders will be reduced. In addition, the equity or debt securities that the Company would issue may have rights, preferences or privileges senior to those of the holders of its common stock. The Agreements with Wells Fargo will terminate in accordance with their terms on September 30, 2014. The Company expects to renew the Agreements prior to their termination with Wells Fargo, but there is no assurance that the Agreements will be renewed.

Although we believe we have sufficient capital to fund our working capital and capital expenditures for at least the next twelve months, 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 current 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 increased sales volume which is dependent on many factors, including:

- the market s acceptance of our products and services;
- our business, product and capital expenditure plans;
- capital improvements to new and existing facilities;

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- 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 allowance for doubtful accounts, was $22.0 and $17.9 million as of December 31, 2013 and March 31, 2013, respectively. Days sales outstanding in accounts receivable (DSO) at the end of the third quarter of Fiscal 2014 was 54 days, compared with 53 days at the end of the third quarter of Fiscal 2013. We recorded bad debt expense of $0.2 million during the nine months ended December 31, 2013 compared to $0.5 million during the nine months ended December 31, 2012. No assurances 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 may have been and could continue to be adversely affected by the current economic environment.

New Accounting Pronouncements

In July 2013, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2013-11, Income Taxes (Topic 740) Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists. ASU 2013-11 defines the criteria as to when an unrecognized tax benefit should be presented as a liability and when it should be netted against a deferred tax asset on the face of the balance sheet. ASU 2013-11 is effective for fiscal years beginning after December 15, 2013. We do not believe that the adoption of the provisions of ASU 2013-11 will have a material impact our consolidated financial position or results of operations.

In February 2013, FASB issued ASU 2013-02, Comprehensive Income (Topic 220), Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income, effective for annual and interim reporting periods beginning after December 15, 2012. The new accounting rules require all U.S. public companies to report the effect of items reclassified out of accumulated other comprehensive income on the respective line items of net income, net of tax, either on the face of the financial statements where net income is presented or in a tabular format in the notes to the financial statements. We adopted this updated guidance with no impact on our consolidated financial position or results of operations.

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

No material changes have occurred in the quantitative and qualitative market risk disclosure of the Company as presented in its Annual Report on Form 10-K for Fiscal 2013.

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

Evaluation of Disclosure Controls and Procedures

As of the end of the period covered by this report, we carried out an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) promulgated under the Exchange Act), under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer. 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 the Company that are designed to ensure that information required to be disclosed by the Company in the reports that it files or submits 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 the Company in the reports that it files or submits 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

Additionally, our Chief Executive Officer and Chief Financial Officer have determined that there have been no changes to our internal control over financial reporting during the three months ended December 31, 2013 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II OTHER INFORMATION

Item 1. *Legal Proceedings*

From time to time, the Company may become subject to certain legal proceedings, claims and litigation arising in the ordinary course of business. In the opinion of management, we are not currently a party to any material legal proceedings, nor are we aware of any pending or threatened litigation that would have a material effect on our operating results, cash flows, financial position or results of operations should such litigation be resolved unfavorably.

Item 1A. *Risk Factors*

There have been no material changes to the risk factors disclosed in the Company s Annual Report on Form 10-K for Fiscal 2013.

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

None

Item 3. *Defaults Upon Senior Securities*

None

Item 4. *Mine Safety Disclosures*

Not applicable

Item 5. *Other Information*

None

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Item 6. ***Exhibits***

The following exhibits are filed with, or incorporated by reference into, this Form 10-Q:

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 (b)
3.3	Amended and Restated Bylaws of Capstone Turbine Corporation (c)
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes Oxley Act of 2002
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes Oxley Act of 2002
32	Certification of Chief Executive Officer and Chief Financial Officer 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 Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2005 (File No. 001-15957).

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

CAPSTONE TURBINE CORPORATION

By: /s/ EDWARD I. REICH
Edward I. Reich
Executive Vice President and
Chief Financial Officer
(Principal Financial Officer)

Date: February 10, 2014

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