

CAPSTONE TURBINE CORP

Form 10-QT

January 26, 2004

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549**

FORM 10-Q

(Mark One)

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

OR

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

For the transition period from January 1, 2003 to March 31, 2003.

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.)**

**2121 Nordhoff Street, Chatsworth, California 91311
(Address of principal executive offices) (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 No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Securities Exchange Act of 1934). Yes No

The number of outstanding shares of the registrant's common stock as of December 31, 2003 was 83,240,545.

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CAPSTONE TURBINE CORPORATION
CONSOLIDATED BALANCE SHEETS
(Unaudited)

	March 31, 2003	December 31, 2002
Assets		
Current Assets:		
Cash and cash equivalents	\$ 132,584,000	\$ 140,310,000
Accounts receivable, net of allowance for doubtful accounts and sales returns of \$414,000 at March 31, 2003 and \$194,000 at December 31, 2002	3,748,000	4,893,000
Inventory	12,121,000	9,124,000
Prepaid expenses and other current assets	1,341,000	2,331,000
	<u>149,794,000</u>	<u>156,658,000</u>
Equipment and Leasehold Improvements:		
Machinery, equipment, and furniture	23,914,000	22,996,000
Leasehold improvements	8,480,000	8,480,000
Molds and tooling	4,365,000	4,350,000
	<u>36,759,000</u>	<u>35,826,000</u>
Less accumulated depreciation and amortization	16,857,000	15,346,000
	<u>19,902,000</u>	<u>20,480,000</u>
Non-current Portion of Inventory	4,412,000	6,784,000
Deposits on Fixed Assets	73,000	708,000
Other Assets	505,000	532,000
Intangible Asset, Net	1,961,000	2,029,000
	<u>176,647,000</u>	<u>187,191,000</u>
	<u>\$ 176,647,000</u>	<u>\$ 187,191,000</u>
Liabilities and Stockholders Equity		
Current Liabilities:		
Accounts payable	\$ 2,156,000	\$ 4,321,000
Accrued salaries and wages	1,472,000	2,088,000
Other accrued liabilities	1,117,000	1,132,000
Accrued warranty reserve	6,657,000	6,913,000
Deferred revenue	1,253,000	734,000
Current portion of capital lease obligations	1,411,000	1,522,000
	<u>14,066,000</u>	<u>16,710,000</u>
Total current liabilities	14,066,000	16,710,000
Long-Term Portion of Capital Lease Obligations	736,000	974,000
Other Long-Term Liabilities	1,277,000	1,325,000

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Commitments and Contingencies

Stockholders' Equity:

Common stock, \$.001 par value; 415,000,000 shares authorized; 81,700,735 shares issued and 81,248,782 shares outstanding at March 31, 2003; 81,635,035 shares issued and 81,437,822 shares outstanding at December 31, 2002	82,000	82,000
Additional paid-in capital	527,188,000	526,952,000
Accumulated deficit	(366,281,000)	(358,646,000)
Less Treasury stock, at cost; 451,953 shares at March 31, 2003; 197,213 shares at December 31, 2002	(421,000)	(206,000)
	<u>160,568,000</u>	<u>168,182,000</u>
Total stockholders' equity	160,568,000	168,182,000
	<u>\$ 176,647,000</u>	<u>\$ 187,191,000</u>

See accompanying notes to consolidated financial statements.

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CAPSTONE TURBINE CORPORATION
CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

	Three Months Ended March 31,	
	2003	2002
Revenues	\$ 2,782,000	\$ 4,591,000
Cost of Goods Sold	4,956,000	7,549,000
	(2,174,000)	(2,958,000)
Gross Loss		
Operating Costs and Expenses:		
Research and development	1,006,000	1,439,000
Selling, general and administrative	4,821,000	8,360,000
	5,827,000	9,799,000
Total operating costs and expenses		
Loss from Operations	(8,001,000)	(12,757,000)
Interest Income	439,000	823,000
Interest Expense	(73,000)	(115,000)
Other Income	2,000	21,000
	(7,633,000)	(12,028,000)
Loss Before Income Taxes		
Provision for Income Taxes	2,000	2,000
	\$ (7,635,000)	\$(12,030,000)
Net Loss		
Weighted Average Common Shares Outstanding	81,410,614	77,387,574
Net Loss Per Share of Common Stock - Basic and Diluted	\$ (0.09)	\$ (0.16)

See accompanying notes to consolidated financial statements.

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CAPSTONE TURBINE CORPORATION
CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY
(Unaudited)

	<u>Common Stock</u>		<u>Additional Paid In Capital</u>	<u>Accumulated Deficit</u>	<u>Treasury Stock</u>	<u>Total</u>
	<u>Shares Issued</u>	<u>Amount</u>				
Three Months Ended						
March 31, 2002:						
Balance, January 1, 2002	77,207,383	\$ 77,000	\$ 521,668,000	\$(284,291,000)	\$	\$ 237,454,000
Stock-based compensation			265,000			265,000
Exercise of stock options	200,173		80,000			80,000
Net loss				(12,030,000)		(12,030,000)
Balance, March 31, 2002	<u>77,407,556</u>	<u>\$ 77,000</u>	<u>\$ 522,013,000</u>	<u>\$(296,321,000)</u>	<u>\$</u>	<u>\$ 225,769,000</u>
Three Months Ended						
March 31, 2003:						
Balance, January 1, 2003	81,635,035	\$ 82,000	\$ 526,952,000	\$(358,646,000)	\$(206,000)	\$ 168,182,000
Stock-based compensation			214,000			214,000
Exercise of stock options	65,700		22,000			22,000
Purchase of treasury stock					(215,000)	(215,000)
Net loss				(7,635,000)		(7,635,000)
Balance, March 31, 2003	<u>81,700,735</u>	<u>\$ 82,000</u>	<u>\$ 527,188,000</u>	<u>\$(366,281,000)</u>	<u>\$(421,000)</u>	<u>\$ 160,568,000</u>

See accompanying notes to consolidated financial statements.

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CAPSTONE TURBINE CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Three Months Ended March 31,	
	2003	2002
Cash Flows from Operating Activities:		
Net loss	\$ (7,635,000)	\$ (12,030,000)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	1,573,000	3,083,000
Non-cash reversal of administrative expenses	(1,099,000)	
Provision for doubtful accounts	220,000	125,000
Inventory write-down	243,000	472,000
Provision for warranty expenses	385,000	847,000
Loss on disposal of fixed assets		37,000
Non-employee stock-based compensation	4,000	
Employee and director stock-based compensation	210,000	265,000
Changes in operating assets and liabilities:		
Accounts receivable	925,000	2,740,000
Inventory	(868,000)	941,000
Prepaid expenses and other assets	990,000	(275,000)
Accounts payable	(1,066,000)	(713,000)
Accrued salaries and wages	(625,000)	(152,000)
Other accrued liabilities	(54,000)	(823,000)
Accrued warranty reserve	(641,000)	(308,000)
Deferred revenue	519,000	(84,000)
Net cash used in operating activities	<u>(6,919,000)</u>	<u>(5,875,000)</u>
Cash Flows from Investing Activities:		
Acquisition of and deposits on fixed assets	(271,000)	(394,000)
Net cash used in investing activities	<u>(271,000)</u>	<u>(394,000)</u>
Cash Flows from Financing Activities:		
Purchase of treasury stock	(215,000)	
Repayment of capital lease obligations	(343,000)	(315,000)
Exercise of stock options	22,000	80,000
Net cash used in financing activities	<u>(536,000)</u>	<u>(235,000)</u>
Net Decrease in Cash and Cash Equivalents	(7,726,000)	(6,504,000)
Cash and Cash Equivalents, Beginning of Period	140,310,000	170,868,000
Cash and Cash Equivalents, End of Period	<u>\$ 132,584,000</u>	<u>\$ 164,364,000</u>
Supplemental Disclosures of Cash Flow Information:		
Cash paid during the period for:		
Interest	\$ 73,000	\$ 115,000
Income taxes	\$ 2,000	\$ 2,000

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See accompanying notes to consolidated financial statements.

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CAPSTONE TURBINE CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Business and Organization

Capstone Turbine Corporation (the Company) develops, manufactures and sells microturbine generator sets for use in combined heat and power generation, resource recovery, hybrid electric vehicles and other power, heat and cooling applications in the markets for distributed power generation around the world. The Company was organized in 1988 and has been commercially producing its microturbine generators since 1998.

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

2. Basis of Presentation

The accompanying unaudited financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (generally accepted accounting principles) for interim financial information and with the instructions to Form 10-Q and Regulation S-X promulgated under the Securities and Exchange Act of 1934. They do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. The balance sheet at December 31, 2002 was derived from audited financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2002. In the opinion of management the interim financial statements include all adjustments (consisting of normal recurring adjustments) necessary for a fair presentation of the financial condition, results of operations, stockholders' equity 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 financial statements should be read in conjunction with the financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2002.

Certain reclassifications have been made in some prior year balances to match the current year's presentation.

3. Change in Fiscal Year

On December 12, 2003, the Company adopted a new fiscal year end, moving the end of its fiscal year from December 31 to March 31. As a result of this change, the Company's transition period from January 1, 2003 to March 31, 2003 is covered by this report. The Company's new fiscal year will commence on April 1, 2003 and end on March 31, 2004.

4. New Accounting Pronouncements

In May 2003, Statement of Financial Accounting Standards (SFAS) No. 150, Accounting for Certain Instruments with Characteristics of Both Liabilities and Equity, was issued. The standard establishes how an issuer classifies and measures certain freestanding financial instruments with characteristics of liabilities and equity and requires that such instruments be classified as liabilities. The standard is effective for financial instruments entered into or modified after May 31, 2003 and is otherwise effective at the beginning of the first interim period beginning after June 15, 2003. The adoption of this standard did not have a material impact on the Company's consolidated financial position, results of operations or cash flows.

In April 2003, SFAS No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities, was issued. The standard amends and clarifies financial reporting for derivative instruments and for hedging activities accounted for under SFAS No. 133 and is effective for contracts entered into or modified, and for hedges designated, after June 30, 2003. The adoption of this standard did not have a material impact on the Company's consolidated financial position, results of operations or cash flows.

In January 2003, the Emerging Issues Task Force (EITF) released EITF 00-21: Accounting for Revenue Arrangements with Multiple Deliverables. EITF 00-21 clarifies the timing and recognition of revenue from certain transactions that include the delivery and performance of multiple products or services. EITF 00-21 is effective for revenue arrangements entered into in fiscal periods beginning after June 15, 2003. Alternatively, entities may elect to report the change in accounting as a cumulative-effect adjustment in accordance with APB Opinion 20, Accounting Changes. If so elected, disclosure should be made in periods subsequent to the date of initial application of this consensus of the amount of the recognized revenue that was previously included in the cumulative-effect adjustments. The adoption of this standard did not have a material impact on the Company's consolidated financial position, results of operations or cash flows.

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CAPSTONE TURBINE CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

In December 2002, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 148, Accounting for Stock-Based Compensation Transition and Disclosure an Amendment of SFAS No. 123. SFAS No. 148 amends SFAS No. 123, Accounting for Stock-Based Compensation, to provide alternative methods of transition for a voluntary change to the fair value method of accounting for stock-based employee compensation. In addition, SFAS No. 148 amends the disclosure in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the methods used on reported results. The disclosure requirements apply to all companies for fiscal years ended after December 15, 2002. The Company accounts for its employee stock option plans under the intrinsic value method prescribed by Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees and related interpretations. The Company accounts for equity instruments issued to recipients other than employees using the fair value at the date of grant. The following table is presented in accordance with SFAS No. 148 and illustrates the effect on net loss and net loss per share if the Company had applied the fair value recognition provisions of SFAS No. 123.

	Three Months Ended March 31,	
	2003	2002
Net loss, as reported	\$(7,635,000)	\$(12,030,000)
Add: Stock-based employee and director compensation included in reported net loss	210,000	265,000
Deduct: Total stock-based employee and director compensation expense determined under fair value based method for all awards	(1,897,000)	(2,241,000)
Pro forma net loss	\$(9,322,000)	\$(14,006,000)
Net loss per share Basic and Diluted:		
As reported	\$ (0.09)	\$ (0.16)
Pro forma	\$ (0.11)	\$ (0.18)

In November 2002, FASB Interpretation (FIN) No. 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others was issued. FIN No. 45 elaborates on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. FIN No. 45 also clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. The initial recognition and initial measurement provisions of this Interpretation are applicable on a prospective basis to guarantees issued or modified after December 31, 2002. The Company did not issue any guarantees of indebtedness of others during the quarter ended March 31, 2003. Product warranties are excluded from the initial recognition and measurement provisions of FIN No. 45 but are subject to its disclosure requirements. The required disclosures and a roll-forward of product warranty liabilities are effective for financial statements of interim or annual periods ending after December 15, 2002. The Company disclosed its accounting policy on product warranty in its Annual Report on Form 10-K for the year ended December 31, 2002. The required tabular reconciliation of the changes in the aggregate product warranty liability for the quarter ended March 31, 2003 is disclosed in Note 9.

In July 2002, SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities, was issued by the FASB. SFAS No. 146 requires companies to recognize costs associated with exit or disposal activities when they are incurred rather than at the date of a commitment to an exit or disposal plan. Examples of costs covered by the standard include lease termination costs and certain employee severance costs that are associated with a restructuring, discontinued operation, plant closing, or other exit or disposal activity. SFAS No. 146 is to be applied prospectively to exit or disposal activities initiated after December 31, 2002. The adoption of SFAS No. 146 did not have a material impact on the Company's consolidated financial position or results of operations as it has not initiated any exit activities or disposal activities.

5. Segment Reporting

The Company is considered to be a single operating segment in conformity with SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information. The business activities of said operating segment are the development, manufacture and sale of turbine generator sets. Following is a breakdown by geographical area of the Company's revenues:

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CAPSTONE TURBINE CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

	Three Months Ended March 31,	
	2003	2002
North America:		
USA	\$ 1,411,000	\$ 948,000
Mexico	891,000	
Others	36,000	191,000
Asia:		
Japan	78,000	1,800,000
Others	69,000	94,000
Europe	213,000	2,095,000
South America	4,000	32,000
Africa	80,000	(569,000)
Total	\$ 2,782,000	\$ 4,591,000

Revenues and margins for the three months ended March 31, 2002 were reported net of \$569,000 and \$79,000, respectively, that resulted from the repossession of 20 units of our C30 products from a distributor in Africa.

6. Inventory

Inventory is stated at the lower of standard cost (which approximates actual cost on the first-in, first-out method) or market and consists of the following:

	March 31, 2003	December 31, 2002
Raw materials	\$ 12,724,000	\$ 12,623,000
Work in process	2,271,000	1,831,000
Finished goods	1,538,000	1,454,000
Total	16,533,000	15,908,000
Less non-current portion	4,412,000	6,784,000
Current portion	\$ 12,121,000	\$ 9,124,000

The non-current portion of inventory represents that portion of the inventory in excess of amounts expected to be sold or used in the next twelve months.

7. Intangible Asset

The intangible asset represents the license granted to the Company to use a former supplier's intellectual property for the design and manufacture of licensed product for use in microturbines. Additional information is as follows:

March 31, 2003	December 31, 2002
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Gross carrying amount	\$3,663,000	\$3,663,000
Less accumulated amortization and impairment loss	1,702,000	1,634,000
	<u> </u>	<u> </u>
Net	\$1,961,000	\$2,029,000
	<u> </u>	<u> </u>

The intangible asset, which was acquired in 2000, is being amortized over its estimated useful life of ten years. The Company recorded \$68,000 and \$94,000 of amortization expense related to the manufacturing license for the quarters ended March 31, 2003 and 2002, respectively. The manufacturing license is scheduled to be fully amortized by 2010 with corresponding amortization estimated to be \$199,000, \$267,000, \$267,000, \$267,000, \$267,000 and \$694,000, for the remainder of 2003, calendar years 2004, 2005, 2006 and 2007, and thereafter, respectively.

8. Stock-Based Compensation

During 1999 and 2000, the Company issued common stock options at less than the fair value of its common stock. Accordingly, the Company recorded stock-based compensation expense based on the vesting of these grants as follows:

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CAPSTONE TURBINE CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

	Three Months Ended March 31,	
	2003	2002
Cost of goods sold	\$ 9,000	\$ 11,000
Research and development	59,000	69,000
Selling, general and administrative	142,000	185,000
	\$ 210,000	\$ 265,000
Total employee and director stock-based compensation	\$ 210,000	\$ 265,000

As of March 31, 2003, the Company had \$705,000 in deferred employee and director stock-based compensation, which will be amortized through 2004 based on the vesting period.

On March 20, 2003, the Board of Directors approved an amendment to the 2000 Plan to increase the number of shares of common stock available for grant by 2,500,000 shares. The Plan amendment requires approval of stockholders within twelve months after the action of the Board of Directors. During the quarter ended December 31, 2003, the Board of Directors rescinded their action.

On June 25, 2003, the Company made a tender offer to eligible employees to exchange options with exercise prices greater than or equal to \$2.00 per share. 610,950 options were tendered by eligible employees in the exchange offer. The tendered options were cancelled on July 25, 2003, and new options will be granted at least six months and one day from cancellation date, with the new grant date expected to be on January 26, 2004. The terms and conditions of the new options will vary from the terms and conditions of the tendered options in several ways, including (a) the exercise price of the new options will be the closing price of the Company's common stock on the date of the new option grant, (b) each new option will be a non-statutory stock option, even if the tendered option was an incentive stock option, and (c) the vesting schedule of each new option will be as follows: 12.5% of the shares subject to the new option will be vested on the new option grant date, and 1/48 of the shares subject to the new option will vest monthly thereafter, subject to the option holder's continued employment through each relevant vesting date.

On July 31, 2003, the Company canceled 3,174,194 unvested non-qualified common stock options issued outside of the 2000 Plan to the Company's former Interim Chief Executive Officer.

On August 1, 2003, the Company issued 2,000,000 non-qualified common stock options outside of the 2000 Equity Incentive Plan (2000 Plan) at an exercise price of \$1.18 per share, the fair market value of its common stock on that date. Accordingly, no stock-based compensation was recorded for this grant. In addition, on August 4, 2003, the Company sold 500,000 shares of restricted common stock at a price of \$0.001 per share. Deferred stock compensation of \$590,000 was recorded for this issuance. Both issuances were part of the compensation package for the Company's new President and Chief Executive Officer. Both issuances are subject to the following vesting provisions: 1/4th vests one year after the issuance date and 1/48th vests on the first day of each full month thereafter, so that all shall be vested on the first day of the 48th month after the issuance date; provided, however, that if he is terminated by the Company other than for cause prior to the one-year anniversary of the date of the issuance, 1/48th vests on the one-month anniversary of the issuance date until the termination date.

During the quarter ended September 30, 2003, the Company also issued a total of 1,950,000 non-qualified common stock options outside of the 2000 Plan at an exercise price equal to the fair market value of its common stock, as inducement grants to two new executive officers and two new employees of the Company. Accordingly, no stock-based compensation was recorded for these grants.

During the quarter ended December 31, 2003, the Company issued a total of 245,000 non-qualified common stock options outside of the 2000 Plan at an exercise price equal to the fair market value of its common stock, as inducement grants to three new employees of the Company. Accordingly, no stock-based compensation was recorded for these grants.

9. Accrued Warranty Reserve

The following table represents the changes in the product warranty liability for the quarter ended March 31, 2003:

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CAPSTONE TURBINE CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

Balance at beginning of period	\$6,913,000
Reductions for payments made in cash or in kind	(641,000)
Changes for accruals related to warranties issued during the period	148,000
Changes for accruals related to preexisting warranties	237,000
	<hr/>
Balance at end of period	\$6,657,000

10. Commitments and Contingencies

As of March 31, 2003, the Company had firm commitments to purchase inventories of approximately \$4,300,000 and \$2,400,000 for non-inventory items.

In December 2001, a purported shareholder class action lawsuit was filed against the Company, two of its officers, and the underwriters of the Company's initial public offering. The suit purports to be a class action filed on behalf of purchasers of the Company's common stock during the period from June 28, 2000 to December 6, 2000. An amended complaint was filed on April 19, 2002. No date has been set for the Company to respond to the complaint. Plaintiffs allege that the underwriter defendants agreed to allocate stock in the Company's June 28, 2000 initial public offering and November 16, 2000 secondary offering to certain investors in exchange for excessive and undisclosed commissions and agreements by those investors to make additional purchases of stock in the aftermarket at pre-determined prices. Plaintiffs allege that the prospectuses for these two public offerings were false and misleading in violation of the securities laws because they did not disclose these arrangements. A committee of the Company's Board of Directors conditionally approved a proposed partial settlement with the plaintiffs in this matter. The settlement would provide, among other things, a release of the Company and of the individual defendants for the conduct alleged in the action to be wrongful in the Amended Complaint. The Company would agree to undertake other responsibilities under the partial settlement, including agreeing to assign away, not assert, or release certain potential claims the Company may have against its underwriters. Any direct financial impact of the proposed settlement is expected to be borne by the Company's insurers. The committee agreed to approve the settlement subject to a number of conditions, including the participation of a substantial number of other defendants in the proposed settlement, the consent of the Company's insurers to the settlement, and the completion of acceptable final settlement documentation. Furthermore, the settlement is subject to a hearing on fairness and approval by the Court.

The Company was a defendant in a breach of contract lawsuit, brought by a party that conducts business with the Company, claiming damages in excess of \$10 million. The lawsuit was dismissed, however, the contract provides for arbitration proceeding. In the event of arbitration, the ultimate outcome of such a proceeding would be uncertain.

11. Related Party Transactions

Mr. Eliot Protsch is the Chairman of the Company's Board of Directors. Mr. Protsch is Senior Executive Vice-President and Chief Financial Officer of Alliant Energy Corporation. He is also President of Interstate Power and Light Company, a subsidiary of Alliant Energy Corporation. Alliant Energy Resources, Inc., a subsidiary of Alliant Energy Corporation, is a distributor for the Company. Sales to Alliant Energy Resources, Inc. in the quarter ended March 31, 2003 were approximately \$11,000. There were no sales to Alliant Energy Resources, Inc. in the quarter ended March 31, 2002.

12. Selling, General and Administrative Expenses

As a result of a settlement agreement with a professional services firm, liabilities for \$1,099,000 of administrative expenses recorded in prior years were reversed in the first quarter of 2003.

13. Net Loss Per Common Share

Basic loss per common share is computed using the weighted-average number of common shares outstanding for the period. Diluted loss per share is also computed without consideration to potentially dilutive instruments because the Company incurred losses which would make them antidilutive. Outstanding stock options at March 31, 2003 and 2002 were 10 million and 6.8 million, respectively.

Table of Contents**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following discussion should be read in conjunction with the Consolidated Financial Statements and Notes included in this Transition Report and within the Company's Annual Report on Form 10-K for the year ended December 31, 2002. This document contains certain forward-looking statements (as such term is defined in Section 27A of the Securities Act of 1933, as amended and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act)) pertaining to, among other things, the Company's future results of operations, research and development (R&D) activities, sales expectations, our ability to develop markets for our products, sources for parts, federal, state and local regulations, and general business, industry and economic conditions applicable to the Company. When used in the following discussion, the words believes, anticipates, intends, expects, plans and similar expressions are intended to identify forward-looking statements. These statements are based largely on the Company's current expectations, estimates and forecasts and are subject to a number of risks and uncertainties. Actual results could differ materially from these forward-looking statements. Factors that can cause actual results to differ materially include, but are not limited to, those listed in Item 5 - Other Information of this Form 10-Q. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. The following factors should be considered in addition to the other information contained herein in evaluating the Company and its business. We undertake no obligation to revise or update publicly any of the forward-looking statements after the filing of this Form 10-Q to conform such statements to actual results or to changes in our expectations except as required by law.

Critical Accounting Policies and Estimates

The preparation of the Company's financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues 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. We believe 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, judgments and estimates are described in greater detail in our Annual Report on Form 10-K for the year ended December 31, 2002.

Impairment of long-lived assets, including intangible assets;

Inventory write-downs and classification of inventory;

Estimates of warranty obligations;

Sales returns and allowances;

Allowance for doubtful accounts;

Deferred tax assets; and

Loss contingencies.

Results of Operations***Quarters Ended March 31, 2003 and 2002***

Revenues. Revenues for the quarter ended March 31, 2003 decreased \$1.8 million to \$2.8 million from \$4.6 million for the same period last year. Revenues from product shipments for the quarter decreased \$2.4 million to \$1.4 million from \$3.8 million for the same period a year ago. During the quarter ended March 31, 2003, we shipped 1.3 megawatts, or 38 units, consisting of 32 units of our C30 products and 6 units of our C60 products. During the quarter ended March 31, 2002, we shipped 4.7 megawatts, or 127 units, consisting of 99 units of our C30 products and 28 units of our C60 products. Revenues from accessories, parts and service for the quarter ended March 31, 2003 increased \$0.6 million to \$1.4 million from \$0.8 million for the same period last year.

During the quarter ended March 31, 2003, 50% of our revenues were to two customers in North America as compared to 75% to two customers, a European utility and Sumitomo Corporation in Japan, for the same period last year.

Gross Loss. Cost of goods sold includes direct material costs, production overhead, inventory charges and provision for estimated product warranty expenses. We had a gross loss of \$2.2 million for the quarter ended March 31, 2003, compared to \$3.0 million for the same period last year. The reduction in gross loss was primarily from increased sales of accessories, parts and service, and higher average selling prices of microturbines due to product configuration mix.

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Our cost of goods sold has exceeded revenues each period. We expect this trend to continue until such time that we can sell a sufficient number of units to achieve a break-even margin. Despite our product and market advantages, the rate of adoption for our technology has been slower than initially anticipated. The present economic environment, with tight restrictions for capital expenditures, also makes it significantly more challenging. In our efforts to get to a higher rate of adoption and become profitable, we are working on three focus areas: specific vertical markets, lowering maintenance costs and new product development.

R&D Expenses. Research and development (R&D) expenses include compensation, the engineering department overhead allocations for administration and facilities and material costs associated with development. R&D expenses were \$1.0 million for the quarter ended March 31, 2003, compared to \$1.4 million for the same period a year ago. R&D expenses are reported net of benefits from cost sharing programs. These benefits were \$1.7 million for the quarter ended March 31, 2003 and \$1.3 million for the same period last year. Our gross R&D spending was comparable between periods.

Selling, General, and Administrative Expenses. Selling, general, and administrative (SG&A) expenses include compensation and related expenses in support of our general corporate functions, which include human resources, finance and accounting, shareholder relations, quality, information systems and legal services. SG&A expenses for the quarter ended March 31, 2003 decreased \$3.6 million to \$4.8 million, compared to \$8.4 million for the same period last year. The decrease was due to several factors including:

There was no amortization expense from marketing rights in the quarter ended March 31, 2003, compared to \$1.3 million in the same period last year. The marketing rights were fully impaired during the second quarter of 2002.

As a result of a settlement agreement with a professional services firm, liabilities for \$1.1 million of administrative expenses recorded in prior years were reversed in the first quarter of 2003. We do not expect similar reversals of expenses in future periods.

Spending was lower in 2003 as a result of our actions to reduce our cost structure, resize the business and lower our cash usage.

Interest Income. Interest income decreased \$0.4 million to \$0.4 million for the quarter ended March 31, 2003, compared to \$0.8 million for the same period a year ago. The decrease was primarily attributable to the lower cash balances and lower interest rates. We expect decreasing cash balances from our use of funds will continue to diminish our interest income.

Liquidity and Capital Resources

Our cash requirements depend on many factors, including our product development activities and our commercialization efforts. While we are working to reduce our cash usage, we expect to continue to devote substantial capital resources to running our business, including continuing the development of our sales and marketing programs and continuing our R&D activities. We believe that our current cash balance is sufficient to fund operating losses and our currently projected commitments to reach the point of cash flow positive. We have invested our cash in an institutional fund that invests in high quality short-term money market instruments to provide liquidity for operations and for capital preservation.

We used cash of \$7.7 million during the quarter ended March 31, 2003, compared to \$6.5 million for the same period last year.

Our net cash used in operations, excluding working capital, was \$6.1 million for the quarter ended March 31, 2003, compared to \$7.2 million for the same period last year. This decrease of \$1.1 million was primarily from a lower net loss. We used cash for working capital of \$0.8 million for the quarter ended March 31, 2003, compared to generating a source of cash from working capital of \$1.3 million for the same period last year. This increase of \$2.1 million was largely due to this year's first quarter having lower collections of accounts receivable as a result of lower sales, and higher inventory purchases.

Accounts receivable decreased \$1.2 million to \$3.7 million as of March 31, 2003 from \$4.9 million as of December 31, 2002. The decrease was due to lower sales in the first quarter of 2003 compared to sales in the fourth quarter of 2002.

Total inventory increased \$0.6 million to \$16.5 million as of March 31, 2003 from \$15.9 million as of December 31, 2002. At March 31, 2003, non-current inventory of \$4.4 million represents that portion of the inventory in excess of amounts expected to be sold or used in the next twelve months. The increase in total inventory was due to inventory purchases under firm contracts with our suppliers. As of March 31, 2003, the Company had firm commitments to purchase inventories of approximately \$4.3 million and \$2.4 million for non-inventory items.

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Net cash used in investing activities for acquisition of fixed assets was \$0.3 million for the quarter ended March 31, 2003, compared to \$0.4 million for the same period last year.

Our net cash used in financing activities of \$0.5 million for the quarter, compared to \$0.2 million for the same period a year ago primarily due to purchase of treasury stock of \$0.2 million this year. In October 2002, the Company's Board of Directors approved a stock repurchase program under which the Company may purchase up to \$10 million of the Company's common stock. The Company could purchase shares from time to time through open market and privately negotiated transactions at prices deemed appropriate by management. The program has no termination date. Since the inception of the program, we have repurchased 451,953 shares for an aggregate price of \$0.4 million.

There have been no material changes in the Company's remaining commitments under non-cancelable operating leases and capital leases as disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2002.

Impact of Recently Issued Accounting Standards

In May 2003, SFAS No. 150, *Accounting for Certain Instruments with Characteristics of Both Liabilities and Equity*, was issued. The standard establishes how an issuer classifies and measures certain freestanding financial instruments with characteristics of liabilities and equity and requires that such instruments be classified as liabilities. The standard is effective for financial instruments entered into or modified after May 31, 2003 and is otherwise effective at the beginning of the first interim period beginning after June 15, 2003. The adoption of this standard did not have a material impact on the Company's consolidated financial position, results of operations or cash flows.

In April 2003, SFAS No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*, was issued. The standard amends and clarifies financial reporting for derivative instruments and for hedging activities accounted for under SFAS No. 133 and is effective for contracts entered into or modified, and for hedges designated, after June 30, 2003. The adoption of this standard did not have a material impact on the Company's consolidated financial position, results of operations or cash flows.

In January 2003, the Emerging Issues Task Force released EITF 00-21: *Accounting for Revenue Arrangements with Multiple Deliverables*. EITF 00-21 clarifies the timing and recognition of revenue from certain transactions that include the delivery and performance of multiple products or services. EITF 00-21 is effective for revenue arrangements entered into in fiscal periods beginning after June 15, 2003. Alternatively, entities may elect to report the change in accounting as a cumulative-effect adjustment in accordance with APB Opinion 20, *Accounting Changes*. If so elected, disclosure should be made in periods subsequent to the date of initial application of this consensus of the amount of the recognized revenue that was previously included in the cumulative-effect adjustments. The adoption of EITF 00-21 did not have a material impact on the Company's consolidated financial position, results of operations or cash flows.

Item 3. Qualitative and Quantitative 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 the year ended December 31, 2002.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

An evaluation was performed under the supervision and with the participation of our management team, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Transition Report. Based on that evaluation, our management, including our Chief Executive Officer and Chief Financial Officer, have concluded that our disclosure controls and procedures were effective, as of March 31, 2003, to provide reasonable assurance that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

Changes in Internal Controls

There were no changes in our internal control over financial reporting that occurred during the quarter ended March 31, 2003, that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II OTHER INFORMATION

Item 5. Other Information

Business Risks

Investors should carefully consider the risks described below before making an investment decision. These risks are not the only ones facing our Company. In addition, risks of which we are not aware or that we believe are immaterial may also impair our business operations. Our business could be harmed by any of these risks. These factors are described in greater detail in our Annual Report on Form 10-K for the year ended December 31, 2002 and our Quarterly Reports on Form 10-Q for the quarters ended March 31, 2003, June 30, 2003, and September 30, 2003.

We have a limited operating history characterized by net losses, and we anticipate continued losses;

Our success depends in significant part upon the services of management and key employees;

In any period, our sales may be significantly dependent upon sales to a few customers;

The economic downturn has made potential customers hesitant to make capital expenditures;

If we do not effectively implement our sales and marketing plans, our sales will not grow and we will not achieve profitability;

A sustainable market for microturbines may never develop or may take longer to develop than we anticipate, which would adversely impact our revenues and profitability;

We have limited experience in international sales and may not succeed in growing our international sales;

Product quality and reliability expectations may not be met adversely impacting market acceptance;

We depend upon the development of new products and enhancements of existing products;

We operate in a highly competitive market and may not be able to compete effectively as a result of factors affecting the market for our products;

Our competitors, some of which have significantly greater resources than we have, may be able to adapt more quickly to new or emerging technologies or to devote greater resources to the promotion and sale of their products, and we may be unable to compete effectively;

Changes in government regulations and the electric utility industry restructuring may affect demand for our microturbines;

We operate in a highly regulated business environment and changes in regulation could impose costs on us or make our products less economical;

Utility companies could place barriers to our entry into the marketplace, and we may not be able to sell our products effectively;

We may not be able to retain or develop additional strategic partners and distributors in our targeted markets, in which case our sales would not increase as expected;

We are subject to risks associated with our strategic alliance with United Technologies Corporation;

Our ability to identify and develop Authorized Service Providers can significantly impact our success;

Our suppliers and manufacturers may not supply us with a sufficient amount of components or components of adequate quality, and we may not be able to produce our product;

We may not achieve production cost reductions necessary to price our product competitively, which would impair our sales;

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Our products involve a lengthy sales cycle and we may not anticipate sales levels appropriately, which could impair our profitability;

We may not effectively expand our production capabilities, which would negatively impact our sales;

We may not be able to control our warranty exposure and our warranty reserve may not be sufficient to meet our warranty expense, which could impair our financial condition;

Termination of certain Supply and Distribution Agreements may require us to repurchase parts inventory;

The market price of our common stock is highly volatile and may decline regardless of our operating performance;

Our business is subject to the risk of earthquake;

We may not be able to manage our growth effectively or improve our operational, financial and management information systems, which would impair our profitability;

We depend on our intellectual property to make our products competitive, and if we are unable to protect our intellectual property, our business will suffer;

Potential intellectual property, shareholder or other litigation may adversely impact our business;

We may be unable to fund our future operating requirements, which could force us to curtail our operations;

We face fluctuations in operating results, which could impact our stock price; and

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Our announced stock repurchase program may not produce benefits for stockholders.

Item 6. Exhibits and Reports on Form 8-K:

(a) *Index to Exhibits.*

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

Exhibit Number	Description
3.1(2)	Second Amended and Restated Certificate of Incorporation of Capstone Turbine.
3.2(3)	Fifth Amended and Restated Bylaws of Capstone Turbine.
4.1(2)	Specimen stock certificate.
10.4(4)	Amended and Restated 2000 Equity Incentive Plan
10.12(5)	Transition Agreement and Mutual Release between Dr. Ake Almgren and Capstone Turbine Corporation dated October 31, 2002 and February 26, 2003
10.14(4)	Severance Pay Plan and First Amendment to the Severance Pay Plan
31.1(1)	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2(1)	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32(1)	Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

- (1) Filed herewith.
- (2) Incorporated by reference to Capstone Turbine's Registration Statement on Form S-1 (File No. 333-33024).
- (3) Incorporated by reference to Capstone Turbine's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2003 (File No. 001-15957).
- (4) Incorporated by reference to Capstone Turbine's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2003 (File No. 001-15957).
- (5) Incorporated by reference to Capstone Turbine's Annual Report on Form 10-K for the year ended December 31, 2002 (File No. 001-15957).

(b) *Reports on Form 8-K.*
None

