

LEMAITRE VASCULAR INC
Form 4
March 14, 2014

FORM 4

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

OMB APPROVAL

OMB Number: 3235-0287
Expires: January 31, 2005
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STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP OF SECURITIES

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(h) of the Investment Company Act of 1940

(Print or Type Responses)

1. Name and Address of Reporting Person *
LeMaitre Cornelia W

2. Issuer Name and Ticker or Trading Symbol
LEMAITRE VASCULAR INC
[LMAT]

5. Relationship of Reporting Person(s) to Issuer

(Check all applicable)

(Last) (First) (Middle)

3. Date of Earliest Transaction (Month/Day/Year)
03/12/2014

Director 10% Owner
 Officer (give title below) Other (specify below)
VP, Human Resources, Director

C/O LEMAITRE VASCULAR, INC, 63 SECOND AVENUE

(Street)

4. If Amendment, Date Original Filed(Month/Day/Year)

6. Individual or Joint/Group Filing(Check Applicable Line)
 Form filed by One Reporting Person
 Form filed by More than One Reporting Person

BURLINGTON, MA 01803

(City) (State) (Zip)

Table I - Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1. Title of Security (Instr. 3)	2. Transaction Date (Month/Day/Year)	2A. Deemed Execution Date, if any (Month/Day/Year)	3. Transaction Code (Instr. 8)	4. Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)	5. Amount of Securities Beneficially Owned Following Reported Transaction(s) (Instr. 3 and 4)	6. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	7. Nature of Ownership (Instr. 4)
				(A) or (D) Code V Amount (D) Price			
Common Stock	03/12/2014		S	100 ⁽¹⁾ D \$ 8.3	403,837	I	By spouse
Common Stock					174,581	D	

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly.

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SEC 1474 (9-02)

74

Other long-term liabilities

168

184

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, 35,841,462 shares issued and 35,724,994 shares outstanding at December 31, 2016; 23,857,516 shares issued and 23,753,873 shares outstanding at March 31, 2016

36

24

Additional paid-in capital

870,001

853,288

Explanation of Responses:

Accumulated deficit

(846,245)

(826,955)

Treasury stock, at cost; 116,468 shares at December 31, 2016 and 103,643 shares at March 31, 2016

(1,639)

(1,617)

Total stockholders' equity

22,153

24,740

Total

Explanation of Responses:

\$

56,402

\$

55,892

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		Nine Months Ended	
	December 31,		December 31,	
	2016	2015	2016	2015
Revenue:				
Product, accessories and parts	\$ 16,540	\$ 18,239	\$ 43,841	\$ 57,074
Service	3,645	3,220	10,408	9,270
Total revenue	20,185	21,459	54,249	66,344
Cost of goods sold:				
Product, accessories and parts	21,828	14,979	46,806	48,039
Service	2,356	2,429	7,772	7,641
Total cost of goods sold	24,184	17,408	54,578	55,680
Gross margin (loss)	(3,999)	4,051	(329)	10,664
Operating expenses:				
Research and development	1,282	2,905	4,254	8,193
Selling, general and administrative	4,848	7,002	15,631	21,796
Total operating expenses	6,130	9,907	19,885	29,989
Loss from operations	(10,129)	(5,856)	(20,214)	(19,325)
Other expense	(436)	—	(480)	(38)
Interest income	8	—	21	—
Interest expense	(129)	(159)	(392)	(506)
Change in fair value of warrant liability	1,777	—	1,777	—
Loss before income taxes	(8,909)	(6,015)	(19,288)	(19,869)
Provision for income taxes	—	—	3	3
Net loss	\$ (8,909)	\$ (6,015)	\$ (19,291)	\$ (19,872)
Net loss per common share				
Basic	\$ (0.26)	\$ (0.34)	\$ (0.63)	\$ (1.17)
Diluted	\$ (0.28)	\$ (0.34)	\$ (0.63)	\$ (1.17)
Weighted average shares used to calculate net loss per common share				
Basic	34,761	17,824	30,823	16,975
Diluted	37,947	17,824	30,823	16,975

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,	
	2016	2015
Cash Flows from Operating Activities:		
Net loss	\$ (19,291)	\$ (19,872)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	1,186	1,206
Amortization of deferred financing costs	129	129
Interest on restricted cash	(7)	—
Accounts receivable allowances	(1,384)	(176)
Inventory provision	824	898
Provision for warranty expenses	6,462	266
Loss on disposal of equipment	170	10
Stock-based compensation	653	1,504
Change in fair value of warrant liability	(1,777)	—
Warrant issuance expenses	421	—
Changes in operating assets and liabilities:		
Accounts receivable	1,747	(555)
Inventories	763	1,739
Prepaid expenses and other current assets	(334)	4
Accounts payable and accrued expenses	(1,134)	(248)
Accrued salaries and wages and long term liabilities	(464)	(411)
Accrued warranty reserve	(3,790)	(1,249)
Deferred revenue	212	907
Net cash used in operating activities	(15,614)	(15,848)
Cash Flows from Investing Activities:		
Expenditures for property and equipment	(431)	(1,437)
Net cash used in investing activities	(431)	(1,437)
Cash Flows from Financing Activities:		
Net repayments of revolving credit facility	(795)	(3,353)
Changes in restricted cash	—	(5,000)
Repayment of notes payable and capital lease obligations	(373)	(435)
Cash used in employee stock-based transactions	(16)	(90)
Net proceeds from issuance of common stock and warrants	19,886	7,412
Net cash provided by (used in) financing activities	18,702	(1,466)
Net increase (decrease) in Cash and Cash Equivalents	2,657	(18,751)

Explanation of Responses:

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Cash and Cash Equivalents, Beginning of Period	11,704	32,221
Cash and Cash Equivalents, End of Period	\$ 14,361	\$ 13,470
Supplemental Disclosures of Cash Flow Information:		
Cash paid during the period for:		
Interest	\$ 259	\$ 371
Income taxes	\$ 3	\$ 5
Supplemental Disclosures of Non-Cash Information:		
Acquisition of property and equipment through accounts payable	\$ 43	\$ 43
Renewal of insurance contracts which was financed by notes payable	\$ 503	\$ 477
Acquisition of property and equipment in consideration for the issuance of a note payable	\$ —	\$ 101

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”), and combined cooling, heat and power (“CCHP”)), renewable energy, natural resources, critical power supply, transportation and marine. 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 and gross profit 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 generally accepted accounting principles for complete financial statements. The condensed consolidated balance sheet at March 31, 2016 was derived from audited financial statements included in the Company’s Annual Report on Form 10-K for the year ended March 31, 2016. In the opinion of management, the interim condensed consolidated financial statements include all adjustments (including 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, 2016. 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 condensed 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 continues to be negatively impacted by the volatility of the global oil and gas markets, a strong U.S. dollar (making our products more expensive overseas) and ongoing geopolitical tensions in Russia, North Africa and the Middle East. The Company’s loss from operations for the third quarter of Fiscal 2017 was \$10.1 million. During the third quarter of Fiscal 2017, the Company recorded a one-time non-cash warranty provision of approximately \$5.2 million to proactively retrofit select non-Signature Series C200 microturbines with the more robust new Signature

Series generator components to improve product performance and reliability. Management believes that the Company will continue to make progress on its path to profitability by lowering its operating costs and continuing to develop geographical and vertical markets. The Company's cash and cash equivalents as of December 31, 2016 and March 31, 2016 were \$14.4 million (\$19.4 million when combined with restricted cash related to the line of credit (the "Credit Facility") with Wells Fargo Bank, National Association ("Wells Fargo")) and \$11.7 million (\$16.7 million when combined with restricted cash related to the Credit Facility with Wells Fargo), respectively. See Note 11—Revolving Credit Facility for discussion of the Credit Facility. Cash and cash equivalents and restricted cash, less the amount outstanding under the Credit Facility, or free cash, was \$10.7 million and \$7.2 million as of December 31, 2016 and March 31, 2016, respectively. The Company's working capital requirements during the third quarter of Fiscal 2017 were higher than planned, primarily as a result of warranty claims related to the proactive retrofit for non-Signature Series C200 microturbines. Additionally, the Company did not fully achieve its planned number of product shipments during the third quarter of Fiscal 2017, resulting in lower than expected revenue primarily in the United States and Canadian oil and gas markets. The Company completed an offering of common stock and warrants on October 21, 2016. See Note 9— Offerings of Common Stock and Warrants and At-the-Market Offering Program for discussion with respect to this offering.

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Based on management's projections, free cash of approximately \$10.7 million, is sufficient to meet the Company's anticipated cash needs for working capital and capital expenditures for at least the next twelve months. If revenue is less than management's projections, management may attempt to preserve the Company's cash and cash equivalents by managing certain operating expenses, assets and liabilities, specifically the procurement of inventory, timing of payments of accounts payable and capital expenditures depending on the results of the Company's operations.

If the Company is unable to manage its cash flows in the areas discussed above, the Company may need to raise additional capital in the near term. In connection with the October 21, 2016 offering of common stock and warrants, the Company is subject to a lock-up that expires in March 2017, with certain issuances of securities by the Company being exempt from the lock-up. The Company may seek to raise funds by selling additional securities pursuant to exemptions from the lock-up or after the expiration of the applicable lock-up period (through the at-the-market offering or otherwise) 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. Should the Company be unable to execute its plans (including raising funds through the at-the-market offering program after the lock-up period and maintaining availability under its Credit Facility) or obtain additional financing that may be needed, the Company may need to significantly reduce its operations. The consolidated financial statements do not include any adjustments that might result from the outcome of these uncertainties.

On November 6, 2015, the Company filed a Certificate of Amendment to its Second Amended and Restated Certificate of Incorporation with the Secretary of State of the State of Delaware to effect a 1-for-20 reverse stock split of the issued and outstanding shares of the Company's common stock, par value \$0.001 per share, effective as of 4:30 p.m. Eastern Standard Time on the filing date. For purposes of presentation, all share and per share information and instruments outstanding under stock plans contained in this Form 10-Q have been retroactively adjusted to reflect the reverse stock split.

The consolidated financial statements include the accounts of the Company, Capstone Turbine International, Inc., its wholly owned subsidiary that was formed in June 2004, Capstone Turbine Singapore Pte., Ltd., its wholly owned subsidiary that was formed in February 2011, and Capstone Turbine Financial Services, LLC, its wholly owned subsidiary that was formed in October 2015, after elimination of inter-company transactions. In connection with the Company's strategic plan to reduce its operating expenses, the Company is in the process of dissolving Capstone Turbine Singapore Pte., Ltd.

3. Recently Issued Accounting Standards

In November 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2016-18, "Statement of Cash Flows (Topic 230): Restricted Cash" ("ASU 2016-18"), which amends guidance and presentation related to restricted cash in the statement of cash flows, including stating that amounts generally described as restricted cash and restricted cash equivalents should be included within cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown in the statement of cash flows. ASU 2016-18 is effective for annual periods beginning after December 15, 2017, and interim periods within those annual periods. The Company does not believe that the adoption of the provisions of ASU 2016-18 will have a material impact on the Company's consolidated financial position or results of operations.

In March 2016, the FASB issued ASU 2016-09, Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting (“ASU 2016-09”). The standard is intended to simplify several areas of accounting for share-based compensation arrangements, including the income tax impact, classification on the statement of cash flows and forfeitures. ASU 2016-09 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2016, and early adoption is permitted. The Company is currently evaluating the potential impact ASU 2016-09 will have on its consolidated financial position and results of operations.

In July 2015, the FASB issued ASU 2015-11, Simplifying the Measurement of Inventory (“ASU 2015-11”). ASU 2015-11 requires inventory that is recorded using the first-in, first-out method to be measured at the lower of cost or net realizable value. ASU 2015-11 is effective for annual and interim periods beginning after December 15, 2016, and

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should be applied prospectively with early adoption permitted at the beginning of an interim or annual reporting period. The Company does not believe that the provisions of ASU 2015-11 will have a material effect on its consolidated financial position and results of operations.

In April 2015, the FASB issued ASU 2015-03, Interest – Imputation of Interest (Subtopic 835-30). The ASU was issued as part of FASB’s current plan to simplify overly complex standards. This ASU requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability. The recognition and measurement guidance for debt issuance costs are not affected by this ASU. The update requires retrospective application to all prior period amounts presented. This update is effective for annual and interim periods beginning on or after December 15, 2015, with early application permitted for financial statements that have not been issued. The Company adopted ASU 2015-03 with no impact on its consolidated financial position or results of operations.

In August 2014, the FASB issued ASU 2014-15, Disclosure of Uncertainties About an Entity’s Ability to Continue as a Going Concern (“ASU 2014-15”). ASU 2014-15 requires management to perform interim and annual assessments of an entity’s ability to continue as a going concern within one year of the date the financial statements are issued and provides guidance on determining when and how to disclose going concern uncertainties in the financial statements. Certain disclosures will be required if conditions give rise to substantial doubt about an entity’s ability to continue as a going concern. The amendments in ASU 2014-15 are effective for the annual period ending after December 15, 2016, and for annual periods and interim periods thereafter. Early application is permitted. The Company will apply the provisions of ASU 2014-15 during the fiscal year ended March 31, 2017 and does not believe that the adoption of these provisions will have a material impact on the Company’s consolidated financial position or results of operations.

In June 2014, the FASB issued ASU 2014-12, Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period (“ASU 2014-12”). ASU 2014-12 requires that a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. As such, the performance target should not be reflected in estimating the grant-date fair value of the award. ASU 2014-12 is effective for annual reporting periods beginning after December 15, 2015, with early adoption permitted. The Company has adopted ASU 2014-12 effective March 31, 2016 with no impact on its consolidated financial position or results of operations.

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers (“ASU 2014-09”). ASU 2014-09 supersedes nearly all existing revenue recognition guidance under GAAP. The standard’s core principle is that a company will recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. The Company is evaluating its existing revenue recognition policies and the impact of ASU 2014-09, if any, on its financial position and results of operations. The Company will be required to adopt the revenue recognition standard in annual reporting periods beginning after December 15, 2017 (fiscal year ending March 31, 2019) and interim periods within those annual periods.

4. Customer Concentrations and Accounts Receivable

Sales to BPC Engineering (“BPC”), one of the Company’s Russian distributors, and Horizon Power Systems (“Horizon”), one of the Company’s domestic distributors, each accounted for 16% of revenue for the three months ended December 31, 2016. Sales to E-Finity Distributed Generation, LLC (“E-Finity”), one of the Company’s domestic distributors,

Critchfield Pacific Incorporated, one of the Company's domestic distributors, Horizon and Dtc Soluciones Inmobiliarias S.A. de C.V. ("DTC"), one of the Company's Mexican distributors, accounted for 17%, 13%, 12% and 10%, respectively, of revenue for the three months ended December 31, 2015. For the nine months ended December 31, 2016, BPC and Horizon, accounted for 12% and 10% of revenue, respectively. For the nine months ended December 31, 2015, Horizon, E-Finity and Optimal Group Australia Pty Ltd ("Optimal"), one of the Company's Australian distributors, accounted for 16%, 11% and 10% of revenue, respectively.

Additionally, Horizon, DTC, E-Finity, and MicroTurbine Power, one of the Company's distributors in North Africa and parts of the Middle East, accounted for 22%, 17%, 12%, and 10%, respectively, of net accounts receivable as of December 31, 2016. DTC, Optimal, Reliable Secure Power Systems, one of the Company's domestic distributors, and

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Regale Energy Zrt, the Company's Hungarian distributor, accounted for 28%, 11%, 10% and 10%, respectively, of net accounts receivable as of March 31, 2016.

The Company recorded net bad debt expense of approximately \$12,000 for the three months ended December 31, 2016. During the nine months ended December 31, 2016, the Company recorded approximately \$1.4 million in net bad debt recovery with respect to the collection of cash for receivables primarily from BPC and Electro Mecanique Industries, one of the Company's distributors in the Middle East and Africa, previously reserved during Fiscal 2015.

As of December 31, 2016, the Company collected approximately \$1.5 million from BPC on their combined balances of previously reserved receivable and deferred revenue totaling approximately \$8.1 million. The Company recorded bad debt recovery of \$0.2 million for each of the three and nine months ended December 31, 2015.

5. Inventories

Inventories are valued on a first in first out ("FIFO") basis and lower of cost or market net of provisions for slow moving, excess, obsolete or otherwise impaired inventories and consisted of the following as of December 31, 2016 and March 31, 2016 (in thousands):

	December 31, 2016	March 31, 2016
Raw materials	\$ 14,860	\$ 16,539
Work in process	248	554
Finished goods	1,573	1,176
Total	16,681	18,269
Less non-current portion	(1,949)	(2,143)
Current portion	\$ 14,732	\$ 16,126

The non-current portion of inventories represents the 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 configurations. The weighted average age of the non-current portion of inventories on hand as of December 31, 2016 is 1.4 years. The Company expects to use the non-current portion of the inventories on hand as of December 31, 2016 over the periods presented in the following table (in thousands):

Non-current Inventory
Balance Expected

Expected Period of Use	to be Used
13 to 24 months	\$ 1,541
25 to 36 months	287
37 to 48 months	121
Total	\$ 1,949

6. Property, Plant and Equipment

The Company recorded depreciation expense of \$0.3 million and \$1.0 million for the three and nine months ended December 31, 2016, respectively. The Company recorded depreciation expense of \$0.3 million and \$1.0 million for the three and nine months ended December 31, 2015, respectively. Property, plant and equipment consisted of the following as of December 31, 2016 and March 31, 2016 (in thousands):

	December 31, 2016	March 31, 2016
Machinery, rental equipment, equipment, automobiles and furniture	\$ 18,974	\$ 19,016
Leasehold improvements	9,855	9,855
Molds and tooling	2,857	2,824
	31,686	31,695
Less, accumulated depreciation	(28,857)	(28,158)
Total property, plant and equipment, net	\$ 2,829	\$ 3,537

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7. Intangible Assets

The Company recorded amortization expense of \$0.1 million and \$0.2 million for the three and nine months ended December 31, 2016, respectively. The Company recorded amortization expense of \$0.1 million and \$0.2 million for the three and nine months ended December 31, 2015, respectively. Intangible assets consisted of the following as of December 31, 2016 and March 31, 2016 (in thousands):

	December 31, 2016			
	Weighted			
	Average	Intangible	Accumulated	Intangible
	Amortization	Assets,	Amortization	Assets, Net
	Period	Gross		
Manufacturing license	17 years	\$ 3,700	\$ 3,672	\$ 28
Technology	10 years	2,240	1,549	691
Backlog	Various	490	473	17
Trade name & Parts, service and TA100 customer relationships	1.2 to 5 years	1,766	1,766	—
Total		\$ 8,196	\$ 7,460	\$ 736

	March 31, 2016			
	Weighted			
	Average	Intangible	Accumulated	Intangible
	Amortization	Assets,	Amortization	Assets, Net
	Period	Gross		
Manufacturing license	17 years	\$ 3,700	\$ 3,635	\$ 65
Technology	10 years	2,240	1,381	859
Backlog	Various	490	473	17
Trade name & Parts, service and TA100 customer relationships	1.2 to 5 years	1,766	1,766	—
Total		\$ 8,196	\$ 7,255	\$ 941

Expected future amortization expense of intangible assets as of December 31, 2016 is as follows (in thousands):

Year Ending March 31,	Amortization Expense
2017 (remainder of fiscal year)	\$ 83
2018	242
2019	224
2020	187
Thereafter	—
Total expected future amortization	\$ 736

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 \$7,400 and \$7,200 were earned by Solar for the three months ended December 31, 2016 and 2015, respectively. Royalties of approximately \$22,100 and \$26,400 were earned by Solar for the nine months ended December 31, 2016 and 2015, respectively. Earned royalties of approximately \$7,400 and \$35,000 were unpaid as of December 31, 2016 and March 31, 2016, respectively, and are included in accounts payable and accrued expenses in the accompanying balance sheets.

8. Stock-Based Compensation

The Company effected a 1-for-20 reverse stock split of its outstanding common stock effective November 6, 2015. The reverse stock split did not change the authorized number of shares or par value of the Company’s common stock or preferred stock, but did effect a proportionate adjustment to the per share exercise price and the number of shares of common stock issuable upon the exercise of outstanding stock options, the number of shares of common stock issuable upon the vesting of restricted stock units and performance restricted stock units, and the number of shares of

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common stock eligible for issuance. All per-share amounts and the Company's shares outstanding for all periods have been retroactively adjusted to reflect the reverse split.

The following table summarizes, by statement of operations line item, stock-based compensation expense for the three and nine months ended December 31, 2016 and 2015 (in thousands):

	Three Months		Nine Months	
	Ended		Ended	
	December 31,		December 31,	
	2016	2015	2016	2015
Cost of goods sold	\$ 16	\$ 63	\$ 45	\$ 132
Research and development	6	47	22	56
Selling, general and administrative	152	546	586	1,316
Stock-based compensation expense	\$ 174	\$ 656	\$ 653	\$ 1,504

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 1,849,000 shares.

Stock Options

The Company issues stock options under the 2000 Plan to employees, non-employee directors and consultants that vest and become exercisable over a four-year period and expire 10 years after the grant date. The Company uses a Black-Scholes valuation model to estimate the fair value of the options at the grant date, and compensation cost is recorded on a straight-line basis over the vesting period. Generally, stock based compensation expense is based on awards that are ultimately expected to vest and accordingly, stock based compensation recognized is reduced by estimated forfeitures. Management's estimate of forfeitures is based on historical forfeitures. 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. Information relating to stock options for the nine months ended December 31, 2016 is as follows:

	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value
Options outstanding at March 31, 2016	467,631	\$ 22.68		
Granted	88,930	\$ 1.70		
Exercised	—	\$ —		
Forfeited, cancelled or expired	(199,524)	\$ 25.84		
Options outstanding at December 31, 2016	357,037	\$ 15.69	5.0	—
Options fully vested at December 31, 2016 and those expected to vest beyond December 31, 2016	347,605	\$ 16.07	5.0	—
Options exercisable at December 31, 2016	268,107	\$ 20.33	3.4	—

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Black-Scholes Model Valuation Assumptions

There were no stock options granted during either of the three months ended December 31, 2016 and 2015. The Company calculated the estimated fair value of each stock option granted during the nine months ended December 31, 2016 and 2015 on the date of grant using the Black-Scholes option-pricing model and the following weighted-average assumptions:

	Three Months Ended		Nine Months Ended	
	December 31, 2016	2015	December 31, 2016	2015
Risk-free interest rates	—%	—	1.3 %	1.5 %
Expected lives (in years)	—	—	5.7	5.7
Dividend yield	—%	—	— %	— %
Expected volatility	—%	—	133.9%	59.0%
Weighted average grant date fair value of options granted during the period	\$ —	\$ —	\$ 1.52	\$ 6.84

The Company's computation of expected volatility for the nine months ended December 31, 2016 and 2015 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 term. During the fiscal year ended March 31, 2016, the Company's executive management team voluntarily agreed to cancel and terminate a total of 65,508 unvested stock options that had been previously issued to them. The Company recorded expense of approximately \$8,000 and \$0.1 million associated with its stock options during the three months ended December 31, 2016 and 2015, respectively. The Company recorded expense of approximately \$11,000 and \$0.4 million associated with its stock options during the nine months ended December 31, 2016 and 2015, respectively. As of December 31, 2016, there was approximately \$0.1 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 3.7 years.

Restricted Stock Units and Performance Restricted Stock Units

The Company issues restricted stock units under the 2000 Plan to employees, non-employee directors and consultants. The restricted stock units are 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 is reduced by estimated forfeitures. The Company's estimate of forfeitures is based on historical forfeitures. The restricted stock units vest in equal installments over a period of four years. For restricted stock units with four year vesting, one-fourth vest annually beginning one year after the issuance date. The restricted stock units

issued to non-employee directors vest one year after the issuance date. The following table outlines the restricted stock unit and performance restricted stock unit (“PRSU”) activity:

Restricted Stock and Performance Restricted Stock Units	Shares	Weighted Average Grant Date Fair Value
Nonvested restricted stock units outstanding at March 31, 2016	256,787	\$ 6.53
Granted	230,439	1.64
Vested and issued	(95,383)	8.28
Forfeited	(44,582)	6.54
Nonvested restricted stock units outstanding at December 31, 2016	347,261	2.80
Restricted stock units expected to vest beyond December 31, 2016	322,475	\$ 2.83

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The following table provides additional information on restricted stock units for the three and nine months ended December 31, 2016 and 2015:

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2016	2015	2016	2015
Restricted stock compensation expense (in thousands)	\$ 165	\$ 204	\$ 540	\$ 715
Aggregate fair value of restricted stock units vested and issued (in thousands)	\$ 25	\$ 4	\$ 132	\$ 344
Weighted average grant date fair value of restricted stock units granted during the period	\$ 0.91	\$ 1.19	\$ 1.64	\$ 3.34

As of December 31, 2016, there was approximately \$0.6 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 1.7 years.

PRSU activity is included in the above restricted stock units tables. The PRSU Program has a three-year performance measurement period. The performance measurement period will begin on April 1 of the first fiscal year and end on March 31 of the third fiscal year. The program is intended to have overlapping performance measurement periods (e.g., a new three year cycle begins each year on April 1), subject to Compensation Committee approval. The Chief Executive Officer was the only participant for Fiscal 2016. At the end of each performance measurement period, the Compensation Committee will determine the achievement against the performance objectives. Any earned PRSU awards will vest 50% after the end of the applicable performance measurement period and 50% one year thereafter.

There were no PRSUs granted during either of the three or nine months ended December 31, 2016. During the first quarter of Fiscal 2016, the Company granted a total of 10,000 PRSUs to the Chief Executive Officer. The weighted average per share grant date fair value of PRSUs granted during the first quarter of Fiscal 2016 was \$15.50. Based on the Company's assessment as of March 31, 2016 that the PRSU threshold for the first performance measurement of the PRSUs granted in Fiscal 2016 likely would not be met, the Chief Executive Officer PRSU awards were adjusted and no compensation expense was recorded or recognized during Fiscal 2016. Any compensation expense will be recognized over the corresponding requisite service period and will be adjusted in subsequent reporting periods if the Company's assessment of the probable level of achievement of the performance goals changes. The Company will continue to periodically assess the likelihood of the PRSU threshold being met until the end of the applicable performance period.

Restricted Stock Awards

The Company issues restricted stock awards under the 2000 Plan to employees and non-employee directors. During the three and nine months ended December 31, 2016 the Company granted stock awards 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 following table outlines the restricted stock award activity for the three and nine months ended December 31, 2016 and 2015:

	Three Months December 31,		Nine Months Ended December 31,	
	2016	2015	2016	2015
Restricted stock awards compensation expense (in thousands)	\$ 1	\$ 317	\$ 102	\$ 380
Restricted stock awards granted	1,389	255,912	63,500	263,594
Weighted average grant date fair value of restricted stock awards granted during the period	\$ 0.90	\$ 1.24	\$ 1.56	\$ 1.44

For each term of the Board of Directors (beginning on the date of an annual meeting of stockholders and ending on the date immediately preceding the next annual meeting of stockholders), a non-employee director may elect to receive a stock award in lieu of all or any portion of their annual retainer or committee fee cash payment. The shares of stock were valued based on the closing price of the Company's common stock on the date of grant.

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Grants outside of 2000 Plan

As of December 31, 2016, the Company had outstanding 131,430 non-qualified common stock options and 14,820 restricted stock units issued outside of the 2000 Plan. The Company granted 88,930 of these stock options during the three months ended September 30, 2016, 42,500 of these stock options prior to Fiscal 2017 and 14,820 of these restricted stock units during the three months ended September 30, 2016 as inducement grants to new officers and employees of the Company, with exercise prices or values, as applicable, based on the fair market value of the Company's common stock on the grant date.

Outside of 2000 Plan	Options	RSUs
Executive Vice President of Sales and Marketing	42,500	—
Vice President, Manufacturing	88,930	14,820
Outstanding stock outside of 2000 Plan	131,430	14,820

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.

Stockholder Rights Plan

On May 6, 2016, the Company entered into Amendment No. 5 (the "Amendment") to the Rights Agreement, dated as of July 7, 2005, as amended by Amendment No. 1, dated as of July 3, 2008, Amendment No. 2, dated as of June 9, 2011, Amendment No. 3, dated as of July 1, 2014 and Amendment No. 4, dated as of August 5, 2014, (the "Original Rights Agreement") between the Company and Computershare Inc.

The Amendment accelerated the expiration of the Company's preferred share purchase rights (the "Original Rights") from 5:00 p.m., California time, on the 30th day after the Company's 2017 annual meeting of stockholders to 5:00 p.m., California time, on May 6, 2016, and had the effect of terminating the Original Rights Agreement on that date. At the time of the termination of the Original Rights Agreement, all of the Original Rights distributed to holders of the Company's common stock pursuant to the Original Rights Agreement expired.

On May 6, 2016, the Company entered into a rights agreement (the "NOL Rights Agreement") with Computershare Inc., as rights agent. In connection with the NOL Rights Agreement, the Company's Board of Directors authorized and declared a dividend distribution of one preferred stock purchase right (a "New Right") for each share of the Company's common stock authorized and outstanding. Each New Right entitles the registered holder to purchase from the Company a unit consisting of one one-thousandth of a share of Series B Junior Participating Preferred Stock, par value \$0.001 per share, at a purchase price of \$8.76 per unit, subject to adjustment. The description and terms of the New Rights are set forth in the NOL Rights Agreement.

The purpose of the NOL Rights Agreement is to diminish the risk that the Company's ability to use its net operating losses and certain other tax assets (collectively, "Tax Benefits") to reduce potential future federal income tax obligations would become subject to limitations by reason of the Company's experiencing an "ownership change," as defined in Section 382 of the Internal Revenue Code of 1986. A company generally experiences such an ownership change if the percentage of its stock owned by its "5-percent shareholders," as defined in Section 382 of the Internal Revenue Code of 1986, increases by more than 50 percentage points over a rolling three-year period. The NOL Rights Agreement is

designed to reduce the likelihood that the Company will experience an ownership change under Section 382 of the Internal Revenue Code of 1986 by (i) discouraging any person or group from becoming a 4.99% shareholder and (ii) discouraging any existing 4.99% shareholder from acquiring additional shares of the Company's stock.

The New Rights will not be exercisable until the earlier to occur of (i) the close of business on the tenth business day after a public announcement or filing that a person has, or group of affiliated or associated persons or persons acting in concert have, become an "Acquiring Person," which is defined as a person or group of affiliated or associated persons or persons acting in concert who, at any time after the date of the NOL Rights Agreement, have acquired, or obtained the right to acquire, beneficial ownership of 4.99% or more of the Company's outstanding shares of common stock, subject to certain exceptions or (ii) the close of business on the tenth business day after the

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commencement of, or announcement of an intention to commence, a tender offer or exchange offer the consummation of which would result in any person becoming an Acquiring Person (the earlier of such dates being called the “Distribution Date”). Certain synthetic interests in securities created by derivative positions, whether or not such interests are considered to be ownership of the underlying common stock or are reportable for purposes of Regulation 13D of the Exchange Act, are treated as beneficial ownership of the number of shares of common stock equivalent to the economic exposure created by the derivative position, to the extent actual shares of the common stock are directly or indirectly held by counterparties to the derivatives contracts.

The New Rights, which are not exercisable until the Distribution Date, will expire prior to the earliest of (i) May 6, 2019 or such later day as may be established by the Board of Directors prior to the expiration of the New Rights, provided that the extension is submitted to the Company’s stockholders for ratification at the next annual meeting of stockholders of the Company succeeding such extension; (ii) the time at which the New Rights are redeemed pursuant to the NOL Rights Agreement; (iii) the time at which the New Rights are exchanged pursuant to the NOL Rights Agreement; (iv) the time at which the New Rights are terminated upon the occurrence of certain transactions; (v) the close of business on the first day after the Company’s 2017 annual meeting of stockholders, if approval by the stockholders of the Company of the NOL Rights Agreement has not been obtained on or prior to the close of business on the first day after the Company’s 2017 annual meeting of stockholders; (vi) the close of business on the effective date of the repeal of Section 382 of the Internal Revenue Code of 1986, if the Board of Directors determines that the NOL Rights Agreement is no longer necessary or desirable for the preservation of Tax Benefits; and (vii) the close of business on the first day of a taxable year of the Company to which the Board of Directors determines that no Tax Benefits are available to be carried forward.

Each share of Series B Junior Participating Preferred Stock will be entitled, when, as and if declared, to a preferential per share quarterly dividend payment equal to the greater of (i) \$1.00 per share or (ii) an amount equal to 1,000 times the dividend declared per share of common stock. Each share of Series B Junior Participating Preferred Stock will entitle the holder thereof to 1,000 votes on all matters submitted to a vote of the stockholders of the Company. In the event of any merger, consolidation or other transaction in which shares of common stock are converted or exchanged, each share of Series B Junior Participating Preferred Stock will be entitled to receive 1,000 times the amount received per one share of common stock.

9. Offerings of Common Stock and Warrants and At-the-Market Offering Program

On October 18, 2016, the Company entered into a securities purchase agreement with certain accredited investors, pursuant to which the Company agreed to sell 3.6 million shares of common stock, pre-funded Series B warrants to purchase up to 2.7 million shares of common stock, and Series A warrants to purchase up to 6.3 million shares of common stock. Pursuant to a placement agent agreement, dated as of October 18, 2016, the Company engaged Oppenheimer & Co. Inc. as the lead placement agent for the offering and ROTH Capital Partners, LLC as co-placement agent for the offering. Each share of common stock was sold at a price of \$1.20. Each Series B warrant was issued with an exercise price of \$1.20 per share of common stock, \$1.19 of which was pre-funded at closing and \$0.01 of which will be payable upon exercise. Each Series A warrant was issued with an initial exercise price of \$1.34 per share of common stock. These Series A warrants contain anti-dilution provisions that reduce the exercise price of the warrants if certain dilutive issuances occur. The anti-dilution provisions of the Series A warrants are subject to approval by the Company’s stockholders. The Series A warrants are classified as liabilities under the caption “Warrant liability” in the accompanying balance sheets and recorded at estimated fair value with the corresponding charge under the caption “Change in fair value of warrant liability” in the accompanying statements of operations. See Note 10—Fair

Value Measurements for disclosure regarding the fair value of financial instruments. The net proceeds to the Company from this offering, after deducting the placement agent fees and other estimated offering expenses, were approximately \$6.8 million. The offering closed on October 21, 2016. In connection with the offering, the Company is subject to a lock-up that expires in March 2017, with certain issuances of securities by the Company being exempt from the lock-up.

On April 19, 2016, the Company entered into an underwriting agreement with Oppenheimer & Co. Inc. as the sole book-running manager, and Rodman & Renshaw, a unit of H.C. Wainwright & Co., LLC, as the co-manager, related to the public offering of 2.7 million shares of our common stock and pre-funded Series B warrants to purchase up to 5.5 million shares of common stock, which were offered in lieu of common stock to those purchasers whose purchase of common stock in the offering otherwise would result in the purchaser beneficially owning more than 4.99% of the Company's outstanding common stock following the completion of the offering. Also included in the offering were Series A warrants to purchase 4.1 million shares of common stock. Every two shares of common stock were sold with

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one Series A warrant to purchase one share of common stock at a collective negotiated price of \$3.50. Every two Series B warrants were sold with one Series A warrant to purchase one share of common stock at a collective negotiated price of \$3.48. The Series A warrants are exercisable, subject to certain limitations, during the period commencing six months after the date of the issuance and expire five years after the first day they are exercisable. The pre-funded Series B warrants are exercisable, subject to certain limitations, upon issuance and expire nine months from the date of issuance, subject to extension under certain circumstances. The net proceeds to the Company from the sale of the common stock and warrants, after deducting fees and other offering expenses, were approximately \$13.1 million. The offering closed on April 22, 2016.

The following table outlines the warrant activity for the nine months ended December 31, 2016:

	Series A Warrants	Series B Warrants
Balance, April 22, 2016 (date of issuance)	4,107,500	5,515,000
Warrants exercised	—	(4,107,500)
Warrants expired	—	—
Balance, September 30, 2016	4,107,500	1,407,500
Issuance of warrants October 21, 2016	6,300,000	2,700,000
Warrants exercised		(1,407,500)
Balance, December 31, 2016	10,407,500	2,700,000

Effective August 28, 2015, the Company entered into a sales agreement with respect to an at-the-market offering program pursuant to which the Company may offer and sell, from time to time at its sole discretion, shares of its common stock, having an aggregate offering price of up to \$30.0 million. The Company will set the parameters for sales of the shares, including the number to be sold, the time period during which sales are requested to be made, any limitation on the number that may be sold in one trading day and any minimum price below which sales may not be made. During Fiscal 2016, 6.9 million shares of the Company's common stock were sold pursuant to the at-the-market offering program and the net proceeds to the Company from the sale of the common stock, after deducting fees and other offering expenses, were approximately \$12.7 million. In connection with the October 2016 offering of common stock and warrants, the Company is subject to a lock-up that expires in March 2017, which includes the at-the-market offering program. During the nine months ended December 31, 2016 the Company did not sell any common stock pursuant to the at-the-market offering program.

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.

Explanation of Responses:

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

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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 must maximize the use of observable inputs and minimize the use of unobservable inputs.

The table below presents our assets and liabilities that are measured at fair value on a recurring basis at December 31, 2016 and are categorized using the fair value hierarchy (in thousands):

Fair Value Measurements at December 31, 2016

	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash equivalents	\$ 9,015	\$ 9,015	\$ —	\$ —
Restricted cash	\$ 5,009	\$ 5,009	\$ —	\$ —
Warrant liability	\$ (2,463)	\$ —	\$ —	\$ (2,463)

Cash equivalents include cash held in money market and U.S. treasury funds at December 31, 2016.

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, 2016 and are categorized using the fair value hierarchy (in thousands):

Fair Value Measurements at March 31, 2016

Explanation of Responses:

	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash equivalents	\$ 3,002	\$ 3,002	\$ —	\$ —
Restricted cash	\$ 5,002	\$ 5,002	\$ —	\$ —

Basis for Valuation

The carrying values reported in the consolidated balance sheets for cash and cash equivalents, restricted cash, 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 Credit Facility are based on adjustable market rates reflective of what would currently be available to the Company, 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, 2016		As of March 31, 2016	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
Obligations under the credit facility	\$ 8,665	\$ 8,665	\$ 9,459	\$ 9,459

During the three months ended December 31, 2016, the Company sold and issued additional warrants that provide certain anti-dilution protections for the Holders. See Note 9— Offerings of Common Stock and Warrants and At-the-Market Offering Program for further discussion. The fair value of the Series A warrants issued on October 21, 2016 was \$4.2 million after giving effect to anti-dilution adjustments under the assumption that the anti-dilution mechanism contained in the Series A warrants was in effect. The change in the estimated fair value of the Series A warrants from the October 21, 2016 to December 31, 2016 was \$1.8 million and has been recorded under the caption “Change in fair value of warrant liability” in the accompanying statement of operations. The Company will continue to

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adjust the warrant liability for changes in fair value until the earlier of the exercise of the warrants, modification of the warrants, or expiration of the warrants. Changes in the fair value of Series A warrants will be recorded in the statements of operations under the caption “Change in fair value of warrant liability.”

The fair value of the Company’s warrant liability (see Note 9— Offerings of Common Stock and Warrants and At-the-Market Offering Program) recorded in the Company’s financial statements 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 is 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 calculated the estimated fair value of warrants on the date of issuance and at each subsequent reporting date using the following assumptions:

	Nine Months Ended December 31, 2016
Risk-free interest rates range	1.3% to 2.0 %
Contractual term (in years)	5.3 years to 5.5 years
Expected volatility range	68.5% to 69.1%

From time to time, the Company sells 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 statements of operations. The table below provides a reconciliation of the beginning and ending balances for the warrant liability which is measured at fair value using significant unobservable inputs (Level 3) (in thousands):

Warrant liability:	
Balance as of September 30, 2016	\$ —
Total realized and unrealized (gains) losses:	
Income included in change in fair value of warrant liability	1,777
Issuances	(4,240)
Balance as of December 31, 2016	\$ (2,463)

11. Revolving Credit Facility

The Company maintains two Credit and Security Agreements, as amended (the “Credit Agreements”), with Wells Fargo, which provide the Company with a line of credit of up to \$20.0 million in the aggregate. As previously disclosed, the twelfth amendment to the Credit Agreements provided the Company the right, under certain circumstances, to increase the borrowing capacity available under the Company’s revolving lines of credit to an aggregate maximum of \$20.0 million from an aggregate maximum of \$15.0 million (the “Accordion Feature”). In addition, Wells Fargo has provided the Company with a non-revolving capital expenditure line of credit up to \$0.5 million to acquire additional eligible equipment for use in the Company’s business. Effective as of June 30, 2015, the Company exercised the Accordion Feature, thereby increasing the maximum borrowing capacity available to a maximum of \$20.0 million. 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. One of the Credit Agreements will terminate in accordance with its terms on September 1, 2017, and the other one will terminate on September 30, 2017.

The Credit 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

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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 Credit Agreements contain financial covenants, including (i) a requirement not to exceed specified levels of losses, (ii) a requirement to maintain a substantial minimum cash balance relative to the outstanding line of credit advances, which was \$7.4 million as of December 31, 2016, and (iii) limitations on the Company's annual capital expenditures. The Credit 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.

Several times since entering into the Credit Agreements the Company was not in compliance with certain covenants under the Credit Facility. In connection with each event of noncompliance, Wells Fargo waived the event of default and, on several occasions, the Company amended the Credit Agreements in response to the default and waiver. On June 10, 2015, the Company received from Wells Fargo a waiver of one such event of noncompliance, and as a condition of the amended Credit Agreements, the Company had restricted \$5.0 million of cash equivalents as additional security for the Credit Facility. If the Company had not obtained the waivers and amended the Credit Agreements, the Company would not have been able to draw additional funds under the Credit Facility. In addition, the Company has pledged its accounts receivables, inventories, equipment, patents and other assets as collateral for its Credit Agreements, which would be subject to seizure by Wells Fargo if the Company were in default under the Credit Agreements and unable to repay the indebtedness. Wells Fargo also has the option to terminate the Credit Agreements or accelerate the indebtedness during a period of noncompliance. As of December 31, 2016, the Company was in compliance with the covenants contained in the amended Credit Agreements for Fiscal 2017. Based on the Company's current forecasts, the Company believes it will maintain compliance with the covenants contained in the amended Credit Agreements through the end of Fiscal 2017. If a covenant violation were to occur, the Company would attempt to negotiate a waiver of non-compliance from Wells Fargo. On February 7, 2017, the Company and Wells Fargo entered into an amendment to the Credit Agreements regarding the release of restricted cash and the exclusion of certain items from the financial covenant calculations.

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 was 4.7% and 4.4% at December 31, 2016 and March 31, 2016, respectively.

The Company is 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, 2016 and March 31, 2016, \$8.7 million and \$9.5 million in borrowings were outstanding, respectively, under the Credit Facility. As of December 31, 2016, approximately \$9.7 million was available for additional borrowing. Interest expense related to the Credit Facility during the three months ended December 31, 2016 was \$0.1 million, which includes \$43,800 in amortization of deferred financing costs. Interest expense related to the Credit Facility during the three months ended December 31, 2015 was \$0.2 million, which includes \$43,800 in amortization of deferred financing costs. Interest expense related to the Credit Facility during the nine months ended December 31, 2016 was \$0.4 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, 2015 was \$0.5 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 microturbine product sold and geography of sale. The Company's product warranties generally start from the delivery date and continue for up to eighteen 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 to address reliability repairs on products no longer in warranty when, in the Company's judgment, and in accordance with a specific plan developed by the Company, it is prudent to provide such repairs. The Company assesses the adequacy of

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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 then taken into account in estimating future warranty liabilities. During the three months ended December 31, 2016, the Company recorded a one-time non-cash warranty provision of approximately \$5.2 million to retrofit proactively select non-Signature Series C200 microturbines with the more robust new Signature Series generator components to improve product performance and reliability. The balance of this reliability repair program as of December 31, 2016 was \$3.0 million. Changes in accrued warranty reserve during the nine months ended December 31, 2016 are as follows (in thousands):

Balance, beginning of the period	\$ 1,639
Standard warranty provision	1,274
Accrual related to reliability repair programs	5,188
Deductions for warranty claims	(3,790)
Balance, end of the period	\$ 4,311

13. Deferred Revenue

As of March 31, 2016 the balance of deferred revenue was \$4.4 million and the change in balance attributed to FPP contracts increased \$0.6 million and the change in deposits decreased \$0.4 million. Changes in deferred revenue during the nine months ended December 31, 2016 are as follows (in thousands):

FPP Balance, beginning of the period	\$ 2,929
FPP Billings	10,268
FPP Revenue recognized	(9,697)
Balance attributed to FPP contracts	3,500
Deposits	1,080
Deferred revenue balance, end of the period	\$ 4,580

Deferred revenue attributed to Comprehensive Factory Protection Plan (“FPP”) contracts represents the unearned portion of the billed 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 orders to be delivered in the future.

14. Other Current Liabilities

Explanation of Responses:

The Company is a party to a Development and License Agreement with Carrier Corporation (“Carrier”) regarding the payment of royalties on the sale of each of the Company’s 200 kilowatt (“C200”) microturbines. Carrier earned \$0.2 million and \$0.3 million in royalties for C200 and C1000 Series system sales during the three months ended December 31, 2016 and 2015, respectively. Carrier earned \$0.6 million and \$0.9 million in royalties for C200 and C1000 system sales during the nine months ended December 31, 2016 and 2015, respectively. Earned royalties of approximately \$0.2 million were unpaid as of each of December 31, 2016 and March 31, 2016, and are included in accrued expenses in the accompanying balance sheets.

15. Commitments and Contingencies

Purchase Commitments

As of December 31, 2016, the Company had firm commitments to purchase inventories of approximately \$30.5 million through Fiscal 2019. 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, 2020. All of the leases require the Company to pay maintenance, insurance and property taxes. The lease agreements for primary office and manufacturing facilities provide

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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 \$0.2 million as of each of December 31, 2016 and March 31, 2016. Rent expense was approximately \$0.6 million during each of the three months ended December 31, 2016 and 2015. Rent expense was approximately \$1.7 million and \$1.9 million during the nine months ended December 31, 2016 and 2015, 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. The contract had a term of five years, a project cost of approximately \$11.7 million and was completed in September 2015. The DOE contributed \$5.0 million toward the project, of which \$4.2 million was allocated to the Company, and the Company incurred approximately \$6.7 million in research and development expense. The Company billed the DOE under the contract for this project a cumulative amount of \$4.2 million through September 30, 2015, the date on which the contract was completed.

The Company has agreements with certain of its distributors requiring that if the Company renders parts obsolete in inventories the distributors own and hold in support of their obligations to serve fielded microturbines, then the Company is required to replace the affected stock at no cost 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 at distributors. As of December 31, 2016, no significant inventories were held at distributors.

Legal Matters

Federal Securities Class Action

Two putative securities class action complaints were filed against the Company and certain of its current and former officers in the United States District Court for the Central District of California under the following captions: David Kinney, etc. v. Capstone Turbine, et al., No. 2:15-CV-08914 on November 16, 2015 (the “Kinney Complaint”) and Kevin M. Grooms, etc. v. Capstone Turbine, et al., No. 2:15-CV-09155 on December 18, 2015 (the “Grooms Complaint”).

The putative class in the Kinney Complaint is comprised of all purchasers of the Company’s securities between November 7, 2013 and November 5, 2015. The Kinney Complaint alleges material misrepresentations and omissions in public statements regarding BPC and the likelihood that BPC would not be able to fulfill many legal and financial obligations to the Company. The Kinney Complaint also alleges that the Company’s financial statements were not appropriately adjusted in light of this situation and were not maintained in accordance with GAAP, and that the Company lacked adequate internal controls over accounting. The Kinney Complaint alleges that these public statements and accounting irregularities constituted violations by all named defendants of Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder, as well as violations of Section 20(a) of the Exchange Act by the individual defendants. The Grooms Complaint makes allegations and claims that are substantially identical to those in the Kinney Complaint, and both complaints seek compensatory damages of an undisclosed amount. On January 16, 2016, several shareholders filed motions to consolidate the Kinney and Grooms actions and for appointment as lead plaintiff. On February 29, 2016, the Court granted the motions to consolidate, and appointed a lead plaintiff. On May 6, 2016, a Consolidated Amended Complaint with allegations and claims substantially identical to those of the Kinney Complaint was filed in the consolidated action. The putative class period in the Consolidated Amended Complaint is June 12, 2014 to November 5, 2015. Defendants filed a motion to dismiss the Consolidated Amended Complaint on

June 17, 2016. Plaintiffs' opposition was filed July 29, 2016, and Defendants' reply was filed September 23, 2016. The Company has not recorded any liability as of December 31, 2016 since any potential loss is not probable or reasonably estimable given the preliminary nature of the proceedings.

State Derivative Lawsuits — California

On February 18, 2016, a purported shareholder derivative action was filed in Los Angeles Superior Court in the State of California against the Company and certain of its current and former officers and directors under the following

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caption: Stesiak v. Jamison, et al., No. BC610782. The lawsuit alleges that certain of the Company's current and former officers and directors knew or should have known that BPC would be unable to fulfill its obligations to the Company, but allowed the Company to make false and misleading statements regarding BPC and the Company's financial condition. The complaint also alleges that the defendants failed to timely adjust the Company's accounts receivable and backlog to reflect BPC's inability to pay the Company. The complaint asserts causes of action for breach of fiduciary duty and unjust enrichment. It demands damages for the amount of damage sustained by the Company as a result of the individual defendants' alleged breach of fiduciary duties and unjust enrichment, that the Company institute corporate governance reforms, and disgorgement from the individual defendants. On May 5, 2016, the parties filed a stipulation and proposed order seeking to stay this action until such time as the defendants' motion(s) to dismiss the federal securities class action are decided. On May 10, 2016, the Court entered that proposed order. A status conference is scheduled for March 8, 2017.

On June 8, 2016, a purported shareholder derivative action entitled Velma Kilpatrick v. Simon, et al., No. BC623167, was filed in Los Angeles Superior Court in the State of California against the Company and certain of its current and former officers and directors. The complaint alleges that certain of the Company's current and former officers and directors knew or should have known that BPC would be unable to fulfill its obligations to the Company, but allowed the Company to make false and misleading statements regarding BPC and the Company's financial condition. The complaint also alleges that the defendants failed to timely adjust the Company's accounts receivable and backlog to reflect BPC's inability to pay the Company. The complaint asserts causes of action for breach of fiduciary duty. It demands damages for the amount of damage sustained by the Company as a result of the individual defendants' alleged breach of fiduciary duties, and that the Company institute corporate governance reforms. On August 23, 2016, the parties filed a stipulation and proposed order seeking to stay this action until such time as the defendants' motion(s) to dismiss the federal securities class action are decided. A status conference is scheduled for February 22, 2017.

On December 27, 2016, a purported shareholder derivative action entitled Andre Rosowsky v. Jamison, et al., No. 30-2016-00894859-CU-MC-CJC, was filed in Orange County Superior Court in the State of California against the Company and certain of its current and former officers and directors. The complaint alleges that certain of the Company's current and former officers and directors knew or should have known that BPC would be unable to fulfill its obligations to the Company, but allowed the Company to make false and misleading statements regarding BPC and the Company's financial condition. The complaint also alleges that the defendants failed to timely adjust the Company's accounts receivable and backlog to reflect BPC's inability to pay the Company. The complaint asserts causes of action for breach of fiduciary duty and unjust enrichment. It demands damages for the amount of damage sustained by the Company as a result of the individual defendants' alleged breach of fiduciary duties, that the Company institute corporate governance reforms, and restitution from the individual defendants.

Federal Derivative Lawsuits

On March 7, 2016, a purported shareholder derivative action was filed in the United States District Court for the Central District of California against the Company and certain of its current and former officers and directors under the following caption: Haber v. Jamison, et al., No. CV16-01569-DMG (RAOx). The lawsuit alleges that certain of the Company's current and former officers and directors knew or should have known that BPC would be unable to fulfill its obligations to the Company, but allowed the Company to make false and misleading statements regarding BPC and the Company's financial condition. The complaint asserts a cause of action for breach of fiduciary duty. It demands damages for the amount of damage sustained by the Company as a result of the individual defendants' alleged breach of fiduciary duties, and equitable relief, including that the Company institute appropriate corporate governance reforms. On May 11, 2016, the parties filed a stipulation and proposed order seeking to stay this action until such time as the defendants' motion(s) to dismiss the federal securities class action are decided. On May 13, 2016, the Court entered that proposed order.

On July 12, 2016 and July 18, 2016, respectively, two additional purported shareholder derivative actions were filed in the United States District Court for the Central District of California against the Company and certain of its current and former officers and directors, under the caption Tuttle v. Atkinson, et al., No. CV16-05127, and Boll v. Jamison, et al., No. CV16-5282, respectively. The lawsuits allege that certain of the Company's current and former officers and directors knew or should have known that BPC would be unable to fulfill its obligations to the Company, but allowed the Company to make false and misleading statements regarding BPC and the Company's financial condition. The Tuttle complaint asserts causes of action for breach of fiduciary duty, gross mismanagement, and unjust enrichment, and the Boll complaint asserts causes of action for breach of fiduciary duty, unjust enrichment, abuse of control, gross mismanagement, and waste of corporate assets. Both complaints demand damages sustained by the Company as a result of the individual defendants' alleged breaches of fiduciary duties, and equitable relief, including

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that the Company institute appropriate corporate governance reforms. The federal derivative actions have been consolidated and stayed until such time as the defendants' motion(s) to dismiss the federal securities class action are decided.

16. Net 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, 2016 which would make these instruments anti-dilutive. As of each of December 31, 2016 and 2015, the number of anti-dilutive stock options and restricted stock units excluded from diluted net loss per common share computations was approximately 0.7 million. As of the three and nine months ended December 31, 2016, the number of warrants excluded from diluted net loss per common share computations was approximately 6.8 million and 13.1 million, respectively. As of December 31, 2015, the Company did not have any warrants outstanding.

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2016	2015	2016	2015
Net Loss				
Net Loss - Basic	\$ (8,909)	\$ (6,015)	\$ (19,291)	\$ (19,872)
Change in fair value of warrant liability	(1,777)	—	(1,777)	—
Net Loss - Diluted	\$ (10,686)	\$ (6,015)	\$ (21,068)	\$ (19,872)
Basic Shares				
Basic weighted average shares outstanding	34,761	17,824	30,823	16,975
Diluted Shares				
Basic weighted average shares outstanding	34,761	17,824	30,823	16,975
Effect of dilutive warrants	3,186	—	—	—
Diluted weighted average shares outstanding	37,947	17,824	30,823	16,975
Net income (loss) per share:				
Basic	\$ (0.26)	\$ (0.34)	\$ (0.63)	\$ (1.17)
Diluted	\$ (0.28)	\$ (0.34)	\$ (0.63)	\$ (1.17)

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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, 2016. 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 2016 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. We assume no obligation to update any of the forward-looking statements contained herein after the filing of this Form 10-Q to conform such statements to actual results or changes in expectations except as may be required by law. All dollar amounts are approximate.

Overview

Capstone is the market leader in microturbines based on the number of microturbines sold. Generally, power purchased from the electric utility grid is less costly than power produced by distributed generation technologies. Utilities may also charge fees to interconnect to their power grids. However, we can provide economic benefits to end users in instances where the waste heat from our microturbine has value (combined heat and power ("CHP") and combined cooling, heat and power ("CCHP")), where fuel costs are low (renewable energy/renewable fuels), where the costs of connecting to the grid may be high or impractical (such as remote power applications), where reliability and power quality are of critical importance, or in situations where peak shaving could be economically advantageous because of highly variable electricity prices. Because Capstone microturbines can provide a reliable source of power and can operate on multiple fuel sources, management believes they offer a level of flexibility not currently offered by other technologies such as reciprocating engines.

During the third quarter of Fiscal 2017 our net loss increased by 48% to \$8.9 million and our basic loss per share improved by 24% to \$0.26 (\$0.28 diluted loss per share) compared to the same period last year. The increase in the net loss during the third quarter of Fiscal 2017 was primarily the result of a one-time non-cash warranty provision of approximately \$5.2 million to retrofit proactively select non-Signature Series C200 microturbines with the more robust new Signature Series generator components to improve product performance and reliability. As a result of the proactive retrofits performed in the third quarter, the warranty reserve liability remaining at the end of the quarter was approximately \$3.0 million for future proactive retrofits. During the third quarter of Fiscal 2017, our revenue from the Russian market was approximately 16% of revenue compared to 1% of revenue the same period last year as we continue to rebuild our business in the Russian market. During the third quarter of Fiscal 2017, our revenue from the oil and gas market was approximately 38% of revenue compared to 22% of revenue the same period last year as our oil and gas business continues to improve gradually. Our revenue continues to be negatively impacted by the volatility of the global oil and gas markets, a strong U.S. dollar (making our products more expensive overseas) and ongoing geopolitical tensions in Russia, North Africa and the Middle East.

Capstone products continue to gain interest in all six of the major vertical markets (energy efficiency, renewable energy, natural resources, critical power supply, transportation and marine). 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 is fueled by landfill gas, biodiesel, and biogas from sources such as food processing, agricultural waste and cow, pig and chicken manure. Our product sales in the oil and gas and other natural resources market is driven by our microturbines' reliability, emissions profile and ease of installation. Given the volatility of the oil and gas market, however, we have refocused our business strategy to target projects within the energy efficiency and renewal energy markets. The actual shift to the energy efficiency market is reflected in the product shipment by vertical markets table on page 25. We have also seen increased interest in critical power supply

applications as customers want solutions that can handle both primary and backup power.

We continue to focus on improving our products based on customer input, building brand awareness and new channels to market by developing a diversified network of strategic distribution partners. Our focus is on products and solutions that provide near term opportunities to drive repeatable business rather than discrete projects for niche markets. In addition, management closely monitors operating expenses and strives to improve manufacturing efficiencies while simultaneously lowering direct material costs and increasing average selling prices. The key drivers to Capstone's

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success are revenue growth, higher average selling prices, lower direct material costs, positive new order flow and reduced cash usage.

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 are as 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, marine and transportation 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. Given the volatility of the oil and gas market, Capstone has refocused its business strategy to target projects within the energy efficiency and renewable energy markets.

The following table summarizes our product shipments by vertical markets:

	Three Months Ended December 31, 2016		Nine Months Ended December 31, 2015	
Energy efficiency	53%	71%	58%	55%
Natural resources	38%	22%	34%	37%
Renewable energy	8%	7%	8%	8%
Critical Power Supply	1%	—	<1%	—

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 85% 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.

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.

Renewable Energy

Explanation of Responses:

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

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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.

Transportation

Our technology is also 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.

Marine

Our technology is also used in marine applications. Our customers have applied our products in the commercial vessel, work boats and cargo ship 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. This application is similar to our HEV application where the vessel is driven by an electric propulsion system and the microturbine serves as an on board range extender.

Backlog

Backlog represents the estimated amount of future product revenue to be recognized under negotiated contracts as shipments convert backlog to revenue for accounting purposes. A portion of our backlog is concentrated in the global oil and gas market which may impact the overall timing of shipments or the conversion of backlog to revenue. 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 18 months and that our backlog may not be indicative of future revenue. 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.

The following table summarizes changes in our backlog for the three months ended December 31, 2016 and 2015 (dollar amounts in millions):

	As of December 31,			2015		
	2016					
	Megawatts	Units	Dollars	Megawatts	Units	Dollars
Backlog, beginning of the period	113.3	581	\$ 109.1	108.0	579	\$ 104.8
Orders, net	12.4	54	11.5	13.0	49	12.3

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Shipments	(13.2)	(61)	(12.8)	(15.6)	(52)	(14.8)
Backlog, end of the period	112.5	574	\$ 107.8	105.4	576	\$ 102.3

Ending backlog as of December 31, 2016, includes the removal of a portion of our 100 kW microturbine (“TA100”) backlog of approximately \$2.4 million for 17 units, or 1.7 megawatts, acquired from Calnetix Power Solutions, Inc. This impairment, which occurred during the three months ended March 31, 2016, aligns our TA100 backlog with management’s decision to limit the production of TA100 systems on a case-by-case basis for key customers. The backlog balances as of December 31, 2015 in the above table do not reflect this adjustment.

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The following table summarizes our backlog:

	As of December 31,		2015	
	2016		Megawatts	Units
C30	1.7	57	1.7	56
C65	26.2	403	26.0	401
TA100	0.2	2	1.9	19
C200	3.4	17	2.8	14
C600	9.0	15	7.2	12
C800	4.0	5	4.8	6
C1000	67.0	67	60.0	60
Waste heat recovery generator	1.0	8	1.0	8
Total Backlog	112.5	574	105.4	576

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 102 distributors and Original Equipment Manufacturers (“OEMs”). In the United States and Canada, we currently have 24 distributors and OEMs. Outside of the United States and Canada, we currently have 78 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. Together with our global distribution network, we offer a comprehensive factory protection plan (“FPP”) for a fixed annual fee to perform regularly scheduled and unscheduled maintenance as needed. We provide factory and on-site 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, 2016 was \$77.2 million, which represents the value of the contractual agreement for FPP services that has not been earned and extends through Fiscal 2031. Our FPP backlog as of March 31, 2016 was \$66.5 million.
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, 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 and reduce direct material costs. During the three months ended September 30, 2016 we continued to make progress on our fuels program with a new and cleaner fuel injector apparatus. When used with liquid fuel, Capstone’s multi-staged lean pre-vaporizing, pre-mixing fuel injector provides ultra-low emissions that meet United States Environmental Protection Agency (EPA) Tier 4 requirements for power generation. The new fuel injector is currently available for Capstone’s C65 microturbine and will soon be extended to our other microturbine products. During the three months ended December 31, 2016, we continued development of our new Tier-4 liquid fuel injector, entered into a new partnership with the U.S. Department of Energy (“DOE”) on High Hydrogen fuels, continued successful testing on our Butane fuel program, and implemented

cost reductions on the Signature Series products.

During the three months ended September 30, 2015 our C200 and C1000 Series microturbines became Verband der Elektrotechnik (“VDE”) and Bundesverband der Energie - und Wasserwirtschaft (“BDEW”) and Comitato Electtrotecnico Italiano (“CEI”) certified. These new standards were attained following the development and implementation of new microturbine system software architecture.

We are also developing a more efficient microturbine CHP system with the support of the DOE, which awarded us a grant of \$5.0 million in support of this development program, of which \$4.2 million was allocated to us and was used through September 30, 2015. We successfully completed the first phase of the development program

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on September 30, 2015 and achieved 270 kW with a prototype C250 microturbine in our development test lab. Management intends to continue with the next phase of development and commercialization after we achieve profitability. The next phase will be to continue development of the C250 product architecture as well as the associated power electronics and software controls required for successful commercialization.

During Fiscal 2016, we unveiled the Capstone C1000 Signature microturbine as part of our new Signature Series microturbine energy systems which also includes an 800kW or 600kW microturbine. The Signature Series microturbine incorporates over 70 components, system and design upgrades intended to improve the overall product quality and enhance the microturbine ownership experience in all applications but specifically for CHP and CCHP applications. A few of the key upgrades include integrated heat recovery for CHP and CCHP applications, two-stage air filtration system, improved enclosure, relocated engine exhaust stack and redesigned discharge for enclosure cooling air. The C1000 Signature microturbine is one of the world's most integrated and compact one megawatt CHP solutions. The 8-foot wide by 30-foot long one megawatt power plant reaches approximately 82% total system efficiency and is significantly quieter than the original C1000 for installation in low noise urban environments.

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 and product mix, pricing and performance, our financial model indicates that we will achieve positive cash flow when we generate \$25 million in quarterly revenue with a 25% gross margin. 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 to \$15 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 condensed 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 condensed 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 condensed consolidated financial statements. These policies are described in greater detail in our Annual Report on Form 10-K for Fiscal 2016 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;
- Accounts receivable allowances;
- Deferred tax assets and valuation allowance; and

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- Stock-based compensation expense.

Results of Operations

Three Months Ended December 31, 2016 and 2015

Revenue Revenue for the three months ended December 31, 2016 decreased \$1.3 million, or 6%, to \$20.2 million from \$21.5 million for the three months ended December 31, 2015. The change in revenue for the three months ended December 31, 2016 compared to the three months ended December 31, 2015 included decreases in revenue of \$3.2 million from the United States and Canadian markets, \$1.4 million from the Latin American market and \$0.7 million from the Asian and Australian markets. These overall decreases in revenue were offset by increases in revenue of \$2.7 million from the European and Russian markets and \$1.3 million from the Middle East and African markets. The decrease in revenue in both the United States and Canadian markets and the Asian and Australian markets during the three months ended December 31, 2016 compared to the same period last year was primarily the result of large non-recurring microturbine product shipments for specific energy efficiency projects that occurred during the three months ended December 31, 2015. The decrease in revenue from the Latin American market during the three months ended December 31, 2016 compared to the same period last year was primarily the result of a strong U.S. dollar and reduced capital and operational spending, particularly in the upstream and midstream oil and gas markets. The increase in revenue in the European and Russian markets during the three months ended December 31, 2016 compared to the same period last year was primarily because of our strategic initiative to improve the diversification of our revenue, the improvement of BPC Engineering (“BPC”), one of the Company’s Russian distributors, and additional revenue from new distribution in the Russian market. The increase in revenue in the Middle East and African markets during the three months ended December 31, 2016 compared to the same period last year was primarily the result of our continued investment in key growth initiatives in those markets. Despite the increase in revenue in the Russian, Middle East and African markets noted above, our revenue continues to be negatively impacted by the volatility of the global oil and gas markets, a strong U.S. dollar (making our products more expensive overseas) and ongoing geopolitical tensions in Russia, North Africa and the Middle East.

For the three months ended December 31, 2016, revenue from microturbine products decreased \$2.0 million, or 14%, to \$12.8 million from \$14.8 million for the three months ended December 31, 2015. Megawatts shipped during the three months ended December 31, 2016 decreased 2.4 megawatts, or 15%, to 13.2 megawatts from 15.6 megawatts during the three months ended December 31, 2015. The decrease in revenue and megawatts shipped was because of delays of certain oil and gas projects, globally, resulting from the continued volatility in the oil and gas market. Average revenue per megawatt shipped was approximately \$1.0 million and \$0.9 million during the three months ended December 31, 2016 and 2015, respectively.

The following table provides additional information on our shipments (revenue amounts in millions):

Three Months Ended December 31,

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	2016		2015	
	Revenue	Megawatts	Revenue	Megawatts
United States and Canada	\$ 5.2	4.7	\$ 9.4	10.1
Europe and Russia	4.4	5.3	1.9	1.9
Latin America	1.8	1.9	3.0	3.2
Asia and Australia	0.1	0.1	0.5	0.4
Middle East and Africa	1.3	1.2	—	—
Total from Microturbine Products	\$ 12.8	13.2	\$ 14.8	15.6

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.

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

	Three Months Ended December 31,					
	2016			2015		
	Revenue	Megawatts	Units	Revenue	Megawatts	Units
C30	\$ 0.8	0.5	16	\$ 0.4	0.2	8
C65	2.3	2.1	32	1.7	1.6	24
C200	0.2	0.2	1	1.1	1.0	5
C600	1.9	1.8	3	0.7	0.6	1
C800	1.5	1.6	2	3.5	4.0	5
C1000	6.1	7.0	7	7.1	8.0	8
Unit upgrades	—	—	—	0.3	0.2	1
Sub-total from Microturbine Products	\$ 12.8	13.2	61	\$ 14.8	15.6	52
Accessories and Parts	3.7	—	—	3.5	—	—
Total Product, Accessories and Parts	\$ 16.5	13.2	61	\$ 18.3	15.6	52
Service	3.7	—	—	3.2	—	—
Total	\$ 20.2	13.2	61	\$ 21.5	15.6	52

For the three months ended December 31, 2016, revenue from our accessories and parts increased \$0.2 million, or 6%, to \$3.7 million from \$3.5 million for the three months ended December 31, 2015. The increase in revenue from accessories and parts was primarily because of an increase in sales of microturbine parts.

Service revenue for the three months ended December 31, 2016 increased \$0.5 million, or 16%, to \$3.7 million from \$3.2 million for the three months ended December 31, 2015. The increase in service revenue was primarily the result of our growing installed base and the market's acceptance of our FPP offering.

Sales to BPC and Horizon Power Systems ("Horizon"), one of the Company's domestic distributors, each accounted for 16% of revenue for the three months ended December 31, 2016. Sales to E-Finity Distributed Generation, LLC ("E-Finity"), one of the Company's domestic distributors, Critchfield Pacific Incorporated, one of the Company's domestic distributors, Horizon, and Dtc Soluciones Inmobiliarias S.A. de C.V., one of the Company's Mexican distributors, accounted for 17%, 13%, 12% and 10%, respectively, of revenue for the three months ended December 31, 2015.

Gross Margin (Loss) Cost of goods sold includes direct material costs, production and service center labor and overhead, inventory charges and provision for estimated product warranty expenses. The gross loss was approximately \$4.0 million, or negative 20% of revenue, for the three months ended December 31, 2016 compared to a gross margin of approximately \$4.1 million, or 19% of revenue, for the three months ended December 31, 2015. The decrease in gross margin of \$8.1 million, or approximately 3,900 basis points, compared to the three months ended December 31, 2015 was primarily because of incremental warranty expense of \$5.8 million, a shift in product mix of \$1.7 million and an increase in production labor and overhead expense of \$0.7 million, offset by lower royalty expense of \$0.1 million. Management continues to implement initiatives to improve gross margin by further reducing

manufacturing overhead and fixed and direct material costs and improving product performance 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 increase in warranty expense of \$5.8 million during the three months ended December 31, 2016 compared to the three months ended December 31, 2015 was primarily because of a one-time non-cash warranty provision to retrofit proactively select non-Signature Series C200 microturbines with the more robust new Signature Series generator components to improve product performance, reliability and customer satisfaction. Management expects warranty expense in Fiscal 2017 to be higher than in Fiscal 2016 because of reliability repair programs, warranty accommodations, timing of warranty claims and benefits recorded in Fiscal 2016 related to the decrease in the number of units covered under warranty.

Production and service center labor and overhead expense increased \$0.7 million during the three months ended December 31, 2016 compared to the three months ended December 31, 2015 as a result of increases in manufacturing supplies expense of \$0.5 million, freight expense of \$0.3 million and consulting expense of \$0.1 million, offset by a

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decrease in salaries expense of \$0.2 million. The increase in manufacturing supplies expense during the three months ended December 31, 2016 compared to the three months ended December 31, 2015 was because of the closeout of purchasing agreements resulting from changes in product configuration and engineering changes.

The following table summarizes our gross margin (in millions except percentages):

	Three Months Ended December 31, 2016		2015
Gross Margin			
Product, Accessories and Parts	\$ (5.3)	\$	3.3
As a percentage of product, accessories and parts revenue	(32) %		18 %
Service	\$ 1.3	\$	0.8
As a percentage of service revenue	35 %		25 %
Total Gross Margin	\$ (4.0)	\$	4.1
As a percentage of total revenue	(20) %		19 %

Product, accessories and parts gross margin decreased approximately 5,000 basis points to negative 32% during the three months ended December 31, 2016 compared to the three months ended December 31, 2015 primarily because of incremental warranty expense and a shift in product mix. Service gross margin increased approximately 1,000 basis points to 35% during the three months ended December 31, 2016 compared to the three months ended December 31, 2015 primarily because of timing of FPP services performed.

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, 2016 decreased \$1.6 million, or 55%, to \$1.3 million from \$2.9 million for the three months ended December 31, 2015. The overall decrease in R&D expenses of approximately \$1.6 million resulted from decreases in salaries expense of approximately \$0.8 million, supplies expense of \$0.7 million and consulting expense of \$0.1 million. As part of our initiatives to reduce operating expenses and achieve profitability, during the three months ended December 31, 2015, we reduced the number of active research projects, which included the development of the C250 microturbine. Management expects R&D expenses in Fiscal 2017 to be lower than in Fiscal 2016 as a result of these cost reduction initiatives.

Selling, General, and Administrative (“SG&A”) Expenses SG&A expenses for the three months ended December 31, 2016 decreased \$2.2 million, or 31%, to \$4.8 million from \$7.0 million for the three months ended December 31, 2015. The net decrease in SG&A expenses was comprised of decreases of approximately \$1.0 million in salaries expense, \$0.5 million in marketing expense, \$0.4 million in professional services, including accounting fees, shareholder expenses, bank fees and legal expenses, \$0.2 million in facility expense and \$0.1 million in business travel expense. These decreases were primarily the result of our cost reduction program to lower operating expenses throughout the organization. Management expects SG&A expenses in Fiscal 2017 to be lower than in Fiscal 2016 primarily as a result of our initiatives to reduce operating expenses and achieve profitability.

Interest Expense Interest expense decreased \$0.1 million, or 50%, to \$0.1 million during the three months ended December 31, 2016 from \$0.2 million during the three months ended December 31, 2015. The decrease in interest expense was primarily the result of lower average balances outstanding under our line of credit (the “Credit Facility”) with Wells Fargo Bank National Association (“Wells Fargo”) during the three months ended December 31, 2016

compared to the same period last year. As of December 31, 2016, we had total debt of \$8.7 million outstanding under the Credit Facility.

Nine Months Ended December 31, 2016 and 2015

Revenue Revenue for the nine months ended December 31, 2016 decreased \$12.1 million, or 18%, to \$54.2 million from \$66.3 million for the nine months ended December 31, 2015. The change in revenue for the nine months ended December 31, 2016 compared to the nine months ended December 31, 2015 included decreases in revenue of \$11.0 million from the United States and Canadian markets, \$5.3 million from the Latin American market and \$3.6 million from the Asian and Australian markets. These overall decreases in revenue were offset by increases in revenue of \$6.7 million from the European and Russian markets and \$1.1 million from the Middle East and African markets. The

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decrease in revenue in the United States and Canadian markets during the nine months ended December 31, 2016 compared to the same period last year was primarily the result of the continued volatility in the global oil and gas market. The decrease in revenue from the Latin American market during the nine months ended December 31, 2016 compared to the same period last year was primarily the result of a strong U.S. dollar and reduced capital and operational spending, particularly in the upstream and midstream oil and gas markets. The decrease in revenue in the Asian and Australian markets was primarily the result of large non-recurring microturbine product shipments for specific projects that had occurred during the nine months ended December 31, 2015. The increase in revenue in the European and Russian markets during the nine months ended December 31, 2016 compared to the same period last year was primarily because of our strategic initiative to improve the diversification of our revenue, the improvement of BPC and additional revenue from new distribution in the Russian market. The increase in revenue in the Middle East and African markets during the three months ended December 31, 2016 compared to the same period last year was primarily the result of our continued investment in key growth initiatives in those markets. Despite the increase in revenue in the Russian, Middle East and African markets, our revenue continues to be negatively impacted by the volatility of the global oil and gas markets, a strong U.S. dollar (making our products more expensive overseas) and ongoing geopolitical tensions in Russia, North Africa and the Middle East.

For the nine months ended December 31, 2016, revenue from microturbine products decreased \$13.5 million, or 29%, to \$33.1 million from \$46.6 million for the nine months ended December 31, 2015. Megawatts shipped during the nine months ended December 31, 2016 decreased 15.1 megawatts, or 31%, to 33.0 megawatts from 48.1 megawatts during the nine months ended December 31, 2015. The decrease in revenue and megawatts shipped was because of delays of certain oil and gas projects, globally, resulting from the continued volatility in the oil and gas market. Average revenue per megawatt shipped was approximately \$1.0 million during each of the nine months ended December 31, 2016 and 2015.

The following table provides additional information on our shipments (revenue amounts in millions):

	Nine Months Ended December 31,			
	2016		2015	
	Revenue	Megawatts	Revenue	Megawatts
United States and Canada	\$ 11.5	10.5	\$ 21.9	21.2
Europe and Russia	14.0	15.6	7.5	7.7
Latin America	2.5	2.5	9.1	11.0
Asia and Australia	3.5	3.0	7.6	7.6
Middle East and Africa	1.6	1.4	0.5	0.6
Total from Microturbine Products	\$ 33.1	33.0	\$ 46.6	48.1

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.

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

	Nine Months Ended December 31,					
	2016			2015		
	Revenue	Megawatts	Units	Revenue	Megawatts	Units
C30	\$ 2.5	1.5	51	\$ 1.1	0.8	25
C65	8.0	6.9	106	8.9	8.1	125
C200	1.0	1.0	5	3.2	3.0	15

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C600	3.8	3.6	6	4.3	4.2	7
C800	3.9	4.0	5	8.1	8.8	11
C1000	13.9	16.0	16	20.7	23.0	23
Unit upgrades	—	—	—	0.3	0.2	1
Sub-total from Microturbine Products	\$ 33.1	33.0	189	\$ 46.6	48.1	207
Accessories and Parts	10.7	—	—	10.4	—	—
Total Product, Accessories and Parts	\$ 43.8	33.0	189	\$ 57.0	48.1	207
Service	10.4	—	—	9.3	—	—
Total	\$ 54.2	33.0	189	\$ 66.3	48.1	207

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For the nine months ended December 31, 2016, revenue from our accessories and parts increased \$0.3 million, or 3%, to \$10.7 million from \$10.4 million for the nine months ended December 31, 2015. The increase in revenue from accessories and parts was primarily because of an increase in sales of microturbine parts.

Service revenue for the nine months ended December 31, 2016 increased \$1.1 million, or 12%, to \$10.4 million from \$9.3 million for the nine months ended December 31, 2015. The increase in service revenue was primarily the result of our growing installed base and the market's acceptance of our FPP offering.

For the nine months ended December 31, 2016, BPC and Horizon, accounted for 12% and 10% of revenue, respectively. For the nine months ended December 31, 2015, Horizon, E-Finity and Optimal Group Australia Pty Ltd, one of the Company's Australian distributors, accounted for 16%, 11% and 10% of revenue, respectively.

Gross Margin (Loss) The gross loss was \$0.3 million, or negative 1% of revenue, for the nine months ended December 31, 2016 compared to a gross margin of \$10.7 million, or 16% of revenue, for the nine months ended December 31, 2015. The decrease in gross margin of \$11.0 million, or approximately 1,700 basis points, compared to the nine months ended December 31, 2015 was primarily because of incremental warranty expense of \$6.2 million, lower volume of microturbines shipped and a shift in product mix of \$6.3 million, offset by decreases in production labor and overhead expense of \$1.0 million, royalty expense of \$0.4 million and inventory charges of \$0.1 million. Management continues to implement initiatives to improve gross margin by further reducing manufacturing overhead and fixed and direct material costs and improving product performance 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 increase in warranty expense of \$6.2 million during the nine months ended December 31, 2016 compared to the nine months ended December 31, 2015 was primarily because of a one-time non-cash warranty provision to retrofit proactively select non-Signature Series C200 microturbines with the more robust new Signature Series generator components to improve product performance, reliability and customer satisfaction. In addition, warranty expense during the nine months ended December 31, 2016 compared to the nine months ended December 31, 2015 reflects accommodations and timing of claims in the current period and the result of a benefit in the same period last year related to the decrease in the number of units covered under warranty. Management expects warranty expense in Fiscal 2017 to be higher than in Fiscal 2016 because of reliability repair programs, warranty accommodations, timing of warranty claims and benefits recorded in Fiscal 2016 related to the decrease in the number of units covered under warranty.

Production and service center labor and overhead expense decreased \$1.0 million during the nine months ended December 31, 2016 compared to the nine months ended December 31, 2015 as a result of decreases in salaries expense of \$0.7 million, freight expense of \$0.2 million, \$0.2 million of consulting expense, and \$0.1 million of business travel expense. These decreases were primarily the result of our cost reduction program to lower labor and overhead expenses throughout the organization. In addition, the amount of overhead allocated to finished goods inventory increased \$0.3 million during the nine months ended December 31, 2016 compared to the same period last year. These decreases were offset by an increase in manufacturing supplies expense of \$0.5 million during the three months ended December 31, 2016 compared to the three months ended December 31, 2015 because of the closeout of purchasing agreements resulting from changes in product configuration and engineering changes.

Royalty expense decreased \$0.4 million during the nine months ended December 31, 2016 compared to the nine months ended December 31, 2015 as a result of lower sales of our C1000 Series systems.

Inventory charges decreased \$0.1 million during the nine months ended December 31, 2016 compared to the nine months ended December 31, 2015 primarily as the result of a decrease in provision for excess and obsolete inventory.

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The following table summarizes our gross margin (in millions except percentages):

	Nine Months Ended December 31,	
	2016	2015
Gross Margin		
Product, Accessories and Parts	\$ (2.9)	\$ 9.0
As a percentage of product, accessories and parts revenue	(7) %	16 %
Service	\$ 2.6	\$ 1.6
As a percentage of service revenue	25 %	17 %
Total Gross Margin	\$ (0.3)	\$ 10.6
As a percentage of total revenue	(1) %	16 %

Product, accessories and parts gross margin decreased approximately 2,300 basis points to negative 7% during the nine months ended December 31, 2016 compared to the nine months ended December 31, 2015 primarily as a result of incremental warranty expense, a decrease in product shipments and a shift in product mix. Service gross margin increased 800 basis points to 25% during the nine months ended December 31, 2016 compared to the nine months ended December 31, 2015 primarily because of timing of FPP services performed.

During the fourth quarter of Fiscal 2015 we shipped approximately \$0.7 million of product to BPC and given the uncertainty as to the collectability of the sale, revenue recognition on this shipment was deferred. As of June 30, 2016, the deferred revenue for this shipment was fully recognized as revenue upon collection of the invoice.

Research and Development (“R&D”) Expenses R&D expenses for the nine months ended December 31, 2016 decreased \$3.9 million, or 48%, to \$4.3 million from \$8.2 million for the nine months ended December 31, 2015. The overall decrease in R&D expenses of approximately \$3.9 million resulted from decreases in salaries expense of approximately \$2.0 million, supplies expense of \$1.5 million and consulting expense of \$0.6 million. These overall decreases were offset by a reduction in cost-sharing benefits of \$0.2 million. As part of our initiatives to reduce operating expenses and achieve profitability, during the nine months ended December 31, 2015, we reduced the number of active research projects, which included the development of the C250 microturbine. Management expects R&D expenses in Fiscal 2017 to be lower than in Fiscal 2016 as a result of these cost reduction initiatives.

Selling, General, and Administrative (“SG&A”) Expenses SG&A expenses for the nine months ended December 31, 2016 decreased \$6.2 million, or 28%, to \$15.6 million from \$21.8 million for the nine months ended December 31, 2015. The net decrease in SG&A expenses was comprised of decreases of approximately \$2.6 million in salaries expense, \$0.9 million in marketing expense, \$0.6 million in business travel expense, \$0.3 million in consulting expense, \$0.3 million in professional services expense, including accounting expenses, and \$0.2 million in facilities expense. These decreases were primarily the result of our cost reduction program to lower operating expenses throughout the organization. During the nine months ended December 31, 2016, net bad debt recovery increased approximately \$1.3 million primarily with respect to the collection of cash for receivables from two customers, previously reserved during Fiscal 2015. Excluding bad debt recovery, management expects SG&A expenses in Fiscal 2017 to be lower than in Fiscal 2016 primarily as a result of our initiatives to reduce operating expenses and achieve profitability.

Interest Expense – Interest expense decreased \$0.1 million, or 20%, to \$0.4 million during the nine months ended December 31, 2016 from \$0.5 million during the nine months ended December 31, 2015. The decrease in interest

Explanation of Responses:

expense was primarily the result of lower average balances outstanding under the Credit Facility with Wells Fargo during the nine months ended December 31, 2016 compared to the same period last year. As of December 31, 2016, we had total debt of \$8.7 million outstanding under the Credit Facility.

Income Taxes - Income tax expense was approximately \$3,000 for each of the nine months ended December 31, 2016 and 2015. Income tax expense was primarily related to local tax payments.

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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 implementing the strategic changes summarized herein. Our planned capital expenditures for the year ending March 31, 2017 include approximately \$1.0 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 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 increased \$2.7 million during the nine months ended December 31, 2016, compared to a decrease of \$18.8 million during the nine months ended December 31, 2015. The overall improvement in cash used during the nine months ended December 31, 2016 compared to the nine months ended December 31, 2015 was primarily the result of proceeds from the issuance of common stock and warrants and underwritten public offering as described below.

Operating Activities During the nine months ended December 31, 2016, we used \$15.6 million in cash in our operating activities, which consisted of a net loss for the period of \$19.3 million, and cash used for working capital of \$3.0 million, offset by non-cash adjustments (primarily warranty provision, accounts receivable allowances, depreciation and amortization, stock based compensation and inventory provision) of \$6.7 million. During the nine months ended December 31, 2015, operating cash usage was \$15.8 million, which consisted of a net loss for the period of \$19.8 million, offset by cash provided from working capital of \$0.2 million and non-cash adjustments of \$3.8 million.

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

	Nine Months Ended December 31,	
	2016	2015
Net loss	\$ (19,291)	\$ (19,872)
Non-cash operating activities(1)	6,677	3,837
Changes in operating assets and liabilities:		
Accounts receivable	1,747	(555)
Inventories	763	1,739
Accounts payable and accrued expenses	(1,134)	(248)
Other changes in operating assets and liabilities	(4,376)	(749)
Net cash used in operating activities	\$ (15,614)	\$ (15,848)

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

The change in non-cash operating activities during the nine months ended December 31, 2016 compared to the same period last year was primarily the result of a warranty provision to retrofit proactively select non-Signature Series C200 microturbines with the more robust new Signature Series generator components to improve product performance, reliability and customer satisfaction. In addition, non-cash operating activities includes the change in fair

value of warrant liability for certain warrants issued in our October 2016 offering of common stock and warrants. The change in accounts receivable was the result of lower revenue and improved level of collection of accounts receivable during the nine months ended December 31, 2016 compared to the nine months ended December 31, 2015. The change in inventory was primarily the result of a decrease in raw materials during the nine months ended December 31, 2016 compared to the same period last year. The change in accounts payable and accrued expenses was primarily the result of lower operating expenses and timing and level of inventory receipts during the nine months ended December 31, 2016 compared to the same period last year. The change in other operating assets and liabilities was primarily because of warranty payments for the proactive retrofit of certain non-Signature Series C200 microturbines during the nine months ended December 31, 2016 compared to the nine months ended December 31, 2015.

Investing Activities Net cash used in investing activities of \$0.4 million and \$1.4 million during the nine months ended December 31, 2016 and 2015, respectively, relates primarily to the acquisition of fixed assets.

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Financing Activities During the nine months ended December 31, 2016, we generated approximately \$18.7 million from financing activities compared to cash used during the nine months ended December 31, 2015 of approximately \$1.5 million. The funds generated from financing activities during the nine months ended December 31, 2016 were primarily the result of proceeds from the October 2016 offering of common stock and warrants and the April 2016 underwritten public offering described below, offset by net repayments under the Credit Facility and repayments of notes payable and capital lease obligations. The funds used in financing activities during the nine months ended December 31, 2015 were primarily the result of cash equivalents restricted by Wells Fargo, net repayments under the Credit Facility and the repayment of notes payable and capital lease obligations, offset by proceeds from the at-the-market offering program described below. As a condition of the amended Credit and Security Agreements (as amended, the “Credit Agreements”) with Wells Fargo, \$5.0 million of cash equivalents was restricted during the nine months ended December 31, 2015 as additional security for the Credit Facility.

On October 18, 2016, the Company entered into a securities purchase agreement with certain accredited investors, pursuant to which the Company agreed to sell 3,600,000 shares of common stock, pre-funded Series B warrants to purchase up to 2,700,000 shares of common stock, and Series A warrants to purchase up to 6,300,000 shares of common stock. Pursuant to a placement agent agreement, dated as of October 18, 2016, the Company engaged Oppenheimer & Co. Inc. as the lead placement agent for the offering and ROTH Capital Partners, LLC as co-placement agent for the offering. Each share of common stock was sold at a price of \$1.20. Each Series B warrant was issued with an exercise price of \$1.20 per share of common stock, \$1.19 of which was pre-funded at closing and \$0.01 of which will be payable upon exercise. Each Series A warrant was issued with an initial exercise price of \$1.34 per share of common stock. These Series A warrants contain anti-dilution provisions that reduce the exercise price of the warrants if certain dilutive issuances occur. The anti-dilution provisions of the Series A warrants are subject to approval by the Company’s stockholders. The Series A warrants are classified as liabilities under the caption “Warrant liability” in the accompanying balance sheets and recorded at estimated fair value with the corresponding charge under the caption “Change in fair value of warrant liability” in the accompanying statements of operations. See Part I, Item 1, Note 10—Fair Value Measurements for disclosure regarding the fair value of financial instruments. The net proceeds to the Company from this offering, after deducting the placement agent fees and other estimated offering expenses, were approximately \$6.8 million. The offering closed on October 21, 2016. In connection with the offering, the Company is subject to a lock-up that expires in March 2017, with certain issuances of securities by the Company being exempt from the lock-up.

On April 19, 2016, we entered into an underwriting agreement with Oppenheimer & Co. Inc. as the sole book-running manager, and Rodman & Renshaw, a unit of H.C. Wainwright & Co., LLC, as the co-manager, related to public offering of 2.7 million shares of our common stock and pre-funded Series B warrants to purchase up to 5.5 million shares of common stock, which were offered in lieu of common stock to those purchasers whose purchase of common stock in the offering otherwise would result in the purchaser beneficially owning more than 4.99% of the Company’s outstanding common stock following the completion of the offering. Also included in the offering were Series A warrants to purchase 4.1 million shares of common stock. Every two shares of common stock were sold with one Series A warrant to purchase one share of common stock at a collective negotiated price of \$3.50. Every two Series B warrants were sold with one Series A warrant to purchase one share of common stock at a collective negotiated price of \$3.48. The net proceeds to the Company from the sale of the common stock and warrants, after deducting fees and other offering expenses, were approximately \$13.1 million. The offering closed on April 22, 2016.

Effective August 28, 2015, the Company entered into a sales agreement with respect to an at-the-market offering program pursuant to which the Company may offer and sell, from time to time at its sole discretion, shares of its common stock, having an aggregate offering price of up to \$30.0 million. The Company will set the parameters for sales of the shares, including the number to be sold, the time period during which sales are requested to be made, any limitation on the number that may be sold in one trading day and any minimum price below which sales may not be made. During Fiscal 2016, 6.9 million shares of the Company’s common stock had been sold and the net proceeds to

the Company from the sale of the common stock, after deducting fees and other offering expenses, were approximately \$12.7 million. In connection with the October 2016 offering of common stock and warrants, the Company is subject to a lock-up that expires in March 2017, which includes the at-the-market offering program. During the nine months ended December 31, 2016 the Company did not sell any common stock pursuant to the at-the-market offering program.

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 \$16,000 of net cash used during the nine months ended December 31, 2016, compared with \$0.1 million of net cash used during the nine months ended December 31, 2015.

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Credit Facility We maintain the Credit Agreements, with Wells Fargo, which provide the Company with a line of credit of up to \$20.0 million in the aggregate. As previously disclosed, the twelfth amendment to the Credit Agreements provided the Company the right, under certain circumstances, to increase the borrowing capacity available under the Company's revolving lines of credit to an aggregate maximum of \$20.0 million from an aggregate maximum of \$15.0 million (the "Accordion Feature"). In addition, Wells Fargo has provided the Company with a non-revolving capital expenditure line of credit up to \$0.5 million to acquire additional eligible equipment for use in the Company's business. Effective as of June 30, 2015, the Company exercised the Accordion Feature, thereby increasing the maximum borrowing capacity available to a maximum of \$20.0 million. 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. One of the Credit Agreements will terminate in accordance with its terms on September 1, 2017, and the other one will terminate on September 30, 2017. On June 7, 2016, the Company and Wells Fargo entered into an amendment to the Credit Agreements which set the financial covenants for Fiscal 2017. As of December 31, 2016 and March 31, 2016, \$8.7 million and \$9.5 million in borrowings were outstanding, respectively, under the Credit Facility.

The Credit 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 Credit Agreements contain financial covenants, including (i) a requirement not to exceed specified levels of losses, (ii) a requirement to maintain a substantial minimum monthly cash balance to outstanding line of credit advances based upon the Company's financial performance, and (iii) limitations on our annual capital expenditures.

Several times since entering into the Credit Agreements the Company was not in compliance with certain covenants under the Credit Facility. In connection with each event of noncompliance, Wells Fargo waived the event of default and, on several occasions, the Company amended the Credit Agreements in response to the default and waiver. On June 10, 2015, the Company received from Wells Fargo a waiver of one such event of noncompliance, and as a condition of the amended Credit Agreements, the Company had restricted \$5.0 million of cash equivalents as additional security for the Credit Facility. If the Company had not obtained the waivers and amended the Credit Agreements, the Company would not have been able to draw additional funds under the Credit Facility. In addition, the Company has pledged its accounts receivables, inventories, equipment, patents and other assets as collateral for its Credit Agreements, which would be subject to seizure by Wells Fargo if the Company were in default under the Credit Agreements and unable to repay the indebtedness. Wells Fargo also has the option to terminate the Credit Agreements or accelerate the indebtedness during a period of noncompliance. As of December 31, 2016, the Company was in compliance with the covenants contained in the amended Credit Agreements for Fiscal 2017. Based on the Company's current forecasts, the Company believes it will maintain compliance with the covenants contained in the amended Credit Agreements through the end of Fiscal 2017. If a covenant violation were to occur, the Company would attempt to negotiate a waiver of non-compliance from Wells Fargo. On February 7, 2017, the Company and Wells Fargo entered into an amendment to the Credit Agreements regarding the release of restricted cash and the exclusion of certain items from the financial covenant calculations.

Working Capital The Company's working capital requirements during the third quarter of Fiscal 2017 were higher than planned, primarily as a result of warranty payments for the proactive retrofit of certain non-Signature Series C200 microturbines and reductions to accounts payable as a result of payments made by the Company. Additionally, the Company didn't fully achieve its planned number of product shipments during the third quarter of Fiscal 2017, resulting in lower than expected revenue primarily in the oil and gas markets. We continue to be negatively impacted

by the volatility of the global oil and gas markets, a strong U.S. dollar (making our products more expensive overseas) and ongoing geopolitical tensions in Russia, North Africa and the Middle East. Our cash and cash equivalents as of December 31, 2016 and March 31, 2016 were \$14.4 million (\$19.4 million when combined with restricted cash related to the Credit Facility) and \$11.7 million (\$16.7 million when combined with restricted cash related to the Credit Facility) million, respectively. Cash and cash equivalents and restricted cash, less the amount outstanding under the Credit Facility, or free cash, was \$10.7 million and \$7.2 million as of December 31, 2016 and March 31, 2016, respectively.

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Based on management's projections, free cash of approximately \$10.7 million is sufficient to meet the Company's anticipated cash needs for working capital and capital expenditures for at least the next twelve months. If revenue is less than management's projections, management has the ability to manage certain operating expenses, assets and liabilities, specifically the procurement of inventory, timing of payments of accounts payable and capital expenditures depending on the results of the Company's operations to preserve its cash and cash equivalents.

If the Company is unable to manage its cash flows in the areas discussed above, we may need to raise additional capital in the near term. In connection with the October 21, 2016 offering of common stock and warrants, the Company is subject to a lock-up that expires in March 2017, with certain issuances of securities being exempt from the lock-up. We may seek to raise funds by selling additional securities pursuant to exemptions from the lock-up or after the expiration of the applicable lock-up period (through the at-the-market offering discussed above or otherwise) 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. Should the Company be unable to execute its plans (including raising funds through the at-the-market offering program and maintaining availability under the Credit Facility) or obtain additional financing that may be needed, the Company may need to significantly reduce its operations. The condensed consolidated financial statements do not include any adjustments that might result from the outcome of these uncertainties.

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 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 significantly increased sales volume which is dependent on many factors, including:

- the market acceptance of our products and services;
- our business, product and capital expenditure plans;
- capital improvements to new and existing facilities;
- 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 allowances, was \$13.2 million and \$13.6 million as of December 31, 2016 and March 31, 2016, respectively. Days sales outstanding in accounts receivable, or DSO, increased by 1 day to 60 days as of December 31, 2016 compared to 59 days as of December 31, 2015. During the three months ended December 31, 2016, we recorded approximately \$12,000 in net bad debt expense. During the nine months ended December 31, 2016, we recorded approximately \$1.5 million in net bad debt recovery with respect to the collection of cash for

receivables primarily from two customers, previously reserved during Fiscal 2015. We recorded bad debt recovery of approximately \$0.2 million for each of the three and nine months ended December 31, 2015.

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 have been and could continue to be adversely affected by the current economic environment.

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Contractual Obligations and Commercial Commitments

Except for scheduled payments made on operating leases during the nine months ended December 31, 2016, 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 2016.

New Accounting Pronouncements

In November 2016, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2016-18, “Statement of Cash Flows (Topic 230): Restricted Cash” (“ASU 2016-18”), which amends guidance and presentation related to restricted cash in the statement of cash flows, including stating that amounts generally described as restricted cash and restricted cash equivalents should be included within cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown in the statement of cash flows. ASU 2016-18 is effective for annual periods beginning after December 15, 2017, and interim periods within those annual periods. We do not believe that the adoption of the provisions of ASU 2016-18 will have a material impact on our consolidated financial position or results of operations.

In March 2016, the FASB issued ASU 2016-09, Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting (“ASU 2016-09”). The standard is intended to simplify several areas of accounting for share-based compensation arrangements, including the income tax impact, classification on the statement of cash flows and forfeitures. ASU 2016-09 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2016, and early adoption is permitted. We are currently evaluating the potential impact ASU 2016-09 will have on our consolidated financial position and results of operations.

In July 2015, the FASB issued ASU 2015-11, Simplifying the Measurement of Inventory (“ASU 2015-11”). ASU 2015-11 requires inventory that is recorded using the first-in, first-out method to be measured at the lower of cost or net realizable value. ASU 2015-11 is effective for annual and interim periods beginning after December 15, 2016, and should be applied prospectively with early adoption permitted at the beginning of an interim or annual reporting period. We do not believe that the provisions of ASU 2015-11 will have a material effect on our consolidated financial position and results of operations.

In April 2015, the FASB issued ASU 2015-03, Interest – Imputation of Interest (Subtopic 835-30). The ASU was issued as part of FASB’s current plan to simplify overly complex standards. This ASU requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability. The recognition and measurement guidance for debt issuance costs are not affected by this ASU. The update requires retrospective application to all prior period amounts presented. This update is effective for annual and interim periods beginning on or after December 15, 2015, with early application permitted for financial statements that have not been issued. We adopted ASU 2015-03 with no impact on its consolidated financial position or results of operations.

In August 2014, the FASB issued ASU 2014-15, Disclosure of Uncertainties About an Entity’s Ability to Continue as a Going Concern (“ASU 2014-15”). ASU 2014-15 requires management to perform interim and annual assessments of an entity’s ability to continue as a going concern within one year of the date the financial statements are issued and provides guidance on determining when and how to disclose going concern uncertainties in the financial statements. Certain disclosures will be required if conditions give rise to substantial doubt about an entity’s ability to continue as a going concern. The amendments in ASU 2014-15 are effective for the annual period ending after December 15, 2016, and for annual periods and interim periods thereafter. Early application is permitted. The Company will apply the provisions of ASU 2014-15 during the fiscal year ended March 31, 2017 and does not believe that the adoption of these provisions will have a material impact on the Company’s consolidated financial position or results of operations.

Explanation of Responses:

In June 2014, the FASB issued ASU 2014-12, Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period (“ASU 2014-12”). ASU 2014-12 requires that a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. As such, the performance target should not be reflected in estimating the grant-date fair value of the award. ASU 2014-12 is effective for annual reporting periods beginning after December 15,

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2015, with early adoption permitted. The Company has adopted ASU 2014-12 effective March 31, 2016 with no impact on its consolidated financial position or results of operations.

In May 2014, FASB issued ASU 2014-09, Revenue from Contracts with Customers (“ASU 2014-09”). ASU 2014-09 supersedes nearly all existing revenue recognition guidance under accounting principles generally accepted in the United States of America (“generally accepted accounting principles” or “GAAP”). The standard’s core principle is that a company will recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. We are evaluating our existing revenue recognition policies and the impact of ASU 2014-09, if any, on our financial position and results of operations. We will be required to adopt the revenue recognition standard in annual reporting periods beginning after December 15, 2017 (fiscal year ending March 31, 2019), and interim periods within those annual periods.

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 2016.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Under the supervision and with the participation of our management, including the Chief Executive Officer and Chief Financial Officer, we have evaluated the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the “Exchange Act”), as of the end of the period covered by this report. 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

There was no change in the Company’s internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the Company’s most recently completed fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company’s internal control over financial reporting.

PART II — OTHER INFORMATION

Item 1. Legal Proceedings

Explanation of Responses:

Federal Securities Class Action

Two putative securities class action complaints were filed against the Company and certain of its current and former officers in the United States District Court for the Central District of California under the following captions: David Kinney, etc. v. Capstone Turbine, et al., No. 2:15-CV-08914 on November 16, 2015 (the “Kinney Complaint”) and Kevin M. Grooms, etc. v. Capstone Turbine, et al., No. 2:15-CV-09155 on December 18, 2015 (the “Grooms Complaint”).

The putative class in the Kinney Complaint is comprised of all purchasers of the Company’s securities between November 7, 2013 and November 5, 2015. The Kinney Complaint alleges material misrepresentations and omissions in public statements regarding BPC and the likelihood that BPC would not be able to fulfill many legal and financial obligations to the Company. The Kinney Complaint also alleges that the Company’s financial statements were not

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appropriately adjusted in light of this situation and were not maintained in accordance with GAAP, and that the Company lacked adequate internal controls over accounting. The Kinney Complaint alleges that these public statements and accounting irregularities constituted violations by all named defendants of Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder, as well as violations of Section 20(a) of the Exchange Act by the individual defendants. The Grooms Complaint makes allegations and claims that are substantially identical to those in the Kinney Complaint, and both complaints seek compensatory damages of an undisclosed amount. On January 16, 2016, several shareholders filed motions to consolidate the Kinney and Grooms actions and for appointment as lead plaintiff. On February 29, 2016, the Court granted the motions to consolidate, and appointed a lead plaintiff. On May 6, 2016, a Consolidated Amended Complaint with allegations and claims substantially identical to those of the Kinney Complaint was filed in the consolidated action. The putative class period in the Consolidated Amended Complaint is June 12, 2014 to November 5, 2015. Defendants filed a motion to dismiss the Consolidated Amended Complaint on June 17, 2016. Plaintiffs' opposition was filed July 29, 2016, and Defendants' reply was filed September 23, 2016. The Company has not recorded any liability as of December 31, 2016 since any potential loss is not probable or reasonably estimable given the preliminary nature of the proceedings.

State Derivative Lawsuits — California

On February 18, 2016, a purported shareholder derivative action was filed in Los Angeles Superior Court in the State of California against the Company and certain of its current and former officers and directors under the following caption: *Stesiak v. Jamison, et al.*, No. BC610782. The lawsuit alleges that certain of the Company's current and former officers and directors knew or should have known that BPC would be unable to fulfill its obligations to the Company, but allowed the Company to make false and misleading statements regarding BPC and the Company's financial condition. The complaint also alleges that the defendants failed to timely adjust the Company's accounts receivable and backlog to reflect BPC's inability to pay the Company. The complaint asserts causes of action for breach of fiduciary duty and unjust enrichment. It demands damages for the amount of damage sustained by the Company as a result of the individual defendants' alleged breach of fiduciary duties and unjust enrichment, that the Company institute corporate governance reforms, and disgorgement from the individual defendants. On May 5, 2016, the parties filed a stipulation and proposed order seeking to stay this action until such time as the defendants' motion(s) to dismiss the federal securities class action are decided. On May 10, 2016, the Court entered that proposed order. A status conference is scheduled for March 8, 2017.

On June 8, 2016, a purported shareholder derivative action entitled *Velma Kilpatrick v. Simon, et al.*, No. BC623167, was filed in Los Angeles Superior Court in the State of California against the Company and certain of its current and former officers and directors. The complaint alleges that certain of the Company's current and former officers and directors knew or should have known that BPC would be unable to fulfill its obligations to the Company, but allowed the Company to make false and misleading statements regarding BPC and the Company's financial condition. The complaint also alleges that the defendants failed to timely adjust the Company's accounts receivable and backlog to reflect BPC's inability to pay the Company. The complaint asserts causes of action for breach of fiduciary duty. It demands damages for the amount of damage sustained by the Company as a result of the individual defendants' alleged breach of fiduciary duties, and that the Company institute corporate governance reforms. On August 23, 2016, the parties filed a stipulation and proposed order seeking to stay this action until such time as the defendants' motion(s) to dismiss the federal securities class action are decided. A status conference is scheduled for February 22, 2017.

On December 27, 2016, a purported shareholder derivative action entitled *Andre Rosowsky v. Jamison, et al.*, No. 30-2016-00894859-CU-MC-CJC, was filed in Orange County Superior Court in the State of California against the Company and certain of its current and former officers and directors. The complaint alleges that certain of the Company's current and former officers and directors knew or should have known that BPC would be unable to fulfill its obligations to the Company, but allowed the Company to make false and misleading statements regarding BPC and the Company's financial condition. The complaint also alleges that the defendants failed to timely adjust the

Company's accounts receivable and backlog to reflect BPC's inability to pay the Company. The complaint asserts causes of action for breach of fiduciary duty and unjust enrichment. It demands damages for the amount of damage sustained by the Company as a result of the individual defendants' alleged breach of fiduciary duties, that the Company institute corporate governance reforms, and restitution from the individual defendants.

Federal Derivative Lawsuits

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On March 7, 2016, a purported shareholder derivative action was filed in the United States District Court for the Central District of California against the Company and certain of its current and former officers and directors under the following caption: Haber v. Jamison, et al., No. CV16-01569-DMG (RAOx). The lawsuit alleges that certain of the Company's current and former officers and directors knew or should have known that BPC would be unable to fulfill its obligations to the Company, but allowed the Company to make false and misleading statements regarding BPC and the Company's financial condition. The complaint asserts a cause of action for breach of fiduciary duty. It demands damages for the amount of damage sustained by the Company as a result of the individual defendants' alleged breach of fiduciary duties, and equitable relief, including that the Company institute appropriate corporate governance reforms. On May 11, 2016, the parties filed a stipulation and proposed order seeking to stay this action until such time as the defendants' motion(s) to dismiss the federal securities class action are decided. On May 13, 2016, the Court entered that proposed order.

On July 12, 2016 and July 18, 2016, respectively, two additional purported shareholder derivative actions were filed in the United States District Court for the Central District of California against the Company and certain of its current and former officers and directors, under the caption Tuttle v. Atkinson, et al., No. CV16-05127, and Boll v. Jamison, et al., No. CV16-5282, respectively. The lawsuits allege that certain of the Company's current and former officers and directors knew or should have known that BPC would be unable to fulfill its obligations to the Company, but allowed the Company to make false and misleading statements regarding BPC and the Company's financial condition. The Tuttle complaint asserts causes of action for breach of fiduciary duty, gross mismanagement, and unjust enrichment, and the Boll complaint asserts causes of action for breach of fiduciary duty, unjust enrichment, abuse of control, gross mismanagement, and waste of corporate assets. Both complaints demand damages sustained by the Company as a result of the individual defendants' alleged breaches of fiduciary duties, and equitable relief, including that the Company institute appropriate corporate governance reforms. The federal derivative actions have been consolidated and stayed until such time as the defendants' motion(s) to dismiss the federal securities class action are decided.

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 2016 except for the revision of certain risk factors as set forth below:

If we continue to fail to meet all applicable Nasdaq Capital Market requirements and Nasdaq determines to delist our common stock, the delisting could adversely affect the market liquidity of our common stock, impair the value of your investment and adversely affect our ability to raise needed funds.

Our common stock is listed on the Nasdaq Capital Market. In order to maintain that listing, we must satisfy minimum financial and other requirements. On December 12, 2016, we received a notice from the Nasdaq Listing Qualifications Department stating that, for 30 consecutive business days preceding the notice date, the closing bid price for our common stock had been below the minimum \$1.00 per share requirement for continued listing on the Nasdaq Capital Market as set forth in Nasdaq Listing Rule 5550(a)(2). In accordance with Nasdaq Listing Rule 5810(c)(3)(A), we have been provided 180 calendar days, or until June 12, 2017, to regain compliance with the minimum bid price requirement. In order to regain compliance, the bid price of our common stock must close at \$1.00 per share or more for a minimum of ten consecutive business days, at which time Nasdaq Listing Qualifications Department would provide written confirmation of our compliance. We may need to implement a reverse stock split to regain compliance with the Nasdaq Listing Rules.

If we continue to fail to meet all applicable Nasdaq Capital Market requirements in the future and Nasdaq determines to delist our common stock, the delisting could adversely affect the market liquidity of our common stock and

adversely affect our ability to obtain financing for the continuation of our operations. This delisting could also impair the value of your investment.

If we are unable to either substantially improve our operating results or obtain additional financing, we may be unable to continue as a going concern.

Our business strategy is focused on profitability-oriented initiatives such as reducing operating expenses, diversifying and increasing revenue, improving gross margin and utilizing the Capstone Energy Finance joint venture to capture lost orders. We may not be able to execute successfully the business strategy. Moreover, the business strategy is

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based upon projections, which are in turn based upon estimates and assumptions. There can be no assurance as to the accuracy of the projections, estimates and assumptions which underlie the business strategy or as to the Company's ability to successfully execute the business strategy.

Should we be unable to execute our plans to build sales and margins while controlling costs, we may be unable to continue as a going concern on a longer-term basis. In particular, we must generate positive cash flow from operations and net income and otherwise improve our results of operations substantially on a longer-term basis. Our available cash and proceeds from future financings, if any, that we may be able to obtain, may not be sufficient to fund our operating expenses, capital expenditures and other cash requirements. Any such lack of funds would affect our ability to continue as a going concern. These events and circumstances could have a material adverse effect on our ability to raise additional capital and on the market value of our common stock and our ability to maintain a credit facility acceptable to the Company. Moreover, should we experience a cash shortage that requires us to curtail or cease our operations, or should we be unable to continue as a going concern, you could lose all or part of your investments in our securities.

A sustainable market for microturbines may never develop or may take longer to develop than we anticipate which would adversely affect our results of operations.

Our products represent an emerging market, and we do not know whether our targeted customers will accept our technology or will purchase our products in sufficient quantities to allow our business to grow. To succeed, demand for our products must increase significantly in existing markets, and there must be strong demand for products that we introduce in the future. In addition, as part of our business strategy, we are focusing our marketing efforts on the oil and gas, renewable energy and combined heat and power markets. We may be unable to grow our business in these target markets. If a sustainable market fails to develop or develops more slowly than we anticipate, we may be unable to recover the losses we have incurred to develop our products, we may have further impairment of assets, and we may be unable to meet our operational expenses. The development of a sustainable market for our systems may be hindered by many factors, including some that are out of our control. Examples include:

- consumer reluctance to try a new product;
- regulatory requirements;
- the cost competitiveness of our microturbines;
- costs associated with the installation and commissioning of our microturbines;
- maintenance and repair costs associated with our microturbines;
- the future costs and availability of fuels used by our microturbines;
- economic downturns and reduction in capital spending;
- consumer perceptions of our microturbines' safety and quality;
- the emergence of newer, more competitive technologies and products; and
- decrease in domestic and international incentives.

Our products involve a lengthy sales cycle, and we may not anticipate sales levels appropriately, which could impair our results of operations.

The sale of our products typically involves a significant commitment of capital by customers, with the attendant delays frequently associated with large capital expenditures. For these and other reasons, the sales cycle associated with our products is typically lengthy and subject to a number of significant risks over which we have little or no control. We expect to plan our production and inventory levels based on internal forecasts of customer demand, which is highly unpredictable and can fluctuate substantially. If sales in any period fall significantly below anticipated levels, our financial condition, results of operations and cash flow would suffer. If demand in any period increases well above anticipated levels, we may have difficulties in responding, incur greater costs to respond, or be unable to fulfill the demand in sufficient time to retain the order, which would negatively impact our operations. In addition, our operating

expenses are based on anticipated sales levels, and a high percentage of our expenses are generally fixed in the short term. As a result of these factors, a small fluctuation in timing of sales can cause operating results to vary materially from period to period.

Our total backlog as of March 31, 2016, was \$109.6 million. However, because our backlog represents only the estimated amount of future product revenue to be recognized under negotiated contracts as shipments convert backlog to recognized revenue for accounting purposes, we may not be able to fully realize the revenue value reported in our

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backlog, and our backlog may not be indicative of future revenues. A significant portion of our backlog is concentrated in the international oil and gas market, which may impact the overall timing of shipments and the conversion of backlog to revenue. The timing of the backlog is based on the requirement date indicated by our customers. Based on historical experience, management expects that a significant portion of our backlog may not be shipped within the next 18 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.

During the second quarter of our fiscal year ended March 31, 2016, we removed approximately \$51.6 million, for 186 units, representing 63.8 megawatts, of backlog from BPC Engineering, one of the Company's Russian distributors. This removal aligned the backlog to management's expectations based on the global macroeconomic environment during our fiscal year ended March 31, 2015, such as the volatility of the global oil and gas market, a strong U.S. dollar (making our products more expensive overseas) and on-going geopolitical tensions involving Russia. In addition, we removed a portion of our TA100 backlog of approximately \$2.4 million, for 17 units representing 1.7 megawatts, from Calnetix Power Solutions, Inc. during the first quarter of our fiscal year ended March 31, 2016. This removal aligned our TA100 backlog with management's decision to limit future production of TA100 systems on a case-by-case basis for key customers.

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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Explanation of Responses:

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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, filed August 30, 2012 (b)
3.3	Certificate of Amendment to the Second Amended and Restated Certificate of Incorporation of Capstone Turbine Corporation, filed November 6, 2015 (c)
3.4	Amended and Restated Bylaws of Capstone Turbine Corporation (d)
3.5	Certificate of Elimination of Series A Junior Participating Preferred Stock, dated May 9, 2016 (e)
3.6	Certificate of Designations of Series B Junior Participating Preferred Stock of Capstone Turbine Corporation (e)
4.1	Form of Series A Warrant issued to investors in the October 2016 offering (f)
4.2	Form of Pre-Funded Series B Warrant issued to investors in the October 2016 offering (f)
10.1	Placement Agent Agreement by and between the Company and Oppenheimer & Co. Inc., as representative of the placement agents named therein, dated October 18, 2016 (f)
10.2	Form of Securities Purchase Agreement used in the October 2016 offering (f)
10.3	Seventeenth Amendment to the Credit and Security Agreements, between Capstone Turbine Corporation and Wells Fargo Bank, NA, dated February 7, 2017
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)

Explanation of Responses:

(c) Incorporated by reference to Capstone Turbine Corporation's Current Report on Form 8-K, filed on November 6, 2015 (File No. 001-15957)

(d) 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)

(e) Incorporated by reference to Capstone Turbine Corporation's Current Report on Form 8-K, filed on May 6, 2016 (File No. 001-15957)

(f) Incorporated by reference to Capstone Turbine Corporation's Current Report on Form 8-K, filed on October 18, 2016 (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/ JAYME L. BROOKS
Jayme L. Brooks
Chief Financial Officer & Chief Accounting Officer
(Principal Financial and Accounting Officer)

Date: February 9, 2017

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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)

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(c) Incorporated by reference to Capstone Turbine Corporation's Current Report on Form 8-K, filed on November 6, 2015 (File No. 001-15957)

(d) 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)

(e) Incorporated by reference to Capstone Turbine Corporation's Current Report on Form 8-K, filed on May 6, 2016 (File No. 001-15957)

(f) Incorporated by reference to Capstone Turbine Corporation's Current Report on Form 8-K, filed on October 18, 2016 (File No. 001-15957)

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