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PARTICIPANTS

Corporate Participants

Pedro J. Lopez-Baldrich – Office of the CEO, General Counsel, Secretary & VP-Administration, Clean Diesel Technologies, Inc.
Nikhil Atul Mehta – Office of the Chief Executive Officer & CFO, Clean Diesel Technologies, Inc.

Other Participants

Matt B. Koranda – Analyst, ROTH Capital Partners LLC
Ian T. Gilson – Analyst, Zacks Investment Research, Inc.

MANAGEMENT DISCUSSION SECTION

Operator: Good day, ladies and gentlemen, and welcome to the Clean Diesel Technologies, Inc. First Quarter 2014 Financial Results Conference Call. At this time, all participants are in a listen-only mode. Later, we'll conduct a question-and-answer session and instructions will follow at that time. [Operator Instructions] As a reminder, this conference call is being recorded.

I would now like to introduce your host for today's conference Pedro J. Lopez-Baldrich, Member of the Office of the CEO and General Counsel. Sir, you may begin.

Pedro J. Lopez-Baldrich, Office of the CEO, General Counsel, Secretary & VP-Administration

Thank you. Good morning, and thanks to everyone for joining us. By now, you should have a copy of our results press release, which crossed the wire this morning prior to market open. A copy of the press release, along with other company information, may be found on the Investor Relations page of our website: www.cdti.com.

Before I turn the call over to Nikhil Mehta, Member of the Office of the CEO and Chief Financial Officer of CDTi, I want to emphasize that some of the information you'll hear during our discussion today will consist of forward-looking statements that are predictions, projections and other statements about future events.

These statements are based on current expectations and assumptions that are subject to risks and uncertainties. Actual results could materially differ because of factors discussed in today's results press release, in the comments made during this conference call, and in the Risk Factors section of our Form 10-K and other reports and filings with the Securities and Exchange Commission. We do not undertake any obligations to update any forward-looking statements.

I'd now like to turn the call over to Nikhil Mehta.

Nikhil Atul Mehta, Office of the CEO & CFO

Thank you, Pedro, and good morning, everyone. I will start with the summary of our first quarter including some brief comments on each of our business divisions and an update on our strategic priorities. We will then open the call to your questions.

Our first quarter operating results were largely consistent with the expectations we shared with you in our year-end 2013 conference call. We experienced modestly lower sales in our Catalyst division, primarily due to lower rare earth reimbursements and a decrease in sale of service parts.

We continue to expand our footprint within our major OEM customer, Honda, to other platform models. In March, we were very pleased to announce that we had begun production of Catalysts, featuring our high performance Mixed Phase Catalyst technology, for Honda's 2015 Acura TLX model, and we expect shipments to commence in the first half of 2014. Along with the Acura TLX, we also provide our Catalyst solutions to Honda for North American versions of their four cylinder and six cylinder Accord, Acura RLX, as well as hybrid and plug-in hybrid models.

Our heavy duty diesel systems, or HDD, division sales were essentially flat for the quarter, as retrofit activity in the U.S. excluding California, and our European mining and material handling business continued to experience soft conditions. The bright spot for the HDD business has been the continued momentum in retrofit sales in California, with sales increasing nearly 60% compared to last year. As previously disclosed, The California Air Resources Board, or CARB, extended the deadline for compliance under the truck and bus rule from January 1, 2014 to July 1, 2014, which is expected to result in greater retrofit activity, in the state, in the second quarter.

Beyond California, we do see increased funding and continued retrofit potential in other states, including New Jersey, New York, Massachusetts, Illinois and Texas, amongst the other states, as additional federal funding from the U.S. Department of Transportation's Congestion Mitigation and Air Quality Improvement Program, or CMAQ, as well as various other state and local programs are moving ahead.

Gross margin was another highlight for the quarter, as both divisions reported increases in our overall gross margin, and our margin was up 7.6 percentage points year-over-year.

Total operating expenses in the first quarter were up modestly from the prior-year period. However, they would have been down on a comparable basis after excluding a charge for severance and other expenses.

While we have made significant progress and we continue our efforts to lower our cost going forward, we are making additional investments in our advanced low-PGM and zero-PGM, or ZPGM, technologies, as we prepare to capitalize on opportunities for top line growth driven by increasingly stringent emission regulations. During the first quarter, we filed four new patents pertaining to our unique ZPGM and advanced low-PGM catalyst technology.

We are also increasing our investments to develop and qualify emission catalyss in order to support our OEM customers as we seek to expand our catalyst technology to other vehicle platforms. The fundraise of approximately $6.1 million, that we completed in early April, enables these investments. We remain keenly focused on pursuing development of our material science platform and capitalizing on the opportunities ahead.

Now I will share some specific comments on our first quarter. Revenue of $12.5 million was down 6.4% compared to last year. The gross margin was 31% compared to 23.4% in the prior year period, up more than 700 basis points.

Total operating expenses for the first quarter of 2014 were $5.3 million compared to $5.1 million in the prior year quarter. First quarter expenses included a charge of approximately $400,000 for severance and other expenses, including a non-cash charge of approximately $200,000 or $0.02 per share related to shares issued in connection with the previously announced settlement agreement with a former company executive.

With the significant improvement in gross margins and the continued focus on expense control, loss from operations narrowed to $1.4 million compared to a loss of $2 million for the prior year period despite the modest decline in sales.

Our expense for the first quarter includes a non-cash charge – I'm sorry, our other expense for the quarter includes a non-cash charge of $2.1 million or $0.21 per share, resulting from an increase in the estimated fair value of the liability associated with issued warrants. The increase in the estimated fair value of this warrant liability was primarily related to the increase in the company's stock price in the first quarter of 2014.

Net loss for the quarter, which includes the non-cash charges of $2.3 million or $0.23 per share that I just discussed, was $3.8 million or $0.39 per share versus a net loss of $2.1 million or $0.29 per share last year. We had $3.6 million of cash as of March 31, 2014 and not included in that amount are the net proceeds from our April 2014 offering in which we received approximately $6.1 million.

Moving on to the operating divisions, I will highlight the performance in the first quarter. Our external Catalyst division OEM sales of $5.3 million reflects a decrease of approximately $700,000 compared to last year's sales. The decrease was a result of lower rare earth prices which are passed through to the customer, as well as a decrease in the sale of service parts.

Reported gross margin was up nearly 7 percentage points year-over-year to more than 26% for the quarter. Gross margin improved due to a favorable product mix resulting from an expansion of models sold to Honda. Lower cost of certain raw materials, improved manufacturing efficiency, and improved margins on the sales to the HDD division. This division generated an operating profit of approximately $200,000 for the quarter compared to a profit of approximately $100,000 last year.

Our HDD Systems division sales of $7.2 million were down 1.7% from $7.3 million last year. Sales increased under the California retrofit program; however, as mentioned earlier, sales were down in North American retrofit activities in the 49 states excluding California, and we continued to experience soft conditions in our mining and material handling business in Europe.

We recorded approximately $4.2 million of sales under the California retrofit program, which was up significantly compared to the prior year quarter. Expanding our HDD Systems division sales from non-retrofit sources for the reduction of emission and exhaust emissions continues to be an area of focus for us as they represent a more sustainable OEM and after-market business. One area within the non-retrofit market that we're now actively pursuing is the emerging after market for replacement filters in North America for both heavy duty and medium duty diesel vehicles. We expect to leverage our existing technology and know-how to cost effectively serve this emerging market, and would expect to see some activity in the second half of 2014 and building from there in the ensuing years.

Lastly, in spite of the weakness in the mining and material handling sectors, we still see opportunities for growth within our HDD OEM customers.

Gross margin in the HDD systems business increased nearly 8 percentage points year-over-year to more than 33% in the first quarter. Gross margins improved as a result of improved manufacturing efficiency, lower raw material costs, and to favorable product mix. The HDD division reported an operating profit of approximately $300,000 in the quarter compared to an operating loss of approximately $300,000 last year.

So to summarize, the positives for the quarter included; one, our strong operating performance and product mix helped drive impressive gross margin expansion; two, we narrowed our net operating loss from a year ago, which is encouraging; three, we reported solid revenue growth in the California retrofit market; and finally, we continued to expand our IP portfolio.

In conclusion, the first quarter was largely consistent with our expectations. We are encouraged by the opportunities we see across our end markets as we move through 2014 giving us optimism about our ability to deliver improved performance going forward.

This concludes my prepared remarks this morning, and would now like to open the call for questions. Operator, we are now ready for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] And our first question comes from the line of Matt Koranda from ROTH Capital. Your line is now open.

<Q – Matt Koranda – ROTH Capital Partners LLC>: Good morning, Nikhil. Thanks for taking my questions. Just wanted to start out on the gross margin piece here. You know, you guys have posted some nice gross margins over the past quarter and continuing on into Q1. Is this sort of the normal run rate you think that we could consider going forward? How do you think about gross margins as we move through the year?

<A – Nikhil Mehta – Clean Diesel Technologies, Inc.>: Matt, as you know we don't give guidance, but we're feeling good about stringing together a few quarters of good margins. I would say that this level is sustainable, but it's so heavily dependent on product mix that I can't really say exactly what kind of margin we'll see going forward. But in terms of manufacturing efficiencies, lower raw material prices, those are real.

<Q – Matt Koranda – ROTH Capital Partners LLC>: Okay, all right, that's still helpful. And in terms of Honda, is Honda looking at you guys for additional platforms? You guys had the nice win with Acura a few months back. And then maybe just higher level, what is it about Honda where they can get comfortable sourcing from CDTi but other OEMs are taking kind of longer. Is it just a function of that they know your technology and they're used to it in the Accord, or is it something different about the way that they procure?

<A – Nikhil Mehta – Clean Diesel Technologies, Inc.>: That's a great question, Matt. Well, as you know, we've had a very, very long relationship with Honda. We've been supplying to Honda for over a decade now. Obviously, they certainly feel that our technology is something that gives them a lot of benefits and they continue to do business because of that. And as you can see that we have been significantly or at least we've been adding several vehicle platforms to our business in Honda, especially over the last 12 months or 18 months or so, and we continue to work with them. They like us. We have a very close relationship with them, and it's our technology, what else can I say.

<Q – Matt Koranda – ROTH Capital Partners LLC>: Okay. That's fair. And then let's just move on to the HDD for a moment here. Now that we're just over a month into Q2 and given the expectations you shared that the retrofit market in California has just experienced a ramp. Can you just comment in general about the market activity that you guys are seeing? How are things trending during the quarter? Any color on that would be appreciated?

<A – Nikhil Mehta – Clean Diesel Technologies, Inc.>: Well, we're still optimistic that there will be a ramp in the California market in the second quarter because of the deadline. There was a meeting at CARB late in April, where the CARB – where the board heard some objections from certain segments of the trucking industry, but the results of that meeting have not really significantly changed anything. So we do expect a push to get – for the truckers to become compliant by the end of this quarter.

<Q – Matt Koranda – ROTH Capital Partners LLC>: Okay. And then, could we just do – I don't know if it's maybe too early, but could you do sort of a postmortem on the California retrofit market, now that it's sort of starting to wind down here. What have you guys learned, and how do you plan on applying it to future potential retrofit markets, maybe in the other states in the U.S. here?

<A – Nikhil Mehta – Clean Diesel Technologies, Inc.>: Okay. So that's a very good question too. Again, you've got to realize that the California retrofit program was very different from what we are doing in some of the other states. Namely in all the other states, the retrofit programs that we are going after are funded by either the federal government or the state government or some kind of state funding. This was a program, the first of its kind in North America, where a state was actually mandating private fleets to retrofit their vehicles or to make their vehicles compliant.

And when you are in a – hate to use the word, but it's a more commercial environment than in other states, you're dealing with a whole set of other factors. And so, what we learned was that vehicle fleets and vehicle owners while they're trying to be compliant, do have different ways of doing it. They have large fleets, can move fleets around between states. Smaller vehicle owners have delayed compliance as much as humanly possible. There have been a lot of industry groups from the trucking industry that have complained about the regulations and delayed.

So there is a whole lot of other factors that have resulted in the California program, while it's been very lucrative, it has resulted in, if I'm right close to $12 million, $13 million of sales a year for the last two years, and we did $4 million in the first quarter this year.

It wasn't as big as CARB had originally projected for some of these reasons. You know, the truckers were able to do certain things that did not require retrofit, and things like swapping out vehicles and the like.

So again, to your question about how do we translate this to other states, it's very different. In the other states there are very specific government-funded programs such as school districts or municipal programs and the like, and that's a different kind of dynamics. I hope that rambling answer kind of answered your question.

<Q – Matt Koranda – ROTH Capital Partners LLC>: Yes, that was actually really helpful Nikhil, and I will jump back in queue. Thanks a lot.

Operator: Thank you. [Operator Instructions]

And our next question comes from the line of Ian Gilson of Zacks Investments. Your line is now open.

<Q – Ian Gilson – Zacks Investment Research, Inc.>: Well good morning, gentlemen.

<A – Nikhil Mehta – Clean Diesel Technologies, Inc.>: Hi, Ian.

<Q – Ian Gilson – Zacks Investment Research, Inc.>: Can you – you sort of raced right by the California number. Could you repeat that, and also give us last year's number as well?

<A – Nikhil Mehta – Clean Diesel Technologies, Inc.>: Okay, so we did $4.2 million of sales in California in the first quarter. And I believe last year's number was $2.5 million or thereabout in the first quarter.

<Q – Ian Gilson – Zacks Investment Research, Inc.>: Okay, okay. The elimination charge, which is to transfer from catalyst to HDD, correct?

<A – Nikhil Mehta – Clean Diesel Technologies, Inc.>: Yes.

<Q – Ian Gilson – Zacks Investment Research, Inc.>: Increased.

<A – Nikhil Mehta – Clean Diesel Technologies, Inc.>: Yes.

<Q – Ian Gilson – Zacks Investment Research, Inc.>: But, catalyst sales declined.

<A – Nikhil Mehta – Clean Diesel Technologies, Inc.>: Right.

<Q – Ian Gilson – Zacks Investment Research, Inc.>: Can you sort of run through why they moved in different directions.

<A – Nikhil Mehta – Clean Diesel Technologies, Inc.>: Yes, okay. So I did say in my remarks that catalyst sales to outside customers declined by about $700,000. And some of that was related to rare earth pricing coming down from last year. As you know, we get dollar for dollar reimbursement for rare earth in our catalyst from Honda, and as those prices come down they have no impact on the gross profit, but the revenue comes down.

And then we had a, I would say a slightly unusually high level of service part sales in the first quarter last year, and this year we were more at the normal level. We sell service parts to customers we supplied in the past such as General Motors and Renault.

<Q – Ian Gilson – Zacks Investment Research, Inc.>: Okay. So basically, the rare earth pass-through charge is sort of exclusive to the Honda contracts?

<A – Nikhil Mehta – Clean Diesel Technologies, Inc.>: Yes.

<Q – Ian Gilson – Zacks Investment Research, Inc.>: Okay. I'm not all that familiar with how Honda sources. Are all of their reported monthly sales from U.S. production, or do they import the Accord as well as from other countries?

<A – Nikhil Mehta – Clean Diesel Technologies, Inc.>: Yes, I believe, if you look at their Accord and Acura sales that they report every month, I believe they are all U.S., now. I think now they are all U.S. sourced. But there was a piece of the Accord that used to be sourced out of Japan, I believe it's now all U.S. sourced.

<Q – Ian Gilson – Zacks Investment Research, Inc.>: Okay, okay. And what takes the place of the CARB deadlines, that we see California drop like the London low emissions Zone revenue did?

<A – Nikhil Mehta – Clean Diesel Technologies, Inc.>: I don't think, it's going to be that kind of a drop, because there are still – remember the program originally was going through 2016, and that's still true. There's still a fair number of vehicles that are out there, but they've been – because of the size of the businesses and all that, their deadlines are strung out over the next two years or three years. So it's not going to be the kind of drop that we saw, because London was a one-time shot, which lasted literally two quarters. This thing will start declining, and it will take maybe through next year before it completely goes away.

<Q – Ian Gilson – Zacks Investment Research, Inc.>: Perfect. Okay, fine. Thank you very much. Oh! And let me see, let me – one last sort of question on the warrant valuation. As we see the price of the stock go up, is that number always going to go up?

<A – Nikhil Mehta – Clean Diesel Technologies, Inc.>: Yes – just to be very clear. We had issued warrants last summer at a strike price of $1.25. About 800,000 of those warrants have been exercised. Most of the warrant liability changed this year; that $2.1 million was associated with those warrants.

<Q – Ian Gilson – Zacks Investment Research, Inc.>: Okay.

<A – Nikhil Mehta – Clean Diesel Technologies, Inc.>: Now in the April fundraise we issued another 800,000 warrants at a strike rates of $4.20. Those also will be classified as a liability warrant, and depending on the stock price as going up or down, we'll be picking up gains or losses every quarter.

<Q – Ian Gilson – Zacks Investment Research, Inc.>: Only as they're exercised, or....

<A – Nikhil Mehta – Clean Diesel Technologies, Inc.>: No. no.

<Q – Ian Gilson – Zacks Investment Research, Inc.>: This is clearly a pay for [indiscernible] (21:25).

<A – Nikhil Mehta – Clean Diesel Technologies, Inc.>: We have to value those warrants every quarter. We've been doing that every quarter. It's not been noticeable, because until January, February, March this year, our stock price was sort of stable last year. It wasn't as volatile as it has been in the past. So you didn't see the big impact that you saw because in the first quarter as you know our stock price went from $1.50 in December all the way up to $7 and then back down to $3.80 in March. So that kind of volatility unfortunately because of the way U.S. debt requires us to record liability warrants, it will have this fluctuating impact on our other income and expense.

<Q – Ian Gilson – Zacks Investment Research, Inc.>: Okay. Is it based on the quarter-end price? Or an average price per quarter? Quarter-end price.

<A – Nikhil Mehta – Clean Diesel Technologies, Inc.>: It's based on the quarter-end price.

<Q – Ian Gilson – Zacks Investment Research, Inc.>: Okay. Great. Thank you very much.

Operator: Thank you. And I'm showing no further questions at this time, I would now like to turn the call back to Mr. Mehta for any further remarks.

Nikhil Atul Mehta, Office of the CEO & CFO

Well thank you all for being at our call today. And we look forward to our next quarter's earnings call. Thank you all.

Operator: Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program. You may all disconnect. Have a great day everyone.