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CDTI - Q3 2014 Clean Diesel Technologies Inc Earnings Call

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Matt Koranda *Roth Capital Partners - Analyst*

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to Clean Diesel Technologies' third-quarter 2014 financial results conference call.

(Operator Instructions)

As a reminder, this conference is being recorded. I would like to introduce your host for today's conference, Mr. Pedro Lopez-Baldrich, CDTi's General Counsel. Please go ahead, sir.

Pedro Lopez-Baldrich - *Clean Diesel Technologies Inc - General Counsel*

Thank you, Sam. 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 page of our website at www.cdti.com.

Before I turn the call over to Chris Harris, President and Chief Executive Officer of CDTi, I want to emphasize that some of the information you will hear during our discussion today will consist of forward-looking statements that are predictions, projections or 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 obligation to update any forward-looking statements.

I would now like to turn the call over to Chris.

Chris Harris - *Clean Diesel Technologies, Inc. - President & CEO*

Thank you, Pedro. Good morning and thank you for joining us. I intend to say a few words about our Q3 results, leaving the detail to Dave Shea, our CFO, and then I would like to talk about our go-forward strategy and focus areas.

Our third-quarter results were impacted by lower heavy-duty diesel revenue, resulting from a decrease in retrofit demand in both California and the 49 states. In addition, catalyst revenue decreased modestly due to lower sales volume to an OEM customer. While we are clearly not satisfied with these results, we are confident in the medium-term trajectory of the Company as we have made significant progress in a strengthening our financial foundation to position us for profitable growth.



Before Dave takes you through the financial detail for the third quarter, I'd like to walk you through our recent progress and outline our plan for strengthening our business. During our last call on August 8, I had been CEO of CDTi for about a month. What excited me most about my new position were the opportunities to leverage CDTi's core competencies to expand our footprint within the emission control industry. Now, three months later, I'm even more optimistic than I was in July. I remain encouraged by the tremendous commitment of our employees to delivering high-quality products, developing world-class technologies and unlocking our potential for significant growth.

I believe CDTi is poised to evolve from a niche emissions solution provider into a major player in advanced materials for emissions management and control. Our strategy is quite simple. We are focused on leveraging our advanced materials platform to provide both technology and product for high-volume applications in the automotive OEM and after-market segments. The focus on advanced materials technology and applications enables us to participate in highly scalable market opportunities that complement our existing manufacturing model and therefore drive revenue growth and profitability.

In support of this strategy, we have filed a significant number of patents that underpin next-generation technology for our advanced low PGM and zero-PGM materials platform and reconfirms CDTi's tradition of innovation. We were recently awarded two significant patents for our Spinel technology, a proprietary clean emissions exhaust platform that promises to dramatically reduce the cost of obtaining more stringent clean-air requirements. This is becoming increasingly relevant as new standards such as the EPA's Tier 3 become effective.

The patents cover the replacement of platinum group and rare earth metals in catalytic converters, their usage rates and cost of which are expected to dramatically increase using conventional technology without innovations such as our Spinel technology. These patents represent the first of family of patents for Spinel technology, which could conceivably power multiple catalytic product lines that have the potential to be highly disruptive to the traditional platinum-based and rare earth-based catalytic device industry.

CDTi's latest innovation represents a major evolution in its leading edge technology already deployed successfully in applications for key OEM customers, including Honda. We are currently conducting vehicle testing to validate our Spinel technology into specific introductory products for global OEMs with the goal of accelerating broad commercialization of this technology.

The Spinel technology enables us to begin a shift in how we pursue large-scale growth in the emissions control market. To more quickly deploy this breakthrough technology in the market, we will, once validated, make it available to OEMs and other global catalytic coaters for potential use in proprietary powder form for other business models that might involve material supply and/or technology licensing. We perceive multiple incremental paths to market for this technology to complement our existing manufacturing-centric model. And we are excited about the important scalability potential this strategy will offer.

We will continue to maintain a world-class manufacturing capability and will deploy it selectively where it adds most value for our customers. As such, our focus will be on supplying catalysts for passenger car catalytic converters and for our own heavy-duty diesel systems division. This includes maximizing the number of models that we are in with our key OEM customer, Honda, and deploying our enabling catalyst in growth markets like DuraFit replacement parts.

Speaking of the heavy-duty diesel emission component replacement market, we are making good headway entering this new growth area. As mentioned in our October 21 press release, we have taken important steps to reallocate our resources away from the retrofit market and into the replacement market where we perceive superior growth and profit opportunities. Recent retrofit market weakness provides support for this decision. The replacement market involves replacing a failed a filter on a truck or bus that had a diesel particulate filter, often called a DPF, installed at the OEM factory.

As such, the replacement market is distinctly different from the retrofit market, which involves installing a full DPF system on a vehicle that did not have one when it left the factory. Retrofits are done on older vehicle model years, 2006 and prior, while more and more trucks in North America put into service starting in 2007 are requiring replacement filters. Today those filters are supplied by the OEMs themselves. However, we see a significant opportunity to supply replacement diesel particulate filters into this market.



Thus, DuraFit is our new cost-effective alternative to OEM replacement filters, which we officially launched this past August. We are bringing to market over 40 part models of DuraFit that address virtually every type of class 5 through class 8 truck on the road today. Furthermore, our DuraFit offering uses less platinum-group metals and meets or exceeds all end-customer requirements. The market for replacement filters is substantial, currently estimated in the range of 125,000 to 150,000 filters per year in North America, which translates into a \$300 million market possibility for CDTi, and it is growing.

To date we have made critical progress, bringing on several key regional distributors in North America, and we are actively engaged with major national dealer networks surrounding defining target markets and comprehensive sales and marketing programs that will underpin future supply agreements. These multiple channels represent thousands of service center and part outlets. While the Q3 results of our heavy-duty diesel segment were a disappointment as we transition our focus to the replacement market, we anticipate incremental traction from the DuraFit roll-out in Q4 and more meaningful revenue contribution during 2015.

In addition to actually getting plans to grow sales in our catalyst and heavy-duty diesel divisions, we have taken action to strengthen our financial and operating foundation. On November 4 we announced we raised approximately \$4.4 million in gross proceeds from an offering of common stock and warrants. We intend to use net proceeds from this offering, and any resulting warrants exercises, for working capital and to fund accelerated vehicle validation testing and commercialization of Spinel technology; continued patent filings to expand our IP portfolio, and to build out our commercial team to accelerate the ramp up of DuraFit.

Meanwhile, we continue to evaluate how best to align our assets with the Company's vision and strategic direction. As such, in October we sold our Reno manufacturing operations to support our advanced materials strategy. The sale prioritizes our resources, reduces our cost and supports higher margins. We have also reduced and streamlined staffing, reallocated resources from our historical retrofit business to our DuraFit growth business and relocated our corporate headquarters to improve our cost structure. We believe these recent actions will result in an estimated net annual reduction in manufacturing and operating expense of approximately \$1.2 million.

Overall, our cost reduction and balance sheet improvement initiatives enhance our ability to commercialize our Spinel technology platform, expand our intellectual property portfolio and bring to market new products such as DuraFit. While ensuring we right-size our cost structure, we are also keenly aware of the need to expand the commercial reach of our products and technologies, and are planning prudent investments to enhance our commercial and strategic business development capabilities.

Given all this, I'm excited about our future. But before I wrap up and we take your questions, I will turn the call over to Dave for a review of our financials.

Dave Shea - *Clean Diesel Technologies, Inc. - CFO*

Thank you, Chris.

For the third quarter of 2014, as Chris mentioned, on October 21 we announced the sale of our standard exhaust and specialty parts business, which is now classified as discontinued operations. Revenue from continuing operations was \$9.3 million compared to \$13.3 million in the third quarter of 2013. Including discontinued operations, revenue was \$10.3 million and \$14.2 million, respectively. Heavy duty diesel revenue for California and the 49 states was down due to a decrease in retrofit demand. In addition, our DuraFit sales had not yet begun to ramp up.

Our catalyst revenue was down due to lower sales volume to an OEM customer, primarily due to timing of shipment and reduction in service part sales. Gross profit was \$2.9 million compared to \$4.2 million. Gross margin for both periods was 31.4%. This represents our fifth consecutive quarter with gross margins above 30%. The breakdown of margins was 31.6% for heavy duty diesel and 28.5% for the catalyst division.

Total operating expenses were \$5.3 million and included approximately \$800,000 in severance expenses. This compares to \$4.1 million in the third quarter of 2013. SG&A was \$2.7 million compared to \$2.9 million in the third quarter of 2013. R&D was \$1.8 million compared to \$1.2 million in the same period last year. R&D increased as a result of testing and development work on advanced catalyst technology, including the numerous patents that we filed during the quarter.

The operating loss was \$2.4 million compared to an operating income of approximately \$100,000 in the same period last year. In the third quarter of 2014 we recognized a non-cash gain of \$700,000 from warrant adjustments, primarily from our April 2014 offering, and to a lesser extent, our July 2013 offering. This non-cash gain reflects lower warrant evaluations due to a lower stock price in the third quarter as compared to the end of the second quarter. Net loss was \$1.6 million or \$0.13 per share and included a loss of \$180,000 from discontinued operations. This compares to a loss of approximately \$1.1 million or \$0.12 per share in the same period last year, which includes net income from discontinued operations of approximately \$8,000.

The average outstanding shares for the third quarter of 2014 were 12.4 million compared to 9.2 million in the third quarter 2013. The increase reflects the approximately 2 million shares in the \$6.1 million offering we conducted in April of this year. At September 30, 2014 we had cash of \$4.9 million compared to \$3.9 million at the beginning of the year. In addition, as Chris mentioned on November 4, we announced the offering of common stock and warrants to a single investor for \$4.4 million. The net proceeds are anticipated to be approximately \$3.8 million after placement agent and other fees. However, this does not include the proceeds from the exercise of any warrants. This transaction did close this morning.

Looking ahead, we will continue to evaluate opportunities to improve our balance sheet and financial flexibility to position us for growth. With that, I will turn the call back over to Chris.

Chris Harris - *Clean Diesel Technologies, Inc. - President & CEO*

Thanks, Dave.

Before we take questions, let me summarize all that we have just discussed in terms of our vision for CDTi. We are taking action to evolve CDTi from a niche manufacturing Company that makes emission control products, to an advanced materials Company that develops proprietary technology and more broadly commercializes it through other major players in the key value chains, global OEMs and coaters in the case of automotive catalysts.

We will continue to manufacture select products for select OEMs to demonstrate to the value of the technology, to remain on the cutting edge in formulation and manufacturing know-how and to drive next-generation developments in our enabling technology. We will also pursue attractive specialized markets like heavy-duty replacement parts, where we leverage our catalyst materials technology and our track history in heavy-duty diesel.

But by emphasizing business models centered on making our technology and proprietary materials broadly available to global players in the value chain, we will expand the commercial reach of our technology and accelerate its deployment while maintaining a limited manufacturing footprint. In a short, while we are very excited about the progress we are making, there is clearly much work to be done. Ultimately our success will depend on focused execution. And I have no doubt that our world-caliber team has the necessary creativity, dedication and passion to get the job done. With that said, we look forward to updating you on future calls.

And now, Operator, we are ready to begin the Q&A session.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Matt Koranda, Roth Capital.



Matt Koranda - Roth Capital Partners - Analyst

Good morning, guys; thanks for taking my questions.

Dave Shea - Clean Diesel Technologies, Inc. - CFO

Hey, Matt.

Matt Koranda - Roth Capital Partners - Analyst

Just a housekeeping item first: On HDD retrofit in California, what was the figure in Q3? And then, what was it in rest of US?

Dave Shea - Clean Diesel Technologies, Inc. - CFO

\$1.4 million in California, and \$0.8 million in the rest of the US.

Matt Koranda - Roth Capital Partners - Analyst

Okay, all right. And then, if we could just shift to the DuraFit opportunity. I think on the last call, you guys had mentioned the market size being in the \$500-million range. If I caught it right, it sounds like you guys said \$300 million in your prepared remarks. Any reason for the delta there? Or have you guys just refined the assumptions around that?

Chris Harris - Clean Diesel Technologies, Inc. - President & CEO

There has been some refining of the assumptions, but I also think, Matt, that we may have been talking about the market size one step down in the value chain, in terms of where we sell. So, the \$300 million represents what we would sell to our distributors and dealers. It's possible the \$500 million was referring to what the dealers sell to the end user.

Matt Koranda - Roth Capital Partners - Analyst

Okay.

Dave Shea - Clean Diesel Technologies, Inc. - CFO

The difference between the \$500 million and \$300 million is dealer level versus our level (inaudible).

Chris Harris - Clean Diesel Technologies, Inc. - President & CEO

We apologize for any [end] mistakes that happened earlier.

Matt Koranda - Roth Capital Partners - Analyst

That's fine; I just wanted to clarify. That's helpful.

It sounds like you guys are expecting some incremental traction with DuraFit, and that's exciting. Can you quantify the opportunity in terms of revenue contribution that you might expect in, say, Q4? And then, just talk about maybe the cadence of how it could ramp through 2015.

Chris Harris - *Clean Diesel Technologies, Inc. - President & CEO*

I think what we're just seeing is, first, sales getting underway strongly at the end of Q3, into Q4. So, I would not expect much more than \$0.5 million-plus in Q4 to actually hit, with 2015 being a much bigger ramp-up period for us.

Matt Koranda - *Roth Capital Partners - Analyst*

All right. And you've talked about the range of SKUs that are available, that can vary in terms of ASPs. Is there a particular product that you plan on starting out with first? How do you go about doing that?

Chris Harris - *Clean Diesel Technologies, Inc. - President & CEO*

The 40 part models that we have talked about that cover the vast majority of class 5 through 8 are a variety of vehicle types and engine sizes, so they have different sized parts themselves. They can range pretty broadly from down near \$1,000 a part up to \$4,000 a part. We see the bulk of our sales, though, coming in the \$2,000-to-\$3,000-a-part range.

Matt Koranda - *Roth Capital Partners - Analyst*

Okay, that's helpful. Is it fair to assume that we're going to see a meaningful revenue ramp by mid-2015? Or are we talking maybe the really meaningful stuff comes in the back half of next year?

Chris Harris - *Clean Diesel Technologies, Inc. - President & CEO*

We are going to see significant traction in the first half, based on all of the marketing and sales plans we have in motion, as well as the various progress we're making in setting up the multiple distribution and sales channels. Clearly, the traction will have full impact in the second half of 2015, in terms of everything we are doing in the next nine months.

Matt Koranda - *Roth Capital Partners - Analyst*

Okay. Can you just elaborate a bit on setting up the channels, and go into some of the mechanics of what you are doing to get these channels prepared, and to get out there and do some of the business development activities that go around launching DuraFit?

Chris Harris - *Clean Diesel Technologies, Inc. - President & CEO*

There's various channels out there, and I'm not going to go into a lot of detail on them, in terms of competitive knowledge. But there are independent distributors out there, whereby, not only do you need to set up agreements, and then you have to set up some training, as well as some logistics arrangements, et cetera.

If you get into national dealerships, it takes on even an order of magnitude larger, in terms of all the set-up because you are dealing with ERP systems; you are dealing with regional distribution warehouses for parts; never mind training and marketing collateral. There's a host of things that you do. This has got comprehensive marketing and sales plans for each of these channels.



Matt Koranda - Roth Capital Partners - Analyst

Great, that's helpful. I think that you had mentioned, maybe it was on the last call, that you were engaging CARB on potentially obtaining approval for DuraFit in California. What is the latest there?

Chris Harris - Clean Diesel Technologies, Inc. - President & CEO

There are some key meetings set up for the third week of November, and a workshop set up for early December with CARB. We will obviously be in high attendance of that.

We maintain dialogue with regulatory authorities, as we always have, leveraging relationships as well as our reputation in the retrofit side of things, to make sure that we accelerate any fine-tuning that CARB needs to do from their regulatory approval, and get homogenization, if you will, with the 49th state. I think that the progress is happening there as fast as it can, and we'll continue to engage.

Matt Koranda - Roth Capital Partners - Analyst

Okay, great. One more here on Spinel -- you talked about potential for licensing revenue. Is there a natural limit to the amount of licensing agreements that you could complete? Is there a certain number of customers before you run up against the natural limit there? Could you talk about that for a second?

Chris Harris - Clean Diesel Technologies, Inc. - President & CEO

The entire marketplace faces the same increasingly stringent regulations, and the same challenge, if you look at the entire market of auto makers, to meet these regulations cost effectively. From that standpoint, Matt, I don't think there is a limit. Because if our technology is as enabling and cost efficient as we believe we will prove it out to be, then it becomes a key tool in every automaker's arsenal to satisfy regulatory compliance cost effectively, so they can put their resources elsewhere in terms of their vehicle development and prioritizations for their companies.

Matt Koranda - Roth Capital Partners - Analyst

Okay, that's helpful. I will jump back in queue. Thank you.

Operator

Ian Gilson, Zacks Investment.

Ian Gilson - Zacks Investment Research, Inc. - Analyst

Good morning, gentlemen. As I look at the last four quarters, and the gross margin specifically have been pretty consistent in the 31% to the 31.5% level. That includes taking the adjustments out of the operating number -- adjustments for the sale of the Reno facilities and people leaving. Where are you going to get the extra margin? Is that going to be only from DuraFit? Or do we have something else in the works on the gross margin level?

Chris Harris - Clean Diesel Technologies, Inc. - President & CEO

Clearly, as DuraFit wraps, and becomes the substantial business that we think it can be, that does give us clear operating scale in terms of its specialty raw material purchases. So, that will feed gross margin expansion as that hits critical mass and volume. So, that's a key, critical contribution there, Ian.

We continue introducing and rounding out the portfolio of business we have with Honda. And as we've announced over the last couple years, leveraging off the four-cylinder model-year 2013 introduction that happened back in 2012, we've introduced six-cylinder, we've introduced hybrids. Those products in and of themselves, and those platforms, are more challenging emission-control situations, and we've been able to secure appropriate margins for those new pieces of business. And as all that solidifies in terms of total mix going forward into 2015, I think we'll see a little bit improved margin there, too.

Ian Gilson - *Zacks Investment Research, Inc. - Analyst*

Okay. Precious metal prices -- gold, for example -- is down to -- I think it is over a four-year low. Platinum and palladium also seemed to have peaked. You still have a fair amount of business that uses platinum-group metals and rare earth metals. Are you benefiting from those prices? Or is it strictly a [passive] agreement with Honda?

Dave Shea - *Clean Diesel Technologies, Inc. - CFO*

Let me take that in two pieces. The first, for precious metals, the majority of our precious metals are consigned by companies like Honda. We do an agreement with Honda and General Motors where they provide us the precious metals that we use in their products. So, we're isolated from the precious metal fluctuations in our sales price.

Obviously, for our diesel products, some of which use platinum, we have exposure there. For the rare earth materials, for Honda, we have an index agreement with them that protects us from fluctuations in that, and we get that passed through -- any fluctuation above a base amount.

Ian Gilson - *Zacks Investment Research, Inc. - Analyst*

Okay. I didn't get the California retrofit revenue in the third quarter. Could you give that to me again, please?

Dave Shea - *Clean Diesel Technologies, Inc. - CFO*

\$1.4 million.

Ian Gilson - *Zacks Investment Research, Inc. - Analyst*

Thank you very much.

Dave Shea - *Clean Diesel Technologies, Inc. - CFO*

Thank you, Ian.

Operator

Thank you. At this time, I would like to turn the call back over to Mr. Harris for further remarks.

Chris Harris - *Clean Diesel Technologies, Inc. - President & CEO*

Well, I would just like to thank everyone for joining us today and for your continued support of Clean Diesel Technologies. We'll look forward to speaking with you soon. So, with that, I'll say goodbye and have a good day.

Operator

Ladies and gentlemen, thank you for your participation in today's conference. This does conclude the program, and you may all disconnect.

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