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CDTI - Q1 2016 Clean Diesel Technologies Inc Earnings Call

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CORPORATE PARTICIPANTS

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CONFERENCE CALL PARTICIPANTS

Rob Brown *Lake Street Capital - Analyst*

Thomas Boyce *Cowen and Company - Analyst*

Amit Dayal *Rodman & Renshaw - Analyst*

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the CDT first-quarter 2016 financial results conference call. (Operator Instructions) As a reminder, this conference call is being recorded.

I would now like introduce your host for today's call, Ms. Becky Herrick from LHA. Ma'am, you may begin.

Becky Herrick - *Clean Diesel Technologies, Inc. - IR, LHA*

Thank you, Eric. Good morning and thanks to everyone for joining us for the CDTi first-quarter 2016 financial results conference call. By now you should've received 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 the Company's website at www.cdti.com. If you would like to be added to the distribution list or if you would like additional information about CDTi, you may call LHA at 415-433-3777.

Before I turn the call over to Matthew Beale, Chief Executive Officer of CDTi, I want to emphasize that some of the information you will hear during management's 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.

Now I would like to turn the call over to Matthew Beale. Matthew?

Matthew Beale - *Clean Diesel Technologies, Inc. - CEO*

Thank you and good morning, everyone. Thank you for joining us today. For the first quarter, we continued our focus on accelerating our commercial and operational goals, firmly positioning the Company toward sustainable profitability and long-term growth. We are doing this by successfully launching new products, winning new customers, and entering new geographic markets.

Today's global market environment provides a significant opportunity for CDTi. As more stringent regulatory changes are implanted in regions such as China and India, CDTi's technology provides a compelling value proposition for large vehicle markets as it significantly reduces platinum



group metals content. This resonates strongly with OEMs and other market participants globally as they seek proven, cost-effective solutions for compliance.

Now I will review our recent progress on capturing this opportunity. Our partner relationships continue to grow. CDTi's agreement with Panasonic exemplifies our strategy to cost-effectively deliver our technology through both value-added manufacturing and our Powder-to-Coat capability. In addition, this relationship provides important validation of our advanced materials technology among industry leaders.

After teaming with Panasonic to supply our new advanced materials technology for the Chinese heavy-duty on-road and off-road retrofit markets, we began supplying substrates coated with SPGM DOC technology in January. Activity has increased since then and we continue to anticipate a meaningful ramp in volumes during the second half of 2016, reaching a low single-digit million-dollar annual revenue run rate by the end of this year.

We are working with Panasonic to explore additional projects that integrate our powder technology into their manufacturing process in multiple geographic markets. Based on our current pipeline of commercial dialogue, we expect to add other partnerships during the balance of 2016 that are consistent with this model, a model that plays to CDTi's strengths.

In February, we entered a distribution agreement for DuraFit with Hino Motors, which is part of the Toyota Group and one of the top medium truck manufacturers in the US. This marks another critical milestone in expanding our North American distribution footprint as CDTi partners with leading OEMs to pursue a key growth market and demonstrates continued commercial momentum in the estimated \$450 million OEM replacement market for DPFs and DOCs.

In addition to our commercial activities, we continue to streamline our cost structure. We took actions in 2015 and into the first quarter of 2016 to adjust our operating footprint to support the execution of our strategy. This included closing our Markham, Ontario, manufacturing facility and outsourcing metal fabrication activities. In the first quarter, we made additional headcount adjustments in line with our focus strategy going forward.

Also, we have taken important steps to strengthen our capital structure. Subsequent to the end of the first quarter, we amended our loan agreements with our long-term lender, Kanis S.A., providing us with a mechanism to convert debt into common stock of the Company in the event of a stock offering or a strategic investment. We believe these agreements provide us with an important opportunity to significantly reduce the debt on our balance sheet and achieve a capital structure more consistent with our growth objectives.

Before I turn the call over to Dave Shea for a discussion of our financials, I'd like to put our Q1 results in their appropriate context. Six months ago, we announced a major strategic and organizational overhaul of CDTi, aimed at achieving sustained profitability and long-term growth.

In the intervening period, we have taken very significant steps to execute that plan, which have impacted all levels of the organization and reshaped it based on our mission. We look forward to seeing the benefits of those initiatives as the year progresses.

Now I'll turn the call over to David Shea to review the financials.

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

Thank you, Matthew. For the first quarter of 2016, revenue was \$9.7 million compared to \$10.3 million in the first quarter of 2015. Catalyst-driven, it was \$6.5 million compared to \$6.8 million in first quarter 2015 due to reductions in certain niche models.

Heavy duty diesel systems revenue was \$4.1 million for both quarters, as an increase in DuraFit sales was offset by a decrease in retrofit. \$885,000 and \$622,000 of intercompany sales from the catalyst division to the heavy duty diesel systems division were eliminated in consolidation for the first quarters of 2016 and 2015, respectively. Gross margin was 28% compared to 27% and margins were 24% for the heavy duty diesel and 27% for the catalyst division for the first quarter of 2016.

Total operating expenses were \$5.9 million compared to \$5.5 million for the first quarter of 2015. Breaking down the operating expenses, SG&A was \$3.4 million for both quarters. In the first quarter, decreased expenses resulting from the closure of Markham facility were offset by increases on some key hires in the sales team in the second half of 2015.

R&D was \$1.7 million compared to \$2.1 million. R&D expenses decreased as a result of reduced testing and development work on new advanced catalytic materials as we completed significant fundamental validation during 2015.

Severance and other charges were \$792,000, related to the closure of our Markham, Ontario, manufacturing facility and near zero in the prior-year quarter. Operating loss was \$3.2 million compared to \$2.7 million in the same period last year. Net loss was \$2.8 million or \$0.15 per share compared to a loss of \$3 million or \$0.21 per share in the same period last year.

Turning to the balance sheet. At March 31, 2015, we had \$1.6 million as compared to \$3.0 million at December 31, 2015. As Matthew noted, in April, we closed a \$2 million loan and amended our existing loan agreement with Kanis S.A. The amended agreement provides CDTi mandatory conversion rights of the aggregate principal balance of \$7.5 million into common stock upon the occurrence of a liquidity event, defined as a strategic investment or public stock offering by CDTi. Also in April, we executed a convertible promissory note for \$500,000 with one of the Company's directors.

We are reaffirming our annual guidance for 2016 of revenue between \$39 million and \$43 million and expect gross margins to be between 27% and 29%. Based on the measures undertaken late in 2015 and in the first quarter of 2016 to reduce our annual fixed cost base, we are targeting to be breakeven on an income before continuing operations basis by the first quarter of 2016.

In addition, we are evaluating a number of opportunities to fund our next phase of growth, including capital raises, strategic investments, joint ventures, and strategic partnerships. Our intention is to choose the path that minimizes dilution for our shareholders while supporting the Company's growth objectives.

With that, I turn the call over to Matthew.

Matthew Beale - *Clean Diesel Technologies, Inc. - CEO*

Thank you, Dave. We are accelerating the execution of our strategy to become an advanced materials technology company focused on high-value manufacturing and Powder-to-Coat market opportunities.

In the short term, we have concentrated our efforts on pursuing opportunities in fast-growing markets in China, India, and North America that we can serve profitably with our new business model. We've added core global partners that value CDTi's full suite of capabilities and will continue to do so in our chosen geographies.

We've added top-tier distributors for our DuraFit product line and continue to expect its revenue contribution to reach \$10 million in 2016. As our success produce a diversified and growing revenue base and the benefits of our streamlined operating structure take effect, we expect to achieve sustainable profitability.

With that, operator, we'd like to open up the call for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Rob Brown, Lake Street Capital.



Rob Brown - *Lake Street Capital - Analyst*

Good morning. Could you update the DuraFit -- did you say the DuraFit revenue in the quarter?

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

[\$1.2 million].

Rob Brown - *Lake Street Capital - Analyst*

Good, thank you. And then maybe -- with DuraFit, do you feel like you've got the description partners in place that you need to grow that? Or do you see more distribution partners coming?

Matthew Beale - *Clean Diesel Technologies, Inc. - CEO*

Just going back to the \$1.2 million, I think we are -- in addition to the \$1.2 million overall, and we look at this as an overall order book, the number was even higher. So we are very pleased with where that is, and as we mentioned, very comfortable with that number of \$10 million this year for DuraFit.

And getting there involves a couple things. I think leveraging the existing wins that we have in the OES channel -- the PACCARs and the Hinos -- that activity is really beginning to strengthen. It takes time to gain penetration in the channel.

But there will be some additional, I would expect, distributors added during the year. We are not done by a far stretch of adding additional locations. We are now, in the OES channel, at least, now about 1,000. We look for that number to continue to grow and to provide visibility and revenue beyond the \$10 million that we are targeting for this year.

Rob Brown - *Lake Street Capital - Analyst*

Okay, great. And then you talk about your strategy of adding new Powder-to-Coat customers for additional catalyst business. If you could give us an update on sort of your thinking on how that manifests itself and the timing?

Matthew Beale - *Clean Diesel Technologies, Inc. - CEO*

We spent a little bit of time in the prepared remarks talking about Panasonic simply because it's such a blueprint for what we are doing, I think, again, we are focused on a core handful of partners that need our full suite of technologies, partners that have global scope or global aspirations and need technology to pursue that opportunity, where there is a strong fit. And Panasonic is a great example.

We have similar dialogue obviously underway in China, India, and a couple of other geographies that we think are consistent with that model. Being highly articulated relationships that can be commercial, strategic, and operational, it takes time to complete. But we during the balance of 2016, as I think we've always indicated, we expect to provide more color and indeed be able to talk specifically about new partnership in these markets.

Rob Brown - *Lake Street Capital - Analyst*

Okay, great. Thanks for that overview. And I guess can you provide an update on AP Exhaust, how that business has ramped and where you're at with the AP Exhaust business?

Matthew Beale - *Clean Diesel Technologies, Inc. - CEO*

Yes. We talked a little bit about this on the last call, and frankly, the status hasn't changed. I think all of the industry we are looking -- there's an important regulatory aspect to it as relates to carb standards being rolled out, and we are at a state of flux there. That will drive very significantly the opportunity and the value proposition, particularly in the context of a, shall we say, PGM thriving type of model.

So I think the relationship continues to be there. We're looking at opportunities; it's a little bit pending, some regulatory changes. But I think that will evolve in the coming months. We will have much more to say about that.

Rob Brown - *Lake Street Capital - Analyst*

Thank you. I'll turn it over.

Operator

Thomas Boyce, Cowen and Company.

Thomas Boyce - *Cowen and Company - Analyst*

Thanks for taking the call. Or the questions. My first one just had to do with the status of Spinel. Now that vehicle testing is complete, what are the next steps in that process? Is that more of a late-2017 event or how should I think about that?

Matthew Beale - *Clean Diesel Technologies, Inc. - CEO*

It depends how you define event. If event is revenue, yes. I think meaningful revenue is some ways away. If you define it in terms of a path to commercialization and partnership, I think it's happening a lot more quickly. In fact, it is playing out as we speak.

With Spinel, the relevance there obviously is across the board. But where it really becomes a blockbuster is in the global OEM arena. And so our efforts are focused on that particular subset of the market, where you get into millions of vehicles types of platforms.

So having completed that initial phase of testing, we are into much more operational dialogue with a small handful of what we think are the most appropriate partners. We've kind of culled back and we would expect to have more to say about that as the year progresses here.

Thomas Boyce - *Cowen and Company - Analyst*

Great. And then just another one. Given kind of the vacillations of SG&A over the past couple quarters, so there's about 35% of revenue this quarter. How should we think about the cadence as we move through the rest of the year? Just trying to get a better handle on that.

Matthew Beale - *Clean Diesel Technologies, Inc. - CEO*

We need to -- we've talked -- obviously in our guidance, we've signaled operating profit breakeven. We are targeting that for the fourth quarter and we continue to move in that direction.

The first quarter continues to be messy, particularly if you compare to the fourth quarter. You've got the pluses and minuses, there is still severance, and frankly, we were continuing to execute on the cost reductions through our facility, eliminating a -- shutting down a facility and some other headcount reductions. Those certainly were not visible in the first quarter.

I think we've been pretty -- I think we've been pretty consistent in talking about the second quarter being where we really expect to begin to see the benefits. And those benefits then in the second and third quarter to get us into kind of an OpEx range, which needs to get down to the \$4 million sort of range for us to achieve that operating income profitability. So that's the dynamic we expect.

Thomas Boyce - *Cowen and Company - Analyst*

Great. Thank you very much for your time.

Operator

Amit Dayal, Rodman & Renshaw.

Amit Dayal - *Rodman & Renshaw - Analyst*

Good morning, guys. On the severance charges, are we done with these or should we expect any additional costs from these next few quarters?

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

There will be some in the following -- within Q2. And Q2, we should wrap it up.

Amit Dayal - *Rodman & Renshaw - Analyst*

Okay. In regards to the cash position from a working capital perspective, are we comfortable with where we are? You mentioned potential strategic investments. Should we read into that a little bit more than just your commentary?

Matthew Beale - *Clean Diesel Technologies, Inc. - CEO*

I wouldn't read into it. We are certainly -- we are pursuing all those avenues. We brought in the \$2.5 million in terms of the additional loan, plus our director contribution. I think both of these we think are tremendous votes of confidence in our future and ability to get to cash flow breakeven. I think the feature of being able to convert those signals that very, very clearly.

So I think that that's shoring up the near-term liquidity. We were able to achieve that. Right now, longer term, obviously our capital structure is not where it needs to be based on our growth aspirations. So part of that, the path to getting the debt off the balance sheet through conversion and other mechanisms, is laid out and before us. So we have the ability to do that and to put in place what's really a definitive capital structure for this Company. And that's really the approach we are taking.

Amit Dayal - *Rodman & Renshaw - Analyst*

Understood. And Dave, if you will, gross margins: should we expect 27% to 29% for the remainder of the year in terms of a range?

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

Yes.



Amit Dayal - *Rodman & Renshaw - Analyst*

Okay. Thank you. That's all I have, guys. Thank you so much.

Operator

At this time, I would like to turn the call back to Matthew Beale for any closing remarks.

Matthew Beale - *Clean Diesel Technologies, Inc. - CEO*

If there's no further question, again, thanks to everyone for joining and your continued support and interest in CDTI. And we look forward to reporting on progress in coming calls. Thanks very much.

Operator

Ladies and gentlemen, thank you for participating in today's call. This does conclude the program and you may all disconnect. Everyone have a great day.

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