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CDTI - Q4 2016 Clean Diesel Technologies Inc Earnings Call

EVENT DATE/TIME: MARCH 31, 2017 / 8:30PM GMT

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Clean Diesel Technologies Fourth Quarter 2016 Financial Results Conference Call. (Operator Instructions) As a reminder, today's program is being recorded.

I would now like to introduce your host for today's program, Cathy Mattison, from LHA. Please go ahead.

Cathy Mattison - *Lippert/Heilshorn & Associates, Inc. - Assistant VP*

Thank you, operator. Good afternoon, and thanks to everyone for joining us. By now you should have a copy of our results press release, which crossed the wires this afternoon following the close of market.

A copy of the press release, along with the company information, may be found at 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.

Speaking on the call today from CDTi are Matthew Beale, Chief Executive Officer; and Tracy Kern, Chief Financial Officer.

Before I turn the call over to Matthew, 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 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 differ materially 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.

And now it's my pleasure to turn the call over to Matthew Beale. Matthew?

Matthew Beale - *Clean Diesel Technologies, Inc. - CEO, President and Director*

Thank you, Cathy, and good afternoon, everyone. Thank you for joining us. As we mentioned in our press release earlier today, emissions control is at the nexus of many key trends that are driving the global automotive industry. From regulatory standards to hybridization to autonomous vehicles, emissions control is a major driver and conditioning factor for engineering and design decisions that are shaping the future of the automobile.

CDTi sits at the confluence of industry trends. With our low-cost catalyst formulations and pedigree as a proven Tier 1 automotive supplier, we are uniquely positioned to disrupt the prevailing industry order and its dependence on platinum group metal, or PGM, catalysts.

The automotive catalyst market is currently concentrated with a small handful of global manufacturers. This industry incumbency derives significant revenue from the recycling and refining of PGMs. PGMs also happen to be one of the largest cost inputs for automotive catalysts. The industry spends an estimated $10 billion on PGMs annually, and that spend is, to a great degree, dictated by the incumbency.

The ability to deliver equivalent or better performance with significantly lower levels of PGM is a $1 billion market opportunity. Our strategy to capitalize on this opportunity is simple: we aim to become the leading provider of enabling technology to the automotive catalyst industry. We will achieve this by, first, establishing important commercial traction among catalyst manufacturers in underserved markets and then by leveraging that traction to drive a catalyst-designed paradigm shift among global OEMs.

We carry important commercial momentum into several key underserved markets in early 2017. The North American heavy-duty aftermarket is one such market, where changes in regulation and a lack of OEM-caliber product created opportunity for CDTi.

As a first step, we launched our own line of DOCs and DPFs under the DuraFit brand name. Sold through a captive distribution network, the DuraFit product line is a recognized market leader in the segment and generated revenue of around $5 million in calendar 2016.

As a second step in addressing the market opportunity, CDTi established itself as a technology provider to the segment by providing solutions for downstream distribution and manufacturing partners.

Earlier this year, we announced such a partnership with DENSO, a global leader in automotive aftermarket products. We have also completed supply agreements with 2 other partners that will be launching their own line of DPF and DOC products for their heavy-duty customers.

We expect to execute additional agreements of this type during the balance of 2017 and to establish CDTi as the reference technology in this $500 million market segment.

With the technology provider business model now active in North America, we are poised to deliver on the promise of the product category we anticipated when launching DuraFit. Our objectives in 2017 in this market segment are to continue to grow the DuraFit brand and support the market penetration of our new downstream partners.

Longer term, we see enormous opportunity and growth in this market as CDTi establishes traction as the technology standard for replacement market DPFs and DOCs.

Traction in North America is likely to translate into important international opportunities. In today's press release, we also highlighted exciting commercial wins for our powder business in China.

The industry structure in that market plays to CDTi's strengths on several levels. As the world's largest automotive market, China is a highly evolved ecosystem, with the domestic manufacturing segment representing some 40% of the total market. Both at the vehicle and catalyst manufacturer levels, domestic players are strong and growing challengers to the global incumbents.

There are numerous domestic catalyst manufacturers with excellent coating capabilities honed by serving a very demanding set of Chinese OEMs. And then, of course, you have increasingly stringent emission standards and their elevation to a matter of public policy in China as important drivers. This environment is ideal for CDTi's technology provider model, as we have strong domestic catalyst manufacturers equipped to challenge the global incumbents and a need for lower-cost catalyst technology to defend and grow market share.

The need for technology combined with demanding existing customers and manufacturing capacity creates the ideal market context for CDTi's Powder-to-Coat capabilities.

We announced the partnership with a leading Chinese domestic coater, [SPMC], in late 2016. We have since entered commercial agreements with 3 other domestic coaters for the supply of our BMARS and SPGM DOC material systems. Overall, our commercial efforts in China have gained important momentum as the industry prepares for the introduction of China VI emission standards, and we expect to conclude agreements with others during the balance of 2017.

Our current program time lines with these customers would result in initial revenue during Q4 of this year. While calendar 2017 revenue contribution may be modest, the annualized volumes available from 2018 onward are transformative for CDTi.

The opportunity represented by the initial commercial rollout in China is significant. Through existing partners alone, CDTi's technology has the potential to be deployed in 2 million vehicles per year.

With revenues per vehicle in the region of $5 to $10 depending on the configuration, our current Powder-to-Coat revenue pipeline in China has become very meaningful. Visibility will continue to grow in the coming months.

We have further developed a path to market as a technology supplier to global players that are well positioned to challenge the industry pecking order as it currently stands, both in China and internationally.

Our partnership with Panasonic began to generate initial revenue in 2016, and we expect that contribution to continue to grow during 2017 as retrofit funding flows increase in intensity.

Of more long-term strategic importance to CDTi and to Panasonic, Panasonic is currently competing for Chinese commercial vehicle OEM business by deploying our DOC technology. Similarly, we are pursuing OEM opportunities with Haldor Topsoe in a variety of international markets.

In India, our manufacturing partner, SCIL, continues to gain important momentum for OEM cost-down programs based on our BMARS and SPGM DOC technologies.

While powder revenue in India during 2017 is unlikely, we expect to have increasing visibility into 2018 revenues during the second half of 2017 as OEM validation milestones are achieved.

Our commercial efforts are now fully allocated to the new business model, and the results just described are extremely encouraging. While the new model involves some measure of dependency on downstream partners, this is mitigated by the profound alignment of interest with our new customers. Our partners need technology to cost-effectively meet new regulatory standards, defend existing customer relationships and, ultimately, grow and take market share from the global incumbents.

As a provider of enabling technology to the emissions catalyst market, our constituency is all market participants that need or want to compete with the global incumbents and that share the view that industry no longer needs costly, high-PGM catalysts.

CDTi's skill set in this segment is completely unique and positions us, together with our downstream partners, to disrupt the current industry order and dependency on PGM catalysts. Again, we believe that this is a $1 billion market opportunity.

Operationally, CDTi has now completed its plans for definitively reconfiguring its manufacturing footprint in support of the advanced materials and high-value catalyst strategy. We have agreed with Honda to pull forward production requirements for existing vehicles into calendar 2017. This agreement provides CDTi with important visibility into 2017 volumes, while also allowing us to complete the rationalization of our production footprint via -- very early in 2018.

Most importantly, however, this will permit a significant reduction in manufacturing overhead and contribute to lowering our breakeven revenue threshold to be between $30 million and $35 million for calendar 2018.

To summarize, the key milestones in 2017 are as follows: Demonstrate consistent growth in our North American heavy-duty business, both as DuraFit and as a technology provider and continue to establish CDTi as the reference technology in the heavy-duty replacement market; demonstrate Powder-to-Coat traction with initial revenue contribution in the fourth quarter of 2017, offering visibility into meaningful annualized revenue streams from 2018 onward; gain visibility into Chinese and international OEM programs with global partners, such as Panasonic and Haldor Topsoe; and continue to manage our operating expense run rate downwards to $3 million per quarter during the second half of 2017.

On that note, I'd like to turn the call over to Tracy for a review of the financials.

Tracy A. Kern - *Clean Diesel Technologies, Inc. - CFO and Corporate Secretary*

Thank you, Matthew. For the fourth quarter of 2016, revenue was $8.6 million compared to $9.7 million in the fourth quarter of 2015. Coated catalyst revenue was $4.9 million compared to 8 -- excuse me to $4.8 million. Coated catalyst revenue is generated from the sale of our high-performance catalysts which reduce emission from gasoline, diesel and natural gas combustion engines.

Emission control systems revenue was $3.4 million compared to $4.1 million. Emission control systems revenues are generated from the sale of products and our extensive line of heavy-duty applications, including DuraFit OEM replacement Diesel Particulate Filters and Diesel Oxidation Catalysts sold to our distribution dealer network and direct sales.

Technology and advanced materials revenue was $256,000 compared to $721,000. Technology and advanced materials revenue includes licenses and royalties as well as sales of our advanced materials platform.

Gross margin was 11% compared to 29%. The decrease reflects $1.1 million of inventory write-offs following the change of manufacturing strategy to an outsource model.

Total operating expenses were $9.3 million compared to $5.5 million in the fourth quarter of 2015. Breaking down operating expenses: SG&A was $3.2 million compared to $2.4 million; R&D was $0.7 million compared to $1.6 million. Also included in fourth quarter 2016 operating expenses were the following items totaling $6.2 million: a goodwill impairment of $4.7 million; $0.7 million related to the final exit of the Canadian location; and $0.8 million of stock compensation expense.

Including seasonally higher costs in the first quarter, we anticipate quarterly operating expense run rate will be between $3 million and $3.5 million in 2017.

Operating loss was $8.3 million compared to $2.6 million in the same period last year. Net loss was $7.6 million or $0.69 per share compared to a loss of $0.9 million or $0.26 per share in the same period last year.

Turning to the balance sheet. At December 31, 2016, we had cash of $7.8 million as compared to $3 million at December 31, 2015. In the fourth quarter, CDTi completed a capital raise of approximately $10.3 million in gross proceeds through a private placement of common stock.

And now for our guidance. We expect full year 2017 revenue to be between $32 million and $35 million. We anticipate gross profit margins to be between 23% and 25%. Based on these assumptions, we are targeting breakeven on an income from continuing operations basis in the second half of 2017.

With that, I will turn the call back over to Matthew.

Matthew Beale - *Clean Diesel Technologies, Inc. - CEO, President and Director*

Thank you, Tracy. We are well on our way to realizing our vision for CDTi as a leading provider of enabling emissions control technology of the automotive catalyst market. Our capabilities align very closely with current industry trends, creating an extremely exciting market opportunity for CDTi and its partners. We look forward to keeping you updated as we execute our strategy during the balance of 2017 and beyond.

With that, operator, that concludes our prepared remarks. We'd like to open up the call for questions, please.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Matt Koranda from Roth.

Matthew Butler Koranda - *Roth Capital Partners, LLC, Research Division - Senior Research Analyst*

Just wanted to start off with the outlook, the $32 million to $35 million. Can you give us the breakdown between coated catalyst, emission control systems and then the technology and advanced materials components of the revenue?

Matthew Beale - *Clean Diesel Technologies, Inc. - CEO, President and Director*

Yes, I mean, I -- the way I'd answer that, we're not providing -- we don't typically provide guidance on a segment level. But directionally, I think, just to help you with the analysis, I'd say that, the Honda during 2017, our current expectation is that we'll be flattish to a little bit down, potentially. That would be the way I'd look at that. We expect now -- we talked -- we mentioned DuraFit as well as the private-label programs that we have. So we are expecting growth there. We'd expect that contribution to be significantly greater. In about 45 days, we'll have our first quarter coming out, and I think we'll be able to talk more exclusively about the run rate we're on, which we think will imply some good growth there. Technology and materials, again, that will grow, probably as a percentage basis, significantly, but from a very low base, as a lot of the new revenues on the powder side are back-ended in the fourth quarter.

Matthew Butler Koranda - *Roth Capital Partners, LLC, Research Division - Senior Research Analyst*

Okay, got it. And then, just in terms of the cadence of the coated catalyst revenue during 2017, I would assume that, that sort of tapers down during the year, just given the sunsetting of the Honda revenue. Is that a fair assumption? And maybe just a little bit of color around that, Matt.

Matthew Beale - *Clean Diesel Technologies, Inc. - CEO, President and Director*

Yes, just in the prepared remarks, we talked about having a program. We're working -- the strategy there is to, together, bring forward some of the production in out-years and to complete some of our production obligations, essentially complete them all in '17. So I think when you look at that, that's likely to mean pretty flattish revenue pattern in 2017. And really, by 2018, it's -- it's a little -- it's tapering out -- it ends, in essence. So 2018 will be without that same revenue stream. So very similar pattern to '16 and '17, and then '18, it's no longer there.

Matthew Butler Koranda - *Roth Capital Partners, LLC, Research Division - Senior Research Analyst*

Got it. Okay, that's helpful. On the gross margin guidance, that seems the -- I mean, I guess I was of the understanding that, when you strip away some of the pass-throughs in the Honda business, that you guys would show through sort of higher gross margins. But it looks like the gross margin guidance seems relatively conservative here. Maybe just a little bit of color around the gross margin outlook for 2017.

Matthew Beale - *Clean Diesel Technologies, Inc. - CEO, President and Director*

Yes. I think as we launch the -- in the heavy-duty market, as we talked about, we have the DuraFit business and then, in addition, increasingly, we've deployed this technology provider model, where we're providing product, technology components, it depends on the partner, and allowing partners to do a private-label type of project. There will be some start-up associated with that. So it also depends on the perimeter supply. While we think there's a lot of growth there, as we get into programs with volumes that get beyond -- get into the thousands, we'll start to have much more normalized margins that are consistent with what we're -- currently what we had achieved with DuraFit. So there's something of a -- there's part of that impact is the ramp, really, of those private-label programs which take a while to get started and to get to critical mass in terms of volume.

Matthew Butler Koranda - *Roth Capital Partners, LLC, Research Division - Senior Research Analyst*

Okay. So those will be a drag on margins in '17, but you'd expect that component of the business to see expanding margins further out as volumes pick up. Is that a fair sort of encapsulation?

Matthew Beale - *Clean Diesel Technologies, Inc. - CEO, President and Director*

Yes, that's fair. And it's just -- they take -- there's a lot of set-up involved. It takes time to get them going. But once you get up into the 4-digit types of volumes, we're in a normalized state. It's not unlike what happened with DuraFit, if you will.

Matthew Butler Koranda - *Roth Capital Partners, LLC, Research Division - Senior Research Analyst*

Okay. All right, got it. In terms of sort of can you give us a sense for -- so I know you guys are targeting breakeven in the back half of '17 on a continuing-operations basis. Do you mean operating income basis or EBITDA? What's the metric you're using on that front? And then, just give us a sense for kind of cash burn in the first half as you ramp into that breakeven point.

Matthew Beale - *Clean Diesel Technologies, Inc. - CEO, President and Director*

Sure. We don't publish non-GAAP metrics. But I think we do try to -- we think about, certainly, internally, we look at kind of cash operating income, that would be the way that we think about it. So it's -- I suppose it's more akin to a measure that you would -- someone might refer to as EBITDA. But that's kind of how we think about that. As it relates to the -- on the cash burn side, again, it's come down significantly as we've gotten operating expenses down despite a somewhat messy fourth quarter as we complete all of the cleanup that was done in 2016. If you peel things back, we are clearly down at that -- we were down at that $3 million in OpEx, and we will continue to push that downward. The burn, which was in '15 and very early in '16, is $1 million. We think we've gotten it significantly below that. We'll have some seasonal swings in the first quarter in particular, where we have a lot of expenses related to certain projects that we're working on as well as the audit. But I think we're down -- we're well below $500,000 kind of on a -- I would say closer to probably $250,000 on a -- if we look at on a monthly basis and going downward when we kind of normalize cash burn.

Matthew Butler Koranda - *Roth Capital Partners, LLC, Research Division - Senior Research Analyst*

Okay, that's helpful. Maybe just one last kind of higher-level question for you guys, and then I'll jump back in queue. Just in terms of the private label opportunity in the DPF market, I was just curious if you could help us understand your thinking around sort of, I guess, for a long time, you've been pursuing the DuraFit-branded line. That seemed to have had some success initially in terms of the ramp-up. What's the attractiveness of doing some of these, I guess, private label and distribution opportunities with customers in that segment? Why pursue those rather than just continue to build out that DuraFit product line?

Matthew Beale - *Clean Diesel Technologies, Inc. - CEO, President and Director*

It's really about playing to our strengths. I mean, CDTi is not a downstream -- I mean, it's not a downstream aftermarket distribution company. That's just -- that's simply not what we do. There's a lot of guys that do that and do that very, very well at high volumes, DENSO being one of those. Our ability to provide technology and product, anything from coated substrates through to finished product where we need to, allows us to focus on what we're really good at. And I think the margin capability for us, particularly around doing our core coating technology is far more attractive. So we're able to combine our technology with a strong -- a partner with strong downstream distribution and potentially also manufacturing capabilities. It's the perfect combination. And so that's really -- it's not private label in the sense of low value. I mean, these are -- there are going to be very high-value programs in the context of some very focused efforts on the part of our partners with existing heavy-duty customers.

Operator

Our next question comes from the line of Jeff Osborne from Cowen and Company.

Jeffrey David Osborne - *Cowen and Company, LLC, Research Division - MD and Senior Research Analyst*

Just a couple of questions. On the OpEx run rate, the $3 million to $3.5 million, is that including stock-based compensation or not?

Matthew Beale - *Clean Diesel Technologies, Inc. - CEO, President and Director*

It is including stock-based compensation. Yes.

Jeffrey David Osborne - *Cowen and Company, LLC, Research Division - MD and Senior Research Analyst*

Okay. Can you just walk me through, then, what the moving pieces are, Matt, just to get to that level in the second half of the year with the $0.9 million or so of R&D? I'm just trying to get a sense of where the cuts are going to come from relative to the run rate today.

Matthew Beale - *Clean Diesel Technologies, Inc. - CEO, President and Director*

Sure. I mean, we'll get into the -- we will get into the -- certainly, with the K, there'll be more details in terms of where the -- where expenses are and where they're coming from. But stock-based comp in the fourth quarter was a high -- that's not a quarterly number that we're going to have in our -- going forward. So it's a lower number. I don't want to get into forecasting stock-based comp, but I don't think that, that -- the fourth quarter is representative. So that is probably what helps you make the adjustment the most. But otherwise, it's really in the -- we'll -- R&D is going to -- we'll stay strong. We -- sales and marketing has come down pretty significantly. I think if you look at the run rate we're at, where we see additional opportunities are in G&A. And clearly, as we get to the end of some of the OEM activity that we're doing with Honda, that gives us further opportunities to reduce SG&A -- I mean, reduce G&A, specifically. So a lot of it will come from G&A. But I think if you kind of back out the -- if you think of that stock comp now in the fourth quarter, that's -- not as a quarterly number, this will all make sense.

Jeffrey David Osborne - *Cowen and Company, LLC, Research Division - MD and Senior Research Analyst*

Okay, that's helpful. And then speaking of Honda again -- you mentioned -- so I guess there's a couple of moving pieces here. My interpretation of your discussion of it was that you approached them and you said, "Hey, I don't want to run this plant, so I'm going to try to accelerate production, and then will you buy this from me?" And so I'm just trying to get a sense for your '18 and '19 commitments of whatever would've been the replacement market for the existing Acuras and whatnot. So I assume there were some price concessions on that negotiation. Is that one of the reasons for the gross margin guidance where it is as well? Or am I reading too much into that?

Matthew Beale - *Clean Diesel Technologies, Inc. - CEO, President and Director*

No, it's not part of the gross margin guidance. I mean, really, just very simply, we're -- again, we -- we're -- this is an orderly departure, and this is something that we started talking about in the end of '15, really. It's an orderly departure from this high-volume, lower-value activity. And we expect to conclude that by the end of the year. And that will involve likely bringing forward production of certain -- for certain models that would have carried out into the future, we'll likely pull forward production. And that's something that we'll work with our partner on. So that's really how that works.

Jeffrey David Osborne - *Cowen and Company, LLC, Research Division - MD and Senior Research Analyst*

I guess it just seems odd to me that Honda would spend millions of dollars in buying inventory for '18 and '19 vehicles. I don't think that's something they would normally do with their existing suppliers, but perhaps I'm wrong.

Matthew Beale - *Clean Diesel Technologies, Inc. - CEO, President and Director*

I don't think -- I mean, I think you're characterizing it a little more, not dramatically, but the numbers, remember, from '18 on anyway -- in fact, from the '17, this was a very small amount. It was a far smaller amount of volume that we were doing. So it's not quite as extreme as you depict. I mean, I think there were -- the volumes anyway, were at a far lower level, the residual volumes that were there.

Jeffrey David Osborne - *Cowen and Company, LLC, Research Division - MD and Senior Research Analyst*

Okay. And then you mentioned the overhead with the facility, and I'm completely onboard with the change and direction that you talked about for the last year or 1.5 years. But can you quantify the overhead for the -- that is in the expense base today? The Honda program, that will be eliminated for 2018. Just as we look at the potential cost of goods sold improvement for next year.

Matthew Beale - *Clean Diesel Technologies, Inc. - CEO, President and Director*

Yes, I -- what -- I think we can -- what we're -- we look to do, I mean, we think that we can reduce -- we can drop manufacturing overhead by somewhere in the region of $1 million to -- another $1 million and $1.5 million. And so that brings it down to a level that, again, based on the model of doing the higher-value stuff, a lot more diesel coating activity would get us at the right level. So I mean, that may be in terms of getting to breakeven when you kind of think about OpEx and you think about gross profit margin, and then you throw into the mix an additional $1.5 million potentially of savings, may be a little bit more, then it'll help you get to your breakeven number there.

Jeffrey David Osborne - *Cowen and Company, LLC, Research Division - MD and Senior Research Analyst*

Got it, that's helpful. And the last one maybe is just more of a suggestion or maybe a discussion about disclosure for the company before, but just how do you think about -- as Panasonic and your partner in India, SCIL, look to get qualified with the OEMs, is there a metric that you could possibly share with us moving forward in 2017 in terms of the number of vehicle programs that they're getting qualified into without naming names? Just a total quantity would be helpful to get a sense of comfort that those partners are actually building momentum for 2018 before recognizing that there won't be a considerable portion of revenue for 2017, just given the qualification time. But any type of big-picture narrative there, I think, would be helpful. Is that something that they would permit you to do?

Matthew Beale - *Clean Diesel Technologies, Inc. - CEO, President and Director*

Yes. I think, it's obviously your -- you obviously understand the sensitivity there. And I think we can do a little bit better. We were pretty explicit as it relates to our kind of our -- some of our light-duty partners with the -- I think in the prepared remarks regarding volumes. But on some of these

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OE programs, it is quite specific. But I think it's a good suggestion, something we can take a look at and -- as the visibility for the programs comes on board, without naming names, I think we'll be able to be far more explicit about what's involved, what the unit numbers are and, obviously, what it implies for revenue going forward. So as these -- we have greater visibility into these programs, we'll -- I think we'll be able to do just that. We could talk more generally about what we see as the -- kind of the heavy-duty market and opportunity there as well, but I think, as the months go by here, we'll be able to be quite granular about the -- certainly the impact in terms of volumes and revenue.

Operator

(Operator Instructions) And this does conclude the question-and-answer session of today's program. I'd like to hand the program back to you, Matthew Beale, for any further remarks.

Matthew Beale - *Clean Diesel Technologies, Inc. - CEO, President and Director*

Right. Thank you again, everyone, for joining us today. We look forward to keeping you updated on our progress. Goodbye.

Operator

Thank you, ladies and gentlemen, for your participation in today's conference. This does conclude the program. You may now disconnect. Good day.
