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CDTI - Q1 2017 Clean Diesel Technologies Inc Earnings Call

EVENT DATE/TIME: MAY 15, 2017 / 9:00PM GMT



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Rebecca Herrick *Lippert/Heilshorn & Associates, Inc. - Principal and SVP of IR*

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

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

Thomas Gordon Boyes *Cowen and Company, LLC, Research Division - Associate*

PRESENTATION

Operator

Good day, ladies and gentlemen, and thank you for your patience. You're joining the CDTi First Quarter 2017 Financial Results Conference Call. (Operator Instructions) As a reminder, this conference may be recorded.

I would now like to turn the call over to your host, Ms. Becky Herrick of LHA. Ma'am, you may begin.

Rebecca Herrick - *Lippert/Heilshorn & Associates, Inc. - Principal and SVP of IR*

Thank you, operator. Good afternoon, and thanks to everyone for joining us for CDTi's First Quarter 2017 Financial Results Conference Call. By now you should have received a copy of CDTi's results press release, which crossed the wire this afternoon following the close of market.

A copy of the press release, along with other company information, may be found on the Investor page of the company's website at cdti.com. If you would like to be added to the distribution list or if you would like additional information about the company, 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'd like 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 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 the company's Form 10-K and other reports and filings with the Securities and Exchange Commission. The company does 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, President and Director*

Thank you, Becky. Good morning, everyone, and thank you for joining us today. CDTi has now entered the final phase of its repositioning. By the end of the year, the company will be an asset-light technology company, uniquely positioned to serve the global emissions catalyst market. The steps we will complete in the coming months will result in a sustainable operating platform capable of capitalizing on the enormous commercial opportunity represented by our technology.



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As highlighted in our press release, those steps include the following initiatives: Number one, exit the high-volume low-value coating. We have now scheduled production to wind this activity down before the end of 2017. This will allow us to eliminate the significant manufacturing overhead and operating expenses driven by this activity and position the company within reach of breakeven.

Two, extend the technology provider model to the North American aftermarket. With our recent success in landing important private-label business, CDTi has established the foundation for its transition in this market segment. With this approach, we are providing enabling technology to a handful of players with strengths in other parts of the value chain. While seeding these arrangements had a negative impact on first quarter margins, the enormous scope for CDTi to focus on specialty coating as part of these partnerships will enhance margins as the year progresses.

Number three, release capital tied up in downstream distribution activities. Through our discussions with commercial and manufacturing partners, we anticipate reducing the amount of capital that is currently deployed to downstream distribution. This is not worth CDTi's value, but where our partners do and can. Our focus on coating to support our partners' downstream distribution and manufacturing efforts creates an obvious win-win opportunity.

And number four, drive our commercial pipeline for ramp of our powder business in 2018 and beyond. The supply agreements completed with Chinese catalyst manufacturers provide a significant revenue pipeline among an OEM customer base of about 2 million vehicles per year. We expect shipments to begin later this year and the forward revenue run rate to gain momentum as the year progresses.

In addition, Panasonic has committed to building its own coating capability in China, providing another path to market for our material systems.

Once these 4 initiatives are complete, we expect CDTi will be a scalable technology company with approximately \$5 million in quarterly revenue, targeting 40% gross margins and approximately \$2 million in quarterly operating expenses. While we would begin with less revenue than under our previous model, we will have higher margins and a streamlined infrastructure resulting in a significantly lower breakeven point just described.

In terms of our commercial pipeline, we are focusing our efforts and resources on pursuing opportunities with catalysts, coaters and producers in fast-growing markets in China, India and North America.

As mentioned above, at the beginning of 2017, we established ourselves as a technology provider to the heavy-duty diesel aftermarket segment in North America. We have created partnerships with global aftermarket leader, DENSO, as well as 2 other additional partners who are launching their own lines of DPF and DOC products for their heavy-duty customers using our technology. With a handful of strong downstream partners, CDTi can become the reference technology in this \$500 million market segment.

China continues to be a cornerstone of CDTi's powder strategy. It has an extensive emission control system supply chain, serving domestic and international automobile manufacturers that produce approximately 24 million vehicles per year. Somewhat unique to China, there are many domestic catalyst manufacturers serving the automotive market in competition with large global catalyst producers. To challenge the global incumbents and to adhere to increasingly stringent emission standards, this segment of the market requires lower-cost catalyst technology to defend and grow market share. This is the ideal environment for CDTi's Powder-to-Coat capabilities.

We gained initial commercial traction for our powder business by entering into agreements with 3 domestic catalyst manufacturers for the supply of our BMARS, SPGM DOC and Spinel material systems. We expect initial revenue from these customers beginning in the second half of the year. While the magnitude of revenue will be modest at first, we expect annualized volumes in 2018 and beyond to be transformative.

Our partnerships with Panasonic and Haldor Topsoe also continue to progress. With Panasonic, we expect revenue contribution to expand during the second half of 2017 as retrofit funding flows increase in intensity. Underscoring the potential long-term benefits of this partnership, Panasonic is currently competing for Chinese commercial vehicle OEM business by deploying our DOC technology. As a sign of their commitment to this market, we expect Panasonic to complete its investments in a DOC coating line in China by the end of the year to better serve OEM customers and the commercial pipeline.



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Also in the OEM heavy-duty segment, we continue to pursue commercial opportunities with Haldor Topsoe in China and beyond. In India, air quality is an important market driver, where over 4 million vehicles were produced in 2016. The country has many domestic and international vehicle manufacturers, served by both global and local catalyst manufacturers. As such, we see significant opportunity to provide CDTi's enabling technologies to domestic catalyst producers with the appropriate manufacturing expertise.

In this regard, we established a partnership with Süd-Chemie, a leading supplier of catalyst for major OEMs in India and abroad. Our joint marketing efforts are focused on cost-down programs for existing vehicle platforms with passenger car and commercial vehicle OEMs.

Overall, we continue to build a strong revenue pipeline with superior profit and growth potential. We will continue to report on progress as our commercialization initiatives begin converting into higher-margin revenue.

With that, I'll turn the call over to Tracy for a review of our financial results. Tracy?

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

Thank you, Matthew. For the first quarter of 2017, revenue was \$8.2 million compared to \$9.7 million in the first quarter of 2016. Coated catalysts revenue was \$4.7 million compared to \$6.5 million. Lower revenues are largely attributable to the timing of sales to Honda. Emission control systems revenue was \$3.3 million, compared to \$3 million. The increase is due primarily to DuraFit sales to new customers.

Technology and advanced materials revenue remain consistent at just over \$200,000 for both periods. Gross margin was 17% compared to 28%. The decrease primarily reflects the ongoing realignment of our business strategy for our heavy-duty applications in North America, including introductory pricing to new customers, the launch of our new private-label programs and the elimination of certain product offerings outside that strategy. We also saw significant increase in palladium prices, which negatively impacted our PGM liability.

Total operating expenses were \$3.8 million compared to \$6 million in the first quarter of 2016. The decline reflects the positive effects of the company's cost reduction initiatives undertaken in 2016, offset by increases in our year-end accounting expenses. We anticipate quarterly operating expenses will continue to decrease to between \$3 million and \$3.5 million by the end of 2017.

Operating loss was \$2.4 million compared to \$3.2 million in the same period last year. Net loss was \$3.1 million or \$0.20 per share compared to a loss of \$2.8 million or \$0.76 per share in the same period last year.

Turning to the balance sheet. At March 31, 2017, we had cash of \$2.4 million as compared to \$7.8 million at December 31, 2016. The equity raise and debt conversion we completed in the fourth quarter of 2016 enabled us to significantly improve our balance sheet. We paid \$2.1 million to Kanis S.A. in the first quarter of 2017 to settle our debt and interest with them, leaving the line of credit as the only debt on our balance sheet. Our line of credit is down by \$600,000 since year-end. And we also paid down our accounts payable and accrued liabilities by over \$5.2 million since the end of the third quarter of 2016.

And now for our guidance. Based on current business configuration as well as first quarter results, we continue to expect revenue to be between \$32 million and \$35 million. Gross margin is expected to be between 23% and 25%, and we continue to target achieving 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. Our strategy is simple. We aim to become the leading provider of enabling technology to the automotive catalyst industry. As we approach the second half of 2017, we will be focusing on furthering our transition into a pure technology company, which we expect will



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translate into improved financial performance as described previously. We are confident our technology provider model has the potential to deliver long-term sustainable and profitable growth.

Thank you for your continued support of CDTi. With that, operator, we'd like to open the call for questions.

QUESTIONS AND ANSWERS

Operator

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

Bradley D. Noss - *Roth Capital Partners, LLC, Research Division - Associate*

This is Brad Noss on for Matt. I wanted to dig into the manufacturing partners that you're looking at for DuraFit. Could you just expand on how long you would be until you'd be able to outsource to them and how we could see this impacting margins for the DuraFit business?

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

Sure. As we tried to lay out a little bit in the prepared remarks, there's a real opportunity here. Our strength is in technology and coating. We have partners who are very good downstream, very good at managing supply chain and manufacturing. And that's where they make their margins. So there's really an opportunity for a win-win situation. What we're -- in order for those characteristics -- some of the partners that we're talking to are very active, obviously, in the heavy-duty diesel space that have good downstream distribution. And in some instances, they also have very, very relevant manufacturing -- directly relevant manufacturing capabilities. So there's any number of scenarios here. I think the ultimate endgame here, really, is for us to be able to focus on what we do effectively, which is develop and deliver technology in the form of specialty coatings for this market segment and to really enable partners that are far better at the other -- at the downstream distribution and manufacturing.

Bradley D. Noss - *Roth Capital Partners, LLC, Research Division - Associate*

Okay, that's helpful. Just in regards to any sort of timing expectations there, it sounds like it would be a little ways off and maybe more towards the 2018 timeframe? Or any color on the specific timing?

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

These -- the conversations continue on. And again, its part and parcel very similar to what we're doing in the private label as we transition and position ourselves to do what we do best. And we've got a variety of partners that are interested in the downstream area here. This could be commercial. It could be more strategic. There're a number of ways that we'll look at it. But the endgame, again, is that we focus on where our core competency is, which is the technology and coating.

Bradley D. Noss - *Roth Capital Partners, LLC, Research Division - Associate*

Okay, perfect. And then just looking at the gross margin, you referenced a few items that sort of weighed on gross margins for the quarter. But would you be able to just break out what that impact was of the -- between sort of the private label ramp-up as well as the palladium price increase?



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

Yes, it's difficult to provide -- we can't really provide an exact -- without -- I think there's some competitive issues and others with providing some real detailed breakout there, given that it's a new business segment as well, not to be coy there. But I think, certainly, the commercial side in trying to get -- it's probably evenly weighted between the repositioning and then some of the more structural things such as the palladium.

Bradley D. Noss - *Roth Capital Partners, LLC, Research Division - Associate*

Okay. And then for the palladium, are there any hedges you have on that? Or I believe is there sort of like a pass-through? And could you just sort of explain how that works and how we would see that coming through on the revenue line if there is a pass-through on palladium?

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

It's -- we don't have -- no. We don't have a hedge on -- in terms of the exposure we have. We have customers that can sign PGM to us. We have to account for the liability. And as prices change in the cost of the underlying commodity, there can be an impact. It's not necessarily a cash impact, but there could be sweeps that gets passed through.

Bradley D. Noss - *Roth Capital Partners, LLC, Research Division - Associate*

Okay. And then looking at the margins from that private-label business, I know we sort of expected to obviously improve as volumes improve. But just on the introductory pricing specifically, how long do you anticipate having that pricing for? And then just overall, should we just expect a gradual increase as the volumes ramp through the end of the year for the margin? Or should we see some sort of snapback in Q2 and then increase from there?

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

I think the -- there will be -- there should be a marked improvement in Q2. We're not -- we won't, at anywhere, I won't -- I wouldn't suggest that we'd be at steady-state margins, which reflect far more technology and coating content in terms of our contribution. But we will certainly come back from where it was in the first quarter, which was -- it's very -- there's some significant impact of the launch of these programs, which is typically the case.

Bradley D. Noss - *Roth Capital Partners, LLC, Research Division - Associate*

Okay, all right. And then looking at -- I guess, you're still targeting breakeven in the second half of this year, but it looks like you had paid quite a bit to your -- some of your suppliers as well as paying down some debt. But can you just talk about the strategy in fortifying the balance sheet until you're able to reach breakeven? Or how you're thinking about that?

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

Sure. In the -- when we talked about guidance obviously, we talked about the current configuration of the business that as our businesses today, certainly, in the first quarter, we were at all levels of the value chain, for example, with the heavy-duty diesel aftermarket product line. But not to say that we would continue to be there. So we obviously have to make an apples-and-apples comparison. So I would just simply point out that it's on the same level of configuration or activity of the business is the -- is how we're continuing to reflect the formal guidance, if you will. As those -- as these initiatives, though, continue to, one, obviously come -- impact profitability, which is extremely important; but two, our ability to retrench again and not be quite as heavily invested -- have capital that's heavily invested in the downstream distribution side will release a significant amount of capital for us. It's having a downstream business with stock inventory -- holding inventory, sales in an aftermarket context, that's just not our core business. It is -- our partners and our private-label guys it is absolutely their core business, and they do that well. We don't do that as well. As



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the -- as we manage to effect that shift, we've got some very motivated partners, and so we're excited about how quickly we expect that to happen. We think that will also have a positive impact on -- ultimately on cash and how much is tied up in that activity.

Bradley D. Noss - *Roth Capital Partners, LLC, Research Division - Associate*

Okay, perfect. So as sort of that shift occurs, we should see that reflected as sort of an ancillary benefit in the working capital improvement and generating some cash through there?

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

Correct.

Bradley D. Noss - *Roth Capital Partners, LLC, Research Division - Associate*

Okay. And then just last one for me here, just for the China revenue ramp. I know it says that -- it's expected to start shifting in the second half of this year. Is there any possibility to see revenue in Q3? Or should we really just think about sort of the initial revenue as pretty nominal in Q4 and then 2018 is where we should really start to see some impact on the top line?

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

I think there -- I mean, overall for the year is I think we've depicted that this is -- it's unlikely the powder revenue from China solicitor markets is unlikely to move the dial in the CDTi context. But I think it'll point to a meaningful run rate in '18. In terms of when we see -- we start to see it, I think it is possible that we will see some initial powder revenue as early as the third quarter, but certainly in the fourth quarter.

Operator

(Operator Instructions) Our next question comes from the line of Thomas Boyes of Cowen and Company.

Thomas Gordon Boyes - *Cowen and Company, LLC, Research Division - Associate*

Just a couple of quick ones from me. Just to kind of piggyback off of the DuraFit discussion. Now that you have 3 distribution partners, do you anticipate kind of entering into more of those agreements domestically? Or is this kind of like when you said there are a close small handful of people that you're looking to work for, is this sufficient coverage for kind of that market? Or would you have to expand?

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

I think we're close to what is kind of an -- it is true

(technical difficulty)

Operator

(Operator Instructions)



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

Market approach that's kind of defined in this product category.

Operator

Ladies and gentlemen, please standby. We are having technical difficulties. Please standby.

(technical difficulty)

Thomas Gordon Boyes - *Cowen and Company, LLC, Research Division - Associate*

I believe the call may have dropped out for me. If I'm still on the line, I just had one big picture one to follow up with. Really just kind of given Spinel's kind of ability to reduce the PGM content and vehicle catalysts and then you kind of hit that same emissions control mark, how do you see the regulatory landscape evolving in the U.S? Should we expect to kind of see this more straight -- as a state-driven enterprise that kind of California and the CARB centers leading the way? Or is there any kind of read on kind of a federal level as well?

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

We don't see real -- any real evidence in -- I think we're back now. We had just momentarily -- the line dropped off now. But I can hear you. Hopefully, I can be heard. Operator, are you able -- can you hear us here at CDTI?

Operator

Yes, sir, loud and clear.

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

Okay. All right, very good. We don't see any change -- shift in the paradigm, where you do have California taking leadership and setting standards. Just most recently as well approving new regs for aftermarket Diesel Particulate Filters, for example, that could be -- that would be launched in California. So we think that paradigm with the carbon leadership and kind of the -- I don't want to say following, but setting the standard is likely to continue for the foreseeable future.

Thomas Gordon Boyes - *Cowen and Company, LLC, Research Division - Associate*

Excellent. And actually, one more quick one, just kind of switching over to China. And I know, obviously, through the heavy-duty applications and other initiatives. Is there any opportunity in the bus market? Because I know that predominantly it's been really the battery technology and fuel cell aspects that have been kind of pushed by the government. Is there an opportunity there?

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

There is. The heavy-duty market overall and again, this is a market that we're addressing, both through our coating partners, but also through Panasonic and through Haldor Topsoe. And Panasonic has well-established relationships with the 2 largest heavy-duty engine manufacturers. So there's absolutely -- it's the bus market, but perhaps more the long-haul market. But there is a market -- there is a bus market. There's -- the penetration of CNG and LNG is a little bit higher perhaps. But there's CMG more than LNG in the bus market, but there is an opportunity absolutely.



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Operator

Our next question is a follow-up from Matt Koranda of Roth Capital.

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

I just had one more quick question here. Would you be able to break out the revenue from DuraFit for us as well as the private-label programs if you're able to?

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

Yes. I think for the -- in terms of the DuraFit or the heavy-duty replacement market product category, this was the strongest quarter that we've had in that area. In order to break it out between DuraFit and private label is not something I am able to do right now, but it was a very strong quarter, part of it reflecting the launch of these new programs.

Operator

Thank you. At this time, I'd like to turn the call back over to Matthew Beale for any closing remarks. Sir?

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

All right. Thank you very much and thanks everyone for joining us today and we look forward to keeping you updated on our progress. Goodbye.

Operator

Thank you, Sir. Thank you, ladies and gentlemen, for your participation. That does conclude your program, you may disconnect your lines at this time. Have a wonderful day.

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