PARTICIPANTS

Corporate Participants

Pedro J. Lopez-Baldrich – Member-Office of the CEO, General Counsel, Clean Diesel Technologies, Inc.
Nikhil Atul Mehta – Member-Office of the CEO, Chief Financial Officer, Clean Diesel Technologies, Inc.

Other Participants

Ian T. Gilson – Analyst, Zacks Investment Research, Inc.

MANAGEMENT DISCUSSION SECTION

Operator: Good day, ladies and gentlemen, and welcome to your Clean Diesel Technologies Fourth Quarter and Yearend 2013 Financial Results Conference Call. At this time, all participants are in a listen-only mode. Later, we'll conduct a question-and-answer session and instructions will follow at that time. [Operator Instructions] As a reminder, this conference call may be recorded.

I now would like to turn the conference over to Pedro J. Lopez-Baldrich, Member of the Interim Office of CEO and General Counsel. Sir, you may begin.

Pedro J. Lopez-Baldrich, Member-Office of the CEO, General Counsel

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

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

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

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

Nikhil Atul Mehta, Member-Office of the CEO, Chief Financial Officer

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

Overall, we are pleased with our financial and operating results for the fourth quarter and full year 2013. Our fourth quarter results were highlighted by revenue growth across both divisions, notably our Catalyst division delivered 23.2% growth in external sales and our heavy duty diesel systems or HDD division grew 22.3% compared to last year. In all, we generated 22.6% revenue growth. We had a very strong year with our OEM customer, Honda, and continue to expand our footprint within this customer to other platform models. We had good momentum in our HDD business, particularly with the pickup in retrofit sales in California in the second half of the year.

Our R&D efforts remain focused on the continued development of new advanced, low and zero-platinum group metal or PGMs material, and we made good progress growing our patent portfolio.

Total operating expenses in the fourth quarter were up from the prior year period. However, the majority of the increase was related to the severance for our former CEO and the previously disclosed settlement with the former CFO of Clean Diesel.

In the fourth quarter, we continued to execute on our core objectives centered on increasing revenue, improving gross margins and reducing net loss.

Looking at our revenues for the year, we reported a decline of 8.7% compared to 2012, due in large part to a substantial amount of heavy duty diesel systems retrofit sales that occurred in the first quarter of 2012 under the London Low Emission Zone program, which concluded in 2012. Excluding the completion of LEZ sales, strong growth in the Catalyst division and gains in the California retrofit market were offset by weakness in retrofit activity in other 49 sales and in our European mining and material handling business.

While revenues were lower for 2013, we are pleased to report a more than 360 basis point improvement in gross margin and a significant reduction in net losses compared to 2012. For several years now, we have focused on operating and financial improvements. That work continued in 2013 and remains an area of focus in 2014.

Last year, we took many cost containment actions to control our manufacturing and G&A costs. The work we did to align our cost structure with our current level of sales is continuing to pay off, as demonstrated by the reduction in our operating expenses by over 12% in 2013 compared to the prior year. This reduction includes the severance and special settlement costs incurred in the fourth quarter.

While we have made significant progress and will continue our efforts to lower our core cost going forward, we are making additional investments in our advance low-PGM and zero-PGM or ZPGM technologies, as we prepare to capitalize on opportunities for top line growth, driven by increasingly stringent emission regulations. We're also keenly focused on our patent position in this area. Since 2013, we have filed 40 patents pertaining to our unique ZPGM catalyst technology and 6 patents pertaining to our advanced low-PGM catalyst technology.

It is important to keep in mind that we are in the early innings of our technology strategy. The work we are doing in this area is often evolutionary and based on specific application and, therefore, will take time and resources. While we are making good progress, we will continue to evaluate and refine our strategy.

A component of this strategy includes combining our manufacturing expertise with advanced low-PGM and ZPGM materials to develop advanced catalyst in powder form. This will allow for potentially broader distribution and delivery options resulting in new commercial opportunities. While it may sound simple, this is a complicated material science challenge.

All of this work relates directly to the growth drivers of our business. As a backdrop to all this, it is important to understand a few things about supply and demand for extensive PGM, which include palladium, platinum, and rhodium.

First, one of the most important factors is the increasingly stringent worldwide emission standards. Virtually every day, there are articles about pollution problems from Los Angeles to Paris to Beijing. The recent finalization of the EPA's Tier 3 light-duty vehicles emission standard is expected to provide us with an important future growth opportunity. The Tier 3 standards which are to be phased in between 2017 and 2025, further reduce emissions from light-duty vehicles by approximately 70% to 80% and some heavy-duty vehicles by approximately 60%. The EPA expects that these new standards will increase per vehicle PGM loading by 50% for palladium and 20% for rhodium.

Second, the global auto industry is expected to produce 85 million vehicles in 2014 and over 100 million by 2018. These production levels are expected to result in continued increases in PGM demand over the foreseeable future.

Third, these PGMs are primarily produced in countries including South Africa and Russia. The continued supply of these metals from the mines in South Africa and Russia is critical in order to meet the increasingly stringent global emission control standards.

The supply and demand for PGMs present a real challenge for the auto OEMs and their exposure to expensive and volatile PGMs. In conversations with OEMs, we are consistently told that minimizing the reliance in exposure to PGM supply is a critical strategy for them. The challenge for the industry is to dramatically reduce PGM use while still meeting the increased air quality requirements.

As emission regulations tighten, global demand for the PGM used in the manufacture of emission control catalyst is expected to increase, resulting in potential supply and demand issues. We believe our advanced low PGM and ZPGM catalyst technology gives us the potential to provide a solution to OEMs at [ph] contrast guaranteed (07:55) solutions; one that reduces the dependence upon increasingly costly and scarce PGMs to meet emission standards.

However, our technology is not just related to reducing PGMs. Our catalysts are high performance. In that we can achieve a given emission standard with lower PGMs or achieve most stringent standards with the same level of PGMs as our competitors. An example of a high performance catalyst is the one we currently supply for the Honda 2014 Plug-In Hybrid Accord. This vehicle was approved by the California Air Resources Board as the first gasoline-powered car to meet what is known as the SULEV20 standard, the most stringent standard in the nation.

Now I will share some specific comments on our fourth quarter. The revenue of $15.2 million was up 22.6% compared to last year. The gross margin was 31.3% compared to 22% in the prior year period, up more than 900 basis points. Gross margin also improved sequentially from the third quarter and was within our expectations. We reported a loss from operations of $1.2 million compared to a loss from operations of $2.4 million last year. As mentioned earlier, $1.2 million of the loss for the fourth quarter included the severance and other special charges incurred during the quarter. Loss per diluted share was $0.27 versus $0.39 last year.

We generated $2 million of operating cash flows in the fourth quarter, bringing our full year of operating cash usage to $400,000. We had $3.9 million of cash at the end of the fourth quarter at December 31, 2013, and we had $2.3 million in borrowings outstanding under our FGI credit facility. Additionally, during the fourth quarter of 2014, 800,000 warrants have been exercised resulting in $1 million of cash received by the company.

Moving onto the operating divisions, I will highlight the performance in the fourth quarter. Our external Catalyst division OEM sales were up over 23% compared to last year, as rare earth prices have stabilized and Honda Accord sales continued to be robust.

Reported sales including inter-company revenue were up 6.2%. Reported gross margin was up nearly 19 percentage points year-over-year to nearly 23% this year. Gross margin improved primarily due to stabilization of rare earth price reimbursement but also due to improved product mix as well as continued improvement in manufacturing efficiencies, somewhat offset by a reduction in year-over-year inter-company sales at higher margins. We are also very pleased to report that this division continues to be profitable.

Our HDD Systems division sales of $10.2 million were up over 22% from $8.4 million last year. Sales increased in the California retrofit program and in our North American OEM business. However, sales were down in North American retrofit activities in the 49 states excluding California.

In 2012, we had significant sales in the New Jersey retrofit program and in the Texas school bus retrofit project. In addition, sales were down in our mining and material handling business in Europe. We recorded approximately $4.8 million of sales under the California retrofit program, which is up over 33% this quarter as compared to the prior year and up over 50% sequentially.

The California Air Resources Board has extended the deadline for compliance from January 1, 2014, to July 1, 2014. As a result, we expect that sales will be somewhat slower in the first quarter as operators work through the data logging and other details surrounding the retrofit process with second quarter sales are expected to benefit from a push by operators to meet the new CARB compliance deadline.

Looking at the other 49 states, we had started to see additional federal funding from the U.S. Department of Transportation's Congestion Mitigation and Air Quality Improvement Program, or CMAQ, as well as various other state and local programs. The CMAQ programs provide a flexible funding source to state and local governments for transportation projects and programs such as diesel retrofit to mitigate particulate matter and to help meet the requirements of the Clean Air Act. So we are tracking the programs and beginning to see increased funding and continued retrofit potential in other states, including New Jersey, New York, Massachusetts, Illinois, and Texas. We would expect many of these opportunities to fall into the back half of 2014.

Expanding our HDD Systems division sales from non-retrofit sources continues to be an area of focus for us, as it represents a more sustainable OEM and aftermarket business for the reduction of exhaust emissions. For the fourth quarter, non-retrofit sales represented approximately 38% of our heavy duty diesel sales compared to approximately 41% in the fourth quarter of 2012. In spite of the weakness in 2013 from the mining and material handling sectors, we still see opportunities for growth with our OEM customers.

One area within the non-retrofit market we are particularly excited about and actively pursuing is the emerging aftermarket in North America for both heavy duty and medium duty diesel vehicles and the need for replacement filters. The emission warranty for these engines expires upon the earlier of 100,000 miles or five years, so as the 2007 and later model year diesel engines come off warranty, aftermarket replacement filters will be in demand.

We expect to leverage our existing technology and know-how to cost effectively serve this emerging market and would expect to see some modest activity in the second half of 2014 and building from there in ensuing years.

Gross margin in the HDD systems business increased 2.4 percentage points year-over-year to 32.9% in the fourth quarter and was up 3.2 percentage points for the full year. Gross margins improved as a result of a richer product mix, as well as due to higher content of CDTi-manufactured low-PGM catalysts in our HDD Systems division products.

So to summarize, the positives for the quarter included: one, our strong operating performance and product mix helped drive impressive gross margin expansion; two, for the fourth consecutive year, we narrowed our net loss from a year ago, which is very encouraging; three, we reported solid revenue growth from both our Catalyst division and our HDD Systems division; and finally, we continued to expand our IP portfolio.

In conclusion, we made meaningful progress in the execution of our business strategy, and as a result, delivered significant improvement in many of our key performance metrics in the year. One important metric we need to improve upon is our bottom line performance. While we were pleased to report a reduction in our net loss, both for the quarter and full year, we need to operate the business profitably. We feel positive about our growth and productivity initiatives, as we begin the year, giving us optimism about our ability to deliver improved performance driven by healthy end markets, and the strength of our business as we progress through 2014.

I would like to sincerely acknowledge the contribution of all our employees for their hard work in 2013, and would also like to thank our customers for their confidence in CDTi.

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

QUESTION AND ANSWER SECTION

Operator: Thank you, sir. [Operator Instructions] And our first question comes from Ian Gilson from Zacks Investment. Your line is now open. Please go ahead.

<Q – Ian Gilson – Zacks Investment Research, Inc.>: Yeah. Thanks very much. Looking at the fourth quarter versus the third quarter, in the Catalyst division as you saw the significant reduction in revenue, was that just [indiscernible] (16:07) factors in the automobile business? It was actually the slowest quarter of the year. Could you comment on that?

<A – Nikhil Mehta – Clean Diesel Technologies, Inc.>: Yeah. Typically the fourth quarter is slower. The strongest quarter in the automotive business is the third quarter as the auto companies are getting ready for the holiday season. So that is our normal cyclical business activity or, seasonal, I should say.

<Q – Ian Gilson – Zacks Investment Research, Inc.>: Yeah. But the decline versus the other quarters was quite significant if you look at the prior year relationships. Are we basically looking at other customers besides Honda? Was Honda basically flat in the quarter or how did that [ph] low (17:03) work through the year?

<A – Nikhil Mehta – Clean Diesel Technologies, Inc.>: I think Honda has had a very strong year last year including the fourth quarter. As I said most of this was all seasonality. We are not aware of any significant or any kind of reduction in their business activity.

<Q – Ian Gilson – Zacks Investment Research, Inc.>: Okay. G&A expenses basically dropped in the third quarter and then went back half in the fourth quarter to essentially close to $3.5 million. Are we looking going forward at the $3.5 million run rate per quarter on G&A?

<A – Nikhil Mehta – Clean Diesel Technologies, Inc.>: So we don't comment on going forward, but some of the reasons for the fourth quarter increase were increased expenses due to some of the legal activity that went on during the fourth quarter.

<Q – Ian Gilson – Zacks Investment Research, Inc.>: That was $100,000, right?

<A – Nikhil Mehta – Clean Diesel Technologies, Inc.>: That was some of it, yes.

<Q – Ian Gilson – Zacks Investment Research, Inc.>: Okay. Tax rate, [indiscernible] (18:13) I presume the tax is paid or actually your California state taxes?

<A – Nikhil Mehta – Clean Diesel Technologies, Inc.>: No, are you talking about our income taxes?

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

<A – Nikhil Mehta – Clean Diesel Technologies, Inc.>: Most of our income taxes, we have profitable businesses in Sweden and Canada. Most of the tax provision – tax payments are made in those countries.

<Q – Ian Gilson – Zacks Investment Research, Inc.>: The $400,000 taxes in the fourth quarter was a significant negative tax rate, if you like, but is there anything in there that was particularly one in a kind, one-time charge?

<A – Nikhil Mehta – Clean Diesel Technologies, Inc.>: No, there wasn't no. It's all related to how we do our worldwide taxes. As you know, most of our income comes from foreign subsidiaries, and our losses are in the U.S. So sometimes, we do have a strange tax rate. We pay positive taxes, even though as a group, we make losses.

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

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

Operator: Thank you. And our next question comes from [ph] Gary Cooper from Pace Capital (19:26). Your line is open. Please go ahead.

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

<Q>: Hi, good morning. I guess the first question is, can you give us any update on the CEO search without telling us who the candidates are, how many people you're considering and kind of where you stand in the process?

<A – Nikhil Mehta – Clean Diesel Technologies, Inc.>: Gary, this is at the board level. They're following a process and we'll only be able to announce something when there is something to announce, frankly.

<Q>: Okay. CARB, it looks like CARB revenue in Q4 was $4.8 million versus $3.5 million in the prior year. Can you confirm those numbers and then can you give us an update on how Q1 is going since we're now on the last day of the quarter?

<A – Nikhil Mehta – Clean Diesel Technologies, Inc.>: Yeah. So I confirmed those numbers and I did mention in my prepared remarks that we are expecting Q1 to be a little slower because there is a lot of data logging activity. You see CARB extended their deadline from December to June of this year. And so we expect a strong push somewhat similar to the fourth quarter and not necessarily in terms of the volumes or whatever but a stronger push to comply in the second quarter.

<Q>: Okay. So when you say Q1 CARB will be weaker, are you speaking to the issue of year-over-year weaker or weaker as compared to Q4?

<A – Nikhil Mehta – Clean Diesel Technologies, Inc.>: I'm talking about sequentially and potentially year-over-year. We don't give out projections. And yes today is the last day of the quarter, but there is certainly a lot of activity that can happen in one day or two, but it's – we don't give out any kind of guidance on that. But we had said that we are expecting – there is a lot of data logging activity going on, which we expect to see converted to orders and installed in the second quarter.

<Q>: Okay. It looks like reading your K, you have not tapped the equity capital line with Lincoln Park at all, is that accurate and...

<A – Nikhil Mehta – Clean Diesel Technologies, Inc.>: That's correct.

<Q>: Okay, that is correct. And do you think you will renew this line? It expires in April. The new [indiscernible] (21:40)?

<A – Nikhil Mehta – Clean Diesel Technologies, Inc.>: We have not made any decisions. We'll have to decide that over the next few weeks.

<Q>: Okay. As it pertains to the tax issue, can you detail the size of your NOLs? And what might happen in the future if you were to become profitable?

<A – Nikhil Mehta – Clean Diesel Technologies, Inc.>: We have NOLs and I don't remember the exact amount of the NOLs that we have, but obviously if we became profitable, we have NOLs to offset some of those taxes for some years going forward. You do have to know that – remember that we do have to do a change of control test every year or two depending on the stock volume activity. And so depending on that is how much NOLs we will have available. Now all of this is disclosed in the footnote if you want to take and go ahead and read through our 10-K. There is a very, very detailed footnote on our taxes.

<Q>: Yes. So I have read through it.

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

<Q>: I guess what I don't understand is, my understanding of a change of control provision is when another company buys you and it has nothing to do with the number of shares traded in the open market, am I ignorant on this issue?

<A – Nikhil Mehta – Clean Diesel Technologies, Inc.>: Well, there is a certain – the IRS does expect you to do a change of control test because it does pertain to shares being traded on the open market, but mainly through for large shareholders. So there is a test that's conducted every year, is not just whenever the company buys you.

<Q>: Did you pass the test?

<A – Nikhil Mehta – Clean Diesel Technologies, Inc.>: If you go and look up the IRS Section 382 you will see what I am talking about. And at this point, we haven't conducted a test in this quarter, no.

<Q>: Okay. All right. Thinking through the capital situation, can you explain to us what occurs – what kind of business occurs in the Reno operation? How much revenue you do there? Is it profitable? And what is the potential in the future to sell this business?

<A – Nikhil Mehta – Clean Diesel Technologies, Inc.>: I can't comment on what business occurs. We don't disclose individual subsidiary financials. The business we do over there is we sell exhaustion accessories mainly for heavy duty diesel vehicles. And I cannot comment on the size of the profitability of the business, or I can't even speculate on how much that business would sell for.

<Q>: Okay. All right. I may come back in the queue. Let me just say that you paid down $3.3 million of debt in Q4 and that's quite a bit. And yet six months prior, you raised capital and you raised at that time a total of $1.8 million diluting existing shareholders by 33%. That doesn't make any sense. Doesn't make any sense that you would be able to pay down debt six months later in that amount when you said you had to raise capital in the summer.

So I don't really understand that and I would further say that I don't think I would necessarily boast about 800,000 warrants being exercised producing $1 million of cash. Let us never forget that those warrants were priced $1.25 diluting the existing shareholder by a ton. So I'll conclude my remarks by simply saying that I hope the management team and the board takes more care with its capital allocation process in the future. Thank you.

<A – Nikhil Mehta – Clean Diesel Technologies, Inc.>: Thank you [ph] Gary (25:34) for your comments. Operator, are there any more questions?

Operator: [Operator Instructions]. I'm showing no further questions at this time, sir.

Nikhil Atul Mehta, Member-Office of the CEO, Chief Financial Officer

Okay. Thank you, everybody. I'd like to thank you for your interest in CDTi and for taking time to participate in our call today. We look forward to updating you on our first quarter call. Thank you.

Operator: Ladies and gentlemen, thank you for participating in today's conference. This concludes our program. You may all disconnect and have a wonderful day.