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CDTI - Q4 2015 Clean Diesel Technologies Inc Earnings Call

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Jeff Osborne *Cowen and Company - Analyst*

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Clean Diesel Technologies fourth-quarter 2015 financial results call. (Operator Instructions) As a reminder, this conference is being recorded. I would now like to introduce your host for today's conference, Ms. Becky Herrick with LHA. Ma'am, you may begin.

Becky Herrick - *LHA - IR*

Thank you, Kaylee. Good morning, and thanks, everyone, for joining us. 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 our 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 may differ materially because of factors discussed in today's results press release and 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. Please go ahead.

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

Thank you, Becky. Good morning, everyone, and thank you for joining us today. For the quarter, we reported both top- and bottom-line improvements. Total revenue was $9.7 million, up from $8.7 million in the last year's fourth quarter. And we reduced net loss to $0.9 million compared to a loss of $2.7 million in the fourth quarter of 2014.

As we close 2015, a transformational year in many respects for CDTi, we look forward to 2016 as a breakout year for the Company. Over the last several months, CDTi has successfully launched new products, won new customers and entered new geographic markets. It has also realigned and repositioned itself in support of an advanced materials and high-value catalyst strategy.

As Dave Shea will discuss in greater detail in his comments on CDTi's outlook, recent commercial and operational progress firmly position the Company on a path to sustainable profitability and long-term growth.

Before discussing in detail our results and exciting prospects going forward, I wanted to focus on trends in the macro environment that favor CDTi and its unique capabilities.

Air pollution and emissions standards have rightly become a global regulatory and political focus area. The World Health Organization has declared air pollution to be a global public health emergency. The UN estimates that air pollution is responsible for approximately 3 million premature deaths annually, with 1.4 million premature deaths in China alone. That equates to nearly 4,000 deaths per day. These are staggering and really appalling numbers.

Emissions from transportations continue to be a primary driver of air pollution, and vehicle production continues to grow globally. Worldwide vehicle production is expected to exceed 100 million units by the end of this decade.

Appropriately, in this context, the bar for emissions standards is being raised globally at a time when vehicle ownership is becoming more and more accessible. All of the largest regulatory regions -- North America, China, India and Europe -- are ratcheting up emissions standards, driving OEMs globally to seek proven, cost-effective solutions for compliance.

CDTi has the unique ability to bring proven OEM-caliber solutions to what are underserved markets globally. Outside of the large incumbent catalyst producers serving the major global OEMs, few, if any, other market participants possess CDTi's ISO-TS automotive pedigree. No other player, we believe, can match our PGM reduction capability and resulting superior cost performance product profile.

CDTi's story is that of an industry underdog, the small catalyst research house that rose to become a tier 1 supplier to a global OEM. But its technology is that of an industry leader with a track record of innovation. Recent new customer additions -- Panasonic, PACCAR, and Hino -- as well as historical customer relationships such as Honda provide obvious confirmation and ultimately validation. They also provide evidence of a go-forward business model for the Company that can lead to profitability and long-term growth.

In this context, CDTi's strategy is simple: cost-effective delivery of our technology in markets where it matters most. Cost-effective delivery means high-value, low-volume coating and technology partnerships with high-volume coaters through our Powder-to-Coat capability. Markets where it matters most means heavy-duty diesel applications where PGM reduction can eliminate hundreds of dollars of cost. It means large vehicle markets at the point of significant regulatory change such as China and India, where domestic players need technology to stay relevant and defend their customer bases. It means providing enabling technology to new entrants in the automotive catalyst market that are equipped to challenge the existing competitive order.

Recent commercial successes, successes that will be part of CDTi's drive towards sustainable profitability, provide the clearest evidence of our strategy at work.

We announced late last year a commercial partnership with Panasonic to provide our DOC technology for the retrofit market in China. Employing our high-value specialized diesel coating capability, we are now shipping product for deployment in the retrofit market, where we anticipate a meaningful ramp in activity during the second half of 2016.

In parallel, we are supporting Panasonic in China as they compete for OEM business in the world's largest heavy-duty diesel market. As volumes warrant, we will assist with their buildout of the local coating capability and eventually will supply them with our catalytic materials in powder form.

We are equipped to support our partner by deploying this working model in other high-volume geographies as they assert themselves as a strong new entrant in the global vehicle catalyst market. This partnership model plays to CDTi's strengths and is one we intend to replicate.

The North American heavy-duty diesel replacement market is another example of strategic execution that plays to CDTi's strengths. Leveraging our OEM pedigree in an aftermarket context, CDTi has emerged as a market leader in the $450 million OEM replacement market for diesel particulate filters and diesel oxidation catalysts.

Over the last six months, CDTi has completed agreements with two of the four largest heavy duty truck manufacturers, PACCAR and Hino, and amassed an impressive national distribution network of over 1,000 locations. Having achieved our revenue target of $5 million in 2015, we expect this business to double in 2016 as we add new customers with national and regional distribution power.

Even modest market share assumptions suggest a compelling revenue opportunity for CDTi in North America over the next several years, as well as the creation of a valuable and leverageable distribution asset. We will be exploring opportunities to export this model to other geographies.

Our targeted business development activities in China, India and North America continue to gain traction as we leverage the tangible commercial momentum from new customer wins we just described. We are currently vetting a final shortlist of partnership opportunities in these markets, consistent with our strategy, and expect to provide additional color in the coming weeks and months regarding our near-term revenue pipeline.

Despite the shorter-term nature of the opportunities just described, we continue to expect our advanced materials focus and technology investment to drive revenue growth over the longer term in the global passenger car market.

In parallel with our near-term revenue initiatives, our dialogue with select global OEM passenger car manufacturers around PGM reduction continues following our completion of vehicle testing for Spinel. The potential savings from deploying our next-generation, three-way catalyst technology in the context of a multimillion-unit global vehicle platform is enormous. While these initiatives are unlikely to make short-term revenue contribution, they represent a potential step change in business volumes over the longer term.

Importantly, we've invested significantly in our IP strategy, which underpins our ability to pursue transformative growth opportunities with industry leaders. We believe we have significant IP leadership in advanced materials permissions controls, with patents across 75 patent families protecting the structures, compositional matter and applications of our technology.

Last but not least, we have now completed important initiatives in detailing our organization and cost structure to our strategy. During the fourth quarter, we embarked on the first phase in this effort as we announced the closing of our manufacturing facility in Markham, Ontario, and we outsourced the canning of our DuraFit product line. Both of these initiatives helped reposition our operating footprint to support the execution of our strategy.

More recently, in 2016, we embarked on a second phase in our efforts to streamline our cost structure as we made additional staffing reductions to better reflect the opportunity set of our business going forward.

All in all, we believe our operating structure better supports our goal to be operating income breakeven by the end of 2016 and ultimately maintain profitable growth going forward.

On that note, I would like to turn the call over to Dave Shea for his review of the financials.

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

Thank you, Matthew. For the fourth quarter of 2015, revenue was $9.7 million, compared to $8.7 million in the fourth quarter of 2014. Catalyst revenue was $5.9 million, compared to $5.5 million in the fourth quarter of 2014, due to increased inter-Company sales. Heavy-duty diesel systems revenue was $4.8 million, compared to $3.5 million, due to an increase in DuraFit DPS sales, international and retrofit sales, and licensing royalties. $1 million and $0.3 million of inter-Company sales from the catalyst division to the heavy-duty diesel division were eliminated in consolidation for the fourth quarters of 2015 and 2014 respectively.

Gross margin was 29%, compared to 23%, due to increased sales volumes and favorable revenue mix. Margins were 31% for heavy-duty diesel and 23% for the catalyst division for the fourth quarter of 2015.

Total operating expenses were $5.5 million, compared to $5.1 million in the fourth quarter of 2014.

Breaking down operating expenses, SG&A was $2.4 million, compared to $3.2 million, reflecting payments made to a venture partner enabling us to enter the Asian market and lower employee-related costs. R&D was $1.6 million, compared to $1.9 million. R&D expense decreased as a result of the timing of testing and development work on our new advanced catalytic materials.

Severance and other charges were $1.5 million related to the separation of two former executives and the announced closure of our Markham, Ontario, manufacturing facility.

Operating loss was $2.7 million, compared with $3.1 million in the same period last year. Net loss was $0.9 million, or $0.05 per share, compared to $2.7 million, or $0.20 per share, in the same period last year.

For the full year of 2015, total revenue from continuing operations was $39.7 million, compared to $41.2 million in 2014. Revenue for the catalyst division was $26.2 million for 2015 and $23.8 million for 2014 due to increased sales to our Japanese OEM customer. Revenue for the heavy-duty diesel systems division was $16.6 million for 2015 and $19.6 million for 2014 due to the downturn in the retrofit due to a compliance deadline in California during the prior-year period. Partially offset by an increase in DuraFit sales, which are continuing to ramp.

$3.1 million and $2.2 million of inter-Company sales from the catalyst division to the heavy-duty diesel systems division were eliminated in consolidation for 2015 and 2014, respectively.

Gross margin for the year was 27% at the high end of our guidance, compared to 30% in 2014, with catalyst margins being 25.7% and heavy-duty diesel being 26.4%.

Total operating expenses were $21.2 million, compared to $20.1 million for 2014. Net loss was $8.5 million, or $0.54 per share, compared to a net loss of $9.3 million, or $0.78 per share.

Turning to the balance sheet, at December 31, 2015, we had cash of $3 million, compared to $7.2 million at the beginning of the year. In October of 2015, we amended our loan agreements with Kanis S.A. to extend the maturity dates from October 1, 2016 to October 1, 2018. This provides for greater financial flexibility as we execute on our growth strategy.

We are providing annual guidance for 2016 of revenue between $39 million and $43 million, and we expect gross margin to be between 27% and 29%.

Based on the measures undertaken late in 2015 and in the first quarter 2016 to reduce our annual fixed base, we are targeting to be breakeven on an income from continuing operations basis by the fourth quarter of 2016.

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

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

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

Thank you, Dave. CDTi is focused on accelerating the execution of our advanced materials business strategy in fast-growing markets. First, we are targeting China and India as well as North America, which we believe we can serve profitably. The new markets we are targeting have shorter product life cycles, allowing the pursuit of multiple customer applications at a time resulting in a diversified and growing revenue base for CDTi. We believe this diversified revenue base, together with a streamlined operating structure, will enable the Company to achieve sustainable profitability.

In pursuit of this goal, we are focused on achieving the following milestones in 2016. Adding new strategic customers and partners that will allow us to pursue opportunities in China, India and North America. Further expanding national distribution with additional partners for our replacement DPF and DOC products. Adding incremental high-value catalyst opportunities with existing customers. And maintaining a streamlined cost structure and operating footprint to support profitability.

With that, we would like to open the call for questions, operator. Thank you.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Rob Brown, Lake Street Capital.

Rob Brown - *Lake Street Capital - Analyst*

I think you said DuraFit was $5 million in 2015. What was the DuraFit revenue in the quarter?

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

About $1.2 million.

Rob Brown - *Lake Street Capital - Analyst*

Okay, good. And then shifting to the Panasonic relationship, that started to ship in Q1, I think you said. What is the revenue opportunity in 2016 from that relationship that you see developing at this point?

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

I think we did talk about this in the release. It's a good question because this is really a flagship relationship and model we wish to pursue. We talked about it being a low single millions type of revenue opportunity. I think that was the language that we used. I think we will update that as the year progresses.

What we are seeing is that the retrofit market as -- they are organized with integrators that they are working with on the ground. There's been some positive growth and developments there, and we see good prospects of that business ramping. I think as we get into the second quarter here and third quarter, we will be able to provide a little more specific color.

I think when you think about that opportunity, at least on the retrofit side, it probably -- there are some analogies potentially in terms of size in ramping to the DuraFit example, if you want to put it in some kind of a context. I think where that really changes though, of course, is as we move that into more of an OEM opportunity, in what's the largest heavy-duty diesel market in the world. And that's obviously the endgame with a partner that is aggressively looking to become a player in the vehicle catalyst market.

Rob Brown - *Lake Street Capital - Analyst*

Okay, good. That's good color. Thank you. And then last question on the AP exhaust business, could you update us on the relationship there and how that has been ramping?

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

Sure. We continue in the North American replacement park, at the aftermarket for the PACCAR three-way market. We continue to work with a number of players including AP in looking for opportunities to bring product to market. I think this -- it's something that hasn't happened as quickly as we expected, partly because of some of the CARB dynamics there. I think as time moves on and there is more of a convergence on CARB standards, the ability to attack PGM and reduce PGM will become increasingly relevant. I think that is really what we've been looking at with AP and other partners and looking to bring product to market that is -- that drives those significant benefits. I think CARB is really the thing to watch there in that context. And I think our activity with our partners will increase exponentially as that standard becomes more diffuse.

Rob Brown - *Lake Street Capital - Analyst*

Okay. Thank you. I will turn it over.

Operator

Amit Dayal, Rodman & Renshaw.

Amit Dayal - *Rodman & Renshaw - Analyst*

Just one question from me, and then I will follow up with you guys off-line. You provided revenue guidance for 2016, sort of flattish year over year. Are you being conservative? I guess with all of the initiatives in play, were you thinking growth would be a little stronger? Could you provide any color on your stance on this?

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

Yes. Obviously we want to put out a target that we believe that is very achievable for us to hit. There are a lot of opportunities out there, but we clearly want to set a marker that we can achieve. Is there upside? Yes. But the most important thing is we need to continue to grow and drive the Company towards being profitable.

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

Yes, I just would add to, Amit, is that remember that we do have kind of a trailing-off business in retrofit. So there are some pluses and minuses in all of that. And I think if you strip out -- and we can obviously talk about this in much greater detail. But if you strip out that piece, what we are looking at is very meaningful growth. If you look at what we suggested as it relates to DuraFit, that is very meaningful growth in 2016.

So as it relates to the businesses that we are going to be targeting going forward, there is growth in the forecast for 2016.

Amit Dayal - *Rodman & Renshaw - Analyst*

That's helpful. Yes, so maybe we can follow up on that off-line. That's all I have for now. Thank you.

Operator

(Operator Instructions) Jeff Osborne, Cowen & Company.

Jeff Osborne - *Cowen and Company - Analyst*

A couple questions. Maybe just following up on the last questioner's line of questioning, could you just touch on if you were to peel back the onion on the guidance of 39 to low 40s? You mentioned $10 million from DuraFit, a couple million from Panasonic. I assume about $20 million from Honda. Is that a reasonable assumption? I'm just trying to get a sense of what the moving pieces are. Certainly, you want to highlight the ones that are growing, but maybe it would be just a little bit more transparent (multiple speakers).

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

Yes, so, like you said, you look at DuraFit doubling. You've got a catalyst business that's been running in the low to mid-20s. So you would expect that to be similar for this year, so that finished the year at about [23]. You've got some of our legacy businesses that we run in Europe running in the [4] to [5] range. And then you still have some tail on the retrofit industrial products that we've been selling out of Canada.

Jeff Osborne - *Cowen and Company - Analyst*

Got it. And then obviously longer-term you've got the Honda hole to fill. Can you just touch on how you think Panasonic will ramp in 2017? And you alluded to India. Maybe Matt can give an update on that very strategic market and the potential timing of a deal there. And would it be a similar -- as you develop these relationships, is it a similar profile? Kind of year one, a couple million, and then, similar to DuraFit, doubling in year two? Is that your anticipation for something like a Panasonic and whoever the Indian partner would be?

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

Yes, and I think that's a fair way to think about it. And, again, we will talk a little bit about -- we will say what we can certainly as it relates to 2017, we (technical difficulty) see that progressing.

But you have touched on really the key drivers of the model here. We are looking for partners, and we are -- this is where our dialogue is focused: on partners that are looking for our full suite of capabilities. Going from coating -- a little bit with manufacturing, but through to coating, and then ultimately technology through our Powder-to-Coat.

I think the way we highlighted Panasonic is a perfect example. The revenue characterization you provided where I think initially it's low single digits, and then with the ability to ramp very rapidly is a good indicator of the sorts of opportunities that we are pursuing.

Right now as it relates to the pipeline -- and we kind of touched on this in the prepared remarks. But China, India continue to be the area where we have a short list of customer dialogue going forward. And, again, these are articulated discussions much like Panasonic, which will end up in a multifaceted relationship where there is a lot of engineering support, there's some manufacturing, and then ultimately there is a Powder-to-Coat and potentially even a licensing type of scenario.

So those are the sorts of additional initiatives that we will be adding in China and India. I would expect as we get into the summer here, we will be providing significantly more color. And those are the items that I think, as you point out, will -- together with DuraFit and the other initiatives we've highlighted will be the revenue profile in a world where Honda is a lot less significant contributor in 2017.

Jeff Osborne - *Cowen and Company - Analyst*

Got it. That's very helpful. I appreciate the detail. Three very quick ones here. Any sense on the cash burn in 2016, and the 10K timing? And then I had one additional follow-up.

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

Sure. As it relates to -- we talked about hitting breakeven toward -- and on the operating income level or operating income from continuing operations in the fourth quarter. So that reflects how we expect to reduce as quickly as possible to cash burn during 2016. As it relates to the K, we would expect that to go out --

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

Yes, that's later today.

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

Later today.

Jeff Osborne - *Cowen and Company - Analyst*

Excellent, perfect. And then you briefly mentioned Spinel in the prepared remarks. Is there any update on the testing, I think it was with Buick, or any other partners?

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

Our vehicle testing has been done. Now it's about -- again, this is the longer-term -- the investment. We are focused obviously on talking about short-term initiatives. But we, Spinel and other potentially transformative technologies, that dialogue continues at pace. We don't have a specific update, but these are longer-term projects that, again, have the ability to generate just a step change in what we are doing and be transformative potentially even for the automotive supply chain.

So we will certainly -- we are very optimistic about the results we have, the dialogue with global players where this technology really matters. And we're talking about players with multimillion-unit passenger car types of opportunities. That's where our energies continue to be focused, and updates will follow.

Jeff Osborne - *Cowen and Company - Analyst*

Excellent. Good to hear. Thanks so much.

Operator

Matt Koranda, ROTH Capital.

Matt Koranda - *ROTH Capital Partners - Analyst*

Just one for me. I will follow-up you off-line a little bit later. I'm on the road today. So was just wondering if you could talk about the competitive landscape as it pertains to the DuraFit product. Now that you guys are sort of started to prove out that market and show that it's potentially a pretty attractive market for you, I would assume you've got competitors that are interested in entering the space. But maybe you could just talk about what you are seeing in terms of competitive developments on the DuraFit front and what kind of a head start you guys have in that market.

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

Sure. I think it is a very visible market. It's a bright spot. It's a market that's growing. We talked about the -- we sized it at $450 million. I think there's expectation that at the market over the near term, it will achieve double-digit growth. We've seen estimates of 15%.

There is -- there are other players in that space. I think that we have been able to assume and capture a leadership position very quickly simply because of the quality of our product. And really we refer to as our OEM pedigree. But that really matters in penetrating the OE side of the distribution chain.

And I think -- we talked about having two of the four main truck manufacturers -- being in their distribution network as part of that. That's a very, very significant development, and consistent with our OEM background. That's the asset; I think the distribution side of things, in addition to the product quality, becomes a very, very valuable asset. As we build that out in 2016, I think we are in a very, very good spot to capture share.

Matt Koranda - *ROTH Capital Partners - Analyst*

Got it. Okay. And so it sounds like maybe we should anticipate some additional distribution agreements, then, just given the commentary you just had. Is that fair to say?

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

We think there's more work to be done in 2016. We are up -- I think the 1,000 distribution locations is a great result, and quality distribution locations including two of four of the top OEs. We're certainly not done -- we are not done there. There is more to be done, and we are very excited about the prospects in that market.

Matt Koranda - *ROTH Capital Partners - Analyst*

Okay, great. I will jump back in queue. Thanks, guys.

Operator

(Operator Instructions) I am showing no further questions at this time. I would like to turn the call back to Matthew Beale for closing remarks.

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

Thank you. Well, we'd like to thank everyone for joining us today, and we look forward to talking with you soon in future calls. Have a great day.

Operator

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