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CDTI - Q3 2016 Clean Diesel Technologies Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the CDTi third-quarter 2016 financial results. (Operator Instructions). As a reminder this conference is being recorded. I would like to introduce your host for today's conference, Becky Herrick from LHA. Ma'am, you may begin.

Becky Herrick - *LHA - IR*

Thank you, Terence. Good morning and thanks to 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 opening. A copy of the press release along with other Company information may be found on the investor page of the Company's website, at www.CDTi.com. If you would like to be added to the distribution list or if you would like additional information about CDTi you may call LHA, at 415-433-3777.

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 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, in the comments made during this conference call, and in the risk factor section of the Company's Form 10-K and other reports and filings with the Securities and Exchange Commission.

We do not undertake any obligation to update any forward-looking statements. Now I would like to turn the call over to Matthew Beale. Matthew?

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

Thank you, Becky. Good morning, everyone, and thank you for joining us today.

For the third quarter of 2016, total revenue increased 4%, gross margins improved to 27%, and operating expenses were down 31% compared to a year ago. While we continue to work to improve our topline, these results reflect the benefits of streamlined and focused organization and demonstrate traction toward our goal of being operating income breakeven on a continuing operations basis in the first half of 2017.

I'll review the factors impacting our financial results in a moment, but first I'd like to talk about our progress in fortifying our balance sheet.

Since late last year, we've conducted a series of corporate actions to improve our financial foundation and enable the execution of our advanced materials and high-value catalyst business strategy. We successfully converted approximately $9 million of debt and equity in September and on November 4 we announced an agreement to raise $10.3 million in gross proceeds through an offering of common stock.

Together these transactions have a transformative impact on our balance sheet and provide us with increased flexibility to prioritize resource allocation to our operating activities. CDTi is now reconfigured as a fully capitalize catalyst technology company with an increasingly visible near-term path to profitability.

While we are very encouraged by our competence in 2016, including new strategic partnerships, a refined go to market strategy and business model as well as a stronger financial footing, we know much work remains to be done to convert this progress into long-term profitable growth.

Now I'd like to discuss our progress in technology development and strategic relationships that will actually drive that growth. Our advanced materials technology has never been more relevant and there is large and growing demand for technology to reduce platinum group metal, or PGM, usage in automotive catalysts.

According to various industry sources, more than 90 million automobiles will be produced worldwide in 2016. The industry spends over $11 billion per year on PGMs and this figure is expected to rise sharply as increasingly stringent emission standards are implemented across the globe. Our technology can deliver up to 90% reduction in PGM usage, while achieving emissions standards. As such, we are uniquely positioned to disrupt the single largest cost component of automotive emission systems and to share in the benefits we can deliver the industry participants.

Importantly, our technology provider business model is highly scalable, allowing us to contend for the 90 million+ vehicle market globally. Critical to this model, however, is CDTi's technology leadership position in advanced materials for emissions control.

The source of CDTi's technology advantage is our proprietary catalyst formulations and the strong IP protection provided by our patents. To date, CDTi has filed more than 380 patents worldwide, 61 of which specifically underpin next-generation technology for our advanced low-PGM catalysts.

This IP position has been a key driver of asserting CDTi's technology leadership as evidenced by the quality of recent strategic partnerships. As a technology provider, CDTi is enabling a new generation of catalyst manufacturers, positioned to challenge the prevailing industry order at its current dependence on PGM catalysts.

To facilitate this, during the past 12 months, we have entered strategic alliances with a handful of the most well-positioned partners in CDTi's chosen markets. These include global players such as Panasonic and Halder-Topsoe, as well as domestic market leaders such as Sino Precious Metals Holding in China and Sud Chemie in India.

Next I'd like to review the markets we are entering. China, in particular, is a large-scale opportunity with more volume potential than any other region. It is the world's single largest passenger car market with over 20 [million] vehicles produced per year.

Our focus in providing enabling technology to strongly position local coders in this market provides significant volume opportunity. We are currently working with our partners on short-term opportunities to reduce cost for current vehicle models as well as our longer-term opportunities to provide technology for new models that will be introduced in 2018 and beyond.

Our current development pipeline targets models representing over 500,000 units annually with initial revenue from these initiatives, primarily cost reduction programs over the short-term, expected during the first half of next year -- during the second half of next year. In China -- in the China heavy-duty market, we are well-positioned through our partnerships with Panasonic and Haldor Topsoe.

We began supplying Panasonic earlier this year and continue to make inroads in the heavy-duty retrofit market. We expect that market to ramp visibly in the first half of 2017. We are working with both Panasonic and Haldor Topsoe as they target the OEM truck market in China. Each partner is very well positioned to win business in the segment with new vehicle introductions beginning in 2018. We believe that the market opportunity can be in excess of 200,000 vehicles here.

CDTi is also gaining traction in India where we've established an important alliance with the local coater Sud-Chemie. Similar to China, we are pursuing cost down opportunities for existing vehicle models while positioning ourselves to compete for new models as they are ready for introduction in 2018 and beyond.

Our current pipeline in India between the light and heavy duty segment represents volumes in excess of 200,000 vehicles.

In the North American heavy-duty market, we continue to see very significant opportunity in the $450 million replacement market. The market is growing rapidly and CDTi is gaining important traction on two fronts. Firstly, we continue to develop the downstream distribution network for our DuraFit branded product line. We've established agreements with leading OEM players such as [Packer] and Hino while also achieving important penetration among independent distributors.

We currently expect revenue from this downstream activity to approach $6 million in 2016. Also, we have over the last couple of months advanced discussions with a handful of partners with extensive downstream distribution reach in heavy-duty aftermarket. We see important scope to supply technology to the segment consistent with our positioning as the supplier of enabling technology in the Chinese and Indian markets. We look forward to reporting more in these initiatives as visibility grows into the early months of 2017.

Last but not least, with our established global OEM pedigree and ability to deliver PGM reduction we are targeting global passenger car OEMs. We've begun development work with select global OEMs primed to challenge the current value chain inequities in the automotive catalyst market.

While this is a longer-term process, the potential is transformative for CDTi. Just one global vehicle platform can equate to multiple millions of units.

Overall, recent progress provides a visible path to growth and profitability for CDTi. Our partnerships and their emphasis on our powder to coat, or P2C, capabilities are key to transforming CDTi into a high-margin business.

In doing so, we will experience a shift in revenue, as P2C volumes ramp during the next 12 to 24 months.

In particular, as our technology material revenue grows, which consists mainly of P2C business, it will be highly accretive to overall gross profit margins which can exceed 40%. Our streamlined organization and significant reduction in OpEx provides important operating leverage and scope for sustained profitable growth.

With that I'll turn the call over to Tracy for a review of our financials.

Tracy Kern - *Clean Diesel Technologies, Inc. - CFO*

Thank you, Matthew. For the third quarter of 2016, revenue was $10.1 million compared to $9.8 million in the third quarter of 2015. Coated catalyst revenue was $7.1 million compared to $5.9 million. Coated catalyst revenue is generated from the sale of our high-performance catalyst which reduced emissions from gasoline, diesel and natural gas combustion engines. Emission control systems revenue was $2.8 million compared to $3.6 million; emission control system revenues are generated from the sale of products and our extensive line of heavy-duty applications, including DuraFit, OEM replacement diesel particulate filters, or DPF, and diesel oxidation catalyst, or DOCs, sold through our distribution dealer network and direct sales.

Technology and Advanced Materials revenue was $244,000 compared to $185,000. Technology and Advanced Materials revenue includes licenses and royalties as well as sales of our advanced materials platform.

Gross margin was 27% compared to 25%, reflecting fluctuations in product mix. Total operating expenses were $3.7 million compared to $5.3 million at the third quarter of 2015.

Breaking down operating expenses, SG&A was $2.3 million compared to $3 million. R&D was $0.8 million compared to $2.3 million. Severance and other charges were $0.6 million for the third quarter of 2016. There were minimal severance charges in the same period last year. Operating loss was $0.9 million compared to $2.9 million in the same period last year. Net loss was $14.4 million, or $2.45 per share, including a non-cash charge of $12.6 million related to the extinguishment of debt during the quarter. This compares to a loss of $2.1 million or $0.64 per share in the same period last year.

Turning to the balance sheet, at September 30, 2016 we had cash of $2.7 million as compared to $3 million in December 31, 2015. As Matthew noted, to support our future growth, we took action to strengthen our financial foundation and improve our capital structure. In August our stockholders approved the conversion of approximately $8.9 million of debt and equity, and subsequent to the end of the third quarter, we signed an agreement to raise approximately $10.3 million in gross proceeds through a registered offering of common stock.

Now for our guidance. We now expect full-year 2016 revenues to be at the lower end of our guided range, and to be between $37 million and $39 million. We expect DuraFit's full-year revenue contribution will approach $6 million. We expect gross profit margins to be between 25% and 27%. We believe our normalized quarterly OpEx run rate is below $4 million.

Based on these assumptions we now expect to be breakeven on an income from continuing operations basis by the first half of 2017. With that I will turn the call back over to Matthew.

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

Thank you, Tracy. Over the last 12 months, CDTi has completed a comprehensive financial and operational restructuring of the Company while gaining important commercial traction with its technology provider business model.

We have eliminated approximately $9 million in debt and secured the funding necessary to reach an inflection point for our advanced material strategy. The elimination of non-core manufacturing activities and streamlined organization has positioned the Company to achieve breakeven during the first half of 2017. We have established significant commercial partnerships in high-growth markets with well-positioned and highly motivated players.

We anticipate material margin expansion as technology and materials revenue begins to gain traction in 2017 and beyond. Terence, Operator, with that we would now like to open the call for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Matt Koranda, ROTH Capital Partners.

Matt Koranda - *ROTH Capital Partners - Analyst*

Good morning, guys, thanks for taking the questions. Just wanted to get a better understanding for the drivers of the lowered revenue guidance for the year. Is that primarily DuraFit, or are you seeing any weakness in other areas of the business that led you to bring it down a little bit?

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

That is primarily DuraFit. And, largely, I think the ramp period in the downstream business that we have identified in the guidance, it's been slower than expected. I think the second quarter we talked about some of the disruption from the transition to more of an outsourcing model, so the uptick there, it's really a matter of timing.

I think we are now trending quarterly, and I suspect in the fourth quarter it will start to show that we are trending at a click that is above the kind of $6 million run rate that we have identified as being the calendar year 2016 number.

Matt Koranda - *ROTH Capital Partners - Analyst*

Okay, got it. And I would assume a lot of the benefit, at least from this year, in terms of the DuraFit revenue has been from sell in to your new distribution partners, but could you just talk about sort of sellthrough metrics that you guys are looking at, and sort of what the does look like in terms of sellthrough to the end-users? Does that sort of bode well for replenishment orders, how are you guys kind of gaining better visibility into the DuraFit market there?

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

I think the whole -- the stocking orders, a lot of that activity actually took place in 2015. So I think we are really seeing the $6 million that we are guiding to, and this is really the difficulty in forecasting a new market segment, I suppose, what we are seeing really is throughput here as relates to 2016.

Some of our channels have ramped faster than others, but I think we've got a much better handle, and hence much more comfort in providing the guidance that we have provided here, and we still see the level of growth. I think understanding what's the component of stocking versus -- kind of throughput orders is obviously something that you learn as you go forward. But I think we are comfortable with it now.

Matt Koranda - *ROTH Capital Partners - Analyst*

Okay, got it. Just looking at R&D expense for the quarter, I noticed it's down very significantly quarter over quarter and year over year. Just given the development in powder to coat and all the testing you are undergoing there, I would expect it to have remained at least sequentially flat.

Was there some cash management going on in Q3 and now that you've got the recent capital infusion under your belt here, do you expect that to re-accelerate? How do we think about R&D on a go-forward basis?

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

I think the quarter was a particularly low number. Remember, we're focused rather than kind of a lot of the testing and validation work that marked what we had done in 2015, and to a certain degree in previous quarters this year, we are really in full-blown application mode. As we talked about in the call right now we've got -- we've identified our strategic partners and we are working with them on delivering product into the market, we are pursuing really application-specific vehicle application opportunities. And that's a very different, it's kind of an HR or personnel-driven activity, there's not a lot of outside costs and testing involved in that. If that makes sense.

I think -- I don't think that the level of this quarter is sustainable, probably a run rate -- a more appropriate run rate number is closer to $1 million, I would suspect. And that will fluctuate depending on kind of development activities that we undertake.

Matt Koranda - *ROTH Capital Partners - Analyst*

Okay, got it. And then there was a bit of a spike in coated catalyst revenue, maybe just a little bit of detail there on what drove the increase sequentially. Was it just some shipments that slipped from Q2 to Q3, are we seeing some sort of fundamental improvement in your main customer there? Maybe just talk a little bit about that.

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

I think it's largely what you identified in a sense there was some shipments that slipped from Q2, and I think we identified this on the Q2 call. But some shipments that slipped from Q2 and Q3 it was largely there, I think also in that line item is the activity -- the activity with Panasonic, and so that provides some -- an additional contribution in the third quarter.

Matt Koranda - *ROTH Capital Partners - Analyst*

Okay, got it. Maybe last one from me, just in terms of the Honda revenue and the ramp down next year, could you guys provide any additional visibility or commentary and sort of how that ramp down is going to proceed, and how we should think about coated catalyst revenue next year in light of that?

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

Sure. I think we talked about this, it's really the second half of the year, of next year, there will be a meaningful reduction in volumes as it relates to the traditional core business. We will continue to pursue as we've mentioned and continue to supply for at least for now on a hybrid platform that we have what we refer to as high-value low-volume activity, but this will take place in the second half of the year.

I think in terms of the coated catalyst line item, that reduction in revenue will be compensated to a certain degree until we get to a full-blown powder to coat model, I think at least towards the end of 217th with Panasonic. We will be compensated by -- we will continue to supply catalyst into that market into the Chinese market with Panasonic, and possibly even some other markets. So that will be a compensating factor there.

It's also -- we alluded to in the prepared remarks some developments in providing technology to large downstream players in the heavy-duty market, that could also have another impact on the coated catalyst line. So there's a portfolio of elements that potentially would compensate in that -- for that specific activity or line item.

I think obviously the one that we really want to see growing and where we have invested our energies and signed the partnerships is our technology and materials line. During the second half of the year, the Chinese opportunities that I outlined as well as India, those are the things that we really excited about that revenue growing and its ability to contribute on a number of levels, including enhanced margins.

Matt Koranda - *ROTH Capital Partners - Analyst*

All right, I'll jump back in queue. Thanks, guys.

Operator

Rob Brown, Lake Street Capital.

Rob Brown - *Lake Street Capital - Analyst*

Good morning. On the China and India ramp, could you give us a sense of the cadence in that ramp next year and into 2018? Does it start right away or how does that play out? And then just sort of how that plays out.

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

I think as it relates to China specifically, there could be some activity in the first half of the year, and it will certainly have a lot of visibility at a minimum into the second half of the year. But largely on some of the -- we've referred to them as cost down programs, some of those that we are working on, we think those will come into play in the second half of the year.

Remember, the initiatives there are divided in two. One is working on these so-called cost down programs for our partners' existing vehicle models, so this is a new business. This is existing business that they have. And we would be pursuing, together with them, introducing our technology, and delivering cost downs, which is obviously something that is always welcome in an OEM context. That is something that could have a much more -- much quicker introduction period.

We are also working clearly on positioning ourselves with our partners for new models that will come into play, a lot of that is likely to happen in 2018. So I think we would expect to see some of these cost down opportunities begin to materialize in China, possibly towards the latter part of the first half of the year, but much more likely in the second half of the year.

India, a very similar situation, a very similar dynamic. Again, we are actively pitching together with our partners, working on a pipeline of opportunities for cost down programs and then also new vehicle platforms which are probably more heavily weighted towards 2018, just given the new model year introduction cycle.

Rob Brown - *Lake Street Capital - Analyst*

Okay, great. And along those lines, what is sort of the value proposition that you offer these guys? I know generally you can reduce up to 90%, but what's really the value proposition that you are pushing in the China India markets?

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

I mean, cost is obviously a tremendous driver in all of this. But if you combine cost reduction with emissions, and remember we are talking about India and China, and specifically I would highlight China, this is a public policy priority that we are talking about. If you can deliver a solution to what is an appalling problem, at the same time as delivering cost reductions, that's a very, very compelling value proposition. And you find that you get a lot of support from really all constituencies in the market.

I think it's very similar in India, but just markedly so in China.

Rob Brown - *Lake Street Capital - Analyst*

Okay, good. And last question on kind of looking into next year, what is sort of the DuraFit growth rate that you expect into next year, given kind of your visibility at this point?

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

Look, I think that based on where we are this quarter and where we expect to be next quarter, it's a little premature to provide guidance, and we will do so much more comprehensively as we get into the K here.

But clearly double-digits, and very healthy double-digit type of growth, that's our expectation from the DuraFit downstream business. I would -- we do think of it more as a consolidated hold, though; remember we are also pursuing opportunities to supply technology into that market.

It's a huge market opportunity. You've got a number of players coming in, again selectively the ability to provide product downstream under a brand, that's one angle, one distribution channel. And I think particularly in a immature market, that was the right way to position ourselves. But longer-term here, just as we are doing elsewhere, we want to supply technology to that market. And so I would expect that's an opportunity that will complement what we are doing kind of downstream with DuraFit. It will begin to become visible and we will contribute, hopefully handsomely, in 2017.

Rob Brown - *Lake Street Capital - Analyst*

Okay, thank you.

Operator

Jeff Osborne, Cowen and Company.

Jeff Osborne - *Cowen and Company - Analyst*

Good morning guys, just a couple questions from me. On the guidance of $37 million to $39 million, I think you used in the text at the lower end of the guided range of $37 million to $39 million. If my memory is right, wasn't it $39 million to $43 million before? So are you saying it's at the low-end of the $37 million to $39 million, or are you just pointing people to $39 million? In essence you're lowering guidance and not within the previous range. Is that a fair statement?

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

We are pointing to the lower end of the range, which is -- it's a reset of the range from $37 million to $39 million. Our previous range was $39 million to $43 million, we set a range which does happen to overlap with the low end of the previous guidance.

Jeff Osborne - *Cowen and Company - Analyst*

Okay. And what would get you to the low end versus the high end of that range, just given there are six weeks left in the quarter?

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

It's really timing. And I think it's timing and it would be -- we talked about a number of the initiatives in the North American heavy-duty market. I think those are the things that would move it from one side of the range to the other. I think a lot of our -- certainly the coated catalyst business is relatively visible, there's a lot of forward planning there. But in the North America -- the aftermarket and some of the retrofit activities that we are doing, there's a little less visibility as to when you're actually shipping. And so I think that's what really drives the variability.

Jeff Osborne - *Cowen and Company - Analyst*

Okay.

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

Less than an absolute winning business or not type of situation.

Jeff Osborne - *Cowen and Company - Analyst*

Got it. And I might've missed it on the call, you talked about DuraFit going to $6 million, I think last quarter you said it was about $1.1 million in the quarter. Can you just give us a sense of what the number was this quarter so we can kind of back into what the implied fourth-quarter expectations are?

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

Yes. I think we were -- it's closer -- we report everything together with the retrofit, but it certainly represents growth with respect to -- with respect to the previous quarter, and we expect a little additional growth, not tremendous growth, but some additional growth in the fourth quarter which will get us to that $6 million.

Jeff Osborne - *Cowen and Company - Analyst*

Got it. And then the healthy -- in response to Rob's question, the healthy double-digit growth that you talked about next year, that's mainly just the broadening of distribution and moving beyond kind of the sell-in period? And greater adoption that's going to drive that, or do you anticipate any more strategic partnerships or distribution agreements to grow that number?

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

It's going to be a combination of both, at least as relates specifically to DuraFit. But also I think the part that we are excited about, which is not actually included in that DuraFit business, is being a technology provider. Getting back to what we really want to do into that segment. And that's something that at this point it's difficult to quantify. But certainly as we get closer to our Q -- to our K, rather, and we provide our guidance release next year we will talk a little bit more about that.

Jeff Osborne - *Cowen and Company - Analyst*

Got it. The last question I had, I appreciate you allowing me so many. But it's just on Panasonic, for China, can you just kind of walk us through what specifically they are doing as it relates to the cost reduction programs that they have with the partners there in China, and what the qualification timelines are? You gave a lot of detail in terms of the pipeline and the number of vehicles that potentially be displaced or are you using your product.

But I'm just trying to get a sense of what physically they are doing today and what kind of the testing and validation expectations are of when we should expect to start seeing that pipeline actually being converted over to orders to then give you the offset that you referenced before in terms of compensating for the Honda declines in the second half.

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

Panasonic, remember, Matt, is entirely heavy duty. So they are right now they are focused on our -- initial activity together is in the Chinese retrofit market, that's where we've begun to ship, and that's a discrete market opportunity.

When the funds are flowing, it brings in business. The funds are starting to flow a lot more right now; we are excited, I think as we said in the prepared remarks, about what that retrofit market can mean for us in the first half of the year.

As relates to other business in that market, clearly the endgame there for Panasonic for us and for all others is to penetrate the OEM market. And that is largely a new vehicle market. And I think when we -- we talked to this a little bit about the prepared remarks there, it's a healthy market. It's a heavy-duty market, the OEM market has been -- has been north of 500,000; on a number of occasions even gotten close to 1 million. I think this year it's back, but that's the real exciting opportunity there.

We talked in the pipeline about that being a 200,000 unit type of opportunity. But this is really new vehicle introduction. And that would be -- that's likely to happen in 2018 so there's no new vehicle heavy-duty opportunities that would be coming to play in 2017.

Jeff Osborne - *Cowen and Company - Analyst*

Got it. Thanks for the clarifications.

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

Specifically as it relates to Panasonic. Now there's obviously the array of other opportunities that we are pursuing, many of which -- the development activity as I said on our side has been done, we are doing a lot of vehicle-specific validation work, or our partners are, using our technology right now. And as it relates to the cost down programs, we are quite a ways in.

I think the overall timetable, much less than a new OEM program which is years can be 12 months, 18 months. And that's what gets -- if you kind of back it out, that's what gets us into beginning those powder to coat shipments on some of these Chinese cost down opportunities in the passenger car market in the second half of 2017.

Jeff Osborne - *Cowen and Company - Analyst*

Perfect, thank you.

Operator

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

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

Okay. Thank you again, everybody, for joining us today, we look forward to keeping you updated on our progress. Goodbye.

Operator

Ladies and gentlemen, thank you for your participation in today's conference. This concludes the program. You may now disconnect. Everyone have a great day.
