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CDTI - Q2 2016 Clean Diesel Technologies Inc Earnings Call

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## CORPORATE PARTICIPANTS

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

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## CONFERENCE CALL PARTICIPANTS

**Rob Brown** *Lake Street Capital - Analyst*

**Jeff Osborne** *Cowen and Company - Analyst*

**Matt Koranda** *ROTH Capital Partners - Analyst*

## PRESENTATION

### Operator

Good day, ladies and gentlemen, and welcome to the CDTi second-quarter 2016 financial results conference call.

(Operator Instructions)

As a reminder, this conference is being recorded. I would like to introduce your host for today's conference, Ms. Becky Herrick of LHA. Ma'am, please begin.

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**Becky Herrick** - *Clean Diesel Technologies, Inc. - IR, LHA*

Thank you, operator. Good morning and thanks to everyone for joining us.

By now you should have a copy of our financial 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 the Company's website at [www.cdti.com](http://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'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 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. CDTi does not undertake any obligation to update any forward-looking statements.

With that I'd now like to turn the call over to CEO, Matthew Beale. Matthew?

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

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



Since the beginning of 2016 CDTi has made significant commercial and operational progress executing our advanced materials and catalyst business strategy. Our progress continued in the second quarter as we achieved a number of important milestones in establishing sustainable capital and cost structures for the Company.

At the end of June, CDTi addressed what has been a major obstacle to improving our financial foundation by reaching an agreement to convert \$8.5 million in debt into the Company's common stock. In addition to the transformative impact of this transaction on CDTi's capital structure it is a testament to our debtholders' confidence in the long-term prospects for the Company.

Once completed, the equitization of debt will give us increased flexibility in prioritizing resource allocation to operating activities.

In a related transaction, CDTi received an investment of \$1.25 million and signed commercial agreements with industry leader Haldor Topsoe A/S. Headquartered in Denmark, Haldor Topsoe is a global organization with production plants, regional offices and engineering activities all over the world.

This multifaceted partnership is highly significant for CDTi. In addition to welcoming Haldor Topsoe as one of our largest shareholders, we also began an important commercial relationship in the heavy duty diesel market where CDTi's technology complements their product capabilities and global reach.

With Haldor Topsoe and Panasonic we now have important commercial partnerships with global players that are committed to achieving leadership positions in the fast-growing heavy duty diesel market and that are equipped to challenge the prevailing industry hierarchy.

In addition to the balance sheet restructuring, we continued to realign the CDTi organization to support our needs as a technology Company and essentially completed the restructuring of our corporate function with the appointment of Tracy Kern as Chief Financial Officer. Tracy's highly relevant experience and skill set include expertise in process improvement and turnarounds and will be invaluable as we continue our momentum into the second half of the year.

Overall, our restructuring program is generating the results we anticipated, albeit with some delay with respect to our original timetable. While initiatives undertaken to reduce operating expenses are already visible in our Q2 results, we incurred important shutdown and startup costs and experienced some supply chain disruption that impacted DuraFit volumes and margins during the quarter. We will discuss the impact of these delays on our calendar year 2016 financial guidance in a moment.

Before discussing the market opportunities I would like to highlight CDTi's unique characteristics that are driving its emergence as an industry technology leader. CDTi's credentials as an ISO/TS Tier 1 supplier to global automotive OEMs represent a set of capabilities and quality level that is comparable only to the large industry players. While it is impractical for CDTi to scale this capability globally, the know-how it represents equips CDTi to act as a supplier of fuel-tested applications of enabling technology.

CDTi is a recognized leader and innovator in platinum group metal or PGM management. The prevailing catalyst technology is based on using PGMs to lower emissions. In a global environment of increasingly stringent emissions standards PGM usage is set to grow dramatically, thus increasing the single largest catalyst cost input.

CDTi's core competency is centered on meeting emissions requirements with significantly lower levels of PGMs. Our extensive patent portfolio implied know-how in this area provides a significant competitive edge.

It is the combination of our ISO/TS Tier 1 supplier experience and PGM reduction technology that underpins CDTi's strong position that makes it truly unique. Technology alone is not sufficient. Applied know-how in automotive coating is required to deliver effective application while reducing PGMs.

This differentiation is driving our recent commercial momentum with new customers.



CDTi's applied technology and unique capabilities align with market trends and other dynamics. Over the near-term CDTi is ideally positioned to partner with two sets of market participants: large global players with aggressive growth aspirations in the automotive emission controls market and domestic players in large internal markets that require technology and know-how to compete with the traditional industry leaders.

Highly favorable trends in the global automotive market in general and the heavy duty diesel market in particular are driving new entrants and increased competition for traditional OEM suppliers. CDTi has successfully positioned itself as a manufacturing and technology partner to strong emerging global players including Panasonic and Haldor Topsoe that are challenging the established industry order in key growth markets such as China. These are relationships that are based on utilizing CDTi's full suite of capabilities and enabling technology from catalyst formulations to coating and associated know-how.

In large national markets such as China and India domestic suppliers are under growing competitive and technological pressure to meet more stringent emissions requirements. In particular, cost-effective solutions are a vital need as they attempt to defend their market against global players. As a technology and materials supplier with an established pedigree as a Tier 1 coater, CDTi's offering to the domestic supplier segment of the market is without peer.

Where a traditional manufacturing focus once defined CDTi as a competitor, our ability to deliver technology in powder form or through licensing arrangements has redefined the Company as a technology partner to other coaters. This change in emphasis has created highly scalable market opportunities in China and India that were previously unreachable.

Finally, we continue to pursue incremental high-value, low-volume opportunities with existing catalyst customers. Demonstrating the continuity of our strong relationship, Honda selected CDTi to provide catalysts featuring our high-performance Mixed Phase Catalyst or MPC technology for its newly designed 2017 Accord Hybrid model.

As it relates to CDTi's financial performance in the second quarter, overall revenue was below our expectations due mainly to timing of OEM catalyst shipments and lower-than-expected replacement market volumes. The performance of our DuraFit product line in the second quarter was impacted by supply chain issues resulting from the closure of our Canadian metal fabrication activities with shipments remaining in the same range as in the first quarter. While volumes are beginning to increase in the third quarter, this lower-than-anticipated transition of manufacturing activities during the second quarter has impacted our full-year outlook as Tracy will discuss in a moment.

On the positive side, we have been receiving higher-than-anticipated ordering volumes from Panasonic in China as well as in certain segments of the retrofit market. These items underscore the momentum that we believe will become increasingly evident during the second half of 2016.

And now it's my pleasure to introduce Tracy Kern who will review the financials.

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

Thank you, Matthew. I'm excited to join CDTi at this pivotal time for the Company and be part of its drive toward sustainable profitability and long-term growth.

Beginning in the fourth quarter of 2015, CDTi has been transitioning from a niche manufacture of emissions control solutions for the automotive and heavy duty diesel markets to becoming a technology and advanced materials provider for these markets. During the second quarter of 2016 the transition was completed and we now view our operations as one reportable segment. As such, we have discontinued reporting revenues as two business division segments based on the products it delivered.

To reflect the progression of our advanced materials and catalyst business strategy we are now analyzing our business as a single platform focused on delivering products to the markets we are pursuing. Therefore, in the second quarter of 2016, we have begun reporting as a single business unit and will provide revenue by product category.

For the second quarter of 2016, revenue was \$8.4 million compared to \$9.9 million in the second quarter of 2015. Coated catalyst revenue was \$4.8 million compared to \$6.1 million. Coated catalyst revenue is generated from the sales of our high-performance catalysts which reduce emissions from gasoline, diesel and natural gas combustion engines.

Emission control systems revenue was \$2.9 million compared to \$3.6 million. Emission control systems revenues are generated from the sale of products in our extensive line of heavy duty applications including DuraFit, OEM replacement diesel particulate filters, or DPFs, and diesel oxidation catalysts, or DOCs, sold through our distribution dealer network and direct sales.

Technology and advanced materials revenue was \$630,000 compared to \$183,000. Technology and advanced materials revenue includes licenses and royalties as well as sales of our advanced materials platform.

Gross margin was 20% compared to 28%. This variance was driven by costs associated with the shutdown of our Canadian facility and transitioning the manufacturing from that facility to outside parties.

Total operating expenses were \$4.8 million compared to \$4.9 million for the second quarter of 2015. Breaking down operating expenses, SG&A was \$2.8 million compared to \$3 million. R&D was \$1.4 million compared to \$1.9 million.

Severance and other charges were \$600,000 for the second quarter of 2016. There were no severance charges in the same period last year.

Operating loss was \$3.1 million compared to \$2.1 million in the same period last year. Net income was \$1.3 million or \$0.35 per share and includes a \$2.8 million gain related to the conversion feature of the Kanis S.A. debt. This compares to a loss of \$2.4 million or \$0.81 per share in the same period last year.

Turning to the balance sheet, at June 30, 2016 we had cash of \$861,000 as compared to \$3 million at 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 July we secured agreements to convert approximately \$8.5 million in debt into equity upon shareholder approval and we received a \$1.25 million investment from Haldor Topsoe.

Due to the factors described above we are revising our annual guidance for 2016. We now expect revenues to be at the lower end of our previously indicated range of between \$39 million and \$43 million.

We believe DuraFit will partially offset the decline in legacy retrofit revenue. However, we anticipate its full-year revenue contribution will approximate \$7 million due in part to supply chain issues related to the closure of our Canadian facility that Matthew indicated earlier. We expect this to be positively offset by a greater-than-anticipated revenue ramp from Panasonic related to shipments of our SPGM DOCs.

Based on the transition costs related to the closure of our Markham facility we now expect gross profit margin to be between 25% and 27%. We have made progress in reducing our fixed cost base and believe that our normalized quarterly OpEx run rate is approximately \$4 million. Based on these assumptions, we now expect to be breakeven on an income from continuing operations basis by the first quarter of 2017.

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

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

Thank you, Tracy. As the year progresses we will continue to execute our strategy based on the following pillars: capitalize on highly favorable competitive and regulatory trends that favors CDTi in the heavy duty diesel market; pursue long-term partnerships in the global passenger car market where CDTi's Spinel technology has truly disruptive potential; focus on North America, China and India where the global automotive opportunity is concentrated; and, finally, develop multiple market entry strategies, leveraging CDTi's broad set of capabilities as a supplier of technology, materials and selectively manufactured product.



As CDTi's technology becomes increasingly widespread and reaches the market in diverse formats from coated catalysts, emission control systems, powder and licensing we believe CDTi's low PGM formulations have the potential to become industry-standard components in the multibillion-dollar emissions control supply chain. In the meantime, CDTi will seek to capitalize on the significant market opportunity on hand. This includes providing enabling technology to underserved markets at the point of change as well as addressing major markets by supplying emerging global players.

Well, that concludes our prepared remarks. Operator, we would like to open the call now for questions.

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## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) Rob Brown, Lake Street Capital.

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### Rob Brown - Lake Street Capital - Analyst

Good morning. First, on your DuraFit issues in the quarter I guess I just wanted to clarify, will that impact the Q3 run rates or will Q3 normalize? And maybe just give a little background on what sort of happened there.

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

Sure. I think Q3 we would expect to see the ramp that we had anticipated, albeit probably delayed by a quarter. That's really the way that we're looking at it at this point.

In terms of what happened, as you transition operating activities from a location to another, get a vendor, an outsourcing partner up to speed, there just was a number -- it took longer, frankly, than we had expected. And for us to get to regime, it's some of the efficiencies that we had hoped to achieve out-of-the-box weren't there. It just took longer, quite honestly.

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### Rob Brown - Lake Street Capital - Analyst

Okay, understandable. And then on the Panasonic business in China I think you highlighted it doing better but could you just give a little more color on what's happening there?

Are you seeing that product on more models or are you seeing greater market penetration? Maybe you can help us understand why that business is doing better. And I guess a follow-on to that, should that continue to ramp at a faster clip?

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

I think what we're starting to see in the second half it's again our initial thrust there with Panasonic is in the retrofit market, the heavy duty retrofit market. And we are just seeing a lot of the monies that have been allocated are starting to be deployed and business is really picking up. They are doing a great job on the ground with their partners.

It's a very, very strong offering. Our DOC technology, again, we think is unique and the value proposition in terms of PGM and cost reduction is extremely meaningful. So it's really starting to pick up there.

I think we're starting to as the retrofit business begins to ramp a little bit more in the second half we'd expect that to continue into 2017. As we get into 2017 we would expect to be talking more about OEM type of opportunities, as well. So that's really proceeding actually better than expected.



So we're very excited about that market. It's just a testament to what's happening in China. It's just a tremendous opportunity.

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**Rob Brown** - *Lake Street Capital - Analyst*

Okay, good. Thank you. I'll turn it over.

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**Operator**

Jeff Osborne, Cowen and Company.

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**Jeff Osborne** - *Cowen and Company - Analyst*

Hey, good morning. Just a couple of questions for me.

I think you mentioned, Matthew, that DuraFit was pretty similar to Q1. Can you flesh that out a little bit? I think Q1 was about \$1.2 million give or take, I'm just trying to get a sense of the ramp to get to the \$7 million for the year.

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

Yes, it was basically flat, maybe slightly lower than -- it was in essence flat with respect to the first quarter.

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**Jeff Osborne** - *Cowen and Company - Analyst*

Okay. And then as the outsourcing, similar to Rob's question, but is the outsourcing issues in terms of raw material disruption in supply and getting your new partners, was that resolved on July 1? Or was that something that is carrying over into this quarter? I'm just trying to get a sense of the cadence of the gross margin improvement through the year.

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

Sure. That I think we're definitely through the issues there. It's always harder to transition an activity.

There's some mentality involved, as well, something you've done in-house and then transitioning it out. But we've definitely got the supply chain issues ironed out.

We've got some new partners, some new suppliers but we're very comfortable going into the third quarter that those issues are behind us. It really took 60 to 90 days longer than we expected, quite frankly.

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**Jeff Osborne** - *Cowen and Company - Analyst*

Got it, okay. And then the Panasonic ramp, is it fair to say that DuraFit was down \$3 million in the guidance and Panasonic is the other \$3 million higher? Or I'm just trying to get a sense of magnitude of things being better than expected there.

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

I wouldn't point to one single factor. I think the Panasonic is more than anticipated. Some of the retrofit market segments continue to perform.

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And then there are some other elements of new business opportunities potentially and just higher volumes in general on the catalyst side. But it's not a linear one-for-one Panasonic DuraFit type of equation.

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**Jeff Osborne** - *Cowen and Company - Analyst*

Got you. And then just two other questions. One maybe for Tracy.

If you could post to your website or put in a 10-Q the historical segmentation would be helpful with the new classifications. Is that something you'd be willing to share of what the quarterlies were for 2015, for example, with the new segments?

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

Due to the shift in business we're still looking at how we're going to be presenting that. So I will certainly consider it.

The Q is coming out a little later today. I think it will give you some more depth.

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

And just to add to that, Jeff, if you think about it, the segments that we're reporting, it's very similar, what we're calling coated catalyst is very similar to our catalyst division. What we're calling emission control systems is very similar to what was our heavy duty diesel business.

We've added a third category there where we see a lot of growth as we transition partners to a Powder-to-Coat model and that's our technology and materials segment. So at least on a revenue point of view it does pretty much track with some very minor exceptions.

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**Jeff Osborne** - *Cowen and Company - Analyst*

Tweaks. Okay. And then maybe can you just touch on, Matt, the India market?

One, we were hoping to get some kind of news flow there either later this year or early next. Just how are your conversations tracking for that potentially exciting market longer term?

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

We are in really final discussions here and I think we will have during the course of the quarter our expectation is we can be a little more explicit there. But we continue to be extremely bullish on the area.

We've identified the right parties to help us be successful that really benefit most from our enabling technology in that market. So I think we're generally on track. And we will look to be a little more explicit in the coming weeks here.

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**Jeff Osborne** - *Cowen and Company - Analyst*

Perfect. Look forward to it.

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**Operator**

Matt Koranda, ROTH Capital.





**Matt Koranda** - *ROTH Capital Partners - Analyst*

Good morning, guys. Thanks for taking the questions.

Just wanted to, a couple of mine have been covered, but I wanted to cover the Haldor Topsoe agreement that you guys have and just start taking a crack at modeling this for 2017. So can you help us think about the ramp-up and magnitude of revenue contribution from that agreement in 2017 and maybe speak to 2018, as well, if you could?

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

Sure. I think we obviously haven't provided multiyear guidance here, Matt, as you know. But I think generally again it's very similar. I think there is an analogy with our relationship with Panasonic potentially and some of the other large heavy duty partners that we have where we have multiple opportunities in terms of initially there's some, a manufacturing opportunity as we currently have with Panasonic. I think longer term there may be a Powder-to-Coat type of opportunity. There's others.

I would expect the shape of it to be not dissimilar from the sorts of relationships that we're developing. If you talk about the DuraFit types of opportunities, the Panasonic types of opportunities, all of these they have a very similar, I think potentially have a very similar type of rollout and cadence.

I think that would be the way that I would think about it. And I think you are right to focus on 2017. Given where we are this year I think any contribution potentially in 2016 is unlikely or wouldn't be material, so it's really 2017. I think that things could move along the same lines as say a Panasonic-type relationship.

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**Matt Koranda** - *ROTH Capital Partners - Analyst*

Okay, got it. That's helpful.

And then similar to Panasonic, I would assume it's addressing the opportunity in a certain region. I know that Panasonic addresses the China market, but maybe you could touch on if Haldor Topsoe is focusing on a particular end market or region that you're willing to share?

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

It's a little early. I think that they are like all, a lot of the global players, really keying on China, India. Obviously we think that North America, together with North America those are the three primary markets.

But China, in particular, it's a matter of public record that they've invested a significant amount of capital in a coating operation in China. I think it's a very meaningful investment there. So there's a huge commitment to the Chinese market, which I think is vivid.

But this is a global company and they are moving very aggressively to become a leader in the heavy duty diesel segment and really challenging the existing order. Panasonic is another example of that, we believe. And so we will be, I think that it will become -- those are really the key markets and obviously where we're keying is they are doing exactly the same thing.

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**Matt Koranda** - *ROTH Capital Partners - Analyst*

Okay, last one maybe just Tracy, if you could touch on the pro forma cash balance. I mean, a lot of moving pieces post-Q2, so maybe you can just touch on with the infusion from Haldor Topsoe where cash stands post-Q2.

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

The Haldor came in just after the close of the quarter. So the Q will be out a little later today, so you can play with the cash flows if you like. But that -- I'm assuming that you're looking at that cash balance at quarter end.

**Matt Koranda** - *ROTH Capital Partners - Analyst*

Right, right. Okay.

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

To be clear, that does not reflect the investment. Yes, exactly.

**Matt Koranda** - *ROTH Capital Partners - Analyst*

Okay. I just wanted to make sure. Thank you.

**Operator**

(Operator Instructions) At this time I see no other questions in queue. I'd like to turn it back to Mr. Beale for any closing comments.

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

Thank you. We look forward to reporting on progress in the weeks and months ahead and we thank you for your continued support and interest in CDTi. Have a good day.

**Operator**

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

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