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CDTI - Q4 2014 Clean Diesel Technologies Inc Earnings Call

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## CORPORATE PARTICIPANTS

**Pedro Lopez-Baldrich** *Clean Diesel Technologies, Inc. - General Counsel*

**Chris Harris** *Clean Diesel Technologies, Inc. - President and CEO*

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

## CONFERENCE CALL PARTICIPANTS

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

**Thomas Boyes** *Cowen and Company - Analyst*

## PRESENTATION

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### Operator

Good day, ladies and gentlemen, and welcome to the Clean Diesel Technologies fourth-quarter and fiscal-year 2014 financial results conference call. (Operator Instructions). As a reminder, this conference call is being recorded.

I would now like to turn the conference over to Pedro J. Lopez-Baldrich, General Counsel. You may begin.

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### **Pedro Lopez-Baldrich - Clean Diesel Technologies, Inc. - General Counsel**

Thank you, operator. 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. 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](http://www.cdti.com).

Before I turn the call over to Chris Harris, President and Chief Executive Officer of CDTi, I want to emphasize that some of the information you will hear during our 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, and are subject to risks and uncertainties. Actual results could materially differ because of factors discussed in today's results press release; in the comments made during this conference call; and in the risk factors section of 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.

I'd now like to turn the call over to Chris.

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### **Chris Harris - Clean Diesel Technologies, Inc. - President and CEO**

Thank you, Pedro. Good morning, and thank you for joining us today. During 2014 we began transforming CDTi into an advanced materials company, evolving our business model to achieve broad commercialization around the globe. We unveiled our breakthrough Spinel technology platform. And we also launched DuraFit to take advantage of the emerging opportunity in replacement diesel particulate filters and drive near-term sales.

While Dave Shea, our CFO, will review the financial results in more detail in a moment, I will point out that our financial performance for the quarter primarily reflects the faster-than-expected drop-off in retrofit sales before our DuraFit sales had begun to ramp up sufficiently to offset that decline. While we are disappointed with our financial performance, we believe the initiatives we undertook in 2014 and are undertaking in 2015 to build the business will translate to improved financial results throughout the year.

During the third quarter we realigned resources, resulting in annual cost savings of \$1.2 million. Retrofit sales appear to have stabilized, albeit at a lower level, and we expect DuraFit sales to ramp up and to begin to substantially replace retrofit sales over the course of 2015. Over the medium-term, we believe our commercialization strategy and new technology advancements will enable us to scale of the business, drive revenue growth and profitability, and create substantial shareholder value.



In fact, we have made significant progress in executing our near-term commercialization strategy. In our catalyst division, subsequent to quarter-end, we expanded our platform of catalyst solutions to our key OEM customer, Honda, who chose our Mixed Phase Catalyst, or MPC technology, for its new Acura ILX.

So we now produce catalysts for the North American versions of Honda's 4- and 6-cylinder Accord, three models of the Acura, as well as Accord hybrid and plug-in hybrid models. We have been supplying catalysts to Honda since 2001 and continue to collaborate with them on research projects incorporating our newest technologies.

In addition, we are in discussions with other international OEMs who are following our vehicle testing closely, and in some cases collaborating with us on initial research studies.

In early March, we took action to ensure we have access to the entire global automotive market by amending our agreements with TTK to enable us to pursue opportunities for the commercialization of our catalyst products in the high-growth Asia-Pacific region. According to IHS Automotive, China alone is forecasted to sell 25.2 million light-duty vehicles in 2015 compared to 16.9 million in the US, where CDTi currently sells the majority of its catalyst products. Since 2008, TTK has been supportive of CDTi and its business goals, and this important agreement reflects our long-standing relationship.

In our heavy-duty diesel systems division, we continue to aggressively roll out DuraFit, our new, cost-effective alternative to OEM replacement filters for the North American marketplace. As we have discussed previously, we have reallocated resources away from the retrofit market toward the replacement market, as trucks eligible for retrofits are reaching end-of-life. While we continue to go after select retrofit projects in the US and abroad, we anticipate that retrofit revenue will be incrementally less as time goes on.

We remain committed to our strategy to pursue the multimillion-dollar replacement filter market with DuraFit, and have made significant progress in bringing this innovative product to market. While DuraFit volume had not yet begun to ramp in Q4, we had targeted initial sales of approximately \$500,000, and we achieved that goal. And we expect DuraFit sales to increase throughout 2015, more so in the second half.

Over the course of the last few months, we have added several key regional distributors that provide coverage of certain territories in the Pacific Northwest, as well as the Northeast and Southeast. Distributors include existing retrofit customers, Diesel Emissions Service and [Mondale Automotive], along with new customers -- Southeast Power Systems; Clean Diesel Specialists, Colorado Springs; and American Radiator -- plus numerous additional distributors throughout the US and Canada.

Demonstrating the effectiveness of our distributor network, we are close to securing the first major fleet customer for DuraFit through one of our independent distributors. We are also working to get national dealer networks on board soon, which will add significantly to our commercial reach in the replacement market. In short, we are targeting multiple major sales channels for DuraFit, including independent distributors, national dealer networks, and regional and national fleets.

Now turning to our advanced material strategy. Initial OEM feedback on our strategy and new business model is most encouraging. Let me explain how this transforms our commercial potential. Historically, we have commercialized our catalyst technology in the same manner as other coaters: by applying liquid formulations to substrates on assembly lines and then baking them in ovens. The liquid formulations contain platinum group metals, or PGMs, and specialty chemical powders sourced from various suppliers around the world. We believe by substituting our highly enabling proprietary catalytic powders for conventional powders, the coaters will be able to meet demanding OEM requirements using dramatically lower amounts of PGM.

We also believe OEMs will set emission performance and cost targets that require this substitution using our proprietary catalytic powders. Such powders can be shipped to coating plants around the world, taking advantage of today's extensive coating plant and supply chain infrastructure. We believe this presents significant opportunity to extend our reach throughout the automotive catalyst world, and to scale the business multi-fold. Global powder plants can supply numerous local coating lines around the world.

Our experience over the past decade in formulating and applying some of the most advanced catalytic coatings in the industry enables us to embody our technology in a powder form that we believe will readily work in other coaters' plants. In fact, we have introduced a powder step in our own manufacturing process and find that it offers significant advantages over traditional wet formulations.

During the fourth quarter we unveiled our Spinel platform, a proprietary clean emissions exhaust technology that promises to dramatically reduce the cost of obtaining more stringent clean air requirements. This is becoming increasingly relevant as new standards, such as the EPA's Tier 3, become effective.

Our Spinel technology can power multiple catalytic product lines, and has the potential to provide global OEMs with a compelling value proposition of unique performance at substantially lower cost compared to the traditional platinum-based and rare earth-based catalytic device industry.



While Spinel is a significant innovation for CDTi, we also have other key materials being validated on light-duty and heavy-duty vehicles. As we stated in our third-quarter call, we have initiated on-vehicle testing to validate and optimize Spinel and other innovative material technologies.

The testing is ongoing at independent certified testing facilities, and involves a number of specific brands of OEM vehicles. We have selected engine platforms that represent the largest future sales opportunities, including small turbocharged direct injection engines. This testing is key to demonstrating the significant value of our technologies for OEMs.

In fact, we're using the same aging and drive cycle testing protocols used by the OEMs. In addition, we will optimize engine calibrations with these new catalyst technologies, all aimed at higher performance at a lower cost. Utilizing such high testing standards takes longer, but it results in more valuable data, particularly when we begin commercializing our technologies with the demanding OEMs.

We will be announcing testing and validation progress on a number of light- and heavy-duty vehicles and engines, demonstrating the significant value of our materials products, including Spinel. We expect to have initial validation testing results by mid-year, and we intend to secure our first customer for enabling catalytic powders in the second half of the year.

Meanwhile, we have made significant progress validating and optimizing our powder processing capability in advance of scaling to commercial quantities in the coming months. As I mentioned earlier, this progress is key to achieving the powder to coat capability that allows us to provide our highly enabling technologies to catalyst coaters around the world.

Underpinning our advanced materials platform is our large and growing portfolio of low-PGM, SPGM, and ZPGM patents. We have a robust, global IP strategy in place, and we will continue to file patents to protect our intellectual property. Our on-vehicle validation program also enables us to patent the uses and applications of our novel material families, in addition to structures and compositional matter.

In the fourth quarter, we filed 20 patent applications and were granted two patents for Spinel. This brings our year total to 65, of which 14 were for SPGM, and 41 were for ZPGM technologies. We anticipate many more patents will be filed in 2015 that will further reinforce the power of our advanced materials platform. We are excited about the potential of our new technologies, and we look forward to keeping you updated.

In summary, our progress to date has been most encouraging, and I am more excited than ever about our prospects. There is clearly much more work to be done to drive near-term growth and ultimately reach our longer-term goals. However, I am confident in our strategy and our world-class team's commitment to building our leadership position in advanced emission control technology.

Before I wrap up and we take your questions, I will now turn the call over to Dave for a review of our financials.

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

Thank you, Chris. As a reminder, the standard exhaust business which was sold in October of 2014 is now classified as discontinued operations. For the fourth quarter of 2014 revenue was \$8.7 million compared to \$14.4 million in the fourth quarter of 2013. Heavy-duty diesel revenue for California and the 49 states was down to the expected decrease in retrofit demand. However, the magnitude of decrease in Q3 and Q4 exceeded our expectations. In addition, our DuraFit sales were in the early launch stage and had not yet begun to ramp.

Our catalyst revenue was down 7% compared to 2013 fourth quarter, driven primarily through lower intercompany catalyst sales and a reduction in service parts for out-of-production vehicles. Gross profit was \$2 million compared to \$4.7 million. Gross margins was 22.7% compared to 33.6%. The fourth-quarter 2014 gross margin reflects lower volumes and costs associated with launching our new DuraFit line. As sales of DuraFit ramp, we expect incremental improvements in margin. The breakdown of margins was 32.6% for heavy-duty diesel, and 16% for the catalyst division for the fourth quarter.

Totaling operating expenses were \$5.1 million compared to \$5.9 million for the fourth quarter of 2013. Breaking down expenses, SG&A was \$3.2 million compared to \$3.4 million in the fourth quarter of 2013. R&D was \$1.9 million compared to \$1.3 million in the same period last year. R&D expense increased as a result of testing and development work on advanced catalyst technology and the patent filings done in the fourth quarter.

Operating loss was \$3.1 million compared to \$1.2 million in the same period last year. In the fourth quarter of 2014 we recognized a non-cash gain of \$372,000 from warrant adjustments primarily resulting from our November 2014 offering. This non-cash gain reflects lower warrant valuations due to our lower stock price in the fourth quarter.



Net loss was \$2.7 million or \$0.20 per share, and included a loss of \$79,000 from discontinued operations. This compares to a loss of approximately \$2.5 million or \$0.27 per share in the same period last year, which included a loss of \$314,000 from discontinued operations.

The average outstanding shares for the fourth quarter of 2014 were \$13.5 million compared to \$9.3 million in the fourth quarter of 2013. This increase reflects the approximately 1.6 million shares in the \$4.4 million offering, and the 2 million shares in the \$6.9 million offering we conducted in November of 2014 and April of 2014, respectively.

For the full year, total revenue from continuing operations was \$41.2 million in 2014 compared to \$51.8 million in 2013. Revenue, including intercompany sales for the catalyst division, was \$23.7 million for 2014 and \$25.8 million for 2013, reflecting lower intercompany catalyst sales and a reduction in service parts for out-of-production vehicles. Revenue for heavy-duty diesel was \$19.6 million for 2014 and \$29.1 million for 2013 as a result of lower retrofit sales in California and the 49 states.

Gross margin was 30.2%, expanding from 28.9% in 2013. Total operating expenses were \$20.1 million compared to \$19.3 million for 2013. Net loss was \$9.3 million or \$0.78 per share, including the loss of \$223,000 from discontinued operations, compared to a net loss of \$7.1 million or \$0.86 and a loss of \$255,000 from discontinued operations.

Turning to our balance sheet. At December 31, 2014, we had cash of \$7.2 million compared to \$3.9 million at the beginning of the year. In November of 2014 we amended all loan agreements with Kanis SA and extended the maturity dates to October 1, 2016. In addition, one of the loans -- the \$3 million convertible -- is no longer callable by the lender. By amending and extending our loan agreements, we have greater financial flexibility while executing our growth strategy.

Going forward, we will be providing annual guidance to enable analysts and our investors to better model the Company and track its progress. 2015 will be a pivotal year, as we invest in our advanced materials strategy. While we do not expect to record revenue from the strategy in 2015, we believe it will enable us to drive profitable growth in 2016 and beyond. In 2015 we expect revenue between \$40 million and \$45 million, depending on the timing of the ramp-up of DuraFit, as compared to \$41.2 million in 2014.

We expect a gross margin between 25% and 28%, approaching the 30% achieved in 2014, due to continued start-up costs and supply chain inefficiencies. As DuraFit scales throughout 2015, we expect margins to improve in the back half of the year as we optimize our supply chain.

We will continue to investigate and evaluate options to better align our assets with our future vision for the Company, as well as review opportunities to improve our balance sheet and financial flexibility to position us for growth.

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

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**Chris Harris - Clean Diesel Technologies, Inc. - President and CEO**

Thank you, Dave. Our vision for CDTi is clear: transform CDTi from a manufacturer that makes emission control products to an advanced materials company that develops proprietary technology and more broadly commercializes it through other major players in our key automotive value chain, namely global OEMs and catalyst coaters. The work we are doing in validation testing of Spinel and our other new technologies is key to our future growth and transforming the business into an advanced materials leader.

Our knowledge of modern engines and vehicles, as well as OEM protocols, enables us to conduct highly rigorous testing, which in turn secures credibility with our OEM partners. We expect this will allow us to expand the commercial reach of our enabling technology and accelerate its deployment.

We look forward to updating you on our vehicle testing results, as well as sharing the progress we have made in validating and optimizing our powder to coat capability and scaling up to commercial quantities. We expect to have initial testing results to share in the second quarter. Furthermore, we expect the testing results to advance our discussions with leading international OEMs.

Through our amended agreements with TKK, we will pursue opportunities for the commercialization of our catalyst products in the high-growth Asia-Pacific region. We also anticipate further reinforcing the power of our advanced low-PGM, SPGM, and ZPGM materials platform by filing many more additional patents in 2015.

In our heavy-duty diesel systems division, we are working to add national distributors for our DuraFit product, as well as closing our first major fleet sales.



Before we close the call, I wanted to welcome Dr. Till Becker to our Board of Directors. Dr. Becker's extensive international automotive leadership experience and in-depth understanding of the global automotive supply chain will be a valuable asset to CDTi, as we transition from an emission control manufacturer to an advanced materials company.

Operator, we're now happy to take questions.

**QUESTION AND ANSWER**

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**Operator**

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

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

Just wanted to start off with the gross margin guidance for 2015. I believe you guys said 25% to 28% target during the year. Could you comment on whether something has changed with the product mix? You also alluded to supply chain inefficiencies in your prepared remarks. Could you just elaborate on that, and just talk about what's going on with the gross margin outlook for the year?

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**Chris Harris - Clean Diesel Technologies, Inc. - President and CEO**

Yes, Matt. Clearly, when you're launching a whole new product line like DuraFit, there's issues with raw material efficiencies in terms of just volumes. So as volume ramps, it will drive down some of the costs of the most critical and high-cost raw materials associated with that product line.

We also have various introductory offers we made to, if you will, set up supply chains with our distributors and set up programs with them. So, some of those start-up costs will disappear also and be mitigated.

So it's a combination of scale that will get us raw material efficiencies and that also will get us some logistics efficiencies, in terms of moving orders out and stocking throughout this hub-and-spoke distribution network that we're establishing throughout North America.

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

Okay, great. That's helpful. So not a major change on the catalyst side for gross margins. It's more just the ramp-up in DuraFit that's driving those gross margins.

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

That's correct.

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**Chris Harris - Clean Diesel Technologies, Inc. - President and CEO**

That's correct.

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

Okay, great. And then in terms of DuraFit during 2015, it sounds like you guys did a nice job driving some revenues during Q4. I think you mentioned \$500,000. What can we really expect for DuraFit in terms of revenue during 2015? Could you help quantify that for us?

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**Chris Harris - Clean Diesel Technologies, Inc. - President and CEO**



Yes, we certainly have various plans in place to expand our customer base and get further penetration with some of their customers and fleets. And, for sure, we believe that we can drive this business north of \$5 million in 2015.

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

Okay, great. That's helpful. Could you talk a little bit more about the powder model that you alluded to in the prepared remarks? At what point will catalyst coaters be ready to start taking powder for commercial qualification? What is that commercial qualification process like? And does it fit with your scale-up in terms of commercial volumes by the second half of the year?

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**Chris Harris - Clean Diesel Technologies, Inc. - President and CEO**

Clearly, in terms of driving value overall in the automotive value chain, the OEMs need to understand the potential of the technology and start embracing it, if you will. And that, in and of itself, will open up dialogues with how do we work with OEMs and coaters to start commercializing this.

So the first phase is the vehicle validation testing that we're doing that we've alluded to, and that we'll be reporting on. And that ultimately drives the value at the OEM level that then those critical suppliers, like ourselves and coaters, then respond to.

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

Okay. But is there a separate process that the coater would have to go through to qualify your material? Or is it mainly done at the OEM level, and once they spec it in, the coater can just pick up and go with commercial volumes going forward?

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**Chris Harris - Clean Diesel Technologies, Inc. - President and CEO**

It eventually will be a hybrid approach, I would say. But, clearly, OEMs have to validate the basic technology on vehicles with their different engine technologies and calibrations. And then, ultimately, whenever you are scaling up any new catalyst programs for any vehicle models, et cetera, there is a qualification process to put it into manufacturing plants, into coating plants.

However, we believe all indications are that our technology is very complementary and compatible with existing manufacturing assets. And we think those scale-up protocols can be met rather straightforwardly, given the quality management systems that we are familiar with, as well as other leading coating manufacturers are familiar with.

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

Okay, great. And one more for me here. On TKK, it sounds like you guys have a royalty agreement in place now. Can we expect any revenue contribution during 2015? Or is this something that's a longer-term type deal?

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**Chris Harris - Clean Diesel Technologies, Inc. - President and CEO**

It's probably -- in any significant revenue, it's a longer-term deal. However, we will be approaching various customers in Asia-Pacific. And depending on the value propositions they see, just like we would say with any OEMs, there are opportunities to accelerate commercialization. And we'll have to see how those unfold.

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

Okay, great. Thanks, guys. I'll jump back in queue here.

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**Operator**



(Operator Instructions). Thomas Boyes, Cowen and Company.

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**Thomas Boyes - Cowen and Company - Analyst**

I appreciate the guidance for 2015. I was just wondering if you could provide any additional color maybe around RMD expectations as you are testing the Spinel platform.

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

Yes. From an expectation standpoint, if you look at what we're doing in Q4, that's probably a good run rate for us.

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**Thomas Boyes - Cowen and Company - Analyst**

Okay. And the other thing, I was just trying to get a better understanding of the implications of having the Mixed Phase Catalyst technology in the new Acura ILX. In previous things I've seen your 2013 catalyst was -- had a PGM content of somewhere around \$30, \$28 -- \$30. With the introduction of that, has that substantially brought down the amount of PGMs required in the new type of catalysts? Is there any information you could share on that?

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**Chris Harris - Clean Diesel Technologies, Inc. - President and CEO**

Certainly, the latest Mixed Phase Catalyst formulations that we have on these vehicles that we announced with Honda have optimized PGM. But because the various vehicles are calibrated different -- the engines -- you can't generalize in terms of PGM levels on an absolute basis per vehicle.

However, we can say that, once again, they are optimized, and they are substantially lower than previous models. And that's why the technology has been chosen.

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**Thomas Boyes - Cowen and Company - Analyst**

Okay. Great. Thank you very much. I appreciate it.

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**Operator**

Thank you. I'm showing no further questions at this time.

I'd like to hand the call back over to Chris Harris for any closing remarks.

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**Chris Harris - Clean Diesel Technologies, Inc. - President and CEO**

Thank you, everyone, for joining us and your continued support of CDTi. Dave and I are going to be meeting with investors quite frequently in 2015. Dave is attending the Northland Capital Markets Growth Conference on March 18, and holding investor meetings in New York the following day, on the 19th. In addition, he and I will be in Chicago March 24 and 25. So if you are interested in meeting us there, and elsewhere in the future, please contact our Investor Relations firm, LHA, whose contact information was listed in today's press release.

We look forward to speaking with you soon, and have a good day.

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**Operator**

Ladies and gentlemen, thank you for participating in today's conference. That does conclude today's program. You may all disconnect. Have a great day, everyone.



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