

Conference Call Transcript

First Quarter 2022 Results: May 9th, 2022

Operator

Thank you for standing by, this is the conference Operator. Welcome to the Westport Fuel Systems First Quarter 2022 Results Conference Call.

As a reminder, all participants are in listen-only mode and the conference is being recorded.

After the presentation, there will be an opportunity to ask questions. To join the question queue, you may press star then one on your telephone keypad. Should you need assistance during the conference call, you may signal an Operator by pressing star and zero.

I would now like to turn the conference over to Christian Tweedy, Westport's Investor Relations representative. Please go ahead.

Christian Tweedy

Investor Relations Representative

Good morning everyone. Welcome to Westport Fuel Systems first quarter 2022 conference call, which is being held following the press release Friday of Westport Fuel Systems' financial results.

On today's call, speaking on behalf of Westport Fuel Systems is Chief Executive Officer David Johnson and Chief Financial Officer Richard Oraziatti. This call is open to the public and the media, but questions will be restricted to the investment community.

You are reminded that certain statements made in this conference call and our responses to various questions may constitute forward-looking statements within the meaning of the U.S. and applicable Canadian securities laws. As such, forward-looking statements are made based on our current expectations and involve certain risks and uncertainties.

With that, David, I'll turn the call over to you.

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David Johnson

Chief Executive Officer

Thanks Christian. Good morning everyone. Thanks for joining us to review Westport Fuel Systems' results for the first quarter 2022.

In Q1, we generated revenues of \$76 million, comparable to the same period of 2021. Excluding foreign exchange translation, our revenues increased by approximately 6% year-over-year. As you know, today's markets are anything but stable. That's true for the broader market as well as our specific automotive markets. Today's markets are volatile, unpredictable and uncertain, and in Q1 volatility increased. Now we have more inflation and we have the Russian-Ukraine war on top of the existing and well known challenges of chip shortages and the still ongoing effects of COVID. There are myriad local market changes that matter, like the collapse of the Turkish lira and the actions governments are taking to manage their economies and help their citizens through these challenging times, fuel rebates, for example.

In light of this, matching our year-ago quarterly revenue in this most recent quarter looks to me like an accomplishment, and as noted, if we were to report in euros instead of U.S. dollars, we'd be up roughly 6% compared to last year because foreign exchange rates are also on the move. The reasons for this modestly robust quarterly result in these rather turbulent times are as follows.

First, our core business is on the right path. Clean affordable transportation is in demand today and in demand tomorrow and, in fact, demand is increasing. Ultimately high energy prices in challenging economic times tend to be tailwinds for our business. Transportation is not a discretionary purchase and we make transportation products that are both low cost to acquire and low cost to operate. During times of financial constraints, our business can continue to grow.

Second, Westport Fuel Systems has both product and market diversity. We serve 70 markets and we provide fuel components and systems for the full range of low carbon gaseous yields: LPG, CNG, LNG, RNG, biomethane and hydrogen. All our fuel systems are applied to a wide variety of engines and fuel cells in a broad spectrum of applications. We sell through diverse channels, both aftermarket and direct to OEMs, as well as to other Tier 1 suppliers, and we have a diversity of customers around the world.

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Finally and most importantly, at Westport Fuel Systems we're on an important mission and our 1,800 global team members and our partners around the world are each and all committed to our mission to deliver the products and services that enable clean affordable transportation. We're determined and we're resilient.

Looking into the quarter, I'm pleased to report that our OEM business continues to grow, up 21% over the year-ago quarter and includes the continued sales growth of our HPDI systems, up 16% to our lead European OEM customer. Why does our HPDI business continue to grow, even in these challenging and volatile times? Because HPDI is an excellent superior product, and it's only available from Westport Fuel Systems. HPDI is surely familiar to you, but let me spend a little more time today reviewing the offer that HPDI makes in the marketplace.

HPDI enables a diesel engine to maintain all the diesel performance and efficiency that fleets and drivers have come to expect, but using clean natural gas and, importantly, biogas, otherwise known as RNG, biomethane or bio-LNG. A recent article in a French trade magazine, *FranceRoutes*, explains, and I quote, thanks to Westport technology, the compression ratio is that of a diesel engine. I point to this quote that maybe only an engine geek like me could love, because maintaining a high compression ratio, maintaining high boost pressure and maintaining high working pressure inside the engine are the key ingredients enabling performance and efficiency. HPDI makes that possible with clean, low carbon natural gas fuel.

FranceRoutes also documented a substantial efficiency difference. Fuel consumption of the HPDI-equipped truck in their test was dramatically lower than that of a competitor truck using spark-ignited natural gas fuel engines, 25% to 30% lower fuel consumption with HPDI. That's a huge difference for most any application, but especially in trucking where competitive advantage and bragging rights are often measured in fractions of a percent. I just have to pile on the torque available using HPDI is 15% higher than those similarly sized engines without HPDI. HPDI is the right way, the best way to use clean gaseous fuels in the internal combustion engine.

Where do we go from here? First, we continue to grow to meet customer demand, respond to regulatory requirements, and realize economies of scale in our manufacturing and supply chain and improve our profitability. As we reviewed before, the fleet average CO2 standards in Europe require a 15% reduction by 2025 and a 30% reduction by 2030. These requirements have not gone away due to COVID, nor due to war, and Europe is working to make those requirements even more stringent. Natural gas fuel provides an inherent 20% reduction in

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carbon compared to diesel fuel. HPDI gets the most performance from natural gas, and so, in combination, our product responds directly and powerfully to the regulations.

HPDI is fully compatible with biogas, which continues to grow strongly in markets around the world, including the U.S. where the Natural Gas Vehicle Association recently reported that RNG achieved a 64% mix in transportation last year. Fantastic. Looking at Europe, a key market for our company, their transport sector generates 27% of the EU's total CO2 emissions, and road transport alone generates almost 19%. Being able to rapidly reach climate neutrality in this sector will require the combined efforts of all stakeholders. Starting in 2025, OEMs in Europe will face substantial financial penalties associated with missing the fleet average CO2 requirements.

Next we move from low carbon natural gas to net zero carbon biogas to zero carbon hydrogen. As we announced last week, this week we are unveiling our high performance, high efficiency hydrogen HPDI demonstration vehicle at the ACT Expo here in Long Beach, California. Our HPDI technology works brilliantly with hydrogen, as we've demonstrated in our laboratory, with more power, more torque, and more efficiency than the original diesel-fuelled engine and with near zero carbon emissions. HPDI with hydrogen is just what the world needs for heavy duty long haul trucking. It's economical, high performance and clean.

Looking ahead, we're in progress with numerous hydrogen HPDI projects, including the announced work with Scania, AVL and TUPY, and Cummins. We look forward to sharing more information at the ACT Expo and later this year as we demonstrate our truck and develop the engine in our lab.

Hydrogen HPDI is a big deal. This will make internal combustion engines with HPDI the best way to use green hydrogen for long haul heavy duty transport applications. We have a disruptive technology. and we're pleased to show it off and offer it to our customers and the industry.

Next after that, off-road and high horsepower applications. We see a clear opportunity to de-carbonize this very hard to de-carbonize sector using Westport Fuel Systems' patented and proprietary HPDI fuel systems and by applying our deep expertise in managing gaseous fuels. Mining vehicles are a good example. Today's mining truck fleets are typically diesel powered, and mining vehicle emissions represent about a third of miners' greenhouse gas emissions. Our low cost, affordable and reliable solutions are available now and play an important role in helping de-carbonize mining while maintaining the reliability and dependability of their fleet by

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continuing to use the well-developed internal combustion engines, but with HPDI fuel systems and clean low carbon gaseous fuels.

The ongoing Russia-Ukraine conflict will continue to have an adverse impact on part of our business. As we highlighted during our Q4 call, about 10% to 15% of our light duty OEM and aftermarket business has been sales in Russia to OEMs and aftermarket customers. This Russian business has been growing as an important market for gaseous fuel systems components. Because of the continuing conflict, the future impact to our business on the commercial and economic consequences of the conflict are, of course, uncertain again. For example, with respect to commodities and component material pricing, 40% of Europe's natural gas and 25% of Europe's crude oil is provided by Russia today, so pricing pressure is expected on components globally as energy costs for production and transport continue to rise as the conflict drags on.

We'll continue to monitor these developments, as the situation is changing rapidly. Despite these pressures, we remain confident that our products will continue to deliver and expand our market share in response to the persistent need for clean, affordable transportation. We saw this through COVID, and we expect to keep seeing it through the current challenges. We are keeping our focus on the long term while we work to mitigate the near-term challenges, as we have successfully done before.

You might not believe what's happening in India, but having just been there, let me confirm that India is now the market with the highest penetration of natural gas-fuelled vehicles with market shares growing towards 40% in passenger vehicles and commercial vehicles and in India's unique three-wheeler segment. It's impressive and exciting, and Westport Fuel Systems is there supplying all the various components and systems required to enable the transition that is underway in India. Why? First, because regulations have driven a market change away from diesel and towards natural gas because of product affordability; second, because Indian customers demand affordable solutions; and third, because the Indian Government has made clean natural gas for transportation a foundational element of their strategy while also improving air quality. Natural gas refueling infrastructure continues to grow, now approaching 3,500 stations, up dramatically in just the past years.

I'd like to quickly turn our attention to China and provide an update and outlook for our business there. Lockdowns are back in effect across major metropolitan cities in China and key import-export areas, which is having a reverberating effect on the global supply chain;

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meanwhile, natural gas prices there continue to be elevated, putting a damper on our JV's existing spark-ignited natural gas engine business. Work continues to bring HPDI to the marketplace, and with high natural gas prices, the government is increasingly focused on the potential for hydrogen. China's hydrogen industry has undergone exponential growth in the recent years, and local authorities and enterprises have shown strong enthusiasm for investing in the sector. A study released by the China Society for Finance and Banking projects that China will invest the equivalent of US\$74 trillion in carbon neutrality financing of the next 30 years, representing five times its 2020 national output.

Westport has the products to help China reach their stringent climate goals. It is a reason why we have ongoing discussions with potential Chinese partners for the usage of patented HPDI. Hydrogen HPDI can play a large role in transportation de-carbonization efforts in a country that is embracing hydrogen and believes in its long-term growth potential and use case as a future fuel. We're excited about this opportunity ahead and look forward to updating the market on further developments.

Despite the pressures we in our industry are facing in this moment, the outlook for our Company is favourable. The world needs clean, affordable transportation. Westport Fuel Systems has the solutions and will grow to respond to the increasingly urgent needs in markets around the world. Hydrogen is an important growth vector for Westport Fuel Systems. HPDI enables the use of cleaner fuels in internal combustion engines for long haul transportation. Growth will enable economies of scale that lead to profitability. We're well positioned, ready, eager and determined.

With that, I'll hand it over to Richard to go over the financials.

Richard Oraziotti
Chief Financial Officer

Thank you David.

Revenue for the first quarter of 2022 of \$76.5 million was comparable to the prior year quarter despite the challenging headwinds from volatile fuel prices, the impact of sanctions on our Russian sales volumes, and continued inflationary pressure and supply chain challenges plaguing the automotive industry.

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We continue to generate growth in our OEM revenues primarily due to the addition of our fuel storage business, and saw modest growth in light duty, heavy duty, OEM and electronics businesses. Offsetting the growth in OEM revenue, our independent aftermarket revenue was significantly lower year-over-year due to the lower volumes caused primarily by the impact of sanctions resulting from the Russia-Ukraine conflict. Excluding foreign exchange translation, revenue increased by approximately 6% year-over-year. Foreign exchange had a significant impact on revenues in U.S. dollar terms due to the 7% appreciation of the U.S. dollar relative to the euro, which is the currency we conduct a substantial portion of our business.

Net income was \$7.7 million for the first quarter of 2022 compared to a net loss of \$3.1 million for the same prior year period. The increase in net income was due to the gain of \$19.1 million recognized on the sale of our interest in the CWI joint venture and the monetization of the related intellectual property. This was partially offset by lower gross margin from our independent aftermarket business, inflationary pressure on cost of materials and manufacturing inputs, and the loss of equity income from CWI. Normalizing for the CWI gain, we generated negative \$6.1 million in Adjusted EBITDA for the quarter as compared to \$2.7 million for the three months ended March 31, 2021.

Turning to our business segments, revenue for the first quarter of 2022 for OEM was \$51.8 million, up 21% compared to the prior year quarter. The operating loss from OEM was \$6.5 million, which was the same for the prior year. The increase in revenue was driven by additional revenues of approximately \$8 million from the acquisition of our fuel storage business in the second quarter last year. We also saw revenue growth in our light duty OEM business due to the rapid growth in sales volumes to OEMs in India, which was partially offset by a challenging market in Western Europe due to volatile CNG prices and the impact of sanctions on our Russian sales volumes.

Despite the headwind of elevated LNG prices at the pump, our heavy duty OEM sales volume to our OEM launch partner increased 16% year-over-year. Revenue growth was partially offset by the annual contractual price reduction to our OEM launch partner. As a reminder, the first quarter of 2021 was the start of production challenges at our OEM launch partner from the shortage of semiconductor chips, which has improved since the fall of 2021.

Higher relative LNG prices are causing a significant challenge to the demand for LNG trucks, which is expected to temper our expected sales volume growth to our OEM launch partner through 2022 until relative LNG prices return to a more favourable equilibrium.

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Gross margin was \$5 million or 10% of revenues for the quarter compared to \$4.9 million or 11% of revenues in the prior year. Gross margin increased by \$1.3 million from our fuel storage business, which was offset by decreases in gross margin across all other OEM businesses due to the increased sales mix to emerging markets with lower gross margins and increases in material costs from the global supply chain shortage and inflation. Gross margin and gross margin percentage from our HPDI 2.0 fuel systems product will vary based on production and sales volumes, levels of development work, successful implementation of initiatives to reduce the cost input materials, and foreign exchange rates. Margin pressure is expected to continue through 2022, as production costs and contracted price discounts with the existing OEM customers are only partially offset by cost reductions in materials until higher scale is achieved.

R&D expenses for the first quarter were \$4.8 million, which were comparatively lower year-over-year mainly due to foreign exchange benefit. Our R&D activities in OEM continue to focus on the development of next-generation HPDI fuel systems technology and demonstrations with potential OEM customers on our HPDI fuel system's hydrogen and natural gas applications.

Now turning to independent aftermarket, the independent aftermarket business faced significant challenges in the first quarter from reduced sales volumes through our Russian customers caused by the sanctions and fuel price volatility. Revenue for the first quarter of 2022 was \$24.7 million, down 27% compared to the prior year period. Aside from the impact of the Russian sanctions, we had lower comparative sales to our African customers, as the first quarter of 2021 included a recognition of a large one-time infrastructure project, and then there was the aforementioned foreign exchange impact of the U.S. dollar appreciation.

Gross margin was \$4.9 million or 20% of revenues for the quarter, down \$3.2 million compared with the same prior year period. The decrease in gross margin and gross margin percentage was attributable to the lower sales volumes to Russia and Western Europe, increased sales to emerging markets with lower comparative gross margin and, to a lesser extent, higher manufacturing costs in the current quarter due to increased material costs. Consequently, we recognized a small operating loss of \$300,000 compared to operating income of \$1.6 million in 2021. On a positive note, the LPG price differential to gasoline has improved favourably during the first quarter, which is providing some support to increased sales demand. With this positive tailwind and other countermeasures to mitigate the impact of inflation and improve productivity, we anticipate a return to profitability of our aftermarket business soon.

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Finally, I'd like to touch on liquidity. Our cash position increased by \$2.7 million during the first three months of the year to \$127.6 million from about \$125 million at year end. The increase was primarily from the \$31.4 million in proceeds received from the sale of our interest in CWI and the monetization of the related intellectual property, offset by cash outflows in net working capital, investments in capital assets, and repayment of our short- and long-term debt.

Our net cash flows used in operating activities were \$16.9 million in the first quarter of 2022, an increase of \$14.3 million of cash used compared to the same prior year period. The increase in cash used was primarily due to the net change in working capital from a build-up of inventory and a decrease in gross margin.

Our net cash from investing activities of \$29.2 million consisted primarily of cash acquired through the sale of our investment in CWI, partially offset by capital expenditures of \$2.8 million. Net cash flows used in financing activities were \$7.9 million for the first quarter of 2022 primarily due to a net repayment of debt as we begin paying down our debt on a quarterly basis after a period of deferral from COVID-19 relief.

As discussed, COVID-19, the impact of the Russia-Ukraine conflict, uncertainty, and volatility in our fuel prices, especially in Europe, had a negative impact on customer demand in the quarter. Further, supply chain disruption and high inflation continue to challenge the automotive industry with rising manufacturing costs, pressuring gross margin in the near term as we respond with pricing and productivity countermeasures to manage our profitability. As conditions continue to persist, the duration and severity of the impact on future quarters is currently uncertain.

Having said that, we do see positive signals in the growth of our OEM businesses and a path to profitability as sales volumes grow in our heavy duty and light duty OEM businesses. Our balance sheet and liquidity to fund the growth is currently in good shape and we will remain prudent in our allocation of capital and resources in executing our strategic and operating plans.

With that, I would like to turn it back to David.

David Johnson
Chief Executive Officer

Thanks Richard.

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While current global sectors are causing headwinds, the market fundamentals, regulatory environment, and the overall global trends remain in our favour. The world needs clean, affordable transportation. We're excited to bring our hydrogen HPDI fuel system technology to the forefront and will be sharing more of our technical and commercial results with you through the year. Our team will continue to work hard to meet the needs of our customers and the industry with a focus on executing our long-term strategy: growth in new markets, new product development, and a commitment to quality and reliability. Westport Fuel Systems is driving the affordable de-carbonization of transportation globally.

Thanks for your time today, and looking forward to your questions.

Operator

Thank you. We will now begin the question-and-answer session. Analysts who wish to join the question queue may press star then one on their telephone keypad. You will hear a tone acknowledging your request. If you are using a speakerphone, please pick up your handset before pressing any keys. To withdraw your question, please press star then two. We will pause for a moment as callers join the queue.

Our first question comes from Eric Stine of Craig Hallum. Please go ahead.

Eric Stine

Analyst, Craig Hallum

Hi David, hi Richard.

Richard Oraziotti

Chief Financial Officer

Good morning.

David Johnson

Chief Executive Officer

Good morning Eric.

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Eric Stine

Analyst, Craig Hallum

Good morning. Maybe just to start with your heavy duty OEM with Volvo in Europe, and maybe this is tough to answer, but for obvious reasons kind of a tempered outlook for the end of 2022. I'm just curious, anything you can share relative to maybe the shortfall versus your expectations potentially versus Volvo's expectations? Just anything to add some details, and then also would just love your thoughts on the linearity of revenues throughout 2022, at least to how things stand today.

David Johnson

Chief Executive Officer

Yes, so glad to talk a little bit about the business in Europe with HPDI with our launch partner. Fundamentally, a key ingredient in that is the fuel price, and fuel prices are a bit elevated these days, specifically LNG price relative to diesel, so that is for sure a headwind. Nonetheless, looking at our results in Q1 and what we shipped to our customer, fundamentally we're up 16% year-over-year, and I would also point to in general our Q1s have been kind of the soft quarters and then Q4 tends to be a stronger quarter, so we're hopeful for a repeat of that and increase through the year as we go forward.

Nonetheless, we do have this headwind of the fuel prices, but we still have the MAUT tax abatement of about €10,000 per truck and other purchase incentives, so the market has many factors. I think one of the things that we can have some significant confidence on is the fact that it is the superior product in the marketplace, and so our customer is taking share from other natural gas and other alternatives in the marketplace, and so we feel good about the business in the long run. We see it as up quarter and kind of forecast that we'll have a relatively good year, although fuel prices are forever a challenge when they're elevated as they are right now.

Eric Stine

Analyst, Craig Hallum

Right, got it. Maybe turning to China, you mentioned that with elevated fuel prices and COVID lockdowns and everything going on there that the government is starting to change or look

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more at hydrogen. Just curious, you've got the take-or-pay with Weichai. I mean, is there a mechanism in there where that can be shifted, or a portion of that can shift to hydrogen; or when you're talking about elevated interest, are you talking about potentially other parties as well?

David Johnson Chief Executive Officer

Yes, I think it's both. Basically what we see in China today relative to hydrogen is a lot of push from the government, a lot of funding available, and basically all of the OEMs have varying degrees of interest in how to approach the market with hydrogen. Frankly, we have work to do to make sure they understand, like we do globally, like we're doing this week at ACT Expo, to help the world understand what's possible with hydrogen and HPDI, because this really is quite novel compared to the other alternative of spark-ignited hydrogen engines.

This is our work, to help them understand the potential of HPDI with hydrogen; but fundamentally going back to the contract, anything is possible but at this point in time, we have a contract in place and we have a customer, and they continue to do the work to bring HPDI to the marketplace, and a pivot to either add or move towards hydrogen, I would say, would be beyond the time frame of the contract period that we're talking about with Weichai.

Eric Stine Analyst, Craig Hallum

Got it. Okay, thanks for that.

Then just maybe one quick one, you know, bookkeeping here for Richard, just on the debt repayment. Can you just maybe give some colour into debt repayment expected for the remainder of the year, and then I guess maybe in 2023 as well as you start paying things that were deferred?

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Richard Oraziotti
Chief Financial Officer

Yes, it's outlined in the notes to the financial statement. You can see it's going to be roughly about \$12 million on our debt, and then there's usually a \$5 million bullet for the Cartesian royalty.

Eric Stine
Analyst, Craig Hallum

Got it, thanks a lot.

Richard Oraziotti
Chief Financial Officer

You're welcome.

David Johnson
Chief Executive Officer

Thank you Eric.

Operator

Our next question comes from Rob Brown of Lake Street Capital Markets. Please go ahead.

Rob Brown
Analyst, Lake Street Capital Markets

Hi, good morning. Thanks for taking my call.

Just wanted to follow up on the China comments. Are you implying that maybe the HPDI product is not launching into the market right now in terms of the natural gas side, or is that still moving forward, and I guess just relative to your comments on the hydrogen, what does that mean for the natural gas product at the moment?

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David Johnson

Chief Executive Officer

Yes, so first of all, the project with respect to natural gas HPDI with our partner and with their customers, the truck OEMs, this continues to move in terms of the work that's happening on our customer's side and on their customer's side to get the validation done and be ready to launch. The comment I made was in the context that every OEM looks for that launch window, when would be the best time to go to the marketplace and launch a product, this is on the truck OEM side, and so with elevated LNG prices right now, it's easy to see it's maybe not the best time right now, so we're hopeful for a realignment in the marketplace that then creates a window for properly launching the product commercially in the marketplace, but we wait for our customers to take the decisions.

With respect to hydrogen, I think we have the same, I'll call it, dynamic, sales dynamic, with hydrogen HPDI in China that we do with hydrogen HPDI in Europe and in North America, and that is that the technology that we have at Westport Fuel Systems of HPDI, we are demonstrating now with our vehicle at ACT Expo and (inaudible 26:46) results we presented in Vienna a few weeks ago, and previously in the press release to the various results. This offer of more power, more torque, more efficiency using hydrogen and HPDI in combination gives all OEMs that are considering how to respond to the marketplace and demands for lower CO2 and clean transportation, gives all OEMs this basic vision and potential that they can adopt HPDI today with natural gas, use HPDI today with biogas, and use it in the future with hydrogen as hydrogen becomes increasingly available in the marketplace, so this really provides us longevity of a technology, this road map ahead, for decades to come that makes then the decision to adopt HPDI sooner more tenable and more interesting for our OEM customers. I think that is the key dynamic we see in all markets around the world, including China.

Rob Brown

Analyst, Lake Street Capital Markets

Okay, thank you. That's helpful.

Within the pricing environment, maybe differentiation between OEM and independent aftermarket, how much pricing ability do you have in each of those markets and how quickly can you change prices as your cost structure changes?

David Johnson

Chief Executive Officer

Yes, great question, and I think it's a different time in the marketplace than we've seen for some decades, frankly, with respect to inflation being relatively low and stable for many, many years, and now we have this high and unstable, high and growing in many markets around the world.

You're right that our aftermarket business and the ability to price is different than or OEM business. Typically, OEM business is characterized by long-term supply agreements that have some clauses in them that allow you to go back and renegotiate and pass on costs, and so each one of those contracts with OEMs is different and requires going back and talking to the OEMs and negotiating and discussing, so it takes some time and some work. We've been doing that and we've had numerous successes, but there's more that needs done because, of course, the material costs keep going up in this inflationary environment.

On the aftermarket side, frankly, we can raise prices, I would say, more easily. Recognize that on the aftermarket side, not too dissimilar from the OEM side, but it's a different equation, customers are buying those products to save money on fuel, and so the key ingredient to pay attention to is the fuel price differentials in the various markets and then the cost of the product. While we can price if material cost goes up, it makes the attractiveness of the product less in all cases, so that's our challenge.

As we see oil prices going up, as gasoline, petrol and diesel prices are going up, as Richard mentioned, relative to LPG today, that price differential is actually working in our favour. Also, in general, higher fuel prices just in general make people more sensitive and look for ways to save money on fuel, and LPG kits, as an example, are, I would say, increasingly in favour in this moment because of this rising fuel price, rising fuel price differential, and so into this environment we can price, but we have to do it market by market. As we've talked about, we have 70 markets around the world and they're all different, and not all of them are LPG markets, by the way, so that's more challenging when you talk about natural gas markets, for example.

Rob Brown

Analyst, Lake Street Capital Markets

Okay, great. Thanks for the colour. I'll turn it over.

David Johnson

Chief Executive Officer

Thanks Rob.

Operator

Our next question comes from Colin Rusch of Oppenheimer. Please go ahead.

Colin Rusch

Analyst, Oppenheimer & Co.

Thanks so much, guys. You've got a certain amount of engineering work that you have to do to get the HPDI 2.0 for hydrogen to market. Can you just give us an update on where some of the balance of system engineering and preparation is at this point?

David Johnson

Chief Executive Officer

Yes, thanks for asking, Colin. Good to speak with you this morning.

Fundamentally, the applications that we've done so far of our HPDI system to existing engines have been to apply the product that we use today for natural gas with no modifications. We expect that there will be some modifications as we develop and optimize the system for production, but we're in this phase of basically demonstrating the capability which has been really, I would say, frankly exciting for us and for our customers to see the potential to apply our fuel system off the shelf, if you will, and already achieve this on the order of 15% to 20% improvement in power and torque compared to diesel or natural gas, which in general are at parity, right. When we talk about HPDI with natural gas, it tends to be at parity with the diesel engine powering torque, whereas with hydrogen HPDI, we could actually increase by 15% to

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20%. Similarly with efficiency, we see this five percentage points, four to five percentage point improvement in brake thermal efficiency, which turns into about a 10% improvement in engine efficiency on a kind of miles per gallon or litres per hundred kilometres kind of basis, so equal type efficiency.

These are really big benefits that we're demonstrating in the lab, and now we're looking forward to demonstrating them on the road and basically handing people the keys. But fundamentally, the product development to support that so far is relatively straightforward from our perspective, but we have work to do. No OEM is going to take the HPDI system, bolt it onto their engine, and starting feeding it hydrogen and selling it to customers without the validation steps, so I think these are programs that are multi-year programs to bring hydrogen to market; but frankly, that will be plenty fast enough relative to the infrastructure development and the availability of affordable hydrogen.

Colin Rusch

Analyst, Oppenheimer & Co.

That's super helpful. Then could you just give a sense as to where things are from a labour perspective on your manufacturing side? Certainly labour has been an issue all over many geographies, but I just wanted to see where you guys are at in terms of labour inefficiency or concerns as you navigate through some of these ups and downs of the market.

David Johnson

Chief Executive Officer

Yes, I would say that, in general, we don't see ourselves having, let's say, a labour problem of any kind. We're able to access the quantity we need. Of course, there is inflationary pressure; people want, let's say, to raise their salaries and their pay in order to respond to the costs they're seeing in the marketplace, and we have to manage that, of course, but it's just another element of our cost structure.

But in terms of labour in total, we don't have an access to labour problem or a quantity of labour problem, and I would say the one thing that we are seeing is still some trailing effects of absenteeism due to people getting sick and then worrying it's COVID, or having it actually be

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COVID, so that still is a challenge for us, but I would say it's one we've been managing now for two years and not one that really affects our operations. It's just something we manage.

Colin Rusch

Analyst, Oppenheimer & Co.

Perfect, thanks so much.

Operator

Our next question comes from Amit Dayal of HC Wainwright. Please go ahead.

Amit Dayal

Analyst, HC Wainwright

Thank you, good morning David, good morning Richard.

Just on the pricing question earlier, have you started implementing some of these price increases, and by the time maybe you get through some of it, is it a 2022 time period where you can achieve most of these price increases? And any colour on how that is being executed would be helpful. Thank you.

David Johnson

Chief Executive Officer

Yes, great question. I think as mentioned earlier, it's kind of a new regime we're in, in the inflationary time. We did a bit of this last year specifically related to the chip shortage and that extra cost we were paying to find and access the materials we needed in the marketplace, and so we did make pricing changes, I'll say historically, during 2021 on some of our aftermarket products to mitigate those added costs. We're doing that now as costs continue to rise across all sorts of commodities, raw materials as well as some labour cost increases from Colin's question, so all these costs, and even right now in Europe we see it with the Russia-Ukraine war, our energy costs have almost doubled, so that's kind of a structural cost change on our OpEx side.

Fundamentally we're seeing these cost increases, we're able to pass them on to our customers; but with the OEM business it takes, I would say, more time. We can't be as quick to implement them because it means going back and sitting with our customer to negotiate the passing on of those costs. In most cases, that means we have to—I would say the typical thing for a Tier 1 supplier to sit in front of their customer and say, here are our cost increases that we have that we have passed onto you, and everyone, I would say, is very understanding of that. Of course they don't want the costs either; nobody wants a price increase, but at the end of the day we're able to justify those but it does take some time, therefore there's a lag. There's a lag between costs going up and prices going up that does put pressure on margins in the near term, and you can imagine two thirds of pricing over time, pricing in costs, how we might have on the back side of that, hopefully when prices stabilize, some benefit to our margins.

Amit Dayal

Analyst, HC Wainwright

Understood, thanks for that, David.

Then with respect to the independent aftermarket business, is the pressure primarily coming from Russia? Is there—what are the other sort of drivers that could help you recover in this segment?

David Johnson

Chief Executive Officer

Well, relative to our Q1 results, we saw a direct impact of the sanctions and therefore the tapering or the reductions in our Russian business in the aftermarket, which is good business for us typically, profitable business for us, so that was a consequence of the war started by Russia. This is the situation we face with respect to the aftermarket and the Russia-Ukraine conflict that, as far as we can tell, it looks like it's going to persist and we don't know when it might end, so that's just a special case.

With respect to the rest of the markets around the world, the operating characteristics of the marketplace really are fuel price differentials, and so I'll give a very specific example. We have had for some time a relatively depressed market in Italy, where basically our business in the aftermarket historically has been strongest in Italy, and during the COVID period with

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lockdowns and everything, it was hard for us to decide or understand exactly how much was the COVID effect and people not buying vehicles, not converting vehicles and so forth, and how much was the market dynamics that actually altered fuels. What we saw in March, actually, was a steep uptick in our business. Basically, with the outbreak of war in Russia-Ukraine, fuel prices really went up dramatically and the price differential between petrol and LPG got much larger, so there was this huge benefit in moving to LPG and we saw a bit uptick in our sales and deliveries in the month of March.

Unfortunately, I would tell you the government came in, in the month of April and offered some incentives, some free gas cards. I'm not sure what the mechanism that they used exactly was in Italy, but we've been doing this around the world, where we're helping the population by giving money back from the government to ease the pain at the pumps, and when they did this, it had a differential effect, more savings, more help with respect to petrol prices than LPG prices, so we've seen some tapering down of that good demand cycle we saw in March.

This is just an example, and it really depends market by market around the world, and we're managing all those and doing the best we can in these turbulent times.

Amit Dayal

Analyst, HC Wainwright

Understandable, David.

With respect to China, could you give us any sense of what your overheads are in terms of just maintaining status quo at this point for that effort?

David Johnson

Chief Executive Officer

Yes, this isn't a lot of effort on our part. Basically, we support our customer through regular dialogue and answering technical questions as they come up, but frankly it's not so much work on our part. We're not spending a lot of money on it.

I would say the biggest impact to our business is the absence of the volume which we planned on, right, so we expected volume from our businesses in China already, of course like you did, like we've been discussing for some years, and the absence of this volume means that we're

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not able to access the economies of scale that we wanted to have, therefore our profitability is still challenged. This is, I would say, the big effect of our business in China being in the state it is right now, but in terms of actual day-to-day work and spending and R&D and costs, there's very, very little.

Amit Dayal

Analyst, HC Wainwright

Okay, all right. That's all I had, David. My other questions were already discussed. Thank you so much.

David Johnson

Chief Executive Officer

Perfect, thanks Amit.

Operator

Our next question comes from Mac Whale of Cormark Securities. Please go ahead.

Mac Whale

Analyst, Cormark Securities

Hi David. I think I just missed the answer to one of the earlier questions about expectations for volume sales in OEM heavy duty HPDI with Volvo in Europe. Did you say 16% was the year-over-year increase in volume?

David Johnson

Chief Executive Officer

Yes, it was 16% in Q1 of 2022 versus 2021, Q1 2021.

Mac Whale

Analyst, Cormark Securities

What would have been—like, entering into the quarter, what was sort of the expectation of growth?

David Johnson

Chief Executive Officer

Well, we've seen over a long period of time since we launched in 2018 nearly a doubling, kind of, year-over-year of the volume, so it's been in some cases larger than that, in some cases smaller than that, but kind of year-over-year over a long period of time it doubled, so our expectations are very—we have big expectations for the product in Europe. We think it's really important in the marketplace. We think it's very well received. We can see the testimonials from customers, and frankly, it's hard to understand exactly how the higher LNG prices in this moment are affecting sales, because sometimes sales are booked and then the trucks come later, so it's tough to tell in this moment what the rest of the year will be. Of course, if LNG prices decline or diesel keeps going up and the price differential gets re-established in a favourable way, that will propel sales. There's CO2 regulations that come into play in 2025 that OEMs need to meet, and then 2030, so there's really a lot going on and it's hard to, even for us and our customer on the inside, to figure out all the factors and forecast where it's going, so hence no forecast for the market. Sorry for that.

Mac Whale

Analyst, Cormark Securities

Let's suppose the various regulations, they don't move. Is there a—as the shipments are low, how do you expect the next few years to play out in terms of catching up to where they need to be? Is there enough slack capacity where you would see much greater than doubling in order to catch up by mid-decade? How would it play out, do you think?

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David Johnson

Chief Executive Officer

Yes, the way I view it is that we have a really good future in Europe specifically with our launch partner, and we expect other companies and customers to come along and join in, because the CO2 standards have moved through all of COVID, through chip supplies, through now war. None of these things are deterring the European Union from their goals with respect to de-carbonizing transport, specifically heavy transport, and we see our product in the marketplace proving itself as very effective at de-carbonizing and providing all of the fundamental transportation capabilities that a fleet or a truck driver expects from their truck.

In terms of scale and where it could go, we have the capacity installed and we're ready to scale up significantly, and so does our customer because basically for them, all it means is instead of grabbing a diesel tank and putting it on the truck, they grab an LNG tank and put it on the truck. Same thing with the injectors; instead of grabbing a set of six diesel injectors, they grab a set of six HPDI injectors, so for them this is kind of normal production. They have their full production capacity available. There might be some constraints along the way as they break bottlenecks to actually change the mix, but these are relatively easy for them to overcome.

The capacity is there, and the requirement fundamentally doesn't come into play until 2025. That's when OEMs, if they don't meet the 15% reduction requirement from the baseline established two and a half years ago, that's when they'll have to start paying penalties, at which point in time they'll make the decision about whether they prefer to pay penalties, or would they prefer to incentivize and otherwise help the sales of a product that reduces CO2, like HPDI does.

Mac Whale

Analyst, Cormark Securities

Given that the customers are so focused on total cost of ownership and that the pricing for the fuel is volatile, and you have this additional cost coming on through regulation, is there any exploration of different pricing regimes where, say for instance, you capture some of the potential given the fact that your technology is helping them to be very efficient with meeting the lower carbon? In other words, as pricing differentials increase, that you could over time capture some of that, so that the save—because the customer really only cares about PCO and

you're giving them some stability and you're sort of taking a little bit of, you have to wait, so to speak, to get paid, but you don't have to really give up the price of your product, is there any ability to do that, think of new ways or better or—you know, to capture some of that volatility, or it is impossible?

David Johnson

Chief Executive Officer

I think—no, no, I don't think it's impossible, but I do think it's challenging, I would say especially for us, perhaps easier for OEMs, to make this kind of transaction, if you will, with their customers. If you look at, for example, what Nikola is proposing to do with their trucks, where they're saying, hey, we're going to put the fueling infrastructure in place and here's these trucks and voila, you have a business model in which we can share in the fuel efficiency benefits or some savings. I think the same thing could be constructed on the OEM side for HPDI trucks, but really it's on the OEM side, it's not something that—you know, we're not as Westport Fuel Systems selling to fleets a product. We sell our product to OEMs, who then sell trucks to fleets.

But the basic idea that you raised is very interesting, I believe.

Mac Whale

Analyst, Cormark Securities

Okay, that's all my questions. Thanks guys.

David Johnson

Chief Executive Officer

Thanks Mac.

Operator

Once again, if you have a question, please press star then one.

Our next question comes from Jeff Osborne of Cowen & Co. Please go ahead.

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Jeff Osborne

Analyst, Cowen & Co.

Good morning. Quite a bit's been discussed already, but a couple of housekeeping questions and clarifications.

One, Richard, I was wondering can you just, maybe for all of last year, disclose what percent of revenue is euro-denominated, just as we think about FX changes and the impact to you folks?

Richard Oraziotti

Chief Financial Officer

I want to say it's close to, like, 85%, so it's a significant portion.

Jeff Osborne

Analyst, Cowen & Co.

Okay, got it. That's helpful.

Then I wanted to dig into the LPG comments. You talked a lot about in the Q&A on the LNG side, but I thought you had said that the differential between gasoline and LPG is improving in some markets, so I just wanted to clarify, A, if that's right; and then B, if you could talk about which countries that is, and then maybe as a second derivative, what the impact of those differentials are to your tank business, which was, give or take, 10% of revenue this quarter.

David Johnson

Chief Executive Officer

Yes, thanks for the question, Jeff.

Fundamentally it is different market by market, and I don't have the laundry list in front of me, but as an example, in Italy we saw these price differentials very favourably, moving in a favourable direction in the Netherlands, in Germany, in Poland, Turkey, so I would say our typical markets in Europe where we saw it moving in the right direction as basically gasoline and diesel prices went up quite significantly and LPG prices didn't move up so significantly. They did go up some, but not nearly as much as LPG—excuse me, as petrol and diesel.

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This was where we've seen this benefit, but it's a modest benefit. It's in the right direction and helps us, but it doesn't overcome some of the challenges we've seen with respect to CNGS, as an example. CNG prices are some of the highest fuel prices in Europe right now, and so on the passenger vehicle side we've seen significant pullback in our CNG business in various markets.

Jeff Osborne

Analyst, Cowen & Co.

Got it, that's helpful David.

Maybe just a last one from me is you touched on the demand side in China and potential shift to hydrogen. I was curious on the supply side, are you having any issues with your manufacturing partners on availability of fuel injector technology or any other adjacent equipment you need or produce yourselves through third parties?

David Johnson

Chief Executive Officer

No, I would say no specific issues. I would tell you in general that we're kind of—embracing is the wrong word, but we have big anxiety around, okay, so when does the COVID lockdown in Shanghai and Beijing actually going to affect us tomorrow and the next day, and so we're doing what we can, working with suppliers to try and make sure that our supply chain is continuing to move. But fundamentally we haven't—I don't have a specific issue to call out that says this hurt us by X in Q1 or is about to hurt us in Q2.

Jeff Osborne

Analyst, Cowen & Co.

Got it, that's helpful. That's all I had. Look forward to seeing you later this week at the ACT show.

David Johnson

Chief Executive Officer

Sounds great, thanks Jeff.

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Operator

This concludes the question-and-answer session. I would like to turn the conference back over to Mr. Johnson for any closing remarks.

David Johnson

Chief Executive Officer

Yes, thanks everyone. Thanks for your time today. Appreciate your questions and tuning in for the call.

We are—you know, it's a challenging time for sure in the marketplace, but I think fundamentally we have great products, we have a great presence around the world. I think the diversity of our markets that we serve, so the fact that CNG markets are down but LPG markets are up, hopefully—Russia is down but hopefully it can be up in other markets, and fundamentally the key ingredient here is that we continue to build with respect to HPDI and I can't be clear enough about how we see the HPDI hydrogen opportunity affecting our business in the mid- to long term as we unveil this technology and demonstrate it around North America and later this year in Europe. That's a really exciting part of our business, and we're looking forward to the chance to speak with you more about that in the coming days. We have some investor conferences coming up, the RBC Auto Conference in Toronto, the HC Wainwright conference in Miami, and looking forward to seeing you there and speaking more about this.

Thanks for your time, and have a good day.

Operator

This concludes today's conference call. You may disconnect your lines. Thank you for participating, and have a pleasant day.