

Conference Call Transcript

Second Quarter 2022 Results: August 9th, 2022

Operator

Welcome to the Westport Fuel Systems' Second Quarter 2022 Results Conference Call.

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

I would now like to turn the conference over to Ashley Nuell, Senior Director of Investor Relations.

Please go ahead.

Ashley Nuell speaking

Senior Director of Investor Relations

Good morning, everyone. Welcome to Westport Fuel Systems' Second Quarter 2022 Conference Call, which is being held to coincide with the press release containing Westport Fuel Systems' financial results that were distributed yesterday.

On today's call, speaking on behalf of Westport Fuel Systems, is Chief Executive Officer David Johnson and Chief Financial Officer Richard Oraziotti.

Attendance on this call is open to the public, 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, and, as such, forward-looking statements are made based on our current expectations and involve certain risks and uncertainties.

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

David Johnson speaking

Chief Executive Officer

Thanks, Ashley.

Good morning, everyone. I'm pleased to be with you today to discuss our second quarter.

Once again, our team delivered strong top-line results as we continued to execute against our strategy amid a very challenging macro-economic environment.

Today, I'll be walking you through our HPDI growth story, including the regulatory environment and total cost of ownership analysis, which demonstrates that HPDI is the most affordable way and the most available way to reduce CO2 and meet CO2 standards. I'll also discuss our LPG business for both our light-duty OEM and independent aftermarket channels where we're seeing improvements because of the increased price advantage of LPG compared to petrol. Finally, I'll walk you through our Indian business where we're seeing growth today and expecting this growth to continue, as CNG fuel station build-out continues towards 10,000 stations. Following that, I'll pass it over to Richard to cover the financials.

Our business continues to deliver strong results quarter over quarter, despite the ongoing challenges our industry is facing.

In the second quarter, we delivered revenues slightly up compared to Q2 last year, an achievement considering the combined impact of adverse foreign exchange rates and sanctions stemming from the Russia/Ukraine conflict, which combined to negatively impact the quarter by \$13 million. Excluding these impacts, revenue would have increased by 16%. This is truly a testament to the strong results driven by our business units where we saw increasing sales. That is in India, as well as in our hydrogen and electronics businesses, plus the addition of the fuel storage business we acquired in late May 2021.

Although not a second quarter item, I want to take a moment to highlight the significant new business we announced last month to supply LPG fuel systems to a leading OEM. This deal is forecast to generate €38 million in revenue through the end of 2025, with production expected to begin in Q4 next year. Cost-competitive alternative fuel solutions such as LPG are a compelling option to reduce greenhouse gas emissions in markets like Europe where refuelling infrastructure is well established. We're also developing fuel systems to respond to future

Conference Call Transcript

Second Quarter 2022 Results Conference Call:

August 9, 2022

regulations, including the proposed Euro 7 standards, and we look forward to updating the market on these developments.

This new business highlights our industry position as a leading tier-one supplier of alternative fuel systems that respond to current and future emission standards and to customers' needs for affordable transportation. This new business we've secured is a key step in our plan to grow to profitability.

In May at the ACT Expo in Long Beach, California, we unveiled our hydrogen HPDI fuel system for internal combustion engines for heavy-duty applications, and we did so in the form of a fully functioning heavy-duty demonstration vehicle. There was dramatic interest from all the different players in our ecosystems; OEMs, fleets, fuel providers, and more. Increasingly, hydrogen is viewed as the zero carbon fuel we need for our industry, and we're helping the industry to understand that ICE engines with HPDI will play a critical role in transforming from fossil fuels to clean and renewable fuels, because HPDI is such an effective and affordable path to follow.

Fundamentally, the outlook remains positive for our business as we continue to deliver solid results, despite the various headwinds we and our industry are facing.

In our heavy-duty OEM segment, despite a challenging LNG pricing environment, our European HPDI launch partner is continuing to gain market share over competitors that offers spark-ignited natural gas engines. We're seeing the market appreciating and valuing HPDI's superior performance and efficiency, and, as a result, we continue to see order flow for HPDI systems, despite headwinds from higher LNG fuel prices relative to diesel.

HPDI volumes will be a significant driver to bring Westport to profitability, as increased volumes drive economies of scale, and we're in a good position now for HPDI growth. The 2025 European CO2 regulations will drive OEMs to act to decarbonize. European OEMs need to meet regulations that require a 15% reduction in fleet-average CO2 with products that don't adversely impact the performance and reliability their customers demand. HPDI is the solution.

A key reason HPDI is gaining the marketplace comes down to superior fuel efficiency. In a recently-published road test, HPDI enabled fuel savings of more than 25% when compared to other natural gas engines. Twenty-five percent is a massive number in this industry. In the lifetime of a typical truck, about \$700,000 worth of fuel is consumed, so a 25% savings means \$175,000 in lifetime savings; a very positive business case and why HPDI has continued to prove its economic and environmental benefits every day on the road in thousands of vehicles

Conference Call Transcript

Second Quarter 2022 Results Conference Call:
August 9, 2022

in Europe. HPDI, especially when using biogas, will be an important part of the solution, made even more compelling when the fuel price advantage of LNG versus diesel is re-established.

Looking to the wider policy climate, we continue to see a positive trend that supports our heavy-duty business outlook. The Ukraine crisis has spurred a commitment to reduce a reliance on Russian gas, resulting in additional biogas production demands in the EU, which is a huge positive for our sector. We're already seeing examples of this.

In June, Scandinavian Biogas announced a \$269 million bio LNG delivery agreement, and in Italy, Biomet announced receiving a \$75 million investment to create Europe's largest plant for producing biomethane from waste.

While it's unlikely that any single low-carbon energy source can replace Russian gas, especially as the EU seeks to reduce reliance on fossil fuels and imported energy, the wider adoption of biogas and more investments into net zero fuels creates further growth opportunities and new markets for our clean affordable products.

To summarize, our heavy-duty business remains strong in the face of industry-wide headwinds. There is growing recognition and appeal of our HPDI systems because of its low cost, clear performance advantages over spark-ignited engines, and carbon reductions that fleet operators are looking for and which OEMs require to respond to regulations.

Hydrogen HPDI is going to play a pivotal role in the future of Westport, and we've demonstrated this through both analysis and engine testing, and now with our demonstration vehicles, that HPDI works great with hydrogen. Unsurprisingly, we saw considerable interest in our hydrogen HPDI solutions at the ACT Expo in May, and our work with Scania continues this summer with their newest 13-metre, state-of-the-art engine in our test facility in Vancouver.

Hydrogen HPDI is compelling, with near zero greenhouse gas emissions, lower vehicle costs, and low industrialization costs as compared to fuel cells or battery electric vehicles, particularly for heavy-duty, long-haul trucking applications. We've demonstrated that power, torque, and efficiency using hydrogen HPDI is significantly better than the same engine running on diesel fuel. These demonstrations are changing the conversation right now.

To be clear, OEMs can now see that HPDI has a long and bright future because it's successful on natural gas and biogas today and is the most economic way to use hydrogen in the future. Driving our conversations with both current and future OEM customers regarding our hydrogen

Conference Call Transcript

Second Quarter 2022 Results Conference Call:
August 9, 2022

HPDI solutions is the potential to bring the product to market sooner through the straightforward application of existing HPDI componentry. The opportunity to continue using OEM's existing engine development capabilities and manufacturing capabilities, avoiding large investments required to develop and industrialize other technologies, is very appealing. It makes good economic sense, good business sense, and is a real solution for the industry. Combining better economics with better performance is driving significant interest in our unique product offering.

Hydrogen continues to gain significant traction and attention globally. The European Union has set a 2050 deadline to achieve its goal of becoming carbon neutral, and hydrogen fuel in the heavy-duty vehicle sector will play a substantial role in their decarbonization strategy. Following our success at the ACT Expo, we'll introduce hydrogen HPDI technology for the first time in Europe at the IAA Transportation Conference in Hannover, Germany, in mid-September, and we're thrilled to continue to demonstrate to the global industry that our HPDI technology works brilliantly with zero carbon hydrogen, and enables the most affordable way to use green hydrogen in long-haul, heavy-duty transportation applications and other important high-load applications. We're enabling HPDI's use by OEMs and fleets to long-haul trucking with natural gas and biogas and with a clear path to zero carbon hydrogen. HPDI is the solution of the future that OEMs can access today.

Just last week, on August 4, we hit another milestone; the Westport hydrogen HPDI truck pulling Raley's Ozark trailer fuelled with hydrogen for the first time in America at the West Sacramento station, the first hydrogen station in the world.

Turning our attention to China, in light of LNG pricing that continues to negatively impact the market in China, Weichai has continued to work with HPDI so they'll be poised to launch as market fundamentals return. Discussions continue with potential Chinese partners, specifically around hydrogen HPDI. China now ranks first in the world for the number of hydrogen refuelling stations with more than 250, accounting for about 40% of the global total. The China Hydrogen Alliance forecast that demand for hydrogen will reach 35 million tonnes by 2030, with continued robust growth for decades to come.

Light-duty vehicles fuelled by LPG are a growing market trend that positively impacts our business through both our aftermarket and OEM channels. High fuel costs create opportunities for our business, as both industry operators and end customers look for lower-cost options; lower cost to acquire and lower cost to operate. Alternative fuels are part of the answer. What's happening currently with the price of LPG is a good example. For LPG, there's a clear price

Conference Call Transcript

Second Quarter 2022 Results Conference Call:

August 9, 2022

advantage that is growing part of our story. Fuel prices change; then customers react. It's in these price advantage environments where we gain market share and ultimately drive profitability.

In important markets like Türkiye, Italy, and Poland, LPG is available and the price advantage over petrol has recently been increasing.

In Italy, for example, historically, the price advantage of LPG was about \$0.60, rising to over \$0.80 more recently, comparing petrol price per litre with LPG price per petrol litre equivalent. Drivers who drive on LPG are saving roughly €50 every time they refuel their car. I'll say that again. Drivers who drive on LPG are saving roughly €50 every time they refuel their car. In addition to the pricing advantage, LPG refuelling infrastructure in Europe is widespread, supporting further growth of the market itself.

Our business in India continues to grow and has become a case study for the type of market where we can be competitive, and, as a result, gain market share with our clean affordable solutions. Our revenues in India continue to grow, up more than 50% to \$10 million this quarter. The market in India is transforming from a diesel/petrol market to CNG where we continue to see a price advantage. Natural gas-fuelled vehicles are taking the place of diesel in a real way, and now represent more than 11% of sales for passenger cars and about 29% of commercial vehicles, and we're seeing strong demand for our products from three-wheelers and taxis, as well as heavy-duty trucks. India aims to have natural gas make up 19% of their overall energy mix in the coming years, alongside plans to build 10,000 natural gas refuelling stations, which are expected to be installed by 2028.

India's poised to play a significant role in the growing hydrogen economy, as well. In June, Adani New Industries, one of India's largest energy companies, announced a \$50 billion investment to develop green hydrogen ecosystem, representing India's largest commitment to green hydrogen from an individual company to date.

In summary, industry represents a growth market for us, supported by strong fuel price advantage, a supportive policy backdrop, and a growing hydrogen economy. No question, we continue to face headwinds now, but we also have substantial tailwinds; emissions regulations, government actions, societal demands, economic, and great products that respond to the call to action right now. We remain well positioned as a company. We have the right products for today and for the future. China, the world's top LNG buyer last year, is in the midst of the largest build-

out the industry has ever witnessed. Ten new LNG import terminals are slated to come online in 2023 alone, and capacity will roughly double in the five years through 2025.

In Europe, we're just two-and-a-half years out from the 2025 regulations, with penalties being implemented, and I can tell you from discussions we're having with global OEMs around HPDI that light bulbs are going off, as the cost of goods against an overall capability and reliability concerns of the newer technologies are being laid bare.

The European Union has re-launched REPowerEU in the face of its energy challenges. REPowerEU's plans call for rapidly-increased imports of LNG replacing imported pipeline gas from Russia, the utilization of the significant untapped biomethane resource in Europe, and also green hydrogen production, all of which will require significant prioritization and build-out infrastructure. There's also been the quadrupling of the hydrogen targets originally set out in the Fit for 55 legislation. The ambition was five million tonnes, and now with REPowerEU plan, they target 20 million tonnes by 2030. This represents a significant growth opportunity for our Company. All of this indicates increased interest in hydrogen HPDI as a game-changer for heavy-duty transport.

With that, I'd like to turn it over to Richard to go through our financials.

Richard Oraziotti speaking

Chief Financial Officer

Good morning, and thank you, David.

Revenue for the second quarter of 2022 of \$80 million was slightly up from the prior-year quarter, despite the challenging headwinds from volatile fuel prices, inflationary pressures and production input costs, continued supply chain challenges plaguing the automotive industry, and the negative impact from the Russia/Ukraine conflict on our sales volumes to the Russian market. Further, the weakening of the Euro against the U.S. Dollar during the quarter has had a significant impact on the translation of our financial results due to our large Euro exposure. As David mentioned, the combined impact from the Russia/Ukraine conflict and the 13% decrease of the Euro against the U.S. Dollar negatively impacted revenue this quarter by about \$13 million. Despite what feels like a long list of headwinds, we are proud of the work that our team accomplished this quarter in our business units.

Conference Call Transcript

Second Quarter 2022 Results Conference Call:

August 9, 2022

Our OEM business continued to grow, primarily driven by the addition of our fuel storage business acquired in June 2021, but as well as modest growth in our hydrogen and electronics businesses and increased sales of our light-duty OEM products in the Indian market.

Offsetting the growth in OEM revenue, our independent aftermarket revenue was lower year over year due to reduced sales volumes, primarily a result of the impact of sanctions from the Russia/Ukraine conflict.

Net loss was \$11.6 million for the second quarter of 2022 compared to a net income of \$17.2 million for the same prior-year period. As a reminder, the second quarter 2021 included two significant one-time items that bolstered earnings; namely the recognition of a \$5.9 million bargain purchase gain related to the acquisition of the fuel storage business, and an \$8.9 million tax recovery recognized for a COVID-19 tax release ruling from the Government of Italy. Besides these non-recurring items, the decrease in earnings was driven by lower year-over-year gross margins of \$5.2 million and the loss of equity income from the termination and sale of the CWI joint venture.

Adjusted EBITDA was negative \$4.3 million compared to positive \$6.2 million in the same prior-year period. The \$10.5 million decrease was mainly due to the loss of equity income from CWI and the lower gross margin, partially offset by decreased operating expenses.

We are experiencing gross margin pressure due to higher material costs from the global supply chain shortage, general price inflation in our production input costs, and lower sales volumes related to the Russia/Ukraine conflict, and also, we are seeing pressure from volatile CNG and LNG prices, particularly in Western Europe on our sales volumes.

Turning to our business segments.

OEM revenue for the second quarter of 2022 was \$54.3 million, up 15% compared to the prior-year quarter. The operating loss from OEM was \$5.6 million, up from a loss of \$3.4 million for the prior year. The increase in revenue was primarily driven by the additional revenues of \$5.1 million from our fuel storage business.

We also saw increased light-duty OEM business sales volumes, specifically in India, as well as increased sales volumes in our electronics and hydrogen businesses. This was partially offset due to lower sales volumes to our European OEM customers caused by higher CNG fuel prices.

Conference Call Transcript

Second Quarter 2022 Results Conference Call:

August 9, 2022

Our hydrogen components business continues to grow, with Europe, China, and North America being our primary markets. Our existing GFI branded hydrogen business supplying components to Plug Power, Ballard, and others have seen average annual revenue growth of 50% over the last three years.

In our electronics business, we are seeing volume growth from a key customer and supported by overall demand increase across the business unit.

Turning to heavy-duty OEM, our sales volume to our European OEM launch partner decreased slightly compared to the same prior-year period, but remains in line with year-to-date volumes from last year. The decrease in the quarter was a direct result of the softness in demand caused by unfavourable fuel price differential between LNG and diesel in many Western European markets. Higher LNG prices are causing a significant challenge to the demand for LNG trucks, which is expected to temper our expected volume growth to our OEM launch partner through 2022 and until relative LNG prices return to a more favourable equilibrium.

Gross margin was \$4.7 million, or 9% of revenues for the quarter, compared to \$7.2 million, or 15% of revenues in the prior year. We saw a decrease in gross margin in our light-duty OEM businesses due to lower sales volumes to our European OEM customers caused by the higher CNG fuel prices, which was partially offset by higher sales growth to emerging markets with lower gross margins. Gross margin in our heavy-duty OEM business decreased year over year due to lower comparative sales volumes, a contracted annual price discount to our OEM launch partner in the first quarter of 2022, and higher material and warranty costs.

Further, we continue to incur higher production input costs from supply chain challenges, and inflation and logistics, utilities, and other costs, which we have only partially been able to pass on to our OEM customers. Partially offsetting these pressures, gross margin increased by 1.1% from our fuel storage business.

R&D expenses for the second quarter were \$4.1 million, which were lower year over year due to foreign exchange. Our heavy-duty OEM R&D activities continue to focus on the development of next-generation HPDI fuel system technology and demonstrations with potential OEM customers on our HPDI fuel systems' hydrogen and natural gas applications. Our light-duty OEM research and development is focused on development of new LPG systems in line for installations for potential OEM customers.

Conference Call Transcript

Second Quarter 2022 Results Conference Call:

August 9, 2022

Now, turning to independent aftermarket, our business continues to face significant challenges from reduced sales volumes in Eastern Europe due to the ongoing Russia/Ukraine conflict and volatile fuel prices. Revenue for the second quarter was \$25.7 million, down 19% compared to the prior-year period. Aside from the impact of Russian sanctions, sales volumes were lower to key markets of Türkiye and Argentina. Softness in the Argentine market was specifically due to higher CNG prices, which have been a recent challenge for our CNG products due to the volatile fuel price. Further, the aforementioned foreign exchange impact of the weakening Euro had a significant impact on the comparative performance.

Gross margin was \$5.8 million, or 23% of revenues for the quarter, down \$2.7 million compared with the same prior-year period. The decrease in gross margin and gross margin percentage was attributable to lower sales volumes and increased material costs from the global supply chain shortages and inflation.

On a positive note, the LPG price differential to gasoline is improving, which is providing some support for increased sales demand, which we are seeing signals in some of our key markets like Argentina, Italy, Poland, and Türkiye. With this positive tailwind and other countermeasures to mitigate the impact of inflation and improve productivity, we are taking the necessary steps now to improve profitability in our aftermarket business.

Finally, I'd like to touch on liquidity.

Our cash position decreased by \$29.4 million during the second quarter to \$98.2 million.

Our net cash flows used in operating activities were \$16.5 million in the second quarter of 2022, an increase of \$7.8 million compared to the same prior-year period, primarily driven by an increase in operating working capital, specifically a build-up of accounts receivable and inventory. We've built up inventory to manage against supply chain risk, along with shortages of raw materials and components. Further, our inventory levels increased due to lower-than-expected sales volumes from Russia and other markets, and our growing electronics business, which we are taking actions to monetize the existing inventory and optimize our inventory levels.

Our net cash used from investing activities in the quarter was \$3.5 million, primarily driven by capital investments in HPDI. Net cash flows used in financing activities were \$8.5 million for the second 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.

We remain focused on our allocation of capital and resources and executing our strategic and operating plans, and, as such, are focused on improving profitability and liquidity. We have also seen continued pressure on gross margin, a trend we are working to reverse. Currently, we are working with our customers in both OEM and independent aftermarket businesses to implement price increases, and also taking productivity countermeasures to manage our profitability going forward.

As the negative macro-economic and uncertain geopolitical 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. We are also optimistic about a return to improved profitability of our independent aftermarket business from the current tailwind of favourable LPG prices.

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

David Johnson speaking

Chief Executive Officer

Thank you, Richard.

Before we open up the call for questions, I want to close on a few key points.

Westport Fuel Systems delivers market-ready transportation solutions that reduce emissions and save money, lower cost to OEMs to bring to market, and lower cost vehicles for feedstock rate. We remain encouraged by the outlook for our business, and here are just three reasons why: our HPDI story, performance, efficiency, low cost, and even better with hydrogen; second, the growth of our LPG business; and third, the growth we're seeing and we expect to see in our business in India.

As a supplier of advanced fuel delivery components and systems for clean, low-carbon fuels, I'm confident in our ability to capture the additional market opportunities we have in front of us. All these factors give us optimism in our ability to meet the needs of our customers and advance towards our financial objectives.

With that, I'll turn it over to the Operator to open the call for questions.

Operator

Thank you. The first question is from Colin Rusch with Oppenheimer. Please go ahead.

Colin Rusch – Analyst, Oppenheimer and Company

Thanks so much, guys.

Now, could you talk about what you're seeing right now in terms of the ecosystem developing to support the ramp of hydrogen with HPDI? Certainly, there's a lot of action, now, particularly in the U.S., but certainly in Europe, as well, around some of the fuelling and supply chain elements that are going to be required to support that ramp.

David Johnson speaking

Chief Executive Officer

Yes, good morning, Colin.

Good question on hydrogen. I would say it's a very exciting time in the history, and developments around the world, primarily driven by a combination of government and industry action, are taking different approaches in different details, of course, but fundamentally, what we see, and I think the Russia/Ukraine crisis has really crystallized this in Europe, is that there's like a renewed energy or an increased energy around taking those actions and making those investments, whether it's investments in building out the capability to produce and make available green hydrogen, or incentives in the marketplace to—for all elements of the ecosystem. I think this is a really important development.

What we saw at ACT Expo in May was that there's a preponderance of—or even a majority of the offerings out there are fuel cell based, and ourselves and Cummins were at the show with internal combustion alternatives, and this, I think, is really what's new, is kind of the recognition

by the existing and mature industry that hydrogen is coming as a fuel, that it's going to be the fuel of the future, and it will have a place in the industry, and, therefore, we need to get ready and now searching for what are those best ideas, best technologies, most practical and realistic to respond to the availability of hydrogen fuel in the future and the need to use that to decarbonize transportation, so I really see this kind of as a really formative time in our industry, and actors like the Hydrogen Council, collaboration of industry and government, all the different players in ecosystem really having an important effect on capitalizing towards action of both generation of hydrogen, distribution of hydrogen, and use modes of hydrogen, and where we see HPDI playing is being this very practical and affordable way to use hydrogen very effectively for long-haul, heavy-duty transportation.

In addition to showing our demonstration vehicle, as we did at ACT Expo in Long Beach in May and then just last week in Sacramento, and then in September at the IAA in Hanover, we're demonstrating this capability in dyno (phonetic 30:46) cells with customer engines, and there's, I would say, a tremendous amount of increasing momentum to accept and understand this potential to use the existing internal combustion engine infrastructure; existing plants, existing vehicles, all the existing infrastructure can be reused with HPDI and deliver a very effective product that uses green hydrogen in the future, and therefore, has a huge impact on decarbonization in a very affordable way. So we think this is really important for Westport Fuel Systems and really promising for our industry.

Colin Rusch – Analyst, Oppenheimer and Company

That's super helpful, and then just in a more practical way, given what we've seen in terms of raw material movement, and (inaudible 32:08) baskets and other elements recently, I'm just curious how quickly that might start flowing through some of your cost structure, and what you're doing to kind of attend to that and start working down some of the component costs.

David Johnson speaking

Chief Executive Officer

Yes, so I think as a general premise in our industry right now, not specifically to HPDI, but just thinking about the industry, we have—in the world, we have this huge inflationary pressure around the world, and so we're seeing that the key aspect for us is to manage our pricing in real time with the cost increases. This is super challenging. In the OEM business, for example, basically, our customers are, let's say, open, begrudgingly, of course, to price increases to reflect the inflationary cost pressures that we're seeing and they're seeing, but it's a process whereby the costs go up and then you ask for the price increase, and we're successful in getting those price increases, but it's after the fact, not before the fact.

That's different from our aftermarket business, where basically the price goes on to a consumer, and the consumer is willing to pay that price if they can make it back up with fuel price savings, and this is where we're very pleased about the movement we've seen in the price advantage of LPG versus gasoline and diesel, because that allows customers to pay back the cost of acquiring the hardware to put on their vehicles, and allows us, therefore, to recover the cost increases we're seeing on our aftermarket products with increased product pricing there, so yes, in general, the key element is being able to pass those cost increases that we're seeing on to our customers.

Then fundamentally, with our HPDI business, probably the more important aspect is getting the volume up so we can access economies of scale, bringing the cost down and increasing our margins, and that is a path we're on, but not yet got to the point where we can declare that we've got to those appropriate margins for that product. It's still at relatively low volumes in total and needs more growth before we can get to a profitable standpoint.

Colin Rusch – Analyst, Oppenheimer and Company

Perfect. Thanks, so much, guys.

David Johnson speaking

Chief Executive Officer

Thank you, Colin.

Operator

The next question is from Eric Stine with Craig-Hallum Capital Markets. Please go ahead.

Eric Stine – Analyst, Craig-Hallum Capital Markets

Hi, David. Hi, Richard.

David Johnson speaking

Chief Executive Officer

Hi there.

Eric Stine – Analyst, Craig-Hallum Capital Markets

Hi, so you just mentioned some of the market developments. As we think about hydrogen HPDI, I know we've got the introduction of the demo unit in Europe here in mid-September, but as you think about the next—I guess, for the remainder of 2022 and into 2023, without naming specifics, I know you can't do that, but just maybe some signposts that we should look for or expectations that you would have that say that you are on the right track here and in a timely fashion.

David Johnson speaking

Chief Executive Officer

I think there can be any number of developments that could get announced in the future, Eric, but obviously, I can't forecast those or promise those, but fundamentally, the business with respect to hydrogen is one that we've found, so far, people are willing to talk about a bit more than perhaps our natural gas developments, as an example, so I could expect that, and we're looking forward to the chance to show that.

For us right now, what's wonderful is this demonstration truck that we do have, because, basically, you can hand the keys to customers and government officials and other people that need to understand what the potential is of hydrogen HPDI, and we can do that by showing the capability of the truck to pull a load, to drive just like trucks that they're used to, and in all of my experience in the industry through the years, there's nothing better than handing someone the keys to a vehicle and saying, try this out, see what you think, and so that's what we're doing now. It's what we did this past week in Sacramento.

I think it really makes a big difference in the psychology of approaching what is essentially new technology, right; new technology of the industry to think, hey, we can run hydrogen through the internal combustion engine and have not just a viable product, but a great product. We're demonstrating more power, more torque, and more efficiency with hydrogen HPDI than you get with the base diesel engine that we apply it to, so really a great, great offering, and we're looking forward to the chance that, one by one, we'll be able to make more announcements that will help the investor community understand the progress we're making.

Eric Stine – Analyst, Craig-Hallum Capital Markets

Right. No, absolutely, and the—maybe a follow-up on that, I mean, do you feel like acknowledging, yes, this is the OEM world. It still takes quite a bit of time, but if you compare this to LNG, I mean, the fact that you now have Volvo in Europe, you've got trucks in the market, the market knows HPDI, I mean do you think that potentially hydrogen moves faster in its development, or do you expect kind of a similar—how it plays out similar to LNG?

David Johnson speaking

Chief Executive Officer

Well, first of all, for sure, I expect that, from our side as a fuel system provider, we can move faster with hydrogen than look at a history of HPDI with natural gas, just because we're taking existing components and system know-how and applying it to just basically connecting and using hydrogen as natural gas, so that development path looks quicker to us. It certainly looks quicker to us than the full industrialization of a fuel cell path, for example, where they've got to go build plants. The componentry we're using comes off of standing lines as the componentry for our natural gas solutions, and so that seems faster.

I would say also that, fundamentally, the economics are in the favour of HPDI with respect to the efficiency the engine delivers and the cost of the componentry versus the change that has to be made in the vehicle to adopt other technologies, so I think, yes, that can move faster, but perhaps most importantly, this view that we're helping our OEM customers and customer prospects understand that HPDI is a long-term solution to achieving low-carbon, long-haul, heavy-duty transport; that because hydrogen is a long-term solution with HPDI and you can use natural gas and biogas today, there is a path forward that says you can act today with natural gas and access the hundreds of stations in Europe, the thousands of stations in China, the thousand-plus, almost 2,000, stations in the U.S., there's this ability to use HPDI today and have a path forward with hydrogen, and that adds to the potential for an accelerant of our business, pulled by hydrogen in the future, but grounded in natural gas and biogas today.

Eric Stine – Analyst, Craig-Hallum Capital Markets

Yes. Understood.

Maybe last one for me, just on Weichai. Thanks for the update there in China, and I know you've got the take-or-pay, but likely, just given the macro, you're not going to hit those timing targets. Is that something that potentially could be renegotiated to, in some way, include hydrogen, a mix of hydrogen and LNG, or how should we think about that?

David Johnson speaking

Chief Executive Officer

Yes. As you've seen before, we struck the agreement with Weichai back in 2018, and then we had a renegotiation of the terms and the volumes just last year, so everything's up for negotiation, I would say. Nonetheless, we do have some commitment, and it always should be an improvement on what we have today, but nonetheless, there are some practicalities, and today, we see this adverse price condition in China with respect to natural gas that is really weighing on the marketplace, and specifically, the launch of our product with Weichai, so as that is remedied, as that is fixed in the marketplace through market mechanisms and perhaps government action, then we would look forward to some action, and that could include some change in our contract. But who knows? That's all in the future.

Eric Stine – Analyst, Craig-Hallum Capital Markets

Okay. Thank you.

David Johnson speaking

Chief Executive Officer

Thank you, Eric.

Operator

The next question is from Rob Brown with Lake Street Capital Markets. Please go ahead.

Robert Brown – Analyst, Lake Street Capital Markets

Good morning.

My first question's on the European HPDI product. I think it was a slight growth this year or this quarter. How do you see the order rates sort of in real time here? Are they continuing to slow down with the price spread, or are they sustaining sort of flat, or just sort of directionally? How's the order flow given the current price situation?

David Johnson speaking

Chief Executive Officer

Yes, so it's a very interesting thing. Historically, we've talked about our product, HPDI, and our other gaseous fuel products, being able to offer and unlock and give customers access to an economic advantage because of the price advantage that natural gas and LPG typically offer versus gasoline and diesel, and right now, in Europe and China, we kind of have this parity, or in some cases at the pump, LNG tends to be a bit more expensive than diesel, and so we have this adverse condition right now, which we don't expect to persist, but that is really flattening the curve, if you will, in some fashion in the near term as we've looked at this year where the kind of volumes are on the flattish side with respect to HPDI as opposed to growth.

Nonetheless, we're really happy and we see that the CO2 standards are on the horizon, and so our OEM customers and prospective customers face this regulatory requirement starting in 2025 with substantial penalties if they don't meet it, and so we think that becomes more of a driving force, but the driving force, really, in the marketplace is actually the OEM's requirement to reduce CO2 and our solution being one of the most effective ways to do that.

I mentioned earlier in the call that we've got this report, road test report, showing 25% better fuel economy (inaudible 41:48) fuel economy associated with doing HPDI versus spark-ignited engines, and so this really crystallizes and makes a glaring example of how HPDI really benefits, and so when you say, hey, I've got to get to a lower carbon fuel, now, what's the most effective one, it's HPDI, and so those are kind of the two forces in the marketplace. We've got higher LNG prices, but we've got this big economic benefit and the need to decarbonize, and that's kind of flattening our growth curve in this moment, but we don't expect that to persist, and certainly, as 2025 is on the horizon, we expect an acceleration of that volume, because HPDI is that very cost-effective way to respond to the regulation.

Robert Brown – Analyst, Lake Street Capital Markets

Okay. Thank you, and then on the LPG contract you announced with an OEM, is that a new contract or a new OEM, or maybe just some colour on what market it's in; and is it an extension, or is a new contract? Thank you.

David Johnson speaking

Chief Executive Officer

Yes, sure. This is a really important step for us. It is a new business for us, so we're really excited to have this new customer and have this new business. Obviously, it's a meaningful number for us in terms of our revenue outlook over the contract period of €38 million, so that's a big deal for us, and fundamentally, our path to profitability as a company is through growth, and so we can secure new business like this based on the technologies and the products that we offer and the services that Westport Fuel System offers to our OEM customers. It's a big deal, and we're real excited about it, and we hope to add more to that, of course, and continue the growth trajectory.

For us, as we look at LPG, the benefit of LPG is growing; the economic benefit, the environmental benefit, the huge installed infrastructure of refuelling stations. We're talking tens of thousands of stations across Europe where LPG is a very common fuel there, the most common in the world for transportation right now, and so that's a great development for us. We're excited about it, and we think it really demonstrates that Westport Fuel Systems is the leading OEM for supplying these kinds of systems to the OEM industry in total.

Robert Brown – Analyst, Lake Street Capital Markets

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

David Johnson speaking

Chief Executive Officer

Thanks, Rob.

Operator

The next question is from Amit Dayal with H.C. Wainwright. Please go ahead.

Amit Dayal – Analyst, H. C. Wainwright & Co.

Thank you. Good morning, everyone.

Most of my questions have been asked, David. With respect to sort of the HPDI 2.0 sales environment, I know there are some near-term headwinds, etc. But have you seen any deals fall through, or are customers just slowing down or other option in this environment? Like how should we think about that product over the next few quarters, sales for that product?

David Johnson speaking

Chief Executive Officer

Good to speak with you, Amit.

I think, generally, most of our activities are now—with customers are now considering the opportunity that HPDI offers with both hydrogen and natural gas, and so this is really what's catalyzing our discussions with customers is the opportunity for HPDI to do both and to have that path to zero carbon hydrogen in the future, and so that's making the opportunities for HPDI with natural gas and biogas more accessible, more interesting for our customers, and so that, I would tell you, is probably the main ingredient that's really driving discussions, and we see this around the world, right.

As an example, we've spent a lot of time talking about our business with Weichai and looking to get that launched with natural gas, but there is a tremendous amount of opportunity for HPDI with hydrogen in China. We're carrying on conversations with many OEMs there around that opportunity, and they're building on hydrogen structure, so we talked about Europe, because it's very accessible to us, but in China, they're in the lead, like they are with natural gas, in terms of refuelling infrastructure, and so we see a big opportunity there, and that, to me, is really the catalyst for the discussions on HPDI in general across markets around the world, is this move to hydrogen in the future, natural gas and biogas now.

Amit Dayal – Analyst, H. C. Wainwright & Co.

Understood, so just want to bridge that, so it's almost like we have to come out with a new offering that has—that can support both these capabilities, or you have the hydrogen capability provided. What would be the timeline to introduce a product like this? Are you already sort of working on developing it at an accelerated pace? Like any colour on sort of your thoughts strategically on how you can tap into this opportunity?

David Johnson speaking

Chief Executive Officer

Yes, so I should clarify that the fundamentals of our HPDI system from the injector and the system architecture and the componentry and so forth are very, very similar, so basically, today, in our demonstration vehicle we're using the same hardware. We do expect and are working on the various details of tuning that hardware and modifying it to make it fully validated and available for hydrogen, so I do expect in the long run that the actual hardware will be different, right. It won't be exactly the same components for hydrogen and natural gas. Nonetheless, the fundamental technology, and, for example, how it fits on the vehicle, how it fits in the engine is the same, and so this is what really opens the door for those developments that are future hydrogen, natural gas now, and biogas, too, and so that is the path that we see and the path that we're working with our customers on many fronts for many markets like China, Europe, and North America.

Amit Dayal – Analyst, H. C. Wainwright & Co.

Yes, yes. I think I did see some of that at the ACT Expo. You showed me some of the models alongside—around this, basically.

With respect to the LPG systems, David, I think you mentioned production could begin in the fourth quarter next year. I don't know if I got that correct.

David Johnson speaking

Chief Executive Officer

No, no, that's exactly correct. Fourth quarter of next year is start-up production for that project, and then over the two-year period that unfolds after that, €38 million of revenue is our expectation.

Amit Dayal – Analyst, H. C. Wainwright & Co.

Okay. Understood, so near-term sort of margin outlook, should we, from a—just a conservative standpoint, even though the macro environment could be improving to your favour (inaudible 48:32) from a supply chain perspective, etc., should we assume similar levels for margins in 3Q and 4Q?

David Johnson speaking

Chief Executive Officer

Generally, I would expect, in the near term, as mentioned about—I mean, the big levers going on with respect to pricing—excuse me, margins are three factors: cost pressure from inflation, pricing activity that we take on, and then with respect to HPDI, we need the volume curve to actually achieve the economies of scale and improve our margins there. So I would expect not a big movement in the margin in the near term as we work to pass along costs that we're acceding to our customers in terms of pricing, and then looking for that improvement in the

economic conditions of LNG in the marketplace to drive the recovery and then the resumption of growth in our volumes of HPDI.

Amit Dayal – Analyst, H. C. Wainwright & Co.

Okay, got it. Thank you. That's all I have for now. I'll take my other questions offline.

David Johnson speaking Chief Executive Officer

Thanks, Amit.

Operator

The next question is from Jeff Osborne with Cowen. Please go ahead.

Jeffrey Rossetti – Analyst, Cowen and Company

Hi. This is Jeff Rossetti on for Jeff Osborne. Thanks for taking our questions.

I just wanted to see if I could ask on the O&M volume—OEM volume side, how to think about the headwinds on the LNG side for heavy duty with respect to the tailwind you're seeing for LPG for light-duty. I know you called out that, given the LNG prices, you may see some slowdown with your HDB—HDPI 2.0 OEM launch partner.

David Johnson speaking

Chief Executive Officer

Yes, so our outlook right now, I would say, for HPDI is flattish with some upside potential, and certainly, we've seen in global markets some moderation of the LNG prices, but the condition in Europe is really quite challenging with respect to trying to forecast fuel prices with the ongoing Russia/Ukraine war. I think someone who's got a crystal ball on that should be super valuable at this juncture, but fundamentally, in the long run, I do believe that the LNG flows around the world, natural gas availability will continue to grow, and certainly, with high LNG prices, we have more and more biogas coming online, and that will help, so fundamentally, until there is some kind of, let's say, re-establishment of an LNG price advantage versus diesel, and then the implications associated with the CO2 standards in Europe, I would expect some flattish and modestly upward trend with some luck, and then when the price is re-established and CO2 standards come in place, we expect a big change and big growth potential, as HPDI continues to demonstrate that it is the most cost-effective way for OEMs to respond to the regulations and for customers to access cleaner transportation.

Jeffrey Rossetti – Analyst, Cowen and Company

Got it. Okay, and one that's very—another one that's probably difficult to sort of postulate on, but one large tier one provider talked about potential gas supply disruptions in the back half of the year in Europe, and was just thinking if you had contemplated any scenarios around that, or if you had any thoughts around that potential.

David Johnson speaking

Chief Executive Officer

Yes. No, I think as a general premise—we don't have an ore in the water with respect to controlling availability or prices of fuel, so we're—it's an external factor that we respond to. One of the things that I think is very positive for our Company in this, let's say, dynamic market or

volatile market or unknowable market of the future is the fact that we do have a diversity of markets, a diversity of products, and a diversity of fuels that we support.

As an example, we're seeing growth in our hydrogen business right now in our markets in North America and in China, and we're seeing growth in our electronics business. Our LPG business sees growth, and then we're working in markets around the world, so it's not all about Europe LNG and HPDI. There are other elements of our business which are having those tailwinds supporting us, and so that's where I think, fundamentally, and looking at our results just this past quarter, coming off flat in the context of really constraining the business in Russia that was important to our P&L, historically, and hopefully in the future, will be important again, but right now is super impacted by the conflict, and then the foreign exchange, so to think that we would have been up more than 10% had we not had those factors, I think, is indicative of where the Company is going in the long run.

Jeffrey Rossetti – Analyst, Cowen and Company

Okay. Thanks for that, and just one last one, if I could. I think Richard talked about the working capital build. I just wanted to see if there was any thoughts on—if there was going to be any kind of release near term on the working capital side.

Thanks.

David Johnson speaking Chief Executive Officer

Yes, for sure. We did build up some inventories, specifically with respect to the electronics business. I think everybody around the world understands the challenges this business has faced. We didn't have much choice in the matter, so basically, suppliers of chips in the marketplace said, if you ever want to get chips again, you'd better place orders, and so in this context, we didn't have a lot of flexibility, and so we have built up those inventories, and certainly, we expect to get those inventories down as a function of time, as we use them up, and perhaps and hopefully, the markets for—from our suppliers, specifically, become more stable,

predictable, and ones that we can return to normal terms and normal order cycles as opposed to having to hold inventory to protect our sales.

Jeffrey Rossetti – Analyst, Cowen and Company

Thank you.

David Johnson speaking Chief Executive Officer

Thanks, Jeff.

Operator

The next question is from Mac Whale with Cormark Securities. Please go ahead.

MacMurray Whale – Analyst, Cormark Securities

Hi. Good morning.

In terms of when there's a truck sales downturn, we usually see fleets drive their vehicles longer, and that builds up some pent-up demand. So when you finally do launch, or when your partner is actually ramping up, do you have any insight from, say, new OEM projections about whether that will play a role in the ramp-up phase?

David Johnson speaking Chief Executive Officer

Yes. Good morning, Mac.

The view I have in this regard is that our business right now is still sub-5% of the marketplace, right. It's a very small fraction of the total market, so if the market declines by 10%, 15%, 20%, the reality is that I expect, and we've seen this historically, the markets moved around, and we've been growing through the years as we—after the launch in 2018, despite the ups and downs in the marketplace, because with a small percentage and the focus of our customers, the OEMs, and of their customers, the fleets, is in accessing lower carbon fuels for their trucks, and being able to offer a lower-carbon solution to the marketplace, so I don't think that affects us so much.

Of course, it can't be viewed as positive if the volume goes down, and it can be viewed as positive as the volume of the market goes up in total, but I would say the impact is not nearly as important as the impact of the growth of market share of our product, so historically, just a couple of years ago, gaseous-fuelled products in the European truck market were sub-1%, and now they're on the order of 3%, so it's tripled, right, and we've seen that in our volume, which has gone up dramatically during this time, but still, it's still relatively low volume even though the growth has been good, so yes, overall, I don't see the market volume in total as having such a big impact, but rather the growth trajectory of our product, and that's driven by the economics that we talked about and the regulations that we talked about.

MacMurray Whale – Analyst, Cormark Securities

I understand that, so you have the mark—you'll have a market share, but you'll also have the market rebounding. Like there's normally a big pent-up demand, so are you saying that the adoption will be the adoption for natural gas regardless, and so your market share growth might actually slow because the adoption will just be based on this sort of niche? Or are you saying the opposite; saying, no, the market will grow and it'll raise all boats, including alternative fuels, so your growth rate would actually be faster? I'm not quite sure I understood your answer.

David Johnson speaking

Chief Executive Officer

Yes, so I think there's two percentages, right, so there's what's the percentage growth of the marketplace. Is it going from—so if you think about Europe, is it going from 300,000 trucks a year to 400,000 trucks a year, or 350,000 down to 250,000, or what is that movement, and then there's the market share of our product in the market, and that, to me, is the more important growth factor.

MacMurray Whale – Analyst, Cormark Securities

I see.

David Johnson speaking

Chief Executive Officer

And so as we—as LNG—so what's primary, what's secondary, and for us, what's primary is that movement of our market share in the market, so if you compare it, if you will, to like diesels right now are 97% of the market, 98% of the market, so if the market goes down by 10%, diesel volume goes down by 10%. In our case, it doesn't move that way, because we're expecting and we've seen that our market share is growing dramatically, and so that's the more important effect.

MacMurray Whale – Analyst, Cormark Securities

Okay. Okay. I have a bunch of other questions, but we will take it offline this afternoon. I have a call at 11:00 I have to jump on, so sorry, I was late in the queue, but hope we'll talk later.

Thanks.

David Johnson speaking

Chief Executive Officer

Okay. Sounds good, Mac. Thanks so much.

Operator

The next question is from Bill Peterson with JP Morgan. Please go ahead.

Bill Peterson – Analyst, JP Morgan & Co.

Yes. Hi. Thanks for taking my questions.

Wanted to come back to hydrogen. You've done some work with TUPY and AVL. I believe Cummins was supposed to happen this year. I just want to get an update on that one in particular. Do you still expect that? And I believe you talked about the potential fourth partner. I'm just trying to understand how the interest in hydrogen should play out with these specific partners.

David Johnson speaking

Chief Executive Officer

Yes. Good morning, Bill. Thanks for your question

It's right. We have these projects. We have a project with Scania that we mentioned earlier in this call. We have a project with AVL and TUPY also working. That activity is actually taking place at AVL in Graz, Austria. We have work going on with Cummins that was announced as part of our announcement earlier this year on the share sale that we did, so these projects are all running, and we'll look forward to sharing some information about them when our partners agree that's okay to do, when we hit certain milestones and so forth, and we do expect to have new customers added to the queue as we work with customers around the world, including

China, Europe, and North America, to demonstrate, as we are doing with our demo vehicle, so all those are progressing, and we look forward to sharing updates when they're available and approved by our customers.

Bill Peterson – Analyst, JP Morgan & Co.

Okay. Thanks for that, and then secondly, on the cost side, specifically for OpEx, I guess how should we think about the OpEx trajectory for the remainder of the year? Presumably, you probably built that in, but also you might get some—who knows what's going to happen with exchange rates, but just try to help us understand what you're doing on the cost side.

David Johnson speaking

Chief Executive Officer

Richard?

Richard Orazietti speaking

Chief Financial Officer

I'm here. Bill, I think we'd—you'd estimate that we're going to be comparable going towards the back end of the year. In terms of OpEx, like the R&D, our program is expected to spend approximately about \$30 million this year, and G&A, it might be a little bit lighter. We're investing more money for sure within business development, so sales and marketing is something that, as we're getting the hydrogen truck on the road and more activity in terms of development in North America, but these are just small numbers.

The bigger issue, Bill, was actually within our gross margins, and that's something that—there's a—we'll call it a mix change that's happening. I mean, we can talk about on the call a little bit later, but we're looking for upside in our independent aftermarket, so we should see margins improve there. Our OEM business is—as we've talked about, and I know it's been challenged by

Conference Call Transcript

Second Quarter 2022 Results Conference Call:
August 9, 2022

the higher CNG prices, and so there's a little bit of a mix change where we're seeing really great growth in India. That's had a slightly lower margin, but very promising.

With regards to our heavy-duty business, we're going to—we'll see sort of flattish year-over-year growth is kind of where we're sort of estimating right now, and so I would say that margins will be more or less kind of what you saw in the second quarter. It might improve a little bit with regards to—we had some additional warranty costs that were a little bit higher than normal, but that are being sorted out by our engineering department.

Bill Peterson – Analyst, JP Morgan & Co.

Great. Thank you. Good luck.

Richard Oraziotti speaking Chief Financial Officer

You're welcome.

Operator

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

David Johnson speaking Chief Executive Officer

Yes. Thanks, everyone, for your time and attention this morning.

In the grand scheme of things, appreciate the chance to review our results with you. Feel guardedly optimistic in this really challenging time that we continue to deliver the products that

Conference Call Transcript

Second Quarter 2022 Results Conference Call:
August 9, 2022

the marketplace needs to both economically and environmentally improve transportation. There's work to be done ahead, and we look forward to reviewing with you in upcoming investor conferences.

Thanks again for your time.

Operator

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