

Westport Fuel Systems First Quarter 2023 Financial Results Conference Call Transcript

Operator

Welcome to the Westport Fuel Systems' First Quarter 2023 Financial Results Conference Call.

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

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

Ashley Nuell **Senior Director, Investor Relations**

Good morning, everyone. Welcome to Westport Fuel Systems' first quarter 2023 conference call, which is being held to coincide with the press release containing Westport's financial results distributed yesterday.

On today's call, speaking on behalf of Westport is Chief Executive Officer David Johnson and Chief Financial Officer Bill Larkin.

Attendance on this call is open to the public, but questions will be restricted to the investment community.

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You're 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 M. Johnson **Chief Executive Officer**

Thank you, Ashley, and good morning, everyone. I'm pleased to be with you today to discuss our first quarter results.

Today, in addition to reviewing our Q1 results, we'll be providing updates on our growing light-duty LPG business, and, of course, our heavy-duty business where our patented HPDI products and technology are poised to play an important role in affordably decarbonising heavy-duty, long-haul trucking. Also, we'll share some observations and highlights from last week's ACT Expo in Anaheim, California and from the Vienna Motor Symposium, which was held the week before last.

Amid a macro environment that continues to be turbulent, we delivered year-over-year revenue growth of 7% to \$82.2 million, primarily driven by increased sales volumes in many of our business lines, including delayed OEM, fuel storage, hydrogen and electronics, as well as increased sales volumes in our independent aftermarket segment. In the first quarter, we also delivered gross margin improvement in both our OEM and IAM segment, driven by pricing and higher sales volumes and an improving sales mix in our OEM segment.

Westport Fuel Systems is a leader in the light-duty LPG space, and demand for our clean, low-cost LPG solutions continues to grow in Europe and other markets, supported by the increasing price advantage for consumers who can run on LPG instead of petrol and can therefore save money every time they refuel at their local fuel station. The LPG price advantage is driving growth in key markets like Italy, Türkiye, the Netherlands, and also in North America.

As the cost of new cars continues to escalate, consumers are looking for affordable alternatives; vehicles that are low cost to acquire and low cost to operate. That's an LPG advantage. Advantageous LPG pricing in major markets plays a key role in the decision to switch existing cars from petrol to LPG, and we have the products to enable this switch. Also, customers buying new cars are seeking affordable LPG-equipped models. OEMs are taking notice of growing consumer demand, which is expected to persist globally for decades. OEMs are acting now to commit to the future of LPG, providing a significant runway for growth for Westport Fuel Systems.



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As we recently announced, we'll begin production and supply of the Euro 6 LPG system through a leading European OEM in Q4 of this year. This new business materially adds to our revenue and market share. Our LPG market share in Europe is currently about 35%, and with this newly announced OEM business, we expect to increase to above 50%. As a reminder, the Euro 6 LPG system production and sales that begins in the fourth quarter of this year, will run for two years, generating approximately €38 million over the contract period. The follow-on Euro 7 business we've secured will double this scope, generating approximately €40 million per year.

We continue to experience growth in our delayed OEM business and expect this growth to continue. As a reminder, our delayed OEM business is when we or our customers apply one of our LPG fuel systems to a new vehicle in advance of selling and delivering that vehicle to end-use customers. More OEMs are taking advantage of our vehicle conversion capabilities. Volumes grew significantly this quarter compared to Q1 of last year due to strong demand from DR Motors, an Italian OEM that provides LPG-fuelled vehicles to the Italian and other markets in Southern Europe.

Moving to our heavy-duty business, in the first quarter, we recorded a positive pricing adjustment for our HPDI fuel systems sold to our European launch partner. Our existing contract with our European launch partner concludes in early 2024. As we move through the rest of 2023, pricing is being negotiated.

In the first quarter, HPDI volume declined by 13% compared to the year-ago quarter, primarily driven by unfavourable fuel price differential between LNG and diesel, which existed through all of 2022, causing fleets to reduce and/or delay their purchases of LNG-fuelled vehicles. As we discussed last quarter, production volumes lag vehicle sales volumes and vehicle sales volumes lag fuel price changes. Now that LNG fuel prices have re-established their advantage compared to diesel, we expect an improving vehicle sales outlook later this year and production and sales of HPDI systems to follow that trend, again, with some timing lag.

Looking ahead, Westport Fuel Systems offers the solutions needed by heavy-duty OEMs to meet future emissions reduction requirements while delivering the performance, efficiency, and affordability that their fleet customers demand. As LNG pricing re-establishes a persistent advantage versus diesel, and as emissions regulations and associated penalties for OEMs loom, there is growing realization that affordable, low-carbon solutions like HPDI, are required to meet OEM CO2 emissions requirements and fleet decarbonisation goals. HPDI is already reducing real-world emissions with thousands of vehicles on the road today. We're confident we'll continue to grow HPDI volumes through this decade and beyond.

Earlier this year, our HPDI launch partner announced new trucks that deliver more horsepower, increased efficiency, less emissions, and an extended driving range using bio-LNG. As is typical with new product introductions, we expect this model change will result in lower volume near term and higher volumes later this year.



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In China, we continue to support Weichai as they work with their customers, the Chinese truck OEMs, to bring HPDI-equipped vehicles to their market. This includes demonstrations and field trials. We remain optimistic about the launch of production and sales, especially now that LNG prices in China have declined. China is the largest natural gas trucking market in the world by far and measured in terms of volume and market share and has stringent emissions targets that are supportive of both LNG and bio methane. LNG prices have been normalizing in China, with prices just recently at a 21-month low, a significant drop from the elevated levels we saw last year. We're encouraged by the ongoing work we're supporting and the improving market conditions.

Similar to the rest of the world, we're also fielding significant interest in China for our hydrogen HPDI offering as an affordable path to using zero carbon hydrogen in long-haul, heavy-duty applications. Bottom line, our HPDI opportunity in China is significant using LNG and bio methane today and hydrogen in the future.

Our business is on the right path. Clean, affordable transportation is in demand today, and we see that demand increasing into the future. High energy prices and challenging economic times tend to be tailwinds for our business. Transportation is not a discretionary purchase, especially for commercial vehicles, and we make clean transportation products that are low cost for OEMs to develop and industrialize and low cost for end customers to acquire and operate.

Last week at the ACT Expo in Anaheim, California, we showcased two fully functioning heavy-duty vehicles with our HPDI fuel systems for internal combustion engines; one truck fuelled by low carbon methane, either fossil or bio methane, and the other truck fuelled by zero carbon hydrogen. We helped ACT Expo attendees understand how HPDI with natural gas and renewable natural gas enables all the performance, efficiency, and durability of the diesel engines they're used to, with very little change to engines or vehicles, and yet, all the low carbon and affordability benefits to enable a scalable solution. With hydrogen and HPDI, performance and efficiency improves quite significantly, enabling an ICE engine technology path for decades to come.

Given the growth we've seen and our recent expansion announcement in China, we also displayed at ACT Expo our 350 and 700 bar hydrogen components that support both fuel cell and internal combustion engine applications. This follows fuel cell Expo's we joined in Germany and Japan already this year. We continue to generate significant interest from key constituents throughout our ecosystem, including OEMs, fleets, fuel providers, and more. Importantly and increasingly, hydrogen is considered the zero-carbon fuel the industry needs. We're continuing to help the industry to understand that internal combustion engines with HPDI will play a critical role in transforming away from fossil fuels to clean and renewable fuels, because HPDI is the most effective and affordable path.

Two papers highlighting hydrogen HPDI were presented at the Vienna Motor Symposium. An industry event with the latest technological developments and product proof points are reviewed with our peers; engine and vehicle



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OEMs and tier 1 suppliers. What makes this exciting for the Westport team is that these papers were each written based on engine dynamometer testing completed on two different engine platforms. Our work with Scania is well known, and the paper we presented with Scania outlines our success in demonstrating brake thermal efficiency of 51.5%, while achieving a 97% reduction in tailpipe CO2 emissions.

The second paper, published by TNO, is based on research conducted using another European OEM engine platform and was focused on outlining the differences in power density, efficiency, and emissions, between spark-ignited combustion and HPDI-enabled combustion of hydrogen fuel. TNO's testing analysis demonstrated that hydrogen HPDI clearly outperformed spark-emitted hydrogen combustion with respect to power and efficiency, and doing so with HPDI requires minimal changes to today's diesel engines. This aligns well with our own results and with the superior performance achieved today in the marketplace using HPDI with methane as compared to spark-ignited combustion of methane. The results are clear. Injecting hydrogen using HPDI on an internal combustion engine produces a highly efficient, yet practical, green solution for long-haul, heavy-duty trucking.

Overall, it was highlighted in Vienna that for heavy-duty trucking and other high-load, high-duration applications, the required combination of power density, fuel efficiency, and durability can be challenging for technologies other than HPDI. For a certain segment of the transportation sector, near zero carbon internal combustion engines continue to be evaluated as the key cost-effective solution, and our HPDI fuel system is well-suited to applications requiring high torque and high fuel efficiency. This, not surprisingly, has led to interest in HPDI and an evaluation of HPDI by multiple OEMs. Affordable performance will drive adoption. The results announced at Vienna confirmed that hydrogen HPDI offers lower CO2 abatement costs along with the high performance demanded by customers. Our hydrogen HPDI demonstration trucks continue to provide high-profile and valuable evidence of the feasibility of HPDI fuel system-equipped engines fuelled with hydrogen to deliver high-performance, cost-effective decarbonisation of heavy-duty vehicle applications.

With that, I'll turn it over to Bill to walk through our financials.

Bill Larkin **Chief Financial Officer**

Good morning, and thank you, David.

In the first quarter of 2023, we generated revenues of \$82.2 million, an increase of 7% compared to Q1 of 2022.



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In Q1 of '23, sales volumes increased in our delayed OEM, fuel storage, hydrogen components, and electronics products, along with increased sales volumes in our IAM segment, particularly in North America, Eastern Europe, and South America. However, we did realize a slight reduction in light-duty OEM sales volumes to our customers in India.

The unfavourable price differential between LNG and diesel in Europe experienced in the first half of fiscal '22 impacted HPDI volumes sold during the first quarter of 2023 to our European launch partner. However, this quarter's volume decline was offset by an increase in the HPDI system pricing, as well as higher engineering services revenue.

Our gross margin increased to 16% in Q1 2023 compared to 13% in the prior-year period.

We reported a net loss of \$10.6 million for Q1 of 2023 compared to net income of \$7.7 million for the prior-year period. The prior-year period included \$19.1 million gains from the sale of our interest in the CWI joint venture.

During the first quarter of '23, we increased our research and development expenditures by \$1.4 million compared to the prior-year period, focusing on our HPDI technology and hydrogen components.

Moving on to the next slide, in Q1 of 2023, we reported Adjusted EBITDA loss of \$4.5 million compared to a loss of \$6.1 million in the same period last year. The improvement in Adjusted EBITDA loss is primarily due to the result of higher revenues and improvement in our margin.

Gross margin increased year-over-year to \$13.3 million or 16% of revenue, compared to \$9.9 million or 13% of revenue for the same period in 2022. This improvement was mainly due to higher sales volumes across multiple businesses and positive sales mix in our delayed OEM business segment. However, our manufacturing costs continue to be impacted by higher material, energy, and labour costs as a result of widespread inflation and global supply chain challenges. These cost increases continue to weigh on our gross margin.

On the next slide, OEM revenue for the first quarter of 2023 was \$56.3 million compared to \$51.8 million in the same period in 2022. The \$4.5 million or 9% increase was driven by a significant increase in sales volumes in our delayed OEM business, as well as an increase in volumes in our fuel storage, hydrogen, and electronics businesses. However, we did see year-over-year decreases in sales volumes of our light-duty OEM products in India and Eastern Europe.

Beginning late last year, we've been talking more about our hydrogen components business and the growth we are seeing, along with our expansion plans in China. We continue to see year-over-year revenue growth and the sale of hydrogen components of over 50%, as compared to the same quarter in the previous year and expect our hydrogen components business revenues to continue to increase when we begin production in China in 2024.

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The unfavourable fuel price differential between LNG and diesel in Europe in fiscal '22 negatively impacted our HPDI sales volumes to our European launch partner. In the first quarter of 2023, we saw a 13% decline in volumes, which was offset by an increase in the HPDI system pricing. More recently, we've seen a return to a more normalized LNG pricing environment in Europe. We are encouraged by this recent trend in fuel prices, which we anticipate will be helpful in driving demand for trucks with our HPDI systems.

As a reminder, our European launch partner earlier this year announced a new HPDI-equipped engine with higher horsepower and extended range. As is typical in the release of new products, we predicted seeing a decline in sales of the current offering as customers opt to wait for the updated, more powerful option with extended range. This will have more of an effect on our top line given the current tight margins in our HPDI business and expect to see an increase in volumes in the second half of 2023 with the launch of the newer product offering.

Also, in the first quarter of 2023, we saw significant improvements and reduction in our warranty claims, and do not have an adjustment to our warranty provision outside of the normal warranty estimation process.

Gross margin in the first quarter of 2023 was \$8.1 million, which was a \$3.1 million increase over the prior-year period. Increased sales volumes in multiple OEM businesses, along with improved sales mix in delayed OEM volume and HPDI system pricing, positively impacted our gross margins. This was partially offset by higher production input costs from inflation.

Moving to the next slide, our independent aftermarket revenue for the first quarter of '23 was \$25.9 million compared with \$24.7 million for the same period in '22. Gross margin was \$5.2 million compared to \$4.9 million in the first quarter of '22. The increase in both revenue and gross margin was driven by higher sales volumes to North America. We also realized an increase in sales in Eastern Europe and Argentina markets, which were partially offset by lower sales volumes in the Middle East and Africa, along with higher production input costs.

Looking ahead, supported LPG pricing continues to create a positive demand trend in Europe and will be an important area of growth for our Company in the years ahead. In the fourth quarter of this year, we'll begin production for our previously announced business with a leading European OEM for the supply of LPG fuel systems for both Euro 6 and Euro 7 standards. This business will significantly increase our OEM revenue. As a reminder, the Euro 6 delivery begins in Q4 of this year and runs for two years, generating approximately €38 million of revenue over those two years. Euro 7 delivery approximately doubles the related revenues, generating approximately €40 million per year through 2035 and beyond.

Next slide, finally, I'd like touch on liquidity. Our cash position decreased by \$14.2 million to \$72 million during the first quarter of '23. The decrease was primarily due to the net cash used in operating activities of \$8.6 million, purchases of fixed assets of \$3 million, and the net debt payments of \$3.5 million.

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Inventory levels slightly increased during the quarter following a delay in the shipment of products related to our tender in Bolivia, which these products will be shipped during Q2 of this year. Despite the increase in inventory in the quarter, work is ongoing to reduce our inventory on hand to free up cash, which would be a net positive for our balance sheet moving forward.

In the first quarter of 2023, net cash used in operating activities was \$8.6 million compared to \$16.9 million in the same period last year, an \$8.3 million decrease. This was primarily driven by changes in working capital, specifically in inventory, accounts payable, and accrued liabilities in accounts receivable. We will continue to be prudent in how we manage our liquidity. As a reminder, we have outlined a prudent capital program for 2023 with about \$12 million to \$15 million focused on advancing our work with hydrogen and adding test cell capacity. Again, we invested about \$3 million in CapEx during the first quarter of '23.

I'd like to take a moment to provide an update on a few items that have occurred in April.

On April 1, we entered into an agreement with Cartesian to terminate the initial financing and consent agreement in exchange for mutual releases of any future obligations. This included the release of the security interest in our HPDI 2.0 fuel system intellectual property. We paid \$8.7 million, which results in elimination of the minimum future royalty payments totalling \$7.9 million.

On April 26, we announced that our Board approved a share consolidation on a 10-to-one basis, which is expected to be effective in early June.

With that, I will turn it back to David.

David M. Johnson **Chief Executive Officer**

Thank you, Bill.

Westport Fuel Systems' products are critical to decarbonise transportation, and because our products are affordable, they can and will scale. As the world gets more serious about decarbonising transportation, Westport is ready. Twenty twenty-three is an important year for us as we focus on enhancing our financial performance, driving margin expansion, revenue growth, and technology development. While we're pleased with the progress we demonstrated in Q1 of this year, we recognize that we still have substantial work in front of us. We know we need to deliver both financially and operationally. Capturing efficiency, delivering revenue growth, increasing margin, and developing great products and technology are our priorities.



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Our recently announced Chief Technology Officer Fabien Redon will lead our team to develop and deliver clean alternative fuel system products from concept to customer for the global transportation and off-road markets.

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

Operator

Thank you. (Operator Instructions) The first question comes from Colin Rusch with Oppenheimer. Please go ahead.

Colin Rusch – Analyst, Oppenheimer and Company

Thanks so much, guys. Could you talk a little bit about the competitive landscape for hydrogen with internal combustion engines? We've seen some announcements around spark-ignited solutions. Just want to get your sense of the maturity and relative performance that you're seeing and expecting from the (inaudible 23:34) purchase.

David M. Johnson Chief Executive Officer

Yes. Good morning, Colin. Glad to talk on that topic. Thanks for the question. Interestingly, I think everyone in the world sees the hydrogen opportunity. As we think about how do we get to a zero-carbon fuel, that's basically the only one for the long-haul heavy-duty application, and I think everybody is realizing the challenges that remain with fuel cells. They'll have a place, but that leaves the door open for the internal combustion engine, which has a tremendously well-established reputation and install base around the world. The vast majority are headed down the path of spark-ignited engines, I'll say, as their first attempts, and what they're finding is that this is challenging.

We commented a little bit about Vienna Motor Symposium. There were quite a few papers about spark-ignited internal combustion engines. What this requires and what results from changing an engine into a spark-ignited engine is really tremendous in terms of the effort required and rather poor in terms of the performance that



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results. Basically, with our HPDI product, we eliminate those challenges. I think people are literally agog when they understand that we can apply HPDI to a diesel engine, change almost nothing. Not change the piston, no change to the air handling system, no changes to the combustion formula or the peak cylinder pressures or any of the fundamentals of the engine or hardware of the engine. Just adapt our fuel system, run that engine on a diesel cycle and have performance that's better than the base diesel engine by 20% on power, about 15% on torque, 10% on efficiency, and that sets us apart from those spark-ignited engines by a wide margin. Which really is consistent with what we have today with HPDI and natural gas where leading market magazines and journals have demonstrated that the products that use HPDI have a significant fuel efficiency and performance advantage in the marketplace today with natural gas. That advantage is accentuated as we go to hydrogen because of all the changes that are required if you choose a spark-ignited approach.

While people are trying spark-ignited because it's, I would say, relatively obvious to try, the results are less than compelling in terms of the performance of the engine, the fuel efficiency of the engine, and the offer to the marketplace in terms of how much you have to invest to create such a different engine in order to work with hydrogen, and yet how simple it is with HPDI. I think we're well-differentiated, and at ACT Expo and at Hanover last year, we were able to have these conversations and help people understand, and then again at Vienna Motor Symposium. We'll continue to do that. We had team members at an important conference in Sweden just last week, and we'll continue to help our customers understand the opportunity that HPDI presents. That manifests itself when those customers bring their engines to us and say, show us on our engine. We've talked about the projects we have going already, and we think it's a really exciting time for us to demonstrate that differential that we offer with HPDI that can't be replicated with somebody else's systems.

Colin Rusch – Analyst, Oppenheimer and Company

All right. Perfect. Thanks so much, and then just a quick follow-up on supply chain things. I mean, are you seeing a real easing to the point where you might be able to bring down inventories just from an overall level as we go throughout the balance of the year? That's it for me. Thanks.

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David M. Johnson **Chief Executive Officer**

Yes, I think fundamentally on supply chain, we have two stories. One story is electronics, and that story is somewhat improving, but not to the point that it's going to allow us to dramatically change our inventory situation. Suppliers are still allocating products. We're still having to put out long orders. Orders with long lead time used to be—you can get chips in the matter of a few months, and now it's 18 months, so this is really constraining our supply chain management and causing us to have to have that extra stock on hand. We don't see that abating significantly with respect to electronics.

With respect to the rest of the supply chain, I would say the only battle is inflation, the inflation on material costs. We see inventories going up just because materials cost more. In terms of having to hold more inventory because of supply chain problems, we don't see so much of that other than electronics.

Operator

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

Robert Brown – Analyst, Lake Street Capital Markets

Good morning.

David M. Johnson **Chief Executive Officer**

Morning.

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Robert Brown – Analyst, Lake Street Capital Markets

Just wondering if you could give some further colour on the price adjustment with the OEM launch partner. Was that for the fuel system or does that apply to this sort of next-generation generation system, and really, what was the sort of sense of scale on what that price adjustment was?

David M. Johnson Chief Executive Officer

Yes. Thanks, Rob. Do you want to take that, Bill? No, you go ahead.

Bill Larkin Chief Financial Officer

As we've talked about, we've been dealing with inflationary pressures on our system pricing. We've been in discussions with our partner for our HPDI systems and came to an agreement on incremental pricing to cover or offset some of those increases as a result of kind of the inflationary pressures that we're seeing. That definitely helped both the top line and the bottom-line kind of mitigate some of those pricing increases that we're seeing.

Robert Brown – Analyst, Lake Street Capital Markets

Okay. Great to see, and then I guess sort of the environment is stabilizing in terms of LNG pricing, but you said there would be some timing differences in terms of demand response. What's your latest view in when that price improvement sort of translates into demand improvement?

David M. Johnson **Chief Executive Officer**

Yes, I think the market behaviour we see—obviously, every customer does their own thing, but fundamentally, when you aggregate all of that, people are quick to stop purchasing and slow to restart purchasing. Really, when you buy an asset like a truck, you want to know that it's going to be a fruitful asset to your fleet operations over three to five years and then have a good resale value at the end. When there is a price shock like we endured in 2022, there is hesitancy throughout the industry about getting back into LNG trucks. Nonetheless, they can't stare at that fuel savings and operating cost savings in the face for too long without taking action. We're confident the market will come back.

The kind of aberration or the market behaviour we had in 2022, primarily due to the war in Ukraine and the disruption of LNG supplies from—or natural gas supplies from Russia really impacted market heavily. Now we have a normalized situation again, and this applies around the world. We're also seeing that in China, and that's really important for our business, and we already see customers just coming back. We think this too shall pass, but it does take some time, hence the comments about the lags in the marketplace you see. When customers do place an order for a truck, then that truck gets scheduled, and then that truck gets built, and the truck gets delivered, and that takes some time. We do see kind of the return being more robust in the third and fourth quarters of this year than in the second quarter.

Robert Brown – Analyst, Lake Street Capital Markets

Okay, great.

Operator

The next question comes from Chris Dendrinos with RBC Capital Markets. Please go ahead.

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Chris Dendrinis – Analyst, RBC Capital Markets

Hi. Yes, good morning, and thanks for taking the questions. I just wanted to go back to that last question and maybe ask it a little bit differently. I understand that you can't really provide too much detail on price renegotiations with the OEM customer, but maybe just thinking about the impact holistically on that segment, on the OEM segment, how should we think about contribution margins on the HPDI sales kind of going forward? Does this really put you in a place where current volumes, it's kind of contributing more meaningfully, or are you still kind of in a situation where volumes really need to come up a lot more before margins can really be accretive?

David M. Johnson Chief Executive Officer

Chris, thanks for the question. Fundamentally, I think it's important to say, every system we sell is accretive to the bottom line today with HPDI. Fundamentally, what we do want to see is kind of a bit of a chicken and egg problem. We want the volume to be high so that we can get the economy to scale but get the cost down so that our customer can sell those high volumes and we can offer them a price that's attractive in the marketplace, and we can have a margin that is beneficial to our shareholders and the bottom line of our Company. That's the generic textbook, let's say, playbook for our business, and what we're coming out of right now with the low volumes due to the higher LNG prices last year. We're looking forward to higher volumes and the ability to offer customers the product at an attractive price. In the meantime, we'll work with our lead customer to make sure that we work through this and do so in a way that's good for both parties.

Chris Dendrinis – Analyst, RBC Capital Markets

Got it. Okay. Maybe just shifting gears a little bit to the IAM business, you have, I guess, a good growth potential here in the back half of the year. Thinking about that win for that, I think, the Euro 6 business, how should we think about the margins of that new win in relation to where you're at kind of today at around 20% margins? Is that business sort of in line with where you're at today?

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David M. Johnson **Chief Executive Officer**

For that business, we're real excited about the launch in Q4, and really not just the launch, but the fact that we've (inaudible 34:26) also the follow-on business to keep going and grow that business as a function of time with this new for us customer. That's a very important business. In terms of margins, we do see it, I would say, more in the kind of standard range than something that's exceptionally high or low, so I think it's fair to say that.

Chris Dendrinis – Analyst, RBC Capital Markets

Got it. Thank you.

Operator

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

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

Thank you. Good morning, everyone. Just quickly on sort of the hydrogen components pipeline, David, this was around \$100 million in the last conference call. Has any of this started converting into orders yet?

David M. Johnson **Chief Executive Officer**

Yes, thanks for the question, Amit. Good to hear you this morning. Our hydrogen business is really a great growth story for the Company, but I would say we're still in the early stages. When I talked about previously the \$100 million of new business that we'd secure, this is really all, I would say, in our future still. The growth we're having today is sales of our current 350 bar systems and components in North America and China, primarily. Meanwhile, because of the push around the world on hydrogen, we're just fielding a tremendous amount of inbound RFQs and project requests from customers in basically every geography. Europe, North America, Japan, really around

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the world, everyone recognizes that hydrogen is an important fuel for the future for many modes of transportation. Fuel cell will be a part of the solution, and we have great products that are recognized around the world, also in China. We see really big opportunities, but the \$100 million hasn't start to hit the income statement at this point in time.

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

Understood. Thanks, David. Thank you, and then for the Euro 6 and Euro 7, the additional revenues coming through those contracts, is that a base case scenario, David, or is there upside to those numbers?

David M. Johnson Chief Executive Officer

Yes, it's a good question. This is how our customer is seeing the market developing. There is a ramp that has been going on for years with respect to LPG products in the marketplace being more and more meaningful. We see this in our delayed OEM business, as an example. A different business than the one we're talking about, but fundamentally, same phenomenon where basically customers are able to—are interested in asking for LPG products and OEMs responding, some by having a delayed OEM product, others by having a direct OEM supply where they're installing our products in their factories. Looking forward, I think it's a lot of crystal ball gazing as we try to understand where the market will be two, three, four years out. What's very compelling to us is that our customer is committed to high-volume production and next generation emission standards and the continuation of this product and has chosen us as their supplier.

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

Thank you, David. That's all I have.

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David M. Johnson **Chief Executive Officer**

Thanks, Amit.

Operator

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

Mahima Kakani – Analyst, JP Morgan & Co.

Hi. This is Mahima Kakani on for Bill Peterson, and thanks so much for taking our questions. Maybe touching on the LPG contract as well, how should we really think about the cadence of revenue generation beginning in 2023 onwards, and is there any additional spend kind of required to help ramp up that production as well?

David M. Johnson **Chief Executive Officer**

Yes, great question. Good to speak with you this morning, and thanks for your question. The spending required, actually, this is largely the case where there is minimal spend requirement. There's a bit of development and validation that we do. There's a bit of augmenting our capacity as the ramp occurs. More in the out years, not in '23 or '24. Basically, our customers come to us with a number of models, and as they change those models and change the sourcing and select us at the provider and the tier 1 supplier for them, the volume grows for us. You kind of see that in the revenue figures we've provided; \$38 million over the next two years and then \$40 million annually going forward. That volume ramp progresses over time for us, and then you have the market dynamic. When we get into the out years, there is some capacity we need to put in place in the '25/'26 timeframe to support that ramp with the Euro 7 product, but nothing in the near term.

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Mahima Kakani – Analyst, JP Morgan & Co.

Got it. That's really helpful. Thank you. Then how should we think about gross margin—thank you. How should we think about gross margin trajectory as we move through the year, and what are some of the puts and takes that could really drive it up or maybe potentially be a little bit weaker?

Bill Larkin Chief Financial Officer

I think from a gross margin perspective, we're really excited about what we generated during the quarter, and there's still work to do on improving our gross margins. A lot of it is we're sort of seeing somewhat of a stabilization in our supply chains and continue passing on those incremental costs to our customers just to try to preserve that margin. We've got to be very careful in terms on how much we pass on and not price ourselves out of markets. Another important factor that improves our gross margin, and this is—the new LPG business that's coming on later on this year will help our margins as well, because it drives throughput within our existing capacity. We will expect more of that profit to drop to the bottom line, because we really don't have to make significant investments for this additional capacity in terms of CapEx. There'll be a little bit from working capital, mostly inventory, to start prepping for that. We still have work to go on our margins, and eventually, we do expect, hopefully, to see some improvements as—hopefully, as inflationary pressures come down, we start increasing—picking up the capacity that we have from a production standpoint, but we still have work to do on that.

Mahima Kakani – Analyst, JP Morgan & Co.

Okay. Thank you so much.

Operator

The next question comes from Eric Stine with Craig-Hallum. Please go ahead.

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Eric Stine – Analyst, Craig-Hallum Capital Group

Good morning, everyone.

David M. Johnson Chief Executive Officer

Good morning.

Eric Stine – Analyst, Craig-Hallum Capital Group

Hey, I know you touched on it a lot here, but I just want to go back to the situation with the contract with Volvo. I mean, should we think about the—the price adjustment in the first quarter, I mean, is this something that we should kind of view as more of an interim agreement while you work towards potentially a new one, or is this one where there may be some quarter-to-quarter variability where it's kind of on an ongoing negotiation basis?

David M. Johnson Chief Executive Officer

Yes, go for the second category, Eric. We have ongoing negotiations, and as mentioned in prior calls, we do have a contract that's expiring early next year, and we'll be—are in the process of negotiating what will be the next turn of that contract in the future. It's a work in process. We feel good about the results that we achieved so far this year, but as the market moves and as material costs rise and as the business unfolds, we have to continue to work with the customer to do that, but we see a productive environment with our customer to do that.

Eric Stine – Analyst, Craig-Hallum Capital Group

Yes. I mean, it would seem to be at least a good indicator in advance of that. Okay, maybe just turning to—again, sticking with HPDI and LNG, the launch of the new longer-range, higher-powered truck offering. I can understand a pause or a little bit softer in advance of that, but maybe thoughts on maybe over the next couple of

quarters, or maybe even into the first half of '24, what that potentially looks like when you kind of balance that pause. Then what potentially is pretty nice demand there with what we also have talked about for quite some time, it's the impact, that lingering impact of the price, the 2022 higher LNG prices?

David M. Johnson

Chief Executive Officer

Yes. I think you understand it well in terms of model change, and what that means is now the announcement is out there, customers are saying that's the product I want. I think 500-horsepower is a really important figure in trucking around the world. Of course, everybody can drive the 460-horsepower product or the 420-horsepower product, but fleets really like to have that added capability of 500-horsepower. It is some kind of magic number that's really important in the marketplace, and customers are wanting that. Moreover, in long-haul trucking, people want to go as far as they can go with a truck. The extended range that is offered for the efficiency that was unlocked in the product and the range that was unlocked by a larger tank, also very appealing, so we have this phenomena. It's kind of the opposite of a pre-buy. Instead of buying in advance of the emissions change, they're waiting and then buy later when the new product is available.

Then I would say importantly in the marketplace, I think our product is generated and our customers' product generates a very strong reputation as in a lot of pull forward. Through all the difficulties that we've had over the last few years in Europe with COVID, and the Ukraine war, and inflation and chip supply, all these challenges, we see that trucking and the emissions push around the world to clean up trucking has persisted and even accelerated. When we think about 2030 with a 45% reduction in CO2 now being proposed as a requirement in terms of reduction of CO2 and 90% by 2040, this is really pushing in the direction and fleets understand and OEMs understand that they need to move in the direction of cleaner trucking. Then they see how our offering of HPDI, first with LNG, then with bio-LNG, then with hydrogen, is a really excellent path to follow. Very affordable, very practical, delivers for the trucker, and doesn't require a lot of investment. We see that all the indicators are pointing in the right direction. We have to get through this year; a challenging, transformational year for us, but we see a very bright future already, and hopefully in the fourth quarter and then into 2024.

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Eric Stine – Analyst, Craig-Hallum Capital Group

Yes, understood. Thanks. Last one for me, maybe for Bill, just, I know that potentially securing more debt just to feel more comfortable on the balance sheet has been a priority, and I know that that's option centred in Italy where a lot of the operations are in the light-duty business, maybe just a status update on that.

Bill Larkin Chief Financial Officer

Yes. No, we are continuing to pursue options around debt financing. I was just over in Italy a few weeks ago meeting with our local banks and talking about what options we do have available. It is attractive. There are still tie-in government programs available, which, essentially, they guarantee the debt, which, in turn, drives substantially low interest rates on those loans. We're going to go—we're in discussions with the banks and pursuing those, as well as we're evaluating other options here at the corporate level in terms of debt financing.

Eric Stine – Analyst, Craig-Hallum Capital Group

Okay. Thank you.

Operator

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

Jeff Osborne – Analyst, TD Cowen

Hey. Good morning. Just a couple of questions on my side. A lot of it's been already addressed. Bill, how should we think about linearity through the year? I know you don't give quarterly guidance, but should we think about 2Q being similar to Q1, and then a ramp-up in the second half?

Bill Larkin

Chief Financial Officer

As you know, we do have seasonality in our revenues, and typically, our second quarter is kind of the highest quarter in terms of revenue during the year. However, as David mentioned, we expect the—we're seeing a little bit of a pause in the heavy-duty business until the higher horsepower (inaudible 48:22) range comes online. Then, of course, in the third quarter, we start seeing the dip because of the holidays, and then we see the ramp-up back in the fourth quarter. That's how we're looking at the rest of the year.

Jeff Osborne – Analyst, TD Cowen

Got it, and then are you seeing any impact on the delayed OEM side or straight OEM side in 2Q just given where fuel mix prices are?

Bill Larkin

Chief Financial Officer

No, David, you can elaborate on this. I think that's one of our bright spots in the delayed OEM business. We've seen a significant increase with DR, and that's been really one of the bright spots in our business, and we continue to see year-over-year growth in our delayed OEM business.

David M. Johnson

Chief Executive Officer

Yes, I think the element there that's hard for us to really put our hands around and be confident on is how many vehicles are the OEMs able to produce and ship? Like us, they're facing chip crises too, and so far, that hasn't adversely impacted our customer, DR, but our Korean customers have been affected, as well as our Japanese customers. It depends customer to customer, but I definitely see an opportunity in the near term still for delayed OEM.

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These LPG price spreads are really a serious driver of our business right now, where pricings, they have never been as large as they are right now with people able to save €50, €60 every time they fill up if they run an LPG. Frankly, a lot of jurisdictions around the world have backed off on incentives for battery electric and hybrid vehicles. Now those vehicles that looked attractive because of the incentives don't look so attractive, and people are looking for lower-cost opportunities, and that points straightaway to LPG; lower cost to buy and lower cost to operate.

Jeff Osborne – Analyst, TD Cowen

Got it. My last question, David, is just at the ACT show, one of your competitors on the spark-ignited presented sort of a vague timeline as to when they thought their solution would commercialize, and I think they talked about field trials, field testing in the second half of '25 and through '26, and then volume production for revenue in '27. Is there any rough timelines that you can put out there for your HPDI hydrogen solution and when you think you'll start actually having field trials as opposed to testing that's presented at shows like Vienna and others?

David M. Johnson Chief Executive Officer

Yes, I think what I would call is we'll have maybe more in the near term than you were just talking about, demos of vehicles. We're talking with a number of different parties now about where we could demonstrate our technology in a larger way; five, 10, 15 trucks, something like that. Maybe we call those field trials too. We'll see about the words, but fundamentally, that is in the near future. In terms of production, I think this really depends more than anything else on availability of fuel in the marketplace. Frankly, we need green hydrogen. If it's gray hydrogen, this might be good for a transitional period, but frankly, if we're making hydrogen from natural gas, we shouldn't bother. We should just make natural gas into LNG and use it in trucks that very efficiently use them with our fuel system. That's my view. It really is the timing of production and volume; is more driven by the availability of affordable green hydrogen in the marketplace. We're ready.

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Jeff Osborne – Analyst, TD Cowen

Got it. That's all I had. Thank you.

David M. Johnson speaking Chief Executive Officer

Thanks, Jeff.

Operator

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

MacMurray Whale – Analyst, Cormark Securities

Hi. Just a follow-up on the Euro 7 LPG business you talked about in 2025. I'm just wondering if you can give us the basic underlying assumptions on that forecast and how do they compare to today? I'm assuming you have things in there like truck sales, costs, LPG diesel spread, that type of thing. I just want to understand what you've put into your model in that timeframe.

David M. Johnson Chief Executive Officer

Yes, maybe it's a two-part question, Mac. With respect to the Euro 7 that we've been talking about, primarily, this is on the light-duty side, and this is a new customer for us. What we see with the Euro 7 is that we've been awarded more of the total models that this OEM makes, and so, therefore, our volume will grow. What exactly the market is in 2025, '26, '27 timeframe as the Euro 7 comes into play and how the business looks at that point

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in time is maybe anyone's guess, but definitely, our customer says it's up and to the right. The market is growing. People are asking for and demanding these low cost to acquire, low cost to operate products.

In terms of the trucking market with Euro 7, I think that no one sees this really as a barrier to further growth of clean fuels in trucking, whether that's natural gas or hydrogen. Response to the regulations is no problem, and again, the driver in the second half of this decade are the CO2 standards starting in 2025 and then going on 2030, 2040, and that applies also to cars as well as trucks, and really driving customers to look for cleaner fuels that they can use with our technology.

MacMurray Whale – Analyst, Cormark Securities

Is the projection, then, one based on your view of a certain number of vehicles have to be cleaner of a certain amount, so it's top down on an emissions basis rather than a bottom-up looking at particular customers and sort of a production schedule? Is that how you're doing that? I'm just trying to figure out—€40 million is a pretty precise number. I'm just wondering what goes into that.

David M. Johnson Chief Executive Officer

Oh, I see, basically, this is the calculation based on a combination of units and selling price, and it is an expectation put on us by our customer. There's always a chance to exceed that. There's always a chance to fall short, but that seems to be an appropriate number for us. It's very meaningful, obviously, for our P&L, and, of course, our top line. We're—yes, it's a combination of factors in the end, Mac. We look at all the factors in the marketplace; we listen to our customer; we make our own judgment; and then we do some rounding so it sounds good and easy to remember.

MacMurray Whale – Analyst, Cormark Securities

Okay, but it's based on reaching certain points like cost points? I'm trying to figure out—we have our own forecast, and I'm trying to figure out whether your €40 million forecast is consistent with assumptions that I'm using, maybe it is, maybe it isn't. I'm just trying to figure out how much of that do I incorporate into a model,

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because it's a good number to have that you've put out there. I just want to make sure it's based on things that I'm thinking are aligned with my own thoughts.

David M. Johnson **Chief Executive Officer**

Yes, I'm not sure how to advise you on how to do your model in this regard, but I can say that this is our calculations based on our read of the marketplace and our work with our customers, so I think it's a good number.

MacMurray Whale – Analyst, Cormark Securities

Okay, great. Thanks. That's all I have.

David M. Johnson **Chief Executive Officer**

Thanks, Mac.

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.

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David M. Johnson

Chief Executive Officer

Thank you very much. Thanks, everyone, for your time today. Really appreciate you joining and the Q&A. Clearly, as we look at this quarter, we're quite satisfied that it's an improvement over prior year. Nonetheless, for us, 2023 is quite a transformational year as we put the past behind us and set our sights on the future. We have really important business coming as the heavy-duty LNG market recovers and as we launch for our new customers later this year, and looking forward to continuing the conversation. We have a number of opportunities yet this month. We're at the Oppenheimer Emerging Growth Conference this Thursday; next week with RBC at their Automotive and Industrials Conference. Then we'll be with investors in London with TD Cowen, and we'll end the month at Craig-Hallum Conference in Minneapolis and be glad to be back there in person with that fabulous team. Thanks, everyone, for your time, and have a good rest of your day and see you soon.

Operator

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