

Tecogen Inc. [TGEN]
Fourth-Quarter and Full-Year 2015 Earnings Conference call
Monday, March 28, 2016, 11:00 AM ET

Company Participants:

Ariel Babcock; Director, IR

John Hatsopoulos; Co-CEO

Benjamin Locke; Co-CEO

Robert Panora; President and COO

David Garrison; CFO, Secretary and Treasurer

Presentation:

Operator: Good morning and welcome to the Tecogen fourth-quarter and full-year 2015 earnings conference call. (Operator Instructions) For your information, this conference is being recorded.

As a reminder, a recording of this conference call will be available for playback approximately one hour after the end of the call and will remain available until Monday, April 4, 2016. Individuals may access the recording by dialing 877-344-7529 from inside the US, 855-669-9658 from Canada, or 412-317-0088 from outside the US. Enter the replay conference number of 10079911 followed by the pound sign.

Now I would like to introduce Ariel Babcock, Tecogen's Director of Investor Relations. Please go ahead.

Ariel Babcock: Thank you, Rocco. Good day, and thank you all for joining us on our fourth-quarter and full-year 2015 earnings conference call.

On the call with me today are John Hatsopoulos and Benjamin Locke, our Co-Chief Executive Officers. Also joining us today are David Garrison, Tecogen's Chief Financial Officer, and Robert Panora, our President and Chief of Operations.

During the call, we will be referencing slides posted on the Investor Relations section of our website at Tecogen.com.

Before we begin, I'd like to remind you this presentation includes forward-looking statements within the meaning of Section 27A of the Securities and Exchange Act of 1933, and Section 21E of the Securities and Exchange Act of 1934. Such statements include declarations regarding the intent, belief or current expectations of the Company and its management.

Prospective investors are cautioned that any such forward-looking statements are not guarantees of future performance and involve a number of risks and uncertainties that can materially and adversely affect the actual results as identified from time to time in the Company's SEC filings. Forward-looking statements provided herein are as of the specified date and not reaffirmed or updated at any time.

I will now turn it over to John Hatsopoulos, our Co-CEO, for some opening remarks. John?

John Hatsopoulos: Good morning, ladies and gentlemen. Thank you very much for listening to our story.

This is an exciting period for us. Some of you shareholders for a long time know that we have spent a tremendous amount of money for technology, for new technology of combined heat and power. Also we have spent a lot of money for patents, large amounts of money that I never thought that would reach that kind of level. But it appears that now that our technology is moving along it looks like we're going to start getting back some of our, or all of our investment and maybe more.

I want to remind you that our patents are covered by Lloyd's of London, which is something that was very important for us, because spending all this amounts of money without the protection of a large institution like Lloyd's made them worthless.

With that, I'd like to ask Ben, who's my partner, to give you an update how the Company is doing and hopefully tell you how he sees the Company in the future. Ben?

Benjamin Locke: Thank you, John.

I'd like to start off our call by reminding those who may be new to our company with Tecogen's core business model as shown on slide 4: Heat, power, and cooling that is cheaper, cleaner, and more reliable. Our proprietary technology for improving efficiency, emissions and grid resiliency is truly disruptive to the traditional methods of heating, cooling, and powering buildings and infrastructure.

As I'll describe in this discussion, the combination of our unique technology, overall trends in energy supply and demand, and increasing global emphasis on environmentally clean technology all favor Tecogen's continued growth. As seen from the timeline on slide 4, 2015 was a very productive year for the Company, and we will spend some time discussing these strategic accomplishments.

First, turn to slide 5. I will review some of the key financial metrics for our company: revenues, margin, and sales backlog.

The year 2015 saw revenues reach \$21.4 million compared to \$19.3 million in 2014, an increase of 11%. This was driven by a 16.6% growth in product revenue and 6.2% growth in service revenue.

Gross margin for 2015 increased by 250 basis points to 35.6% compared to 33.1% in 2014. This improvement was driven by improved margins in both product revenues and service revenues, accomplishing a stated goal for 2015. And, although it wasn't one of our strongest fourth quarters, significant progress was made on key metrics that we'll build on in 2016.

First, in the fourth quarter we increased our gross margin to 37.4%, exceeding our objective of achieving margins [above] 35% each quarter.

Second, we made good progress controlling operating expenses for the quarter. We feel our expenses have leveled and hope to make more improvement in managing them going forward.

While we ended the quarter with a loss, it's worth mentioning that important activities such as business development and product marketing proved to be excellent areas to invest our resources. The marketing of our new InVerde and emissions technology and the business development efforts to reach new sales markets and geographies, as well as developing strategic ventures such as ULTRATEK, while consuming resources that contributed to our loss, in the long run are very important for the Company to ultimately reach profitability.

Moving to backlog, we continue to have a robust sales pipeline. Backlog as of year-end 2015 was \$11.6 million, a 17% increase compared to \$9.9 million at the end of 2014. Current backlog as of March 21 is \$12.2 million, well ahead of the Company's goal to maintain backlog above \$10 million.

Lastly, gross profit for 2015 increased to \$7.63 million compared to \$6.4 million in 2014, an increase of 19%.

Turning to slide 7, I'd like to now take a few moments to discuss some of the key strategic accomplishments for the Company.

First, I'd like to discuss the Ilios heat pump. We have initiated the process to acquire the remaining minority stake in Ilios via a private placement exchange offer. We expect to have this transaction completed in the coming months.

This is exciting because of the continued progress we are making towards advancing sales of the Ilios products. Not only did we double Ilios sales from the previous year, we installed Ilios units in key market segments such as the seven units in a major biotech facility in Florida, installations in hotel and hospitality projects, and sales in new geographies such as Hawaii, Puerto Rico, Atlanta, and the UK.

We have also introduced a new product variation, which is a split air-sourced heat pump. This allows the air-sourced heat exchanger portion of the Ilios unit to reside outside, where it is needed, while the actual Ilios engine and unit are located inside in the boiler room where piping and installation is more cost effective.

Now turning to sales more broadly, we have added new sales associates to round off our team. We expect this team to continue focusing on our key market segments as well as growing

additional market segments and, in combination with our product representatives and sales agents, continue to grow our backlog in 2016.

And, as announced last week, we entered into a strategic partnership with a large gas company to bring Ilios chillers, and ultimately CHP systems, to commercial and industrial customers. This exclusive partnership includes a commitment to joint marketing, dedicated local sales resources from a gas company, and yearly milestones for project leads and installations. We look forward to sharing more details of this partnership as we make progress in 2016.

Turning to service, we made excellent progress increasing our service revenues and margins. As mentioned in previous calls, our turnkey installation services not only help Tecogen bring CHP systems directly to our key market segments, but also assures long-term profitable service revenues to the Company.

Total service revenues for 2015 showed a 6.2% growth over 2014 service revenues, with gross margins improving nearly 300 basis points over 2014 margins. This improvement was due to the startup of good quality turnkey sites by Tecogen in 2015, as well as lower costs by virtue of better located Valley Stream service depot, better inventory control, and overall improved cost control measures.

Turning to slide 7, we've made some significant technology advances that will better position Tecogen for further growth in 2016.

First, as indicated by our recent press release, we introduced the next generation InVerde product, called the InVerde e+. The e+ offers several new features that improving saving for customers and provide additional functionality not available by any other competing product. Through a combination of improved InVerde technology and a new engine platform, electrical efficiency has increased to levels best in class for any engine-driven CHP system.

Additionally, the e+ has other upgrades, such as rapid, less-than-10-second startup in black-start situations. Being able to start and energize emergency building loads in under 10 seconds is an important aspect for buildings with stringent emergency power requirements. Bob will discuss other important improvements to the e+ system a little bit later in the call.

A related improvement we introduced in early 2016 is a partnership with GE's Equipment Insight system, to provide dramatically improved data collection, analyzation, and management capabilities. The GE system will not only allow customers to see real-time production data such as power output, historic production, gas consumption, and system efficiency, it will also allow Tecogen service staff to more efficiently monitor, diagnose, and maintain Tecogen systems using modern technologies such as mobile applications and real-time data monitoring.

As we advance this roll-out of the GE system, we expect to develop user-friendly mobile apps and other systems that will clearly show how our product operates and saves money for customers.

Lastly, and potentially most importantly, we've made significant progress bringing our proprietary emissions technology to larger markets. Beginning with the rebranding of the emissions technology under the brand name Ultera, we reached several milestones for retrofitting the technology of stationary engines such as biogas engines and generators, which Bob will describe in just a moment.

An important development on emissions was also announced in January of this year, where we established a joint venture for the development of Ultera for gasoline vehicles. As Bob will describe in more detail shortly, we have always contemplated the application of Ultera for gasoline vehicles, and the recent controversy over current auto emissions capabilities and testing has provided us with the right context to investigate Ultera for automotive applications.

In all, we've made excellent progress in 2015, and we believe we'll make 2016 even more successful. Slide 8 shows a sampling of some of the growth in product sales in 2015 in our key market segments. As you can see, we continue to reach a broad swath of market segments and customers.

And turning to slide 9, it further demonstrates that our backlog and installed base are consistent with our stated market segments and sales goals.

With that, I'd like to turn it over to Bob for more detailed discussion of our technology developments, followed by Dave with a more detailed view of our financials. Bob?

Robert Panora: Thank you, Ben, and good morning.

I will begin my discussion with our new product launch just mentioned by Ben and announced January 26th. As described in the press release, our mainstay CHP product, the InVerde, will be phased out over the next few quarters, replaced by a significantly more advanced second-generation model, the InVerde e+. This new model has been in development for a number of years and represents a large body of upgrades and refinements that further distance us from the competition. Now let me elaborate.

The heart of the e+ is a new proprietary inverter. Utilizing the latest electronics, it operates at a higher efficiency than its predecessor, with less components and reduced noise signature. The inverting includes onboard power electronics and control to directly accept DC power from a battery or solar PD system. We believe the battery application will be an important one, especially as battery technology improves.

Similar to solar systems, being able to bank electricity and withdraw it at a later time has significant value. This would be, for example, in applications where electricity tariffs vary by time of day and electricity produced off peak would be expended on peak for greater revenue and so forth. Battery storage also provides us the capability to apply our systems on critical power applications such as UPS, uninterrupted power supply type systems.

Our engine has also been upgraded to a larger, more efficient model, which includes the Ultera emissions after-treatment, but also enhanced features such as computer managed ignition system

requiring no maintenance or adjustment. The larger engine permits us to run at a lower engine RPM, which has positive impact on fuel consumption, service, and noise. Its larger size provides an opportunity for higher kilowatt rating, which we anticipate for the e+ down the road.

We have upgraded our user interface, as Ben mentioned, to a modern touch screen with our GE monitoring system. Operators will be able to connect to the unit using any handheld device through our user-friendly interface.

As with the original InVerde, the e+ will include the microgrid feature and, of course, the Ultera emissions after-treatment.

The e+ has been certified to all the standards for standby power and utility interconnection and we have incorporated a rapid startup feature, 10 seconds. The e+ will then qualify as a primary backup power source in New York City.

All told, we believe the e+ resets the benchmark for modular cogeneration for years to come into the future.

I'll move now to update on several ongoing emissions-related items. As we reported about a year ago, the Company sold an Ultera emissions kit to a water district in Southern California. In this case the kit was to be utilized on a much larger engine and fueled not by natural gas, but by a gas manufactured on site as a byproduct of their waste water treatment process.

Power generation with biofuel, a common practice in recent years, is becoming problematic in Southern California. Biofueled engines beginning in 2017 will be subject to regulations equivalent to those applying to natural gas sources -- hence, the interest in the Ultera system by this customer.

The biofueled engine commenced operation with the Ultera device last November, with excellent results day one, and has performed just as well since. Last week the water district hosted their trade association meeting at the site, featuring the system to other California water districts. So a very positive outcome to that project.

Our other notable project is the application of the Ultera device to a group of natural gas generators sited near Los Angeles. As I discussed in our last earnings call, the application requires extraordinary low emissions as these generators need permits for heavy duty use.

In Q4 we completed shipment of the kits and the prototype generator that was used in the first phase of the project to demonstrate performance. The work that remains is for us to retrofit the kits. This has been postponed because of conflicting onsite work there.

Otherwise, the stationary after-treatment [market] -- we will continue to pursue numerous leads and have a number of proposals issued that we are hopeful of closing as the regulatory urgency builds.

Okay, I want to move next to our newly formed joint venture involving gasoline vehicles, ULTRATEK, which is obviously of great interest.

As we discussed during our January conference call, this program is an important opportunity for us. The timing is excellent, as the problems related to vehicle emissions have been widely exposed by the Volkswagen scandal, and relate precisely to the class of pollutants addressed by our technology, namely NOx, CO, and hydrocarbons. Moreover, we are especially pleased to have been provided the substantial resources to conduct a focused scientific inquiry thoroughly and without delay, both being essential elements for this effort to succeed.

Let me provide some background for those who might have missed our call in January, and then I'll provide an update.

Last fall, the Volkswagen scandal prompted the Company to form a committee of knowledgeable individuals to assess the Ultera technology for applicability to gasoline vehicles. We understood that our technology was not a fit for diesel engines. However, we noted that the reporting of diesel noncompliance included considerable mention of gasoline vehicles -- not that there was an issue regarding the integrity of the testing, but rather that the testing method failed to replicate emissions associated with real-world driving. In other words, the test cycles appear to understate the actual pollution impact of gasoline vehicles.

This is not a surprise. The basic test cycle was developed 40 years ago, a very different era, and we see evidence of the problem in our urban air quality, which has lagged expectations, given the improvements made to autos in the last few decades.

As I reported in our last earnings call, the outcome of the Committee was strongly positive and I'll summarize here their main conclusions.

Current after-treatment systems for gasoline vehicles may be inadequate for future industry needs. Two reasons stand out. First, stricter emission standards will commence in 2017, which are structured to be more restrictive each year through 2025; secondly, random test scrutiny already underway will pressure regulators to make modifications to the certification process. As such, after-treatment systems that may have been considered adequate for the future must now be cause for concern.

The other compelling theme from the Committee is that the Ultera technology is a good fit for addressing the weakness of current automotive technology. That is, it addresses problems that occur in the difficult extremes of operation -- rapid acceleration and deceleration, heavy duty cycles, et cetera, while at the same time being relatively simple and nonintrusive.

Lastly from the Committee, we believe that the success of the technology with natural gas engines demonstrated continuously since 2010 in many engines in the US can be replicated in gasoline-operated vehicles. This needs to be proven, of course, but we are optimistic.

Since the formation of the new company we have focused on executing our business plan. This begins with a team which is now fully formed for our initial phase. As I stated during the January

call, our plan is to not utilize significant internal Tecogen resources. Instead, we will complete much of the work through third-party resources such as consultants.

To that end, and as was announced on January 21, ULTRATEK has contracted AVL North America to perform testing and delegation of the system. We are very pleased to have them under contract. They have world-class personnel and facilities for this type of work, and they are certainly well respected by automakers.

In addition to AVL, we have retained several consultants with relevant expertise to the project work statement. This includes a senior project engineer to perform the detailed technical work that we require. Technical oversight will be the responsibility of Professor Ghoniem and the Tecogen engineering management.

Currently the ULTRATEK team is moving forward with our business plan, with our first task being to baseline test our candidate vehicle. We have a lot of work to do, for sure, but I couldn't be more pleased with the capabilities of the group and their prospects.

I don't want to conclude without mentioning the group's foremost members, our Swiss investors. They are ready and willing to provide the necessary funds to bring this company to a successful outcome.

And one thing I want to mention also is, for obvious reasons we will be very guarded in reporting our progress until we feel the time is appropriate.

With that, I would like to turn the call over to David Garrison to discuss the Company financials.

David Garrison: Thanks, Bob.

Reviewing the highlights from the year-over-year financial results, revenues increased with strong product revenue related to an increase in cogen unit shipments. While the heat pump unit volume increased, the decrease in chiller unit volume led to a decrease in dollar revenue for the category. We expect this category to rebound in 2016.

Installation services and service maintenance contract revenue continued its steady growth, resulting in more than half of our total revenues. We are pleased with the nearly 11% growth in revenues. This growth, in conjunction with consistent backlog of over \$10 million, meets Management's goal of a book-to-bill ratio in the range of 1 to 1.5.

Cost of sales benefited from reaching scale as manufacturing volume continues to grow and our efficiency programs continue to yield improvement. Margins for both products and services improved with lean initiatives and continued focus on higher value-added work. Management expects to continue this trend in the near future. Gross margins and expense reduction programs continue as Management uses its cash resources in a thoughtful manner.

On slide 15, we have our charts that we use to guide us through this process. Starting with the chart in the upper left-hand corner, total revenue for the year is \$21.5 million. The year-over-year

growth is 11%. While the quarter-to-quarter revenue shows some volatility, the longer-term growth trend continues and we expect our recent partnerships will yield greater growth in the near future.

The chart in the upper right illustrates Management's success in our goal of improving consolidated gross margins of greater than 35%. This success is expected to continue into the future.

In the lower right is a chart of our operating expenses. After our first full year of being public, Management's goal to lower operating expenses have begun. We believe the current year will be our peak as the team works to tighten and decrease spending as a move forward towards profitability continues.

And finally, in the lower left, the backlog chart plots our weekly backlog. Currently at \$12.2 million as of March 21, this backlog is ahead of Management's goal to exceed \$10 million in product and turnkey service revenue. As a reminder, backlog does not include service contract revenue, which was more than one third of our revenues in 2015.

On slide 16 our targets are clear. Management continues to meet its goal of delivering improving margin in the range of 35% to 40%. Backlog has been maintained above \$10 million in revenue from product and installation sales. And stable operating expenses of \$10 million on a 12-month basis is our target that we believe we can meet.

And now, I'll turn it over to Ben for closing remarks.

Benjamin Locke: Thanks, Dave.

In terms of trends in our favor, we expect demand for our CHP systems to remain strong. The fundamental economics of CHP, such as high electric rates, low gas rates, and great resiliency concerns continue to be in our favor.

The Ilios market continue to expand both geographically and in different market segments. And we expect additional sales of our water-source system and facilities that consistently have the need for simultaneous heating and cooling process water, such as manufacturing.

And, as Bob described, adapting the Ultera emissions technology to gasoline vehicles represents an exciting and game-changing new market for Tecogen. The prospect of vehicle fleets and passenger vehicles operating with standard engine technology but realizing fuel-cell-like emissions is tremendously compelling from a policy and market standpoint. Our plan is to seize on this opportunity to prove the Ultera technology is the best way to meet strict emission standards.

And, lastly, we will continue to grow our patent and intellectual property base around this technology. In addition to the patent applications filed this year around emissions controls, new patents and trademark applications will be filed to protect the Company's competitive position in this very promising market.

In closing, we have very bright prospects for growing Tecogen in 2016, and look forward to sharing developments with you as they occur.

With that, I'd like to thank you for joining our call and look forward to speaking with you again in our next earnings call.

Operator: Thank you. I would like to thank you all very much for participating in our conference call. This concludes today's event. You may now disconnect your lines.