

Tecogen Inc. [TGEN]
First-Quarter 2016 Earnings Conference call
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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

Analysts and Investors:

Ralph Wanger; RW Investments
Roger Liddell; Clear Harbor Asset Management
Michael Zuk; Oppenheimer & Co.
Tom Orr; Investor
Alex Blanton; Clear Harbor Asset Management

Presentation:

Operator: Good morning and welcome to the Tecogen first-quarter 2016 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 Wednesday, May 18, 2016. Individuals may access the recording by dialing 877-344-7529 from inside the United States, 855-669-9658 from Canada, or area code 412-317-0088 from outside the United States. Enter the replay conference number 10084852 followed by the pound key.

Now I would like to introduce Ariel Babcock, Tecogen's Director of Investor Relations. Ms. Babcock, the floor is yours, ma'am.

Ariel Babcock: Thank you. Good day, and thank you all for joining us on our first-quarter conference call.

Speaking on the call today are John Hatsopoulos and Benjamin Locke, our Co-CEOs. Also joining us today with prepared remarks 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 would like to remind you that 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 intents, 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, and good afternoon for whoever is in Europe.

This is an intriguing period for us, for two reasons. The market of cogeneration has been a very simple market for a long period of time. And as a matter of fact, a lot of people in garages can slap pieces together and make a small cogeneration unit and get some orders. Well, actually probably we have lost a very small amount of orders that are in the Northeast where we're mostly in the market, and none in California.

The reason I say this is interesting, that our equipment is different than anybody else's. We have eliminated the bulk of emissions which, by the way, is just starting to wake up in the whole world. And our emissions technology, even though it makes at times our equipment a little more expensive because of -- and I'll let Bob, who is the scientist, I'm not an engineer, explain it to you. But in the additional equipment that we add to our units, there's a little bit of extra cost at times, while the guys in the garage don't have to do that.

Now, all of a sudden the whole world is switching into low emissions. And we believe, number one, that our competition on a long-term basis cannot compete with us, because our emissions control is fully patented and insured by Lloyd's of London. And all of these people that can put together a simple unit will eventually disappear. Or at least maybe we hope they'll eventually disappear, unless they make a new invention that is better than ours, which we don't believe it is.

With that, I would like to ask Ben Locke, who really runs this operation, and talk to you about where we are.

Ben Locke: Thanks, John.

So I'd like to start off the call, as always, by reminding those who may be new to our company of Tecogen's core business model, as shown on slide 4 -- heat, power and cooling that is cheaper, cleaner, and more reliable.

As John mentioned, we have proprietary technology for improving efficiency and, more importantly, emissions, as well as great resilience to be truly disruptive to the traditional methods

of heating, cooling, and powering buildings. As you see in our Company timeline, technology development and product innovation is our most valuable asset, and we've made tremendous achievements so far this year.

Turning to slide 5, before I go into our actual earning results for the quarter I want to describe the very important strategic steps we've taken to both improve our current products as well as grow our technology applications outside of our traditional markets.

First, we continue to strengthen our product offering with the introduction of the new InVerde e+, as well as the implementation of the GE Equipment Insight mobile remote monitoring system in the first quarter. It's very important that we continue to improve on our products in order to maintain our competitive advantage in the CHP market, as John described. And with the new e+ improved efficiency, better economics, quieter operation, and other improvements all reinforce our goal of providing our customers with the most advanced clean energy technology available.

With regard to our GE partnership, we're beginning to implement the GE system on new products, as well as retrofitting existing projects. The GE system allows real-time access on the function of all of our units -- CHP as well as chillers, heat pumps, and even our retrofit emission systems.

While the Tecogen service people have always had this capability, the new GE system allows customers to access dashboards that can demonstrate the operations and savings of the equipment real time on the computer or mobile devices. It also allows an overall fleet view of real-time operation of our installed systems, which we've permanently displayed in our Waltham offices but, more importantly, at all of our service depots.

Evidence of the importance of these new innovations is clear in the recent award with the very large energy service company, or ESCO, for CHP in the Long Island School District, which consists of both InVerde CHP and 75 kW induction CHP units for a total of 900 kW of CHP. The contract award was aided by the innovation of the new e+ and by the functionality of the GE system. The new remote monitoring system will be included on all orders from ESCO going forward.

Bob will provide a little more detail on the e+ and the GE system later in the call.

The second area that holds exciting potential for the Company is in the development of the emissions technology for automotive applications. As our press release this morning indicated, our joint venture company, ULTRATEK, completed its first-phase testing of the Ultera emissions reduction technology on a gasoline-powered, light-duty vehicle.

The results conclusively proved the Tecogen Ultera emissions technology was highly effective in reducing pollutants from the test vehicle. I'll let Bob describe the importance of the CO and non-methane hydrocarbon levels, but suffice to say these results are tremendously promising and validates the technology's effectiveness in reducing harmful pollutants contained in automotive emissions.

Lastly, as previously stated, in the first quarter we initiated the process to acquire the remaining minority stake in Ilios, the private placement exchange offer. As of May 2nd, this process was completed and Ilios is now fully integrated into Tecogen.

This transaction is very important as Ilios becomes recognized as an offering, giving important cost saving solutions within the engineering community, which is often the key sales channel to our targeted markets.

We are very optimistic about the heat pump potential, as evidenced by the gas partnership agreement announced in March. This exclusive partnership includes a commitment to joint marketing, dedicated local sales resources from the 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.

So, turning to slide 6, I will review the key financial metrics for our company -- revenues, margin, and sales backlog.

Our revenues for the quarter were just under \$5.1 million compared to \$6.1 million in the first quarter last year.

There are several contributing factors to the challenging market conditions we've seen recently, such as customers taking longer to sign contracts and a decline in orders from some of our traditional sales partners and agents, particularly with chiller orders. Interruptions in some of the incentive programs have also contributed to delays in customer bookings in the past quarter.

On a positive note, service revenues increased 9.5% over the prior-year period as a result of the increasing population of new units and service contracts.

Our gross profit for the quarter was approximately \$1.7 million compared to \$2.2 million in Q1 of 2015.

While we were disappointed with the top-line revenue results, we did make progress reducing our operating expenses through strategic cost improvement measures. Our OpEx for the quarter was approximately \$2.57 million compared to \$2.84 million in the first quarter of 2015. Our goal is to deliver full-year operating expense near \$10 million. With Q1 expenses typically higher than other quarters, we believe our efforts to reduce OpEx are paying off and we are on track to reach this goal.

Our overall gross margin was just under 34% compared to 36.5% in the first quarter of 2015. The gross margins benefited from the product cost reduction initiative I just mentioned. But these improvements were offset by a legacy installation project that unavoidably went over budget. We have instituted a more structured process for our installation projects that will prevent such overruns in the future.

Moving on to backlog in slide 7, we anticipate many projects that have been delayed for the reasons stated earlier will begin to be contracted as we move forward into 2016. Backlog as of

May 6, 2016, was \$13.1 million, well ahead of the Company's goal to maintain backlog above \$10 million. As you can see, our backlog maintained a healthy mix of projects in our core market segments.

With that, I'd like to turn it over to Bob Panora for more detail on our technology developments, followed by Dave, with a little more detail of our financials. I'll then wrap up before we take your questions. Bob?

Robert Panora: Good morning, everyone, and thank you, Ben.

Today I want to provide updates on several topics that we have discussed on previous calls. I will begin with the GE equipment monitoring system.

As discussed in our last call and as Ben has talked about today, the Company has adopted through formal agreement a General Electric IT platform for remote data rack collection. The system, which GE has branded Equipment Insight, provides remote internet access to data from the Tecogen modules and other onsite equipment at the facility. The information can be viewed in standardized reports, in dashboards, or may be custom configured by the user as desired.

The purpose of the GE Insight is to provide owners and operators of our equipment, and of course also our service personnel, a multiplatform tool for evaluating the performance of the CHP plant in both real time and in the past.

Essential attributes for the Insight system are the field setup is very simple, inexpensive, and without requiring intrusion into our customer networks. The adaptation of a GE operating system and the Tecogen customer-ready product has been completed. Revision 1, if you will, is fully operational at several sites, allowing users and service personnel to gain immediate access through their smartphones, tablets, and PCs. It's quite impressive and it has tremendous potential beyond its current utilization.

In one display configuration, as Ben talked about, groups of installations can be viewed collectively. Utilizing this feature we are equipping our service centers with large flat-screen monitors strategically placed in each office such that fleet status is visually prominent. The same is being done at the factory, of course, but on a larger scale such that the entire Tecogen fleet is monitored in real time.

Next I want to provide update to our new CHP product, the InVerde e+. And, as we detailed in our January announcement, our mainstay CHP product, the InVerde, is being phased out, replaced by a significantly more advanced second-generation model which we've called 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. These include a more advanced InVerde [and] generator for which we own and control the intellectual property, a larger and more powerful engine, and state-of-the-art controls compatible with GE Insight, of course.

In addition, the InVerde e+ has the ability to integrate its electricity production with other direct current sources such as solar, PV and, of course, batteries.

Another feature is that the larger engine provides 25% more electrical output which can be dispatched during periods of high electricity costs such as would be the case during a hot summer day.

I want to expand on one additional feature of the e+. As we discussed last time, it has a lower noise signature relative to its predecessor. Recently we have further reduced its noise profile with a new high-attenuation sound closure. With this and the other sound improvements, the product is a full 10 decibels quieter than the original InVerde.

This is a very significant drop in sound level, one that equates to the product noise level being cut in half -- half the noise of the older product. This feature will expand our ability to place the product in areas of critical noise sensitivity, an important competitive advantage.

The InVerde e+ has generated a great deal of interest and we are reaching out to our ESCO friends and consulting engineers for a series of seminars on the product. The option to operate in peak periods at a higher output level as an immediate response tool has generated particular interest in the energy services community.

Today our current production is virtually all e+ and we don't anticipate the older project beyond this quarter.

Moving on to emissions technology, our stationary biogas and natural gas installations continue to do well. And we have a good slug of additional quotation activity that's been ongoing.

We have filed several new patent disclosures and received formal notification of an additional emissions-related patent. These are very important as they also cover technical areas in common with our Ultera vehicle project and therefore help secure stronger IP protection in this endeavor as well.

As Ben discussed, we have been very active with our new venture, ULTRATEK. This is the newly formed Tecogen subsidiary whose purpose is to demonstrate the emissions after-treatment process on gasoline-powered vehicles.

This work has been funded primarily by two strategic investors in Europe and of course is related to the heightened awareness of pollution brought on by the Volkswagen scandal. Since we have begun our work, the auto industry story has not subsided; rather, it's only expanded to other brands and other areas of vehicle certification such as fuel economy.

So for the Ultera process, the fit is for gasoline vehicles. This category has not been implicated in any improper testing. However, there is a growing awareness that the pollution output measured in controlled laboratory drive cycles significantly under-represents the true emissions output of

vehicles of this type in real-world driving. As such, there is an expectation that the certification process will be altered in some aspect to correct this shortcoming.

The Ultera strengths are well suited to this issue because the system provides robust performance, especially in extreme edges of operation, that being high acceleration, deceleration, heavy loading, and so forth.

Currently through our joint venture with ULTRATEK we have concluded our Phase 1 testing, which is to test the Ultera system on a new model light-duty gasoline vehicle. Our purpose is to confirm the chemistry of the process with this fuel, which is of course outside of our experience.

As announced in January, we have contracted on behalf of ULTRATEK with AVL, a highly respected vehicle powertrain development and test company, to perform these tests. They are extremely qualified for this task. Their staff is highly experienced in this field. And their test facility is world class.

The testing, which covered just over two weeks, has just concluded and we have collected a great volume of data which we have been carefully analyzing. At this time -- we issued a press release this morning that says the same thing -- we are pleased to announce that the Ultera process was confirmed to be effective in the gasoline vehicle application.

In standard EPA drive cycles emissions from the test vehicle relative to carbon monoxide was reduced by as much as 90%, while non-methane organic gases, or NMOGs, were likewise reduced by as much as 80%. The chemistry, in short, behaved as we expected and conformed to our stationary natural gas engine experience.

We should mention that the vehicle was compliant. It was a typical vehicle that you would buy off the lot and was compliant in all respects relative to its current government certification. So our process was to enable and improve upon these baseline results.

The impact of the Ultera process on organic acids, NMOG, is especially significant. And let me explain a little bit about that. In the vehicle certification process the NMOG chemical group is of major importance, factored into the latest standards equally with NOx, with nitrogen oxides. In fact, NOx and NMOG are added together in the scorekeeping as a single pollutant.

Moreover, and until the AVL testing our experience with these organic gases was minimal. We didn't have the equipment. It doesn't really exist for stationary sources. These chemicals are simply not measured in a meaningful way in our normal product testing.

So we were very pleased to see this result in real time, which is what we wanted to verify, made possible by this exceptional instrumentation available to us at the AVL facility.

So we have more work to do. We're not done. And we are in the process of evaluating our next steps. But, in any case, this is a very positive start to ULTRATEK, which we're very pleased about.

That concludes my discussion. I'll turn the call over to Dave Garrison to discuss some of the financials.

David Garrison: Thanks, Bob.

Reviewing the highlights from the year-over-year financial results, total revenues declined compared to the prior-year period, although on a sequential basis the Company posted modest improvement over fourth-quarter 2015 revenue results.

While chiller sales rebounded from a weak fourth-quarter showing, they still fell short of last year's mark. Similarly, heat pump and cogeneration sales were delayed for the reasons that Ben previously discussed. Despite a small decline from the prior year in installation services revenue as a result of a few project delays, total service revenue continued its steady growth, delivering well over half of our total Company revenues in the quarter.

Revenue from long-term contracted maintenance and service agreements accounts for over one third of total Company revenues, providing a reliable, annuity-like revenue stream. This stable revenue should only continue to grow as the installed base and fleet operating hours grow, helping to smooth the impact of cyclical sales resulting that are typically found in our industry.

Cost of sales was impacted by the product mix, lower sales volume, and the loss of a legacy installation contract Ben previously mentioned. This loss impacted both service costs and gross margins.

Product margins improved as manufacturing efficiency programs continued to yield positive results. 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. Starting with the chart in the upper-left corner, total revenue for the trailing-four-quarters period is \$20.4 million, a slight year-over-year decline. While the quarter-to-quarter revenue showed some volatility, we expect longer-term growth to continue, benefiting from our recent selling and product initiatives.

The chart in the upper right illustrates the smooth gross margin trend. As you can see on the trailing-four-quarter basis, Management delivered gross margin in line with the lower end of our targeted range of 35% to 40%. We expect cost controls and sales initiatives to continue to deliver margins within this stated range.

In the lower right is a chart of our operating expenses. After our first full calendar year as a public company, Management's plans to lower operational expenses has begun to produce results. We believe 2015 will prove to be our OpEx peak, as the team works to tighten spending and move the Company towards profitability.

Finally, in the lower left the backlog chart plots our weekly backlog, currently at \$13.1 million as of Friday, May 6. This backlog is well ahead of Management's goal to exceed \$10 million in product and turnkey service revenue.

Clearly, the large and much anticipated order from the multinational ESCO for a Long Island school district received in the start of April provided a nice bump to backlog. As you can see in this chart, other recent project wins have added to this number. But as a reminder, backlog does not include service contract revenues, which were more than one third of our revenues in 2015 and continue to show consistent growth.

Again, the targets of the Company: Management plans to continue to meet its goal of delivering improving margins in the 35% to 40% range, maintain backlog of product and installation sales above \$10 million, and deliver stable operating expenses of approximately \$10 million on a 12-month basis.

With that, I now turn it back over to Ben for closing remarks.

Benjamin Locke: Thanks, Dave.

So in closing, while we're very disappointed with the drop in top-line revenues for product sales, we've responded to the market challenges aggressively. Our rollout of the new InVerde e+ will provide customers with superior economics and operation compared to any other CHP product in its class. And the additional functionality of the GE system will not only enhance our service capability, but allow customers the ability to see how their equipment is performing and the savings associated with it.

We believe some of the delays in product orders will gradually relent in the coming quarter as we bring backlog into production and bring top-line revenues back where we want them. We also anticipate the New Jersey CHP incentive program will restart this summer, and the New York chiller incentive program later this year.

Similar to the Ilios gas company partnership, we also continue to look for strategic partnerships, in all of our product lines, which can enhance our sales capability. And as our installed base continues to grow we expect to see our service revenues continue to trend upwards.

As Dave mentioned, we'll also continue our concerted efforts to reduce our operating expenses to establish a base line for achieving profitability in the coming quarters.

Lastly, we are very excited about technology development at ULTRATEK, as Bob described, and we look forward to sharing those results with you as they occur.

With that, I'd like to turn it over to the Operator for any questions.

Questions & Answers:

Operator: Thank you, sir. (Operator Instructions) Ralph Wenger; RW Investments.

Ralph Wenger: Is there any breakthrough in California sales likely? Is the regulatory picture out there -- so, what's the regulatory picture in California? And what's our chances there?

Benjamin Locke: Sure, Ralph. That's a good question. Certainly the California, particularly Southern California, is where our Ultra emissions package shines and is a valuable selling tool for us in terms of what the standards are there. There are their own set of challenges in California from the utility standpoint. The tariff structures in California are much different than the tariff structures we're used to here on the East Coast and, in many cases, punitive towards CHP.

Without going into too much detail, there's this thing, non-bypassable charges and other tariffs, that could take a really high utility of, say, \$0.13 or \$0.14 per kW hour and ultimately reduce it to something less because you're still being charged, despite your CHP.

But with that said, there is up markets in California that take advantage of the emissions system. Our West Coast office is on them as well as on the regulators to try to say, look, this [initiative] is possible. You should really be thinking about changing. I know Bob has talked about the BACT and what the measurement is for emission standards, such that we would really be the only game in town.

Bob, do you want to add anything to that?

Robert Panora: No, (multiple speakers) --

John Hatsopoulos: Bob, excuse me. This is John. From what I understand there is nobody in California that meets the requirements other than us.

Robert Panora: Just very, very large turbines can make it, very expensive, very -- injection of chemicals and so forth that really don't apply to our market, you know, the big solar turbines and so forth.

Benjamin Locke: I will add one more thing, Ralph. California, it's an interesting environment and we've seen this in other states where they have a real focus on renewables. And everything's all about renewables. And for us who consume natural gas and we're efficient and we're clean and all those things, that's not good enough for them. That's not high enough with the angels with them. They want things to be renewable.

And this is why -- and I know I've mentioned this in the past and something Bob and I have spent time on -- we really in our technology development would like to come out with a unit that could run on biogas. That's not something we can do right now with these engines. But if we can get the technology to run these CHP units on biogas, then we'd be in favor with the angels in California on the renewable side and I think that would help us substantially.

Ralph Wenger: Okay. Thank you.

Operator: Roger Liddell; Clear Harbor Asset Management.

Roger Liddell: I wanted to go back to the AVL and the testing that was disclosed today. First of all, I believe that AVL was the entity that proved that VW diesels were emitting these enormous, what, 20 or 40 times the authorized limit.

Robert Panora: (Inaudible) the case, Roger. I think it was a group in North Carolina. But go ahead.

Roger Liddell: In any event, what can you tell us about the status of NOx? We heard about CO and the non-methane hydrocarbons. But is there anything at this point on NOx itself?

Robert Panora: Yes. Let me speak to that a little bit. In our current cogeneration products, what we've been able to do, because of the way the process works, we split it up into two separate chemical reactors. We're able to optimize the first reactor for NOx and optimize the second reactor for these other chemicals by the way we burn the fuel.

And that's a subtle thing, but in current vehicles you would have a vehicle such that the emissions on both types of pollutants was sort of a compromise, because you've only got the single reactor. And so by splitting it in two if you really carefully tune the vehicle or, in our case, the engine in our cogen, you can get to lower NOx levels without paying any penalty on these other components because you're dealing with them very effectively in the second reactor.

So, having said that, we have not done that yet. These results that we're reporting are essentially without having manipulated the vehicle in any way, which is the way you want to start and which is the perfect way to start. So down the road for the testing this is one of the important questions we want to ask ourselves.

But by and large the NOx is pretty good from these vehicles anyway. It's these other constituents that they struggle with that we were able to really pull down.

Does that answer your question, Roger?

Roger Liddell: Yes, that does. And in Southern California, I was heartened by the sales that took place into the manufacturer who needed the ability to operate emergency or backup generation to be --

Robert Panora: Yes.

Roger Liddell: -- (inaudible) suite of his supply. Is that installation in business and can it be a reference point for other such manufacturers or customers?

Robert Panora: Yes, it certainly will be. But the plant, or the facility, is extremely large facilities, undergoing a major rehab, if you will. And they've pushed us to the back of the back burner. We've shipped them all the equipment. They paid for it. And they just asked us to stand by until they finish the stuff they're doing there and then they'll bring the units online.

So, we're not able to turn that ship because they've got certainly a much bigger development going on in their facility that's well beyond our stuff. So we'll wait for them. I assume we'll be doing something very soon with them. But we haven't heard in the last few weeks.

Roger Liddell: Okay. Thank you.

Operator: (Operator Instructions) Michael Zuk; Oppenheimer & Company.

Michael Zuk: This question principally I think is for you, Bob. But tell us where we stand with Ilios and the use of propane as a basic fuel for Ilios, and what the potential market might be there.

Robert Panora: Yes. It might actually be better for Ben. But in terms of sales and so forth we have sold the Ilios to propane and it works fine on propane.

Benjamin Locke: Yes. In fact, propane users are the ideal target for the Ilios. Because, as you know, you're going to cut down their consumption -- in half, if not two thirds. So if they're paying \$2 or \$3 a therm for propane, you're going to tell them your propane bill is going to be cut in half, that's the whole driver right there.

So propane is indeed the markets, the most lucrative markets, for Ilios.

Michael Zuk: Are we making any effort or will there be a potential market, say, in some of the Caribbean nations? I know that a lot of them have converted from fuel oil to LNG and to propane. What are our efforts in that direction?

Benjamin Locke: Absolutely. I think I've mentioned in the past our channel to market for the Ilios, certainly outside the United States, is through manufacturers' representatives, reps. That makes more sense, particularly because when you go to some of these far flung locations, certainly in the Caribbean, you need to have somebody local selling things. I couldn't show up there and try to sell them something.

So we have reps in many of these places. We have reps certainly in Puerto Rico, which is one of the locations. And I'd have to check with our Ilios guy where else we have reps. But I know we have a rep network in the Caribbean for the exact reasons you mentioned, which is they have expensive energy. They've got resorts that use lots of hot water. People take showers and run in pools in these places. And they're paying an arm and a leg for their propane. And if we come there with the Ilios cutting their propane bill in half, it's a good play.

So you're absolutely right. And, in fact, once those sales start to pick up, it's ultimately going to be serviced out of our Florida office. As we've mentioned before, we're getting a population of units in Florida. At some point in time in the near future I anticipate we're going to be opening up a Florida service office. It's not just Florida but it's Georgia and some of the overall southeast United States. And that office would be doing the service on the Caribbean. So it's a great market for us.

Michael Zuk: With regard to Ilios, if it begins to demonstrate the potential that I think it has, will we at some point in time consider setting up a independent production line just for the Ilios-type units?

Benjamin Locke: Possibly. Mike, we've considered that. It comes down to economies of scale. Certainly at the rate of production right now, it doesn't warrant it. In fact, the actual labor costs, it doesn't dominate the cost of the Ilios unit. It's dominated by components -- engines, compressors, heat exchangers and all those type things.

But when you reach some critical volume of production, of course you'd consider perhaps producing it somewhere else where the economics and labor are a little bit cheaper.

Michael Zuk: Well, I think that Ilios has huge potential, particularly in the Southeast and in the Caribbean. Also, now that Hawaii has entered into a contract for the direct import of LNG, will that be another opportunity for us with the Ilios and I guess the InVerde e+ systems?

Benjamin Locke: Yes. Hawaii's a great market. It's another kind of like California, has all sort of intricacies in the energy industry certainly. I think it's in flux. I think there's some acquisitions going on. I think there's debate about that LNG terminal. I'm not sure if that's a done deal.

But all that aside, absolutely, Hawaii's a fantastic market for these things. And we've got a lot of activity there to try to get our Ilios units installed.

Michael Zuk: Well, it sounds like we're getting on track. I appreciate everything that everyone is doing there, and keep up the good work.

Operator: Tom Orr; investor.

Tom Orr: Bob, so you answered this somewhat. Phase 1 for ULTRATEK was good. We've validated the chemistry; that's all great. What do we want to have happen now? What's Phase 2, Phase 3? And how quickly can we get to there? You touched on it a bit. But can you provide more color about what we do now with this data, where we go and how we leverage it and what we might expect to see, as an investor, happen in the next six months?

Robert Panora: Sure. This is being debated internally. And the data, when you collect -- as an engineer I always want more data and more facts. But aside from that, what I think we need to do is now take a look at different vehicle types, if you will, and see where the most strain is on meeting emissions. And that will resonate -- now we have the technology, and I'm very confident about the chemistry. Now we have to figure out where the most acute need is, if you will, if that makes sense.

Tom Orr: And so what do you think -- it's probably a hard question to answer. What's a timeline reasonably, or what's an internal expectation to where you can get this to a point where we can then license the technology or partner with someone to build or actually start to generate sales, or be able to go to an automotive company where they have to start to take the technology and look

at it? What's a reasonable timeline before people really start to see this as something we can turn into defined revenues?

Robert Panora: I'm very reluctant to put anything out on that subject. As you can imagine, it depends on a lot of factors, including how the regulatory climate unfolds. There's a lot of expectation that, you know, with the Volkswagen scandal things will kind of change and that will trigger some activity. So I don't want to give a timeline. And anything I say will be changed in a week anyway because of different situation and different opportunity. So, regretfully, I'd like to pass on that one, Tom.

Tom Orr: Are we talking to any automotive manufacturers right now actively? I'm assuming we've probably had some discussions with them, but are we engaged alongside with the testing with ULTRATEK in this joint venture of proactively going to automotive manufacturers and starting to broach this subject and introduce our technology to them?

Robert Panora: Again, I can't comment on that right now, Tom. It's just --

Benjamin Locke: Yes, Tom. I'll just say it's something we spend a lot of time thinking about, as clearly you have as well. And it's something that we certainly have not reached any conclusions. There are many options, different ways we could go. We want to keep all of our options open. And when we decide on a good path carefully and deliberately, we'll share it.

Tom Orr: All right. Appreciate it. Thank you.

Operator: (Operator Instructions) Michael Zuk; Oppenheimer & Company.

Michael Zuk: Just a thought for a follow-up. I know that Tecogen has entered into some sales agreements with ADGE and with EuroSite. Could you bring us up to date on what we hope to accomplish with those licensing agreements, and what the status is and how they're progressing?

John Hatsopoulos: Mike, the agreement with EuroSite and ADGE, especially ADG, has existed for over 10 years. As a matter of fact, I'm glad you said that. We started ADGE on the theory -- and some of you, a few of you anyway, heard me 10 years ago when I said that the reason I was very hesitant in bringing Tecogen public was that the capital goods market for our products is erratic. And we might have some fantastic quarters, and we might have some stinky quarters. So we didn't want to take it public.

The reason we did take it public is because now with all these developments that Bob and his team have created, that makes it -- and I hate to use the word, because it's probably wrong -- a billion dollar company if we succeed. So we decided to take it public.

But this agreement has existed all along. And at the time that ADG -- actually, the fact that ADG right now is in the process of paying off their debt will allow them on a long-term basis to find a way to raise capital or get capital somehow to expand. We have a lot of inquiries on ADG which we're not accepting right now until we complete the removal of their debt, to which we're in the process of doing. As you know, \$9 million out of the \$17 million or \$18 million or whatever it

was was paid off. And hopefully over the next few weeks or months the balance will be paid off. And then we have to start worrying about finding ways to finance units for expansion of ADG. But we're not accepting them right now, which in a way is -- Ben has pointed out to me it does not do Tecogen any good, the fact that we don't have right now orders from ADG.

Now, as far as EuroSite, EuroSite has an agreement to use Ilios for the British market -- I can't think of the word, England and Ireland, whatever they're called -- and they always shared the right to use Tecogen but on an exclusive basis.

So nothing has changed. I don't know what I have said to give you an impression that something has changed, other than they don't have money right now to expand. But they have enough money to make it a cash flow positive company.

Mike Zuk: I was just curious as to what benefit Tecogen was getting from these agreements when there doesn't seem to be much activity on the ADGE side, and it seems that EuroSite is developing some other relationships for sourcing CHP, particularly with I think the Czech company. So I was trying to figure out how much benefit Tecogen will get from these agreements. And it doesn't seem that at the moment they're really producing more than a nominal benefit.

Benjamin Locke: Mike, I can answer that a little bit. So there actually is a tremendous benefit that Tecogen has with helping ADG. I don't want to talk too much about ADG except that I think they've stated that their goal is to improve the operation of their existing fleet to get it more profitable. And that helps Tecogen, because our service is based on a per-run-hour basis. And one of their largest sites maybe ran 5,000 hours a year is now running 8,000 hours a year. And so that's additional service revenue that Tecogen is getting. So that's tremendously beneficial to Tecogen.

And it's beneficial for Tecogen to help ADG become a better company because once they become a better company, as John said, they'll start placing orders again for Tecogen equipment. Now, that brings me to your comment about EuroSite.

Each geography is different in terms of what their needs are for CHP equipment. And Bob has talked about this in the past. Our equipment is specifically designed for the United States market, for the interconnect complexities, for the emissions complexities, all of those things are what is in the DNA of the InVerde equipment.

Europe's different. Europe is accepting of different engine technologies. They're accepting of lean-burn turbocharged engines and different emissions profiles. And it's a square peg in a round hole sometimes, bringing our equipment over there. And they already have round pegs for round holes over there. And so of course EuroSite is free to find the equipment that makes the most sense for their applications, whether it's emissions regulations, whether it's how they run, whether it's electric versus thermal efficiency. All of those things EuroSite takes into account.

So that's kind of a long answer, Mike, but I think --

John Hatsopoulos: Well, I'd like to add something to Ben's. In Europe right now they're not worried about emissions like we're worried in the United States. With all this commotion about the Volkswagen and the various other units, they're starting to look into emissions. The units -- and I'm using Bob's words and if he thinks I'm wrong he should correct me -- that the units that they're using in Europe are units we used to sell in the United States 10 or 15 years ago, not what we have right now. Bob, is that correct or --?

Robert Panora: In terms of emissions, they have a much higher bar than we would have had 20 years ago. Yes.

John Hatsopoulos: That's right.

Michael Zuk: Thanks for your answer. That clarifies a lot of things in my mind. Appreciate it.

Operator: Alex Blanton; Clear Harbor Asset Management.

Alex Blanton: Very interesting so far. I'd like to ask a question about the gross margins. They're shown on slide 12 and they're calculated for us for both the product and service revenue. And it shows that the product gross margin went up to 31.5% from 27.8%, when the sales were down 28% year over year. So how did you manage that? That's very unusual. How did that happen?

David Garrison: Alex, thanks. This is Dave Garrison. The product margin improvements that we've made in our process are going to give us specific incremental improvement on sourcing, some of the resourcing our parts and how we source those, to how we assemble those. And all those are variable costs that are calculated on a per-unit basis. So we would achieve those reductions whether our product sales are lower or higher. So the improvements that we're making are incremental improvements.

Well, of course I think you're probably surprised because you might have thought we had a much higher fixed cost in our manufacturing operation. And that fixed cost is not as high as you would expect and that is probably where you were thinking that that would have been normal in that regard.

Does that answer your question or --?

Alex Brand: That's very interesting. What does that mean for margins when the volume goes back up?

David Garrison: So when the volume goes back up we should continue to see that reduction, as we said earlier. And the bigger point on the volume reduction -- I mean the margin reduction with the volume increase -- is that by purchasing higher number --

Alex Brand: You mean margin increase.

David Garrison: Margin increase, I'm sorry. The cost reduction program that we're working through right now, we're able to improve the margins by negotiating better with vendors, because of volume increases. So we expect that to continue.

Also, I think it's important to keep in mind that product mix has a factor on this as well, because we do have variability in our margins for our products. They're not exactly the same for all of our products. So chillers versus heat pump versus the two different types of cogen modules that we have -- all of those have different product margins individually as well. So --

Alex Brand: I understand that. But your chillers were down. They have the highest margin. So even with chillers down you got a margin improvement. Does this mean that when volume goes back up to what people might have expected here, that you're going to have record margins because of these cost reductions on the material side?

David Garrison: I think our margins are going to continue to stay in that path of 35% to 40%. And Management is working hard to show improvement in those margins every single quarter.

Alex Brand: Yes, well, we were almost there in this last quarter on the product side. Now, the service margins were down. What happened there?

David Garrison: That's in reference to that one legacy installation project that had a cost overrun. And as Ben explained, the process in those projects has been put in place that should alleviate that problem from the future.

Alex Brand: Yes, well just by inspection it looks like your margins in total would have been up in the quarter if that hadn't happened. Is that right?

David Garrison: Yes.

Benjamin Locke: Yes, they would have.

Alex Brand: So that's a one-off thing. Right?

Benjamin Locke: Yes, that project's behind us. We had to get it installed. We got it installed. The customer's happy. But unfortunately it was an older project, as we said, a legacy project. That's done and over with now.

Alex Brand: Yes, so what are your service margins normally?

David Garrison: Our margin in the fourth quarter is representative -- I'm sorry -- the first quarter last year is representative of the target Management is trying to achieve, which is in the high 40%'s.

Alex Brand: Okay. That's very, very interesting. Thank you. The second question is this: John, in your letter May 3rd you mention that there was competition in our important New York City markets, significant competition from other CHP manufacturers, which -- because of lucrative

incentives. Why was the competition greater with the incentives? And are these the competitors you referred to today that don't have the emission capability? Are these (multiple speakers) and who are they?

Benjamin Locke: Alex, I can start to answer that. So, New York is the area where there's some very lucrative incentives. And that requires -- in order to get that incentive requires you to provide black-start power, this ability to run during an outage. And there's different technologies that can do it. The inverter-based interconnect is the one that's acceptable by many utilities in all areas of New York.

But there's other cogeneration technology -- I won't get into too much detail -- called synchronous that can indeed -- is eligible for the incentive. It's got some limitations, to be sure, about where you can place it. But there are numerous synchronous cogen manufacturers out there. It's not a novel or a new technology. Sometimes they find their niches in there. And when there's incentives, of course that's where people kind of come out of the woodwork.

I think it's fair to say we have a far superior product. That goes without saying. And I think we're going to -- especially with the introduction of the InVerde e+ -- further distance ourselves from some of these other people that are hanging around.

So, Operator, I think we're out of time.

Operator: All right. Thank you very much, sir, to the management team for your time today. At this time we will go ahead and conclude the conference call. I would like to thank you all very much for participating in the conference. Take care. Have a great day, everyone. Thank you.