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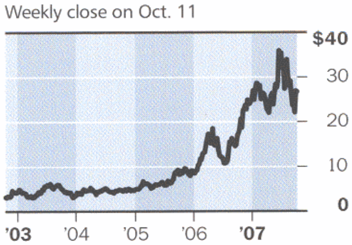
Bulls and bears have squared off over Fuel Tech, a small company with promising clean-air technologies. Why the shorts may be wrong.

The Sweet Smell of Success

by Christopher C. Williams

Fuel Tech announced $16 million in orders in August, and another $4.8 million in September.

Fuel Tech (FTEK - Nasdaq)
Weekly close on Oct. 11



Source: Thomson Financial / Baseline

The Bottom Line

Fuel Tech peaked at 38 in June, only to retreat to 22. Now the stock is on the rise again, along with the company's orders, and some fans think it could top 40 in the next year.

LIKE MAIN STREET, WALL STREET HAS embraced all things green in recent years, including shares of Fuel Tech, a tiny company with big dreams of abating air pollution. The Batavia, Ill.-based concern (ticker: FTEK) rallied 480% in the two years ended June 21, to a peak of 38, only to fall back to 22 after it reported in early August that second-quarter results had slumped. Bulls fled the stock, bears cheered and the market moved on to companies and technologies with seemingly brighter prospects.

But not so fast. Fuel Tech's business historically is lumpy, and its quarterly setback resulted mainly from delayed orders for the company's air-pollution-control technologies and start-up costs related to new contracts. Now Fuel Tech is being refueled by new orders, and its shares, which have rebounded to 28, look poised to top 40.

Indeed, the company reported $16 million in orders at the end of August, and another $4.8 million in late September, suggesting it is rebuilding a backlog that had fallen to a three-year low of $9 million at the end of June. A significant catalyst for growth: more stringent air-pollution regulations, which are are expected to spur power plants and utilities to turn to companies such as Fuel Tech to help cut noxious emissions beginning next year.

Fuel Tech is betting on a big second half to meet management's (lowered) guidance for 2007: 30 to 35 cents a share in earnings, on $80 million to $85 million in sales. The Street's is lower still, at 28 cents; however, analysts see profits rising to 62 cents in '08. Last year, Fuel Tech earned $7 million, or 28 cents, on revenue of $75 million.

On Fuel Tech's second-quarter conference call, Chief Executive John Norris said the third quarter "is a question mark," but promised the fourth quarter "is going to be exceptional." Norris also was optimistic when talking to Barron's. "The third quarter could [result in] a record backlog number for the company," surpassing the $28 million in orders it reported at the end of '05, he said.

More than 7 million Fuel Tech shares–about 40% of the company's outstanding float–were held by short sellers as of mid-September, versus 5.5 million shares the preceding month. Bears think the decline in the backlog means the company is running out of gas, and that big competitors like General Electric (GE) eventually will eat Fuel Tech's lunch.

Merriman Curhan Ford analyst Jesse Herrick, who has a Neutral rating on Fuel Tech, suggests that the stock's lofty valuation–100 times this year's estimated earnings–leaves management little room for error. But Fuel Tech seems cheaper when valued on the basis of its price-to-earnings growth, or PEG ratio of less than 1. The company has more than $30 million of cash, no debt, and gross margins in excess of 40%. Analyst John Quealy of Canaccord Adams sees Fuel Tech rising to 45, or more than 60%, which is about half of his '08 estimated earnings-growth rate of 117%. "It's a cash-flow and earnings-positive company with significant insider holding and buying," he says.

Led by utility veterans, 20-year-old Fuel Tech has spent years carving a niche in the multi-billion-dollar market for clean-air technologies. Its Air Pollution Control (APC) business provides technologies that help cut nitrogen-oxide emissions from utility and industrial boilers. The NOxOUT system injects a urea-based additive into boilers during combustion, cutting emissions of noxious gases up to 85%. Fuel Tech has installed its systems on more than 450 units worldwide.

While APC sales fell nearly 42% in the latest quarter, due to project delays and tough comparisons with robust results last year, Fuel Tech's Fuel-Chem division gained 30%. Its patented Targeted In- Furnace Injection technology helps to reduce the buildup of slag, a waste product that causes costly plant shutdowns. Fuel Tech said its slag-busting system can reduce a plant's need for coal while boosting energy efficiency by 10%. Jimmy Blakley, senior plant engineer at Western Farmers Electric Co-op in Hugo, Ohio, says his 450-megawatt facility has blasted out 100 extra megawatts daily since turning to Fuel-Chem in 2003 after considering a pricier offering from General Electric. "We are overloaded with utilities coming to see it," says Blakley.

Owing to customers like Blakley and Detroit Edison, Fuel Tech has inked deals with 30 coal-fired plants in four years. That number could grow dramatically if markets such as China develop as expected. Fuel Tech announced $5.4 million of Chinese orders for APC systems this year.

With 1,500 coal-fired boilers as potential customers, the global market for fuel-chem could easily top $1 billion. Fuel Tech gets a $1 million or so in annual fees for each system. If Fuel Tech outfits 500 of those plants, the stock could run to 100 in two to three years, says Jackson Robinson of Winslow Green Growth Fund (WGGFX), whose firm holds 300,00 shares.

Fuel Tech has no magic bullet for eliminating greenhouse gases, but it has first-mover advantage. If orders pour in as expected, its stock could move sharply higher.■

Fuel Tech at a Glance

In order to keep the bears at bay, Fuel Tech must meet profit forecasts, including an ambitious 63 cents a share in 2008.

Recent Price	$26.73	**EPS 2007**E	$0.28
12-Month Change	56%	**EPS 2008**E	$0.63
Market Value (mil)	$596	**P/E** (2008E)	43
2006 Revenue (mil)	$75	**Net Cash** (mil)	$32.6

E=estimate. Source: Thomson Financial / Baseline