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Fuel Tech - Driving Profits by Cleaning up Coal

Fuel Tech (Nasdaq: FTEK) is one of the fast growing public greentech / cleantech companies focused on cleaning up dirty coal.

I have known John Norris, the CEO of Fuel Tech, and his family for years, and have had the pleasure of following his career for some time. He's one of the many former nuclear engineers that grew up in the electric utility industry. He has held utility executive positions including CEO of Duke Engineering & Services, SVP and CEO of Duke Energy Global Asset Development, and Senior Vice President, Operations and Technical Services, at American Electric Power (NYSE: AEP).

He took the reins at Fuel Tech early last year (the stock promptly started climbing). When I ran into him at a recent conference, he filled me in on the goings on at this cleantech company that I not previously followed. I had a chance to chat with John for the record on Cleantech Blog about Fuel Tech in specific, and his thoughts on emissions technologies, carbon and greenhouse gases, and cleaning up electric utilities. I hope you enjoy.

You are relatively new to Fuel Tech. What compelled you to join the company?

I started with Fuel Tech as an Executive Consultant in April of 2005 to try to open doors with utility execs. When the Board approached me late that year about becoming the CEO, I thought about what I had seen over that last 8 months and really liked the prospects for growth. I have had the opportunity in the past to build high growth, highly profitable enterprises including one the most fun periods in my life in leading Duke Engineering & Services. This reminded me a lot of that experience, although I think Fuel Tech has even better prospects than DE&S had when I first got there.

What are the key drivers an investor should understand for the recent and continuing growth of the business?

There are several. On the Air Pollution Control (capital projects) side, investors should watch for market penetration of Ultra systems in the China/Pacific Rim market as well as a broader acceptance of all our NOx reduction technologies in the US market. They will be able to track this by watching our announcements regarding contract wins. On the Fuel Chem (specialty chemical) side, the key driver is market acceptance by utility coal units. Again they can track this through our announcements.

And in short - what caused the recent revenue growth?

We have better defined our products and services and have recognized a much broader market for those services. We have a more focused R&D effort to bring solutions to client problems quickly. And it doesn't hurt that customers are looking more earnestly for ways to reduce pollution and increase efficiency. All of these have come together for us in sort of a "perfect storm." Still, we have to deliver results for our customers and for our investors.

Do you view Fuel Tech as part of the emerging cleantech investment theme?

Very much so, but also maybe with an important difference. Too often the greentech sector has, in my opinion, over-promised and under-delivered for clients and for investors. We aim to be a different breed in those regards.

If I understand correctly, Fuel Tech has long been a leader in post combustion pollutant reduction systems, and pre-combustion technologies are a newer business for you. Is this correct? What does the future hold? Where is the industry going?

Fuel Tech has long been a leader in post-combustion NOx control as you mention. Our Fuel Chem product line is really a combustion/post-combustion technology that helps reduce slag problems, dramatically reduce SO3 emissions (both in the boiler and across an SCR), and improve plant efficiency thus reducing CO2 emissions in the process. These latter two items have only recently (in the last few years) become important to customers. I think in the future, clients will much more strongly focus on all these and other environmental and operational issues, both domestically and internationally.

Can you give us some color on the overall direction and key issues in the regulatory environment for these pollutants?

For all air pollutants the direction is towards dramatic reduction. You can sense that the whole world is looking to clean up the environment and they are not so much focused on CO2 but rather all the more serious pollutants (SOx, NOx and Hg especially).

You reported an all time high international sales for 2006. How much of the business do you expect to be from overseas in the next 2 to 3 years? What has happened on that front? Has the growth been because it is a newer area of focus for the company, or because the overseas markets are growing? And how does China play into the company plan?

Our dramatic international revenue growth in 2006 really came from our projects in China. I expect China and the Pacific Rim to become a much larger part of our business going forward. China consumes more coal today than we do in the US and within a decade they will be using about 3 times the coal we use. The Chinese have now recognized the pollution issues of smog and acid-rain (from NOx and SOx emissions) and are working hard to do something about that. The upcoming Olympic games have heightened the sense of urgency to clean up the air and water. We have worked hard for a number of years to establish our credibility there and to demonstrate our technologies. In 2005 we won two major contracts to demonstrate our NOxOut SNCR and eventually our NOXOUT Cascade technologies and then earlier this year we won two major contracts to install our NOxOUT ULTRA urea to ammonia system on new plants that have the catalyst NOx control technology installed (SCR). Those wins position us well to really make this a major and growing part of our business going forward.

What about CO2? In a Kyoto world, is Fuel Tech looking at CO2 reduction, sequestration, or capture technologies? If so, what can you share about that?

Our Fuel Chem targeted injections can typically reduce CO2 emissions by 1 to 1.5% for coal utility plants, while dramatically reducing slag and SO3 operational issues and emissions. That may not sound like much but it is very hard to make any significant CO2 reductions in plants and our reductions can be achieved while actually REDUCING plant costs. A 1.5% CO2 reduction for a 500 MW plant would be a reduction of about 8 tons/hr or about 65,000 tons per year of CO2 emissions. That is not insignificant and there is much interest in this in China and India especially where we can sell the emission reduction credits on the European Kyoto market (if done thru our Italian subsidiary).

A large portion of your business has been focused on cleaning up NOx or other pollutants at coal fired power plants. With low-carbon power likely to be a larger and larger portion of the global generation mix, what does this mean for the coal-fired pollution control sector?

While I strongly support the push for more renewable energy sources and a renewed push for nuclear power (I am a nuclear engineer, as you know), the reality is that for our lifetimes and beyond, fossil fuels will supply most of our energy needs. I think our company has a long and exciting future in making those energy sources cleaner and more efficient and thus making this planet a better place.

You announced not too long ago a series of Company firsts, among others:

- Installation of a NOx Out Cascade System on a Coal-fired boiler***
- Commercial SNCR/RRI project, and***
- SNCR lignite fired application.***

What does this actually mean for the Company?

We are looking with great haste and much effort for ways we can provide a much broader array of solutions for clients in pollution control, efficiency gains, and operations and maintenance cost reductions. We have a dedicated R&D team of our best and brightest folks focused on this effort and their work has paid off. One technology that you did not mention is our Targeted Corrosion Inhibition Program, which was introduced in 2006 and is aimed at helping municipal solid waste plants dramatically reduce the corrosion rates in their boilers. Our patent in this area was but one of 7 patents applied for or granted here in the US and another 12 internationally. We are on the leading edge of technologies in these areas and we intend to stay on that leading edge.

Revenues are obviously up, and you've said you expect revenues to increase 20-27% in 2007, with growth from both technology segments. What about 2008, 2009 and beyond? What markets and which products do you expect to deliver the longer term growth?

We do intend to grow but have provided no guidance beyond 2007.

In 2006, compared to 2005, the gross margins were down in the NOx Reduction business, but up in the Fuel Treatment business. Net income for the 4th quarter was down year over year, even though 2006 vs. 2005 was up significantly. Can you talk a little about this, as well as tell us what the long term margin objectives are for the Company?

First, our revenues for 2006 were up 42% over 2005 and our pre-tax income in 2006 was up 64% vs. 2005. (These results were above our guidance.) The net income (after-tax) blip you mentioned is that in 2005 we recorded \$4.3 million in non-cash tax benefits related to the anticipated utilization of new operating loss and tax credit carryforwards. So, we believe our performance in 2006 was considerably better than 2005 and has positioned us to do even better in 2007.

You keep a healthy amount of cash and no debt on your balance sheet. What is your view on the Company's capital structure?

I love our capital structure---lots of cash, no debt, unsecured borrowing ability and a business model that is delivering rapid growth in revenues, profits and cash.

I know you've had to discuss this a lot lately, but the stock price has doubled in the last year, and P/E and valuation metrics are looking rich. What is your view on how the capital markets should look at the stock and valuation?

Personally, I think this is a great buying opportunity (and I just recently did so in my personal accounts). If you believe that we can and will execute our business plan and grow this Company rapidly and profitably, then today's stock price is not over-valued at all. If you don't believe that we can execute and achieve the results, then the stock price is already too high. It all depends on what you believe about the Fuel Tech team.

Finally, if I was an investor interested in the Company, what should I be looking for over the next 6 to 12 months?

You should be watching for contract announcements to see if we are winning in the market place. The first quarter will be the hardest for us from a results point of view but the orders need to come over the next 6 months if we are going to deliver this year's revenue and profit results. We are working hard to make that happen, but until the contracts are in hand, it is just talk.

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