Rising Energy Tech Stars In 2016: *Special Issue*

Featured in this Special Issue

Exa Corporation

Mobileye

FEI Corporation

ABC Gold

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OVERVIEW

Investing today is getting harder and harder. From hedge funds that charge ridiculous fees and don’t deliver, to ETFs that don’t track their benchmarks well, investors are faced with a difficult set of choices when it comes to investing effectively.

One method of investing that has proven very effective is investing in stocks with significant earnings and price momentum. In numerous academic and practitioner studies that have looked at the strategy, investing in companies that have a strong secular growth story has proven to be a winning formula.

Those types of stocks with a truly strong economic moat and significant growth opportunities are few and far between. In this newsletter, we have identified four stocks that appear to have significant growth tailwinds and yet also have a reasonable valuation. All four stocks relate to the energy and natural resources sector, which is our area of expertise. The first three firms are tech companies that have significant opportunities in the conventional and clean energy space, while the fourth is a direct natural resources investment.

EXA Corporation

NASDAQ: EXA

A lot of investors are excited about Tesla these days. And what's not to like? At a time when many firms are struggling to grow sales at all or generate excitement about their products, Tesla is growing sales by more than 50% annually and has hundreds of thousands of back orders.

It's easy to invest in TSLA, but the problem is that the stock is very expensive on a valuation basis and the company is facing tough competition from traditional carmakers, which are introducing their own electric vehicles.

There is a little-known small cap company that will benefit the most from "The Tesla Effect". In short, they provide THE solution for EV manufacturers to increase the range of their vehicles. That company is EXA Corporation.

EXA Corp is not followed by many analysts on Wall Street. While most firms have a dozen or more analysts following them, EXA has just four. But all four of those analysts are excited about the company's prospects and think the stock is a good buy.

ANALYST RECOMMENDATIONS

Thomson Reuters I/B/E/S Mean: Strong Buy (4 Analysts)

Recommendation	Analysts
Strong Buy	3
Buy	1
Hold	0
Reduce	0
Sell	0

The reason for this enthusiasm is that EXA's business model is extremely attractive in many respects. The firm makes a complex set of software packages that enable customers to simulate complex problems in product design. In particular, one of their biggest client groups are automotive firms that are designing new vehicles. EXA's software can be used to design vehicles that have the minimum aerodynamic drag, which in turn allows them to go further on a single battery charge.

"We used Exa's PowerFLOW transient solver that directly resolves very large eddies to deliver superior accuracy compared to conventional (methods)," said Rob Palin, Lead Aerodynamicist at Tesla Motors. "This approach is especially beneficial in areas where flow physics are complex such as in the rear of a curved vehicle. The result is a full-size electric sedan with a drag coefficient of 0.24."

In other words, EXA is providing software that modern vehicle manufacturing firms cannot do without. Of course, it's not just car companies that are customers of EXA. Tire companies use the firm's software to design better tires, aircraft makers use the software to create better planes, and even NASA uses it for spacecraft.

Just like Microsoft, EXA is in the business of providing an intangible software product that makes its customers' lives easier. It's an asset light business model that offers the opportunity for big profits, especially with EXA moving away from having customers buying a single copy of a software license to a cloud based software as a service (SAAS) business model. That business model lets EXA generate consistent recurring monthly revenue. The transition can be a bit rough initially, but once it's completed it is usually hugely successful.

For evidence of the potential in the SAAS model, just look at Adobe – the company made a similar transition with its software products a couple of years ago. Investors balked at first, but after a transition period, profits and ADBE's stock have

both soared. EXA could follow the same path.

Just as importantly, EXA is seeing its revenues expanding quickly. The firm has only been public since mid-2012, but during that time, annual revenues have expanded from $46 million in the fiscal year ending January, 31, 2012 to ~$66 million in the fiscal year ending January 31, 2016. The company is plowing millions into new research and development efforts to help it take advantage of emerging opportunities in the electric vehicle space, the aircraft arena, and other customer verticals.

In a tough overall economic environment for 2016 with oil price drops hurting the EV market, EXA Corp still managed to grow its first quarter revenues by about 15% versus the year earlier period.

One issue that has held back EXA's shares is that the company is basically breaking even on a GAAP basis. Investors seem to have been nervous about that limited current profitability, especially with the weakness in most software company stocks right now. A deeper dive into the company's financial statements reveals a different picture though.

EXA has about $40M in cash on its balance sheet – just a little bit less than the firm's $62M in total debt. EXA produced about $12M in operating cash flow in the first quarter of 2016 compared with a total market capitalization of around $180M. On an annualized basis that would equate to $48M in operating cash flow generated against $180M in market cap.

A big reason for EXA's limited GAAP profitability is that the company poured more than $24M into R&D from its $65M in revenue. EXA is making those investments to keep growing its product offerings for the future. Over time, though, the firm will be able to cut back on R&D, and when that happens, profitability will explode higher.

The average P/E multiple in the software sector is 22x. Forecasting EXA profitability five years from now suggests that the firm should be earning around $1.20 a share – about $17M annually in net income. That would give the firm a share price of $26.40. Discounting that price back to the present, suggests that EXA should be worth around $16.25 at present.

With EXA trading below $13 a share, the stock looks like a compelling buy with substantial long-term growth opportunities. The EV and aerospace markets are both going to continue to grow rapidly and that will mean more and more need for EXA's products. Investors looking for a strong secular growth story should carefully consider an investment in EXA stock. The company is riskier than the overall market, but it has considerably more growth potential as well.

Mobileye

NYSE: MBLY

Investors are always looking for the next big thing – that next great innovation that will change the way people live and work. There are a number of very promising innovations on the horizon, but the one that seems poised to have the most disruptive effect is self-driving technology.

Self-driving technology can literally change the way every person in America lives, and it can upend entire industries from taxi cabs to delivery trucks. Perhaps most importantly though, self-driving technology has the potential to completely disrupt the long-haul trucking industry.

There are roughly 6 million tractor trailers on the nation's roads. All of these costly vehicles are driven by well-paid drivers that trucking companies struggle mightily to recruit. (Ask yourself – when was the last time you went past a tractor trailer on the highway that did NOT have a "we're hiring" sign on the back of the truck?) Self-driving technology is a huge boon to this industry that will change the way every trucking company does business.

There is one company that is poised to benefit from the rise of driverless trucking like no other. This one technology company will dominate the market. That company is Mobileye – the Israeli company that makes the sensors used in self driving vehicles.

Self-driving vehicles are a huge market and it all begins with self-driving trucks. If even 1% of the trucks on the highways each year incorporate the technology made by MBLY, the company will generate $900M in annual revenues. That would lead to roughly $700M in annual net income, and the company could see their stock could rise by more than 100%.

Mobileye's sales are already skyrocketing. Annual sales have grown from $20 million in 2011 to $241M in 2015. Revenues grew 68% YOY in 2015 and 77% YOY in 2014. Assets have swelled from $90M in 2012 to almost $600M in 2015, and the firm is sitting on more than $200M in cash and no long term debt at present. Mobileye is the Amazon.com of self-driving technology.

Mobileye is likely to see revenue growth of at least 40-50% for 2016 and 2017, and with gross margins of roughly 75%, the company is enormously profitable. This could make Mobileye a very attractive takeover target for a larger peer that is lagging in the space such as Intel.

Mobileye has a commanding market share in the self-driving cars market. The company commands roughly 80% of the global market share in the Advanced Driver Assistance Systems market. While new entrants into the market may introduce competition in both the hardware and software space in the future, MBLY is clearly the dominant player in the space right now.

Mobileye is facing competition in the self-driving vehicle sensors space from larger firms like Google, but these competitors are generally focused on passenger cars rather than tractor trailers, despite the fact that tractor trailers represent an opportunity potentially worth tens of billions of dollars.

Mobileye's technology allows fleets of trucks to improve driving safety and increase profits. The company cites benefits of its systems for trucks such as preventing collisions, improving driving habits of human drivers, reducing the total cost of truck ownership, reducing vehicle wear and tear, increasing fuel efficiency, preventing driver and pedestrian injuries, and improving return on investment in trucks.

Mobileye's tech captures situations like tailgating, lane deviation, impending forward collisions, and then warns drivers or takes corrective action on its own. In addition, fleet operators get increased insight into the behavior of their drivers since Mobileye's software sends data on driving performance to third party fleet computers. That enables effective monitoring of drivers.

A new tractor trailer truck costs between $140,000 and $175,000, depending on the options included in the truck. Mobileye's products add at most only a few thousand dollars to that cost. From both an investment and a risk mitigation standpoint then, the MBLY product is a no-brainer for the trucking companies.

Moreover, Mobileye's products are poised to become even more important over time. Oil prices are starting to rise again, and as they do, it becomes increasingly important that trucks have technology improvements that can help avoid wasting fuel. Mobileye's sensors do just that by helping to avoid needless braking and acceleration in the stop and go traffic that so many trucks run into on highways.

Overall, then, Mobileye is one of the strongest secular growth stories in the market right now. Some investors have become concerned about the stock in recent months and whether its technology gives it a big enough competitive advantage to be able to maintain its market share over time. That concern is overplayed at this point. Mobileye will certainly face some competition in the future, but the market is growing so fast that the earnings should more than catch up to its valuation by the time serious competition emerges.

Mobileye will probably earn EPS of $0.70 in 2016, and $1.10 in 2017, versus earnings of $0.48 in 2015. MBLY is generating massive amounts of free cash flow, so shareholders don't need to worry about dilutive equity raises, or the company running into liquidity troubles.

Mobileye's valuation may look rich at present, but the reality is that there are very few companies with the kind of growth being generated by this company. Given that, investors can safely invest at prices below $45. The stock will more than grow into that valuation. An average of valuation models on the stock suggests the shares should be worth around $86 a share at present – far above where the stock is currently trading.

FEI Company

NASDAQ: FEIC

In the current oil environment, a major key to success turns on being able to improve efficiency. The vast majority of oil companies are not making money when prices are below $60 a barrel. That means that for many oil companies the name of the game in a down market is efficiency. Beyond that though, even as we start to take tentative steps moving beyond the oil crash of 2014-2016, efficiency is still key. Oil stock investors in the current environment are a lot less patient than they were five years ago. Companies need to show that their wells are productive and make economic sense or investors will revolt.

All of this means that today's oil companies are really looking for technological solutions that let them increase the effectiveness of their operations. There is one company that offers a patent-protected "nano-scale" technology which allows oil & gas companies to squeeze 2X/3X/4X more energy out of reservoirs. This has broad application in a falling or rising market because their solution provides efficiency gains. The company in question is FEI Company.

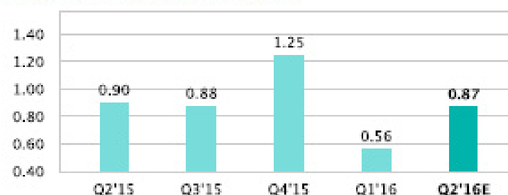
FEI makes analytical equipment used in a wide range of different industries. One of their most exciting products is a product they call Digital Rock.

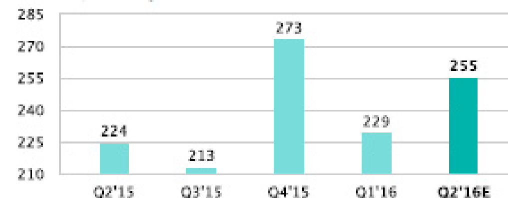
Digital Rock is a product originally developed by a small company called Visualization Sciences Group, which was acquired by FEI in 2013. VSG was one of the leaders in the 3D software applications and components space for the oil and gas industry. FEI added to its portfolio in this vertical by acquiring Lithicon, a digital rock services company in 2014.

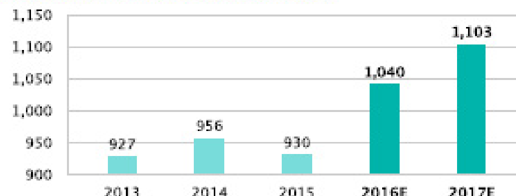
Today FEI offers services around digital rock from designing digital rock labs for large exploration companies to helping firms image, model, and evaluate specific reservoirs. FEI's team offers E&P firms with unparalleled expertise in next generation multiphase flow modeling.

FEI's digital rock tools let E&P firms evaluate numerous metrics about their wells including porosity, acoustic velocity, elasticity, wettability, permeability, and more. All of these technical characteristics give firms the ability to more effectively tap underground resources and figure out how to structure a well to maximize output. These tools are protected by patents, which gives FEI a long-term monopoly in the space.

Given the technical advantages of the company, it's probably not a surprise that FEI is a solid financial performer.







As the graphic (previous page) shows, FEI's earnings and revenues have grown nicely over time. The estimates figures above are compiled from analyst forecasts, which suggest that FEI's runway still has plenty of room to go.

On the whole then, the FEI story is far from over. Yet that story is also about to get even more interesting.

FEI is currently the subject of a takeover effort by larger competitor, Thermo Fisher (TMO). Thermo Fisher has offered $107.50 a share for FEI. It is possible the deal could run into regulatory pressure or shareholder dissent that might stop it from going through, but both scenarios are somewhat unlikely.

If TMO's bid for FEI does go through, investors can still take advantage of the FEI technology by investing in TMO directly.

TMO is a larger company than FEI and that means that the combined entity will likely be able to offer a package of products and services that should be even more enticing for the industry.

TMO's deep bench of products and services in the O&G space makes the company an obvious partner for many exploration firms looking for stable suppliers.

TMO itself has a great business that has been growing solidly and consistently for years. The acquisition of FEI should help to continue that trend of excellence.

FEI will become a leading part of TMO's analytical instruments segment – a segment that is seeing huge growth potential because of opportunities that are developing around a huge emerging industry – the Internet of Things.

The Internet of Things or IOT lets companies evaluate what is happening with equipment and tools without having to stop the equipment and inspect it by hand. General Electric for instance is developing new tools to let them evaluate the health of jet engines while planes are in mid-air. TMO's new suite of tools will have similar benefits for oil and gas companies.

The FEI technology gives firms that ability to understand everything they could ever want to know about a well all while continuing to pump oil. This lets companies take actions to maximize resource production.

Now with TMO's larger set of R&D capabilities, FEI's tools will become even more powerful and useful. This should help TMO to keep growing its sales for the foreseeable future.

Whether investors choose to buy into FEI directly and hope for a higher price in the buyout or invest in TMO and wait for the transaction to close and FEI to join the larger TMO organization, it is clear that both investment choices are excellent. TMO and FEI are both high quality stocks with excellent product portfolios and a bright future ahead as a single company.

Fortuna Silver Mines

NASDAQ: FSM

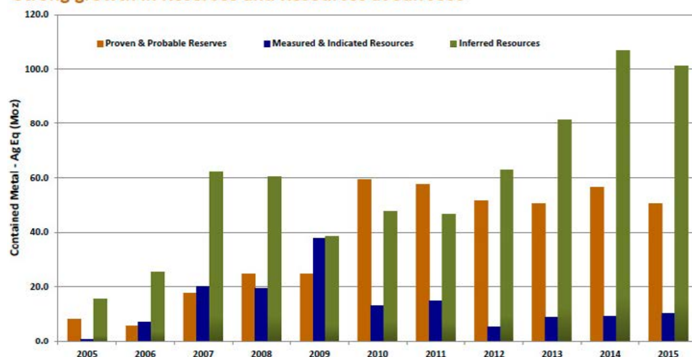
This $750 million market cap precious metals miner is sitting on reserves of $1.7 billion. At the current price of gold and silver, for investors getting shares in this company right now, it is like buying gold and silver at a 56% discount.

Fortuna Silver Mines is a Vancouver-based miner with mines in Mexico and Peru. The firm is led by its co-founder Jorge Ganoza, a Peruvian geological engineer who first identified and negotiated the purchase of the company's mine in Peru, Caylloma, which has proved to be an extremely lucrative investment.

Fortuna Silver Mines has a growing reserve base that gives it years of production potential, and it's All In Sustaining Cash Cost of AISCC is roughly $9.39 per ounce meaning that it has a hefty profit margin even if silver prices do not move any higher.

Growing Reserve and Resource Base

Strong growth in Reserves and Resources at San Jose



Silver is much more common than gold of course, and correspondingly, most of Fortuna's production is in silver.

In the first quarter of 2016, the company produced 1.6M ounces of silver and 9,200 ounces of gold. For the year, the company is expecting to produce 7 million ounces of silver and 43,000 ounces of gold. As an added bonus, the company also produces lead and zinc along with gold and silver at its mines in Peru.

The company had operating earnings at its mines of $15.5M in Q1 which on an annualized basis would translate to around $62M in operating earnings from mining. So FSM is currently trading at a little more than 12X its operating earnings – not bad for a company sitting on almost $2B in precious metals.

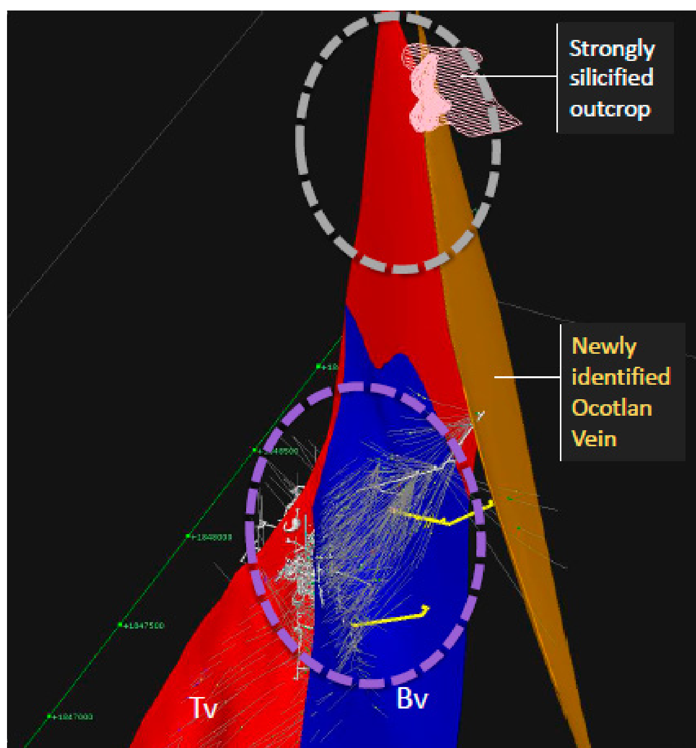
Gold and silver production at Fortuna mines are continuing to increase and that trend is likely to continue for years to come according to company estimates.

Increasing Silver and Gold Production

Low cost organic growth

All of this points to an investment with a lot of potential for investors. Many precious metals miners have seen their stocks spike since the start of 2016 thanks in large part to rising gold prices. Fortuna is no different in that regard.

What makes the stock a better investment than other miners right now is that investors are systematically overlooking its huge reserves base. But it's not just about FSM's current reserves either. The company's San Jose mine could have even more minerals that have yet to be discovered according to Fortuna management.



As the graphic above shows, The company has identified a new vein in that mine and there could be more undiscovered gold and silver below the surface as well.

The company is focused on expanding both its Mexico and Peru mines and is investing in projects to improve both assets. At the same time though, the firm has consistently rewarded shareholders through significant free cash flow generation.

The firm is actually sitting on almost $100M in cash which is more than enough to pay off all of its $40M in long term debt with plenty left over for shareholders.

While the company is not reporting a profit on a GAAP basis, this is not surprising since FSM has heavy depreciation and amortization non-cash expenses. Those non-cash charges are typical at many miners, but they don't really hurt investors. Instead, the important metric for investors to focus on is the firm's AISCC which captures the cost to get gold and silver out of the ground. FSM has a very efficient operation and a very low AISCC. That in turn means that the company can keep rewarding investors with big profits going forward.

Based on the Fortuna management's inferred reserves of just over 100M ounces of precious metals, the gold and silver composition of those metals, and current prices of gold and silver, Fortuna's reserves appear to be worth around $1.7B. After taking into account debt and cash, that implies a target price for Fortuna of roughly $11.80. The company is small though, so it is a high-risk, high-reward investment opportunity, and one which investors should evaluate carefully.

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