

# THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

## Identifying Potential Investments by Focusing on Insider Activity



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### SECTOR — GENERAL INVESTING

#### TWST: Could you tell me a little bit about the firm?

**Mr. Laks:** We manage about \$200 million across a few different strategies, and our philosophy focuses a lot on people. We look at insider transactions and insider ownership, and also follow a number of investors with great track records. If we can find a company that has significant insider ownership where insiders have recently been buying, and it's owned by a number of smart investors, that's usually a good starting point for us to begin a more traditional value analysis.

#### TWST: Is there a unique investment philosophy with the funds?

**Mr. Laks:** Yes. I think the focus on insider activity is pretty unique in our space. Many of our good ideas have come from noticing an insider transaction, such as a large purchase of stock, that got us to look at a name, and it seemed like other investors just completely ignored it. We look every day at large transactions, and it's surprising that they're not more closely followed, but we think it's good for us because the opportunity set is there and hasn't yet been competed away.

#### TWST: Did you want to highlight a stock you find interesting?

**Mr. Laks:** Yes. I have four stocks we can talk about today that we're excited about now. The first one is **Enphase Energy** (NASDAQ:ENPH). They make electrical equipment for the solar industry. When solar panels generate electricity, it has to be converted into alternating current before being fed into the grid. This was traditionally done with a central inverter, which is a piece of equipment that takes power from all of the panels as a group and then performs the conversion. But a problem with that design is that there is a single point of failure, so if it needs to be repaired or replaced, the entire solar array goes down. Additionally, because the panels are strung together as a group, if any one

of the panels has an issue, like too much shade or a malfunction, the entire system can be affected.

**Enphase** has a different approach to avoid this. Instead of a single piece of equipment, each panel receives its own microinverter that processes the conversion. Along with their energy management software, each individual panel can be monitored and operated remotely, and this optimizes the output of the entire system. This improved design has seen very rapid adoption since it was introduced.

Quarterly revenue for the company had gone from \$1 million in 2009 to over \$100 million by 2014. The gross margins increased steadily from single digits to over 33%. The company was profitable, and it had a market cap of over \$800 million.

But after 2014, the solar industry went into a downturn. Falling energy prices made renewables less attractive. Increased competition among the panel makers, especially in China, caused massive supply increases that eroded prices throughout the value chain. And changes in regulatory policies added uncertainty into the market, which had initially been supported by subsidies and other incentives.

So by the time we started looking at it in May 2016, it had fallen to \$1.00 per share, the market cap was under \$100 million, and there were concerns about the company's survival. At the time, gross margins had fallen well into the teens. They couldn't cover overhead since sales levels were reduced, and the company had to raise debt and equity just to stay afloat.

With any new idea, we always turn to the proxy to understand the insider ownership. It was surprising that a number of notable funds had significant stakes, which we thought unusual since the company was apparently circling the drain. Directors and officers as a group owned over 25%, and that large insider ownership intrigued us. So we started to look at it more closely.

It was impressive that the company had shipped more than 15 million of their microinverters, which was 3 gigawatts of installed power in over 600,000 residential and commercial systems in 100 countries. Given the popularity of their products and what we saw as long-term tailwinds for renewable energy, we thought that if they

And these initiatives that they've done have already started bearing fruit. Gross margins bottomed below 13% in Q1 and were above 18% in Q2, which was the highest level in the last five quarters. Cash burn was reduced, and the company posted positive operating and free cash flow in the most recent quarter.

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could manage to get their costs under control, then the upside potential was pretty large. At that point, we decided to monitor it and keep an eye out for any large insider transactions because that might suggest that the ones that were closest to the operation were gaining confidence in a recovery.

And so in January of 2017, we saw just that. There was a large strategic investment from T.J. Rodgers, who was the Founder and former CEO of **Cypress Semiconductor** (NASDAQ:CY), and as part of the investment, he was appointed to the board of directors. He has a long history in the technology industry. He founded **Cypress** in 1982 and grew it into a multibillion-dollar company before he retired in 2016. He also had experience in the solar industry as Chairman of **SunPower** (NASDAQ:SPWR) during its IPO. So he comes on, brings in consultants from **McKinsey** who he had worked with before, and they started to grapple with some of these cost issues and essentially initiated a companywide restructuring.

Then, in April, they brought in another **Cypress** veteran to the newly created role of Chief Operating Officer. He had a 20-year career with **Cypress**, including five years as head of **Cypress India**. And his first impressions were, yeah, the company has great products, but they don't have a strong focus on costs. They didn't have strong sourcing agreements, which were crucial given their average product contained over 300 components. Their costs were also high for a number of reasons: warranties, servicing, freight. And they lacked pricing discipline.

So to combat all of these issues, the company adopted a number of lean manufacturing practices and accelerated their product development road map. They also began partnering with panel manufacturers to incorporate their microinverters directly into the panels themselves. These so-called AC modules reduce costs, simplify installation and give the company a steady high-volume demand.

With the release of their earnings report this past August, the CEO stepped down, and the company announced that the successor would be named within weeks. We figured it would be the COO, especially because they gave a pretty short window for the search, and that guess turned out to be correct when they announced it in September.

After they announced his promotion to CEO, we had a conference call with him, the CFO and Director Rodgers, which gave us a lot of confidence.

The newest version of their product, the IQ7, gives the company the ability to offer the same version of the product to all geographies, which further reduces the manufacturing cost, weight and number of components. All steps in the right direction. Then, by the end of 2018, the IQ8 will launch, which is the real blue-sky upside for this company because it's the first product that can work in both weak-grid and off-grid environments.

Surprisingly, most solar power systems only work in tandem with a functioning electricity grid. These so-called grid-tied systems don't work in places where electricity coverage is spotty or nonexistent. So having a product that can work in those environments really increases the potential market size.

During the call, the CEO cited India as an example. The government there has announced plans for 100 gigawatts of grid-tied solar capacity by 2022, of which 40 gigawatts is expected to come from rooftop solar. That's a huge opportunity for **Enphase** given their annual run rate is slightly less than 1 gigawatt. And yet, the estimated off-grid demand in addition to that is a further hundreds of gigawatts.

We think the plan they have outlined to reach a 10% operating margin by the end of 2018 is achievable given the product road map and cost reduction initiatives they have put in place, and at that rate, we found ourselves buying a company trading at less than 5 times forward earnings before giving any credit to the revenue growth just mentioned. The stock has had quite a run in the last few months as other investors are starting to realize this too, but we think there's still a good deal of upside ahead.

#### Highlights

*Brian Laks discusses Old West Investment Management, LLC. The firm's philosophy focuses on people. Mr. Laks looks for companies with significant insider ownership, where the insiders have been buying recently. He also likes to see investors with great track records owning the stock. These characteristics will trigger Mr. Laks to initiate a more traditional value analysis. Many of the companies that Mr. Laks likes currently are ones that were doing very well and then fell from grace as a result of an industry change.*

*Companies discussed: Enphase Energy (NASDAQ:ENPH); Cypress Semiconductor Corporation (NASDAQ:CY); SunPower Corporation (NASDAQ:SPWR); Intrepid Potash (NYSE:IPI); CARBO Ceramics (NYSE:CRR) and Cameco Corp. (NYSE:CCJ).*

**TWST:** Looking at it at the macro level, do you get a sense that even though there might be bumps along the road that solar energy is going to be here to stay and there's going to be increasing demand over decades?

**Mr. Laks:** Yes. We strongly believe that. Solar is the fastest-growing component of our energy supply, but it's coming off a small base. We think that as the costs of the technology continue to decrease, the adoption will increase. And so there's a lot of runway ahead. I think the India example that the CEO talks about perfectly reflects that.

**1-Year Daily Chart of Enphase Energy**



Chart provided by [www.BigCharts.com](http://www.BigCharts.com)

their stocks drop by nearly a third on the news, and the price of potash has traded pretty steadily down in the years since then, which brings us to **Intrepid**. The stock had come public in 2008 at \$32 a share, rose from there shortly thereafter to \$70 and had a market cap of \$5 billion. It was huge. The industry downturn had a substantial effect on their operation.

When we started looking at them in late 2016, early 2017, the company was trading near \$1 a share and had a market cap of only a few hundred million. Going back to our process, it came on our radar when we saw the CEO and a few other insiders make large purchases as part of a secondary offering. The company was trying to restructure. They were transitioning from traditional processing to solar evaporation as a way to reduce their operating costs, and they were raising equity to pay down debt and strengthen their balance sheet. We started looking further into it and were pleased to see that the insiders owned close to 30% of the company.

We started to do a little more work, and it became clear pretty quickly that even with the cost reduction initiatives that they were putting in place, they would still need to see an industry recovery and pricing improvement in order to see any meaningful upside. And so if that were the only leg to the investment thesis, we probably would not have gotten involved. What got us really excited and eventually led to our taking a position was when they started to talk about their water rights.

Over their multidecade operating history in New Mexico, the company had come to own over 30,000 acre feet of water rights. In addition to that, the counties near their operations — Eddy and Lea in

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And yes, of course there'll be bumps along the road, especially since in a lot of places still there's a political element involved, but we think that the long-term demand trends are there. And this kind of reminds us of the saying about selling shovels in a gold rush. A lot of the panel makers are killing themselves competing with price wars and all of that. Having a company that can supply products to any panel maker, especially a product that is superior to the existing way of doing things, we think is a great way to benefit from the growth in renewables.

**TWST:** Did you want to mention a second company?

**Mr. Laks:** The second company that we are interested in right now is called **Intrepid Potash** (NYSE:IPI). They are a fertilizer producer. They produce potash, which is potassium chloride, and langbeinite, which is a low-chloride combination of potassium, sulfur and magnesium that they sell under the Trio brand name.

Up until 2013, the potash industry was dominated by two large cartels. One of them was Canadian, and one was Eastern European. Together, they controlled about 70% of the market. The cartels set limits on output in an effort to support prices, and the companies earned bumper profits as strong demand from China and India drove up sales. In the middle of 2013, however, the Eastern European cartel fractured when one of its members decided to go it alone, forgoing the output restrictions in order to maximize their sales volumes.

The effect that this announcement had on the industry was immediate and dramatic. Most of the publicly traded companies saw

**1-Year Daily Chart of Intrepid Potash**



Chart provided by [www.BigCharts.com](http://www.BigCharts.com)

southeastern New Mexico — happened to be two of the most active counties for oil and gas exploration and production in the Permian Basin. Oil and gas companies use a lot of fresh water in the development of their wells, upwards of millions of barrels for each well. And **Intrepid** estimates that if they sell just a third of their annual water allotment to these companies, the sales would be roughly \$30 million. Given that much of the infrastructure is already in place to deliver it, they believe the margins on those sales are north of 90%.

So the question was, how do we value that sort of cash flow stream? Similar royalty-type companies might trade at 5% to 10% free cash flow yields, and if we assigned a similar multiple, that gave us \$300 million to \$600 million for just the value of the water. So here we had a company whose core business was struggling to break even, trading an enterprise value of less than \$300 million, and yet, they were sitting on a hidden asset that was potentially worth double that, and that was for only a third of their water rights. So with potash pricing showing signs of improvement year to date, we thought this was a great opportunity to own a company at a substantial discount to that asset value with the added optionality of a turnaround in their core business.

As a kicker, on the latest conference call, the CEO mentioned the company had also discovered a known quantity of lithium on their property, and they're evaluating several different extraction technologies. Anyone who's followed that industry has seen the incredible demand that electric vehicles have put on the battery supply chain, and lithium producers have seen their stocks substantially reprice. So while we don't currently assign any value to that facet of their business, we continue to monitor it closely because it is a nice potential addition to the asset value.

***“The market seemed to think the company was heading for bankruptcy. But a closer look at the numbers and we saw something interesting. After six consecutive quarters of volume declines, overall volumes in the quarter had actually increased, and in the week following that earnings release, the CEO purchased over \$100,000 worth of stock on the open market.”***

**TWST: And I understand, generally, potash is used as a fertilizer, and it's used in animal feed and also in some industrial applications, so it has some different uses in the economy.**

**Mr. Laks:** Yes. And it's been several years since the cartel broke, but it's heartening for us to see the pricing starting to improve. We say that this used to be a company where you were waiting for the core business to improve, and they had this other hidden asset, and now, it almost seems like the hidden asset could become their core business, and the option is on the potash improvement. We like the fact that they have this other asset as a sort of downside protection while we wait for the industry to improve, and in the last few quarters, we've been seeing that improvement. So we think this could be firing on all cylinders several quarters down the road.

**TWST: Did you want to mention a third company?**

**Mr. Laks:** The third company is called **CARBO Ceramics** (NYSE:CRR), and they are a technology company that provides products and services to the global oil and gas and industrial markets. When energy companies complete an oil or gas well, in addition to pumping fluids at high pressure to fracture the rock, they also pump a granular material that fills those fractures and prop them open once the pumping stops, and this proppant has seen pretty steadily increasing demand because of the increases in production that it gives.

There are a variety of proppant types that can be used depending on the demand of a particular well. Typically, producers will use sand that has been selected to optimize a number of characteristics, such as grain size, shape and crush strength, which is the amount of pressure that the grain can withstand before being crushed. In instances where the downhole pressure or temperature is too high for common

sand or where high commodity prices justify the increased costs, producers can use a specially engineered ceramic proppant, which has superior performance.

**CARBO** is one of the world's largest suppliers of this ceramic proppant, and they had peak sales of almost 2 billion pounds in 2013. By mid-2014, with oil prices north of \$100 a barrel, their product was in high demand, and the stock was trading for \$150 a share, and they had a market capitalization well over \$3 billion. But when the oil price began to decline in late 2014, their stock got crushed, volumes fell off a cliff, industry activity was curtailed, and customers couldn't afford to use that premium proppant in their wells. By the time we started looking at it in late 2016, the stock had fallen all the way to \$6 a share, and their market cap was under \$200 million.

When they released their Q3 earnings report in October of last year, the stock got slammed, down over 25% on six times the previous day's volume. The market seemed to think the company was heading for bankruptcy. But a closer look at the numbers and we saw something interesting. After six consecutive quarters of volume declines, overall volumes in the quarter had actually increased, and in the week following

that earnings release, the CEO purchased over \$100,000 worth of stock on the open market. Now while the absolute amount was fairly small, what was significant was that it was his first purchase of stock in over two years.

So we looked at the proxy like we always do and, again, were impressed by the ownership. The Chairman owned over 14%, and total ownership by directors and officers was close to 20%. The Wilks brothers, billionaires who had made a fortune selling their energy company in 2011, also owned close to 10%.

By Q4 of 2016, after seven consecutive quarters of revenue declines, total revenues finally increased, and we began to wonder if Q3 was the bottom, and their business was finally starting to improve. During the downturn, management had taken steps to mitigate some of the effects of their loss of ceramic volume. They expanded into traditional sand, which allowed them to take advantage of their existing distribution infrastructure and client relationships. They reduced fixed costs and sold noncore assets to improve their cash flow and strengthen their balance sheet.

But what has really gotten us interested is that more recently the company has been working with clients outside the oil and gas industry, tailoring their ceramic production to service industrial clients for uses such as casting materials and grinding media. The total addressable market here is substantial, and we think that there is a good chance of significant market penetration given the superior performance characteristics of their ceramic products over traditional materials.

The results have already started to become apparent. Gross margins have improved in each of the past four quarters, and they're targeting cash flow neutrality this quarter as well as positive EBITDA for

2018. We think the stability these new measures have brought to the business offer us the downside protection we look for in our investments, and the new revenue streams give them the ability to grow their earnings while reducing their reliance on the energy industry. Of course, if energy prices continue to improve, the additional upside here is tremendous. We're really excited about this one.

**TWST: And I understand too there are some safety reasons why their products might be preferable to some alternatives. There is also a new OSHA silica permissible exposure limit requirement going into effect in 2018, and they say that the workplace environment is safer for clients and employees by eliminating risks associated with silica dust, so there are some safety reasons that this product could be preferred.**

**Mr. Laks:** That's absolutely correct. In fact, that's one of the major selling points they use when they're marketing these new products to the industrial companies. There's a huge safety element to it, especially with the new OSHA requirements, and it's another reason why we think the growth in this industrial segment for them is going to be significant.

***"We actually believe that the events that have transpired over the last several years are setting the stage for uranium shortage in the coming years as demand increases and supply is not there to meet it."***

**TWST: Did you want to mention one final company?**

**Mr. Laks:** The last company we can talk about is **Cameco Corporation** (NYSE:CCJ). **Cameco** is a Canadian mining company that produces uranium, which is used in nuclear reactors to generate electricity. As a fuel source, its performance really is unmatched. A kilogram of uranium can provide over a million times the energy of an equivalent mass of natural gas and roughly 3 million times that of a kilogram of coal. There are about 450 nuclear reactors in operation worldwide that produce roughly 10% of total electricity production, and another 60 or so under construction.

**Cameco** is one of the world's largest producers of uranium. Their Cigar Lake and McArthur River mines are two of the largest, lowest-cost uranium mines in the world. During the commodity boom of the mid-2000s, the share price rose dramatically from under \$2 in 2000 to over \$50 in 2007 as concerns about Chinese demand growth and flooding at their Cigar Lake mine drove spot prices north of \$130 a pound. By mid-2007, the company had an enterprise value of over \$20 billion.

That all changed in March of 2011 when a magnitude 9.0 earthquake struck off the coast of Japan. The tsunami that followed flooded a nuclear power plant in Fukushima, causing a meltdown, and the government reacted by suspending nuclear power generation in the country until they could fully investigate the accident and introduce new safety requirements that other plants would have to follow before being approved for restart. Up until that point, Japan had been heavily reliant on nuclear power, with over 50 reactors providing close to a third of their electricity production.

The shutdown of their reactors took a major portion of demand out of the market, leading to a huge supply/demand imbalance that put

significant downward pressure on the uranium price. From roughly \$60 a pound before the accident, spot prices have steadily decreased to around \$20 a pound, where they are today.

**Cameco**, whose stock was trading above \$40 before the accident, fell to less than \$7.50 at the end of 2016. Other industry participants have gone bankrupt or shelved plans for new mines, but as one of the lowest-cost producers in the industry, **Cameco** was able to take a proactive stance during the downturn, shutting down higher-cost production and benefiting from their strong portfolio of long-term contracts they signed when prices were much higher.

However, the industry has remained stubbornly oversupplied. Utilities have been able to take advantage of ample inventories to feed their short-term needs. At one point, **Cameco** noted that long-term contracting volumes had fallen 90% from what was typical during a given period. All of this sounds pretty bleak, and yet, there are reasons to believe that we're on the cusp of a dramatic turnaround in the industry.

For one, there is significant demand growth forecasted over the next several years. Right now, there are over 50 reactors under construction worldwide, many of them in China and India where pollution concerns

have led governments to seek a reduction in fossil fuel generation. In addition, the demise of production companies and the deferral of scheduled projects has started to affect the supply side of the equation as well. The industry got a little boost earlier this year when Kazakhstan, which is the world's largest producer, announced they were cutting production by 10%. And in just the last month, **Cameco** stunned the industry by announcing the temporary suspension of their McArthur River mine, which effectively takes over 10% of global production offline.

It's hard to overemphasize the impact of this on the industry. We like to draw the analogy to the OPEC discussions that have been going on recently. The price movement in oil seems to swing dramatically on every twist and turn in these negotiations, and yet, it's all over a production cut that's less than 2% of total production.

To put this latest news in context, it would be comparable to Saudi Arabia taking their entire production offline. You can imagine what that would do to the price of oil. And just this week, Kazakhstan announced an additional production cut in a further attempt to bring the market into balance. We actually believe that the events that have transpired over the last several years are setting the stage for uranium shortage in the coming years as demand increases and supply is not there to meet it.

In contrast to power plants that burn fossil fuels, which have relatively low upfront capital costs and high ongoing expense in the form of fuel purchases, nuclear plants are the opposite. They have a very high initial cost due to the safety requirements but then an extremely low fuel expense. Once the plant is up and running, the utilities are fairly price-insensitive when it comes to fulfilling the necessary fuel demand. It's estimated that a new

mine today would require \$75 a pound to be profitable and would take several years to bring into production. This dynamic of price-insensitive buyers and a very high incentive price for new production should be very interesting when these utilities actually need the pounds, and years of supply cuts and project deferrals make them unavailable.

Meanwhile, we can own one of the world's largest low-cost producers trading at a distressed valuation while we wait for this to play out. It's worth noting that even in the heart of this downturn, which the CEO said is the worst he's seen in decades, the company still generated over \$400 million of free cash flow in the last 12 months. We think the risk/reward here is very attractive.

**TWST: Is there also the possibility that the Trump administration could eventually encourage more nuclear reactor technology and you might see more plants in the United States as well as in some of these other countries?**

**Mr. Laks:** Yes. In fact, we've seen the administration come out with a number of supportive comments for the nuclear industry. In our forecast, however, we assume the number of U.S. plants to be fairly flat to declining, so growth here would be an additional benefit. We view most of the growth in the industry coming from these high-population centers in Asia that are making long-term plans and trying to reduce their fossil fuel consumption. But yes, it's actually been one of the things that has helped support the market, at least in the last year or so, the positive comments that have been coming out of the Trump administration with regards to nuclear.

**TWST: And as we're talking about the Trump administration, do you think that there is a chance that the proposed tax cut is going to benefit some of the stocks that you follow, and how will that come to pass?**

**Mr. Laks:** I think there are a couple of aspects to that. One, you'll notice a common theme of these companies is that at one point they were flying high and then something changed in the industry, and they've essentially fallen from grace. Many of them have lost significant amounts of money in the intervening period, and as a result, they haven't had to pay much tax. But I think going forward, with the profitability we foresee in all of these cases, all things equal, a lower tax rate, of course, should benefit them. To speak more generally about the market, it seems that one of the factors that has contributed to rising stock prices since the election has been the anticipation of lower tax rates and the benefit they will have on companies in general.

**TWST: Thank you. (ES)**

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