

# VELOCYS PLC

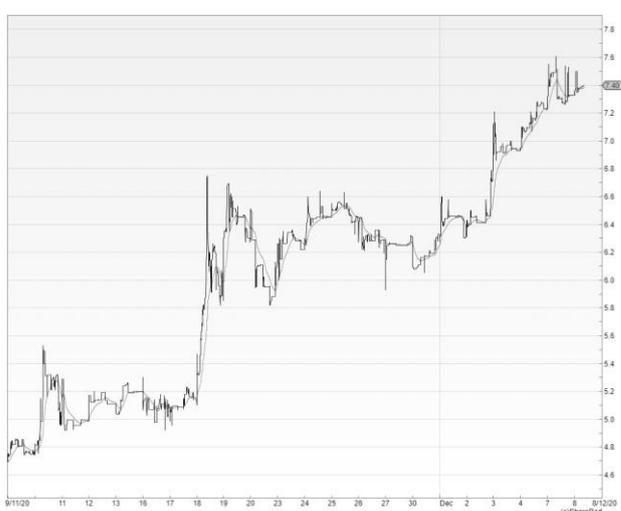
## TRADE NOTE

Trade type:	Short-Term Trade	02 December 2020
Rationale:	Momentum trade	
Buy-in price (p):	6.50	Min. target price (p): 9.40
Market cap (£m):	69.2	Min. target gain: 45%

3-month chart:



1-month chart:



### The Trade: Executive Summary

We have opened a Short-Term Trade in Velocys Plc at an average price of 6.50p. This equates to a market capitalisation of £69.2m, at our average buy-in price. Our minimum target price over our initial one-month investment horizon is 9.40p, which equates to a market capitalisation of £100.0m. This offers a minimum 44.6% target gain from our entry price.

The Trade is based on the following key factor:

- Positive sentiment within the global investment community towards all things ‘Green’ is building rapidly. Velocys offers direct exposure to not only sustainable aviation fuel, but also to carbon capture and storage. In combining these two technologies, it is on track to commercialise a model that will enjoy a *negative carbon intensity*. That is to say, the end-to-end process will remove more CO<sub>2</sub> from the atmosphere than it will emit. We believe that there are very few companies that are more ideally placed than Velocys to ride the ‘Green Wave’, that constitutes one of the core driving forces of resurgent equity markets in recent weeks.

We have classed this position as a Short-Term Trade as we see immediate-term upside in the share price owing to the above. However, we believe that the long-term upside potential for Velocys is immense. We reference the the mean target price in the market at present (from two analysts) of 21p, with one of the analysts suggesting a bull-case target price of over 60p. Were we to upgrade the position to a Long-Term Trade or Investment, we would at a later date provide much more in-depth analysis of the Company.

## Company Overview

### **Overview**

Based in Oxford, Velocys is a sustainable fuels technology company. Its stated mission is to help reduce the environmental footprint of the aviation and heavy transportation industries by enabling a proven and reliable supply of advanced biofuels. Moreover, it has devised an integrated technology process that includes carbon capture and storage (“CCS”): in short, this means that it will theoretically be able to produce biofuels that have a *negative* carbon intensity (“CI”). That is to say, the end-to-end process will remove more CO<sub>2</sub> from the atmosphere than it will emit.

Following many years of research and development, and the running of demonstration projects, the Company is now in the nascent stages of commercialising its offerings, with four projects under development.

### **Assets and operations**

Velocys has designed and developed its own bespoke and patented Fischer-Tropsch (“FT”) technology. The FT technology enables an economic conversion of a wide range of low or negative cost, abundant sustainable feedstocks – such as woody biomass residue or municipal solid waste – into high value sustainable biofuels.

The two types of biofuels that Velocys is initially focussing on are i) sustainable aviation fuel (“SAF”); and ii) biodiesel for road transportation.

Biofuel production and consumption has a very low CI. For example, in the case of aviation fuel, a SAF produced by FT technology with forestry residue feedstock, has a CI of over 90% *less* than fossil aviation fuel. However, by combining existing CCS technology of third parties with gasification technology and Velocys’ own FT technology, in an integrated design – the CO<sub>2</sub> that is generated as a by-product from the gasification process can be captured before it enters into the atmosphere and stored permanently underground in a geological formation. It is this integration of various technologies that will enable Velocys to commercialise a model that will generate biofuel with a *negative* CI.

The Company has four live projects. Two of these comprise licensing agreements, in which Velocys licenses its FT technology to third party developers and site owners. These two clients are **Red Rock Biofuels** (project located at Lakeview, Oregon, US); and **Toyo Engineering Corporation** (Nagoya, Japan).

The second two projects are considered key demonstration projects for Velocys:

**Altalto** (Immingham, UK). This plant will take household and commercial waste which would otherwise be destined for landfill or incineration, and instead convert that waste into clean-burning SAF. Velocys, Shell and British Airways are the commercial partners in the project. The partners are targeting financial close for the project in 2022. Altalto will have a nameplate capacity of 20 million gallons of SAF per annum. It will also consume 500,000 tonnes of waste pa. Shell and British Airways have an option to take a 33% equity stake each in the project.

**Bayou Fuels** (Mississippi, US). This plant will process waste from the paper and lumber industries – woody biomass forest residue – and create biodiesel fuel for road transportation in the US. The project’s nameplate capacity will be 25 million gallons pa of biodiesel, with financial close targeted for Q4 2021. A critical component of the Bayou Fuels project is Velocys’ agreement with Occidental Petroleum, a leading US O&G business: Occidental will capture the CO<sub>2</sub> that is generated when the biomass fuel is burnt, and permanently sequester it in underground geological formations (specifically, depleted oil fields).

## ***Partnerships***

In addition to the major partners of its two reference projects – Shell, British Airways and Occidental Petroleum – Velocys is also a member of the UK Government’s newly formed Jet Zero Council. The Council will provide advice on the Government’s ambitions for clean aviation and will focus on developing UK capabilities to deliver net zero commercial flight through a series of measures including:

- Establishing UK production facilities for SAF and commercialising the industry by driving down production costs.
- Developing a coordinated approach to the policy and regulatory framework needed to deliver net zero aviation.

## ***Target markets***

The two types of biofuels that Velocys is initially focussing on are SAF; and biodiesel for road transportation. As one might expect, the growth prospects for each of these markets is immense. For example, the International Energy Agency forecasts that by 2030, SAF will account for 10% of global aviation fuel demand (which it forecasts at 230 billion litres in total).

## ***Client base***

The Company currently has two (publicly disclosed) clients, namely Red Rock Biofuels and Toyo Engineering Corporation. Following proof of concept at the two reference projects, Altolto and Bayou, Velocys intends to develop a technology licensing model as its primary offering, as well as offering an integrated technology package. As such, its core customer base will be comprised of businesses such as Red Rock and Toyo. Besides the two reference projects, Velocys is therefore not expected to take equity in future projects that license its technology.

## ***Competitive landscape***

There are a variety of different biofuels, both of the type that must be blended with regular gasoline or diesel (such as corn-based ethanol), and of those that can be used as direct replacements (referred to as ‘drop-in fuels’). Fuels developed with FT technology are by a significant margin the least carbon intensive of all SAFs, relative to fossil jet fuels.

Whilst there are a handful of other SAF developers using FT technology, the market is suitably early stage for multiple entrants to in fact be beneficial in catalysing initial uplift in demand. Moreover, we believe that Velocys has a significant competitive advantage in its CCS bolt-on offering that will ultimately stand it apart.

## ***Financials***

Having raised £21m gross in new equity at 5.0p in July, the Company has sufficient working capital until early 2022. Net cash used in operating activities in H1 2020 was £3.0m; the net cash position as at end June 2020 was £0.2m (after accounting for £0.6m of gross debt). As Velocys is only in the nascent stages of commercialisation, its revenues are modest at present. Forecasts in the market suggest sales of £3.3m this year; increasing to £9.4m next year; and to £18.0m in 2022, at which point the Company would move into an EBITDA positive position.

## Trade Rationale

We have opened a Short-Term Trade in Velocys for the following key reason:

- Positive sentiment within the global investment community towards all things ‘Green’ is building rapidly. We believe that there are very few companies that are more ideally placed than Velocys to ride the ‘Green Wave’, that constitutes one of the core driving forces of resurgent equity markets in recent weeks. Velocys offers direct exposure to not only the emerging SAF market, but also to CCS. These two markets are anticipated to enjoy colossal growth over the coming decades.

On the political spectrum, Joe Biden’s recent Presidential victory over Donald Trump is set to accelerate the energy transition within the US. In the UK, Boris Johnson has declared a highly ambitious target for tackling climate change, in upgrading the UK’s Nationally Determined Contribution under the Paris Climate Agreement: it is to cut greenhouse gas emissions by 68% to 69% by the end of the decade, based on 1990 levels.

On the public markets, green energy stocks have rocketed in recent months. *The* flagship company, EV manufacturer Tesla, recently surpassed a valuation of half a trillion dollars, putting it on a price earnings ratio of in excess of 1,000x. We are seeing such dizzying valuations manifest in the UK micro-and small-cap space as well and believe that this pan-sector euphoria will continue to drive Velocys’ market capitalisation in the near-term.

Our minimum target price of 9.4p equates to a target market capitalisation of £100m. We note that this amounts to only 45% of the mean target price in the marketplace of 21p (generated from two analysts’ targets of 16p and 26p, respectively). We consider this a very undemanding target, given the aforementioned lofty valuations of other green tech businesses listed on the LSE.

## Risks to the Trade

Besides black swan events, we believe there is one major risk to the Trade within the short-term investment horizon of one month:

- **Deterioration of wider equity markets owing to the effects of the coronavirus pandemic**  
Numerous market analysts are currently suggesting that a rapid and widespread rollout of multiple vaccines has already been priced into equity markets, so rapid has been their recovery since Pfizer and BioNTech announced that their vaccine candidate had a 90% efficacy, on 9 November. The FTSE 100 for example has increased by 10.9% over the past four weeks, from the day before said vaccine news, to now.

A significant pullback in equity markets in the next three weeks is a distinct possibility, regardless of further positive vaccine news. There is of course a risk that Velocys would suffer as a result, particularly given its status as a micro-cap stock (i.e. high-risk assets are likely to be cut from portfolios first).

## Disclosure

*The author of this paper, Myles McNulty, is a private investor. He and his family hold ordinary shares in Velocys.*

*This paper is non-independent research. It has not been prepared in accordance with legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of the investment research.*

*This paper is designed for information purposes only and does not constitute a personal recommendation, offer or invitation to buy or sell any investment referred to within it. Investors should form their own conclusions and/or seek their own advice to determine whether any particular transaction is suitable for them in the light of their investment objectives, the benefits and risks associated with the transaction and all other relevant circumstances.*

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*Myles McNulty has no business relationship with Velocys or with any other company mentioned in this paper, and has received no compensation from any party for writing it.*

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