SA Interview: Tech Investing With Lucid Capital

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by: PRO+ Interviews

Summary

- Lucid Capital is a technology-focused fund founded by Product and R&D executives.
- Why having a tech ingenuity trumps a financial background when it comes to valuing deep-tech stocks and how to find a needle in the AI-stack are topics discussed.
- Lucid Capital shares a long thesis on Payton Planar, Nice Systems and Ubiquiti.

Feature interview

Lucid Capital is a technology-focused fund founded by Product and R&D executives. We discussed with Lucid Capital the value in under the radar non-U.S. companies, what investors are missing about the autonomous/electric vehicles story and flipping the script on the phrase “insiders have many reasons to sell but just one reason to buy”.

Seeking Alpha: Walk us through your investment decision making process. Can you discuss how your industry expertise and background gives you an edge over investors with a more financial background?

Lucid Capital: When it comes to deep technology B2B companies (unlike consumer technology companies like FB or NFLX), the common capital market analysis tools like P/E or EV/EBITDA are useless. Had you relied on these ratios in 2013 for NVDA, OLED, PANW, you probably would not have invested in them, yet, they all rose more than 200% since then.

Unlike many investors who may have a stellar financial background but lack in-depth technological and product understanding, our team consists of leading product and R&D executives with strategic product management backgrounds, technological ingenuity (e.g. software engineering background) and a vast network in the top 2 of the world’s tech hubs - Silicon Valley and Tel Aviv (Israel).

A better way to value deep tech stocks, is based on first hand assessment of their products and underlying technology vs the competitors, using in-depth interviews with 8-12 potential buyers across the market segments.

Also you should take a look on the technological architectures that Tier-1 cloud providers like Google and AWS deploy as they usually encounter problems 3-4 years ahead of tier 2-3 Scale-Out players (e.g. Workday, ServiceNow, Tesla, etc.) and 5-6 ahead of Enterprises (Kraft, Target, Marriott, etc.)

For example if you sniffed around the fast growing Google’s AI infrastructure in 2015, you’d find a huge Nvidia install base, at the time NVDA traded at ~$40 compared to $200 now. By the way Google has been transitioning lately to its owned TPU architecture, gradually replacing Nvidia’s GPUs….

SA: What area of the market do you focus on and what strategies do you employ? How do you find long and short ideas and what do you look for in them? Can you give an example?

LC: We try to avoid the crowded trades or heavily discussed stocks; we look for companies with deep technology that a small number of analysts can fathom, let alone challenge the management claims.

Things like 3D printing (one of our leadership team members was a Product Director at a large 3D printing vendor) cyber and cloud-scale IT, electrical components, etc. In those domains, the analyst's technological acumen matters more than their financial savviness and the knowledge of the eco-system overshadows the relationship with the CFO.

Take a look for example at the number of analysts who recommended buying 3D printing vendors 3D Systems (NYSE:DDD) or Exone (NASDAQ:XONE) in 2014; both fell 80% since then.

The one 3D printer that did fare well since 2014 is the Swedish Arcam (Arcm.ob, a metal 3D printer that developed a unique technology, Electronic Beam Molding ("EBM"), that can manufacture the most demanding parts like jet turbine blades or joint replacements. Before the company was acquired by GE it traded on the Stockholm stock exchange, out of sight for U.S. traditional investors (though very easy to buy via Interactive Brokers (IEX:IBKR))

A more current example is our published work covering Payton Planar, where we found many aspects we like:

- A technology shift that rattles an industry's value chain ("EV").
- Most media and investors focus on the fight between OEMs (GM, Toyota, etc.) let alone Tesla's endless saga.
- A hard to understand niche technology (Planar Transformers) in the back of the value chain, that plays a crucial role within EV.
- An industry that most investors misperceive as a commodity, undervaluing the moat and know-how provided by Payton's design capabilities as reflected in its GM (44% in H1/2018, or 51% in similar companies like POWI).
- Compelling valuation with single-digit P/E, solid balance sheet with 20% of the market cap in cash.
- Ultra-conservative, engineering-led management that avoids the spotlights at any cost.
- Hints about the upcoming inflection point, embodied in the wording used in the financial reports and rapidly growing backlog numbers (read the article for more color)

By the way, while some may be deterred by the recent 80% rise in the last few months, since it was backed by strong fundamentals (53% revenues growth, GM expansion from 39% to 44%, tripled operating income, and another backlog record), Payton is even cheaper than a few months ago.

SA: What type of reader should follow your work? Who are some of your favorite Seeking Alpha authors and why?

LC: In our articles we try to go under the surface, assemble the puzzle by uncovering insights that weren't provided by the company, using tools like:

- Interviews with the company's customers like the Tier-1 car part manufacturer we interviewed for Payton Planar (we utilize our own network of connections, and avoid using the company's PR/IR connections).
- Extract product and competitive reviews from industries' sources, rather than investors' sources (see for instance the excerpt from OLED-info.com in our OLED short thesis).
- Use inputs from industry experts to arrive at assumptions that enlighten tacit financial info (like GM per product and the products mix).

Hence you should follow us if you are into:

- Fundamentals and less into technical analysis.
- Hidden gems and less into the "celebrity" stocks like AAPL, GOOG, etc.
- 3 year investing time-frame.
- B2B companies with fundamental technology advantage or moat - note by itself these aren't enough to justify investment but the chances the market "misunderstands" these are greater.

Some of my favorite authors are Thomas Bachrach, CFA who also looks under the radar or Grant Beaty that wrote on the Russell Longfin debacle.

Among the more mainstream authors, Whitney Tillson and Gary Alexander are always insightful reads.

SA: You shared a compelling long thesis on Payton Planar as an under the radar and unconventional play on the electric vehicle ("EV") boom – can you share your thoughts on the overall EV trend, which companies are most likely to benefit/suffer from it and any misconceptions you see that investors have about it?

LC: First, many still associate Autonomous Vehicles ("AV") and Electric Vehicles ("EV") revolutions. But unlike the EV revolution that happens now with ~2M EVs sold in 2018 and expected to grow 40-60% in 2019, full AVs (level 5) aren't around the corner. To reach from 95% autonomous to 100% autonomous isn't extra 5% effort, it could be a few times the effort required to reach from 0 to 95% autonomous, so we're looking for companies that will surely benefit from the EV revolution and see AV as a long shot bonus for our thesis.

Second, most investors rotate around the cars industry overlooking the charging eco-system, and the electrical revolution EV embodies. If you think about the electric equivalent of 10 pumps per fuel station, to charge 10 cars in 5-10 minutes, it will require an electric current consumed by a whole neighborhood. So one of the beneficiaries could be a company like Solar Edge (NASDAQ:SEDG) that provides solar-powered EV charger inverters (currently still for homes, though) that claims to charge EVs up to 2.5 times faster than a standard EV charger through an innovative solar boost mode that utilizes grid and PV charging simultaneously is worth looking at.

SA: How can investors leverage the knowledge of industry insiders to determine if a technological trend will continue or change? How can investors find these resources? This seemed to play a key role in your short thesis on Universal Display (NASDAQ:OLED), which dropped >50% within six months of publication.

LC: Everybody knows the phrase that insiders have many reasons to sell, but just one reason to buy.

We believe that if a bunch of insiders sell a bunch of stock over a short time, there is also only one reason for that.

While we don't base our decision solely on insiders, it's definitely a key indicator we look for especially when developing a short position.

In the case of Universal Display (OLED), we complemented our short thesis by checking the amount of stock unloaded by insiders (using TipRanks) and found out that a bunch of insiders sold $250M worth of stock in the preceding 6 months, 7-12 times more than other 6 month periods. That gave us a lot of confidence in our thesis.

SA: What are some tech trends that are closer or farther away than most investors think and how can readers take advantage of this?

LC: AI has been a hot-topic, but not all AI applications were born equally, while many companies pitch AI as a growth engine that would indulge/anticipate their customers, AI is far mature when it comes to vision (image/video recognition).

Don't get me wrong, while AI has solid applications far beyond vision, I'm looking for domains where AI is a game changer for the company's value proposition (for example AAXN, CGNX) and not just another cool feature. Also, I'd rather invest in companies where AI doesn't substitute humans but complements humans (e.g., Search for the exact "violent moment" within hours of videos shot by bodycams, smartphones and security cams from a variety of angles).There are 2 reasons for that: A. substituting humans requires perfecting the AI rather than bringing it to 90% working level. B - Many objections from unions, regulators and others.

SA: What's one of your highest conviction ideas right now?

LC: First, due to the recent correction we sense we're approaching an inflection point for the 10 year bull market, hence we hold sizeable positions in short term, high rated bonds (SLQD or IBDL).

We look for companies who'll thrive even in softer global growth and high-interest rates environments. Payton Planar (PAPL: Euronext Paris) is a good candidate. Payton is now even cheaper than it was when the article was published, since it reported stellar H1/2018 results (53% revenues growth, GM leaped from 39% to 44%, OP almost tripled), and now trades at a P/E of 9 (excluding cash) for 2018.

Obviously a P/E of 9 means the market is utterly skeptical about the viability of the growth, especially in the automotive business. Yet, we've got another reinforcement to the thesis that Payton is starting to monetize on its automotive design-wins when the company announced a $45M deal to supply planar transformers during the coming 7 years to a Tier-1 car part manufacturer.

While we don't expect Payton to grow 50% on an annual basis, if you assume the following:

- Automotive is at least 35% of its revenues (fair assumption given that automotive customer A is 27% of the revenues and they have further tier-1 car manufacturers as customers).
- No other design-wins with car parts manufacturers (like Delphi), so the company's automotive business can grow at the EV end markets CAGR of ~40%.

- A modest 10% CAGR for the aerospace business that actually grew 50% in H1/2018 (customer B in their reports).
- 3-4% growth for telecom and other verticals.

The result is 15-20% revenue growth for the coming years, with no working capital requirements.

Here is a detailed P&L model for 2018 & 2019 based on the above pessimistic scenario:

K USD	2015A	2016A	2017A	H1/2018A	H2/2018 E	2018 E	2019E	Comments
Backlogs as of period start	10,378	11,010	10,681	16,796	25,305			
Revenues	27,372	32,354	33,043	22,056	26,905	48,961	57,773	2018: Revenues is based on the expected backlogs to revenues ratio of 2017, ignoring the much better ratio already experienced in H1/2018,. Applied further -$3M conservative factor. 2019: 18% growth rate
COGS	-17,247	-20,191	-20,064	-12,181	-15,605	-27,786	-33,509	
GP	10,125	12,163	12,979	9,775	11,300	21,075	24,265	
% GP	37.0%	37.6%	39.3%	44.3%	42.0%	43.0%	42.0%	Convesrvatively assumed 200 bps %GM erosion in H2 and 2019 (Mix)
R&D	-949	-1,012	-1,240	-719	-850	-1,569	-1,726	2018 : Assumed 15% increase to reflect bonuses etc, despite no evidence for sequential increase bethween H1 to H2 2017 2019: Assumed 10% growth (vs 18% rev growth)
S&M	-2,149	-2,254	-2,269	-1,150	-1,500	-2,650	-2,915	
G&A	-2,959	-3,101	-3,075	-1,757	-2,000	-3,757	-4,133	
EBIT	4,074	5,163	6,399	6,156	6,950	13,106	15,491	
%EBIT	14.9%	16.0%	19.4%	27.9%	25.8%	26.8%	26.8%	
Intrest earned	1	141	314	94	100	194	300	
Tax	20%	19%	15%	16%	17%	17%	17%	
Net Profit	3,263	4,179	5,419	5,195	5,851	11,046	13,186	
% Net Profit	11.9%	12.9%	16.4%	23.6%	21.7%	22.6%	22.8%	

So with 18% of market cap that is backed by cash, EV/FCF and P/E of less than 10 for 2018 (and <8 for 2019) leaves you a great margin of safety even in the above pessimistic scenario.

Among our other positions, I'd mention Nice Systems (NASDAQ:NICE) which has been transforming successfully into an Enterprise SaaS company in a very similar way to Adobe's transition. The market still prices it on price to sales (P/S) of 4-5x, compared to P/S of 10x for other Enterprise SaaS companies that are slightly profitable like ZEN or HUBS despite the fact that Nice generates a 25% operating margin and robust cash-flow.

Currently, NICE's real growth rate is masked by the transition from upfront on-premise revenues to a subscription model, but once 80-90% of the transition is completed, Nice will be able to reap the fruits.

Another company we like is Ubiquiti (NASDAQ:UBNT), it continues to climb up the market segments, using an out-of-the box business model and will start eating Cisco's and HP's WiFi access points lunch.

Ubiquiti leverages its evangelistic community and word of mouth as key marketing tools (together with extreme value for money pricing), hence it is capable to shave 80-90% of typical sales & marketing costs.

The beauty is that the more the model works and Ubiquiti's products become ubiquitous there is less need for marketing expenses as word of mouth spreads in the social media and relevant forums, so high end segments (Stadiums, Enterprises, etc.) have more

legitimacy to buy Ubiquiti’s access points and switches.

While both NICE and UBNT valuation have been stretched lately and tariffs may weigh on short-term UBNT performance, buying patiently on the dips and holding for a few years, could yield a sound return.

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Thanks to Lucid Capital for the interview. If you'd like to check out or follow their work, you can find the profile here.

Disclosure: I/we have no positions in any stocks mentioned, and no plans to initiate any positions within the next 72 hours. I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it (other than from Seeking Alpha). I have no business relationship with any company whose stock is mentioned in this article.

Additional disclosure: Lucid Capital is long Payton Planar, Nice Systems and Ubiquiti.

Comments **(1)**

Lucid Capital, Contributor
In the last 2 days, both NICE and UBNT published stellar reports...

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