Another One Bites the Coal Dust

By Lawrence Carrel
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Here's our weekly look at small-capitalization stocks that are making big moves on Wall Street.

A COAL PRODUCER WITH an identity crisis sure has taken its lumps lately. **Evergreen Energy** (EEE[1]), which until Sept. 29 was known as KFx, shed 42% of its value in September on concerns over the effectiveness of its process for improving low-grade coal. Before tumbling last month, the stock had reaped the rewards of the broader commodities boom, topping out at an all-time high of $22.16 in February. Four years ago shares went for less than $2 apiece.

The name change appears to be paying off, however, at least in the short term. Evergreen Energy shares have climbed 9% (through Thursday) since the company adopted a new moniker and ticker symbol, and moved over to the New York Stock Exchange's Arca Exchange from the American Stock Exchange. The stock is up 25% since announcing the changes on Sept. 25.

Mark Sexton, chief executive of Denver-based Evergreen Energy, defends the name change and denies it was enacted to obscure the negative publicity surrounding the former KFx.

"The name change is that I and other team members are closely associated with Evergreen Resources," says Sexton, who was named chairman on Sept. 29. "We've been here before and we've done this and people have profited from it. [KFx] has a new business plan, and we feel we'll be successful again."

Evergreen Resources was Sexton's previous company, a then publicly traded natural-gas producer that he and Kevin Collins, Evergreen Energy's chief operating officer, grew from a market capitalization of $30 million to more than $2 billion over 10 years. Like Evergreen Energy today, that company also faced early skepticism over its technology for extracting a commercially viable product from coal-bed methane. Two years ago, Sexton sold Evergreen Resources to Dallas-based Pioneer Natural Resources for $2.1 billion. He was named CEO of KFx on Sept. 28, 2005, and was told at the time he could change the name a year later if he achieved certain milestones. Sexton had been on KFx's board from 1999 to 2004.

Sexton's latest energy play is K-Fuel. Evergreen Energy claims to have found a way to process low-grade, high-moisture coal from Wyoming's Powder River Basin so that it contains less water and produces more energy. The company claims K-Fuel also burns cleaner than more expensive coal from Appalachia since the process strips out pollutants.

According to Evergreen Energy, in a test burn conducted earlier this year by Quinapoxet Solutions, an independent third-party testing company, K-Fuel had a quarter to half the moisture of regular Powder River Basin coal and burned 28% hotter. In addition, sulfur dioxide emissions were reduced by 38% to 40%, nitrous oxide emissions fell as much as 22% and the mercury content plunged by 70%. Analysts have said if K-Fuel really works it could revolutionize the coal industry.

Tarred and Feathered
Despite its promise, many investors don't appear sold on K-Fuel. As of Sept. 15, 22% of the company's outstanding shares had been sold short. Short-sellers profit when a stock's price falls, and that pessimism has been rewarded lately.

On Sept. 12, Evergreen Energy reported receiving the test-burn results from its first commercial shipment of K-Fuel to **First Energy** (FE[2]), the nation's fifth-largest utility in terms of customers. In a press release[3], Evergreen Energy said the shipment of more than 100 freight-train cars showed "no significant problems." But a day later rumors circulated among traders and on stock messageboards that the unloading of the shipment released a huge cloud of coal dust into the air and that the coal had spontaneously combusted. The stock plunged 18% before trading was halted.

The next day Evergreen released a revised statement[4]: "Only two issues were reported: first, there was fugitive dust that occurred during the transloading process from rail to barge. Second, a few of the delivered cars exhibited elevated heat content." The company said the coal was sprayed with water and a dust suppressor, and that "the shipment proceeded to the plant as expected."

In a conference call on Sept. 14, Sexton said the information hadn't been disclosed in the first press release because "it is not material...because the coal exhibited handling characteristics that are normal for Powder River Basin coal." He did acknowledge that the coal was the first major shipment for K-Fuel and that it hadn't been packed properly, which may have led to some of the problems.

Chris Blazek, vice president of marketing for Benetech, the firm that takes care of First Energy's coal-dust problems and was on the scene for the K-Fuel delivery, said First Energy had requested that Benetech not comment on the situation.

"There has never been any spontaneous combustion," says Sexton, "But, Benetech did spray the coal with a Benetech product there."

Famed short-seller Manuel Asensio wasn't quite as close-lipped. Within days of the delivery Asensio published what he purported[5] to be photos and videos of the coal drop at the Ohio transfer point. Asensio called the amount of dust that escaped "excessive and unacceptable."

In a Sept. 26 interview on CNBC, CEO Sexton said the photos and videos had been doctored. But in a later interview with SmartMoney.com, he acknowledged he hadn't actually seen the videos but rather was getting reports from other people in the company.

Power Magazine, which covers the global power industry, published an article last month that cast doubt on Evergreen Energy's K-Fuel: "Others have tried to economically dry lower ranked coals to improve the heat content in the past — none have been successful." The magazine reported it had obtained photos that "clearly show considerable amounts of fugitive coal dust at the barge terminal when the K-Fuel was being loaded on a barge. Significant quantities of water were also sprayed over the coal in an effort to reduce the fugitive dust. Neither are normal events when handling [Powder River Basin] coal." Power Magazine said at the time neither Evergreen nor FirstEnergy would release technical or performance data to substantiate their claims.

Both Sexton and First Energy declined to provide SmartMoney.com with details on the test burn. "We don't discuss where we buy our coal or the coal's performance," says Ellen Raines, a First Energy spokeswoman. "Fuel procurement is a very competitive aspect of our business. We haven't decided if we will buy more, and there is no time line on making a decision. Adds Sexton: "We signed a confidentiality document with First Energy."

On Sept. 25, Evergreen published a statement from Marston & Marston, a mining consulting firm hired by the coal company to report on the unloading of K-Fuel from five trucks onto a train in Rapid City, S.D. The report said 150 tons of K-Fuel was treated and loaded onto rail cars "without any material release of dust." That same day, Evergreen said it would release two more shipments of K-Fuel in the following week, but no word of the shipments has been released to the public.

Power Magazine's editor-in-chief, Robert Peltier, didn't return phone calls seeking additional comment. On Friday (Oct. 6), after interviewing Sexton, Power Magazine released an article that softened its stance on Evergreen Energy. It said "first-hand observers of the fuel transfer and unloading processes said...the fugitive dust generated was consistent with a typical [Powder River Basin] coal delivery" and that the "'elevated heat content' were within the acceptable range found in a typical PRB coal car."

Risk vs. Reward
So where does this leave Evergreen Energy's current shareholders as well as small-cap investors considering a stake in the company? On a very slippery slope, as far as we're concerned.

Evergreen Energy has never posted a profit. For the second quarter, the company recorded a net loss of $9.5 million, or 12 cents a share, vs. $3.7 million, or six cents, in the year-ago quarter. Revenues improved to $11.5 million from just $54,000 for the same period in 2005. If all goes well, CEO Sexton hopes to start turning a profit in 2008.

As for the recent surge in the stock price, it may be more a function of a change of scenery than any fundamental improvements. By moving to the NYSE's Arca Exchange, which has less-stringent listing requirements than the Big Board itself, Evergreen Energy may be capturing the cachet of the NYSE.

"The threshold for the NYSE-Arca is lower than the traditional benchmark guidelines for the main NYSE," confirms Bob Power, vice president of the NYSE global corporate client group, the head of NYSE-Arca listings.

Paul Clegg, an analyst with New York brokerage Natexis Bleichroeder, suggested the rise could also be tied to portfolio managers buying back Evergreen Energy shares after dumping the stock at the end of the third quarter. Known as window dressing, it's a tactic used by portfolio managers to eliminate underperforming stocks from inclusion in quarterly performance reports.

Of course, CEO Sexton found success in the energy sector before, and it's not impossible that lightning could strike twice. After more than two decades of development K-Fuel appears on the verge of commercial acceptance, assuming further tests confirm the effectiveness of the refining process. That's a big if, to be sure, but the company's plant is expected to be operating at full capacity in the first quarter of 2007. Sexton says no contracts have been signed as of yet.

"Sexton and Collins [the operating chief] made a lot of money in Evergreen Resources and they changed the name to recapture the old magic and show they are turning into a clean technology energy company," says Natexis Bleichroeder's Clegg, who gives the stock a $25 price target.

Part of that old magic includes a vanishing act for some of the bad press that has hounded the former KFx over the years. Notes Clegg, "Of course, now when you Google Evergreen Energy old articles regarding KFx Alaska and the state's attorney general won't show up."

Alaska Attorney General Gregg Renkes resigned in February 2005 after it was discovered he owned shares of KFx while playing a major role in an international coal deal between Alaska and Taiwan that would've involved K-Fuel. In addition, it came out that the merchant bank in the deal that agreed to license technology, Kanturk Partners, wasn't an independent entity, but rather was run by two large shareholders in KFx, including the former CEO's brother, John Venners.

If skeletons in the closet don't scare you, by all means take a chance on the newly minted Evergreen Energy. But with so many promising small-caps out there, we'd prefer an investment that's less likely to go up in smoke.

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