Feltl and Company

SECURITIES BROKERAGE AND INVESTMENT BANKING

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Technology: Capital Equip.
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Stratasys, Inc. (SSYS - $25.45)

Initiating coverage — **BUY**

Financial Summary

Rev(mil)	2003A	2004A	2005E
Mar	$10.7	$15.8	$18.8E
Jun	$12.1	$17.3	$22.0E
Sep	$12.9	$17.7	$23.0E
Dec	$15.2	$19.4	$25.0E
FY	$50.9	$70.3	$88.8E
P/Sales	5.21x	3.77x	2.98x

EPS	2003A	2004A	2005E
Mar	$0.13	$0.18	$0.23E
Jun	$0.16	$0.22	$0.28E
Sep	$0.20	$0.24	$0.30E
Dec	$0.14	$0.21	$0.31E
FY	$0.64	$0.85	$1.12E
P/E	39.7x	29.9x	22.7x

Price:	$25.45
52-Week Range:	$37.50 -$16.61
Target:	$33
Rating:	BUY
Shares Outstanding:	10.4 mil
Mkt. Capitalization:	$265 mil
Ave. Volume:	161,000
Instit. Ownership:	37%
BV / Share:	$8.13
Debt / Tot. Cap.:	0%
Est. LT EPS Growth:	20%-25%

Company Description

Stratasys is a leading provider of rapid prototyping and 2D printing solutions that allow engineers and designers to create precise 3-dimensionsal plastic and wax parts directly from 3-D computer-aided design (CAD) systems. SSYS has a broad base of customers in the automotive, aerospace, industrial, recreational, electronics, medical, consumer, OEM and educational markets. It has the largest installed base of these systems in the world.

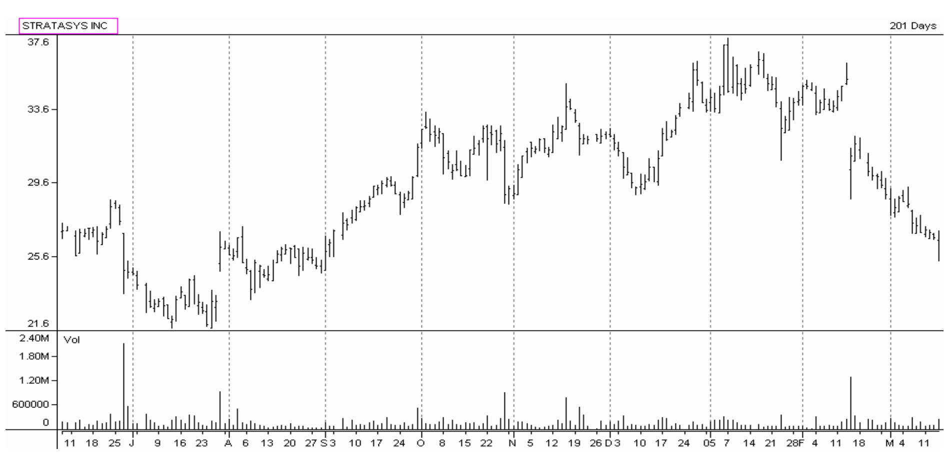
Key Points:

- **We are initiating coverage on SSYS,** a rapidly growing, highly profitable company which is capturing market share in the attractive rapid prototyping/3D printing market.
- Despite a **record revenue and earnings per share year** with excellent growth (38% and 33% respectively), a modest Q4 earnings shortfall has resulted in a stock sell-off of over 25% and set up, in our opinion, a **buying opportunity**.
- SSYS has a very **strong balance** sheet with no debt and $57 million in cash or $5.42 per share. Its modest capital requirements and healthy profitability suggest it should continue to throw off significant free cash.
- This is a **razor/razor blade business**, although the systems that SYSS sells also carry excellent margins. The proprietary supplies they consume represent a very profitable and growing recurring revenue stream.
- We rate SSYS a BUY and have established a price target of $33 based on a 25x P/E (a small premium to its forward EPS growth rate) plus the $5.42 in cash.

Investment Recommendation:

We believe the sell-off in SSYS stock following the Q4 report represents a buying opportunity. Business is good, profits are strong and the modest miss in Q4 should not impact the long-term outlook. This company is growing rapidly in what we believe is still a relatively young and untapped market. It is the leading seller (by units) of rapid prototyping/3D printing systems in the world and is rapidly building a very profitable recurring revenue stream from the supplies these machines consume. It has a very strong balance sheet and should continue to generate significant free cash even at a high growth rate.

This a stock we believe investors can own for a number of years. It appears well managed and has proven that its technology and strategy are sound based on its market share capture over the past several years. We would be buyers of SSYS during this current weakness. We believe our 12-month $33 price target is reasonable, but think over a multi-year period there could be much more upside.



Company Description:

Stratasys, Inc., headquartered in Eden Prairie, Minnesota, manufacturers and sells rapid prototyping (RP) and three-dimensional (3D) systems for creating physical models, parts and molds directly from computerized designs. The company is a pioneer in the field, having sold its first system in 1992 and to date has sold and installed over 4,100 systems worldwide of which 1,090 were shipped in 2004. Typical users are engineers and designers that are creating physical models, tooling and prototypes out of plastic directly from their CAD workstations. Traditionally these have been made by hand sculpting or machining, an expensive and time-consuming process.

SSYS has approximately 265 employees and has some 175 U.S. and international patents and patents applied for. About 40% of revenue is generated from sales outside North America. About 80% of revenue comes from products, including both systems and consumables (which are not broken out). The remaining revenue comes from services including maintenance contracts, rental, training, engineering services and paid-parts, a service bureau where SSYS makes parts for customers. We estimate that consumables and maintenance together are a recurring revenue stream totaling about one-third of total revenue. High-end systems are sold on a direct basis in the U. S. and through distributors internationally, and the low-end products are sold through distribution worldwide. The customer base is broadly diversified and there are no 10% customers.

Large Market Opportunity:

Besides what we believe is a compelling business model (highly profitable, low capital and positive cash flow, and a growing recurring revenue stream), what is attractive about SSYS is our belief that its market may be just in its infancy. The industry has shipped since inception, only about 13,000-14,000 machines, yet there are an estimated 5 million CAD seats in the world today. With the prices of rapid prototyping/3D systems coming down (and SSYS leading the charge) we believe the market potential could expand rapidly. Management believes that there could eventually be a market for as many as 500,000 systems which equates to one system for each 10 CAD seats. As a point of reference, there are more than one million 2D plotters in the market or about one for every 4 or so CAD seats. While determining market size is very difficult, it is clear that SSYS is showing rapid growth and that the market is broadening as its entry level price points come down. Management's strategy seems sound, namely to slowly lower the price of its entry level machines to maximize revenue at each price point. While they could sell their systems profitably at a significantly lower price to more rapidly build the profitable supplies business, dollars would be left on the table.

What is 3D and RP?

Three dimensional printing and rapid prototyping are essentially identical processes differentiated by size, speed, features, precision of output, materials used and cost. 3D tends to be the lower priced office based type systems whereas RP are larger more sophisticated machines used in higher volume and more demanding applications. The process involves taking a product's digital model (typically from a CAD system, 3D digitization or MRI/CT scan) and digitally slicing it into multiple horizontal layers. Then using the company's patented fused deposition technology (FDM), a spool of thin thermoplastic modeling material is fed into an extrusion head where it is melted and squeezed out, "printing" each slice one on top of the other. Think of it as a high precision glue gun attached to a plotter where after each pass the table is lowered slightly for the next layer to be added.

The competition, for the most part, uses technology relying on lasers to fuse powdered or liquid materials or jetting technology. Their technology tends to be more costly, complicated and difficult to use and often have hazardous emission issues. SSYS believes its systems, relative to the competitors, are generally easier to use, require minimal setup time and little or no post processing, can use a wide variety of materials and can be used in an office environment due to the lack of hazardous emissions.

The 3D and RP Market:

We estimate that the market for RP/3D systems, supplies and services is in the $500-$600 million range with probably a 50/50 split between machines/supplies and services, which includes maintenance, spares and the parts produced on a service bureau basis. While growth had been relatively flat for several years in concert with generally low capital investment, there was a pickup last year. We believe SSYS has been capturing market share over the past several years and currently represents possibly over 15% of industry revenue and is the clear unit leader. Since inception SSYS has shipped more than 4,100 systems or around 30% of all systems sold since industry inception. The 1,090 machines it shipped last year probably represented around 40% of all the units shipped.

The largest participant in the market by dollars (and only other public company we know of) is 3D Systems Corp (TDSC) with revenue of $125 million in 2004. The company, which focuses on larger machines (thus larger dollars than SSYS but fewer machines), appears to be completing a turnaround, having posted the first growth and profit after several years of losses and declining revenue. We believe its growth in 2004 supports our belief of some acceleration in the industry. Other competitors include Z Corp in Massachusetts, Solidscape and Sanders Design in New Hampshire, EOS and Perfactory in Germany, Solidimension in Israel, Object Geometries in the UK and D-MEC in Japan.

Product Line:

SSYS has **two systems product lines**, the high-end RP machines and the lower cost 3D printers. The traditional high-end RP machines (Prodigy, Eden, Vantage, Titan and Maxum) range in price from $60,000 to $250,000 while the lower priced Dimension machines sell for $25,000-$30,000. In 2004, SSYS shipped 1,090 systems (versus 691 in 2003) and while management does not split it out, we estimate that a little over 850 of these (versus just under 500 in 2003) were Dimensions.

These systems generate an attractive **ongoing revenue stream represented by consumable supplies and maintenance**. Just like a computer printer consuming cartridges of ink, these machines consume the various modeling materials used to build the parts, models and molds. Fortunately these materials (which SSYS manufactures as a filament and sells in spools) are specially formulated and proprietary, and thus represent a highly captive business which we believe could be generating gross margins of over 80%. SSYS appears to be capturing close to 100% of this revenue opportunity. Management does not break out consumable revenue, but we estimate it could represent 10-15% of a machine's initial sales value, or $4,000-$5,000 annually for a small system to over $20,000 annually for a large system. In addition to consumables we estimate that over 80% of machines sold have an annual maintenance contract which we estimate at about 10% of a system's value. Adding these revenue streams together suggests that close to 20% of a machine's initial sales price could represent an ongoing revenue stream.

The remaining revenue comes from things like rentals, training, parts, engineering services and most importantly, the **paid-parts service bureau** offering. SSYS makes parts for customers who send in data files. They can get the finished product back within several days via FedEx. This is an attractive and profitable business which serves mainly those customers which are not large enough to justify in-house RP/3D printing. It also provides good sales leads to SSYS because once a company starts buying at a certain rate they are typically a good prospect to own their own machine.

We note that SSYS does not break down its revenue or provide average selling prices or margins for its various products and businesses. Thus the figures referenced represent our best estimates and reflect a fair amount of uncertainty. The table on the following page represents our estimated breakdown of 2004 revenue:

Estimated 2004 Revenue Breakdown (mil)

3D		15.0
RP		26.0
Consumables		15.8
Total Product revenue	$	56.8
Service		9.0
Paid-parts		2.5
Other		2.0
Total Service revenue	$	13.5

Recent Results:

Stratasys reported **record 2004 revenue and earnings,** with revenue growth of 38% to $70.3 million, net income up 48% and EPS growth of 33% to $0.85 versus $0.64. Unit shipments grew 58% during the year (1,090 versus 691) driven by 3D printing Dimension systems growth of 73%. These excellent results were in line with management's original guidance given at the beginning of the year calling for EPS of $0.80-$0.90 on revenue of $61-$65 million. The company outperformed on the revenue measure but gross margins were a bit weaker than forecast due to mix and more aggressive pricing to more rapidly penetrate the market. Given the high-profit recurring revenue stream attached to its systems we applaud the company's moves to more aggressively grow the top line.

The **fourth quarter** ended in December was strong on an absolute basis, with revenue above expectations but EPS somewhat short. Revenue was $19.4 million, up 28% and comfortably above the consensus we believe was at $18.3 million. EPS was $0.21, up $50% yr/yr but short of the $0.25 consensus and down from $0.24 in Q3. With the Q3 report, management had raised expectations for the year which implied a Q4 EPS of $0.22-$0.26.

Q4 revenue growth was strong, driven by the shipment of 272 systems versus 226 in Q403 and by a record level of consumable revenue. The earnings shortfall was largely an expense issue, the result of Sarbanes-Oxley compliance, commission accelerators and increased R&D expense. While somewhat disappointing that earnings came up short, the majority seems to be either largely one-time, "can't be avoided" things like Sarbanes-Oxley, or intentional spending/investment for future growth. It appears to us as though management was relatively aggressive in loading expenses into Q404 and has thus may be positioned for a relatively clean start in 2005.

Balance Sheet:

SSYS has a strong balance sheet which continues to be bolstered by the company's generation of excess free cash. Operating cash flow in 2004 totaled about $15.9 million driving cash to $55.8 million ($5.42 per share) from $44.5 million the previous year. There is no debt and equity stands at $84.9 million for an $8.13 book value.

SSYS's strong balance sheet provides for valuable strategic flexibility. The company has a leasing program for Dimension and currently has about 70 units out with about $4.0 million of sales-type lease assets on the balance sheet. SSYS is also using its financial strength to further market penetration by providing extended financing terms to resellers. In 2004 it offered a special program whereby resellers could purchase up to two "demo" Dimension units with 180-day extended terms. Management felt that these units in resellers hands would be valuable selling and marketing tools. The program was quite successful as orders for Dimension units exceeded expectations throughout the year. While virtually all of these extended-payment program demo units were sold to end users and paid for, the program did cause a spike in receivables and days sales outstanding in the first three quarters of the year.

Given the success of the demo program last year, SSYS offered a similar program this year, with a higher number of orders being received at the recent resellers kickoff meeting. While we think this high level of participation bodes well for the year, we note that similar to last year, we expect receivables and DSOs to jump up early in the year.

Outlook and Valuation:

Management guidance calls for 2005 revenue of $84-$89 million (20%-27% growth) and a slight upward revision from the previous 18%-25% growth guidance. EPS is expected to be between $1.07 and $1.12 on a fully taxed basis (37%-39% versus the 34% tax rate in 2004). We note that this guidance does not include the expense of stock option-based compensation which must be included in Q3 and beyond. This expense has been running about $0.03 per quarter, but is not included in our estimates as it is still uncertain how the street will deal with these expenses and how companies such as SSYS may change their practices regarding the use of stock option-based compensation.

In 2004, SSYS met its full year EPS guidance and exceeded its revenue guidance. Following a bit of a disappointment in Q4, which would likely drive some guidance conservativism, and considering the strong response to the demo program at the distributor conference, we are looking for results at the top of the guidance range. We estimate full year EPS of $1.12 on revenue of $89 million.

Conclusion:

SSYS represents a wonderful combination of a high growth, high margin business that generates excess cash and is building a proprietary recurring revenue stream. With a market that still seems relatively untapped, we believe this combination can persist for a number of years. The key to an investment like this is to find an attractive entry point and not overpay. We believe SSYS stock is providing just such an opportunity now. What we view as a relatively modest Q4 EPS miss due largely to some unique year-end expenses has generated some profit taking and a good sell-off in the stock, down over 25% since early February. The market seem to be temporarily ignoring the fact that revenue and earnings were up 38% and 49% respectively last year (hitting management projections at the beginning of the year) and are projected to rise roughly 25% and 35% respectively this year. Backing out the $5 in cash, the stock trades at 19x-20x our projected earnings for a PEG ratio of less than 1x.

Given the unique combination of balance sheet, cash generation and a growing proprietary revenue stream, we believe SSYS deserves to trade at some premium to its growth rate. Using a P/E of 25 relative to what we think is a conservative 20% growth rate and adding in the cash per share gives us our $33 price target. We note that the stock reached over $37 earlier this year and if SSYS tracks on a 25%-30% growth rate this year, we would not be surprised to see that level again.

Other Public Companies mentioned in this report:

3D Systems Corporation (TDSC - $18.02 not rated)

Stratasys, Inc.
Summary Income Statement and Balance Sheet

(in thousands)	Fiscal 2001	Fiscal 2002	Fiscal 2003	Q1 Mar-04	Q2 Jun-04	Q3 Sep-04	Q4 Dec-04	Fiscal 2004	Q1E Mar-05	Q2E Jun-05	Q3E Sep-05	Q4E Dec-05	Fiscal 2005E	Fiscal 2006E
TOTAL REVENUE	**$37,572**	**$39,808**	**$50,890**	**$15,846**	**$17,316**	**$17,721**	**$19,446**	**$70,328**	**$18,800**	**$22,000**	**$23,000**	**$25,000**	**$88,800**	**$108,000**
GROSS PROFIT	**23,001**	**24,366**	**32,782**	**9,706**	**10,480**	**10,444**	**11,700**	**42,330**	**11,468**	**13,200**	**13,800**	**15,125**	**53,593**	**108,000**
Margin %	*61.2%*	*61.2%*	*64.4%*	*61.3%*	*60.5%*	*58.9%*	*60.2%*	*60.2%*	*61.0%*	*60.0%*	*60.0%*	*60.5%*	*60.4%*	*100.0%*
Sales, Gen & Admin	14,598	16,065	18,993	5,592	5,606	5,545	6,950	23,692	6,129	6,930	7,234	8,250	28,542	0
R & D	4,915	4,688	5,047	1,346	1,345	1,298	1,651	5,640	1,600	1,625	1,650	1,675	6,550	0
OPERATING INCOME	**3,488**	**3,613**	**8,742**	**2,768**	**3,529**	**3,601**	**3,100**	**12,998**	**3,739**	**4,645**	**4,917**	**5,200**	**18,501**	**23,112**
Margin %	*9.3%*	*9.1%*	*17.2%*	*17.5%*	*20.4%*	*20.3%*	*15.9%*	*18.5%*	*19.9%*	*21.1%*	*21.4%*	*20.8%*	*20.8%*	*21.4%*
Interest / Other (Income)	(35)	(288)	(402)	(76)	(90)	(209)	(475)	(850)	(315)	(325)	(345)	(365)	(1,350)	(1,500)
PRETAX INCOME	**3,523**	**3,902**	**9,145**	**2,844**	**3,618**	**3,811**	**3,575**	**13,847**	**4,054**	**4,970**	**5,262**	**5,565**	**19,851**	**24,612**
Tax rate	*28.7%*	*20.3%*	*32.7%*	*33.0%*	*33.9%*	*33.5%*	*35.7%*	*34.1%*	*38.0%*	*38.0%*	*38.0%*	*38.0%*	*38.0%*	*38.0%*
NET INCOME	**2,513**	**3,111**	**6,155**	**1,905**	**2,392**	**2,534**	**2,298**	**9,129**	**2,514**	**3,081**	**3,262**	**3,450**	**12,307**	**15,259**
Margin %	*6.7%*	*7.8%*	*12.1%*	*12.0%*	*13.8%*	*14.3%*	*11.8%*	*13.0%*	*13.4%*	*14.0%*	*14.2%*	*13.8%*	*13.9%*	*14.1%*
EPS	**$0.31**	**$0.37**	**$0.64**	**$0.18**	**$0.22**	**$0.24**	**$0.21**	**$0.85**	**$0.23**	**$0.28**	**$0.30**	**$0.31**	**1.12**	**1.35**
Shares Outstanding (avg)	8,239	8,392	9,679	10,702	10,711	10,753	10,824	10,726	10,875	10,900	10,950	11,200	10,981	11,300
Systems shipped:	272	463	691	291	281	246	272	1,090						
Estimated Dimensin units:	0	300	495	243	275	152	186	856						

-- BALANCE SHEET --	Fiscal 2001	Fiscal 2002	Fiscal 2003	Q1 Mar-04	Q2 Jun-04	Q3 Sep-04	Q4 Dec-04	Fiscal 2004
Cash & equivalents	10,211	14,194	45,494	47,537	47,599	53,305	56,570	56,570
Accounts Receivable	12,133	10,640	15,788	15,680	18,408	16,110	14,951	14,951
Inventories	6,878	6,537	6,424	7,267	8,170	8,738	7,520	7,520
Other current assets	805	1,047	3,354	1,859	2,626	3,406	3,536	3,536
TOTAL CURRENT ASSET	**30,027**	**32,419**	**71,060**	**72,343**	**76,803**	**81,559**	**82,578**	**82,578**
Property & equipment, net	6,007	5,937	6,545	8,224	9,305	9,879	10,044	10,044
Other assets	2,630	2,291	3,999	4,424	4,692	4,523	4,026	4,026
Intangibles	3,288	2,953	2,497	2,399	2,698	3,380	2,552	2,552
TOTAL ASSETS	**41,951**	**43,600**	**84,100**	**87,389**	**93,498**	**99,341**	**99,199**	**99,199**
CURRENT LIABILITIES	**8,432**	**8,677**	**10,204**	**11,095**	**13,729**	**17,230**	**14,312**	**14,312**
Long term liabilities	2,216	2,157	-	-	-	136	-	-
Shareholders' equity	31,303	32,766	73,896	76,294	79,049	81,975	84,887	84,887

-- R A T I O S --	Fiscal 2001	Fiscal 2002	Fiscal 2003	Q1 Mar-04	Q2 Jun-04	Q3 Sep-04	Q4 Dec-04	Fiscal 2004
Book Value	$3.87	$4.09	$7.20	$7.40	$7.63	$7.88	$8.13	$8.13
(Cash+Mkt Sec.) / Share	$1.26	$1.77	$4.43	$4.61	$4.59	$5.12	$5.42	$5.42
Current Ratio	3.6	3.7	7.0	6.5	5.6	4.7	5.8	5.8
Inventory Turnover	0.0x	2.3x	2.8x	3.4x	3.3x	3.3x	4.1x	4.0x
Days Sales Outstanding	0	103	93	89	96	82	69	79
Depreciation & Amortization	2,280	2,401	2,534	647	602	640	798	2,687
Capital Expense	3,928	603	2,340	2,147	1,488	840	814	5,290

Analyst Certification

I, **Clinton Morrison**, certify that the views expressed in this research report accurately reflect my personal views about the subject company and its securities. I also certify that I have not been, am not, and will not be receiving direct or indirect compensation related to the specific recommendations expressed in this report.

Important Disclosures:

The analyst or any member of his/her household **does not** hold a long or short position, options, warrants, rights or futures of this security in their personal account(s).

As of the end of the month preceding the date of publication of this report, Feltl & Co. **did not** beneficially own 1% or more of any class of common equity securities of the subject company.

There **is not** any actual material conflict of interest that either the analyst or Feltl and Company is aware of.

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Feltl and Company Rating System: Feltl and Company utilizes a four tier rating system for potential total returns over the next 12 months.

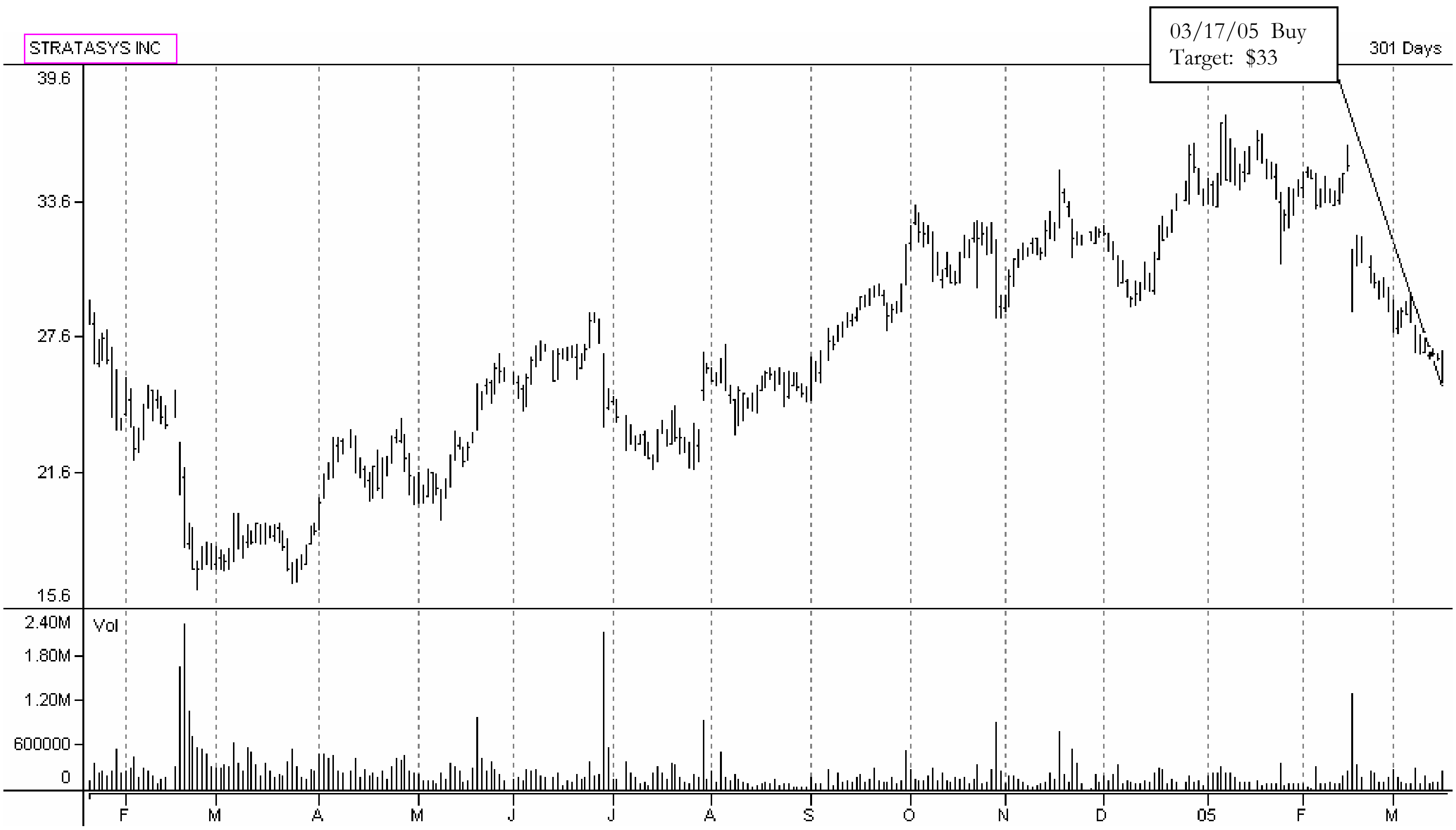
Strong Buy: The stock is expected to have total return potential of at least 30%. Catalysts exist to generate higher valuations, and positions should be initiated at current levels.
Buy: The stock is expected to have total return potential of at least 15%. Near term catalysts may not exist and the common stock needs further time to develop. Investors requiring time to build positions may consider current levels attractive.
Hold: The stock is expected to have total return potential of less than 15%. Fundamental events are not present to make it either a Buy or a Sell. The stock is an acceptable longer-term holding.
Sell: Expect a negative total return. Current positions may be used as a source of funds.

3/1/2005

Ratings Distribution for Feltl and Company

Rating	Number of Stocks	Percent of Total	Investment Banking: Number of Stocks	Investment Banking: Percent of Rating category
SB/Buy	23	66%	4	17%
Hold	11	31%	0	0%
Sell	1	3%	0	0%
	35	100%	4	11%

The above represents our ratings distribution on the stocks in the Feltl and Company research universe, together with the number in (and percentage of) each category for which Feltl and Company provided investment-banking services in the previous twelve months.



Date	Nature of Report	Rating	Price Target
03/17/2005	Initiation	Buy	$33

Feltl & Company **does** make a market in the subject security at the date of publication of this report. As a market maker, Feltl & Co. could act as principal or agent with respect to the purchase or sale of those securities.

Valuation and Price Target Methodology:

We believe that SSYS deserves a valuation represented by some P/E premium to its growth rate due to its high level of profitability, cash generation and its growing recurring revenue stream. With an expected EPS growth rate of 20% or better for the next several years, we are using a P/E multiple of 25x estimated earnings. Adding in the cash per share gives us our $33 price target.

Risks to Achievement of Estimates and Price Target:

- SSYS generates high margins and profitability which might be difficult to sustain as its markets grow and become more competitive and mature. If there is margin pressure, earnings could suffer, negatively impacting the value of the stock.
- SSYS operates in a growing and attractive market that could attract increased competition. This could have the result of negatively impacting growth and/or profitability and thus hurt the stock's valuation.
- There are various technologies employed in the 3D/RP market. If SSYS does not continue to advance its technology or a different approach advances more rapidly, SSYS's growth and profitability could be impacted.
- Managing growth in a high growth company/industry can be challenging. If SSYS does not manage this growth well or has difficulty transitioning from a small entrepreneurial organization into a larger more mature corporation, the value of its stock could suffer.

Other Disclosures:

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