Investors Alley

July 2014 Vol. 1 Issue 1

The Turnaround Stock Report

Welcome

Fellow Investor,

I am honored to be part of the The Turnaround Stock Report and the team that puts it together. I have been investing in the markets since I was a teenager and have over three decades of experience following and trading the markets.

In This Issue

Over that time I have graduated with a degree in finance from Arizona State University, spent a decade as a technology director at American Express and ran a small long/short hedge fund for four years. Currently I am "semi-retired" full-time investor and also a financial columnist for Real Money, Motley Fool and Seeking Alpha, in addition to lead small cap analyst for Investors Alley. TipRanks currently has me ranked in the top 1% of over 3,000 financial bloggers for the quality and capital appreciation of my investment ideas.

I have always been fascinated with turnaround stocks and "busted" initial public offerings. I have made some of my best returns from these areas over the years and look forward to being part of an offering in an underserved niche in the market.

I have been hooked on turnaround stories since I made a small investment in Chrysler when it was on the brink of bankruptcy. Thanks to Lee Iacocca and some prudent government loans, my investment soared over tenfold and helped pay for my first two years of college. It was the second equity I ever purchased and I have been a believer and investor in prudent turnaround stories ever since. Before we get to the attractive features of companies in the middle of a turnaround plan, let's talk a bit about my view on IPOs.

Investors almost by human nature have always been fascinated by initial public offerings as they represent the "new". This is understandable as what investor would not want to get in on the next **Google (Nasdaq: GOOG)**?

For some reason I have never caught IPO fever. Part of it is practical. The fact is I simply do not generate enough trading commissions for my broker for him to reward me with allocations to the hot IPOs. It's likely you don't either as most of us are regular people trying to invest wisely and not Wall Street fat cats looking for the big score (with other peoples' money!) The ones I can usually secure through my brokerage platform are the ones that turn out to be undersubscribed so I just avoid the whole sector completely.

I also am put off with hyperbole, which is common in the industry to generate “buzz” in front of a public offering. That is not to say there is not money to be made in the IPO market. Some of my biggest winners over the years have been “busted” IPOs that I have picked up after the hype and the insider lockups have expired and stock has cratered from the level it traded at after going public.

A recent example of this strategy is found in the case of **ZELTIQ Aesthetics (Nasdaq: ZLTQ).** This maker of laser equipment used in cosmetic procedures debuted with much hype in the fourth quarter of 2011 for $15 a share. Less than a year later when the equity had lost its shine, the stock went for $5 a share where I picked up a decent sized stake.

However, the company had good products and a compelling razor and razor blade business model. In addition, it had a large amount of cash on the balance sheet and insiders were starting to purchase shares after the big decline.

I did not catch the bottom of the stock’s descent as it eventually fell to under $4 a share. This busted IPO turned out to be a big winner. Analysts started to recognize its growth possibilities, the company started to narrow its losses and momentum returned to the shares. I ended up cashing out about a year and a half later at $20 a share when the shares were fully valued. That's roughly at 300% gain on a good company that had temporarily lost its luster.

Along with busted IPOs, turnarounds can be good hunting grounds for lucrative investment ideas. An investor who was lucky enough to acquire Google when it came public in the summer of 2004 would be sitting on better than a tenfold increase over the decade. However, this sort of wealth creation pales in comparison to the shareholder value that was created from the time Steve Jobs returned to a collapsing **Apple (Nasdaq: AAPL)** in 1997 to his unfortunate death in 2012.

There are several things I love about solid turnaround stories. First, sentiment on turnaround stocks is usually starts at or near rock bottom as companies rarely make deep structural changes unless there are critical and usually negative changes to their business models. Second, turnarounds often revolve around new outside management that brings a fresh perspective and can affect the changes previous management was unable to enact as insiders.

In addition, turnarounds frequently come with detailed game plans for pointing the company in the right direction. This gives investors milestones to follow at least on a quarterly basis to ensure the turnaround story in on track and or look for the exit ramps if it is not.

The rise of the activist investor has brought new pressure on the management of more companies than ever to improve their businesses and more effectively reward shareholders. This puts more stocks in “play” which expands the universe of possible lucrative selections for a well-managed turnaround portfolio.

My best turnaround ideas will be diversified across multiple industries and will be organized into a full list of my 20 best ideas. We won't start today with 20 recommendations, that would be too much for any new subscriber; rather we'll build the list and add stocks when the time is right for each, keeping track of them all along the way. This is important as you don't want to be guessing what to do next. Twenty stocks is optimal to mitigate risk by diversification while not being too much to continue to keep detailed tabs on how each turnaround story is unfolding. I also plan to hold the vast majority of these turnaround stocks within my own portfolio.

I do this because I firmly believe in their potential. With each recommendation I'm putting not just my reputation as an editor on the line, but my very own personal funds. Because as much as I dislike asking you to put your money at risk I also dislike losing my own money. When we get a big winner we both share in the victory and if we occasionally come up with a loser, well you'll know that I've lost, too. As the old saying goes, "I have skin in the game." Of course, with every write-up I'll clearly indicate my position in the stock.

I look forward to sharing these turnaround equities with significant upside with new readers as well as to gain insight through their comments as well as interactive dialogue. Of course, I'm always here for you. If you have a question, compliment, complaint, comment or just want to say "hi" you can reach me at bret.jensen@investorsalley.com.

Bret Jensen
Editor
Bret Jensen's Small Cap Gems

Hercules comes back from a near death experience Nasdaq: HERO

Hercules Offshore (Nasdaq: HERO) is the perfect stock to include in our inaugural issue. The once highflying offshore driller sold in the $30s before the financial crisis. However, as energy prices collapsed in the aftermath of the financial meltdown and all firms with significant debt came under intense scrutiny by the market; the shares price collapsed to under $2.00 by early 2009.

Hercules was rocked again by the Macondo disaster in the Gulf of Mexico in 2010 that spilled millions of barrels of oil into the Gulf and led to a yearlong drilling moratorium in the company's most important area for drilling activity.

Somehow Hercules Offshore has survived. The stock currently stands at just over $4.00 a share. However, given myriad catalysts this ascent should accelerate in the years ahead providing patient contrarian investors significant rewards.

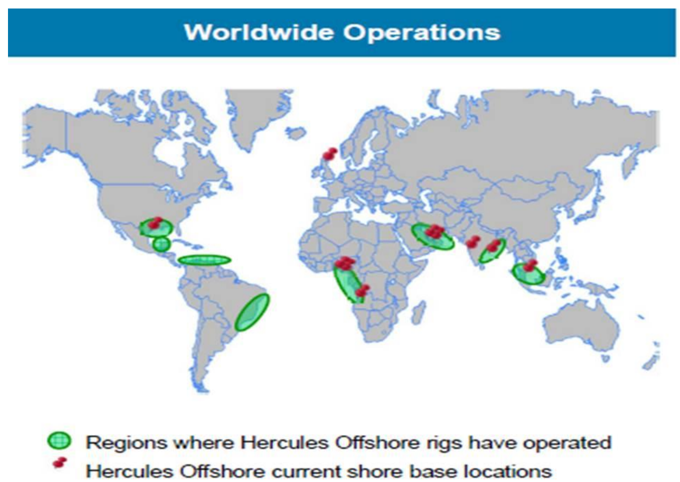
Company Overview:

Hercules Offshore is an energy services concern. The stock has a market capitalization near $800 million and an enterprise value of just under $2 billion. The company possesses the third largest jack-up fleet in the world, currently compromising approximately 40 vessels. Hercules also owns the largest fleet of lift boats in the world. The company has an experienced senior management team with experience in all the major jack-up markets in the world.

Near Death Experience:

Like most offshore drillers in the midst and aftermath of the financial crisis, Hercules had to deal with a perfect storm. Oil and natural gas prices plunged severely curtailing drilling demand and the need for its offshore fleet. Even worse was the freeze in the credit markets that had a major negative impact on the valuation of any company that carried a lot of debt. Drillers depend of this financing to build and upgrade their fleets.

The convergence of these two events resulted in a near death experience for the stock as the equity plummeted more than 90% from its pre-crisis high. Just as things were recovering in the credit markets and drilling activity was increasing again, along came the Macondo disaster in the Gulf of Mexico that resulted in numerous deaths, millions of barrels of oil dumped into the Gulf, numerous lawsuits for British Petroleum which was utilizing the rig that exploded and led to complete drilling moratorium in Hercules' most important market.



Rolling the Dice:

In 2011 Hercules decided to roll the dice even before the presidential moratorium on drilling in the Gulf of Mexico ended. The company increased its stranglehold in the shallow waters of Gulf of Mexico by acquiring Seahawk Drilling, the second largest shallow water driller. The deal had Hercules Offshore buying Seahawk's 20 rigs out of bankruptcy for $25 million in cash and 22 million shares of their common stock. This raised the ire of Seahawk's creditors who believe these assets were worth twice or triple the amount of Hercules paid but the deal was approved. This transaction has served Hercules well as drilling activity in shallow waters in the Gulf of Mexico has now rose steadily since the drilling moratorium was lifted later in 2011.

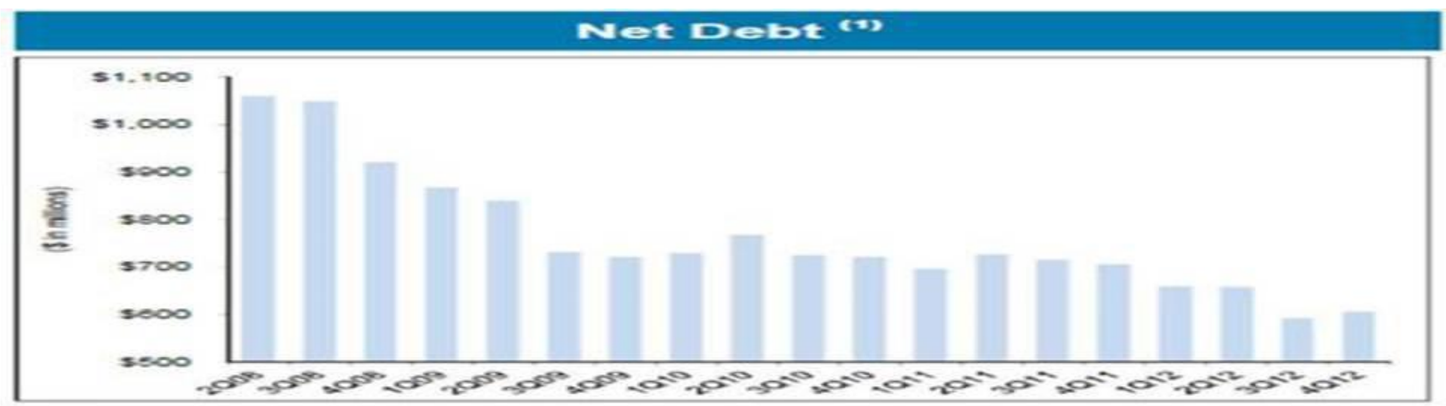
Transforming the Business:

Management did a solid job of managing the company through the financial crisis. From mid-2008 through yearend 2012 the company reduced its overall debt by more than $450 million. Part of this debt reduction was accomplished by disposing of idle or underutilized assets which brought in over $200 million through asset sales. This debt has increased recently to finance three more complex rigs for work in deeper waters.

Hercules still has opportunities to optimize its debt portfolio. The company issued a $200 million bond issued when credit markets were tighter; it carries a 10 1/4% interest rate. It is callable in April 2015. The company should be able to call this bond and reissue new debt at 6 ½% to 7 ½% thereby saving millions in debt service annually.

Out with the Bathwater:

These strategic moves were rewarded in the market and the stock rose to almost $8.00 a share by the summer of 2013. Unfortunately, the equity then was caught on in the general decline in the offshore drillers that started impacting almost all offshore plays starting

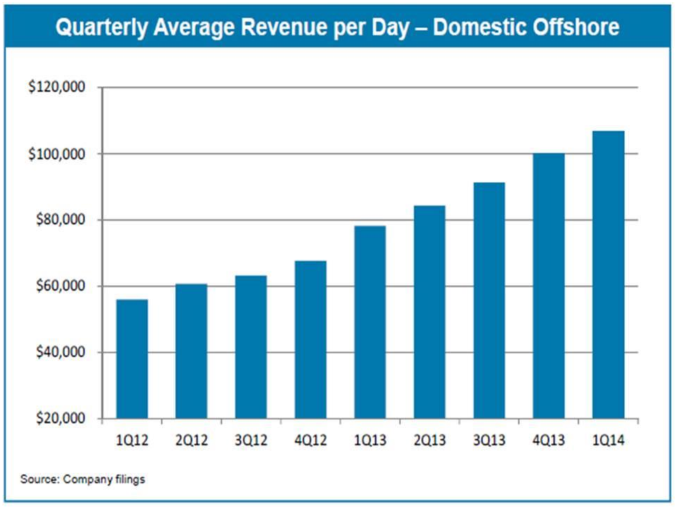


- Net debt reduction of $454 million from mid 2008 through year end 2012
- Proceeds from asset sales have generated nearly $220 million since 2008

Description	Amount ($millions)	Coupon Rate	Maturity	First Call Date
Senior Unsecured Notes	$200	10 1/4%	Apr–2019	Apr–2015 @ 107 11/16%
Senior Unsecured Notes	$400	8 3/4%	Jul–2021	Jul–2017 @ 104 3/8%
Senior Unsecured Notes	$300	7 1/2%	Oct–2021	Oct–2016 @ 105 5/8%
Senior Unsecured Notes	$300	6 3/4%	Apr–2022	Apr–2017 @ 105 1/16%
Other	$4	7 3/8%	Apr–2019	--
Convertible Senior Notes	$7	3 3/8%	Jun–2018	--
Revolver ($150 million)	Undrawn	--(2)	Jul–2018	--
Total Debt (1)	**$1,211**			

in November of last year. This sell-off was triggered by concerns around declining day rates and overcapacity in the industry.

The pullback has brought the share price for Hercules down to $4.00. It is also why Hercules is on our top small cap buy list as it is not experiencing declining day rates and the sell-off is offering a lucrative entry point which we will summarize at the end of this article. Let's look first at some of the positive drivers that should soon get the stock moving forward again.

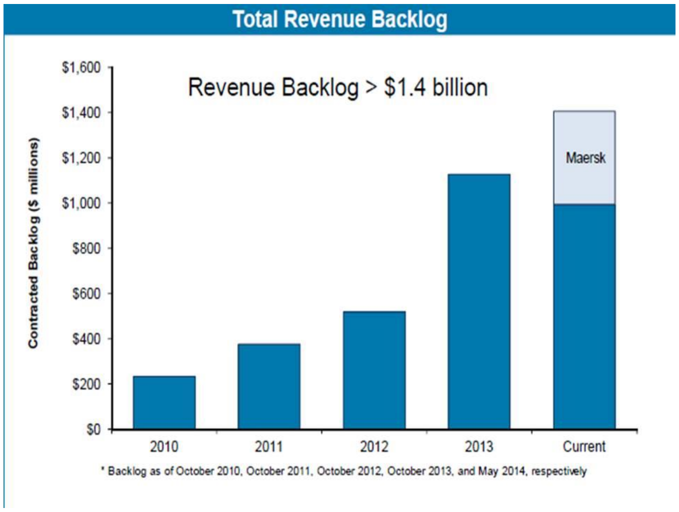


Positive Catalysts:

An improvement in the sentiment on the offshore drillers will be positive for Hercules even if it has limited exposure to deep water drilling. This appears to be already in process. Major offshore drillers like **Transocean (NYSE: RIG)** and **Diamond Onshore (NYSE: DO)** look like they bottomed in mid-March and have slowly begun to move up.

The company has three more sophisticated rigs being built in Asian shipyards right now. These will service much deeper waters. These new builds are currently an overhang on the stock given concerns around overcapacity in the space.

However one of these new rigs just received a five year $420 million contract from Maersk Oil. This is one of the bigger contracts for this sort of rig in recent years. As the other two new builds get contracted out this should be a significant positive catalyst for the stock. Capacity in the industry was helped in late May when **North Atlantic Drilling (NYSE: NADL)** signed a cooperation deal with the Russian energy giant Rosneft. This will result in nine rigs moving from the North Atlantic to Russia which should take some slack out of the space and is helpful on the margin. With the new Maersk Oil contract the company has a record order backlog.



The company is currently seeing low utilization of under 60% within its lift boat fleet. Although this makes up under 20% of overall revenues, as demand picks up this will be a positive. This demand should be buoyed by a pick-up in drilling activity in Africa. In addition, longer term the energy reforms that Mexico has recently put in place should bolstered drilling activity in the shallow waters in Mexico's territory in the Gulf of Mexico.

Perhaps the biggest catalyst for Hercules' shares is that eventually investors will realize it has been unfairly placed with the deep offshore drillers where declining day rates are a legitimate concern. In the shallow waters of the Gulf of Mexico where Hercules gets the majority of its revenues, day rates continue to rise as the company stated it is last earnings report. This continues a trend that has been in place for years.

Other Positive Factors:

The stock has declined to a point where it is starting to attract the attention of insiders. Several directors and officers have bought over a $1 million worth of shares since the last week of June. In addition, the stock feels like it is trying to build a technical bottom right at the $4 level.

Valuation:

The company earned 25 cents a share in FY 2013. The current consensus has Hercules earning over 40 cents a share in this fiscal year. Hercules is currently going for 10 times forward earnings, a deep discount to the overall market which is trading at 15 to 16 times forward earnings. Revenues are tracking to 15% to 20% growth in this fiscal year as well.

Outlook:

Given the positive catalysts in the pipeline, record order backlog as well as significant growth prospects; Hercules should not be priced at such a discount to the market. Putting a conservative 10 to 12 times the projected 50 cents a share of earnings the consensus has the company making in 2015 on the stock gives us a price target range of $5.00 to $6.00 a share.

I believe the shares should easily hit $5 or better a share over the next six to 12 months as sentiment improves in the offshore sector and as the company continues to deliver solid results. Over a longer time frame I believe the company can move substantially higher. The 15 analysts that cover the stock also have a $5 a share median price target on the shares.

Given the dynamic nature of the offshore industry, I hesitate to put a longer term price target on Hercules. Once it hits $5 a share we will revisit the company's investment case and determine whether to take our 25% gain or to ride it for further capital appreciation.

Recommendation: Buy HERO under $4.25 a share and hold up to $6.00 a share

Emerald Oil: turning around NYSE: EOX

Anyone who has followed my columns on Real Money Pro or SeekingAlpha over the past few years knows that I have been a huge bull on the country's march to energy independence. Despite tepid support from the current administration for domestic fossil fuel development, oil production is up better than half over that past half dozen years and production is still growing an impressive clip.

I have parlayed this exuberance for the domestic oil boom into myriad winners within the small cap exploration and production (E&P) space. Some stocks I have owned and highlighted frequently include **Warren Resources (Nasdaq: WRES), Abraxis Petroleum (Nasdaq: AXAS)** and **Gulfport Energy (Nasdaq: GPOR)**. (See chart on page 10 for examples.)

These small production concerns have provided lucrative returns to my portfolio and to my readers who bought these names when I highlighted them. They have also easily outperformed the overall market.

I sold these names earlier in the year as they had run up so much that they were no longer deeply undervalued. One name in the space I bought last year, **Emerald Oil (NYSE: EOX),** has not performed like its peers. However, despite its troubled history, I believe Emerald is finally getting its act together. This potential turnaround play has some of the same traits as my other successful small cap E&P plays when I first took stakes in them. If it can execute against its turnaround plan, I can see the same potential to richly reward its shareholders.

Company Overview:

Emerald is an independent exploration and production focused on developing oil wells in the Williston Basin of North Dakota and Montana while targeting the Bakken and Three Forks shale oil formations. The company controls approximately 85,000 acres in the Williston Basin. 75% of the acreage is operated by Emerald and the remaining 25% is non-operated. This exploration and production company is also actively acquiring more operated leasehold in North Dakota and Montana. (See chart on page ASFDSDA)

A Trouble History:

To put it bluntly, Emerald has been a serial underperformer. It has missed frequently missed earnings estimates, failed to properly control costs, mismanaged a merger and basically has disappointing investors for quite some time. This has been reflected in its stock performance over the past two years. When most small E&P concerns were rallying strongly, the stock of Emerald was heading in the opposite direction. (See chart on page 11.)

Turnaround in the Making?:

So why am I am optimistic about the prospects going forward from a company whose stock has performed so poorly over the past 24 months? There are several reasons I believe the worst for this company is behind it and that patient investors can look forward to brighter days and significant returns.

First, the company has been transitioning from a non-operator to an operator on its acreage. This model has higher operating margins and provides more control as well. The company sold some $125 million in non-core non-operated assets in 2013 and acquired additional operating acreage within its existing footprint. As can be seen from the chart below, Emerald is growing production at a prodigious rate despite some disappointments. It should have over 25 wells (mostly as operators) by the end of 2014. (See chart on page 12.)

Second, although the stock sold off on its latest quarterly earnings report, a good portion of the disappointing results were driven by one of worst winters experienced in several decades and is unlikely to repeated.

Operational Scalability:

The company also has considerable opportunity to get economies of scale as it further rolls out its drilling program. Emerald has approximately 700 drilling locations within its Williston acreage. It is currently operating just a handful of rigs. Emerald recently completed its second Three Forks well, which had results roughly twice as good as its first well. Hopefully this is a start of a trend.

As the company ramps up, costs per well should fall and production and reserves should increase substantially. In 2013 the company grew proved energy reserves just under 150% year-over-year. Production was up some 80% in 2013 over 2012's levels. Proved reserves have grown over 200% annually on average over the past few years. Current production consists of over 85% oil. (See chart on page 13.)

Deeply Undervalued Assets:

As Emerald is just moving to profitability as it continues to expand its drilling program and increases production the value of the stock should go up significantly. Emerald is severely undervalued based on the value per acre the market is assigning to the company compared to other E&P plays in the Bakken shale region.

The enterprise value for the average Bakken energy producer goes for is just under $9,000 an acre it controls. Emerald goes for approximately $3,200 an acre or around 65% less than the average acre value of the average producer. Even giving a substantial discount, let's say 50% to 60% of the average acre value in the Bakken, due to missteps in the past by Emerald leads to a much higher intrinsic value being assigned to the stock. At 50% to 60% of the value of the average competitor gets us to a price range of $10.50 to $12.00 a share. As the company continues to deliver production gains, this discount should narrow considerably. (See chart on page 14.)

Analyst Commentary:

Emerald currently sells right at $7.00 a share. Despite the company's recent travails, analysts continue to be positive overall on the company's prospects. The eight analysts covering the firm currently have a $9.75 a share median price target on the stock. Stephen Berman at Canaccord Genuity, a five star ranked analyst according to TipRanks based on the quality and performance of his previous picks, reiterated his "Buy" rating and has a $12.00 a share price target on Emerald in early May.

Outlook:

Emerald posted a loss of 75 cents a share in FY2013. However, the company is tracking to post a small profit this fiscal year. Analysts have the company making 50 cents a share in FY2015 and the consensus earnings estimate for next year has moved up better than 10% over the last two months. In addition, the company has a strong balance sheet with almost $300 million in liquidity available. It has no net debt after taking into account cash on hand against loans outstanding.

Sentiment should improve significantly on the shares as the company moves into the black this year. As the company continues to improve its operational performance and substantially increases its production, I believe significant shareholder value will be unlocked.

Management has guided to almost a 100% gain in production this year after last year's 80% rise. If the company can achieve that production level by the end of the year the $9.75 a share median analyst price target seems achievable over the next six to 12 months. Longer term the discount based on value per acre controlled between Emerald and its peers should narrow significantly. As stated in a previous section, even a pessimistic value per acre provides a more realistic value of up to $12.00 a share for Emerald. From the current price of $7.50 a share on Emerald, a price target range of $9.75 to $12.00 a share provides 30% to 60% capital appreciation potential.

Recommendation: Buy Emerald up to $8 a share and hold to $12.00 a share.

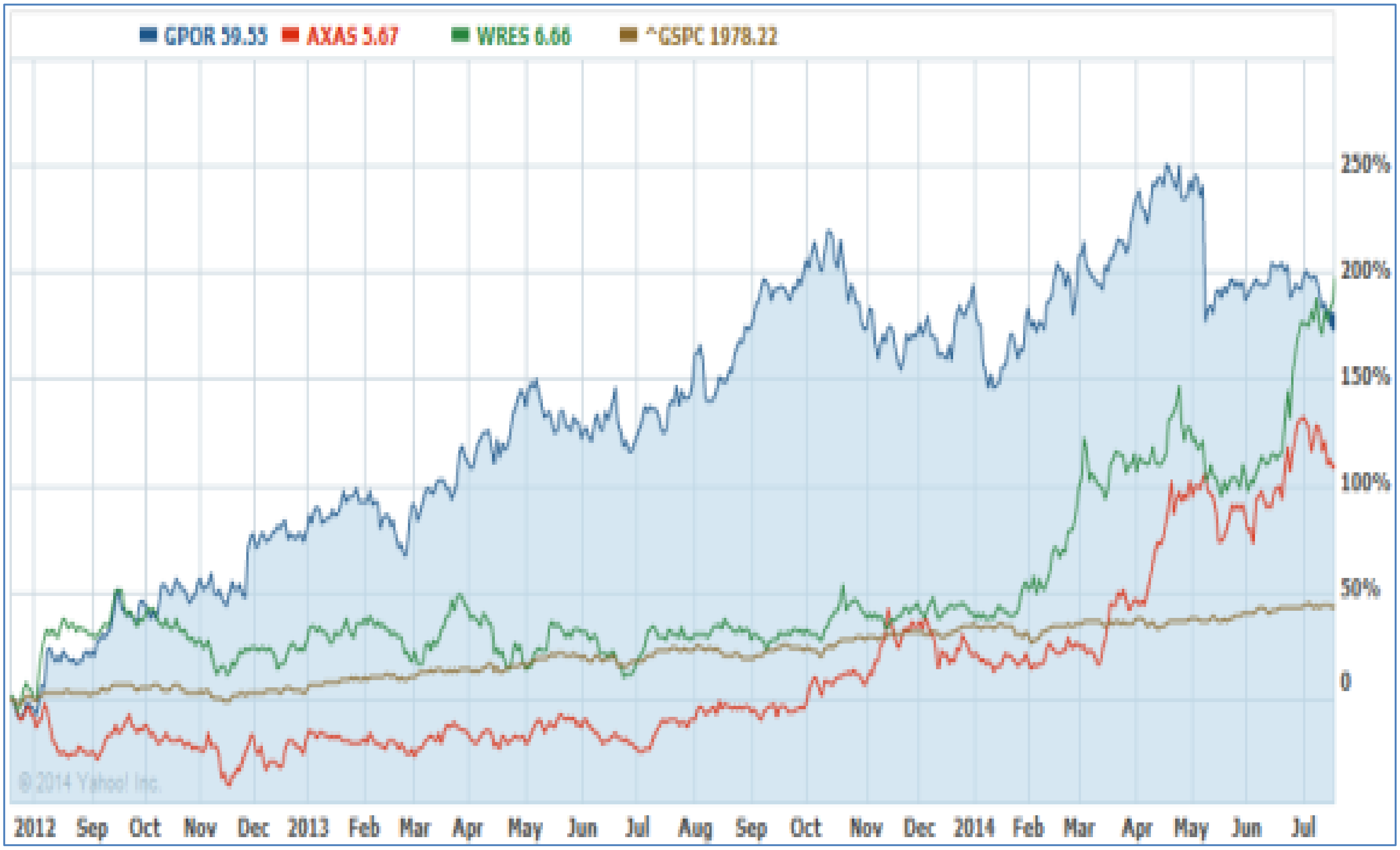


FIGURE 1: GREAT RUNS BY SOME OF THE TOP SMALL CAP E&P FIRMS

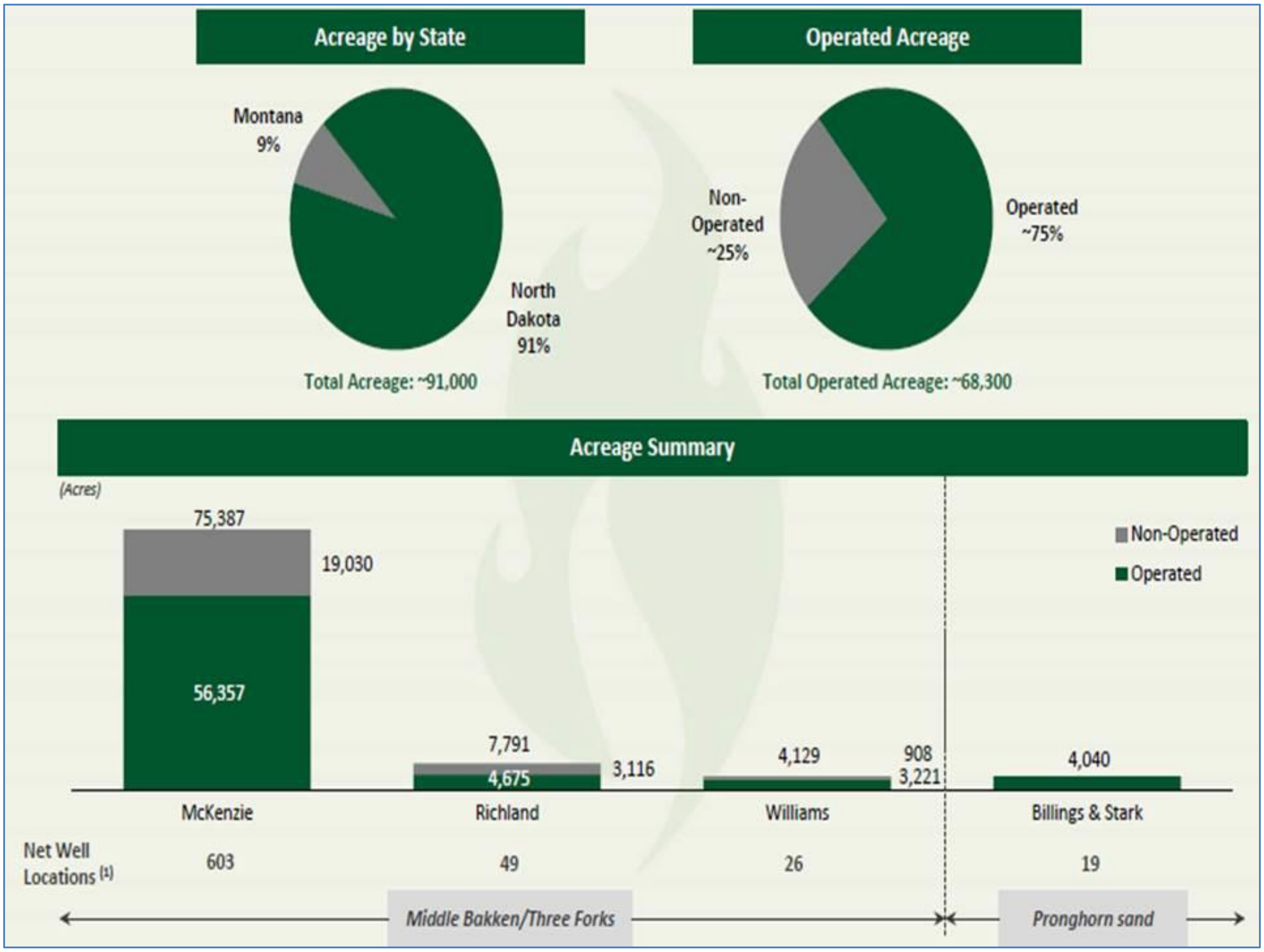


FIGURE 2: EOX WELL DISTRIBUTION BY STATE AND ACREAGE

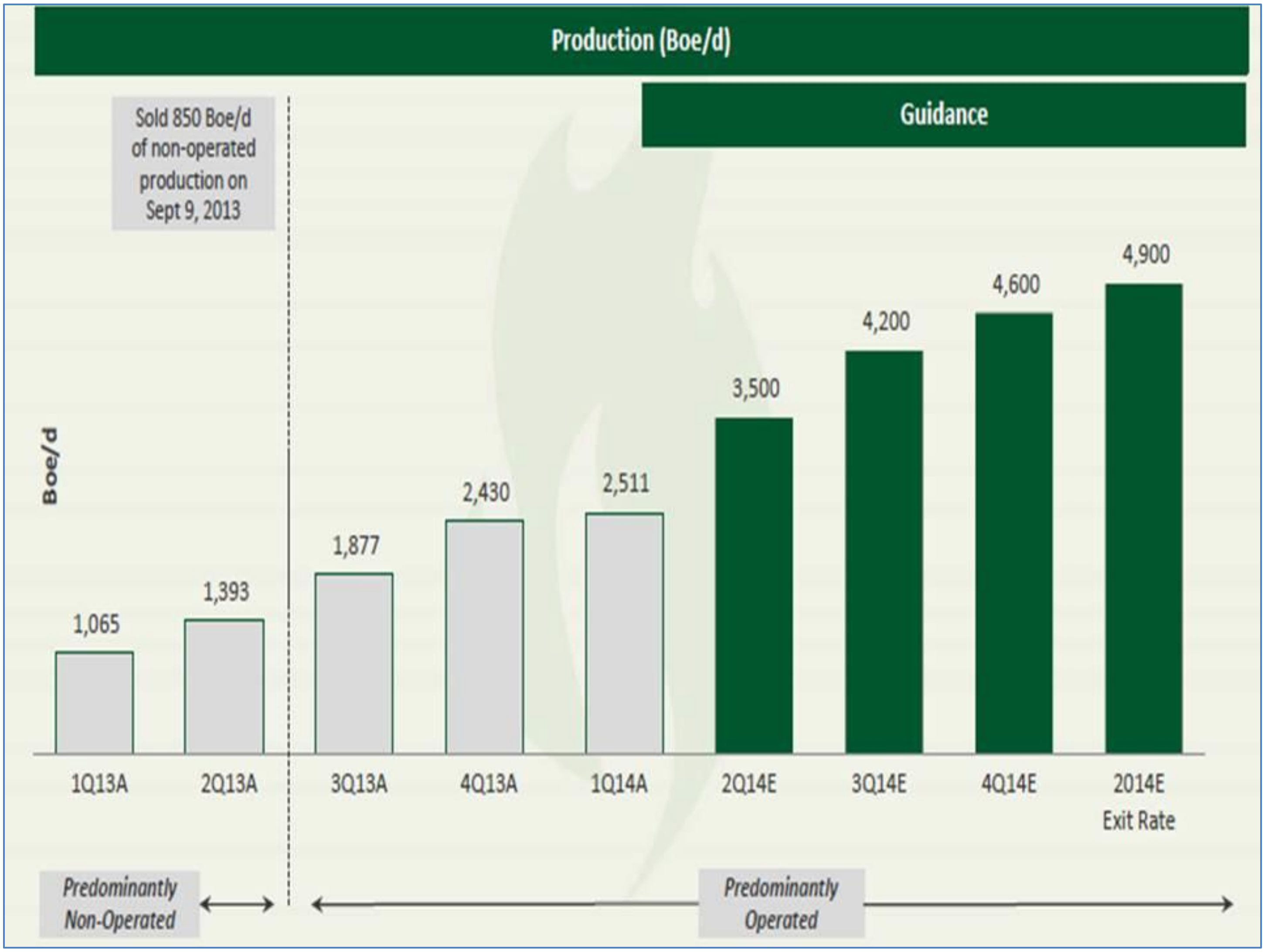


FIGURE 3: EOX PAST AND PROJECTED PRODUCTION

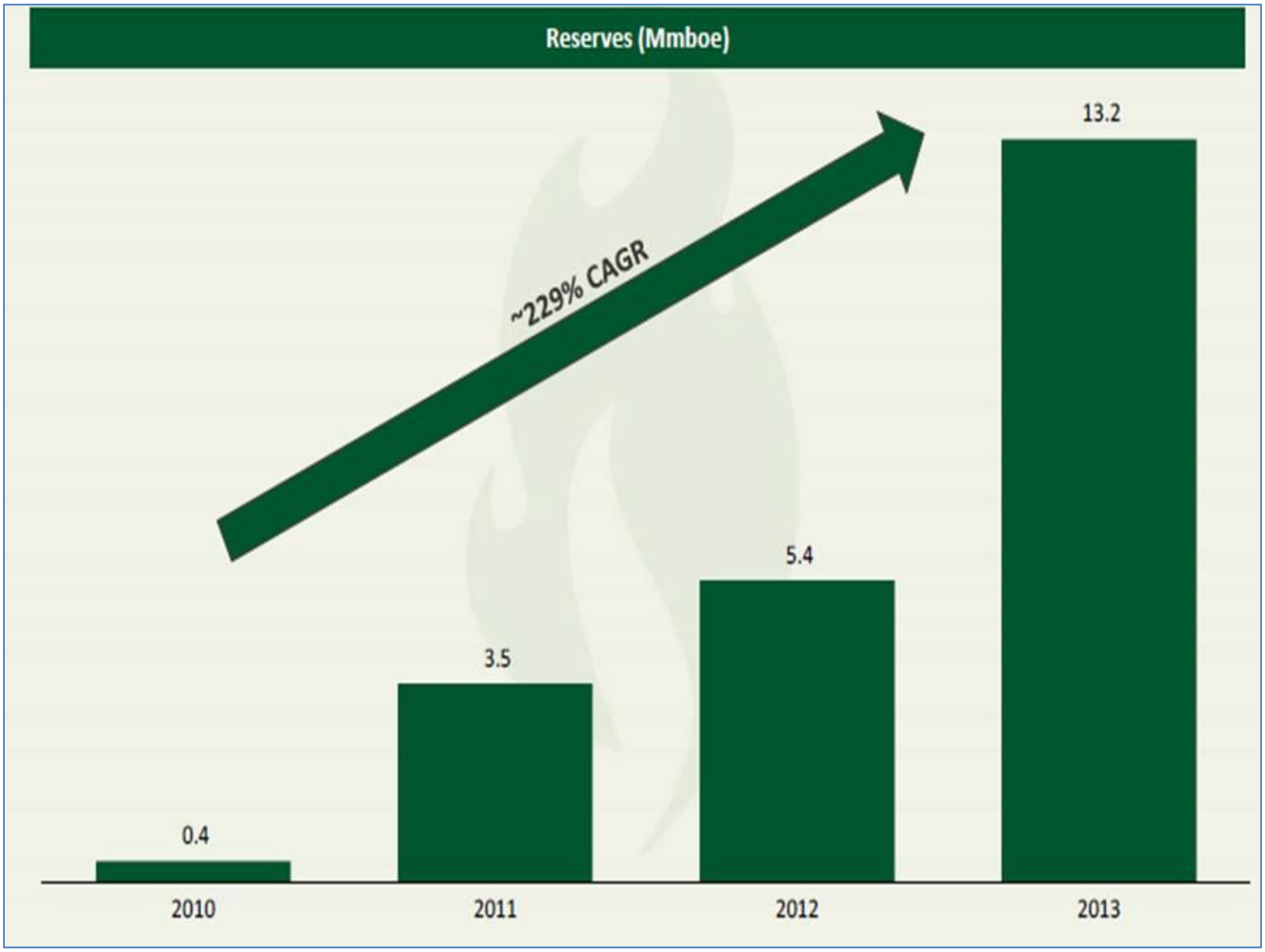


FIGURE 4: TREMENDOUS GROWTH IN RESERVES

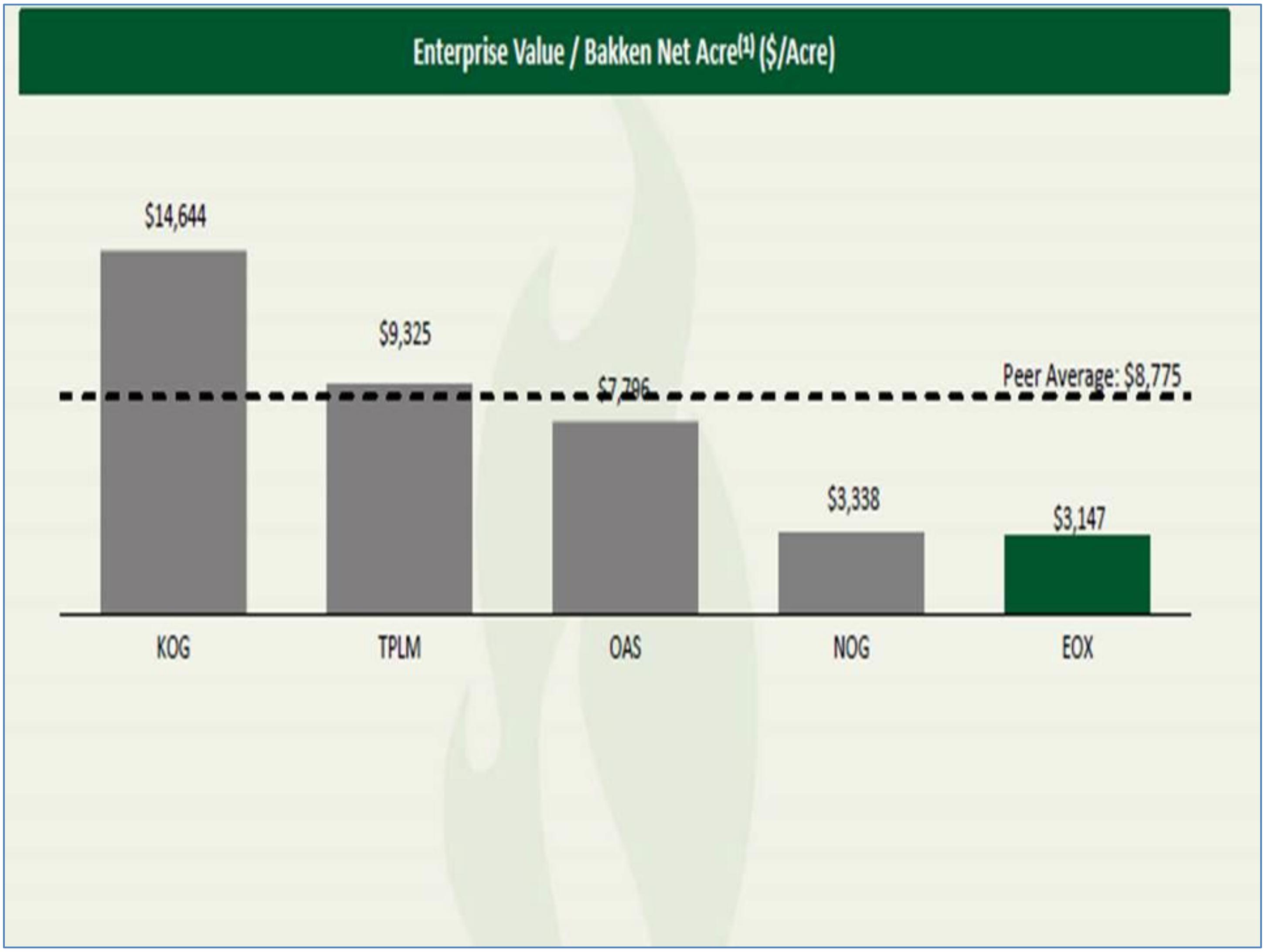


FIGURE 5: EOX IS VALUED WELL BELOW ITS PEERS, FOR NOW

Current Portfolio

Company	Entry Date	Entry Price	Recent Price	Buy Up To	Target Price	Returns	Russell 2000 Comp. Rtn.
Hercules Offshore (HERO)	07/18/14	$4.01	$4.01	$4.25	$6.00	0.0%	0.0%
Emerald Oil (EOX)	07/18/14	$7.56	$7.56	$8.00	$12.00	0.0%	0.0%

Notes:

Entry price is determined by the last "Close" price at the closing of the market on the day before publication.

Recent price is determined by the last "Close" price at the closing of the market on the day before publication; most recent update: 07/18/14.

Returns is share price appreciation or depreciation between entry price and recent price.

Russell 2000 Comp. Rtn. represents the returns on the Russell 2000 Index from the point of entry of a stock listed above through the recent price and is meant to provide a comparison to the overall small cap stock market as comprises that index.

This is not real-time data and should not be interpreted as such.

Announcements

Look for updates at least twice per month, more often as market conditions warrant.