3 Prime Breakout Stocks for 2015

A Special Research Report from **Bret Jensen's Small Cap Gems**

Investors Alley

Progenics Pharmaceuticals (Nasdaq: PGNX)

Following on the success of Avanir I've added another small biotech play to our Small Cap Gems portfolio. There are a couple of reasons for this addition in this volatile sector. The biotech sector had a deep and quick sell-off in early March this year. The vast majority of the big biotech stocks like **Gilead Sciences (Nasdaq: GILD)** and **Celgene (Nasdaq: CELG**) have fully recovered from that pull back and are at or near 52 week highs. Small caps had much deeper pullbacks from that air pocket and are still way under their highs earlier in the year for the most part.

That is starting to change as sentiment has improved on the space recently. Part of this could be "risk on" money fleeing the small cap energy sector which has been decimated on the plunge in oil prices over the past couple of months. In addition, myriad small biotech companies have reported encouraging trial results recently and shot higher. Our own **Avanir Pharmaceuticals (Nasdaq: AVNR)** soared 214% before closing out based on news that it was an acquisition target by a Japanese firm.

With PGNX I also want to further diversify our Small Cap Gems portfolio within the small biotech area. Simply put, investing in the small biotech space is different than investing in other sectors. Some hedge funds employ PhDs in biochemistry but still get it wrong as much as they get it right. How drugs and drug compounds perform in actual trials is next to impossible to predict consistently. These stocks can soar or crater on every trial result. Diversification mitigates the volatility of holding only one or two stocks in the sector.

The small biotech sector calls for a different investing strategy. My philosophy is to take much smaller positions in a larger number of selections than in other sectors. One must realize that there will be many misses within the biotech portion of your portfolio. However, this should be compensated for by the occasional five or ten bagger. Avanir is off to a good start to being one of those possible multi-baggers, already more than doubling since we tagged it as a good prospect in July.

Company Overview:

Our small cap biotech recommendation in this report is **Progenics Pharmaceuticals (Nasdaq: PGNX).** This company has a market capitalization of just north of $300 million. Progenics is developing a stable of products consisting of imaging and therapeutic agents to better detect and treat various forms of cancer and its associated effects. The stock of Progenics sold for just north of $7 a share prior to the big biotech sell-off in March. The shares currently go for just under $5 a share even with a recent rally.

The company's lead product is called Relistor which was just approved to treat opioid-induced constipation (OIC) in patients with chronic non-cancer pain. This drug has been developed in partnership with **Salix Pharmaceuticals (Nasdaq: SLXP**) and the approval for the injectable form of this drug for this new indication triggered a $40 million milestone payment to Progenics which will also get another $50 million milestone payment if an oral form of the drug is approved.

Progenics originally partnered with Wyeth to develop Relistor in 2005. By 2008, Relistor had earned FDA approval for a narrow patient population, those suffering OIC in palliative care. The sales from this small indication total more than $40 million a year currently. By 2010, Wyeth was in the midst of being acquired by **Pfizer (NYSE:PFE)** and jettisoned several partnerships as the result of the merger including that to develop Relistor. Progenics started to partner with Salix in 2011 to develop Relistor for additional indications as well as to get the oral form of this treatment approved.

This approval could take six to 18 months depending on what additional data the FDA will require, up to and including a 52 week trial of the oral form of this medication. The regulatory agency could also approve this version of treatment without any further trial results which would provide a substantial instant positive catalyst for the stock. The oral version of Relistor will have a much bigger customer base than that of the injectable version due to ease of use.

In addition to the milestone payments, the company will receive 15% to 19% of the overall revenues on Relistor as royalties from the commercialization of the drug which Salix believes will eventually have over $1 billion in annual peak sales just in the United States alone. If and when approved, it would be very easy to envision Salix from just buying Progenics outright for a substantial premium to keep all of Relistor's revenue to itself and pick up Progenics' drug pipeline as well.

Other Products in the Pipeline:

Other drugs in early stage development for Progenics include. Azedra and PSMA-ADC. Azedra is an ultra-orphan product in late stage development. It is owned 100% by PGNX without any partnerships, and the company is projecting about $100 million in peak sales from just for one indication. The product contains a radioactive isotope which means the product will never go generic. The company is in the process of restarting a pivotal trial on this compound.

PSMA-ADC is being look at as both from an imaging and therapeutic perspective for prostate cancer. Prostate cancer is the second most common form of cancer affecting men in the United States: an estimated one in six will be diagnosed with prostate cancer in his lifetime. The compound produced encouraging Phase II trials earlier in the year.

The company also has a couple of other compounds in very early stage development that represent additional "shots on goal" at some point in the future. However, given their stage of current development we will not factor them into our valuation on Progenics.

With the recently triggered $40 million milestone payment from Salix for the injectable form of Relistor, Progenics will now have approximately $120 million in cash on hand. This is just under 40% of the company's overall market capitalization. The company's burn rate is less than $10 million per quarter and that is before the additional revenue stream from the injectable form of Relistor to treat OIC in patients with chronic non-cancer pain starts to hit the books. No dilutive capital raises seem likely in the foreseeable future.

Analyst Commentary:

Given the company's small market capitalization, it receives very little coverage from analysts. Only three analysts have price targets on the shares. They range from $6 to $11 a share. The last ratings change on the stock happened in February when Needham moved the stock of Progenics from a Hold to a Buy.

Big holders of the stock are more enthusiastic. A fund that is a beneficial owner (over 10% of the float) in Progenics, added over $7 million shares in July of this year. Insiders own over 10% of the shares and have been net purchasers of the shares over the past two years.

Outlook:

If we cut Salix's estimate for peak Relistor annual sales in half and do not assume any sales outside the United States for now, Progenics should easily receive $100 million in annual revenues as Relistor gets approved for oral use and expanded for other indications.

Putting a very conservative 4-6 times that revenue stream provides a value of $7 to $10 a share just for this compound. Add in $2 a share for the net cash on Progenis' balance sheet which does not include the $50 million milestone payment the company will receive once the oral treatment of Relistor is approved. Finally, throw in a conservative $1 to $2 a share for the value of the other early stage products Progensis has in development. This gives us a sum of the parts valuation for Progenics of $10 to $14 a share for the stock.

Recommendation: Buy PGNX, sell at $14 a share.

Big 5 Sporting Goods (Nasdaq: BGFV)

One of the important traits of a good contrarian investor is recognizing the difference between a company that is going through temporary problems and one whose principal business model has fundamentally changed for the negative.

In the former case, a beaten down stock of that company could be a great long term investment. In the latter, the equity could be a value trap that has a potential to blow a hole in one's portfolio.

Over the years, investing in these types of temporarily beaten down stocks has provided some of the best returns in my portfolio. The recent comeback in the market of **Hewlett Packard (NYSE: HPQ)** is just one recent high profile example of a company that has managed to overcome overly negative sentiment to deliver outsized shareholder returns.

Although I am underweight consumer discretionary stocks right now due to concerns around tepid wage growth as well as too many part-time jobs being created as well as what these trends mean for consumer spending; I have quietly built a significant position in what had been a beaten down retailer.

Company Overview:

Big 5 Sporting Goods **(Nasdaq: BGFV)** operates 425 sporting goods stores in the western United States and has an average store footprint of approximately 11,000 square feet. Half of it stores are in California with Arizona and Nevada constituting another 20% of its retail locations. The other stores are scattered over a myriad of Pacific Northwestern and western states.

A Dismal Quarter:

When the company last reported quarterly earnings in early 2014, its results largely met top and bottom line expectations. However, comp store sales fell 7.9% year-over-year. In addition, management lowered earnings guidance for the upcoming quarter significantly to a range of 12 to 20 cents a share. This set up a great opportunity to pick up shares on the cheap. Prior to the last quarter, Big 5 had delivered five quarterly reports in a row that exceeded bottom line expectations.

Overreaction in the Market:

The stock had a violent reaction to the reduced guidance and the poor same store sales results. The equity dropped some 25% in the aftermath of the poorly received report and continued to slide in the months before we added it to the portfolio. As importantly, the stock was selling at roughly 60% of its level of just the summer prior.

However, I took earnings report with a grain of salt as there were many extenuating circumstances. First, it was a tough comparison as same stores sales gained more than 10% year-over-year during the same quarter in 2013.

A good portion of this previous surge in same store sales was an explosion of gun and ammo sales in the wake of the Newton, Ct. massacre and the push for more federal gun regulation. Although this legislation ultimately failed, gun and ammo sales went through the roof for a quarter or two. (If you're a gun owner you know how difficult it became to find certain types of ammo during that period.) In the latest quarter, these revenues plunged 45% from the same period last year as sales in those areas have come off their peak. Gun and ammo sales account for approximately 10% of Big 5's overall revenues.

Second, while most of the country was experiencing a much colder than normal winter where places like Minneapolis and Chicago having more snowfall than in several decades, the West was mostly experiencing warmer than normal and even drought conditions. This significantly impacted the company's sales in winter apparel and sporting goods. It is kind of hard to sell ski equipment when there is light or no snowfall. Sales in this category were down 25% year-over-year. This product line also accounts for about 10% of Big 5's overall revenues.

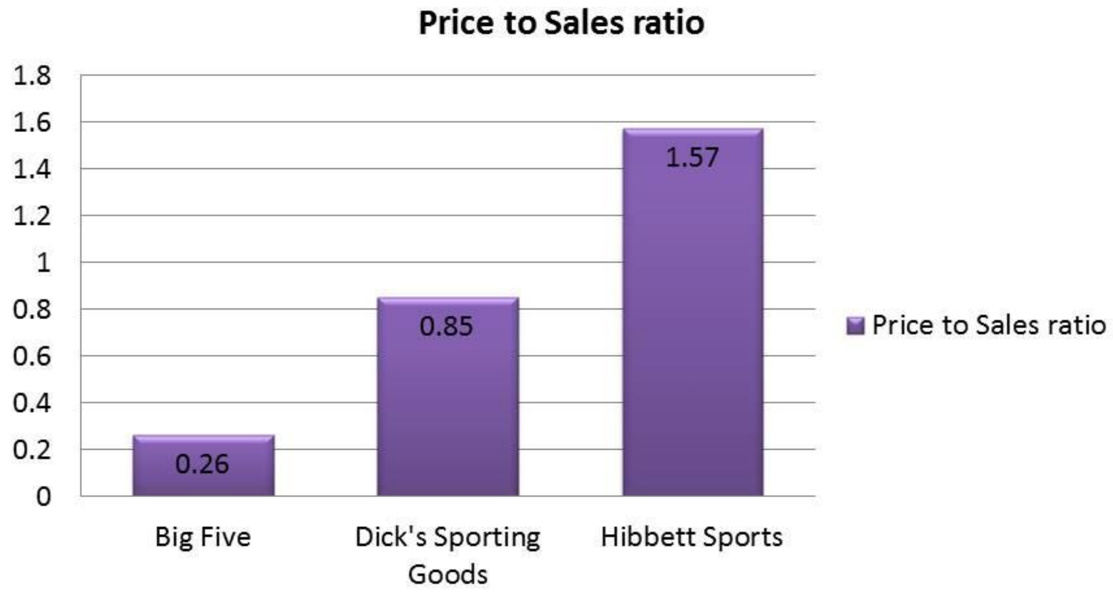
Taking out the big drops in these categories, and same store sales for the rest of Big 5's merchandise mix actually showed same store sales growth in the low single digits year-over-year. Finally, Big 5 is hardly alone in battling these headwinds. The stocks of competitors Hibbett Sports **(Nasdaq: HIBB)** and Dick's Sporting Goods **(NYSE: DKS)** also suffered from the same factors. Dick's also is challenged by its recent expansion into golf equipment which is not going well at this time.

Valuation:

There are several ways to look at the current valuation of the stock for Big 5 Sporting Goods. All of them point to a stock that is deeply undervalued. The shares trade for just over nine times the $1.27 a share it earned in FY2013. This is a discount to the 11.5 times trailing earnings the stock has traded on average over the past five years. Both Hibbett Sports and Dicks Sporting Goods currently sell at just over 16 times trailing earnings even with their recent pull backs in the market.

Even though Big 5 produces more sales per square foot than either Dick's or Hibbett Sports, the stock sells at a huge discount to either based on price to sales ratios.

Price to Sales ratios



Growth Drivers:

The company plans to continue growing 10 to 15 stores per year over the next few years. Obviously two to three percent growth to a company's retailing footprint should have a corresponding impact on earnings and revenues. The company also has initiatives underway to substantially boost its razor thin operating margins by changing its merchandise mix toward higher margin products.

In addition, the company launched e-commerce initiative before the holiday shopping season. This is expected to add a new sales for the company and its customers, the results of which will show up in future reports. The launch should add a penny a share per quarter going forward as these costs plunge on the rollout of the website. As more states including California collect sales taxes on internet sales, online retailers like **Amazon (Nasdaq: AMZN)** become less of a competitive threat.

Dividend should provide a solid floor:

No one wants to catch a falling knife and the drop in the stock price since last summer can be disconcerting to some investors. However, confidence should be buoyed by its high dividend. The stock pays a generous 3.1% yield with a relatively low payout ratio. This should act as a buffer against further declines.

Outlook:

It is important to remember when analyzing Big 5 or the other sporting goods stocks that the company is not in the same boat as other challenged retailing sectors. Unlike retailing icons such as **Sears Holdings (NYSE: SHLD)** and **J.C. Penney (NYSE: JCP)** which are hemorrhaging money, companies like Big 5 are seeing profit even during difficult times. Debt levels are very manageable and are of no concern as well. In addition, the sporting goods space is not facing the carnage sweeping the teen retailing space which looks like it is facing more long term challenges.

Big 5, Dicks and Hibbetts are all facing their own challenges, but I believe Big 5 is the cheapest of the bunch of sporting good stocks. The combination of declining gun sales and lousy weather have been the perfect storm for these retailers in early 2014 but they have passed and the companies are moving back to what I'd consider normal growth.

Over the next 12 months the stock should recover at least half of its losses from its highs two summers ago. This midpoint would represent upside to $17 to $18 a share.

Recommendation: Look for BGFV to go to $17 or $18 a share before selling.

Sonus Networks (Nasdaq: SONS)

Many of the firms within the technology space have cash rich balance sheets; this makes them even cheaper than they seem on a cursory glance. One such stock is a voice-over-internet (VoIP) technology play named Sonus Networks (Nasdaq: SONS).

The company has been under new management for the past few years, has a game plan to substantially raise operating margins over the next couple of years and is benefitting from huge growth within the session border controller (SBC) market. In addition, the stock has recently started getting more positive coverage from analysts and is seeing substantial new insider buying as well.

If the company can execute against its strategic plans, the stock should have major upside over the next few years.

Company Overview:

Sonus Networks, a company with a market capitalization of $900 million, designs and manufactures key components to enable VoIP solutions, and it is benefiting from the build-out of 4G networks as well. VoIP is a solution to move voice, data and other traffic via the internet rather than by more traditional cable and phone lines. VoIP subscribers in the United States have increased from just over 20 million in 2010 to a predicted over 60 million in 2015.

Sonus Networks manufactures both lower-margin gateway equipment and higher-margin session border controller (SBC) products that help enable this technology. These session border controllers are products that combine hardware and software that Voice over Internet phone (VoIP) systems to control the signaling and media streams.

Secular Growth Story in the SBC space:

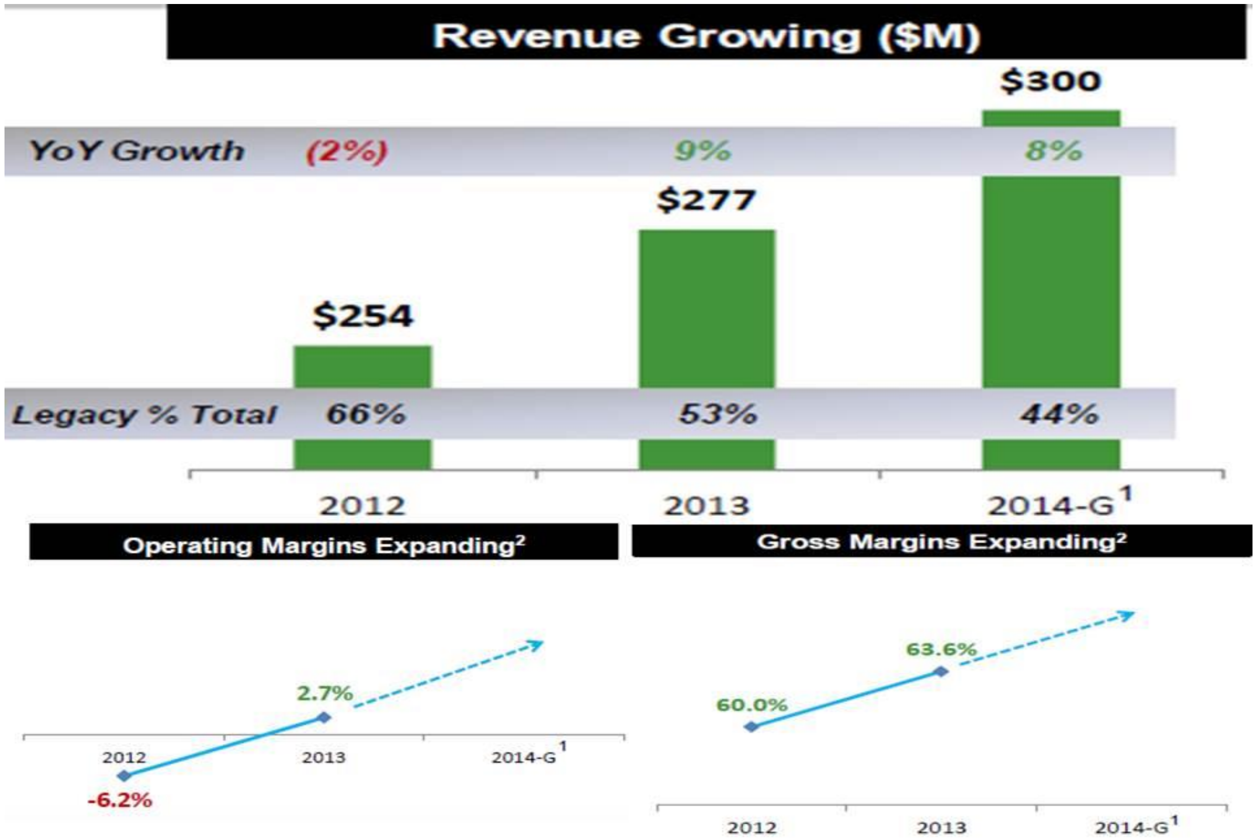
VoIP systems and capabilities are expanding in leaps and bounds. This is powering the demand for SBC products. Growth in the SBC space is expected to grow at a better than 25% annual rate from 2013 to 2018. This development should act as a significant tailwind for Sonus Networks' growth prospects over the next few years.

Sonus Networks also recently acquired **Performance Technologies (PTIX)** for some $30mm in December 2013. Performance Technologies was a supplier of advanced, high availability network communications. This acquisition will add to the company's cloud, mobile, and multimedia offerings.

Margin Improvement Plan:

The company brought in a new CEO around two years ago. Its current game plan is to migrate to a higher-margin product mix in order to boost its margins to 10% by the end of 2015. Those margins are currently just under 3%.

The primary driver of this margin improvement is growing the percentage of sales coming from much higher margin SBC products rather than lower margin legacy Gateway products. The company has done a great job in relentlessly driving this sales ratio off over the years (See Chart).



2014-G – Refers to company guidance for 2014

Sonus should get this percentage up to 80% over the next few years. The company is managing to increase revenues by 8% to 10% annually despite seeing legacy Gateway sales continuing to fall at a decent clip. This margin improvement effort and annual sales increase should drive significant earnings growth in coming years.

Sonus made just two pennies a share in profit in FY2013 but should post better than a nickel a share in earnings for FY2014 once all is said and done. Further out the consensus has Sonus earning 12 cents a share in FY2015. If the company can execute its plans to continue to migrate sales to higher margin SBC products in coming years I believe it can earn 20 to 25 cents a share in FY2016 and 30 to 40 cents a share in FY2017 as operating margins expand.

Analyst Commentary:

I am not the only analyst bullish on this company's longer term prospects. Jefferies recently issued a report recently that if Sonus is successful at executing these plans, the stock could see $10 a share by 2017. Jefferies analyst, James Kisner, calls Sonus Networks "one of the most underappreciated stories in the technology sector today."

His price target calculation seems straight forward in my opinion. Currently the company is getting just under 3% operating margins and selling just north of $3 a share. If margins can more than triple to 10% over the next few years to 10%, it seems straight forward the stock could be worth $10 a share all other factors being equal.

Sonus Networks recently was initiated as an “Outperform” over at William Blair. Overall this tech stock is now followed by six different analyst firms. Four have “Buy” ratings, one is at “Outperform” and the Credit Suisse has a “Hold” rating on Sonus.

Potential Buyout Candidate:

Although it is not a primary reason to own this equity, the company could find itself at some point the target of a larger tech concern interested in getting into the fast growing SBC space. Another SBC manufacturer, Acme Packet, was purchased last year by **Oracle (NYSE: ORCL)** for a substantial premium. Sonus rallied more than 15% on the day of the announcement on speculation it might be the next target in this space.

Insider Buying & Balance Sheet:

Insiders seem to have increasing confidence that their strategic plans will lead to a higher stock price. Its CEO bought one million shares at the end of April. The CFO also added 15,000 shares to his personal stake in that same time frame. These were the first purchases by corporate officers in over two years.

Sonus recently did a 37.5 million share secondary offering primarily to reduce investment firm Legatum Group’s stake in Sonus from just over 22% to right at 6%. In conjunction with this event, the company bought back some 75 million dollars of stock to mitigate any dilution. Even with this use of cash and its $30 million purchase of Performance Technologies last December Sonus still has approximately $175 million of net cash on its balance sheet. This represents a bit over 20% of the company’s total market capitalization.

Summary:

I am encouraged by the company’s efforts so far in 2014. Sales growth should accelerate in coming years as the company lowers its exposure to its legacy Gateway product line and gets closer to 80% level of sales from the faster growing SBC market.

In addition it should be relatively easy to track the company’s progress against its strategic goals. As long as the percentage of overall sales from SBC products continues to rise and operating margins increase consistently, I feel good holding the stock. If either of those metrics start to deteriorate an exit might be necessary.

I am not as bullish as Jefferies on Sonus but I believe the stock has significant upside. Sonus has over 20% of its current market capitalization is in net cash. Given this, a price to earnings range of 15 to 20 times the 30 to 40 cents a share I think the company can earn by FY2017 seems attainable over the next few years.

This would give us a long term price target of $4.50 to $8 a share on Sonus. This represents 25% to 130% upside from the stock's current price of $3.20 a share. If fortune smiles upon shareholders, this value could be realized in short order via being purchased as M&A activity in the space picks up. I am a short term buyer of the stock as I believe the equity can hit $4.50 to $5 a share just by delivering a couple of additional quarterly earnings report showing similar progress to its last reported results.

Recommendation: Purchase SONS up to $4.50 a share and hold for $8.00.

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