Investors Alley
July 2014 Vol. 1 Issue 1
Bret Jensen's Small Cap Gems

Welcome

Fellow Investor,

I am honored to be a part of this new small cap newsletter service. Before we dive too far into specific stock recommendations I'd like to share with you a bit about my background and approach to investment research.

In This Issue

I have been investing for over three decades and have been obsessed with the markets and equities for as long as I can remember. In the past decade I have been a hedge fund manager, a trader and a professional financial journalist including being a daily columnist on Real Money Pro and now with Investors Alley.

I have always been fascinated with small cap stocks. I cut my teeth on the space when I was teenager. I remember having to beg my father to open a brokerage account so I could buy several small cap stocks with the money I was earning from a part-time job.

I was fortunate that the first few stocks I bought as an investor turned out to be rocket ships. I was hooked and I used these profits to pay for college and emerged with a degree in finance from Arizona State University without even a cent of student debt.

If I had grown up on the east coast I am sure I would have matriculated to Wall Street after graduation. However, being closer to the west coast I spent twenty years moving up the corporate ladder in technology. I never lost my interest in the financial markets though. I continued to research and manage my own portfolio, enjoying a great deal of success over two decades.

After twenty years at the same company and having accumulated enough in my retirement and brokerage accounts I “semi-retired” in my early 40s; I jumped at the chance to take a severance package and started a small hedge fund with two partners in 2008, six weeks before the Lehman Brothers collapse.

Although the fund easily outperformed the S&P 500 in three of its four years of existence, running a fund was proving to be a huge distraction from my first passion: small cap stock research. So we decided to shut it down in 2011.

One of the offshoots of the fund was the launch of a new career in financial journalism. I had started writing and blogging about investment ideas on Seeking Alpha to attract attention to our nascent hedge fund. My posts proved to be popular and provided myriad profitable investment ideas and soon there were several thousand regular followers of my posts, in addition to many more who just read the articles from time to time.

This also led to being noticed by Jim Cramer’s TheStreet.com where I have been a daily columnist for Real Money and Real Money Pro for over two years. Some of my more satisfying moments of the past few years are the hundreds of "thank you's" from readers from both sites for helping them identify small cap investments that have doubled, tripled, quadrupled or better since they purchased them. For some of these readers these have been truly life altering events. These stock ideas have included **Abraxas Petroleum (Nasdaq: AXAS)**, **Swift Transportation (Nasdaq: SWFT), Novavax (Nasdaq: NVAX)**, **Himax Technologies (Nasdaq: HIMX)** and **ZELTIQ Aesthetics (Nasdaq: ZLTQ).**

This newsletter is the next phase in my evolution as a trader, investor and journalist. It provides several advantages compared with my other writings. It is a medium where I can do much deeper dives into equities I believe have attractive long term potential. They are my best ideas among small cap stocks that I have done extensive research on and hold in my own portfolio.

That last part is important and I'll disclose right now that I have or will hold positions in the vast majority of stocks in this letter. 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. 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.

Insights in the small cap space can add significant value and capital appreciation potential as these firms receive scant analyst coverage and are "off the radar" of most investors. There is very little insight that I can provide on a large cap like **Apple (Nasdaq: AAPL)** when over 70 analysts already cover the company and not a day goes by when it's not mentioned on the business news networks. However, research that uncovers the next biotech that is a developing a blockbuster or the next small E&P concern that is about to hit a gusher in a new shale find can be invaluable and very lucrative.

I already do extensive research in the small cap area for ideas for my own portfolio. This newsletter is my way of sharing the best investment ideas I find. My investment strategy in this sector is to look for firms that seem to be significantly undervalued and/or have potential catalysts the market is either ignoring or is unaware of.

Given the volatility of the sector, which has been demonstrated once again since March; my best 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. I believe this is an optimum size to mitigate some of the risk inherent in the small cap space while keeping the potential for outsized gains by adhering to a core group of the best investment ideas in the area.

I look forward to sharing these small cap stocks with significant upside with new readers as well as to gain insight through their comments as well as interactive dialogue. It should be a satisfying and prosperous journey together.

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.

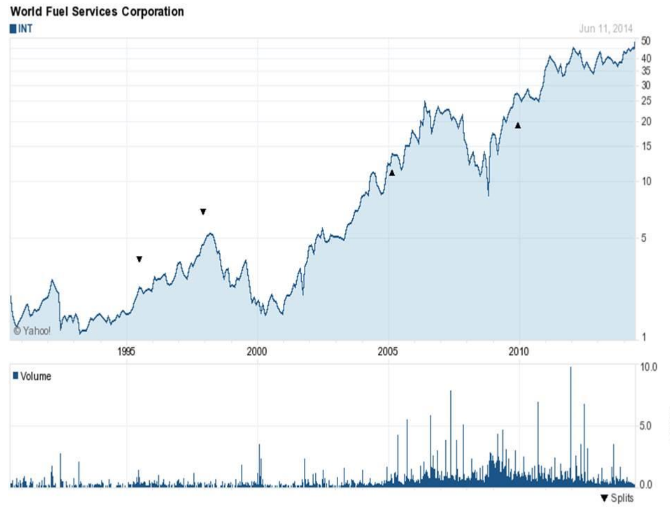
Bret Jensen
Editor
Bret Jensen's Small Cap Gems

Rick's Cabaret: Plans in place to delight shareholders NYSE: RICK

One of the earliest and most influential books on investing I ever read was Peter Lynch's "Beating The Street" when I was in college. I found it contained numerous common sense investing themes like investing in companies whose products one uses and touches. Another investing strategy I took from the book was how powerful a market leader growing market share by acquiring less efficient firms in a very fragmented industry could be.

The famed Fidelity Magellan fund manager profiled Service International who made hundreds of acquisitions in the funeral home industry in the 1970s and 1980s to become the clear market share leader in that space. He also highlights Safety- Kleen which did the same in consolidating the niche waste disposal area of picking up grease from restaurants and oil from auto repair locations. More importantly, Mr. Lynch notes he rode both of these consolidation stories to over 1000% returns during his fifteen year tenure at the Magellan fund.

I try to employ this consolidation theme when it seems warranted to do so. One stock that has paid many dividends within my own portfolio over the years is **World Fuel Services (NYSE: INT).** This Fortune 500 firm has been the major consolidator in the fuel logistics space for many, many years. It has consistently grown consistently through acquisitions over the last decade but still has less than 10% market share in the fuel logistics sector and has many, many years of growth ahead. It has also richly rewarded its shareholders by following this consolidation strategy.



Another company I have recently taking a stake in has an opportunity to consolidate and prosper within a more exotic space. It is profiled below.

Company Overview:

Rick's Cabaret International (Nasdaq: RICK) is the nation's leading hospitality company in adult gentlemen's clubs and the only play in the space that is a publicly traded company. Rick's owns and operates just over 40 clubs under various brand names in 10 states. Approximately half the company's overall revenues come from fast growing Texas. Rick's has a market capitalization of just over $100 million with an enterprise value just north of $175 million currently. The stock is selling for just under over $11 a share.

Consolidation Winner:

The adult club industry is very fragmented. There are almost 4,000 adult clubs in the United States. There are some significant economies of scale to owning multiple clubs such as consolidation of legal, compliance, marketing and human resources departments. Obviously, volume discounts can be had with liquor as well as lowering other costs substantially such as overall insurance expenses. Rick's can also provide professional management as well as consistent branding across the clubs under its umbrella.

Bret Jensen's Small Cap Gems

Rick's Cabaret	Club Onyx	XTC and Temptations	Tootsies	Jaguars	Vivid
• Flagship brand • High-end clubs with restaurants	• Upscale nightclubs	• Casual atmosphere • BYOB clubs	• Unique facility • 74,000 sq. ft. • Four clubs in one	• Lively clubs	• Our newest • Leverages leading brand in adult video • High energy party atmosphere
• Higher net worth, mature patrons • 35-55 years	• African-American professionals	• Younger and blue-collar patrons • 18-35 years	• Higher net worth, mature patrons • Younger patrons (tourists, college students)	• Primarily workers in booming Texas energy industry	• Younger patrons • 18-35 years
11 Units • Texas (7) • Minneapolis (2) • NYC • Indianapolis	4 Units • Texas (2) • Charlotte • Philadelphia	9 Units • Texas (8) • Sulphur, LA	1 Unit • Miami, FL	10 Units • Texas (9) • Phoenix	2 Units • Los Angeles • NYC

The company is well positioned to continue to be a winner as club owners retire and want to cash out. Rick's can finance most purchases via internal cash flow and is the only player in the space that also has publicly traded stock that can be included in the purchase price allowing the retiring owner to participate in the continuing profits in the industry.

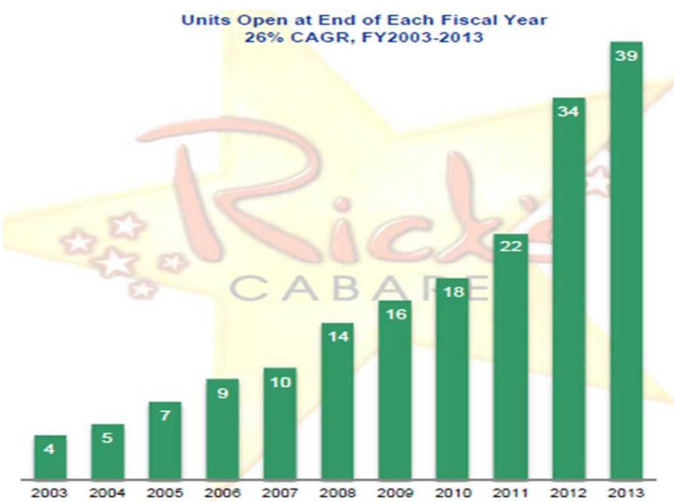
In addition, licensing a new club can be an expensive and time consuming process. Since the licenses in general are limited and usually attached to the property in most states, rolling up existing facilities is a logical strategy for growth. Rick's recently bought a mega club in Chicago using a combination of cash and stock and is now renovating and expanding the club. This has been and will continue to be a major driver of the company's growth.

Smart Operator:

One thing that stands out about the management at the company is that they are smart operators. They recently cut their lease expenses by over 40% annually at one of their two clubs in New York City by selling the "air rights" of that space for some $8 million over five years. Air rights are valuable to cellular carriers and include the space directly above the property.

They also partnered with the leading adult video concern to come up with and implement a new upscale club model called Vivid Cabarets. The first club with that concept just opened this year and is exceeding expectations by a wide margin. Rick's modeled $6 million in annual revenue for the initial opening of this first version of Vivid Cabaret in NYC with sales currently closer to an $8 million annual run rate.

The company is also very smart where it locates new clubs. For example, Rick's is planning to open a new club in Odessa, Texas which is the second fastest growing metropolitan area in the country. The city's population has been bolstered by exploding oil and gas production. This has brought an influx of well-paid industry workers to the city to work on the rigs around the city. These new additions to the city are also exactly the core demographic Rick's clubs seeks to attract. Finally, insiders have a strong incentive to ensure continued and prudent growth as they own approximately 15% of the company.



A Better Business Model:

Adult clubs are not for everyone but the business model is very attractive on an economic basis compared to other plays in the hospitality space such as restaurants and bars. Gross margin in those areas average a bit more than 35% on average on a historical average. Rick's gross margins companywide at its clubs is north of 85%. Operating margins are over 20% which is mostly unheard of in the restaurant sector. As can be seen below, the company gets high margin revenues from a variety of sources.

High Gross Margins (FY13)

Category	Comment	% of Revenue	Gross Margin
Service	• Cover charges • Patron charges • Dancers • Room rentals	44.0%	Approaching 100%
Alcohol	• Liquor • Beer • Wine	40.6%	78.5%
Food & Merchandise	• Food • Non-alcoholic drinks • Merchandise • Cigars, cigarettes	9.3%	54.0%
Other	• Internet and media revenue • ATM commissions • Valet income • Video games / vending	6.1%	95.4%
		100%	86.7%

Cheap Valuation:

This stock has a very cheap valuation given its high gross margins and growth. Last year the company grew both revenues and EBITDA by 18% year-over-year (Y/Y) over 2012's levels. In the first quarter this year the company delivered 15% Y/Y growth in revenues. Earnings were up better than 27% Y/Y and EBITDA was up 23%. This was despite some horrid winter weather in Texas that affected sales in its clubs there.

The company also upwardly guided its GAAP earnings for this year for $1.10 to $1.20 a year. Non-GAAP earnings should come in at $1.60 to $1.70 a share. Revenues companywide for FY2014 is currently projected to be around $130 million up some 15% year-over-year. The company also announced it has authorized a $10mm stock repurchase program that would retire approximately 10% of its float at current price levels.

Upcoming Positive Catalysts:

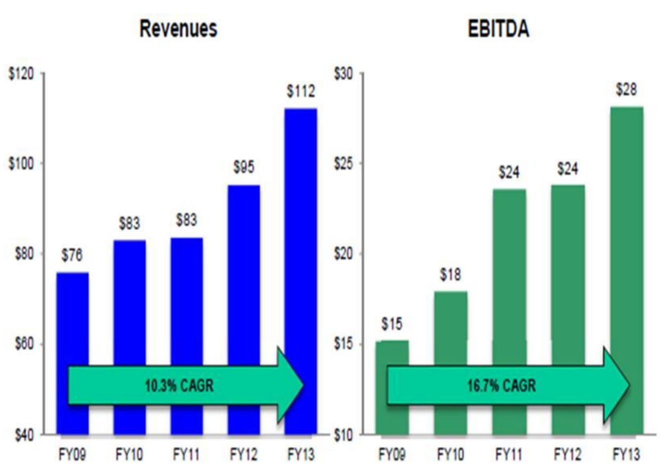
The company has invested in a new sports bar themes, Bombshells. Bombshells is a military themed restaurant bar to be located near military bases. The initial restaurant/bars have shown strong initial results.

The company believes each of these facilities can produce between 15% to 25% operating margins on annual sales of $3 million to $4 million per location. The company plans to have ten of these restaurants opened or under development by the end of the year. This represents a lucrative potential new source of revenues, growth and increased cash flow.

The company also has been in an ongoing and protracted dispute regarding the constitutionality of the state of Texas forcing adult establishments to collect and forward a $5 fee per patron. This issue has been tied up in the courts for years and is a potential $6 million to $10 million liability for retroactive fees. The company has adequate liquidity to easily deal with this contingency.

The company should continue to see increase revenues streams from its recently opened New York City location and renovated new Chicago club throughout 2014 in addition to new clubs opening in Odessa and elsewhere in Texas. The new Vivid Cabaret launch in New York should be a huge driver of growth in the years ahead.

Rick's other location in New York City that opened in 2005 saw revenues increase 40% in its second year of operation as it established itself in the space and built brand recognition. The new location is also seeing operating margins in the 50% range much higher than the company overall which should be significant driver of earnings growth in the years ahead.



The company is targeting 20% to 30% annual revenue growth in coming years as it opens new sports bars and acquires new clubs. The company did a marvelous job of growing revenues and EBITDA during the five years coming out of the financial crisis and that growth is accelerating due a myriad of positive catalysts.

The biggest potential catalyst in the near term is the sale of its club facilities to a private real estate investment trust (REIT) investor. This negotiation is in advance stages and should result in a transaction providing cash inflow of between $90 million to $100 million according to the latest guidance.

The company could use these proceeds to retire debt, resolve litigation and accelerate expansion. The company would pay approximately 8% of the current properties' value in rent in a long term sales leaseback transaction included in selling these properties to a REIT. This is lower than the overall 9.4% rate the company is currently paying in "rent" when interest costs are included. This would have an immediate positive impact on the bottom line. The company has also said it would look to initiate a dividend after this REIT deal is complete. I would anticipate an initial 3% to 5% dividend yield.

Summary:

I expect the positive catalysts listed above to have a high probably of closing by the end of the year. Rick's would then be a mostly debt-free company with a $100 million market capitalization and growing revenues at better than 15% a year.

The company should continue to have very high operating margins north of 20% and a possible nice dividend payout as well. Fast growing restaurant bar concepts like **Buffalo Wild Wings (Nasdaq: BWLD)** currently are selling at 20-30 forward earnings. Few have Rick's growth projections or gross/operating margins.

Even discounting Rick's fair valuation substantially to say 12 to 15 times this year's projected earnings of \$1.10 to \$1.20 a share provides a price target of approximately \$13.50 to \$18 a share, significantly above the stock's current price of \$11.25 a share. I believe we will see the stock in this price range by the end of the year as positive catalysts come to happen. This is potential return of approximately 20% to 65% over the next six or seven months.

Longer term I can see a price multiple of 15 to 18 times the \$1.80 to \$2 a share I see the company earning in FY2016. This would give the stock a longer term price target of \$27 to \$36 a share. This would represent approximate gains of 150% to 225% over the next few years.

Recommendation: Buy RICK under \$12.00 a share and hold up to \$25.00 a share.

Positions: Long RICK

Walter Investment Management: an undervalued opportunity NYSE: WAC

The whole financial sector has been upended and reconfigured over the past half dozen years on the back of the financial crisis and the huge onset of new regulations and additional governmental scrutiny that have come in its aftermath. Every business line has new rules of the road and we are in the early innings of this adjustment throughout the financial industry.

Even the mundane business of mortgage servicing is starting to be transformed from the way it operated pre-crisis. Mortgage servicing consists of collecting payments, sending out bills, remitting property taxes and all also aspects of keeping a mortgage current and squared away. Banks have traditionally been by far the biggest players in this stable business.

However, thanks to the Dodd-Frank regulations that came to pass after the financial crisis, capital requirements for holding mortgage servicing rights have gone up substantially for banks. This has drastically lowered the profitability for retaining these servicing rights for these financial institutions. As a predictable result, banks have sold off these rights in droves to a set of independent servicing concerns that are emerging as the major players in the mortgage servicing arena going forward.

Ironically, as the Federal government is basically forcing banks to rid themselves of these rights; state attorney generals have recently begun targeting these firms for their "growing pains" associated with integrating huge new servicing portfolios within their overall business.

Particularly active in focusing on these fast growing servicing concerns is the attorney general of New York. Following a long and proud tradition of speaking up for the "little guy", and garnering national headlines in the process in gearing up for a run for higher office, the attorney general of New York has made waves primarily focusing on the practices and customer servicing gaps of **Ocwen Financial (NYSE: OCN).**

While these probes will probably force some changes that could push up compliance and customer servicing costs somewhat, investors should take these efforts with a grain of salt. We have seen this movie before from this office where concerns fade on the industry once the attorney general has got his headlines and runs for higher office, most recently with the now disgraced Elliott Spitzer.

The sell-off in the sector as the result of these probes should be view as a longer term buying opportunity. These firms will continue to grow as they take over the lion's share of servicing rights the banks still want to disinvest. The sector is also cheap. Let's take a look at my favorite play in the market right now.

Company Overview:

Walter Investment Management (NYSE: WAC) is a leading business solutions provider focused on generating recurring, fee-based revenues from an "asset-light" platform including servicing a wide variety of residential mortgages. The company currently services over $300 billion in mortgages of which it is the sub-servicer on 20% of that total. Sub servicing requires less capital and has slightly higher margins. It also has an originations business and a small reverse mortgage line as well as a consumer lending area. Only the originations business is material along with the main servicing part of the company, so those will be the two areas we will focus on in this article.

Recent Pullback:

The stocks of mortgage servicers recently had a significant pullback on the aforementioned scrutiny by state attorneys generals as well as other governmental agencies. The stock of Walter lost a third of its value from its highs earlier in the year before recovering about half of its recent decline recently.

It is important to note a couple of things. First, the primary focus of this government focus has been competitor Ocwen Financial, not on Walter. Second, the quality processes at Walter are quite good. For the second consecutive year, Walter Investment Management received a 4-star rating from Fannie Mae, the highest rating assigned to a nonbank servicer.

The company is focused on becoming the first nonbank specialty servicer to attain a 5-star rating. Any changes or modifications to policies, standards or customer care that come from various governmental probes are more likely to have greater impacts on Walter's competitors than on the company itself.

Opportunities:

As I stated earlier in this piece, Walter's primary businesses are mortgage servicing and mortgage origination/refinancing/modification. Mortgage servicing is a thin margin but very scalable business. Each dollar value of a mortgage represents 12 to 15 basis points of profitability and 16 to 22 basis points of adjusted EBITDA (Earnings before Interest, Taxes, Depreciation and Amortization) on an annual basis.

The company has grown the amount of mortgage servicing rights (MSRs) it has in its pipeline to over $300 billion from $90 billion in 2012. The company has stated that it believes banks will shift another $1 trillion in these MSRs to non-bank servicers over the next two to three years.

Obviously this is a huge opportunity, and Walter will get a good portion of these additional MSRs based on recent history. In its last reported quarter the company acquired a $37 billion servicing portfolio from UBS as well as $7 billion in sub-servicing rights from the bank. As of its quarterly conference call in early May, Walter had added $60 billion in servicing rights so far in 2014. To start the year, the company had guided to $85 billion to $115 billion in additional servicing rights for all of 2014. The company is on track to exceed that guidance.

Despite its huge growth in this area, Walter has managed to keep solid credit ratings from the main credit rating agencies and has some $80 million in excess capital which it can use to acquire additional mortgage servicing portfolios. A rise in interest rates will actually help this side of the business as it will reduce the "churn" of the portfolio due to refinancing. This segment accounts for 70% of Walter's overall profitability.

Things are also going well on the mortgage refinancing and modification front. The company is currently the top originator of HARP (Home Affordable Refinance Program) loans for Fannie Mae. It modified some 14,000 loans in the first quarter and in a recent investor presentation stated it was currently ahead of that pace in the second quarter. The company has recently stated that its current portfolio has 375,000 mortgages that are eligible for these HARP modifications, a significant pipeline of future growth.

Guidance & Valuation:

During its last conference call the management of Walter guided to $5.25 to $6.25 in earnings per share in 2014 as well as $650 million to $750 million in adjusted EBITDA. At its current price of around $30 a share, this means the shares of Walter Investment Management are trading at five to six times forward earnings and less than two times adjusted EBITDA.

Given that overall market is trading at approximately 15 times forward earnings, this is cheap especially in light of Walter's growth prospects. Over the last five years Walter has traded at an average of 12 times forward earnings. In addition, analysts consistently underestimate Walter's earnings power. The company has crushed bottom line expectations four of the past five quarters.

If we put a conservative estimate, given the current murkiness of governmental intentions in this space, of eight to ten times forward earnings on Walter we get a price target range of $42 to $62.50 a share on Walter. This represents 40% to 110% upside from current levels. The stock traded at around $45 a share last summer. Once sentiment improves on the sector, this level or higher seems attainable.

Recommendation: Buy WAC up to $35 a share and hold until $60 a share.

Positions: Long WAC

Current Portfolio

Company	Entry Date	Entry Price	Recent Price	Buy Up To	Target Price	Returns	Russell 2000 Comp. Rtn.
Rick's Cabaret (RICK)	07/18/14	$11.23	$11.23	$13.00	$25.00	0.0%	0.0%
Walter Investment Mgmt. (WAC)	07/18/14	$27.27	$27.27	$35.00	$60.00	0.0%	0.0%
Big 5 Sporting Goods (BGFV)	07/18/14	$11.51	$11.51	$13.00	$17.00	0.0%	0.0%
Avanir Pharmaceuticals (AVNR)	07/18/14	$5.39	$5.39	$6.00	$10.00	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

Still accepting subscriptions to The Turnaround Stock Report. We still have a few openings left for subscriptions to The Turnaround Stock Report. For more information, please click here.

For more on other other two holdings, BGFV and AVNR, click here for the new special report. You may need your login information handy.