Investors Alley

August 2014 Vol. 1 Issue 2

The Turnaround Stock Report

Welcome

Fellow Investor,

It has been a difficult few weeks for stocks. Escalating tensions in Ukraine and Israel have been added to rising number of already existing geopolitical concerns. Europe is under pressure due to an already tepid recovery and the headwind created by new sanctions on Russia. Very concerning is Italy, the third largest economy in the Eurozone, as it just officially went back into recession.

Closer to home rising quarterly GDP growth and the highest consumer confidence 2007 are welcome economic signs after a contraction of growth in the first quarter of this year. Investors right now are focusing more on increasing geopolitical turmoil and the upcoming end of the Federal Reserve easing programs which should occur in October.

In This Issue

Investors have been fleeing “risk on” and high beta areas in the market such as small caps for some six weeks. It feels like the market is at an inflection point and we feel wise in slowly building a turnaround portfolio of 20 top names instead of all at once as the direction of the market is very unclear at the moment.

The two names already in the portfolio have had a challenging couple of weeks since inclusion into the portfolio. This is not surprising given the increasing volatility in the market and the up and down nature of turnaround stories in general. We'll get to more about them in the Portfolio Update section a little further in this month's letter.

This month we're adding a holding that's a play on a European turnaround. It may sound odd to put those two words, "European" and "turnaround", together especially in terms of investment opportunities, however not all of Europe is Greece or Italy, or Spain or Portugal. Parts of Europe are actually doing quite well. Most notably the northern countries like Denmark, the Scandinavian countries, Poland, and the Netherlands. It's that last one that we'll focus on this month.

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.

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AEGON: A European Turnaround Play NYSE: AEG

One thing I have learned from almost three decades of being a contrarian investor is solid turnaround plays come in many sizes and forms. Although most good turnaround investments primarily occur in small and mid-cap sectors, sometimes even the biggest company can successfully execute turnarounds.

One can make a legitimate argument that **Apple (Nasdaq:AAPL),** the largest public company by market capitalization, has executed one of the biggest turnarounds in the market over the last year or so. In June of 2013, the stock of this tech giant was trading at just over $55 a share from over $100 a share just nine months earlier – split adjusted.

Stories ran weekly on how Apple had lost its "mojo" and investors and analysts incessantly squawked about the company's falling margins and lack of innovation. The company even attracted the attention of noted activist fund managers like David Einhorn and Carl Icahn which never would have happened during the leadership of Steve Jobs.

One year later, it is a completely different story as CEO Tim Cook has executed a successful strategy that has seen the stock rise more than 60% since its nadir last June. The company launched well received updates to its iconic iPhone and iPad franchises which arrested its margin decline. Apple also initiated a dividend and bumped its payout twice since that initial dividend and also used its huge cash hoard to buy back over $50 billion of its own stock over the last year or so. The stock has responded impressively and Apple is once again a market darling.

This month's turnaround story is bigger than our normal concern in this category and has a market capitalization north of $15 billion. The company is a large insurance company based in the Netherlands called **AEGON N.V. (NYSE: AEG).** Being a European firm it is off the radar of most domestic investors but I believe it has terrific upside over next few years as it recovers from a near death experience during the financial crisis and its aftermath.

European financial firms are several years behind their U.S. counterparts in their recovery but they should follow the upwards trajectory of their American brethren over time. As can be seen from the chart below the company is a long way from previous highs even as the stock has doubled from its post-crisis lows (See Chart).

European advantages:

The Eurozone has experienced much lower growth since the end of the financial crisis than even our anemic 2% annual GDP growth over the past five years, but Europe does provide some advantages for financial firms that may be overlooked by most investors.

The continent's financial sector has not benefited from their central bank engaging in a massive easing program as our financial firms have benefited from over five years of the Federal Reserve's largesse. That could be changing in the near future. Italy, the third largest economy in Europe, recently reentered recession territory. In addition, new sanctions on Russia will slow an economy that is barely achieving any growth.

I believe the European Central Bank (ECB) will be forced to engage is a large easing program before the end of 2014 to stave off deflation and another recession in the Eurozone. This action will bolster stocks in general and the financial sector in particular just as the same actions by Japanese and American central banks have done for their respective financial sectors.

Second, with some notable exceptions, major European financial institutions did not have to be bailed out to the same extent as the United States had to support most of its major banks and insurers like **Citicorp (NYSE:C)** and **American International Group (NYSE: AIG).** This means European financial institutions are not as beholden to or facing the same scrutiny from government agencies as they are here in the States.

This also means European financial institutions are not being forced to accept the same fines or settlements with governmental authorities that have become part of business for American banks and insurers. Major banks alone here have paid upwards of $200 billion in fines and settlements and counting in the last few years. Ironically, most of the fines paid by European banks have been levied by U.S. regulatory institutions.

Finally, Europe is a much less litigious society than America. This means banks and insurers are not seeing the same avalanche of civil lawsuits that financial firms continue to deal with here in the aftermath of the financial crisis.

North American exposure:

While AEGON should benefit from its European location moving forward, it also is unique due to its exposure to North America; primarily the United States. The company gets roughly two thirds of its sales – mainly life insurance and annuities – from North America. This does two important things that may not be recognized yet by the market.

First, it exposes the company to the faster growth being seen in United States rather than Europe which is on the brink of another recession. Second, those dollars are going to translate into greater earnings power if the ECB does institute a substantial easing program which should lower the value of the Euro significantly.

In addition, a good portion of AEGON's remaining revenues come from the United Kingdom which is also seeing much faster growth than Europe as a whole.

Improving Operations:

The company is largely finished with a significant restructuring that gives it a solid operating base and enhanced capital strength. These initiatives have resulted in better group cost controls and have created a stronger set of core operations at the firm

Valuation and Outlook:

A recent decline in interest rates has caused the overall insurance sector to decline, thus offering a very solid entry point for new investments. The sector should also benefit when interest rates go up again which is likely as the Federal Reserve ends its last easing program in October and the domestic economy turns in solid growth for the rest of 2014.

AEG goes for under $8 a share after being above $9 a share before this latest interest rate decline. The stock goes for approximately 10 times forward earnings. More importantly it is less than half the $16.25 a share tangible book value the company ended 2013 with.

This is the most important valuation metric on AEGON. At less than half book value, the shares are where our insurance sector was in 2009. Since then insurance companies like **Travelers (NYSE: TRV)** have recovered substantially and now go for 10% to 20% over tangible book value.

Even if we put a "European" discount on AEGON (even though it gets two-thirds of revenues from North America) and project it should sell at tangible book value two or three years down the line, we get a stock that should have 100% upside by 2017. This assumes that tangible book value does not increase during that time frame which is very unlikely.

Finally, the shares yield a solid 3.4% dividend at these levels. The company currently has a significant amount of excess capital compared to what is needed for its operations. This excess capital should mean dividend payouts will be enhanced significantly over the next few years. This should put a nice floor under the stock giving us a turnaround play with little downside and substantial upside for patient investors willing to wait while the market "discovers" AEGON's true value. A nice little dividend makes this waiting more palatable as well.

Recommendation: BUY AEG up to $9 a share; Hold until $15 a share.

Position: Long AEG

Portfolio Update

Hercules Offshore (Nasdaq: HERO) posted a disappointing quarterly earnings report. The firm posted a small loss on decreasing offshore drilling activity as well as the disruption caused by transitioning assets to the Gulf of Mexico. The quarters ahead look brighter and the company has over a $1 billion order backlog, revenue was up in the quarter 15% year-over-year and insiders have upped their stock purchases recently.

I added a few shares in the recent post-earnings dip and am willing to give the company another quarter or two to show additional progress in executing against its turnaround plan.

Emerald Oil (NYSE: EOX) had a tough start since its inclusion into our portfolio but the shares have behaved better recently. The stock has been caught up in the same downdraft in the market that has impacted almost every energy exploration and production concern, especially in the small cap space.

However, the company just reported very solid quarterly earnings of 11 cents a share, seven cents above the consensus estimate. Revenues rose more than 100% year-over-year on a huge production hike. The company should have great earnings visibility going forward as it books 15 to 20 cents of profit in 2014 after a loss in 2013. The consensus has it earning 55 to 60 cents a share in 2015.

Howard Weil, a boutique energy investment research firm, just moved its price target for Emerald to $13 a share, up from $11. This is more than 50% upside from its current price and I expect other analysts to make similar moves in the weeks ahead.

The markets feel like they could give investors some indigestion over the next few months as the Federal Reserve removes the training wheels from equities and the world works its way through some near term geopolitical concerns. We will continue to use any pull back to initiate positions in new and attractive turnaround plays as we build out the portfolio.

Positions: Long EOX & HERO

Current Portfolio

Company	Entry Date	Entry Price	Recent Price	Buy Up To	Target Price	Returns	Russell 2000 Comp. Rtn.
AEGON N. V. (AEG	08/14/14	$7.74	$7.74	$9.00	$15.00	0.0%	0.0%
Hercules Offshore (HERO)	07/18/14	$4.01	$3.20	$4.25	$6.00	-20.2%	-0.7%
Emerald Oil (EOX)	07/18/14	$7.56	$7.76	$8.00	$12.00	2.6%	-0.7%

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: 08/14/14.

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.