Investors Alley

September 2014 Vol. 1 Issue 3

The Turnaround Stock Report

September Volatility and Coming Entry Points

In This Issue

Fellow Investor,

It has been an interesting month for equities since we last talked about the market in Mid-August. Stocks continued their rise throughout August, posting their best performance overall in that month in 14 years. However, equities have hit more resistance since the S&P 500 hit the magical 2,000 level for the first time ever in early September. I think this level could be a tough bar to get past until we start to see Q3 earnings reports in early October.

One of the developing trends in the market is the strengthening of the dollar against major currencies such as the Yen and the Euro. The Euro is down more than 5% from recent highs and that decline could accelerate after the European Central Bank announced what some are dubbing “QE Lite” last week. The strengthening dollar is having numerous impacts to the global currency and equity markets, including driving a sell-off in gold prices from their earlier highs earlier this summer. I've included in this issue an abridged version of a piece I recently wrote on the Investors Alley website on the return of "King Dollar”.

Oil prices have continued their recent decline over the last month and are now down some 15% from recent levels. As one might imagine, this has impacted the energy complex with significant declines in the stocks of exploration and production (E&P) companies of particular note. Some of these pull backs are overdone in my opinion. Most of these production concerns hedge most of their forward production of oil and natural gas, so the recent declines in energy prices are likely to have less of an immediate impact to earnings than most investors assume. I have been adding to some of my favorite plays in the space on the recent dip.

Ukraine and ISIS continued to be geopolitical worries and are prone to “flare ups” that bring volatility to our markets; these should remain as “watch items” for investors. I would also be cognizant of the outcome of the vote for Scottish independence on September 18th. A “Yes” vote is unlikely but possible. Independence would have some serious implications for the global markets. The Conservative Party prime minister in the United Kingdom would almost certainly have to step down as the leader of the party. Sterling’s recent decline would accelerate and the dollar would strengthen further.

Finally, the markets are vulnerable here at near all-time highs. September and October have traditionally been volatile months as traders return from their summer vacations. In addition, the Federal Reserve will attempt again to end its latest quantitative easing program in October. The first two attempts caused double digit declines in the equity market; hopefully the third time will be the charm.

I have my own portfolio on a cautious stance with a higher allocation to cash than normal. We anticipated a more volatile market by the end of the year so are prepared to act on any significant dip in the market. It is the core reason we are slowly building our portfolio of "turnaround" stocks instead of rolling out a big portion of the portfolio upfront.

The chances to get lower entry points in some segments in the market are highly probable and we want to take advantage of any declines. August was a great month for investors. September has seen the markets struggle a bit at current levels and October should be a critical month with Federal Reserve actions and with third quarter earnings coming in to determining whether the market can go higher from near record levels.

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
The Turnaround Stock Report

Chesapeake Energy: Unlocking Shareholder Value NYSE: CHK

One of my more successful investing strategies over the past few years is in buying mid-cap exploration and production concerns that decide to simplify their portfolios, shed non-core assets, and become more "oily" in their production.

Sometimes these efforts were driven as the result of agitation from activist fund managers like Elliott Management. Sometimes they were internally triggered. Two of these notable gainers are **Devon Energy (NYSE: DVN)** and **Hess Corp (NYSE: HES).** The stock of Hess had more than doubled since Elliott Management first targeted it in 2012 and Devon is up 30% over the past 12 months and their transformation still has a ways to go to fully play out.

I have started to accumulate stock in **Chesapeake Energy (NYSE: CHK).** The company it looks like it is starting to implement that same game plan as Devon and Hess: a case of if you cannot beat them then join them. I believe this strategy could unlock significant shareholder value as the shares are trading at the same level as they were five years ago as almost every other mid-cap E&P concern is up substantially over that time span.

Company History:

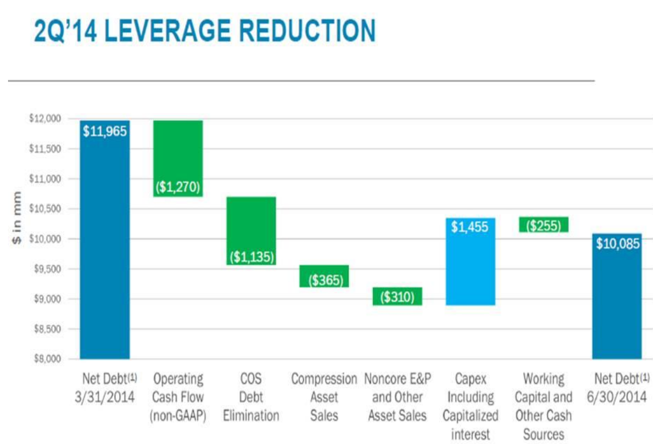
For most of its history, Chesapeake Energy was led by the flamboyant billionaire Audrey McClendon, owner of the NBA's Oklahoma Thunder. Mr. McClendon's growth at any cost philosophy transformed the company into the second largest natural gas producer in the United States. This strategy also worked well when natural gas prices were much higher than they are now.

The company capital budget increased much faster than operational cash flow towards the back end of Mr. McClendon's tenure and the debt accumulated started to become a major strategic issue when natural gas prices plunged earlier in the decade. Mr. McClendon stepped down completely from the company in April 2013. New management has instituted a new game plan to reduce debt, grow production from higher margin oil and liquids as well as to unlock significant shareholder value.

Rationalize Balance Sheet:

The company recently announced it will repurchase some $1.25 billion in preferred debt at its Utica unit. This will eliminate Chesapeake's highest cost leveraged instrument and save approximately $75 million in annual cash dividend payments. The result of these asset sales and debt buybacks is starting to be seen in an improving balance sheet.

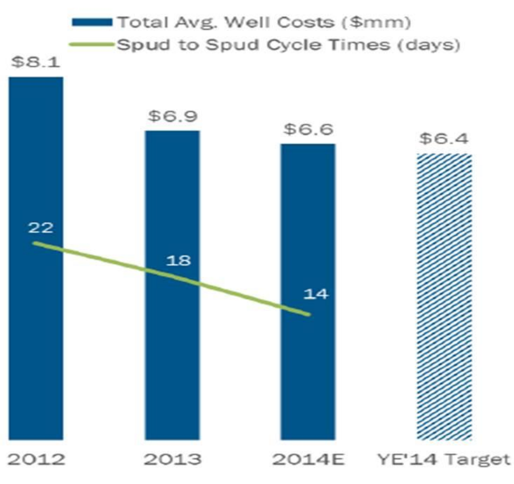
In its last reported quarter the company managed to get solid production increases (see sections below) despite cutting its capital budget by just over 25% year-over-year. The company also reported over $5 billion in liquidity at the close of the second quarter which also saw Chesapeake increase its cash and cash equivalents balance to $1.5 billion from $450 million. As can be seen in the chart below the company is making rapid progress reducing its overall leverage.



Get More Production From Oil & Liquids:

In its last reported quarter, Chesapeake saw oil production increase 12% year-over-year while natural gas liquids increased an impressive 72% over the same quarter in 2013. Oils & Liquids climbed to 28% of total production from just 25% in 2Q2013. This is in line with the company's efforts in 2013 where natural gas production fell by 3% even as Oils & Liquids production rose in the low teens year-over-year.

With Chesapeake's more focused capital budget and continued asset sales and swaps; I expect this growth to continue and/or accelerate in the years ahead. This will be positive for margins and earnings. The company has also done a commendable job using new risk mitigating drilling techniques such as multiwall pad drilling in driving down the cost and time it takes to drill each well. This well cost and time reduction can be seen in recent results on its Eagle Ford acreage. The company is seeing similar reductions in its Marcellus and Utica facilities.



Between well cost reductions, its strategically placed acreage, and other economies of scale Chesapeake is one of the lowest "all-in cost" natural gas producers among the major players. Even though the majority of production is hedged, any increase in natural gas prices will fall quickly to the bottom line as well as improve sentiment on the stock.

Sell-off Non-Core Assets:

This company recently spun off its oil services business as a standalone entity called Seventy Seven Energy Inc. **(NYSE: SSE)** at the start of the third quarter of this year. Chesapeake also recently sold some natural gas compression units for $135 million as well as some non-core acreage in the Marcellus for over $300 million. I would look for the company to continue to prudently prune and consolidate its production portfolio in the months and years ahead which should improve margins and management focus.

As importantly, combined with a more rational capital budget should lessen concerns about Chesapeake being able to maintain its production growth. In 2012 Chesapeake had capital spending of almost $12 billion ahead of its cash flow from operations, but this year and next it is expected to be able to cover its spending almost entirely from its income, marking a huge improvement.

Summary:

I have been accumulating these shares on the recent decline in the energy sector throughout the overall market as oil and natural gas prices have staged an actionable decline over the past three months. With a mild summer this year and the Farmer's Almanac calling for another "big chill" this winter, it is not unreasonable to see this seasonal pattern repeat. Even though most of Chesapeake's natural gas production is hedged, a spike in natural gas prices like during the fourth quarter of 2013 is going to boost sentiment on natural gas producers.

The company's recent efforts are already starting to show up in improved results. In its last reported quarterly results in early August, Chesapeake posted earnings of 36 cents a share which was slightly below consensus. However, revenue came in over $400 million over expectations and the company upped its forward production guidance. Stifel Nicolaus upgraded the shares the next day from "Hold" to "Buy" and placed a $34 a share price target on Chesapeake.

I also like the fact that insiders have been net buyers of the stock over the past six months. The shares only yield 1.3% but I expect dividends to increase nicely over time as the company continues to de-lever. I do not see Chesapeake being able to double like Hess as it does not have the same opportunity to spin off non-core assets, for example, gas stations.

However, I believe it can easily deliver the same 30% return Devon has delivered over the past year as it has executed against the same type of turnaround plan. In a recent investor presentation Chesapeake estimated its current net asset value based on industry standard valuation metrics at some $40 a share. We are going to be a bit more conservative in our projections.

The shares currently go for just over $25 a share. 30% upside from current levels would put us right at $33 a share. This would be approximately 20% under Chesapeake's net asset value calculation and right below Stifel's recent price target on Chesapeake. When the stock gets near this level, we can review how Chesapeake is executing against its turnaround strategy and determine whether to take profits or stay the course for further upside.

Recommendation: BUY CHK up to $27, SELL at $33.

Position: Long CHK

The Return of King Dollar

One of the interesting developments over the past few months is the strengthening of the U.S. dollar against most major currencies. The U.S. economy is delivering better growth than either Europe or Japan (though that's not saying much) and the Federal Reserve is poised to complete its latest quantitative easing program. These trends should continue for the foreseeable future and will have a significant impact on the global equity and currency markets. Some pundits are even calling this the start of the return of "King Dollar".

The dollar is up some seven percent against the Euro since earlier in the summer as the domestic economy is accelerating while the Eurozone's economy stagnates. The Euro's decline is likely to accelerate after last week's decision by the European Central Bank to engage in what has been dubbed "Quantitative Easing Lite".

The Japanese Central Bank engaged in their own version of quantitative easing on steroids last year in an effort that saw Japanese equities climb more than 55% while the currency slid over 20% against the dollar. The Yen's decline has continued against the dollar this year albeit at a slower rate. Given Japan's aging demographics and huge government debt load, it is hard to see how this devaluation does not continue to gain strength. Jeffrey Grundlach, one of biggest managers of fixed income funds in the world, was on CNBC this week with his opinion that the Japanese Yen could hit 200 to the dollar in the next three to five years (source). The Yen currently stands at about 106 to the dollar.

The return of King Dollar has numerous implications for various sectors of the global markets. First, this is not good for the prices of commodities or the stocks of commodity producers. This is especially true for precious metals with gold down more than $90 an ounce since its highs earlier this summer tracking the Euro's decline against the dollar almost perfectly. I would expect this trend to continue and it is why investors should be considerably underweight miners and other commodity producers.

Second, American multinationals that get a good portion of overall sales from Europe are going to see negative currency impacts against their overseas earnings from this region. This is just one more reason not to own names like **McDonalds (NYSE: MCD)** and

IBM Corporation (NYSE: IBM) whose stocks are basically flat, not including dividends, over the past two years as the S&P 500 has shot ahead by some 40% over the same time frame.

Let's go back to the Japanese market for a moment. With the Japanese Central Bank continuing to be supportive, the declining Yen should be good for Japanese exporters and the economy as a whole. Even with last year's rally, the Nikkei trades at a fraction of previous highs in the late 80's. The way investors want to play continuing appreciation in Japan's main index is through a currency hedged index fund which will protect investors from further declines in the Yen while allowing them to post gains if Japanese equities continue to go up.

Ironically, one of the biggest beneficiaries of a lower Euro and higher dollar would be Germany, the Eurozone country that has been the main obstacle to engaging in monetary easing programs earlier. Germany is by far the largest exporter in Europe and one of the largest in the world. A lower Euro makes their goods more competitive against those produced in America and other countries.

One final benefit to a stronger dollar is it should help keep inflation in check as it will increase purchasing power. This is one reason gasoline prices have come down a bit lately. I believe this currency trend is in its infancy, investors should position themselves to take advantage of it.

Portfolio Update

As I noted in this month's opening, the big rally in equities in August has turned into a more meandering market after the S&P 500 hit 2,000 for the first time ever early in September. We are entering the time of year where the markets have seen some historical downdrafts and the market calls for caution at these levels.

☞ NOTE: If we get a significant decline in stocks over the next couple of months we are ready to buy the dip and increase our new portfolio additions to two or three new names a month to benefit from any pull back.

Turning to the three current names in our portfolio, the last thirty days have been a mixed bag. Let's start with Netherlands based insurer **AEGON N.V. (NYSE: AEG).** The stock is up nearly six percent over the last month. The shares have been buoyed by the recent decision by the European Central Bank (ECB) to engage in its own flavor of quantitative easing.

The actions by the ECB have accelerated the decline of the Euro against the dollar. This is a big tailwind for AEGON which I expect will continue to be a positive catalyst for the foreseeable future. Remember, this insurer gets two thirds of its revenues from North America. This means higher earnings as these dollars are translating to Euros. The stock still sells for under 60% of book value and provides an almost 4% dividend as well. I expect this stock's recent strength to continue.

The shares of **Hercules Offshore (NASDAQ: HERO)** are almost exactly flat to where they were one month ago. This is a victory in itself given how negative the sentiment currently is on the offshore drilling space and taking into account the recent declines in oil and natural gas prices. We will continue to be patient on this long term contrarian play.

The stock has built a good technical support level at just over $3.00 a share even as consensus earnings estimates for FY2014 and FY2015 have been revised down 40% to 60% over the past three months. Even with the downward revisions, Hercules should remain solidly profitable and has an over $1 billion order backlog, more than twice the company's current market capitalization. The shares are cheap at nine times consensus earnings for next year and with revenues continuing to run above 2013's levels.

This brings us to our final holding, **Emerald Oil (NYSE: EOX).** The stock was up some five percent in late August from our last update but has sold off some 10% since then as oil prices are now 15% below their recent levels. This has caused almost exploration and production companies to sell off sharply.

I have used the recent dip to add a few shares of this fast growing Bakken producer in my portfolio. The value the market is assigning to Emerald's acreage is less than half that of peers. In addition, 60% of the company's projected production through 2015 is fully hedged. This means the recent decline in energy prices will have a much lesser impact on earnings than the market is anticipating. Earnings estimates have actually gone up 20% over the past three months on a more robust drilling schedule and the company should triple earnings in FY2015 over this year's projected earnings.

The recent pull back in the stocks in exploration and production companies is why I am adding another one of these concerns to our portfolio. It is **Chesapeake Energy (NYSE: CHK)** which is a much larger concern, the second largest natural gas producer in the United States and has a turnaround strategy that differs greatly from the one Emerald is using to deliver shareholder value.

Current Portfolio

Company	Entry Date	Entry Price	Recent Price	Buy Up To	Target Price	Returns	Russell 2000 Comp. Rtn.
Chesapeake Energy (CHK)	09/15/14	$25.05	$25.05	$27.00	$33.00	0.0%	0.0%
AEGON N. V. (AEG)	08/14/14	$7.74	$8.46	$9.00	$15.00	9.3%	0.3%
Hercules Offshore (HERO)	07/18/14	$4.01	$3.16	$4.25	$6.00	-21.2%	-0.4%
Emerald Oil (EOX)	07/18/14	$7.56	$7.62	$8.00	$12.00	0.8%	-0.4%

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: 09/15/14.

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.