Investors Alley
October 2014 Vol. 1 Issue 4
The Turnaround Stock Report

Time for Us to Add More Positions

Fellow Investor,

The market has gotten decidedly scarier for investors over the last month and in front of Halloween. Last week the S&P 500 and Nasdaq had their worst weekly performances since May of 2012. The Down Transports had their worst week since October 2011 despite a fall in oil prices. The decline was driven by both worries about the direction of global growth and the spread of Ebola.

In This Issue

For all intents and purposes the Russell 2000 is in in correction territory. Small caps have struggled mightily despite a lack of exposure to Europe whose slackening growth corresponding with a significant pullback in the Euro is a major concern for the market.

Oil prices have pulled back some eight percent over past four weeks and are down more than $20 a barrel from their recent highs this summer and are firmly in bear market territory. Although the subsequent drop in gas prices should boost consumer spending in front of the holidays the price decline in oil has decimated small and mid-cap exploration and production (E&P) stocks with most declining 25% to 50% since summer.

Chip stocks came under extreme pressure last week after a Q3 profit warning from **Microchip Technology (Nasdaq: MCHP)** which also observed that "another industry correction has begun and that this correction will be seen more broadly across the industry in the near future". Technology was one of the safer havens in the market over the past month before this landmine came to light.

The market is likely to remain volatile as the Federal Reserve hopes to end quantitative easing this month and in front of mid-term elections early next month. It is important to remember the market staged double digit declines on the Fed's two earlier attempts to end this liquidity support. Europe looks like it easily could reenter a recession and the strengthening dollar is hammering commodities, commodity stocks like miners and emerging markets.

In short, it is just plain ugly out there in the equity markets right now. As one would imagine, the stocks in the Turnaround Stock Report have performed dismally over the past few months as these types of stocks are always high risk/high reward plays.

Ending on a brighter note, valuations in the stocks we look at here are much more attractive after recent declines which bode well for future performance. We made a conscious decision when we launched this service to build our turnaround portfolio slowly as we were wary of the valuations in some sectors of the market at that time.

This is the key reason we have added just one new selection a month hoping for a correction to accelerate our investment selections as lower entry points hopefully became available. Thanks to the recent pull back in the market, we are beginning that process in this month’s issue as we are adding two new recommendations that are selling at significantly lower levels than their recent highs. As they saying goes “When life gives you lemons, make lemonade”.

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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Editor
The Turnaround Stock Report

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Dynavax Technologies Corp.: Cheap Vaccine Maker Worth a Shot (Nasdaq: DVAX)

Ebola has dominated the news in recent weeks due a major outbreak in West Africa as well as the first patient in the United States who ended up dying from the disease despite access to world class facilities. These outbreaks happen from time to time in our increasingly connected world and there have been significant scares in recent years including bird flu and SARS.

The recent events have highlighted the need for effective vaccines to fight and prevent these types of outbreaks. It is a good backdrop to add a high risk/high reward vaccine play to our Turnaround portfolio. I have been fortunate over the last two years in getting better than triples in a couple of other vaccine plays including **NovaVax (Nasdaq: NVAX)** and **Inovio Pharmaceuticals, Inc. (Nasdaq: INO)**

In addition, small biotech stocks were plastered in the "risk off" sell-off in early March. Most lost 30% to 60% during that quick six week pull back. Many of these stocks have yet to recover. However, the sector has behaved better recently ironically just as the small energy exploration and production sector has been hammered like these small biotechs were in March.

So let's take a deep look at vaccine maker **Dynavax Technologies Corporation (Nasdaq: DVAX**) which is currently going for around $1.50 a share.

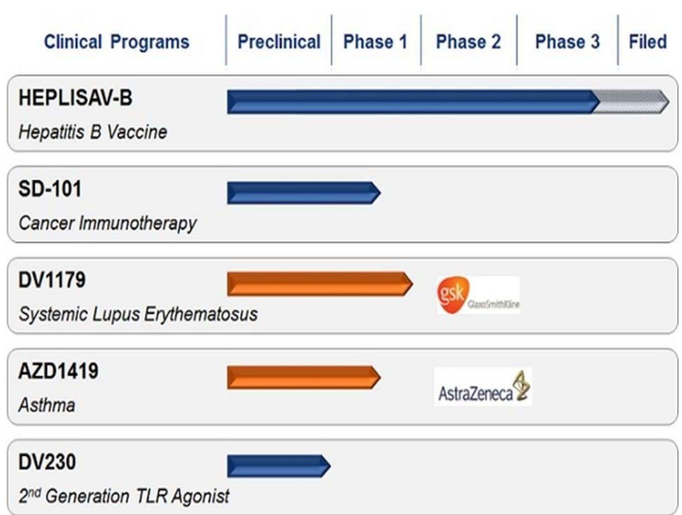
Company Overview:

Dynavax, with a market capitalization of about $400 million, is a small biotech that focuses on pioneering a new approach to therapies for multiple autoimmune and inflammatory diseases including lupus, psoriasis, and rheumatoid arthritis. The company's technology looks to that inhibit Toll-like Receptors (TLRs). TLRs are key receptors of the innate immune system that can induce strong inflammatory responses.

The commercial opportunity is quite large. Over 20 million individuals just in the U.S. and Europe have autoimmune diseases such as lupus, psoriasis, and rheumatoid arthritis. Key biologic drugs used to treat these conditions generate over $15 billion in worldwide sales each year.

The company has several compounds in development. However, near term prospects will be driven by the development of Heplisav-B which is a vaccine in Phase III trials that is targeted at hepatitis B. Hepatitis B is the most common serious liver infection in the world. It comes in two varieties: acute and chronic. Most individuals have the acute version of this disease which affects the individual for 1-4 months presenting symptoms like fatigue, appetite loss, nausea, as well as itching, jaundice, and aches in the liver region. This version of the disease is usually defeated without drugs over a few months.

The chronic version of this type of hepatitis does not go away by itself and can cause a form of liver cancer and death. Children are particularly at risk if they are infected with this type of hepatitis.



The company's early stage development for treatment for Lupus is within a partnership with **GlaxoSmithKline (NYSE: GSK)** and its early stage asthma compound is being developed in conjunction with **AstraZeneca (NYSE: AZN).** Dynavax will receive milestone payments as both compounds reach successive successful endpoints as well as royalty payments should they attain approval and market distribution.

The Turnaround Story:

The stock ran up to almost $5 a share in late 2012 on the anticipation of the approval of Heplisav-B. Unfortunately that is where the company ran into a roadblock. Even though results from its Phase III trials were encouraging, neither the FDA nor its European equivalent would grant approval of the compound. Both agencies cited that there were not enough test subjects in these studies to provide confidence in the efficiency and safety needed to approve Heplisav-B.

As one can imagine, the market was not kind to the stock of Dynavax on the back of these disappointments and the shares plunged to around $1 a share over the next few months. I have been building a stake in this promising vaccine maker as the stock bumped along a bottom and the company gathered itself to overcome the obstacles regulators had put in front of it.

It is important to note that the FDA <u>did not</u> say this compound was ineffective, just that it needed a larger sample size for Phase III trials to be approved. Dynavax has spent the better part of a year enrolling more than 8,000 patients in a new Phase III study for Heplisav-B.

That enrollment was just completed recently and the stock has behaved more strongly as a result. Also helping the shares is the news that **Arrowhead Research Corporation (Nasdaq: ARWR)** just posted disappointing results with that company's experimental hepatitis B drug in Phase II trials.

I believe that it is a likely possibility that Heplisav-B will be approved soon after this huge study is completed probably sometime in the second half of 2015. I am also encouraged that the company has some $150 million in net cash on the balance sheet and should not to have to access the capital markets in the foreseeable future to raise additional funds for development.

Three ways to win:

As we get closer to the end of the new trial, the stock should again run up on anticipation of the approval of this vaccine for hepatitis B. In addition, given the company's small market capitalization, the potential for Heplisav-B if approved, other compounds in early stage development and cash on the balance sheet Dynavax could make a very attractive buyout target even at a substantial premium. The larger pharma players it currently is partnered with could make logical acquirers.

Obviously the biggest catalyst for Dynavax would be the approval of Heplisav-B. The stock ran up to $5 a share in anticipation of approval previously so logically a floor if approved would be $5 a share. I like the risk/reward of this stock at current levels and want to overlay my own risk mitigation strategy on this position as well.

Risk Mitigation Strategy:

Now that sentiment is starting to improve on the small biotech sector six months after a huge sell-off in March and Dynavax has finally completed the huge enrollment for phase III trials for Heplisav-B; the downside for the stock seems limited in the short term. The shares have built two big support levels over the past year and encouraging the second bottom is higher than the first. (See chart on next page.)

In addition, approximately 40% of the company's market capitalization sits in net cash further limiting downside. I expect the stock to run up the closer we get to the end of the new Phase III trial for Heplisav-B just as the shares did in late 2012. Obviously, either a buyout or positive results from the other compounds

Dynavax has in development could be positive wildcards as well.

I believe there is a good possibility that the shares run up to $3.00 a share sometime in 2015 as Heplisav-B move through its final trials. If that possibility plays out, I recommend that investors sell half their holdings in Dynavax at that level. This way we are all playing on the "house's money" and a free ride is never a bad thing in the market. If Heplisav-B is approved I believe Dynavax is at least a $6 stock and we will revisit the investment case for Dynavax at that time. Happy Hunting.

Recommendation: BUY DVAX up to $1.75 a share, sell half of stake at $3.00 a share. Hold other half until Heplisav-B approval decision.

Position: Long DVAX

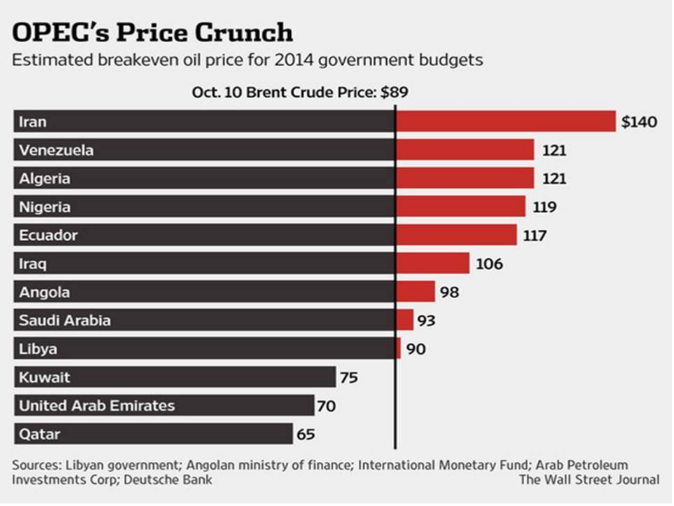
Warren Resources: 40% Decline Too Good to Pass Up (Nasdaq: WRES)

The past several months have not been the best of times to energy investors and the last few weeks having been particularly brutal. West Texas Intermediate (WTI) prices have fallen more than 20% since their recent highs this summer and Brent is touching four-year lows.

The energy sector has suffered deep declines as a result, with small exploration and production concerns getting taken out and treated like a rented mule by investors. Many have been cut in half. The carnage has spread into the stocks that build energy infrastructure, run pipelines and gathering systems and ironically even the Dow Transports which will see their operating costs drop dramatically on the fall in oil prices. The sell-off is approaching irrational levels with all stocks in the energy complex being punished as the baby is getting thrown out with the bathwater.

Part of the decline in oil prices has been triggered by concerns around the prospects on global growth. Another negative recently has Saudi Arabia has upped their production to send a message to other oil producers to toe the line and not cheat on their quotas.

However, most of the countries within OPEC need high oil prices and this should shortly be a counteracting force to the recent fall in oil. Not because their cost of production is high but because of promises they have made to and have targeted for support programs for their people are paid for with oil revenues.



Most of these countries have large swaths of unemployed youth with exposure to radical religious doctrines and thus it is in the best interests of these regimes to do what they can to see high oil prices remain in place.

I believe this is a good opportunity to buy some of the better plays in this sector as I believe capitulation in the energy sector is near and valuations are more attractive than I have seen in some time. One of these is an old friend that I originally bought at around $2.00 a share back in June 2012. I sold earlier this year as it broached $6.00 a share as a triple over two years was just too good of a profit to pass up. However, with the stock's recent steep decline it is time to get back into the fast growing small cap exploration and production concern.

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This is especially true given a recent purchase that transformed the company's production mix and outlook.

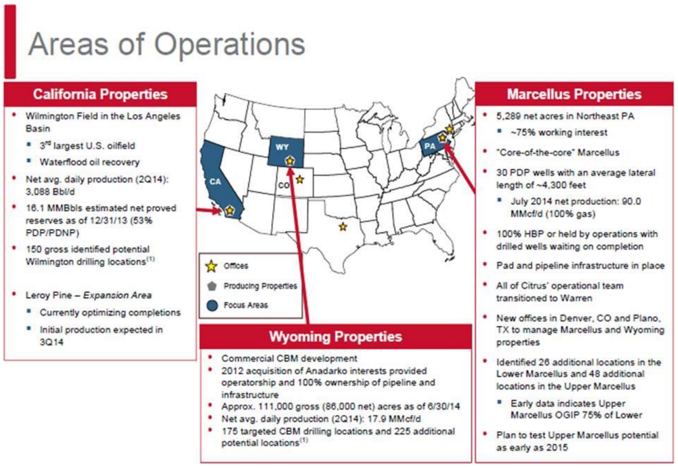
Company Overview:

Warren Resources (Nasdaq: WRES) is an independent energy company engaged in the development and production of domestic onshore crude oil and gas reserves. Until recently the company's primary productive assets consisted of waterflood oil recovery properties in the Wilmington Field within the Los Angeles Basin of California. Warren is also one of the leading developers of coalbed methane natural gas in the Rocky Mountain region with production in southwestern Wyoming. Coming into this summer Warren's production tilted toward oil and liquids.

A Transformative Acquisition:

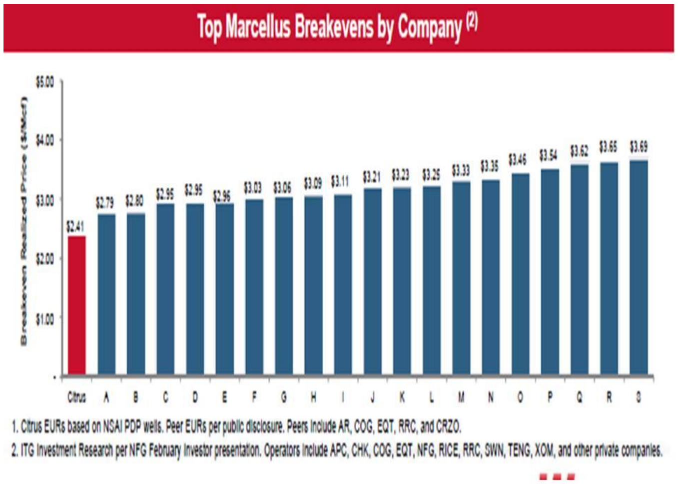
In July the company agreed to purchase almost all of the productive assets Citrus Energy had in the Marcellus region of Pennsylvania for just over $350 million which consisted of $40 million in stock and just over $300 million in cash.

This acquisition will have several important points of impact to Warren over the near and the longer term. First, the company will see a slight decline in earnings this year to account for the shares that were issued as part of the purchase.



Source: Recent Investor Presentation

More importantly this purchase will be significantly accretive starting in 2015 both on an earnings and the cash flow basis as the properties the company bought in the Marcellus consist of some of lowest breakeven acreage in this huge gas field. This new acreage and facilities will also substantially boost Warren's overall production. Integration of these energy assets should accelerate revenue growth into the 40% to 50% range in 2015.



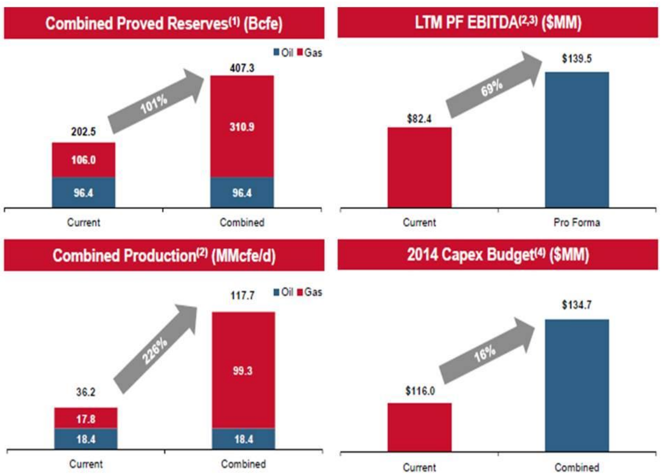
Source: Recent Investor Presentation

Finally, this tilts Warren's production mix to approximately three quarters natural gas. The purchase comes at a very opportune time as natural gas prices have appeared to bottom in recent weeks even as oil prices have continued to plunge. With winter on the way, it is hard to see natural gas prices falling in the near term and another hard winter like this past one could boost these prices substantially.

Massive Synergies:

The transformational impact of this acquisition is hard to overstate. They say a picture is worth a thousand words so I direct you to the chart below. As can be seen, this purchase will tilt production and proved reserves heavily toward natural gas. More importantly, Warren will now be able to achieve huge increases in production and EBITDA with a relatively small increase in its capital budget.

Looking at the synergies of this purchase in these contexts, it is hard not to be excited about purchasing the stock of Warren at these discounted levels.



Source: Recent Investor Presentation

Warren was also able to close financing for its Marcellus purchase before recent volatility in energy prices started to impact financing rates for energy purchases. It was also able to use stock valued at $6.00 a share as part of purchase price instead of today's low values, another positive. Even after the purchase, Warren has ample liquidity and credit facilities, and remains relatively unlevered for a fast growing E&P company. Warren uses rolling hedges to mitigate volatility on two years of forward production as a general practice.

Opportunity & Valuation:

The market has been indiscriminate in the sell-off in the energy sector. Warren has sold off 40% over the past six weeks. This is in line with other small E&P plays. This divergence from Warren's earlier share price is an opportunity as the vast majority of those small cap energy concerns are heavily tilted to oil in their production and their declines are more warranted given the plunge in oil prices. However considering Warren's new production mix on the back of its recent purchase its decline is overdone as it does not correspond to recent action in natural gas prices.

As I previously mentioned, earnings will fall slightly this year to 35 to 40 cents a share. However, thanks to a boost in production provided by Warren's recent purchases, the consensus currently calls for this small cap energy producer to earn some 60 cents a share in 2015.

Summary:

When a sector implodes like energy has recently, it is very hard to step in front of a "falling knife" even as valuations become much more attractive than they were previously on a long term basis. These big dips frequently turn out to be greatest buying opportunities in hindsight that go non-actioned by investors. One way to overcome this fear is by accumulating shares in increments on dips instead of all at one time.

The stock of Warren Resources looks very oversold at current levels after its recent sell-off. The shares go for under seven times forward earnings, a better than 50% discount to the overall market multiple. Given the company's revenue and earnings growth prospects in 2015; a more reasonable multiple would be 12 times forward earnings. This would still be a significant discount to the overall market and would give us a price target of $7.20 a share. Let's conservatively round that down to $7.00 share, which implies 110% upside from the current price levels. Not an outlandish price target given the shares touched this level recently intraday before the bottom fell out of the entire energy sector.

Recommendation: Buy WRES up to $4.50 a share; hold until $7.00 a share.

Portfolio Update

It is getting ugly in the market and one cannot sugar coat that fact any longer. Small caps are in official correction territory and the energy sector has been taken out and shot by investors as oil prices continue to decline thanks to a stronger dollar and worries about slowing global growth. The Philadelphia Semiconductor Index is down more than 15% over the past few weeks and airline stocks have collapsed by more than a third from previous highs in recent weeks partly on worries around the possibility of a worldwide outbreak of Ebola.

The turmoil that originated in high beta sectors has spread to the general market. The Nasdaq, S&P 500, and Dow Transports just posted their worst weekly declines in several years. As we go to press the Dow Jones Industrial Average has had five straight days of at least a 200 point move, something that has not happened since the financial crisis. And it's down 4% in just the past week.

Not surprisingly given what has happened in high beta sectors and the energy complex, the majority of our small selection of turnaround stocks have not performed well at all so far. Turnaround stories are almost always high risk/high reward propositions. When sentiment turns on the overall market, these types of plays tend to get hammered. Our energy positions have been extremely weak over the last month as the sector has been slammed on falling oil prices.

Of our positions in the sector, I like **Chesapeake Energy (NYSE: CHK)** to be the first to turn up in the months ahead. The majority of its production is still natural gas even as the company transforms into a more “oily” concern. Natural gas prices have remained relatively stable during the recent steep downturn in the exploration and production space while oil prices have cratered. Chesapeake has been the baby thrown out with the bathwater and I believe a nice rally will be in order when sentiment improves just a bit on the sector.

Emerald Oil (NYSE: EOX) and **Hercules Offshore (Nasdaq: HERO)** have been treated like ugly redheaded stepchildren over the past month in the market and the latter is priced like it is heading towards bankruptcy, an unlikely scenario even with the challenging environment in the offshore drilling space. The firm still has a better than a $1 billion order backlog which dwarfs its current market capitalization of less than $300 million.

AEGON N.V. (NYSE: AEG) has held up very well despite worries Europe. It continues to benefit from a falling Euro, a trend I expect to continue. Not being a conspiracy theorist but the recent decline is occurring right at the time the Federal Reserve is trying for the third time to exit from quantitative easing. The Federal Reserve had to come in with a new liquidity program after previous attempted exits coincided with double digit declines in equities. As the Ian Fleming quote goes “Once is happenstance. Twice is coincidence. Three times is enemy action”.

This is the primary reason we decided to start our portfolio with just a few turnaround positions when we started this service instead of an established portfolio of our top 20 names. We projected there was a high probability of lower entry points in the market if we were patient.

The vast majority of the eventual portfolio has yet to be constructed and we will now accelerate that effort by adding two new names in this month’s edition as market conditions warrant. This will be a common occurrence in the months ahead if the market holds at these levels or pull backs further. The valuations in the market are becoming much more compelling than they were just a month ago and that is the silver lining in the steep recent sell-off in the market.

Current Portfolio

Company	Entry Date	Entry Price	Recent Price	Buy Up To	Target Price	Returns	Russell 2000 Comp. Rtn.
Warren Resources (WRES)	10/15/14	$3.37	$3.37	$4.50	$7.00	N/A	N/A
Dynavax Technologies (DVAX)	10/15/14	$1.43	$1.43	$1.75	$3.00	N/A	N/A
Chesapeake Energy (CHK)	09/15/14	$25.05	$17.36	$27.00	$33.00	-30.7%	-7.4%
AEGON N. V. (AEG)	08/14/14	$7.74	$7.63	$9.00	$15.00	-1.4%	-7.1%
Hercules Offshore (HERO)	07/18/14	$4.01	$1.53	$4.25	$6.00	-61.8%	-7.8%
Emerald Oil (EOX)	07/18/14	$7.56	$3.44	$8.00	$12.00	-54.5%	-7.8%

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: 10/15/14.

Returns data represents 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.