Investors Alley
February 2015 Vol. 1 Issue 2
Bret Jensen's Blue Chip Gems

Momentum Continues

Fellow Investor,

It has been an eventful few weeks since Blue Chip Gems launched with its inaugural five attractive selections in the large cap growth arena. The market overall has reversed course and erased January's declines as quarterly earnings season for the last quarter of 2014 is now mostly complete.

In This Issue

The oil markets continue to be volatile and the energy complex is still consistently making large weekly moves as crude is still looking for a bottom. The dollar is still strengthening against major currencies but this trend is decelerating a bit from the pace of late 2014. The strong dollar made itself felt during this earnings season crimping profits at American multi-nationals, a trend that should spill over to coming quarters.

Europe remains a mess but some encouraging economic signs have been reported recently even as the Eurozone navigates the latest debt challenges with the new government of Greece. Ukraine is not even close to near a possible resolution, recent "cease fire" notwithstanding, and is likely to be a sporadic geopolitical irritant in the coming months.

Emerging markets are challenging right now with no one sure about the real rate of growth in China, Russia entering a recession due to sanctions and falling oil prices and Brazil going into the tank thanks to falling commodity prices, endemic corruption and high inflation.

On a brighter note, the recent jobs report showed some decent wage growth along with robust job creation. It will be interesting if this can continue in light of the significant layoffs starting to occur in the high paying oil and gas industry and all of the smaller businesses that support them and their former employees.

Consumer confidence is strengthening concurrent with falling gas prices and an improving job market. This should bolster consumer spending in the months ahead. Housing is showing some "green shoots" as mortgage rates are near historical lows, credit requirements are starting to be relaxed and consumers have more confidence to make significant purchases outside of the oil patch.

Look for lots of commentary around when, if and how much the Federal Reserve will lift interest rates later this year as the market will be impacted by the latest consensus on Fed policies. The strong dollar is putting policy makers in somewhat of a bind as any interest rate hike will strengthen the greenback and put a further cramp on corporate earnings. On the flipside, a stronger dollar means less inflation allowing the Fed more time before they need to boost interest rates.

With the S&P 500 projected to see low to middle single digit growth in earnings in 2015, the market feels fairly or slightly overvalued here at around 18 times trailing earnings. However, the United States remains the best house in a bad neighborhood which could continue to attract fund flows as there are few alternatives to U.S. equities for growth investors at the moment.

We are still finding some reasonable bargains in the large cap growth arena and this month we offer up a "best of breed" refinery play as well as a sold off pharma play that has a great pipeline, attractive valuations and a solid dividend yield.

If you ever have a question or comment you can reach me at bret.jensen@investorsalley.com.

Thank you and Happy Hunting.

Bret Jensen
Editor
Bret Jensen's Blue Chip Gems

Valero Energy: Playing Oil without Exposure to Oil Prices

In our second monthly edition of Blue Chip Gems we are adding a company from the energy sector. It is our first equity from this sector and it will probably be the only selection for our initial twenty stock portfolio we are slowly building in 2015.

I believe an attractive large cap growth portfolio that delivers consistent returns should consist of stocks not dependent on commodity or energy prices. To some extent our selection meets that criteria and the company is well-positioned to benefit from the continuing expansion of North American crude production regardless of oil prices go up or down. The selection is **Valero Energy (NYSE: VLO)**, the largest refiner on the North American continent.

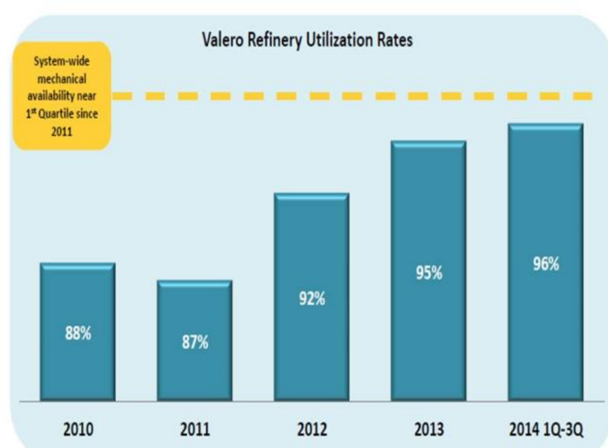
There are myriad reasons to build a position in this well run component of the expanding energy economy. The shares are attractively valued on a long term basis, the company is well positioned for the rapid oil production coming from many areas of the country. I addition, the stock has a nice dividend yield with significant dividend hikes looking very likely in the foreseeable future. Finally, the company is the best positioned of all the major refiners for increasing exports in the years ahead. Valero already gets over 20% of its revenues from exporting refined products and this should continue to make up an increasing amount of its overall sales mix as the company benefits from the nation's increasing energy bounty.

Enviable Long-Term Position

Valero has 15 conventional refineries that convert nearly three million barrels a day of crude into marketable refined products. The company owns 70% of the refinery capacity in the Gulf Coast and Mid-Continent which has seen an explosion of production growth in recent years. These are valuable assets as crude production continues to increase in this country keeping in mind that stringent environmental restrictions have kept any major new refinery complex from being built since the late 70s. These refineries are also well positioned on the Gulf of Mexico to ship product to Europe, Asia and South America.

Valero's facilities also have the advantage that they can process heavy crude from Canada and Mexico, which is even cheaper than the benchmark U.S. oil price. Valero's geographical footprint also lowers the long term input costs for the company especially as natural gas prices have also come down drastically due to huge production growth there as well. Logistical costs should continue to fall as infrastructure continues to get built throughout the various shale formations from which Valero gets feedstock for its refineries.

The company has done a great job of optimizing its collection of prime assets over the past couple of years resulting in increasing in impressive utilization increases.

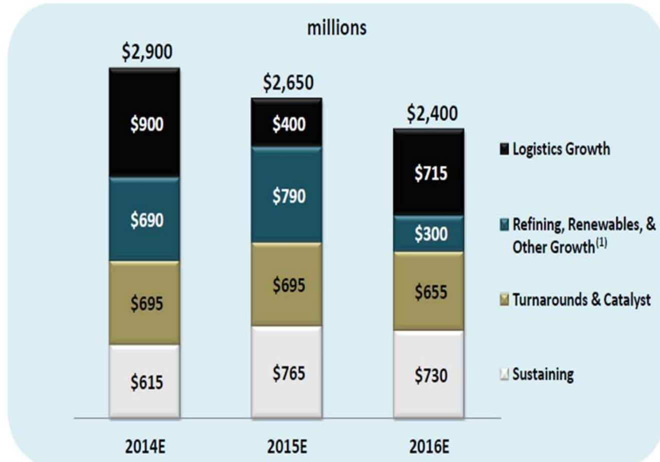


Rewarding Shareholders

The company announced a whopping 45% dividend hike announced late in January. This was just the latest part of Valero's long-term focus on using its free cash flow to reward its stockholders. These efforts have been exemplary and should continue if not accelerate over the medium term for a couple of quantifiable reasons. The company has also been accelerating stock buybacks in recent years retiring a good portion of outstanding float and boosting earnings per share.

Source: January Company Investor Presentation

One of the reasons shareholders should expect Valero to continue to increase dividend payouts and stock buybacks over the next few years is that capital expenditures should slow. Valero has added capacity, invested in building an ethanol business and upgraded facilities. It should now start to reap the rewards for those efforts resulting in higher free cash flow and more funds available to return to investors in coming years. As can be seen from the chart below, Valero's capital expenditures needs should drop significantly in the coming years.



Source: January Company Investor Presentation

In addition, in late 2013 the company also spun out an energy partnership aptly named **Valero Energy Partners (NYSE: VLP).** This entity is a fee-based, growth-oriented, traditional master limited partnership formed to own, operate, develop and acquire crude oil and refined petroleum products pipelines, terminals and other transportation and logistics assets. Valero owns entire 2% general partner interest, all incentive distribution rights, and 68.6% of the limited partner interest.

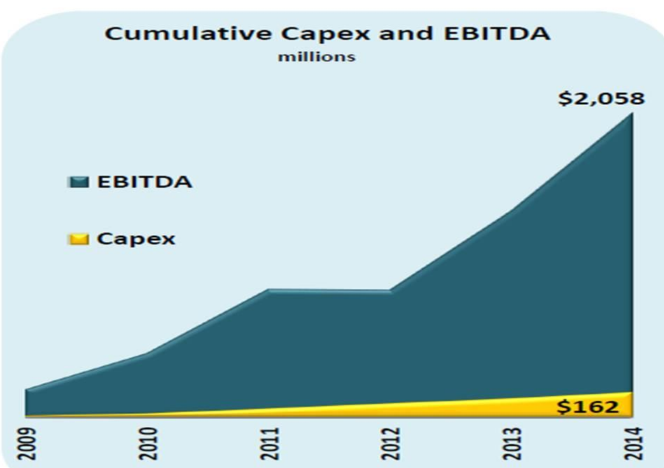
This gives Valero a great vehicle to "drop down" assets to concentrate on higher returning parts of the business. This does several shareholder friendly things for the company. Spinning off lower returning assets improves the company's overall return on invested capital. These types of assets tend to rewarded with higher multiples to cash flow within a partnership structure that has to pay at least 90% of this distributable cash flow out to unit or shareholders. Proceeds received from these drop downs also improves Valero's already solid balance sheet and should give it even more flexibility to add to its dividend payouts and stock buybacks.

Valero has plenty of possible drop down assets such as retail locations, storage, rail and terminal facilities. I would look for the company to be very active utilizing this new channel to enhance shareholder value in the coming years. The company recently guided to approximately $1 billion in drop down assets channeling into Valero Energy Partners in 2015. VLP was also upgraded to “outperform” at Credit Suisse in late January and Valero’s substantial ownership stake in this entity should continue to increase in value.

Major Ethanol Play

Valero made a bold bet in 2009 during the depths of the financial crisis to enter the ethanol business. It bought 11 ethanol refineries for just under $800 million which had an annual capacity of roughly 1.3 billion gallons of ethanol. It paid approximately 35% of the replacement value for these facilities, a shrewd and strategic move.

As can be seen from the chart below, this investment has already been paid back handsomely and the continued cash flow from these shrewdly and timely acquired assets is just “gravy” as this point in time and a business that will continue to be a nice enhancement to shareholder returns that most investors do not realize.



Source: January Company Investor Presentation

Summary

The company reported its latest quarterly results late in January. The company delivered a report that easily surpassed both top and bottom line expectations.

Valero posted earnings of $1.83 a share, more than a half a dollar a share above the consensus. Revenues declined year-over-year thanks to falling gas prices, but also came in around $1 billion above expectations. The company has now beat bottom line estimates by a wide margin for three of the last four quarters as analysts have consistently underestimated Valero’s earnings power and operational excellence.

As stated in the beginning of the investment case for Valero, this will be most likely to be the only Blue Chip Gems holding within the energy sector as earnings can be “lumpy” in this space. However, Valero’s combination of value, ability to benefit from increasing oil production in the United States, geographical footprint and improving business fundamentals are hard to ignore.

The company has a great portfolio of assets and is focused on rewarding investors over the long term. The stock goes for just over 8 times trailing earnings, in a market trading at around 18 times trailing earnings. The stock has an almost three percent yield which I project will increase some 40% to 50% over the next couple of years. This is a stock I have been accumulating slowly over the past year on every significant dip in the overall market. This is a strategy I will continue to employ as I believe Valero offers great value over the long term.

Position: Long VLO

AbbVie: One of the Cheapest Big Pharma's You Need to Own Now

For our second selection for the February edition of Blue Chip Gems, we are adding another big pharma play to go along with one of our inaugural recommendations of **Gilead Sciences (NASDAQ: GILD)**. **AbbVie (NYSE: ABBV)** is a logical and complimentary offset for our investment in the biotech juggernaut. AbbVie just entered the hepatitis C space with its Viekera Pak. Although inferior in many ways to Gilead's hepatitis C drugs of Sovaldi & Harvoni, it should still garner some 15% to 20% of the huge global market for hepatitis C treatments according to most analysts' early takes on the new competition.

Abbvie also has the biggest selling drug in the world based on global sales with a compound named Humira which is used to treat patients older than 18 years of age with moderate to severe rheumatoid arthritis. Humira is also approved to treat ankylosing spondylitis, Crohn's disease, ulcerative colitis and plaque psoriasis in the United States. Sovalid/Harvoni will compete with Humira for the bestselling drug in 2015.

The patent for Humira will expire in the United States in December 2016 and in Europe in 2018. Until then, sales should continue to increase 10% to 15% annually and vie for top selling honors worldwide. After patents expire, biosimilars will come to market and according to most projections will take 30% to 40% of the market share for this blockbuster drug. That being said, Humira can be expected to rack up sales of approximately $10 billion or more even in outer years as it is not as easy to duplicate as some less complex blockbusters that have come off patent in recent years like Lipitor from **Pfizer (NYSE: PFE).**

Luckily for AbbVie's shareholders it has other drugs on the market as well as a huge pipeline with some 40 drugs in various stages of development. The company also has a solid balance sheet, has issued strong guidance, is cheap compared to peers and pays an over three percent yield as well. Let's take a look at some of the core components of AbbVie's investment case.

Diversified Drug Portfolio

AbbVie has a myriad of other drugs on the market, the most important and visible of which is the Viekera Pak consisting of multiple drugs in a combo that is taken twice a day. This course of treatment for hepatitis C is 95% effective in curing the disease and has a price advantage to Sovaldi/Harvoni. It cannot be used with certain other conditions (Ex, anemia) or for all forms of hepatitis C.

That being said, Viekera Pak is a multi-billion dollar franchise with the company recently stated it believes this drug combo will exit 2015 at a run rate of $3 billion in annual global sales. The treatment is approved in the United States, Europe and AbbVie just filed for approval in Japan which has over one million hepatitis C carriers.

The company also has a stable of other drugs that are racking up between $100 million to $300 million per quarter including AndroGel, Kaletra, Synagis, Synthroid, Lupron, Sevoflurane, Creon and Dyslipidemia as well as several other compounds doing less than $100 million per quarter in annual global sales.

Drug Pipeline

AbbVie has one of more impressive drug pipelines in the pharma and biotech space. It has over 40 active clinical development programs currently ongoing both internally and within partnerships. These include at least five compounds in Phase II trials for arthritis that could help the company stave off competition from biosimilars when Humira starts to come off patent.

The company has a very exciting unfolding oncology pipeline as well. Numerous Phase II trials are underway in this field as well as Phase III trials underway for Leukemia, breast cancer and multiple myeloma. AbbVie also has Phase III trials underway for compounds to treat endometriosis, a type of multiple sclerosis and diabetic kidney disease.

2015 and 2016 will see many milestones being reached within this vast pipeline. Combined with the successful rollout of the Viekera Pak, AbbVie should be able to weather Humira coming off patent and still achieve revenue and earnings growth.

Valuation

During the company's recent quarterly earnings call, AbbVie's management guided earnings per share in 2015 to a range of $4.25 to $4.45 a share. Management also stated gross margins should increase 100bps year-over-year while more importantly operating margins will improve 400 bps over 2014. At midpoint of guided range, earnings would increase slightly above 30% over 2014's levels. The current consensus calls for profit to gain some 10% to 15% in FY2016 as well.

AbbVie increased its dividend payout 17% in 2014 and the stock now yields 3.5%, the highest dividend payout of any large biopharma firm right now. The company is also using its increasing cash flow by rewarding shareholders through increasing stock buybacks. The company has stated it will buy back $5 billion worth of shares over the next two to three years which would remove some five percent of outstanding float at current prices.

Solid Entry Point

The stock has declined some 15% recently and offers a solid entry point to start accumulating this Blue Chip Gem with a high dividend yield and good growth prospects. The triggers for the decline were primarily twofold. The company had to pay a $1.6 billion breakup fee to **Shire plc (NASDAQ: SHPG)**, a merger that did not go through thanks to the kerfuffle in Congress around "tax inversion" in pharma space in the last half of 2014. There also has been some weakness in the stock as there was some "buy the rumor, sell the news" activity around the rollout of the Viekera Pak.

Summary

AbbVie is going for just over 13 times forward earnings in an overall market that currently sells for just over 16 times forward earnings. This is despite projected earnings growth of just over 30% this fiscal year on a revenue increase in the mid-teens. Looking at the consensus for FY2016's profits, ABBV goes for under 12 times earnings two years out. In contrast, the stock Pfizer goes for 15.5 times FY2016's projected earnings. Pfizer also has a lower dividend yield as well as lower projected earnings and revenue growth over the next couple of years. AbbVie's pipeline is also superior to the drug giant which is one reason Pfizer has been on a huge acquisition spree recently.

In conclusion, AbbVie is a solid long term growth and dividend play at current levels. Earnings and revenues are increasing at an impressive pace. The company should also be able to replace the loss of sales from Humira as it comes off patent given its stable of existing drugs as well as one of the deeper pipelines in the industry. The company will also continue to reward shareholders with dividend hikes and stock repurchases. If priced in line with peers, the shares would go for 30% to 40% above their current valuation. This is a valuation discount that will eventually narrow and the stock is a buy at these levels.

Position: Long ABBV

Portfolio Update

The five recommendations in the inaugural edition of the Blue Chip Gems portfolio got off to nice start within a fairly strong market environment since launch. The star of the portfolio not surprisingly was **Apple (NASDAQ: AAPL).**

The tech giant reported a quarter for the ages booking some $18 billion in profit in the fourth quarter while easily blowing through top and bottom line expectations. The company sold an eye popping 34,000 iPhones per hour during the just completed quarter. Read that again and let it sink in for a moment.

Not unexpectedly the blow out quarter has triggered a rash of analyst upgrades and upward revisions on the price target. The stock is up almost 20% in recent weeks but the shares are still cheap compared to the overall market. The Apple Watch is set to launch in a few months, Apple Pay continues to gain impressive traction and I would expect a dividend hike along with next quarter's results.

Micron Technology (NYSE: MU), the other tech stock in our portfolio, performed well over the last week as it renegotiated a joint venture agreement with a Taiwanese partner which alleviated some of the concern about DRAM pricing within the market. Jefferies also upped its price target on this chipmaker to $42 a share recently which is substantial implied upside from where the stock is trading.

Las Vegas Sands (NYSE: LVS) posted better than expected earnings thanks primarily to strength from its Singapore operations which offset somewhat a still struggling Macau environment. The company also confirmed it will raise its dividend 30% in 2015 and the shares now yield north of 4.5% at current levels. I expect Macau will start to turnaround in the second half of the year in front of the company's opening of the 3,000 room Parisian Macao now scheduled for early 2016.

JP Morgan (NYSE: JPM) is up slightly since portfolio launch which is a positive given major banks' earnings continue to be under pressure. Regulatory costs should start to ebb in the quarters ahead and interest rates have started to move upward over the past week or so which will be a significant positive for net interest margin.

Gilead Sciences (NASDAQ: GILD) has been the one disappointment in the portfolio so far and is down slightly since our inaugural edition of Blue Chip Gems. This is despite the company reporting blowout results that easily exceeded the top and bottom line expectations.

Discounting in the hepatitis C market will accelerate in 2015, but the market is overly pessimistic on this name. Domestic hepatitis C scripts should increase to 250,000 in 2015 from just over 140,000 in 2014 and I look for Japan to approve Sovaldi/Harvoni by the end of the first half of the year.

The company announced its first ever dividend along with earnings and the stock will have an initial yield of 1.6%. Gilead also added a whopping $15 billion to its stock repurchase program, enough to retire approximately 10% of the outstanding float at current prices. I added a few shares on the recent dip as the shares go for just over 10 times forward earnings. I expect an approximate 15% year-over-year earnings gain in FY2015 on back of a six to 10% revenue increase. The stock remains one of the cheapest large cap growth plays in the market.

Current Portfolio

Company	Entry Date	Entry Price	Recent Price	Returns	S&P 500 Comp.
AbbVie (ABBV)	02/13/15	$58.05	$58.72	1.4%	0.2%
Valero Energy (VLO)	02/13/15	$58.60	$58.73	0.2%	0.2%
Gilead Science Inc. (GILD)	01/16/15	$100.71	$103.84	3.1%	4.0%
Micron Technologies, Inc. (MU)	01/16/15	$28.99	$32.33	11.5%	4.0%
Apple Inc. (AAPL)	01/16/15	$105.99	$127.83	20.6%	4.0%
JPMorgan Chase & Co. (JPM)	01/16/15	$55.93	$60.10	7.5%	4.0%
Las Vegas Sands Corp. (LVS)	01/16/15	$54.89	$60.43	10.1%	4.0%

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: 02/17/15s. Returns is share price appreciation or depreciation between entry price and recent price. S&P Comp. represents the returns on the S&P 500 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.