Investors Alley
May 2015 Vol. 1 Issue 11
The Turnaround Stock Report

Even in This Market Bargains Remain

Fellow Investor,

The market has continued to trend higher over the past month. This is a fairly impressive performance given first quarter earnings for the S&P 500 came in flat year-over-year thanks mainly to the strong dollar, tepid global demand and the collapse in profits in the energy sector thanks to much lower oil prices versus the same period a year ago.

In This Issue

In addition, earnings would have easily been negative had it not been for the huge number of stock buybacks currently being done. In April, companies announced $141 billion of new stock repurchase authorizations; an all-time record. Although a tailwind for earnings, this kind of activity usually occurs near market tops. It also is not encouraging given business investment levels remain very tepid, this is hardly a vote of confidence by the business sector in the economy.

Although it is nice that stocks have managed to climb a “wall of worry” throughout 2015, I am getting more and more concerned about the near term direction for equities in front of the first Federal Reserve interest rate hike since 2006 which most likely will occur either in September or December. I am also concerned about the recent divergence between the Dow Jones Industrial Average and the Dow Jones Transports, something that historically has signaled a coming break down in the market. (See chart above.)

I am also watching the sovereign credit markets right now. The 10 year treasury yield has backed up some 60 basis points since it lows of the year. German Bunds have also sold off recently. Finally, Greece is once again on the verge of defaulting and being pushed out of the Eurozone. Although yet another last minute deal to kick the can down the road is the most likely outcome, both sides seem closer to acknowledging what in the end looks like destiny. The continent is much more insulated from this possibility that in was in 2010 or 2011; however, such an event will still bring turmoil to the global markets.

With the markets trading at 18 times trading earnings, interest rates moving up and flat earnings and economic growth so far in 2015; it is hard to be optimistic about the market at current levels. This is about as cautious as I have been since the recession ended in June of 2009. I am up to 15% cash in my portfolio.

Although I think that it is very likely lower entry points will present themselves at some point before the end of summer; I am still finding some bargains. In this month's edition of the Turnaround Stock Report we profile two companies most investors are aware of and whose stocks have sat up the recent grind up in the market and offer good value in an otherwise overbought market.

I'm always here for you. If you have any questions about the strategy or the stocks in the portfolio please feel free to email me at bret.jensen@investorsalley.com.

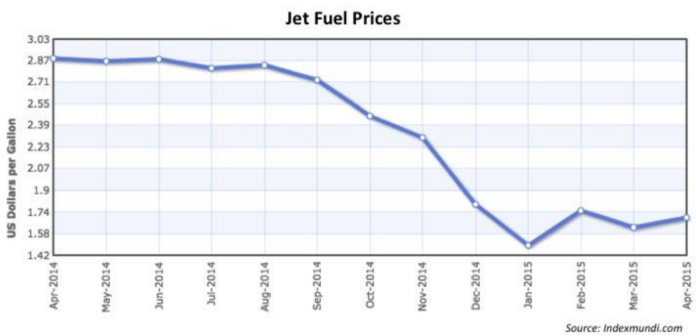
Bret Jensen
Editor
The Turnaround Stock Report

P.S. In late June I plan to officially launch my new *Biotech Gems* service to the public. In mid-May we beta published our first issue and took on subscribers. There have been a few requests to open up the service to *Turnaround Stock Report* subcribers before going fully public with it. If you're interested in being a beta tester and early subscriber **just click here for a short description of the service and a link to sign up**.

The Turnaround Stock Report

DAL: Superior Management and Low Fuel Prices

This month we delve into our first selection from the transportation sector which has been weak recently providing some lower entry points. Crude oil prices have seen a sharp decline and have ravaged much of the energy sector over the past nine months. However, this has been a positive tailwind for the airline industry. Jet fuel prices are closely linked with the cost of crude and the pullback in oil prices has resulted in much lower costs and firmer margins for the industry.



Delta Airlines (NYSE: DAL) stands out as the most successful player in the ever-shrinking commercial passenger aviation industry. The share have appreciated approximately 20% over the past year but the stock has even greater upside potential after some recent weakness. Lower fuel prices, consolidation within the industry, increasing free cash flow and Delta's desire to return money to its shareholders through buybacks and dividends are compelling reasons to purchase a stake Delta Airlines right now.

Consolidation:

The airline industry has long been crowded field with too many players. This has resulted in ruthless price competition driving the profitability of some companies into the dirt. A boom and bust pattern has existed in the past, in which good economic times brought solid earnings, but recessions led to bankruptcies. The significant consolidation across the industry has trimmed the competition considerably.

Various high profile mergers have occurred between Delta and Northwest in 2008, United Airlines and Continental in 2010, AirTran and Southwest in 2011, and more recently between American Airlines and US Airways. As a result, more than 80% of the U.S. travel market is now covered by just four carriers including United Continental, Delta, Southwest and American Airlines.

Consolidation within the airline industry has enabled firms to maintain strict discipline as it pertains to price competition and expansion. Previously, airlines added new capacity in an attempt to grow market share at the first opportunity. As the supply of seats increased more rapidly than demand, airline carriers were forced to charge lower fares and attempt to undercut their competitors which eroded margins.

The four primary carriers controlling the domestic airline industry have consistently indicated that they will increase capacity at a restrained rate, less than the growth in demand. This has led to increasing load factors and stable prices even as it has led to more crowded flights. The airline industry has stabilized significantly from its more tumultuous past, and Delta Airlines is poised to capitalize.

Fuel Savings:

Delta reported that at current levels, the decline in fuel prices will provide a net benefit of $2 billion to it in 2015. Like other carriers, Delta Airlines hedges jet fuel costs to help eliminate volatility associated with the difficult to forecast oil market. Hedging guarantees the delivery of a particular quantity of fuel in the future at a specified price as well as protects the airline from spikes in jet fuel prices.

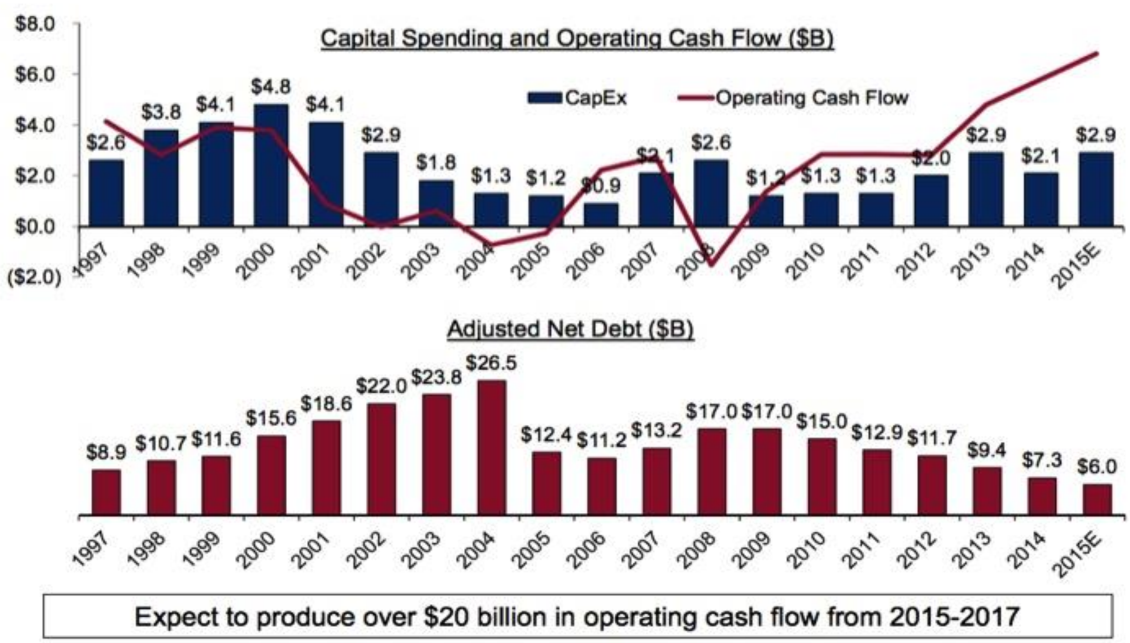
Delta Airlines' highly hedged fuel positions on a recent decline in oil prices required restructuring enabling the firm to take advantage of the low market rate. Following restructuring, its price per gallon should fall by about 20%, consistent with the industry average. The two billion dollar net benefit to Delta previously noted is a solid earnings tailwind that will help its already impressive cash flow continue to grow.

For the June quarter, Delta is approximately 40% hedged against an increase in prices but has nearly full downside participation to crude prices of $40 a barrel. It is important that the firm retain some upside protection going forward, as oil prices remain difficult to forecast, and volatility could spike. Delta signaled in its most recent earnings call that it is positioned to benefit if fuel prices remain low through 2016. I expect the airline will set hedges for fuel near their current low levels to lock in that tailwind in case oil prices significantly appreciate over the long term.

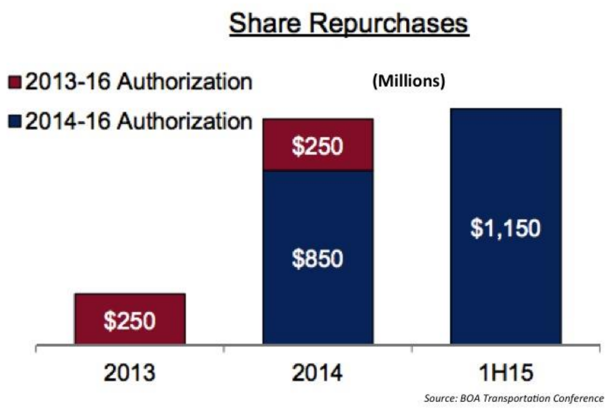
Cash Flow:

Delta is on track to generate an impressive $4 to $5 billion in free cash flow annually, up from about $3 billion currently. Management has done well in strategically utilizing this additional cash flow, reducing debt by nearly $10 billion over the last five years and maintaining disciplined capital expenditures. The company will complete a $2 billion repurchase authorization program this quarter, more than one year ahead of expiration, and will have returned $3 billion to shareholders in just two years.

Looking forward, Delta announced a new $5 billion repurchase authorization through 2017. This is almost 15% of the stock's outstanding float at current levels. The firm plans to return at least 50% of free cash flow to shareholders going forward, and will do so through dividends and buybacks. Its annual dividend per share will increase to $0.54 in the fourth quarter, and share repurchases should total slightly over $1 billion in the first half of 2015.



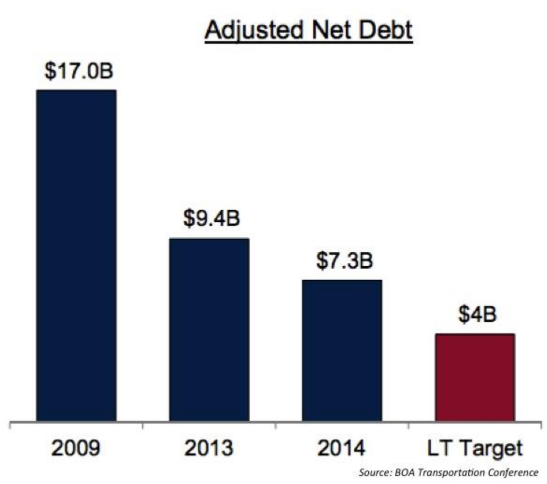
Source: BOA Transportation Conference



Delta Airlines is focusing intently in rewarding its shareholders. Considering the carrier completed its 2013 and 2014 repurchase authorizations approximately two years ahead of expiration, I am confident management will continue to deliver on its promises. Delta currently has a free cash flow yield higher than 90% of the S&P 500. Management is doing an excellent job putting that money to work by rewarding shareholders, reducing debt and reinvesting in Delta.

Balance Sheet and Valuation:

The carrier has solidified the balance sheet by reducing debt and is approaching its $4 billion long-term adjusted net debt target. Delta is progressing toward investment grade credit status after Standard & Poor upgraded its credit rating on Delta three times in the last 18 months. Interest expense will fall to $200 million annually once the airline hits its debt target, which should help bolster earnings and lower financial risk.



With plans to invest around $3 billion annually into its fleet, facilities, and technology the quality of Delta Airlines' assets will only improve. An estimated 20% of Delta's mainline fleet will be replaced over the next three years which will make the airline more fuel efficient and reduced maintenance expenses as well.

Delta delivered a record pretax income of approximately $600 million in the first quarter, improving its pretax margin slightly over three percent. After earning approximately $3.30 a share in FY2014, Delta is on track to earn over $4.50 a share in FY2015 and the current consensus has the company posting a profit of over $5.50 a share in FY2015. This leaves the stock trading at eight times next year's earnings, half the overall market multiple. Some discount – say 10-12 times forward earnings – is warranted given the cyclical nature of the industry, but the shares do appear to be significantly oversold.

Now is an opportune time to pick up shares with the recent pull back in the stock due to the rise of oil since the end of the first quarter back over $60 a barrel and some concerns that the industry might be losing some of its capacity discipline. I believe the recent rally in oil is about over as new supply will come online if shares broach $65 a barrel and with the industry in the hands of so few players; the remaining players should remain disciplined around adding new capacity over time.

Eight analysts have a median share price target just under $60.00 a share on Delta, which is currently trading around $44.00 per share. Consolidation of the airline industry, the tailwind provided by low oil prices, and Delta's wise management of its impressive free cash flow and a strong balance sheet is a solid combination.

With the stock down some 10% from recent highs, this is a good opportunity to buy into this company's transformation into a better disciplined and less leveraged transport. If things continue to go right the shares could easily hit $60 a share over the next 12 -18 months which would be approximately 11 times the earnings expected in 2016.

Recommendation: Buy DAL up to $47.00 a share and hold up to $60.00 a share.

Position: Long DAL

YHOO: Poised for a Move

Our second stock is **Yahoo! Inc. (NASDAQ: YHOO)**, an internet pioneer that has been an ugly "also ran" in the market for most of the last decade. However, thanks to some investments in Asia made after the internet bust as well as a new leader who seems intent on unlocking the value of those stakes and making the investments necessary to finally restart growth in its core business the stock has staged quite the turnaround over the past couple of years.

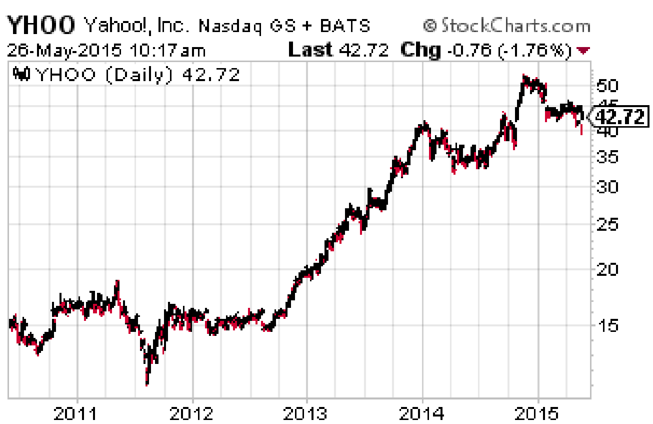
Investors are getting a nice chance to play this "sum of the parts" story after a steep one-day decline this month as a prime example of how a news release can result in a severe overreaction from investors. Thanks to a general statement released by the IRS, investors rushed to the conclusion that Yahoo's spin-off of its significant stake in Alibaba Group (NASDAQ: BABA) would be suspended or hit some serious roadblocks.

The market's intense focus over the past months on the Alibaba spin-off has stolen the spotlight away from Yahoo's other assets. The company possesses an equity interest in Yahoo Japan, and a significant number of internal moving parts as it tries to solidify its businesses. Management is actively engaged in turning around the company as its core of PC advertising declines, and recent growth in Yahoo's mobile and video segment is a good start. Let's take a look at the speculative nature of the company's one-day plummet in share price and then dissect its other value components.

Overreaction:

Yahoo's remaining investment in Alibaba is worth about $32 billion according to the company's first quarter financial highlights, so any potential obstacle related to the sale of that investment is definitely a cause for concern. Yahoo intends to spin-off its stake in Alibaba as a package with its active Yahoo Small Business unit to avoid a substantial tax liability in the billions of dollars.

The IRS indicated that it is considering changes to its rules on "spinoffs of trades or businesses that are small compared with a company's other assets," while noting that existing applications would still be reviewed. The agency did not mention Yahoo or target it, and Yahoo's pending ruling request regarding the spinoff was filed prior to the remarks in Q1 2015.



When the IRS statement broke, shares of Yahoo dropped nearly eight percent in value to around $41 per share. Prices for the company's stock have rebounded in the ensuing days but are still below their previous levels. The stock is down almost $10 a share from its recent 52 week high. The recent rebound shows that the market did not consider the IRS' statement a significant threat to Yahoo's Alibaba spin-off, and I think the sale will go through without hindrance. Meanwhile, the somewhat depressed prices of Yahoo represent a good buying opportunity.

Yahoo Japan and Core Businesses:

The firm possesses an equity interest in Yahoo Japan of approximately 35%, worth slightly above $8 billion at current prices. In its most recent quarterly earnings call, Yahoo's CEO indicated that the firm has hired advisors to figure out the best possible avenue for selling off this stake and returning that capital to shareholders. The fact that Yahoo Japan is located in a different international market will complicate the tax implications of a sale, but Yahoo will still be able to bring back a hefty sum of capital to its U.S. operations. Obviously any talk or action around a congressional "tax holiday" to repatriate overseas holdings would a positive development.

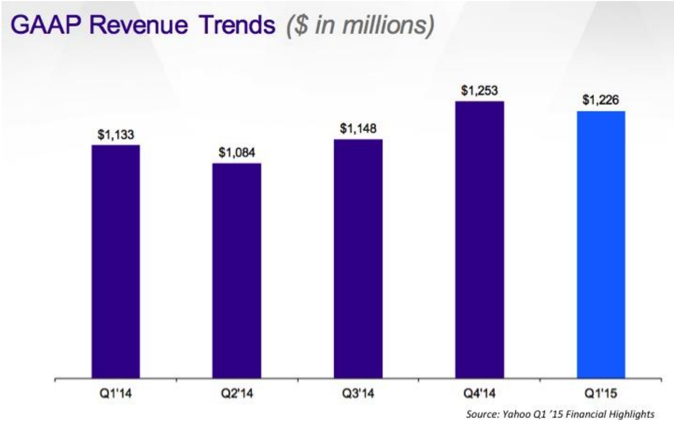
From a turnaround perspective, the spin-off of Alibaba and eventual sale of the Japan stake come at an excellent point in Yahoo's lifecycle. The company needs cash to grow its remaining businesses and distance itself from its dwindling PC advertisement segment. I expect much of Yahoo's future will be dictated by its Mobile, Video, Native and Social (MVNS) business.

Unique mobile users of the Yahoo now total over 600 million per month. The MVNS business saw GAAP revenue increase 58% year-over-year to $363 million, with mobile revenue representing the bulk of that growth. Yahoo also possesses 13 fairly new digital magazines, a 16 year-old fantasy sports operation that is rampantly popular, the social media website Tumblr, the image hosting website Flickr, the streamlined advertisement service called Yahoo Gemini, and the mobile analytics service known as Flurry. I would not be surprised if Huffington Post ends up in Yahoo's hands after Verizon's (NYSE: VZ) purchase of AOL Inc. (NYSE: AOL).

Tumblr traffic alone is approaching the half-a-billion mark, and fans spend nearly 30 billion minutes a year playing fantasy sports on Yahoo. The firm should be able to take greater advantage of its massive user base. If management can deploy the capital unlocked from the firm's Asian assets to more effectively leverage its asset base, I expect Yahoo will finally rejuvenate its revenue and solidify its position.

Microsoft and Mozilla Deals:

Yahoo recently reported year-over-year GAAP revenue growth of eight percent, reeling in slightly over $1 billion.



The issue at hand, however, is the firm's extremely high traffic-acquisition-costs (TAC), which came in at $183 million during the first quarter of 2015. TAC are payments made by internet search companies to affiliates and online firms that direct consumer and business traffic to their websites and they are not included in GAAP measurements. Yahoo needs to get these costs under control if it wants to bolster its bottom line results.

A new deal inked with Microsoft to continue using Bing as the default search engine on Yahoo could help reduce those costs. The companies agreed that 51% of desktop search traffic generated through Yahoo must carry Bing ads, leaving the other 49% of searches open to advertisements generated by Yahoo's own Gemini system. Under the previous agreement, Yahoo was required to carry only Bing advertisements, and kept 88% of the net revenue from the ads after affiliate payouts. Now Yahoo keeps 93% of the gross revenue when it runs a Bing advertisement, which should help control traffic-acquisition-costs.

Yahoo also entered into an agreement with Mozilla last year to become its default search engine in the U.S. for the next five years. The deal immediately increased Yahoo's search engine market share. The company's number of paid clicks increased 21% in the first quarter of 2015, and I expect that boost is owed at least in part to the deal with Mozilla.

What's it All Worth?

Yahoo's market capitalization is about $41 billion, and its stake in Alibaba is estimated at $32 billion at current levels. That mean's over three quarters of the company's valuation is rooted in its position in Alibaba. After settling about $3 billion of income tax liability in the first quarter of 2015 related to the sale of Alibaba, Yahoo holds cash and marketable securities of nearly $7 billion. The sum of Yahoo's cash and stake in Alibaba comes out to around $39 billion dollars, meaning the market values all of the company's business units at a measly $2 billion. I am wholly excluding the value of the firm's Yahoo Japan investment from my rough valuation, and even then it is still clear that the market has undervalued and unfairly beat down shares of Yahoo.

I will be keeping a close eye on Yahoo, monitoring the Alibaba sale and looking for more guidance from management on how it will liquidate its position in Yahoo Japan. The migration toward mobile advertisement is a smart move and should help this turnaround company improve its business model going forward. Adjusted EBITDA for the next quarter is expected to total about $250 million, and 19 analysts covering the firm have set an average price target of $56 per share.

Any positive news regarding the spin-off of Alibaba will serve as a catalyst for share price appreciation. Any earnings results that exceed expectations will boost prices significantly and likely prod the market into valuing the firm's assets at a more appropriate and higher level.

Yahoo should be able to employ some of the Alibaba spin-off capital toward growing its current businesses, and I think over the long-term this company has the opportunity to return to its former glory.

If Yahoo continues to make progress against its turnaround strategy I can see the stock reaching $55.00 to $60.00 a share in the next twelve months. At current prices with Yahoo's assets it is hard to see much downside setting up a nice risk/reward play in an overbought market.

Recommendation: Buy YHOO up to $47.00 a share and hold until $60.00 a share.

Position: Long YHOO

Portfolio Update

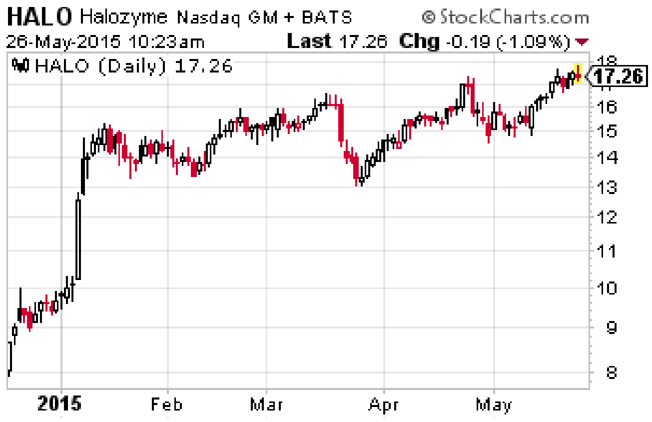
The previous month was a mixed bag for the portfolio of The Turnaround Stock Report as one might expect as we get closer to our optimal 20 stock portfolio. Here are some of the highlights from the month that was.

Our "construction" picks did pretty well over the last 30 days. **United Rentals (NYSE: URI)** acquitted itself quite well since inclusion in last month's issue rising some six percent since then.

Chicago Bridge & Iron (NYSE: CBI) was up some 10% for the month as it continues to reward its selection into the portfolio. The company had two major contract wins since our last update which is transitioning the perception of the company into a "LNG play".

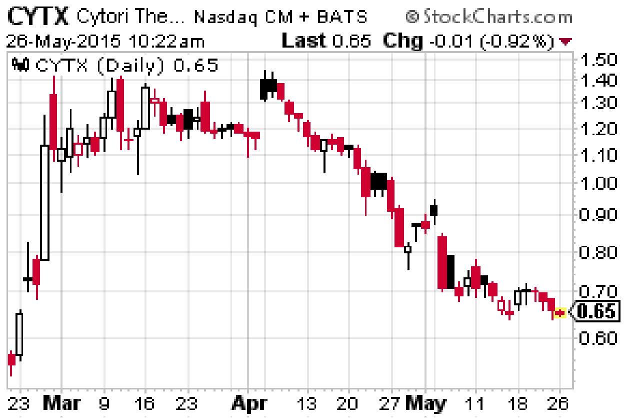
Our biotech and biopharma picks had their ups and downs for the month. **Halozyme Therapeutics (NASDAQ: HALO)** continues to be the star of the portfolio and as it finally looks to stay over the $17.00 a share level that has proven to be a stubborn resistance level.

This represents a 101% winner for us since adding it back in December.



Dynavax Technologies (NASDAQ: DVAX) and Zogenix **(NASDAQ: ZGNX)** were down for the month but I still like their longer term prospects.

Cytori Therapeutics (NASDAQ: CYTX) continues to disappoint after a big initial rise after its addition to portfolio. Although still up nicely from recommended entry point, it has given up most of its initial gains. At least the company raised funds through a secondary offering and will not have to come back to the till in the foreseeable future.



This is why one must exercise the "Jensen Rules" when investing in small cap biotech/biopharma sector. This involves selling 10% of your original stake after a 50% gain in the stock, 20% after stock doubles and 20% more if it triples. Now you have booked a guaranteed profit and the remaining half is riding on the house's money. This way you don't have regrets when a stock goes way up only to come down without taking profits and you don't miss the next **Celgene (NASDAQ: CELG)**. I have found this is a very solid risk mitigation strategy and improves performance of the portfolio. I try to follow it religiously.

The only other notable mover this month was **Sequential Brands Group (NASDAQ: SQBG)** which is up some 15% since our last update and 23% since inclusion in the portfolio. The company easily beat on the top and bottom line consensus when it reported quarterly results at the end of April.

This month we've added two bigger more well-known names to the portfolio. Both are well on their way through their transitions but the stocks still have further upside as the companies continue to execute against their turnaround plans.

Current Portfolio

Company	Entry Date	Entry Price	Recent Price	Buy Up To	Target Price	Returns
Yahoo! (YHOO)	05/22/15	$43.49	$43.49	$47.00	$60.00	N/A
Delta Airlines (DAL)	05/22/15	$43.18	$43.18	$47.00	$60.00	N/A
United Rentals (URI)	04/22/15	$97.90	$104.8	$105.00		7.1%
HD Supply (HDS)	04/22/15	$33.14	$33.32	$34.00		0.5%
Michael Kors (KORS)	03/26/15	$66.97	$61.63	$75.00	$100.00	-8.0%
American Cap. Realty (ARCP)	03/26/15	$9.90	$9.07	$10.75	$14.00	-8.4%
FelCor Lodging Trust (FCH)	02/20/15	$10.78	$10.93	$11.50		1.4%
Cytori Therapeutics (CYTX)	02/20/15	$0.55	$0.66	$0.75		20.0%
Sequential Brands (SQBG)	01/21/15	$11.09	$13.67	$12.00	$17.00	23.3%
Chicago Bridge & Iron (CBI)	01/21/15	$40.31	$56.31	$45.00	$60.00	39.7%
Greenbrier Cos. (GBX)	12/17/14	$46.51	$61.91	$50.00	$80.00	33.1%
Halozyme Thera. (HALO)	12/17/14	$8.65	$17.45	$10.00	$18.00	101.7%
Zogenix (ZGNX)	11/18/14	$1.24	$1.40	$1.75	$4.00	12.9%
General Motors (GM)	11/18/14	$32.27	$35.70	$34.00	$47.50	10.6%
Warren Resources (WRES)	10/15/14	$3.37	$0.89	$4.50	$7.00	-73.8%
Dynavax Technologies (DVAX)*	10/15/14	$14.30	$21.74	$17.50	$30.00	52.0%
Chesapeake Energy (CHK)	09/15/14	$25.05	$15.06	$27.00	$33.00	-39.9%
AEGON N. V. (AEG)	08/14/14	$7.74	$7.94	$9.00	$15.00	2.6%

Closed Positions

Company	Entry Date	Entry Price	Close Price	Close Date	Returns
Hercules Offshore (HERO)	07/18/14	$4.01	$0.45	03/26/15	-88.6%
Emerald Oil (EOX)	07/18/14	$7.56	$0.86	03/26/15	-84.8%

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: 05/22/15. Returns data represents share price appreciation or depreciation between entry price and recent price.

* Dynavax did a 1/10 split on 11/05/14 thus the original entry price of $1.43 has been adjusted to $14.30 to reflect current pricing level comparisons.

This is not real-time data and should not be interpreted as such.