The Turnaround Letter

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ESG INVESTING – DOING WELL BY DOING GOOD

Investors of all types are increasingly seeing the merits of being more active and aware. Intangibles that go beyond traditional financial measures, such as how companies protect the environment, promote fair treatment of people and practice good corporate governance are becoming mainstream ingredients in analyzing companies. A common term for this approach is "ESG" investing, which stands for Environmental, Social and Governance. It is also sometimes called "sustainable," "socially responsible" or "impact" investing.

Once dismissed as irrelevant or even a detractor from good investment returns, there is a growing body of evidence that shows this approach actually contributes to better returns over the long run. The logic: if management is paying attention to ESG issues, they probably are paying attention to all the details of their business and are likely to be running it better. On the other hand, companies that ignore ESG issues may be taking risky short-cuts that could lead to lower long-term value and much higher legal and reputational costs. Many investors see the benefit in this approach, as nearly $7 trillion is invested in U.S. equities using ESG principles.

At *The Turnaround Letter,* we firmly agree that ESG analysis is an important tool for successful long-term investing. We not only want to understand a company's current ESG status, but also where it is headed. In many cases, we have found that companies with weak but improving ESG practices can be outstanding investments. Turnarounds in ESG practices often go hand-in-hand with turnarounds in financial results.

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RECOMMENDATIONS:

Listed below are five companies that score well on ESG practices and also have strong elements of a turnaround in their financial performance. Many of these are higher-quality companies already, and so their valuations tend not to be overly discounted but still offer attractive upside potential.

ANALOGIC CORPORATION (ALOG) – This $500 million (sales) company produces equipment and subsystems that can see through living tissue: MRI, CT scan, digital mammography and ultrasound systems as well as airport security screening systems. Analogic earns good marks for its low ESG-related risks. Its shares, however, have gone nowhere in three years as revenue and profit growth has stalled, particularly in its ultrasound unit. Recent changes in top management, however, offer the prospect of new focus and better execution. Last October, a new CEO with considerable outside experi-

Good ESG Marks & Good Gain Potential						
Company	Symbol	Recent Price	52-Week High-Low	Market Cap $ Bil	2017 P/E	Dividend Yield%
Analogic	ALOG	83.40	95.85 – 70.84	1.0	20.4x	0.5
Axalta	AXTA	29.24	30.45 – 24.27	7.1	21.3x	0.0
Leidos	LDOS	54.04	54.20 – 37.79	8.1	16.5x	2.4
VF Corp	VFC	53.07	67.10 – 48.05	22.0	17.3x	3.2
Whole Foods	WFM	31.10	35.58 – 27.67	10.0	23.4x	1.8

ence was brought in, and the company has also replaced its CFO and its chairman. The company produces adequate free cash flow and carries no long-term debt. Adjusting for the $11/share in cash, the otherwise high P/E drops to a more reasonable 17.7x this year's earnings.

Axalta Coating Systems Ltd (AXTA) – Axalta is one of the world's largest makers of automotive paints and other surface coatings. Formerly part of DuPont, the company's shares have shown only modest gains since its initial public offering in late 2014. This is despite paying down a considerable amount of debt and generating a rising stream of earnings and free cash flow. Like many recent spin-offs, Axalta scores high ESG marks because, being less burdened by longstanding corporate policies, they can implement solid practices right away. It also doesn't hurt to have Warren Buffett as a 9.7% shareholder. While not particularly cheap, better operating performance should lead to much higher earnings and a higher share price.

Leidos Holdings (LDOS) – Spun off in 2014 from Science Applications International, Leidos provides advice and services to governments and corporations on national security, healthcare and information systems. The company's spin-off allowed them to implement smart ESG practices from a clean slate. Operationally, Leidos has shown tremendous improvement under its talented management, and its roster of highly skilled employees (including over 9,000 with 'top secret' security clearance) provide a meaningful competitive edge. Last August, Leidos acquired Lockheed Martin's Information Systems business, potentially transforming the company. Cash flow is strong, helping fund debt repayment and an attractive 2.4% dividend. Its earnings multiple remains below the market average of 17.5x and well below peers that average over 20x.

VF Corp (VFC) – This highly regarded maker of enduring branded clothing like Lee and Wrangler jeans, North Face outdoor gear, Timberland boots and Vans action sports apparel has struggled with slowing revenue and profit growth. While its adaptation to an increasingly internet-based retail environment has been impressive, many of its brands are maturing and sales have been hurt by bankruptcies at some retailers. Its shares have declined over 30% peaking their highs in 2015. The company earns some of the highest ESG scores among its peers. Management is taking a more aggressive stance to re-invigorate its brands, and there is the potential for more strategic changes. VF has a conservative balance sheet, produces over $1 billion of free cash flow and sports a 3.2% dividend yield along with a below-market earnings multiple.

Whole Foods Markets (WFM) – Whole Foods is the nation's largest natural and organic foods supermarket with nearly $16 billion in sales. It is a leader in ESG practices in its industry. Since opening its first store in 1980, growth came easily for many years, building to the current base of 465 stores. However, revenue and profit growth have now stalled. Attractive new locations are scarce and competition from other organic stores and traditional grocers are pressuring traffic and margins.

WFM shares are down 50% from their 2013 highs. The company has recently taken a more aggressive approach to fixing its problems: improving in-store execution, reducing prices, taking a butcher knife to corporate bloat and abandoning its co-CEO format. It also is closing at least nine weak stores and re-directing efforts toward its new "365" format that offers lower prices and smaller stores. The turnaround is supported by good free cash flow and a minimal debt burden. Trading at 7.9x cash flow and offering a 1.8% yield, Whole Foods shares could provide a healthy return for patient investors.

UNLOVED "TRUMP" STOCKS MEET WARREN BUFFETT

In his much-anticipated annual letter to Berkshire Hathaway shareholders released recently, Warren Buffett proclaimed strong confidence and enthusiasm for the US economy. If his forecast is accurate, the economy will continue to produce strong growth, which will include increasing government and corporate spending on infrastructure, energy-related facilities and other large, complex projects.

Curiously, while the stock market has shown great enthusiasm for many companies that could benefit from regulatory reform and increased government spending (so-called "Trump" stocks), as well as other companies that will be aided by higher and more stable oil prices, it has overlooked several that could be particularly direct beneficiaries.

Listed below are five companies closely involved with building infrastructure, including refining and other energy-related facilities, yet whose stocks have been laggards:

CHICAGO BRIDGE & IRON (CBI) – CB&I is a leading provider of infrastructure to the energy industry, focusing on refining, liquid natural gas (LNG) and combined-cycle power generation facilities. Engineering and construction services comprise about 56% of its $11 billion in revenues, most of which is structured under CB&I's unique lower-risk approach to fixed-price contracting. It has a strong position in building large LNG facilities and is expecting up to $10 billion in new project signings this year. Overhangs include a lawsuit related to Westinghouse's purchase of CB&I's nuclear construction operations as well as execution risk on the Cameron LNG project. Cash flow is strong and debt is reasonable. At 7.4x this year's earnings, CBI shares look like a bargain.

FLUOR (FLR) – This high quality company was just named by Fortune magazine as the #1 "Most Admired Engineering and Construction Company" for the sixth consecutive year. Fluor, with $19 billion in revenues, focuses on highly complex, large-scale projects for a diversified industrial client base spanning oil and gas, chemicals, mining, transportation, power, life sciences and advanced manufacturing as well as domestic and international governments. About 73% of its revenues are on a cost-reimbursable basis, producing a lower-risk operating model. Its backlog is healthy, with new opportunities starting to emerge in the sluggish commodity-focused segments. The shares remain well below their 2014 highs, and valuation at 18.9x this year's earnings doesn't adequately reflect this company's future earnings power.

KBR, INC. (KBR) – This $4.3 billion (sales) engineering and construction company is undergoing an extended turnaround led by CEO Stuart Bradie, who joined in 2014. Under Bradie, KBR has streamlined its cost structure, narrowed its focus and emphasized lower-risk professional services contracts. Last year's acquisitions of Wyle and Honeywell Technology Solutions expand its higher-margin technology services capabilities. KBR's turnaround is still a work-in-progress with on-going cost over-runs in some legacy projects. Also, while KBR will soon receive upwards of $400 million in damages from Mexico's ➔

Stocks Yet to Get Their Trump Bump

Company	Symbol	Recent Price	52-Week High-Low	Market Cap $ Bil	2017 P/E	Dividend Yield%
Chicago Bridge & Iron	CBI	34.31	41.33 – 26.12	3.39	7.4x	0.8
Fluor	FLR	56.19	58.37 – 44.05	7.77	18.9x	1.5
KBR	KBR	15.61	17.95 – 12.08	2.20	11.8x	2.1
Manitowoc	MTW	6.26	7.57 – 3.55	0.84	Na	0.0
McDermott Int'l.*	MDR	7.57	8.33 – 3.17	1.80	25.0x	0.0

**Previous TL recommendation*

PEMEX, this will probably be spent fixing problems with older fixed-price contracts rather than share repurchases or company acquisitions. However, the company's turnaround should eventually result in steadier and more predictable profit growth, which would lead to an upward valuation. A reasonable 11.8x earnings multiple and a 2.1% yield provides investors with an attractive entry point.

The Manitowoc Company (MTW) – Founded in 1902 and taking the name of its home town in Wisconsin, the Manitowoc Company is a leading global manufacturer of cranes and lift solutions. Revenues for fiscal 2016 will be around $1.6 billion, with as much as half generated outside the United States. The company continues to struggle with the sharp slowdown in mobile cranes (especially in the oil-rich Middle East and the United States) and general sluggishness in tower cranes that is being amplified by global excess capacity. Although it is currently unprofitable, its future may be turning brighter. It spun off its unrelated food service equipment company, has a relatively new CEO (just over a year), and is aggressively working to streamline its cost structure. Shares on a post-spin-off basis are down about 50% from their prior highs, and earnings power in the next upcycle could make the current share price look like a bargain.

McDermott International (MDR) – While McDermott has moved up nicely since the election, it remains well below its $13 per share price range before oil prices collapsed. Currently on *The Turnaround Letter's* recommended list, McDermott is a $2.6 billion (sales) provider of engineering and construction services with a heavy emphasis on offshore oil and natural gas structures and pipelines. Perhaps much more than its peers, the company has struggled with the sharp decline in its customers' markets, particularly the energy-driven Middle East. Prospects for its multi-year turnaround are looking up, as McDermott has cleaned up nearly all of its problem projects, improved its liquidity profile and recently guided to a stronger 2017 than investors expected. Bookings of new projects look healthy, although nearly 67% of its backlog is from Saudi Aramco. With earnings power of $1/share or more, the current price looks very attractive.

HIGH YIELD BONDS: PROCEED WITH CAUTION

From time to time we comment on high yield bonds (sometimes called "junk bonds') because we think they may be of interest to turnaround investors for several reasons. While they are called bonds, many high yield issues have return – and risk – characteristics closer to stocks than to other fixed income instruments. Also, many companies that issue high yield debt are in the process of turning around, or at least trying to. And some high yield issuers don't make it, file for Chapter 11 and eventually provide interesting distressed bond or post-bankruptcy stock opportunities.

While we like high yield bonds generally as a place to invest – the BofA Merrill Lynch High Yield Index has a solid 10-year annualized total return of 7.3%, and it has only been down in six years since 1987 – we are cautious about the asset class right now for a couple of related reasons. First, high yield bonds seem fairly expensive by historical standards. After the asset class had a tough year in 2015, many investors, who were desperate for yield, rushed back into junk bonds in 2016. As a result, the BofA index rose 17% last year. While not at historic low levels, the yields on most junk bonds have fallen considerably over the last year or so to the point where we think they may not compensate you for the risks you are taking on – there is a reason they are called "junk" bonds after all.

Speaking of the risks, we believe that defaults are going to increase over the next few years in sectors outside of energy (which saw historic numbers of defaults last year). As we have commented before, there are huge quantities of bonds across all sectors that come due over the next few years, and some meaningful fraction of those bonds will default. This increase in defaults is likely to spook many high yield investors, pushing bond prices down. Also, as interest rates inevitably rise further, that will create more volatility in the high yield markets.

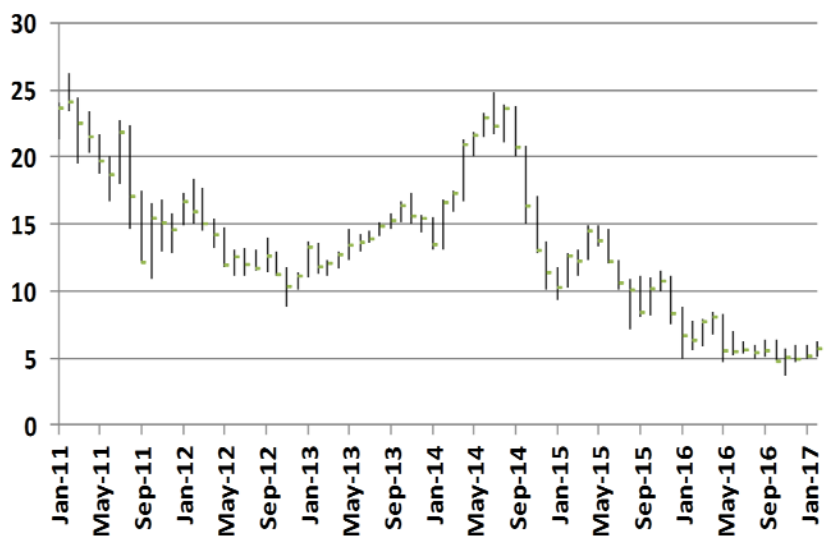
All of that said, we do believe that there should be a place for high yield bonds in most portfolios. We just recommend proceeding cautiously, perhaps increasing your exposure to the asset class gradually over the next several years. Also, we believe that high yield is an area where actively managed mutual funds are likely to outperform index funds and ETFs.

RECOMMENDATION:

Purchase Recommendation: Weatherford International plc

WEATHERFORD INTERNATIONAL PLC
BAHNHOFSTRASSE 1
6340 BAAR, SWITZERLAND
TEL. 41-22-816-1500
www.weatherford.com

CATEGORY: MID CAP ($5.7 BIL.)
SYMBOL: WFT EXCHANGE: NYSE
BUSINESS: OIL SERVICES
ANNUAL REVENUE: $5.7 BIL.
EARNINGS: ($3.4 BIL.)
2/28/17 PRICE: $5.66
12-MONTH RANGE: $8.49-$3.73
EST. DIVIDEND YIELD: 0.0%



Background: Weatherford is an energy services company, helping oil and natural gas clients across the globe evaluate drilling locations, construct and complete wells and intervene to boost production as wells age. It also owns a small fleet of 110 land drilling rigs. ➔

An estimated 90% of its revenues come from land-based activities. Since 1998, it was led by Chairman and CEO Bernard Duroc-Danner, who became known in the industry simply as "Bernard" due to his large, highly-confident personality. Under Bernard, Weatherford grew rapidly to reach $15.3 billion in revenues in 2013, nearly a third the size of industry giant Schlumberger.

The flaws in Weatherford's aggressive, debt-funded growth strategy were exposed by the collapse in oil prices in mid-2014. Its revenues fell by 62% and cash flow turned heavily negative. During the downturn, Bernard implemented several wide-ranging restructurings, including cutting staff by 43% and raising $1.1 billion in new equity. Yet, by late 2016, the share price had fallen by 85%. Ongoing operational and fraudulent disclosure issues compounded Weatherford's problems. Investors and creditors were rapidly losing patience, as Bernard's growth-focused mentality was simply not geared to the new environment, and they were looking for more aggressive changes.

Analysis: In November 2016, dramatic change arrived, when Bernard resigned from all positions other than an advisory-only Chairman Emeritus position. Finally free from his dominating personality, Weatherford is on a well-defined path to recovery. The new CEO, Krishna Shivram, who joined in 2013 as CFO from highly respected Schlumberger, is rebuilding the management team and emphasizing four priorities: 1) cutting debt by half, 2) refocusing on their core expertise and divesting capital-intensive and non-core operations, 3) expanding their opportunity set with alliances and new sales channels and 4) getting "back to basics" to improve operational execution, accountability and service quality.

The turnaround is not without challenges, and so the shares are not without risk. Competition is fierce especially with the excess industry capacity. Weatherford produced an operating loss (adjusted for non-cash charges) of $706 million last year, and it carries $7.6 billion in debt (partly offset by $1.0 billion in cash). However, its game plan looks promising, debt maturities are minimal through 2018, and cash flow is already showing significant improvement. Margins are likely to expand quickly with new revenues because the company's cost structure will be lean. In addition, $1.7 billion in net operating loss carryforwards (NOLs) will largely eliminate any income taxes for several years. And if management can't get results back on track, Weatherford could be an acquisition target for healthier competitors.

<u>We recommend purchasing shares of WFT up to 10.</u>

Sale Recommendation: Arctic Cat

Arctic Cat – With little time remaining for a higher bid, as Textron's $18.50/share cash tender offer ends on March 3, we are recommending that holders sell their ACAT shares.

NEWS NOTES

Bank of America – The story for Bank of America keeps getting better. Their fourth quarter earnings were strong, and the bank's earning power continues to increase, as reflected in the steadily rising earnings estimates. Bank of America also has considerable excess capital that could be used to reward shareholders through higher dividends and share repurchases once it gets the necessary Fed approval. We are raising the buy limit to $28.

<u>**Disclosure Note**</u>: Accounts managed by an affiliate of the Publisher own BofA warrants.

PERFORMANCE

The tables below and on the next page show the performance of all of our currently active recommendations, plus recently closed out recommendations. For additional details please visit the "Our Portfolio" pages (under the "Subscriber" menu) at *www.turnaroundletter.com.*

SMALL CAP[1] (under $1 billion) CURRENT RECOMMENDATIONS

RECOMMENDATION	SYMBOL/ EXCHANGE (2)	REC. ISSUE	PRICE AT REC.	2/28/17 PRICE	TOTAL % RETURN (4)	CURRENT STATUS (3)
Bristow Group	BRS/NY	Nov 86	0.75	15.71	+2489	Buy (25)
Fairpoint Communications	FRP/NQ	July 11	9.42	15.85	+68	Hold
Layne Christensen Co.	LAYN/NQ	Nov 13	19.59	9.55	-51	Buy (12)
Ply Gem Holdings, Inc.	PGEM/NY	Apr 14	12.63	17.35	+37	Buy (20)
M/I Homes, Inc.	MHO/NY	Aug 14	20.67	23.60	+14	Buy (27)
tronc	TRNC/NY	Dec 14	21.09	14.60	-27	Hold
McDermott International	MDR/NY	Apr 15	3.73	7.36	+97	Buy (9.5)
Star Bulk Carriers Corp.	SBLK/NQ	Aug 15	15.50	9.37	-40	Hold
NII Holdings, Inc.	NIHD/NQ	Nov 15	7.00	2.00	-71	Buy (4)
Arctic Cat, Inc.	ACAT/NQ	Dec 15	22.26	18.50	-17	Sell
TriMas Corp.	TRS/NQ	Sept 16	19.18	22.05	+15	Buy (31)

MID CAP[1] ($1 billion - $10 billion) CURRENT RECOMMENDATIONS

RECOMMENDATION	SYMBOL/ EXCHANGE (2)	REC. ISSUE	PRICE AT REC.	2/28/17 PRICE	TOTAL % RETURN (4)	CURRENT STATUS (3)
Janus Capital Group	JNS/NY	Aug 05	15.27	12.66	-1	Buy (21)
MGIC	MTG/NY	Jan 11	10.11	10.65	+5	Buy (12)
Cypress Semiconductor	CY/NQ	Jan 13	10.63	13.27	+38	Buy (16)
PennyMac Mortgage Investment Trust	PMT/NY	Sept 13	21.40	16.86	+12	Buy (26)
Allscripts Healthcare Solutions	MDRX/NQ	Feb 14	16.43	12.18	-26	Buy (24)
Oaktree Capital Group, LLC	OAK/NY	Oct 14	51.23	44.70	-2	Buy (63)
Globalstar, Inc.	GSAT/NY	Nov 14	2.16	1.37	-37	Buy (2)
FTI Consulting	FCN/NY	Feb 15	40.24	40.24	0	Buy (50)
Mattel, Inc.	MAT/NQ	May 15	28.43	25.73	+1	Buy (38)
Chesapeake Energy Corp.	CHK/NY	June 15	14.11	5.45	-61	Hold
Extended Stay America	STAY/NY	Feb 16	12.79	17.30	+41	Buy (20)
SeaWorld Entertainment	SEAS/NY	Apr 16	21.45	19.27	-9	Buy (27)
Crocs, Inc.	CROX/NQ	May 16	8.35	6.65	-20	Buy (13)
BorgWarner, Inc.	BWA/NY	Aug 16	33.18	42.19	+28	Buy (52)
DSW, Inc.	DSW/NY	Oct 16	20.78	21.03	+2	Buy (33)
Time, Inc.	TIME/NY	Nov 16	13.05	17.55	+37	Buy (21)
Washington Prime Group, Inc.	WPG/NY	Dec 16	10.02	9.27	-7	Buy (17)
Conduent, Inc.	CNDT/NY	Feb 17	14.96	16.09	+8	Buy (20)

KEY: (1) Market Capitalization at original recommendation (2) Exchanges: NY= New York; NQ= NASDAQ; OTC = OTC Market
(3) Maximum recommended buy prices in parentheses; (4) Total return includes dividends as well as price changes.

LARGE CAP[1] (over $10 billion) CURRENT RECOMMENDATIONS

RECOMMENDATION	SYMBOL/ EXCHANGE (2)	REC. ISSUE	PRICE AT REC.	2/28/17 PRICE	TOTAL % RETURN (4)	CURRENT STATUS (3)
Ford	F/NY	Dec 03	13.00	12.53	+19	Buy (20)
General Electric	GE/NY	July 07	38.12	29.81	-1	Buy (37)
Motorola Solutions	MSI/NY	Aug 07	68.52	78.97	+26	Buy (85)
Bank of America	BAC/NY	Oct 08	35.00	24.68	-27	Buy (28)
General Motors	GM/NY	May 11	32.09	36.84	+27	Buy (45)
Xerox	XRX/NY	Aug 11	9.58	7.44	+19	Buy (10)
Weyerhaeuser Co.	WY/NY	Apr 12	21.89	33.72	+67	Buy (35)
BP plc	BP/NY	July 13	41.78	33.92	+2	Buy (55)
Freeport-McMoRan Copper & Gold	FCX/NY	Aug 13	28.21	13.40	-45	Buy (20)
Citigroup, Inc.	C/NY	May 14	48.16	59.81	+26	Buy (65)
Ally Financial, Inc.	ALLY/NY	Sept 14	24.95	22.49	-9	Buy (33)
Royal Dutch Shell plc	RDS-B/NY	Jan 15	69.95	55.00	-9	Buy (85)
Nokia Corporation	NOK/NY	Mar 15	8.02	5.14	-30	Buy (12)
Caterpillar, Inc.	CAT/NY	July 15	85.30	96.66	+20	Buy (110)
The Mosaic Company	MOS/NY	Sept 15	40.55	31.19	-19	Buy (50)
Rio Tinto plc	RIO/NY	Jan 16	29.09	41.52	+52	Buy (51)
Rolls-Royce Holding plc	RYCEY/NQ	Mar 16	9.25	9.90	+9	Buy (14)
First Data Corporation	FDC/NY	June 16	12.53	16.10	+28	Buy (18)
Macy's, Inc.	M/NY	July 16	33.61	33.22	+1	Buy (48)
Viacom, Inc.	VIAB/NY	Jan 17	35.52	43.45	+22	Buy (54)

RECENTLY CLOSED OUT RECOMMENDATIONS (ALL CATEGORIES)

RECOMMENDATION	SYMBOL	REC. CAT.	BUY ISSUE	PRICE AT BUY	SELL ISSUE	PRICE AT SELL	TOTAL % RETURN (3)
Drew Industries	DW	Small	Mar 11	23.13	Apr 16	64.40	+204
Federal-Mogul	FDML	Mid	May 08	21.00	Apr 16	9.84	-53
The Fresh Market	TFM	Mid	Oct 15	22.94	Apr 16	28.52	+24
Superior Industries	SUP	Small	Sept 10	14.75	June 16	27.14	+104
Coca-Cola	KO	Large	Apr 11	32.86	July 16	45.33	+59
Sony	SNE	Large	Sept 11	22.01	Aug 16	33.41	+52
EMC	EMC	Large	Dec 13	23.72	Sept 16	29.09	+25
Accuride	ACW	Small	Oct 13	5.14	Oct 16	2.56	-50
ACCO Brands	ACCO	Small	Mar 10	7.17	Nov 16	11.10	+55
Stewart Information	STC	Small	Jun 13	29.34	Dec 16	47.44	+68
Fifth Third	FITB	Large	Nov 10	12.56	Dec 16	26.02	+122
Old Republic	ORI	Mid	Jun 08	14.64	Feb 17	20.80	+85

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