

Investment Outlook

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The Beauty of Value Investing

The last three issues of Investment Outlook surveyed the economy and attempted to predict the trend. This is about as fruitful as trying to predict the weather. At least the weatherman has a map and can see which way the wind is blowing.

The beauty of value investing is you don't depend on being able to predict the economy. Instead, you find investments that will retain value under most any economic scenario. Here are a few principles of value investing:

First, find companies with valuable assets that provide a margin of safety. For example, a real estate company or an oil company have tangible assets which can be sold or mortgaged in a pinch. Compare that to a semiconductor manufacturer whose only tangible asset is used equipment, saleable for pennies on the dollar.

Second, find companies that are generating good cash flow relative to the stock price. This is the surest way to increase shareholder value. In contrast, many growth stocks turn out to be dogs because the profits are continually plowed back into growing the company.

Third, avoid companies with excessive debt levels. Leverage is fantastic when business is good, but it can be ruinous when business is bad. Debt laden companies have a greater chance of becoming a total loss, and loss avoidance is key to successful investing.

Here are a pair of stock recommendations that meet the above criteria. As an experiment, the profiles presented are longer than usual. Please let me know if you like the greater detail.

Caplease (LSE, \$5.90) owns single tenant buildings and pays a 4.1% dividend. The adjusted funds from operations, based on the December quarter, represents a 15% return. The book value per share is \$5.38.

The real estate portfolio is Office 50%, Warehouse 20%, United States General Service Administration 12%, Retail 11%, Office/Warehouse 5%, Other 2%.

Of the 61 properties owned, 55 are leased to single tenants. The weighted average remaining lease term is approximately 8 years and the average tenant credit rating in the Single Tenant Owned Property Portfolio is "A". Since there are only 31 major tenants, each tenant is listed by name in LSE's financial reports, and the quality of each tenant is verifiable. The long lease duration and the high quality of the tenants gives LSE some insulation from a poor economy. Only 3.5% of LSE's leases expire in 2010 and only 5.1% expire in 2011. Many of the buildings are corporate headquarters which are less subject to tenant turnover.

Only 3% of LSE's debt is due this year, 11% matures in 2011, and 14% matures in 2012. 58% of the debt has a maturity greater than 5 years. 83% of the debt is fixed rate, with the average rate under 6%.

There are two negatives which account for LSE's discount relative to its peers. First, LSE has higher leverage, with a debt-to-undepreciated assets ratio of 75% versus 50% for most REIT's. However, with net cash from operating activities of \$57 million and interest expense of \$86 million, LSE has a good cushion against declines in rental income. LSE can also raise cash through property sales. Although the commercial rental market is depressed, properties with A-rated tenants, long leases and assumable loans are being sold at premium prices.

The second negative is that 20% of LSE's assets consist of commercial mortgage loans and commercial mortgage-backed securities. Management does a very good job of disclosing the details of these assets, and the borrowers and collateral appear solid. However, a crash in the commercial real estate market is widely discussed and feared. I believe LSE to be a good investment even if these loan assets turn out to be worthless. These assets are on the books at \$374 million, yet LSE's market capitalization is being discounted by \$572 million compared to a peer such as Boston Properties.

Management guidance for 2010 Funds From Operations is \$0.68 to \$0.73 per share. Based on a historical average Price/FFO ratio of 12, I believe the fair value of LSE is \$8.40 per share. While the higher leverage diminishes the valuation, the long leases and high tenant quality increases the valuation. Even if the stock fails to appreciate in the near term, the 4.1% dividend makes it worth the wait.

StealthGas (GASS \$5.41) StealthGas owns a fleet of liquefied petroleum gas carriers which it leases internationally. Shipping is a very cyclical industry in which supply and demand are often mismatched. Back in 2006 and 2007, world trade was booming and the shipping industry ordered record numbers of new ships. These ships are now entering the market at a time when world trade has diminished, causing a glut of supply and a crash in freight rates.

However, the niche market in which StealthGas operates has not seen the glut of new supply characteristic of most shipping, and is perhaps being unfairly punished.

Fundamental Analysis

Fourth quarter 2009 net loss was \$1.22 per share. However this loss included an unusual termination fee on a cancelled vessel purchase (\$0.48), and the following non-cash items: impairment loss on vessels held for sale (0.45) a loss on interest rate swaps (0.14) and stock based compensation (\$0.25). Excluding these items, quarterly net income was \$0.10, which gives a modest price earnings ratio of 13.

The tangible book value is \$13.48 per share, which is 249% of the current stock price. The big question is whether the balance sheet valuation of the vessels reflects the true market value. A clue comes from the recent sale by the company of 5 older, smaller vessels out of its total fleet of 45. Three vessels were sold at a 33% discount to book value. Two vessels were sold at a 4% premium to book value. These transactions include the cost of brokerage commissions. The weighted average of these reported transactions implies the liquidation value of the fleet is 18.2% below the carrying value. Plugging this impairment onto the GASS balance sheet reduces the tangible book value to \$8.63, which is still a hefty premium to the stock value.

Management recently approved a \$15 million stock buyback plan. This represents 14% of the outstanding shares. To do the buyback in an environment of conserving cash shows just how strongly management feels its stock is undervalued.

Long term debt is only 52% of the net book value of the vessels. The debt consists of 6 amortizing bank loans. Approximately 36% of the loans are payable over 12 years, approximately 45% of the loans are payable through 2015, and the balance is payable through June 2016. 57% of the debt is swapped, so in effect is fixed rate debt. Total annual debt payments are about \$24 million. Cash flow from operations was about \$48 million on both 2008 and 2009, so debt payments should be easily manageable.

The Liquefied Petroleum Gas Market

LPG is better known as Propane and Butane. LPG exists in liquid form at much higher temperature and much lower pressure than its more popular cousin Methane (aka Natural gas). LPG is a by-product of both petroleum and natural gas production.

LPG can be transported by ship, truck or pipeline. Ships are needed when the LPG is produced far from consumers. Much LPG is produced in the Middle East and shipped to China, India and Indonesia.

Although world oil production may have peaked, gas production continues to grow about 3% annually. Gas fired power plants are becoming more popular than coal fired plants, due to environmental concerns. Natural gas and propane powered vehicles are proliferating in fleets around the world. Since LPG is a byproduct of both oil and gas, increasing use of natural gas will result in more LPG being produced.

In the Middle East, Qatar is in the process of doubling their current LPG production to 12 million tons a year. World LPG consumption is about 220 million tons per year, so Qatar's increase is significant for representing just one supplier. LPG demand has been steadily rising for decades. LPG is used for heating and cooking in areas where natural gas pipelines do not exist. As countries such as China and India emerge, LPG is replacing wood fuel. In Indonesia and South Africa, the government is actually promoting substitution of LPG for wood in order to preserve their environment.

According to the Dnb NOR survey, current ship orders equal about 15% of the existing LPG fleet. However, no new orders are being placed, and about 5% of the fleet gets retired each year. The world LPG fleet has an average age of 20 years, so there is a constant need to replace aging ships.

Stock Valuation

2009 represented a trough in the shipping industry. Maersk Line, the container shipper, suffered its first loss in 60 years in 2009. Despite this environment, GASS continues to have a comfortable level of positive cash flow. I therefore believe that at a minimum, GASS should trade for its liquidation value of \$8.63, which approximates tangible book value as adjusted above for asset impairments suggested by recent vessel sale prices.

GASS trades at a price to net asset value of 0.45. In comparison, Diana Shipping has a P/NAV of 1.09, Dryships has a P/NAV of 0.73, Nordic America has a P/NAV of 1.78. These other shippers operate in drybulk and crude oil subsectors which are more volatile and also have more new vessels on order, so GASS deserves a P/NAV at least as high as these other shippers. At a P/NAV of 1.0, GASS would be valued at \$13.54.

Cash flow from operations in both 2008 and 2009 was \$2.18 per share. Valuing GASS at 10 times cash flow yields a value of \$21.80.

GASS had steady earnings during 2005 through 2008, varying from a high of \$1.84 to a low of \$1.26. I believe these historical earnings are a better indicator of GASS long term earnings potential than are current earnings which are temporarily depressed by reduced demand. Average earnings 2005 through 2008 of \$1.44, and a price/earnings ratio of 12 suggest a value for GASS of \$17.28. I selected a price/earnings ratio of 12, which is lower than the S&P 500 historical average of 15, to account for the cyclical nature of shipping. Management believes GASS will return to profitability in the second half of 2010. I will assume it will take one year to resume normal earnings, and therefore discount the \$17.28 value for one year at 8% to arrive at a current fair value of \$16.00.



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