



Balopole Investment Management Corp. - Investment Outlook

Rather than focusing on macro-economic conditions, Balopole Investment Management Corp (BIMC) would like to highlight some of the value-based investments we have made for our clients in order to give our clients global diversification and excellent returns. Here are profiles of four of our major recommendations. Our stock selection criteria include financial strength, modest PE ratios, experienced management and employees, and good growth prospects.

VALERO ENERGY CORPORATION

Valero (VLO) is the largest US oil refiner. Last year they earned \$8.30 per share before special items, giving VLO a low PE ratio of about 9.25. This year's earnings are shaping up to be even better than last year's. There is a worldwide shortage of refinery capacity, giving rise to unusually high profit margins. Many of the newer crude oil supplies are heavy and/or sour crude, requiring far more refining than the classic light sweet crude. Prior to 2004, there was very little upgrading of refineries, and Europe was shipping excess gasoline to the U.S.; Valero was one of the few companies which made the investment in equipment to process heavy and sour crude, and they are now reaping the benefit of that investment.

In spite of higher prices, world oil consumption continues to rise by over 500 million gallons per year. Governments continue to phase in cleaner fuel requirements which put more demands on refiners. Although many refineries are attempting to expand capacity, there is a three year wait for certain essential equipment, and shortages of welders, engineers, and electricians. Steel prices are up 74% over last year. Extensive permitting processes are the norm world-

wide. In short, building new refineries is no easy task.

Management has shown confidence by buying back \$4 billion worth of Valero stock so far this year, and plans to buy another \$2 billion worth over the rest of 2007. That represents over 10% of the stock outstanding. Valero is the industry leader in environmental protection and worker safety, and was recently ranked #1 on Fortune's list of Best Big Companies to Work For.

THIELERT

Thielert (THLRF.PK) is a small German company making an innovative die-

sel engine for small aircraft. The general aviation market is small: about 2,200 new aircraft plus a steady 12,000 retrofits annually. However, Thielert is poised to dominate this small market because they offer the only FAA-certified diesel engine for general aviation use. Thielert engines get better fuel economy than the competition, with savings in direct operating costs of up to 60%, and greater range also! Furthermore, competing engines still require leaded gasoline (100LL AVGAS) which is in limited supply or unavailable in many parts of the world. Thielert engines runs on lead free jet fuel

(Jet A), which is the only fuel many foreign airports carry.

A few weeks after we bought Thielert, industry leader Cessna announced they would begin to offer Thielert's engine. For decades Cessna has used engines supplied by Lycoming, which is Cessna's sister company: Cessna and Lycoming are both subsidiaries of Textron. Cessna apparently has been forced by their customers kicking and screaming to offer Thielert engines, a stunning validation of the product.

Competing diesel engines have yet to be certified and we doubt that others can match Thielert's pricing. Thielert has a long relationship with Mercedes Benz, having made prototypes for Mercedes for many years. Thielert uses a substantial number of Mercedes automobile engine components in their engine in order to achieve economy of scale. Any competitor would have to forge a similar strategic relationship, and we believe Thielert has already partnered with the world's best diesel maker. Beyond this hurdle is the lengthy certification process. Thielert hopes to capture half of the current market, and in our opinion this could easily support a doubling of the stock price.



Anadarko Petroleum

Corp. (APC) recently became the largest independent exploration and production company in the oil and gas industry by acquiring Kerr-McGee and Western Gas Resources last summer. Anadarko financed these acquisitions with short term debt and Wall Street punished the stock for the added risk. Anadarko has been selling noncore assets, paying down the debt, and refinancing the balance. Consequently, the stock is up 20% since we began investing last February.

Anadarko has a low risk and a high risk business. The low risk business is oil and gas properties in the Rockies and Southern U. S. and deepwater wells in the Gulf of Mexico. These are mature producing properties. These properties alone produce a PE ratio of about 13 with a projected compound annual growth rate of 5% to 9%. Management has stated that the current market value of their properties is \$85 per share. Subtracting about \$19 per share in net debt gives a \$66 pretax liquidation value; the stock is currently around \$52.

The high risk business is the exploration division. When Anadarko bought Kerr McGee they acquired precious talent and equipment for deepwater gas exploration. Twenty years of low energy prices created a dearth of new petroleum engineers. Anadarko now has the best exploration team in the business, giving them leverage with partners to cut very favorable deals. The exploration business is just the icing on the cake, but the potential for value creation is enormous, while the downside risk is shared with partners.

Our April [Investment Outlook](#) profiled the petroleum market, and concluded that high oil prices are here to stay. Our investment in Anadarko is predicated upon that belief.



Amgen (AMGN), with a \$66 Billion market cap is one of the giants of the biotech industry. The

stock has lost \$23 Billion in market cap since January 1, primarily due to FDA labeling restrictions and proposed Medicare reimbursement limits on anemia drugs Aranesp and Epogen. Amgen estimates these changes will cut sales by \$500 million annually, so we think the stock drop is hugely overdone.

There is also growing concern over Senate proposals to create a pathway for approval of generic biologics. Current rules for generics re-

quire that the active ingredient be chemically equivalent to the approved drug. This is easy to do with a small molecule drug which is basically a chemical compound. However, large molecule drugs derived from a living organism, such as antibodies, vaccines, proteins, hormones, etc., can never be completely chemically equivalent, there will always be variation. The challenge then is to figure out how close is close enough and how much new testing to require. Europe has been allowing what they call "biosimilars" since 2003, and only two generic biologics have come to market.

We believe that generic biologics will eventually come to the US, but that safety concerns will slow the process and any new legislation will protect the incentives for innovators such as Amgen to develop new drugs. We note that pharmaceutical companies have grown dramatically since the original generic legislation was passed in 1984. We are concerned by Medicare cutbacks, but encouraged by the demographics of our aging population.

According to our modeling, Amgen's PE ratio, after adjustment for the \$500 million in lost sales, will be around 13.5. We are happy to buy this marquis name at this price. Some analysts criticize Amgen's "thin pipeline" of new drugs, but we

count 6 drugs in Phase 3 trials, 7 in phase 2, and 15 in phase 1. Some of the late stage drugs address huge markets such as osteoporosis and type 2 diabetes. With over \$4 billion in cash and marketable securities, Amgen can also continue to acquire new drugs to fill their pipeline. Amgen has always stood out among biotech companies as one of the best run. Management recently did a stock buyback at \$61; the stock is currently below \$57.

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