

# HEDGEYE

RISK MANAGEMENT

## HEDGEYE'S BEST IDEAS

15 NOVEMBER 2012

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“IDEAS ARE LIKE RABBITS. YOU GET A COUPLE AND LEARN HOW TO  
HANDLE THEM, AND PRETTY SOON YOU HAVE A DOZEN.”

- JOHN STEINBECK



# RESTAURANTS



## HOWARD PENNEY

Formerly of FBR, SunTrust, & Morgan Stanley. Recognized as the top analyst by both the Wall Street Journal and Institutional Investor.



**LONG JACK**



## STABLE CASH FLOW, COMPELLING GROWTH, NO LOVE

- **Two-Part Company:** Jack in the Box (JIB) and Qdoba are the two concepts that comprise the Company. JIB is a traditional QSR concept that accounts for almost 80% of the JACK system and is 80% franchised. Qdoba is a young, fast-casual, Mexican chain that is 50% company-owned.
- **Ahead Of The Joneses:** While much of the traditional QSR category is increasing cash allocation to renovate capital-starved asset bases, the JIB system has been completely reimaged.
- **Cash Rich:** Capex is declining as FCF is growing. What capital is being put to work is targeting growth rather than maintenance.
- **Growth:** Qdoba is the growth engine of JACK and, as of now, the investment community is giving the stock little-to-no credit for its growth potential. Personnel changes at Qdoba are lending credence to the bear case but we believe there is volume and margin upside at Qdoba as its system matures.
- **Hated:** Consensus is valuing JACK at 7.1x NTM EV/EBITDA versus WEN and SONC at 8.6x and 7.6x, respectively. One turn in the multiple would imply 20% upside.

### Key Stats:

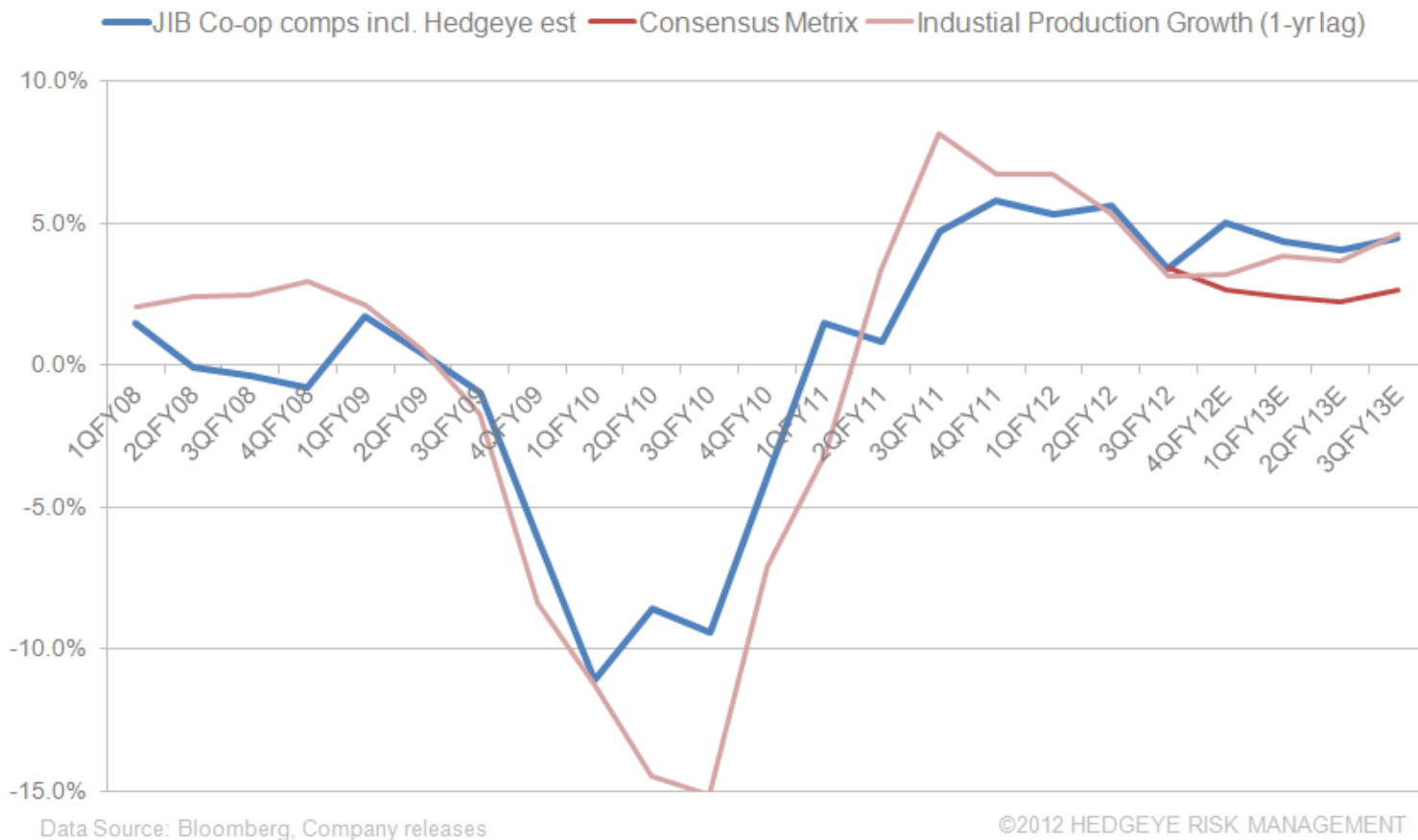
Current price: \$25.01 52-week range: \$18.65 - \$29.47

Market Cap: \$1.1 billion Enterprise Value: \$1.6 billion

7.1x NTM EBITDA

## CONSENSUS ESTIMATES FOR JOB COMPS BEARISH

### JIB COMPS TRACK THE BROADER ECONOMY ON A ONE-YEAR LAG



We believe that consensus estimates for JIB co-op SRS are unlikely to go much lower from here.

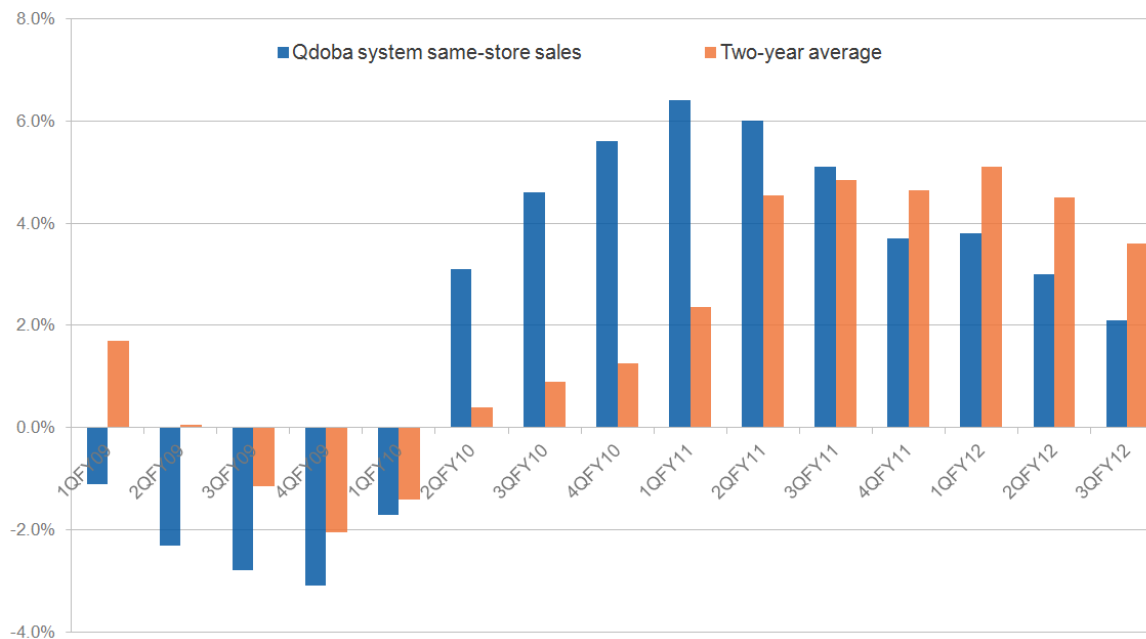


## QDOBA HAS AMPLE POTENTIAL TO DELIVER GROWTH

### Qdoba Unit Economics

| \$ in thousands | Yrs of Operation |       | Higher than<br>\$1mm AUV |
|-----------------|------------------|-------|--------------------------|
|                 | < 3              | > 3   |                          |
| Sales           | \$769            | \$987 | \$1,329                  |
| ROM             | 1.2%             | 18.6% | 24.2%                    |
| EBITDA          | \$53             | \$197 | \$328                    |
| EBITDA Margin   | 6.9%             | 20.0% | 24.7%                    |

Source: Company Presentation



Data Source:

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Qdoba SRS have been decelerating but there is significant upside to EBITDA as system matures.





## LONG-TERM VALUE REPRESENTS SIGNIFICANT UPSIDE

### Sum of the Parts Analysis

| Jack in the Box Enterprise Value          |  | Yr End FY12 | Qdoba Enterprise Value          |             |         |
|---|--|-------------|---------------------------------|-------------|---------|
|   |  |             | Yr End FY12                     | Yr End FY15 |         |
| Company-Operated Stores                   |  | 549         | 318                             | 500         |         |
| Average Unit Volume (mm)                  |  | \$1.45      | \$0.95                          | \$1.00      |         |
| ROP Margin                                |  | 14.9%       | 13.5%                           | 18.5%       |         |
| Corporate G&A                             |  | \$42.3      | \$27.7                          | \$43.6      |         |
| Adjusted Cash Flow                        |  | \$76.3      | \$13.1                          | \$48.9      |         |
| Hedgeye Estimated Multiple                |  | 8.5x        | 10.5x                           | 10.5x       |         |
| EV for Co-Op Stores                       |  | \$648.8     | \$137.3                         | \$513.8     |         |
| Franchise Royalties                       |  | \$106.1     | \$16.4                          | \$20.6      |         |
| Franchise EBIT                            |  | \$84.9      | \$13.1                          | \$16.5      |         |
| Hedgeye Estimated Multiple                |  | 9.0x        | 11.0x                           | 11.0x       |         |
| EV for Franchised Operations              |  | \$767.8     | \$144.0                         | \$181.5     |         |
| Jack in the Box Consolidated EV           |  | \$1,416.7   | \$281.3                         | \$695.3     |         |
| Jack in the Box Estimated Value Per Share |  | \$23.47     | Qdoba Estimated Value Per Share | \$4.66      | \$16.71 |

| FY12 Scenario             |            | FY15 Scenario             |            |
|---------------------------|------------|---------------------------|------------|
| Total JACK EV             | \$1,697.90 | Total JACK EV             | \$2,111.95 |
| Net Debt                  | 441.26     | Net Debt                  | 28.07      |
| Shares Outstanding        | 44.67      | Shares Outstanding        | 41.05      |
| Estimated Value per Share | \$28.13    | Estimated Value per Share | \$40.18    |
| Current Stock Price       | \$25.14    | Current Stock Price       | \$25.14    |
| % upside/downside         | 11.89%     | % upside/downside         | 59.83%     |

Source: Company filings, HRM

Awarding an appropriate multiple to the JIB business and giving full credit to Qdoba over long-term .



## SUMMARY & RISKS

**Summary:** JACK is a stock with significant upside over the long-term TAIL duration. We believe that buying near-term weakness could offer investors 50-60% of upside. In a difficult operating environment, the stable, annuity-like, cash flows generated by the Jack in the Box business should be attractive to investors versus other QSR names like WEN that are burning cash. Qdoba offers growth potential that investors are giving the stock very little credit for. The stock is exceedingly “cheap” at 7.1x EV/EBITDA.

**Upcoming Catalyst:** 4QFY12 Earnings will be released on November 20<sup>th</sup>. We expect the quarter to beat sales and earnings expectations. It is difficult to know how the stock will react, or what management’s “tone” will be perceived to be, but over the long-term TAIL we believe that JACK offers the most upside versus its QSR peers.

## RISKS

- **Unemployment:** Joblessness among younger age cohorts, particularly young Hispanic males, can have a significant impact on JIB SRS.
- **Beef Prices:** Jack in the Box operators purchase fresh beef on the spot market. Fluctuations in beef prices can affect restaurant operating margins significantly.
- **Qdoba:** Investors are skeptical of Qdoba’s future prospects and recent personnel changes have done little to ease concerns.

# GAMING, LODGING & LEISURE



**TODD JORDAN**

Former buy-sider at Jefferies, Cobalt, and Ardsley. A sell-sider at Raymond James, Dresdner Kleinwort Wasserstein, and Buckingham.



**LONG IGT**



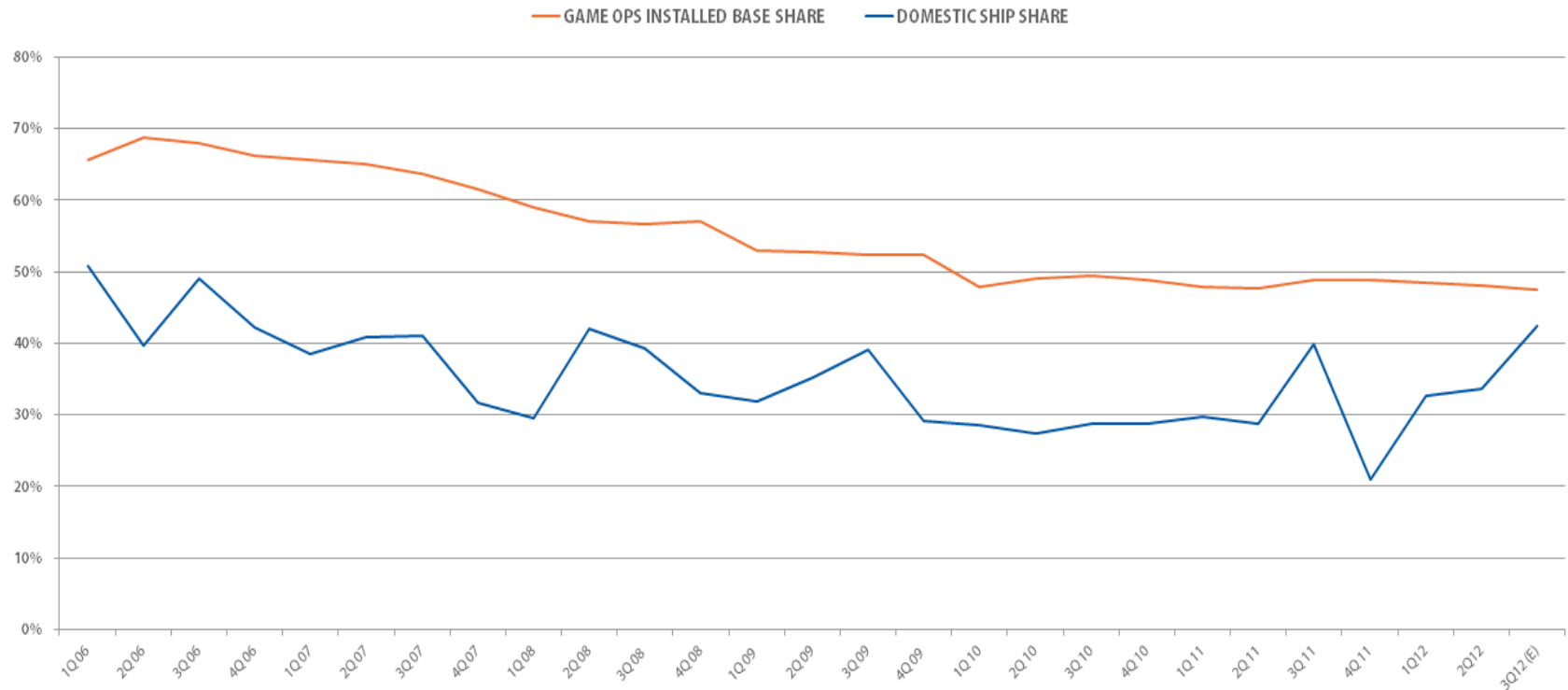
- Long Trade and Tail
- EPS and FCF growth accelerating – 28% and 24% growth projected for fiscal 2013
- Market share stable to growing
- Improving performance of Interactive segment lessening overhang
- Huge and accelerating cash flow – returning cash to shareholders now a priority
- PE of 10x at the very low end of the historical range suggests IGT is a show me stock – FQ4 2012 was a good start



## POSITIVE DEVELOPMENT IN SHARE

- Declining participation share was long our negative call out – share now stable for 10 quarters
- Ship share actually improving given IGT's refocus on content

IGT GAME OPERATIONS INSTALLED BASE AND DOMESTIC SHIP SHARE

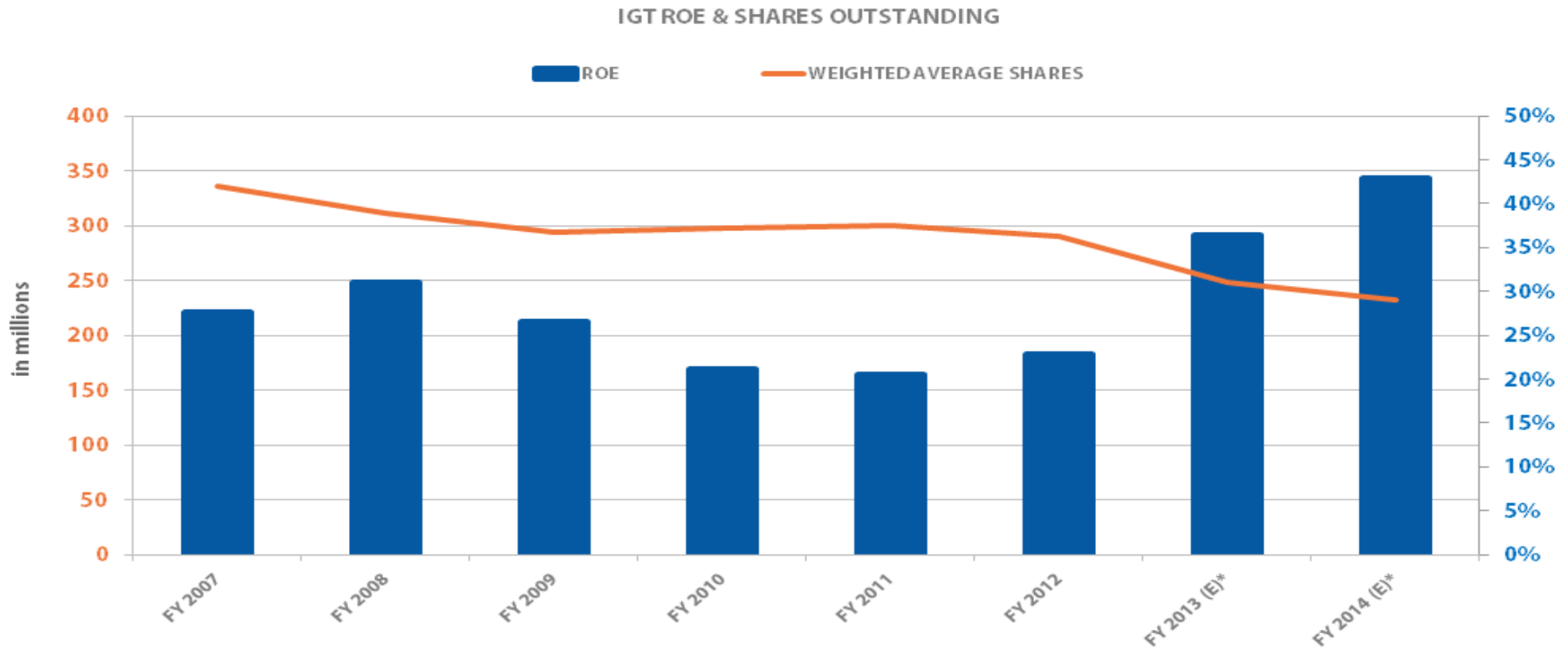


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## SHIFTING CAPITAL DEPLOYMENT PRIORITIES JUICING ROE

- IGT appears done with acquisitions – shifting to aggressive share repurchase
- Management's goal is 2.5x leverage – leaves \$200-450 million annually for share repurchases
- Improving fundamentals and share repurchases meaningfully impacting ROE



\* assumes 2.5x leverage

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## CATALYSTS & RISKS

### CATALYSTS

- 2013 state legislative sessions
- Quarterly earnings – big YoY increases
- Stock buy back should provide a floor
- Accelerated IL roll out
- Continued improvement in Interactive profitability

### RISKS

- Declining yields in gaming operations
- Brain drain
- Secular downturn in slot play
- Emerging competition from smaller players





**BRIAN MCGOUGH**

Formerly of Nike (IR) & Morgan Stanley. Reworked stock coverage blueprint to maximize impact across a materially larger number of stocks.



**LONG NKE**



### TAIL

This is a great company, great brand, and a great growth algorithm. We like when we can buy stocks like that when people are concerned about near-term factors.



### TREND

We think that the key factor that has impacted the stock in recent quarters – Gross Margin – will turn in the coming quarter. The consensus numbers need to come up by at least \$0.20 this year, and \$0.35 next.



### TRADE

Current sales trends look good, and we think that expectations are too low in the upcoming quarter. Nike is more hated today than in anytime in recent history.



## TAIL: HOW OFTEN DO YOU FIND A GROWTH MODEL LIKE THIS

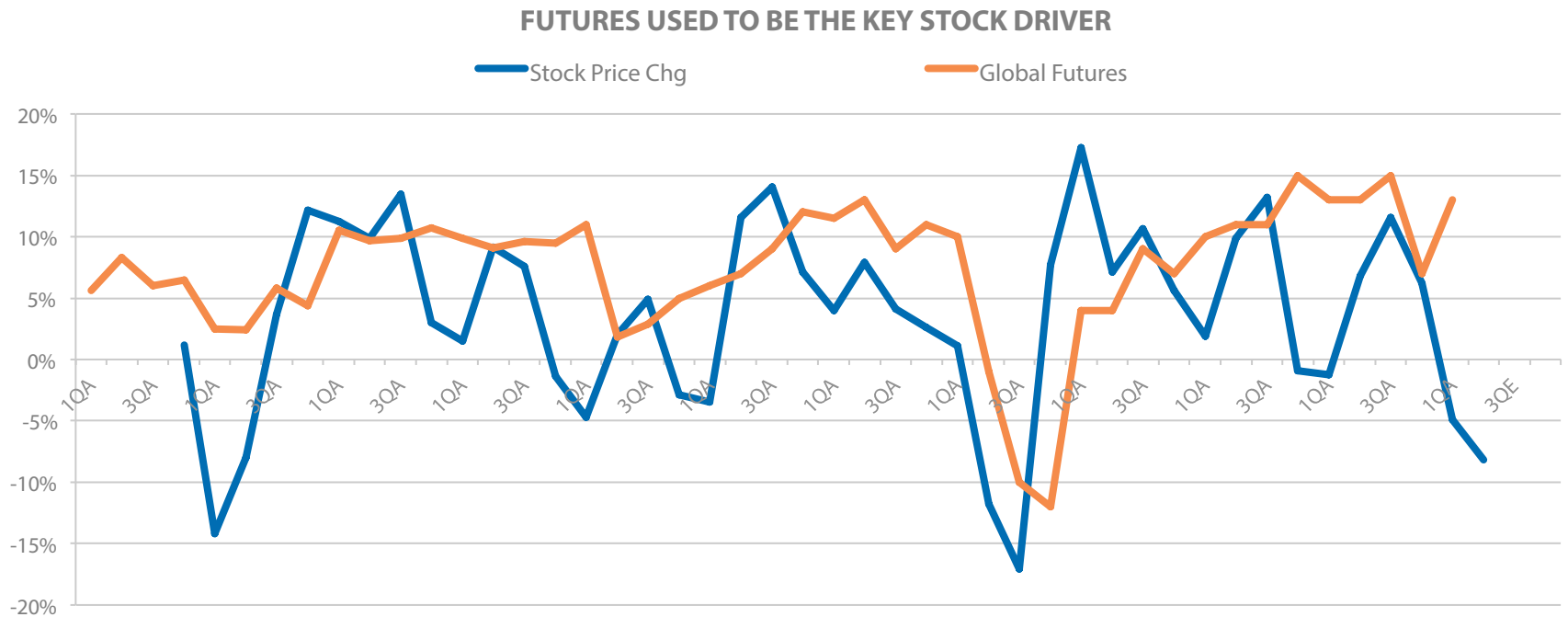
- #1 player in a global duopoly in a GDP+ industry
- Maintains top position in US Footwear with about 48% share that is trending +600bps.
- Similarly, holds 18% in a more fragmented Apparel market – share up nearly 200bp yy.
- Structural competitive advantage with a) arsenal of past SKUs, b) high touch salesforce, c) immense support from vendors and retailers alike. Second only to brands like Apple in owning the supply chain.
- One of the only companies we can find that will have each successive line on P&L and cash flow statement growing faster than the preceding one.

|              | FY12A   | FY15E   | CAGR  |   |
|--------------|---------|---------|-------|---|
| Revenue      | 24,136  | 31,623  | 10.3% | ↓ |
| Gross Margin | 43.4%   | 45.3%   |       |   |
| Gross Income | 10,471  | 14,319  | 12.2% |   |
| SG&A         | 30.8%   | 31.6%   |       |   |
| EBIT         | \$2,986 | \$4,337 | 15.1% |   |
| EBIT Margin  | 12.4%   | 13.7%   |       |   |
| Net Income   | \$2,223 | \$3,240 | 15.2% |   |
| EPS          | \$4.73  | \$7.39  | 18.7% | ↓ |
| CFFO         | 1,944   | 3,500   | 26.7% |   |
| Capex        | (603)   | (791)   | 10.3% |   |
| FCF          | 1,340   | 2,709   | 34.0% |   |



## TREND: KEY STOCK DRIVERS ARE BEGINNING TO TURN

Historically, 'Futures' or the backlog of orders, has been the primary driver of Nike's stock.

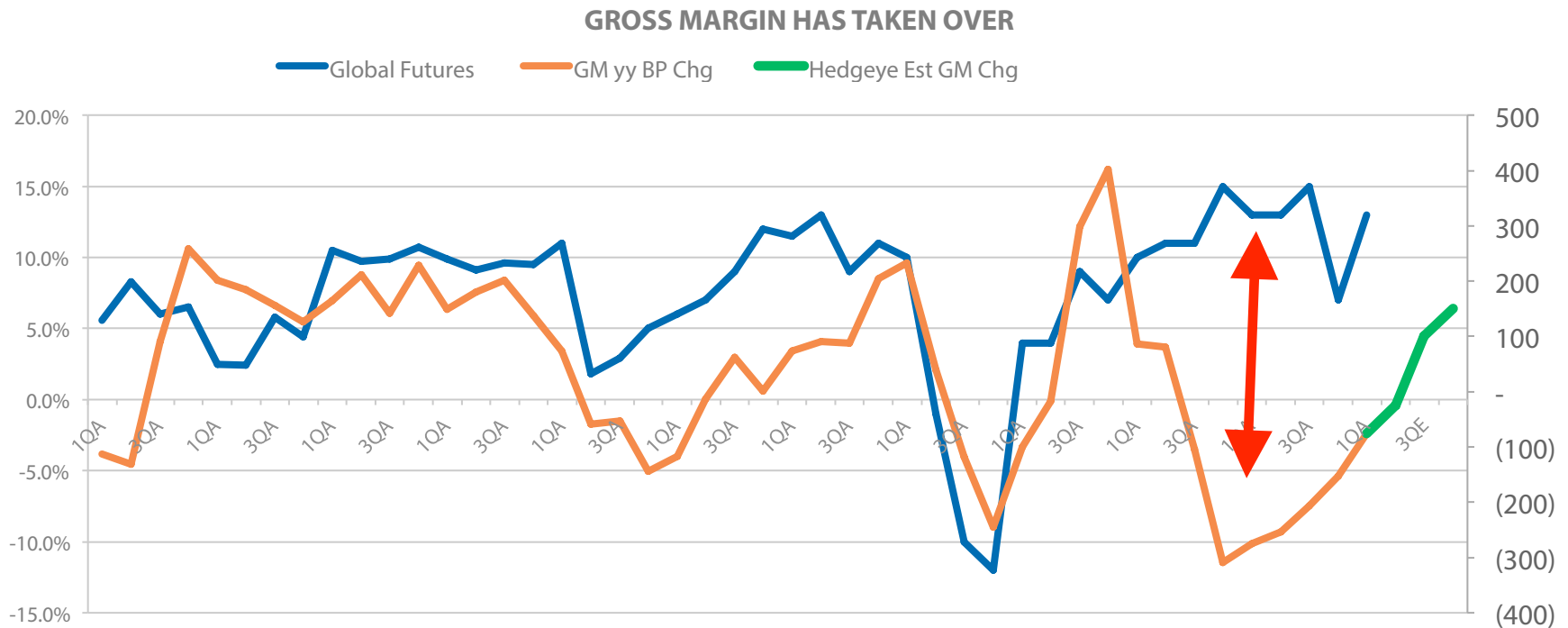


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## TREND: FUTURES NOT DRIVING NKE ANYMORE...FOR NOW

But there was a major deviation between Gross Margins and Futures over the past three quarters. Gross margins weakened, and the stock chased the margins.



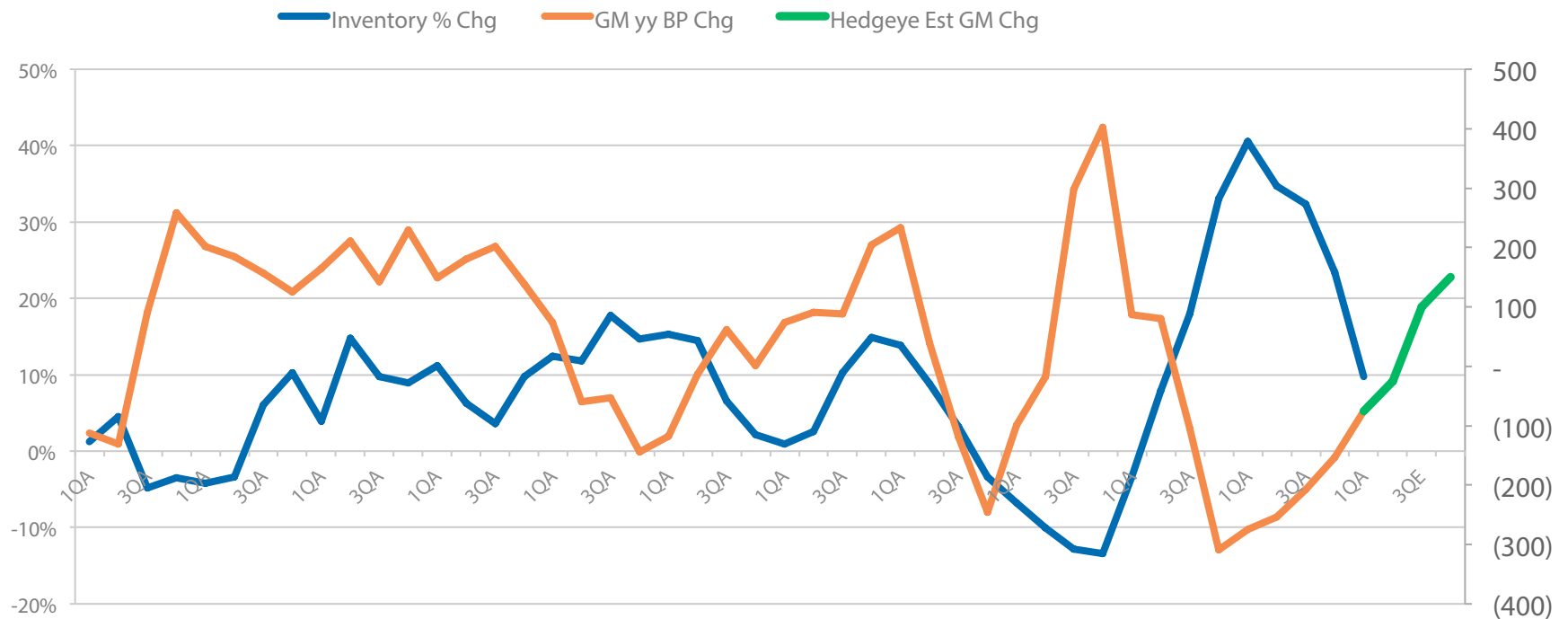
Data Source: Nike and Hedgeye

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## ONE OF THOSE PROBLEM HAS BEEN WITH INVENTORIES

One driver to the Gross Margin erosion has been inventories, but we see them converging with revenue, which has very bullish Gross Margin implications.



Data Source: Nike Inc and Hedgeye

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## TREND: THERE'S A DIRECT POSITIVE IMPACT ON PRICE

Whenever the spread between order rates and inventories widens materially, the stock does what it should do...head higher.



Data Source: Nike, Inc and Hedgeye

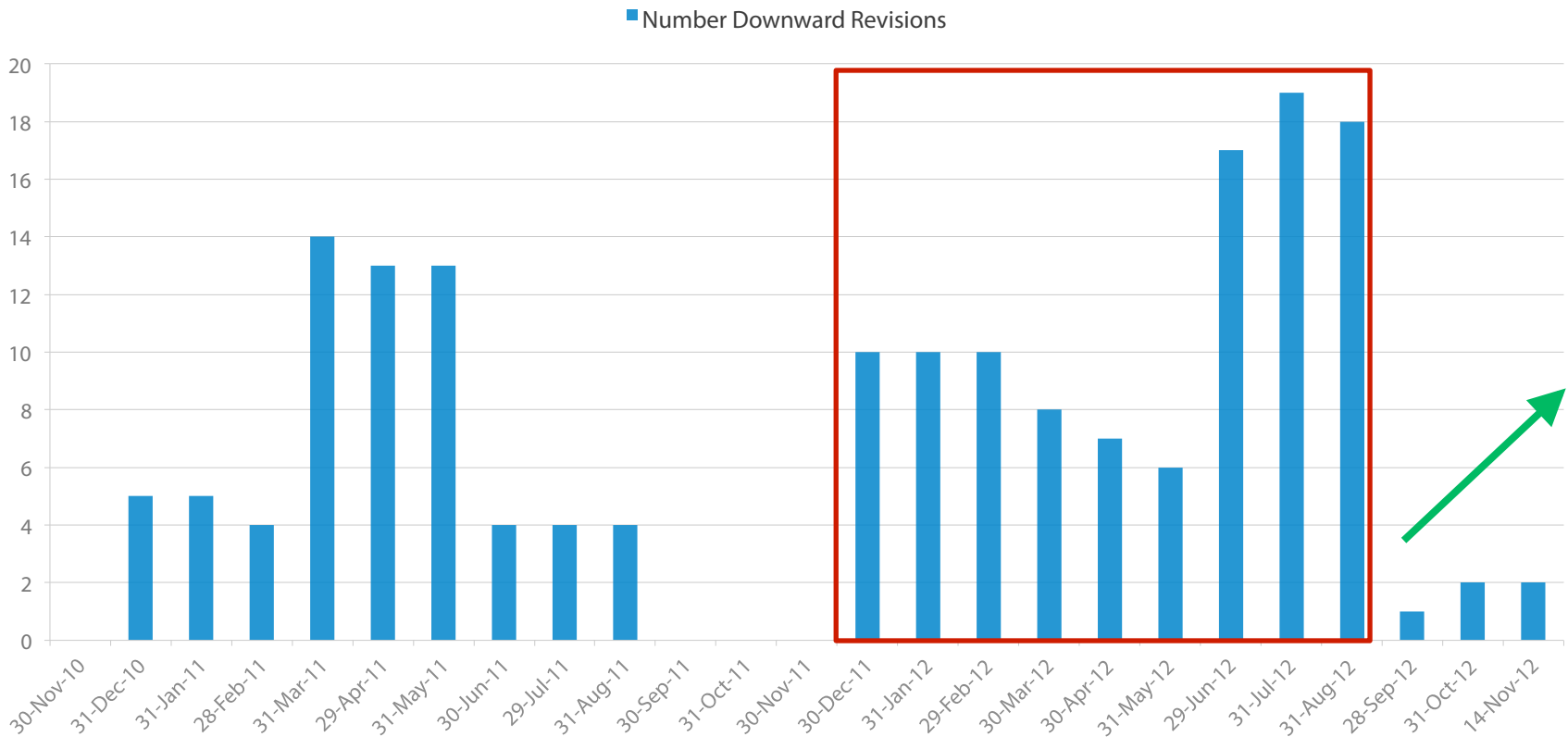
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## TRADE: SENTIMENT IS WASHED OUT

This stock has the lowest 'buy ratio' since 2002. Estimates have come down to a beatable level, and we think that higher Gross Margins will be an immediate catalyst.



Data Source: Factset

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### **VALUATION LOOKS EXPENSIVE, AND IT SHOULD**

The consensus numbers need to come up by at least \$0.20 this year, and \$0.35 next.



### **WHAT WORRIES US THE MOST**

China is a Black Hole. It's already blown them up, but if China takes another leg down, both our numbers and the stock will follow.



### **THE BOTTOM LINE**

Though we think Nike will beat the quarter, this call is bigger than that. It's about buying into a solid business model with a great growth algorithm while people are concerned about near-term factors.



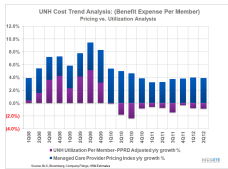
**TOM TOBIN**

Formerly at Dawson-Herman and W.P. Stewart. Research work at MZT Holdings and Harvard/MGH Cutaneous Biology Research Center.



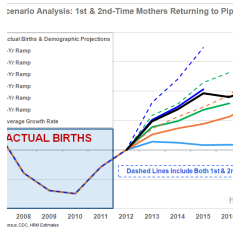
**SHORT UNH**

UNH is a health insurance company which manages medical costs, profiting when the spread between premiums and costs is widening. We believe UNH and the Managed Care Subgroup are near a cyclical top in Commercial Insurance.



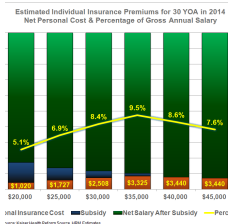
### UTILIZATION HAS BEEN NEGATIVE

Cost trend has been negative for the last 3 years. While some medical spending is discretionary, underlying demand is unlikely to remain negative for long.



### COSTS ARE LIKELY TO ACCELERATE

Our forecast of physician office visits and maternity suggest a recovery is ongoing.

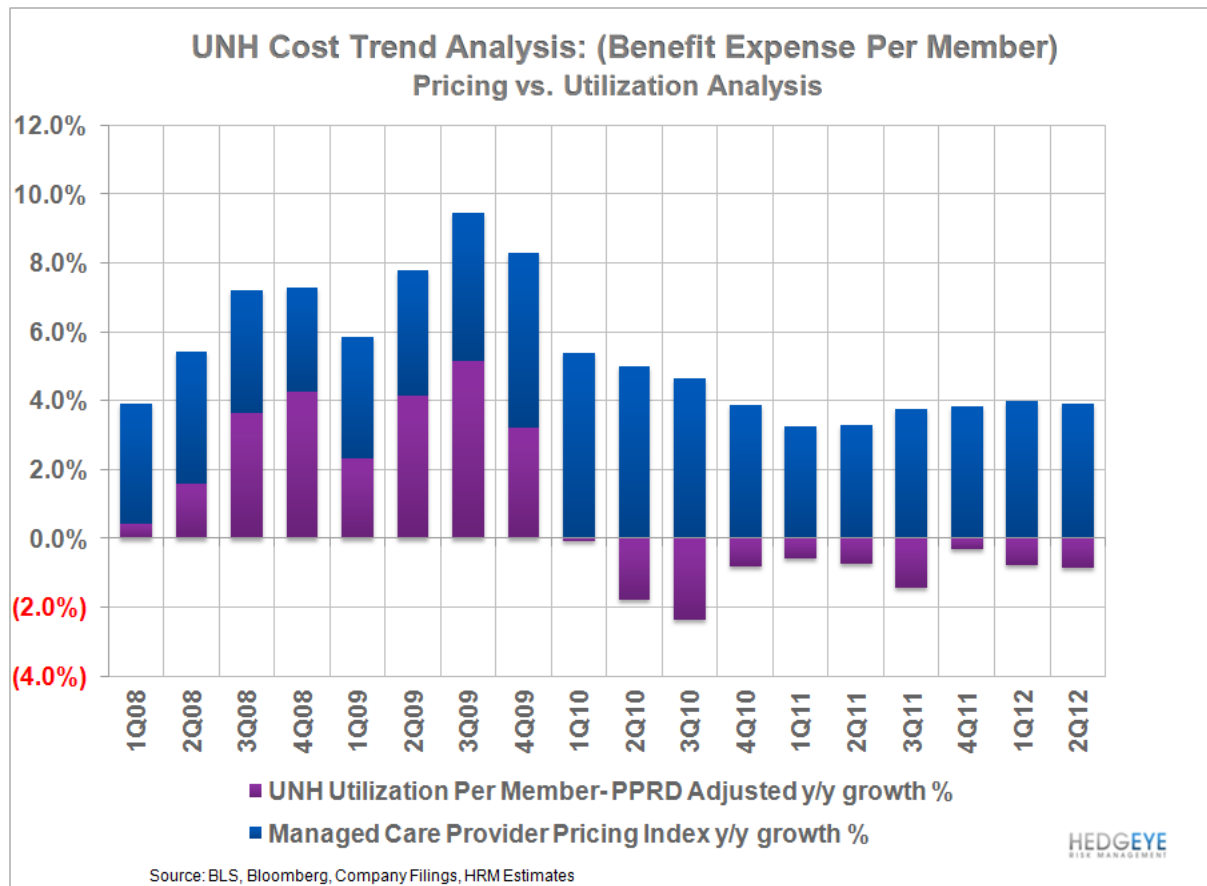


### AFFORDABLE CARE ACT CREATES PROBLEMS

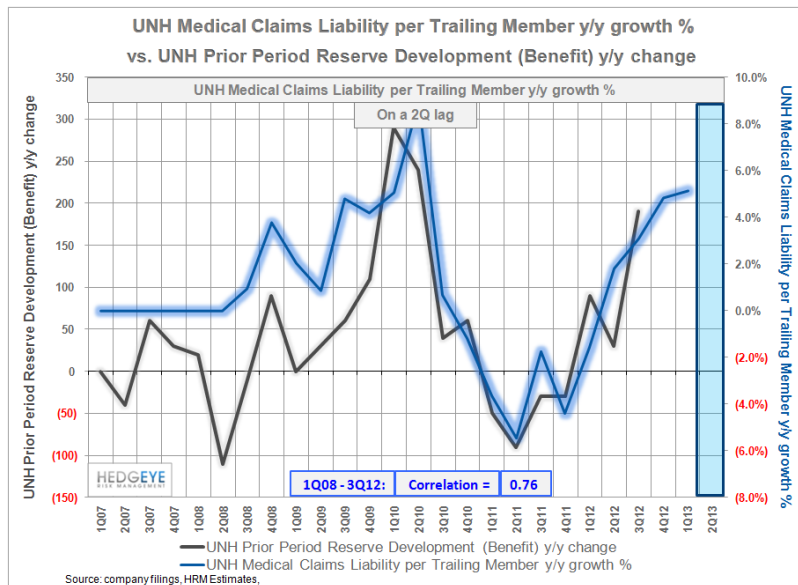
The Affordable Care Act creates a host of market uncertainties and has a high probability of being disruptive to the health insurance market.

## NEGATIVE COST TREND IS UNSUSTAINABLE

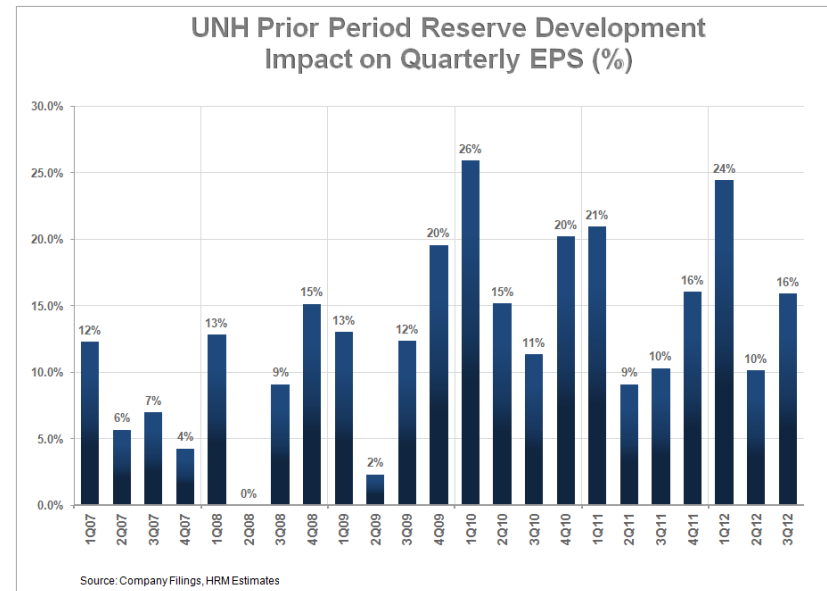
Cost trend accelerated in 2009 due to COBRA subsidies and fear based consumption, but has been in decline since 1Q10. This trend is unlikely to continue.



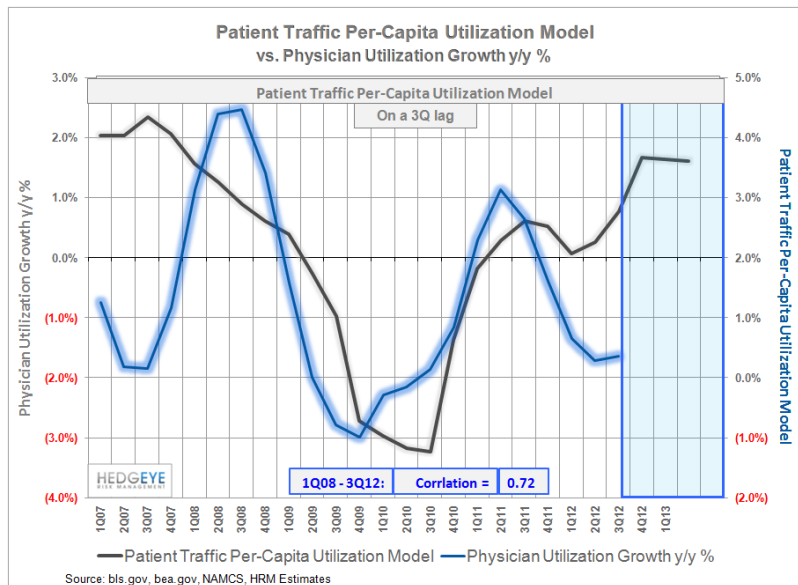
## RESERVE DEVELOPMENT LIKELY HEADING HIGHER IN THE SHORT TERM



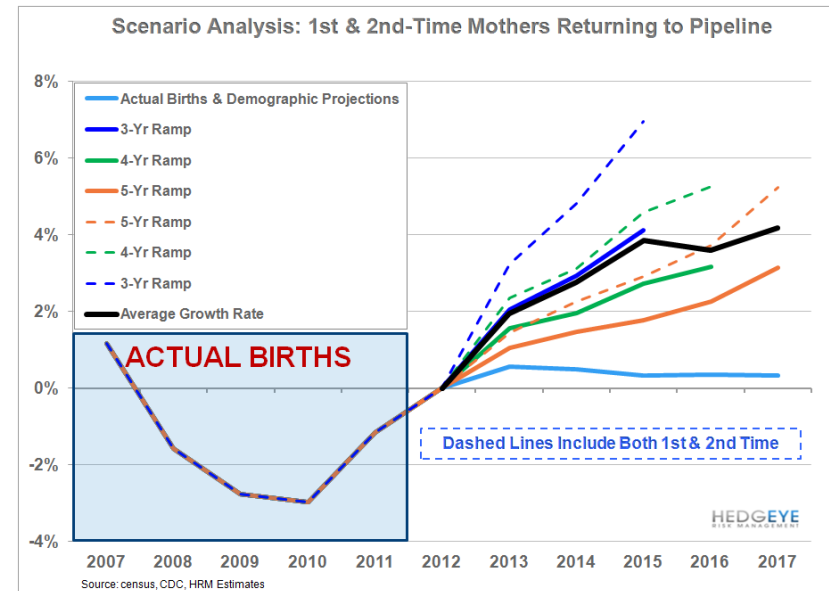
## RESERVE DEVELOPMENT HAS BEEN SIGNIFICANT EPS DRIVER



## DOCTOR VISIT RECOVERY DRIVES HOSPITAL OUTPATIENT AND PHYSICIAN OFFICE VISIT RELATED COSTS

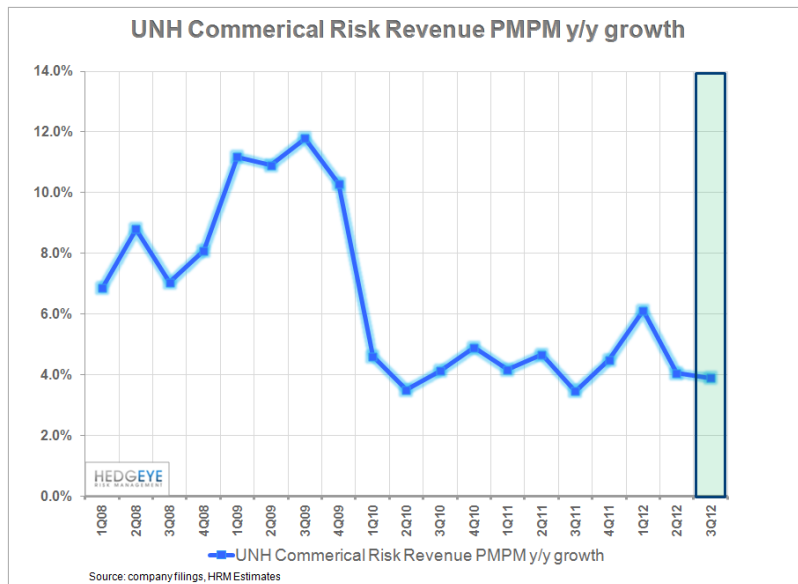


## MATERNITY RECOVERY DRIVES INPATIENT VOLUME

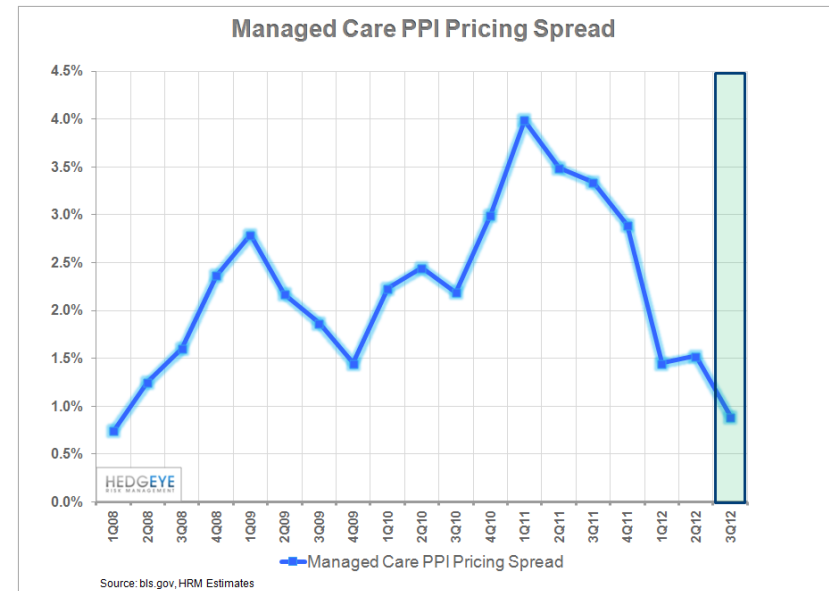




## COMMERCIAL PRICING IS WEAKENING



## SPREADS ARE TIGHTENING



## WHAT HAPPENS IN 2014?

### 1. Employers Drop Coverage:

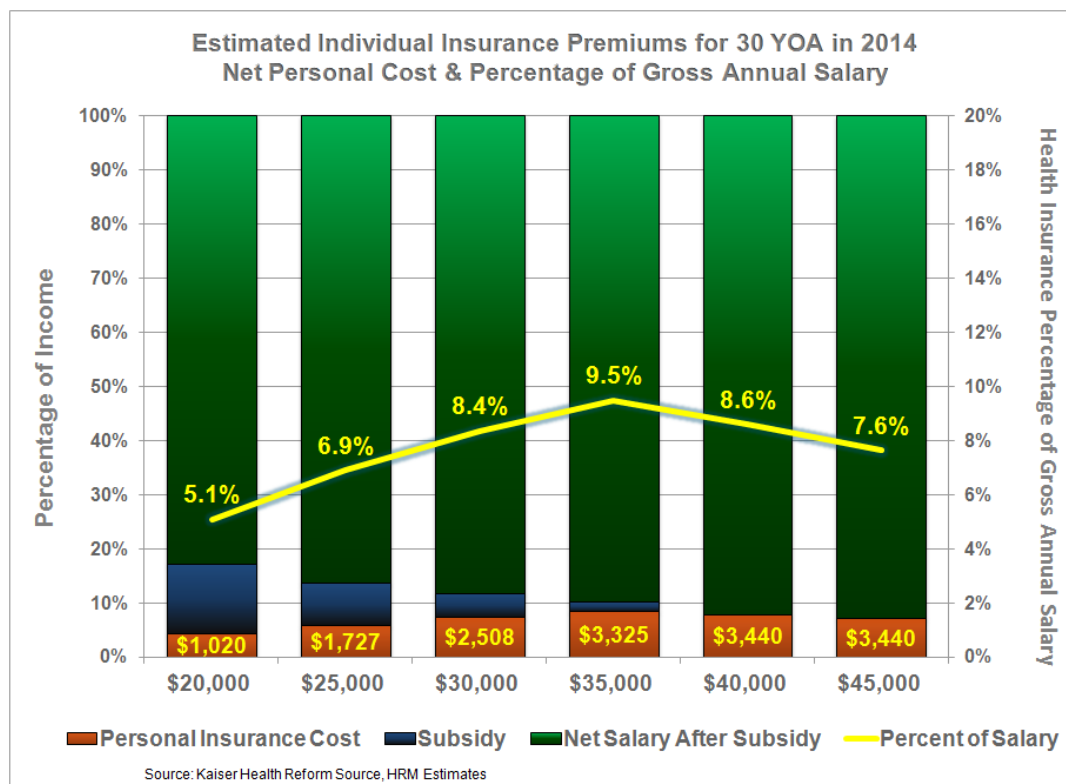
Employers may drop coverage in favor of the penalties and fees, which are lower than the ongoing cost of providing health insurance.

### 2. ACA Subsidies Too Low:

Subsidies under the Affordable Care Act look insufficient to cover the incremental costs of health insurance, even at modest income levels.

### 3. Adverse Selection Cycle:

The cost of the remaining pool of insured will rise faster than the rates that can be charged, resulting in further cycles of attrition.

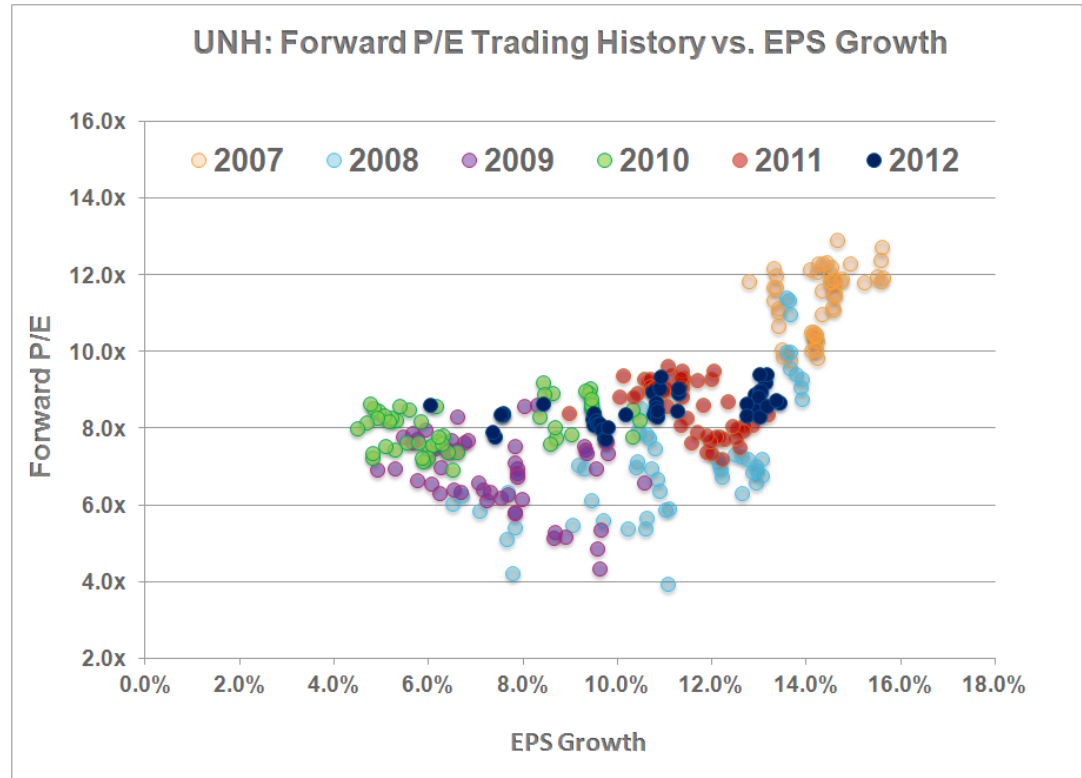


### Upside/Downside

- **Guidance likely of \$5.40 - \$5.60 at Analyst Meeting November 29<sup>th</sup>.**
- Q412 results likely better given our expectation of further positive reserve development.
- Growth slows materially in 2013 against tougher 2012 comp with resulting multiple compression back into the 6X-7X range. Implies a stock in the \$33-\$44 range at the high end of guidance. We expect downside through 2013.

### Risks

- **Continuation of negative utilization trends.**
- Affordable Care Act favorable rules or delay in implementation





# FINANCIALS



## **JOSH STEINER**

Former sell-sider at Lehman, then buy-sider at Amaranth. Part of the number-one ranked team in Institutional Investor and Greenwich Survey.



**LONG TCB**



## REGIONAL BANK IN RECOVERY & STEALTH HOUSING PLAY

**Overview:** TCF Financial (Symbol: TCB) is a Midwest regional bank based in Minnesota, which operates primarily throughout Minnesota, Illinois, Michigan, Colorado and Wisconsin. TCF has 430 branches and just under \$18 billion in total assets. The company offers retail and commercial banking as well as equipment financing, inventory financing and indirect auto finance.

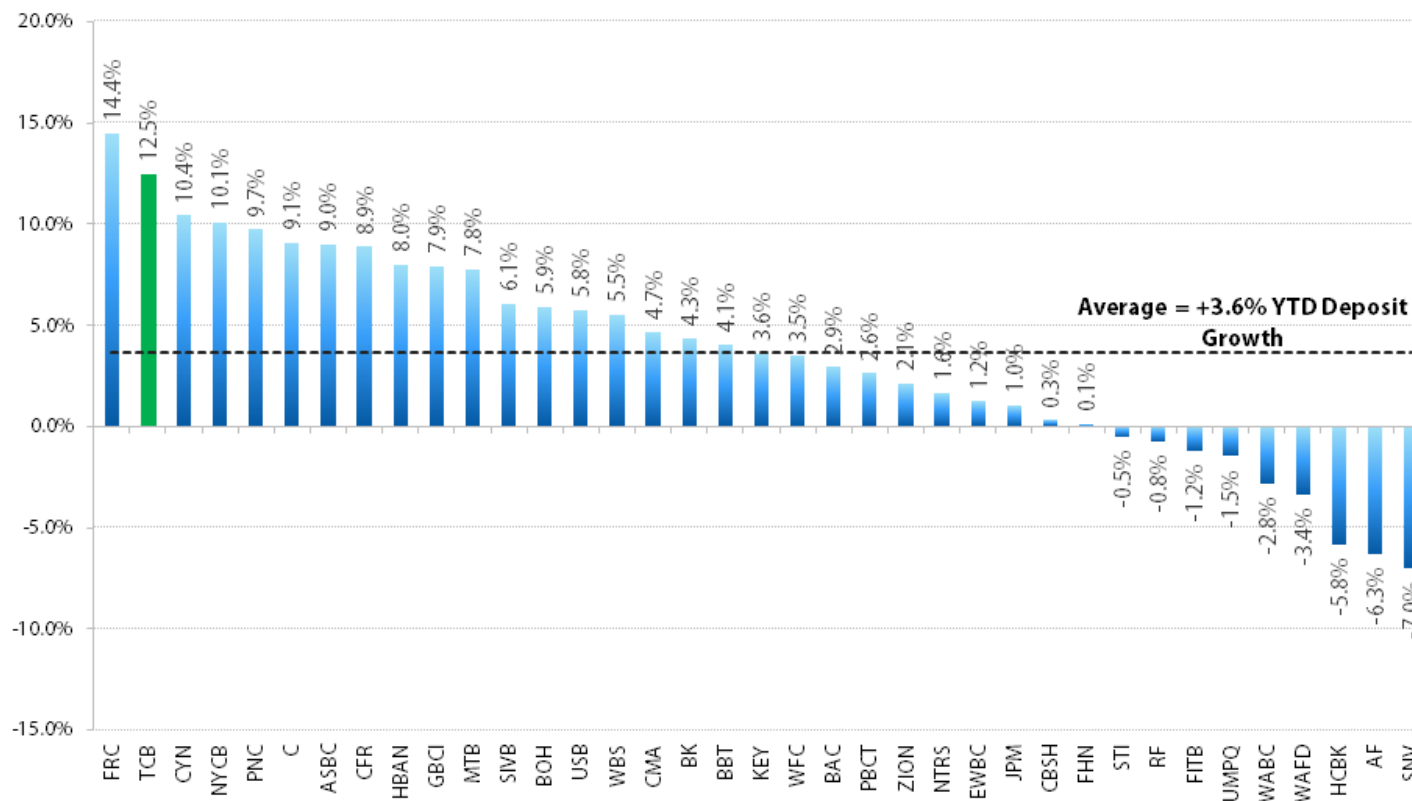
### KEY POINTS

- **Rebuilding Year Coming to an End.** 2012 was a self-proclaimed rebuilding year for TCF following a long slog through 2011. In anticipation of that, we were decidedly bearish 20 months ago when we published a detailed report calling for investors to short TCF. The stock dropped >40% over the next six months. Looking ahead, we think the bad news is over, and this stock now offers compelling value.
- **Improving Fundamentals.** TCF is finally getting stronger. The company is among the best performing banks from a deposit and loan growth standpoint year-to-date.
- **Housing Tailwinds.** TCF's loan footprint is heavy on residential real estate in hard-hit Midwestern areas. That was a core element of the bear thesis in 2011/2012, but those same areas are today some of the best performing distressed real estate markets in the country.
- **Potential Sale.** While not core to our thesis, an undeniable reality is that TCF's CEO, Bill Cooper, is 68 years old, making him very aged by bank CEO standards. The probability of a takeout is rising.



## DEPOSIT GROWTH AT TCF IS STRONG

### 2012 YTD DEPOSIT GROWTH (3Q12 vs 4Q11)



Data Source: SNL Financial

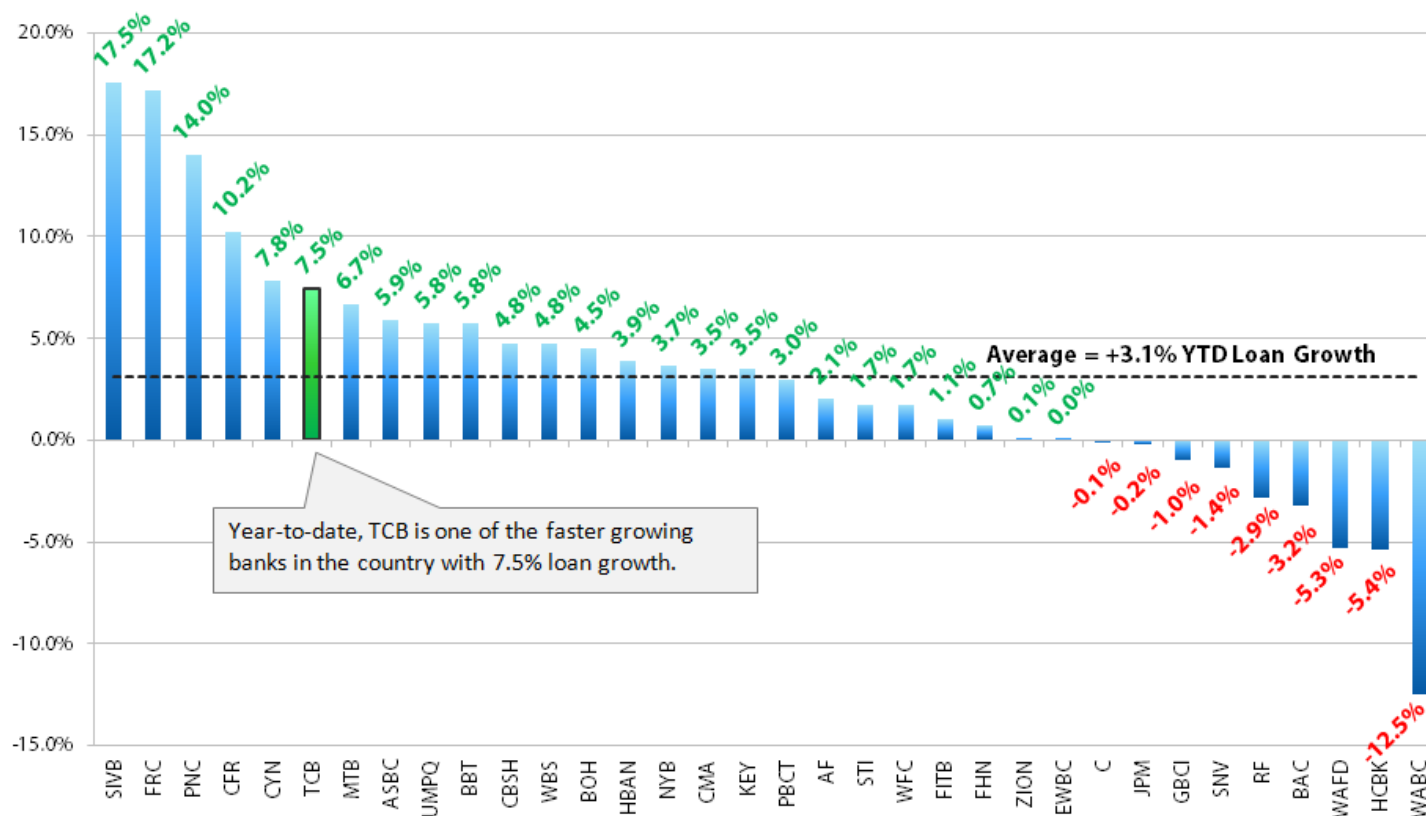
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Deposit growth has long been held as the most important metric for bank investors. TCF's deposit growth YTD has been relatively strong.



## LOAN GROWTH AT TCF IS GOOD

### 2012 YTD LOAN GROWTH (3Q12 vs 4Q11)



Data Source: SNL Financial

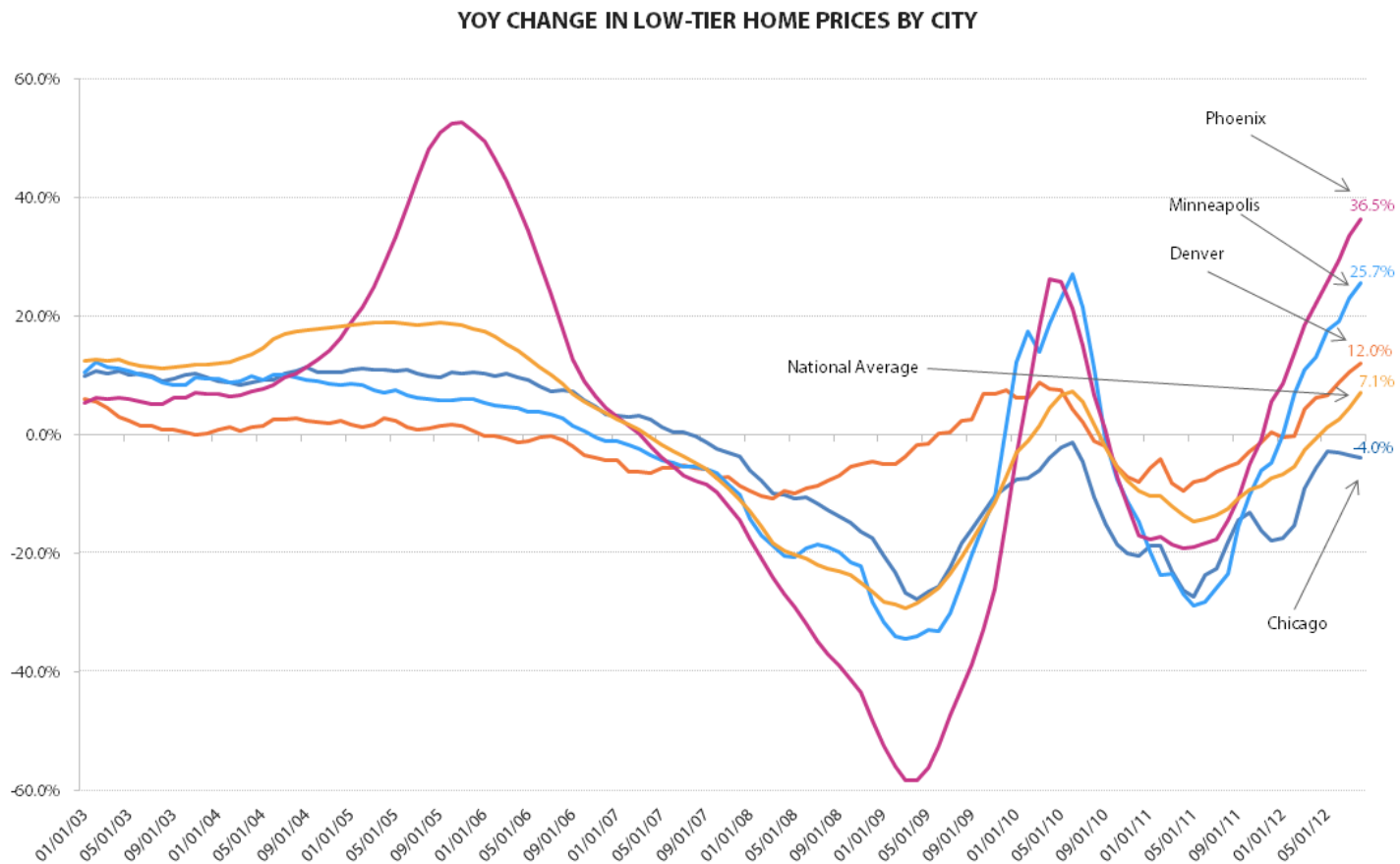
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While the traditional focus of regional bank investors has long been deposits and deposit growth, increasingly, the market is putting a premium on loan growth in a world where little growth exists.





## HOME PRICES ARE REBOUNDING IN THE TCF FOOTPRINT ...



Data Source: Case-Shiller

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TCF stands to benefit from the rebound in low-tiered home prices. Almost 40% of their residential mortgage exposure is in Minnesota, which is among the strongest performing distressed markets in the country, up 25.7% YoY.



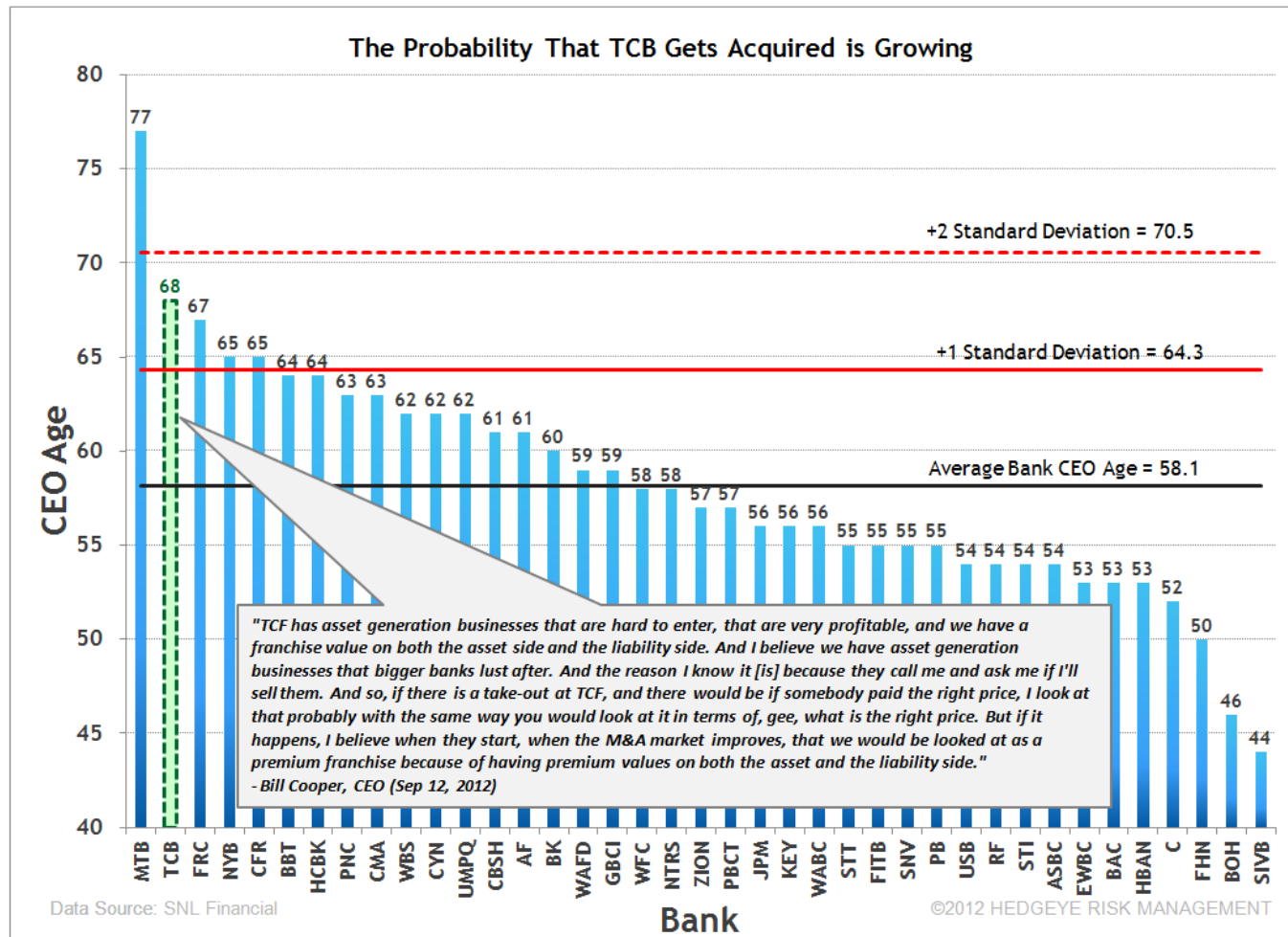
## ... AS IS THE BROADER ECONOMY

|                        | Consumer<br>Real Estate<br>Loans | % of Total    | YoY Home<br>Price Change as<br>of Aug-2012 | YoY Home<br>Price Change as<br>of June-2011 | % Of Homes In<br>State That Are<br>Underwater** | % Of Homes In<br>State Between<br>95-100% LTV** | Unemployment<br>Rate (%) | Unemployment<br>Rate Chg YoY<br>(%) |
|------------------------|----------------------------------|---------------|--|---|---|---|--------------------------|-------------------------------------|
| Minnesota              | 2,707,600                        | 39.58%        | 4.7%                                       | -9.6%                                       | 17.2%   | 5.1%  | 5.8%                     | -0.5%                               |
| Illinois               | 2,073,200                        | 30.31%        | -2.3%                                      | -11.5%                                      | 25.8%   | 4.7%  | 8.8%                     | -1.3%                               |
| Michigan               | 856,700                          | 12.52%        | 5.3%                                       | -8.4%                                       | 32.8%   | 4.8%  | 9.3%                     | -0.9%                               |
| Colorado               | 586,200                          | 8.57%         | 6.9%                                       | -3.0%                                       | 18.2%   | 6.7%  | 8.0%                     | -0.2%                               |
| Wisconsin              | 434,800                          | 6.36%         | 0.1%                                       | -5.7%                                       | 15.5%   | 4.8%  | 7.3%                     | -0.1%                               |
| Arizona                | 49,200                           | 0.72%         | 18.2%                                      | -11.9%                                      | 39.7%   | 5.0%  | 8.2%                     | -1.2%                               |
| Indiana                | 22,400                           | 0.33%         | 2.6%                                       | -2.1%                                       | 9.5%  | 3.9%  | 8.2%                     | -1.0%                               |
| Florida                | 2,600                            | 0.04%         | 6.9%                                       | -7.7%                                       | 42.7%   | 4.1%  | 8.7%                     | -1.7%                               |
| New York               | 2,100                            | 0.03%         | 5.8%                                       | 2.4%  | 8.1%  | 2.6%  | 8.9%                     | 0.6%                                |
| Ohio                   | 2,000                            | 0.03%         | 0.3%                                       | -9.0%                                       | 24.1%   | 5.7%  | 7.0%                     | -1.6%                               |
| California             | 39,900                           | 0.58%         | 5.5%                                       | -6.0%                                       | 29.0%   | 4.4%  | 10.2%                    | -1.5%                               |
| Pennsylvania           | 500                              | 0.01%         | 1.4%                                       | -3.4%                                       | 9.4%  | 3.8%  | 8.2%                     | 0.2%                                |
| Texas                  | 200                              | 0.00%         | 4.8%                                       | -1.5%                                       | 8.8%  | 4.5%  | 6.8%                     | -1.1%                               |
| Other                  | 63,400                           | 0.93%         | na   | na  | na  | na  | na                       | na                                  |
| <b>Total</b>           | <b>6,840,800</b>                 | <b>100.0%</b> | <b>2.6%</b>                                | <b>-9.1%</b>                                | <b>21.8%</b>                                    | <b>5.0%</b>                                     | <b>7.4%</b>              | <b>-0.75%</b>                       |
| <b>National Trends</b> |                                  |               | <b>4.6%</b>                                | <b>-5.7%</b>                                | <b>22.3%</b>                                    | <b>4.7%</b>                                     | <b>7.9%</b>              | <b>-0.63%</b>                       |

TCF's weighted loan footprint has seen home prices reverse from -9.1% YoY in June 2011 to +2.6% YoY in August, 2012.



## A TAKEOUT IS BECOMING INCREASINGLY LIKELY



Bill Cooper, TCF's CEO, is relatively old by bank CEO standards, and is open to selling the company. The above chart includes comments he made recently to this effect.



## TCB: SUMMARY, UPSIDE/DOWNSIDE & RISKS

**Summary:** Regional banks in general are well positioned to take advantage of recovery in the housing market. They benefit directly from increased mortgage banking activity as well as through improved credit performance from inflated collateral values and improved cure rates. TCF's footprint of distressed property has seen some of the strongest distressed home price appreciation in the country, which will roll through their earnings on a lag. The company is also generating strong deposit and loan growth while holding margins and expenses steady. There's also the potential for a takeout.

**Upside:** We estimate that TCF can earn \$1.37 in 2014, slightly ahead of the \$1.20 consensus is expecting. This should equate to a return on tangible capital of 15%. Today, regional banks are trading at a multiple of 1.61x tangible capital for a return on tangible capital of 15%. We forecast tangible capital will end 2013 at \$9.29 and end 2014 at \$10.69, resulting in valuation of \$15 and \$17 over the next 12 and 24 months, or +37% and +56%, respectively.

**Downside:** Downside should be capped at tangible book value of \$8.49 or roughly 23% lower. We presume this based on TCF's ability to earn its cost of capital going forward, which should enable it to at least trade at tangible book value.

## RISKS

- **Recession.** Like most financials, TCF is a cyclical negatively exposed to downturns in the economy, particularly as it relates to credit quality. If the Fiscal Cliff negotiations result in materially stepped up taxes and/or reduced spending, the odds of a recession increase.
- **Margin Pressure.** As the Federal Reserve continues to pressure the long end of the yield curve, driving long-term rates lower, this puts ongoing pressure on the net interest margin of spread lenders like TCF. A recent balance sheet restructuring has put the company in a favorable position in this front, but further curve compression will still adversely affect them.



## **KEVIN KAISER**

Oil & Gas analyst covering the E&P and oilfield services sectors. B.A. in Economics from Princeton University, where he captained the hockey team.

CJES

**LONG CJES**

## LEADING OFS COMPANY NEAR CYCLICAL TROUGH

**C&J Energy Services (CJES)** is an independent oilfield services company that provides hydraulic fracturing, coiled tubing, and wireline services to the US E&P sector. It specializes in complex and technically-demanding projects in the Eagle Ford, Permian, Granite Wash, Bakken, and other onshore US basins. CJES' long-term strategic goal is to become a large-scale, geographically-diverse OFS company, growing its fleet of equipment organically as well as via acquisitions..

CJES

C&J Energy Services Inc

HEDGEYE ENERGY COMPANY SNAPSHOT

HEDGEYE  
RISK MANAGEMENT

CAPITAL STRUCTURE AND TRADING

| MKT CAP | EV      | Net D/C | DEBT  | CASH | INT COV | SI % | BETA, 1Y |
|---------|---------|---------|-------|------|---------|------|----------|
| \$954   | \$1,145 | 25%     | \$204 | \$14 | 34.4X   | 16%  | 1.5      |

MARGINS

| GROSS | EBIT | EBITDA | FCF Yield |
|-------|------|--------|-----------|
| 39%   | 30%  | 34%    | 3.6%      |

ANNUAL DIVIDEND

| per Share | Yield |
|-----------|-------|
| \$0.00    | 0.0%  |

PRICE

| CURRENT | vs. 52W High | vs. 52W Low |
|---------|--------------|-------------|
| \$18.06 | -22.6%       | 12.5%       |

INSIDER ACTIVITY: 6M

| SOLD      | BOUGHT    |
|-----------|-----------|
| (50,800)  | -         |
| Avg Price | Avg Price |
| \$19.71   | \$0.00    |

RELATIVE PERFORMANCE

| vs. SPX |       |       |       |
|---------|-------|-------|-------|
| 1W      | 1M    | 3M    | 6M    |
| -7.4%   | -2.0% | -3.4% | -5.9% |
| vs. XLE |       |       |       |
| 1W      | 1M    | 3M    | 6M    |
| -7.0%   | -1.7% | -2.2% | -8.2% |

BEAT %, last 16Q

| SALES | EPS |
|-------|-----|
| 6%    | 6%  |

CONSENSUS ESTIMATES

| SALES |         |         | EBITDA         |       |       |
|-------|---------|---------|----------------|-------|-------|
| Qtr   | 2012    | 2013    | Qtr            | 2012  | 2013  |
| \$291 | \$1,119 | \$1,299 | \$80           | \$343 | \$336 |
| CAPEX |         |         | FREE CASH FLOW |       |       |
| Qtr   | 2012    | 2013    | Qtr            | 2012  | 2013  |
| \$40  | \$171   | \$81    | \$41           | \$147 | \$196 |

REVISION TRENDS

| NTM REVENUE |       |        |        |
|-------------|-------|--------|--------|
| 1W          | 1M    | 3M     | 6M     |
| -0.8%       | -0.1% | -3.6%  | 1.9%   |
| NTM EPS     |       |        |        |
| 1W          | 1M    | 3M     | 6M     |
| -1.2%       | -4.7% | -12.7% | -18.4% |

SELL-SIDE RATINGS

| Current | -1M | -3M  | -6M |
|---------|-----|------|-----|
| 4.20    | -   | 4.33 | -   |

2013e GROWTH

| SALES  | EBITDA |
|--------|--------|
| 16.1%  | -2.2%  |
| CAPEX  | FCF    |
| -52.4% | 33.3%  |

CONSENSUS VALUATION

| NTM P/E |        | EV/ NTM EBITDA |        |
|---------|--------|----------------|--------|
| 5.8X    |        | 3.4X           |        |
| 1Y MAX  | 1Y MIN | 1Y MAX         | 1Y MIN |
| 6.6X    | 3.7X   | 3.9X           | 1.9X   |
| 5Y MAX  | 5Y MIN | 5Y MAX         | 5Y MIN |
| 6.8X    | 3.7X   | 4.0X           | 1.9X   |

MULTIPLE TURN SENSITIVITY

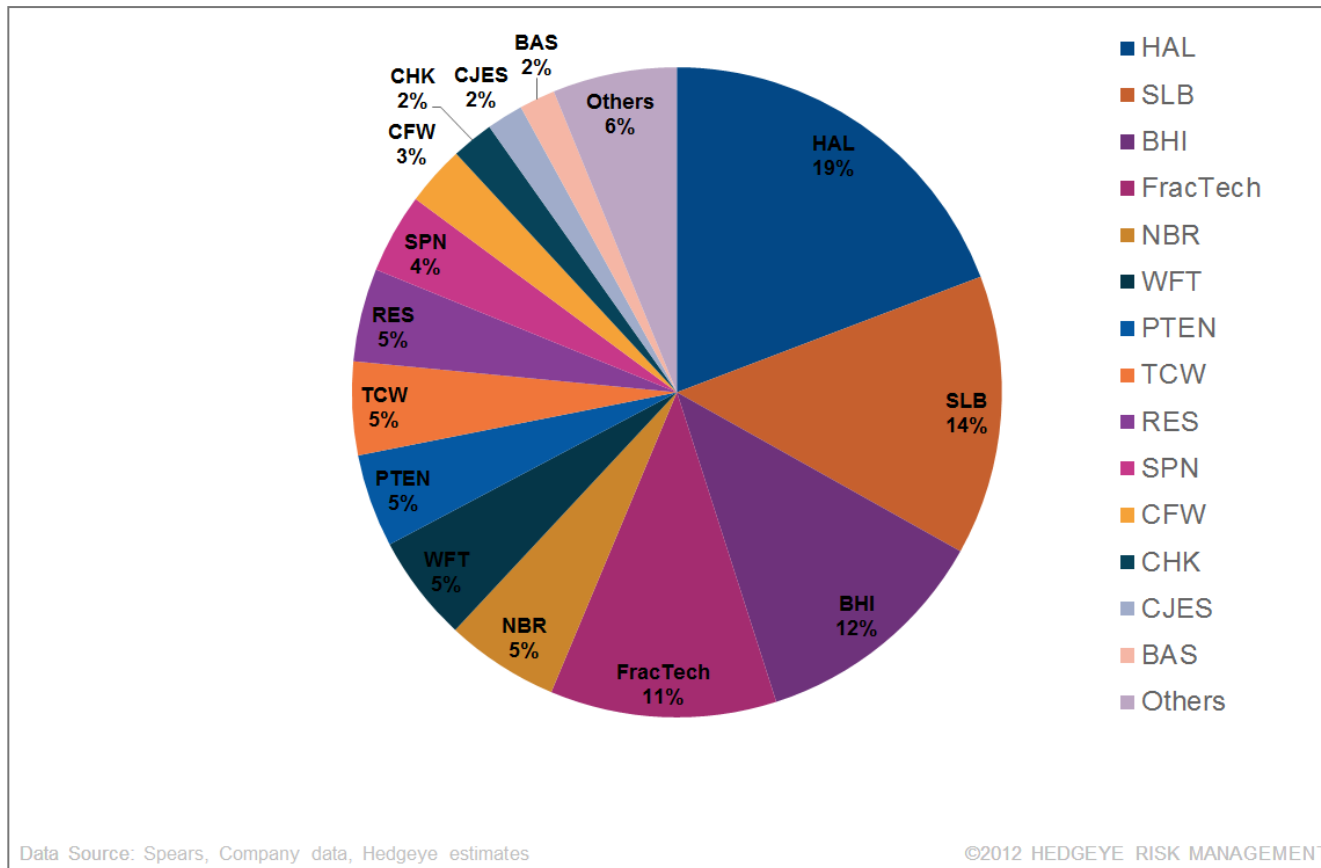
| NTM P/E  |        | EV/ NTM EBITDA |        |
|----------|--------|----------------|--------|
| + 1 TURN | 17.2%  | + 1 TURN       | 35.3%  |
| - 1 TURN | -17.2% | - 1 TURN       | -35.3% |

Source: Bloomberg

Source: Bloomberg

## PRESSURE PUMPING IS CLEARLY WEAK, BUT HEALING

**Industry structure is solid and improving.** Barriers to entry are low, but because the industry is so capital-intensive and cyclical, it consolidates frequently. HAL, SLB, BHI, and FracTech control 56% of pressure pumping equipment in North America. We expect consolidation in 2013. Further, HAL, SLB, and BHI are all now taking capacity out of the market.

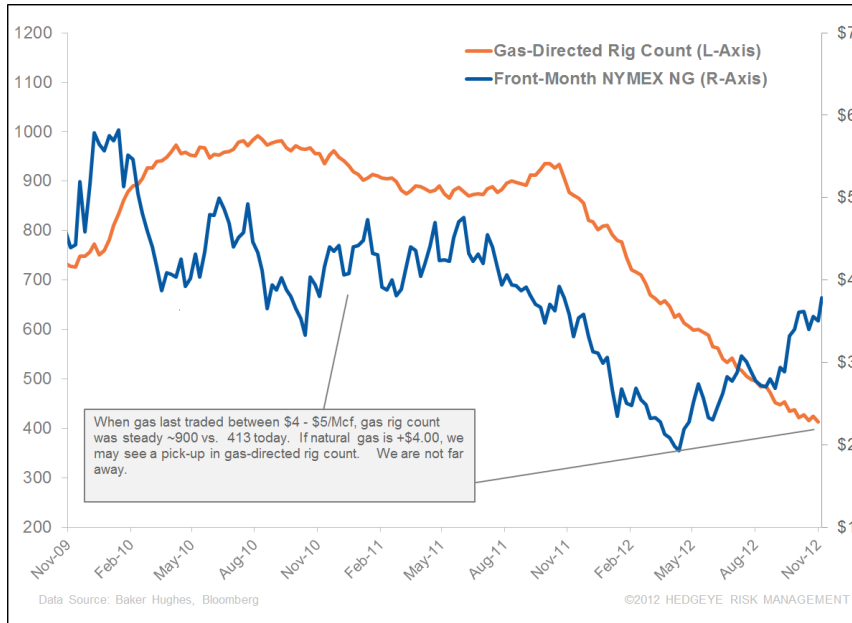






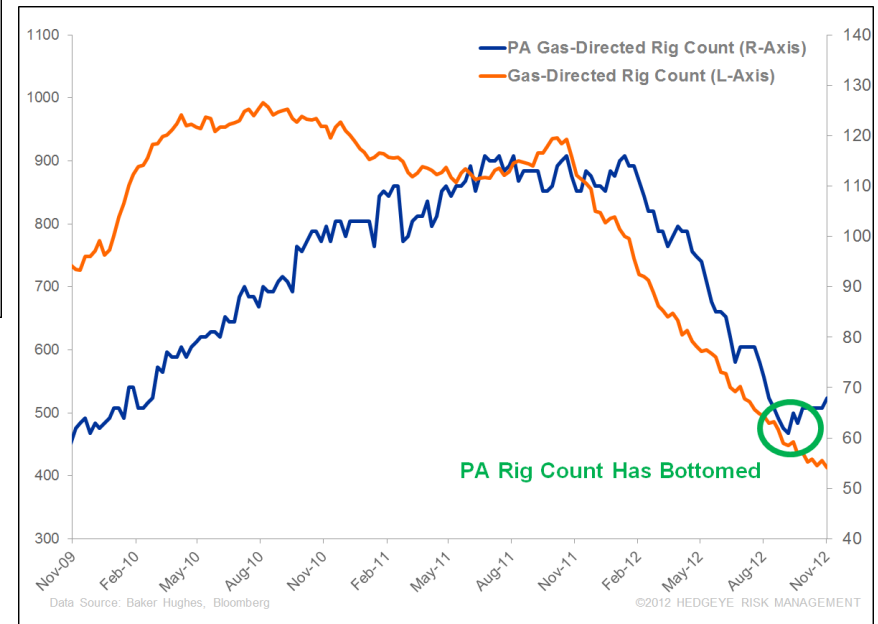
## NON-CONSENSUS WAY TO PLAY NAT GAS RECOVERY

*"To return to the utilization levels we saw in 2010 and 2011, the industry will require some degree of recovery in the natural gas market." – David Lesar, CEO of Halliburton*



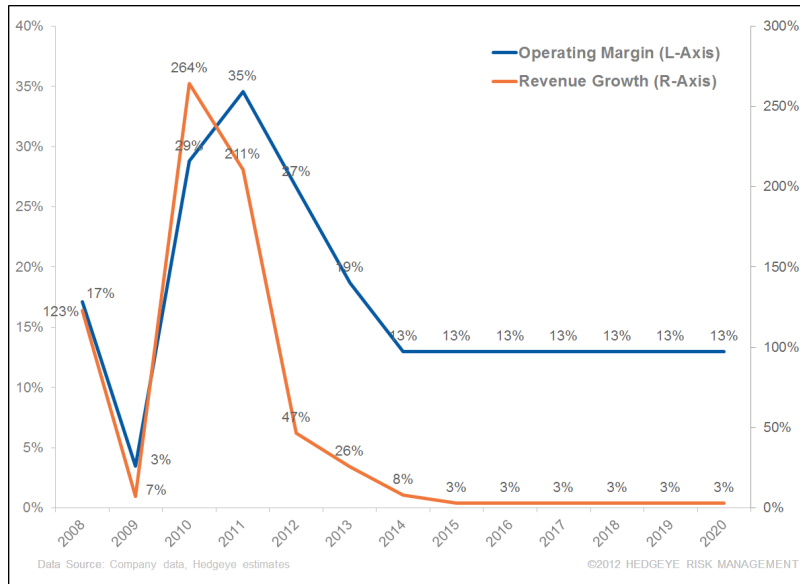
← The # of rigs drilling for natural gas in the US is at the lowest level since 1999, just as prices climb back to \$4/Mcf...

The Marcellus has the best dry gas economics in the US; PA rig count is the lead indicator on broader gas-directed activity, and it bottomed in September...



## ATTRACTIVE VALUATION EVEN IN BEAR CASE

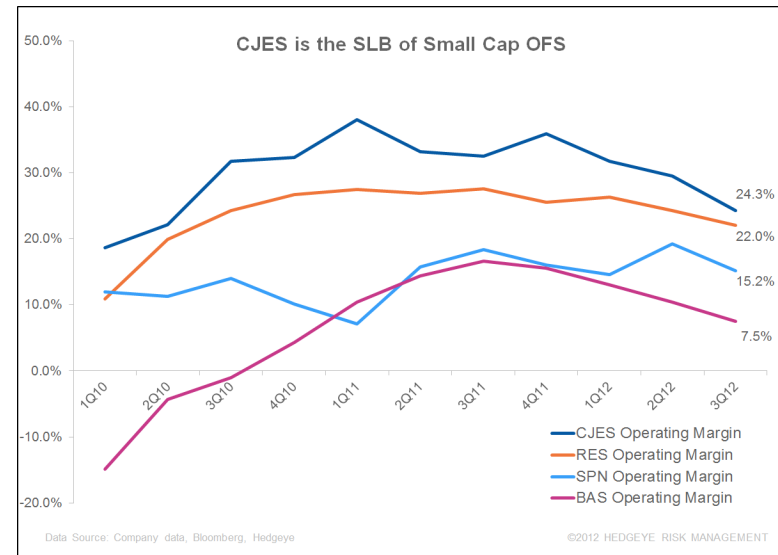
**Legitimate valuation opportunity:** Our cyclically-adjusted valuation range for CJES is \$30 - \$40/share. Even in a pessimistic scenario, CJES is undervalued. These opportunities are rare in the energy sector.



|                            |            |
|----------------------------|------------|
| After-tax NPV at WACC      | \$ 1,655.9 |
| Working Capital            | \$ 159.4   |
| Other Assets (ex Goodwill) | \$ 133.7   |
| Minus:                     |            |
| Long-term debt             | \$ (204.2) |
| Other LT liabilities       | \$ (123.2) |
| Total Equity Value         | \$ 1,621.5 |
| Diluted shares             | \$ 55.1    |
| Value per share            | \$ 29.50   |

Source: Company data, Hedgeye estimates

Relative valuation does not add up... CJES has demonstrated consistently superior margins and returns, but is not rewarded with a higher multiple...



## SUMMARY, CATALYSTS, AND RISKS

**RECAP:** CJES is a strong, growing franchise in a cyclically-depressed industry. The industry weakness is well-understood. It is not a matter of *if* the industry will rebound, it is a matter of *when*. The industry is already showing sign of healing, with major players taking capacity out of the market to protect price. The current share price presents a compelling long opportunity, as it is well below our conservative, fair-value range.

**DURATION:** Bullish TREND(3 months or more) and TAIL (3 years or less)

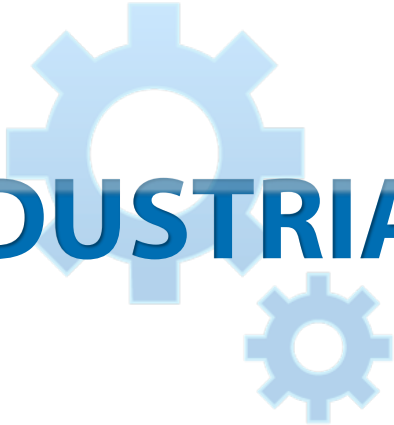
**RISK/REWARD:** Bear case = \$12/share; Bull case = \$35/share. Risk/Reward = 3-to-1

### CATALYSTS:

- Normal winter weather drives natural gas storage overhang down, natural gas prices up
- E&P 2013 capex budget and activity announcements in 1Q13
- CJES takes delivery of two new frac fleets in 4Q12 and 1Q13
- CJES renegotiates Anadarko contract in 1Q12
- CJES goes international in 2H13

### RISKS:

- Natural gas, oil, and NGLs prices decline, CJES's margins fall further than expected.
- Increased environmental regulations on hydraulic fracturing/pressure pumping
- Returns deteriorate as Company grows into a larger, more diversified service company



# INDUSTRIALS



## **JAY VAN SCIVER**

Formerly Co-Founder/Partner at Bishop & Carroll Capital Management. Focus on Industrials, Materials and Consumer Durables. Yale grad.

**PACCAR**

**LONG PCAR**

## Summary

- **Focused Truck OEM:** PCAR produces commercial vehicles and parts for the North American, South American, and European Heavy and Medium Duty truck markets.
- **Strong Position:** The company's Kenworth and Peterbilt brands currently hold around 30% market share in the US/Canadian Class 8 market and the DAF brand has around 16% share in Europe.
- **Old Fleet:** Truck markets are cyclically depressed, with recent orders running well below replacement demand. The North American Class 8 fleet is the oldest it has ever been.
- **Long Opportunity:** Paccar is a competitively advantaged Industrial serving a cyclically depressed market. An improved regulatory environment, rebounding construction markets, and a share gains from a weakened competitor should help the company exceed expectations.

## Key Stats:

Market Cap: \$14.8 Billion

EV: \$19.7 Billion

2012 Est. Net Income: \$1.1 Billion

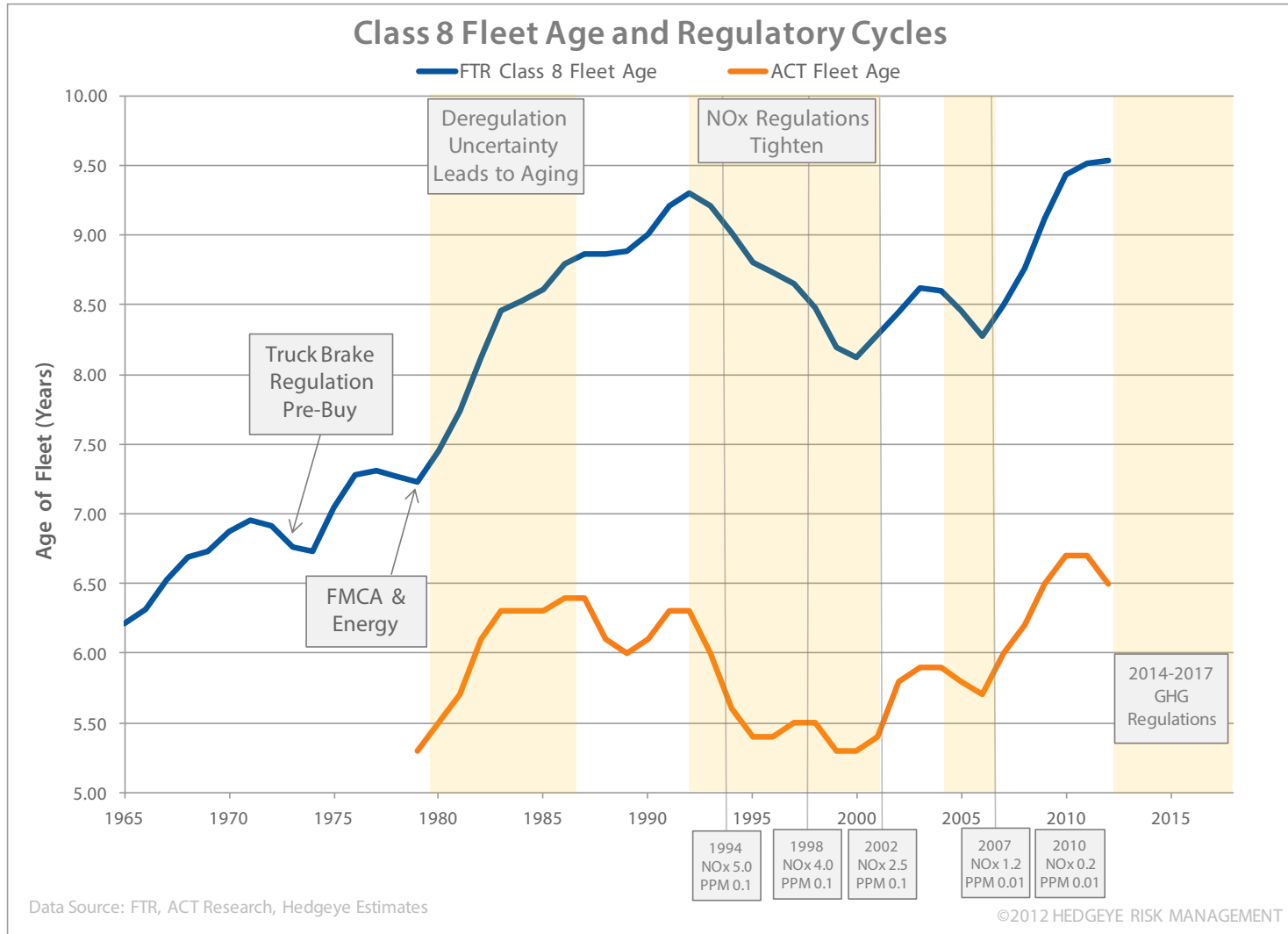
Key North American Competitors: Navistar, Daimler, Volvo

Key European Competitors: MAN, Scania, Volvo, Daimler, Fiat

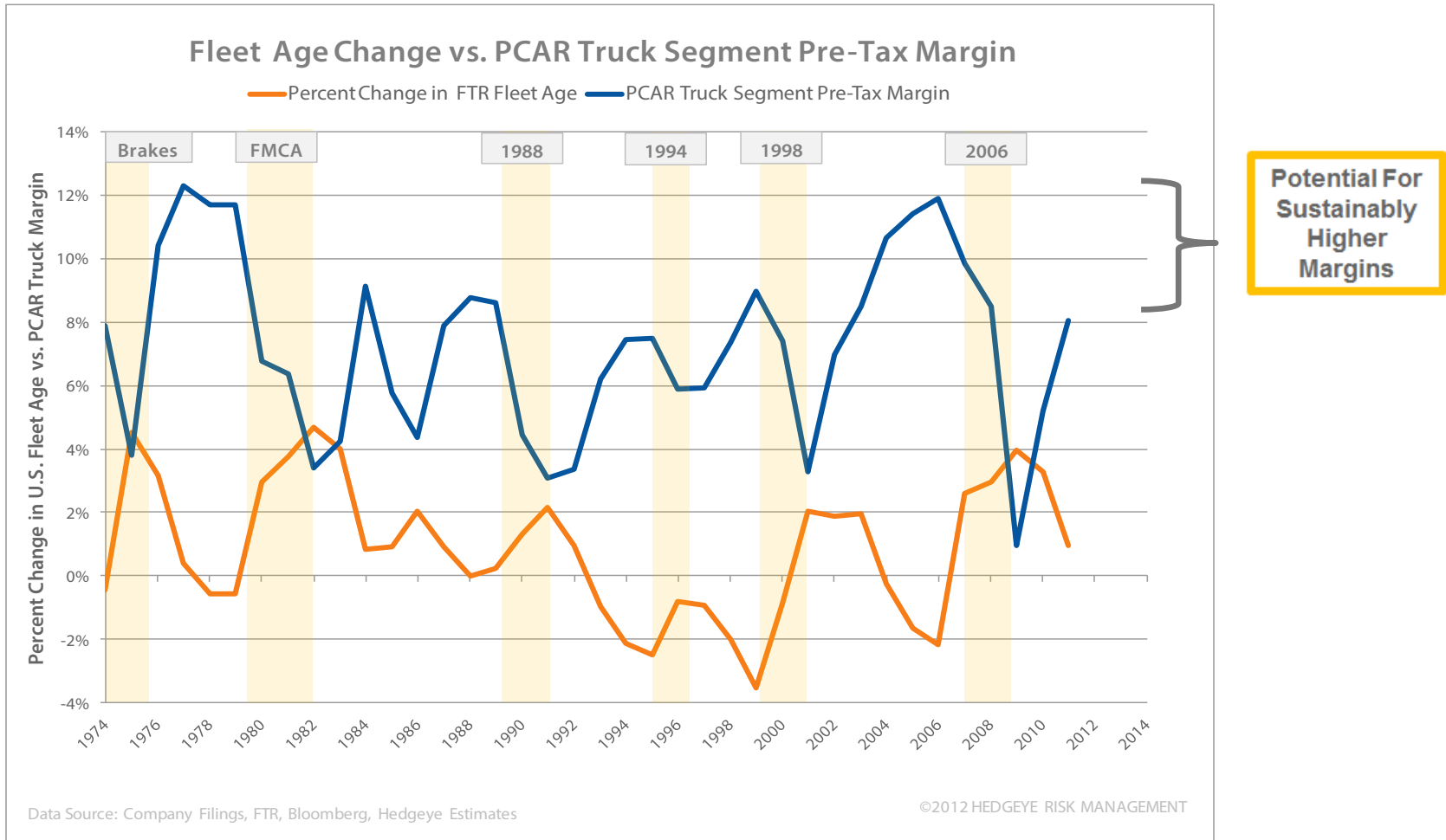


Source: [paccar.com](http://paccar.com)

An old truck fleet supports new truck and aftermarket parts sales.

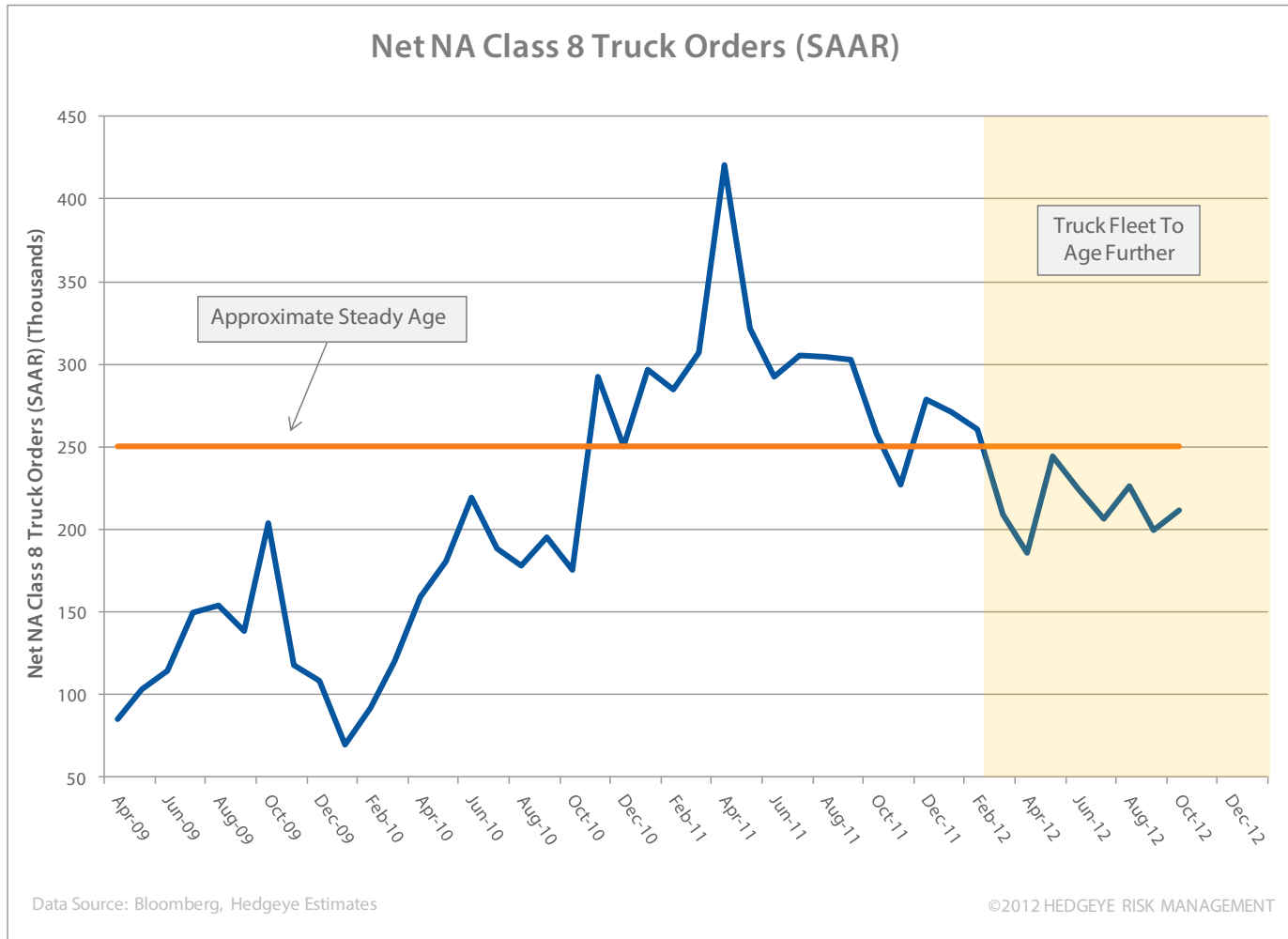


Emissions regulations significantly increase truck costs, so buyers purchased ahead of implementation





Seasonally adjusted October North American annualized orders were well below replacement demand.



Concerns about the reliability of NAV's EGR technology has allowed competitors to take market share. Combining EGR with industry standard SCR seems unlikely to produce a competitive engine.

| Navistar Class 8 Market Share (units) |       |         |
|---------------------------------------|-------|---------|
| 2010                                  | 2011  | 3Q 2012 |
| 25.0%                                 | 21.6% | 18.6%   |

## Truck forum thread following discussions of problems with new NAV trucks:

*"I would venture to say that whoever made the purchasing decision didn't do much research. It is written all over the internet the problems people have had with the Navistar engines. The trucks seem to be built well the engine is just a dog with fleas."*

September 2012 on [www.thetruckersreport.com](http://www.thetruckersreport.com)

North American Class 8 Market Share 3Q 2012

■ Daimler ■ PACCAR ■ Navistar ■ Volvo



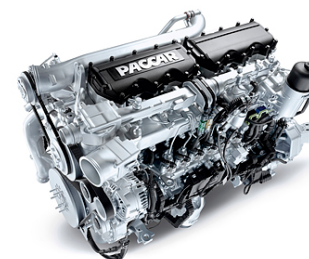
Data Source: Bloomberg, Hedgeye Estimates

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**Summary:** PCAR competes in a structurally advantaged and competitively improving market that is cyclically depressed. An aging fleet should bring stronger aftermarket parts revenue and steady new truck demand. A rebound in construction would provide further support. A near-term catalyst for PCAR is share gain, which seems inevitable given the product and perception issues at Navistar.

### Risks:

- **New Markets:** Paccar is entering Brazil in 2013 and entered the 13L diesel engine business in 2010. These two investments have taken about \$1 billion in capital and may not be successful.
- **Navistar Rebirth:** Navistar may be acquired by a strong new competitor like Toyota/Hino or VW or develop an improved product strategy. That could eventually yield product improvements and regained market share, contrary to Mack's experience.
- **Severe Recession:** While other machinery names may be more impacted, truck orders could drop significantly in a fiscal cliff-type of scenario. While aftermarket parts income should hold-up, new truck margins would be negatively impacted.
- **Price Competition:** Inventory levels are high and some North American competitors have yet to cut build rates fully, in our view.



Source: daf.com



**DARIUS DALE**

Senior Analyst covering Asia and Latin America on the Macro Team. Yale University graduate, member of the Ivy League Championship football team.

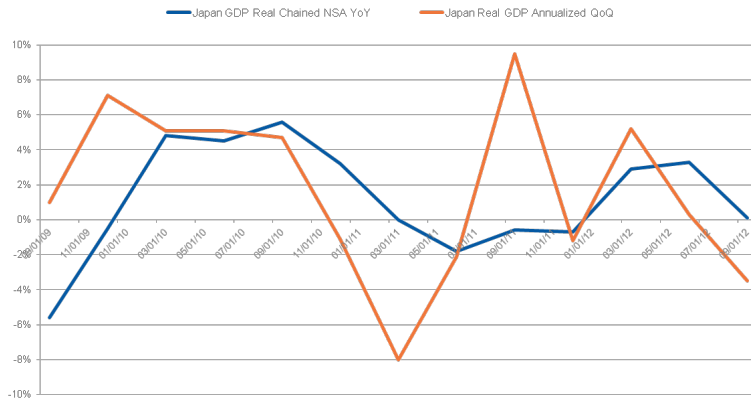
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## FROM A STRUCTURAL PERSPECTIVE, THE JAPANESE ECONOMY HAS BEEN A LABORATORY FOR FAILED KEYNESIAN POLICY EXPERIMENTS

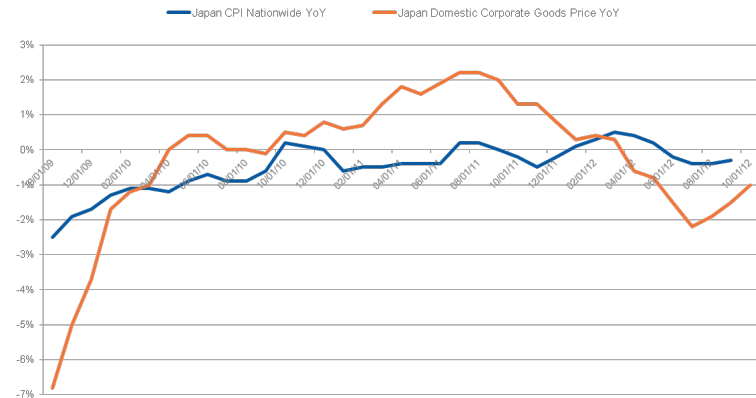
**GROWTH**



Data Source: Bloomberg

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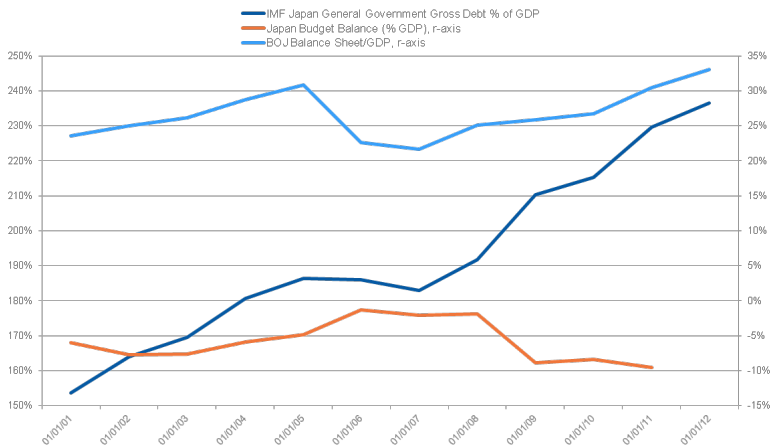
**INFLATION**



Data Source: Bloomberg

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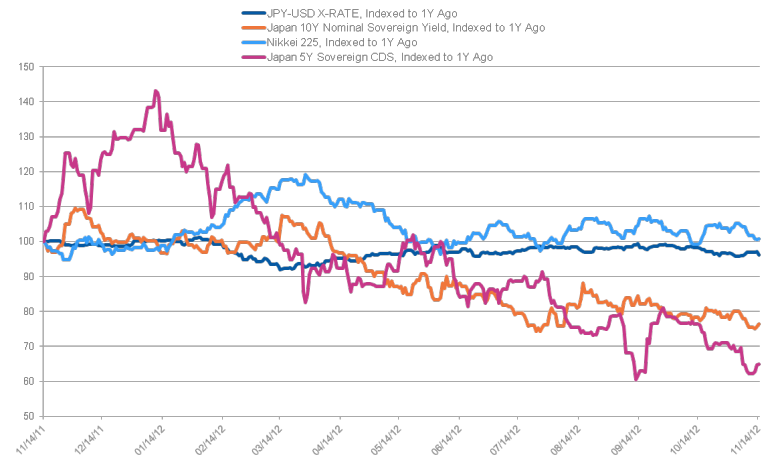
**POLICY**



Data Source: Bloomberg

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**MACRO MARKETS**

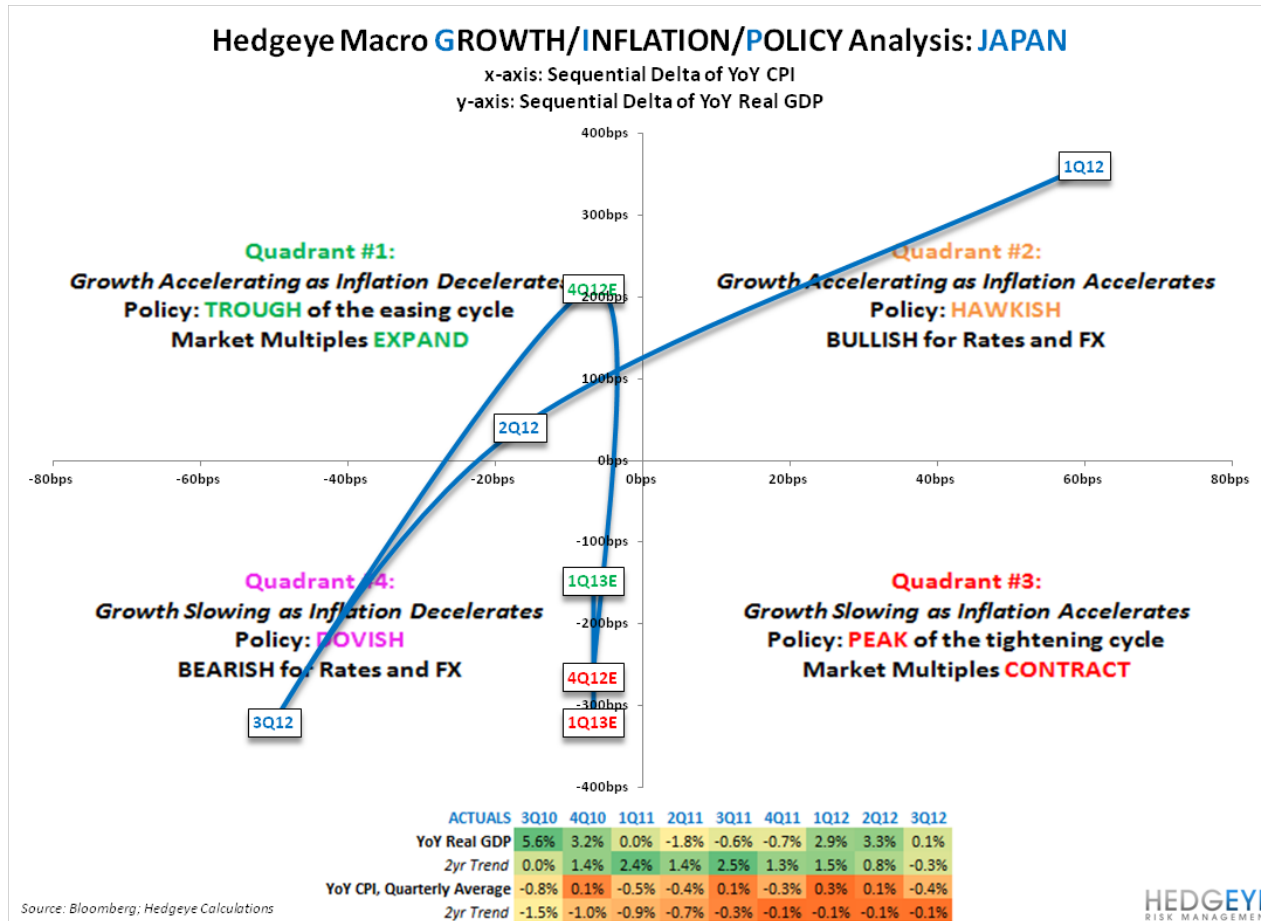


Data Source: Bloomberg

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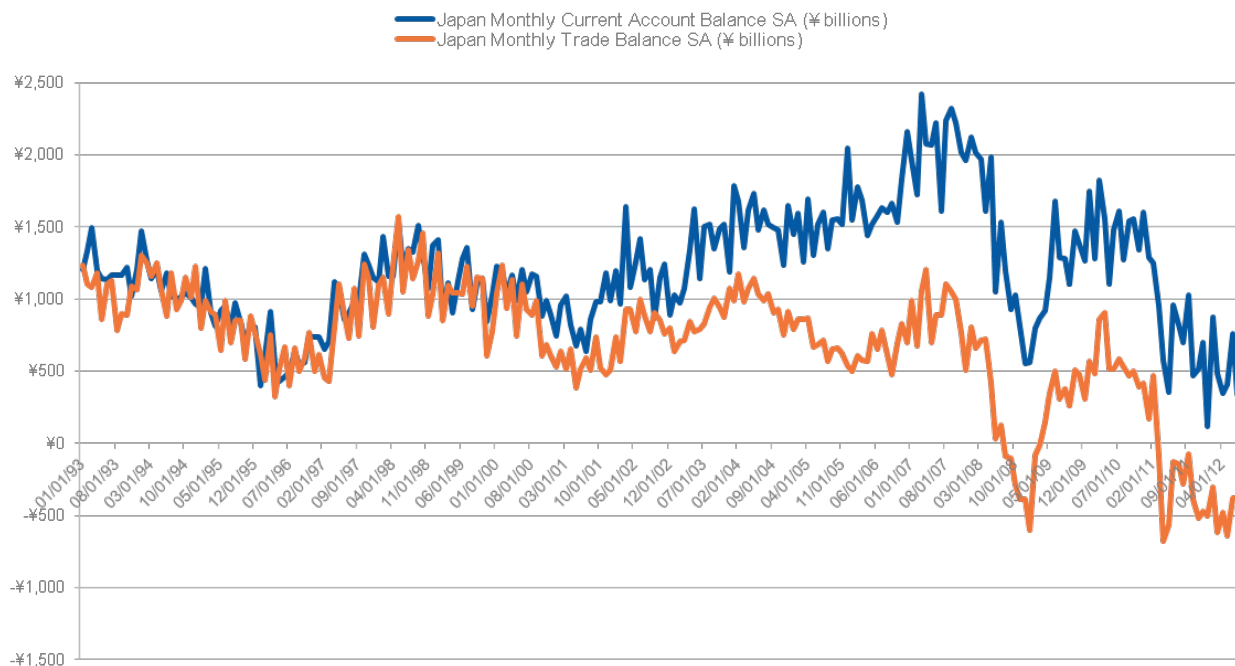
## CYCLICALLY SPEAKING, JAPAN'S G/I/P OUTLOOK IS CURRENCY-NEGATIVE

Both GROWTH and INFLATION are poised to continue slowing over the intermediate term, potentially tipping Japan into its second recession in as many years. We expect the BOJ to respond accordingly.



On a monthly basis, Japan's trade balance and current account hit new all-time lows in SEP. While it may be fair to attribute some of the weakness to the geopolitical dispute with China, the reality is that issue is likely to remain a structural headwind if and when the LDP regains control of the Diet – especially considering LDP Chief Shinzo Abe's recent statement on China's policy stance towards Tibet.

**THE JAPANESE ECONOMY HAS UNDERGONE A SECULAR LOSS OF COMPETITIVENESS**



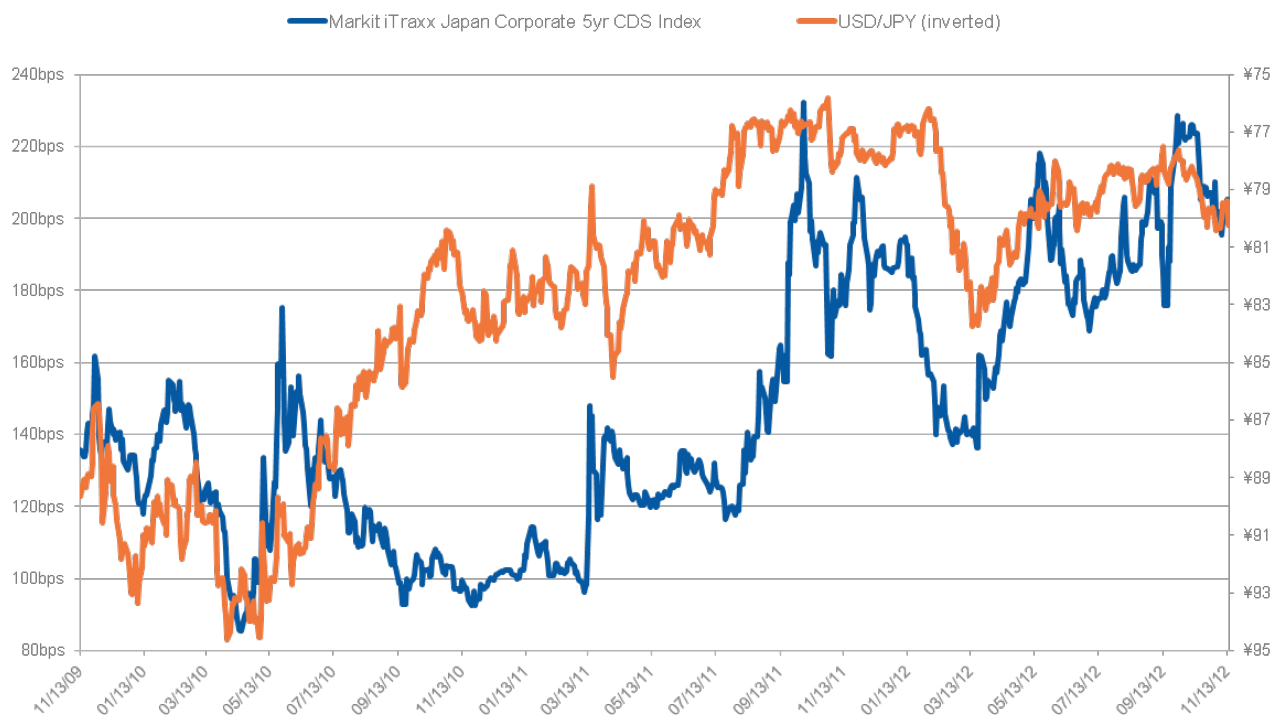
Data Source: Bloomberg

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The JPY has appreciated ~50% vs. the USD over the past ten years – with nearly four-fifths of that move coming in just the last five years alone – threatening Japan’s manufacturing and export oriented GROWTH model, as well as the solvency of externally facing Japanese corporations.

**PERSISTENT YEN STRENGTH THREATENS THE SOLVENCY OF JAPANESE EXPORTERS**



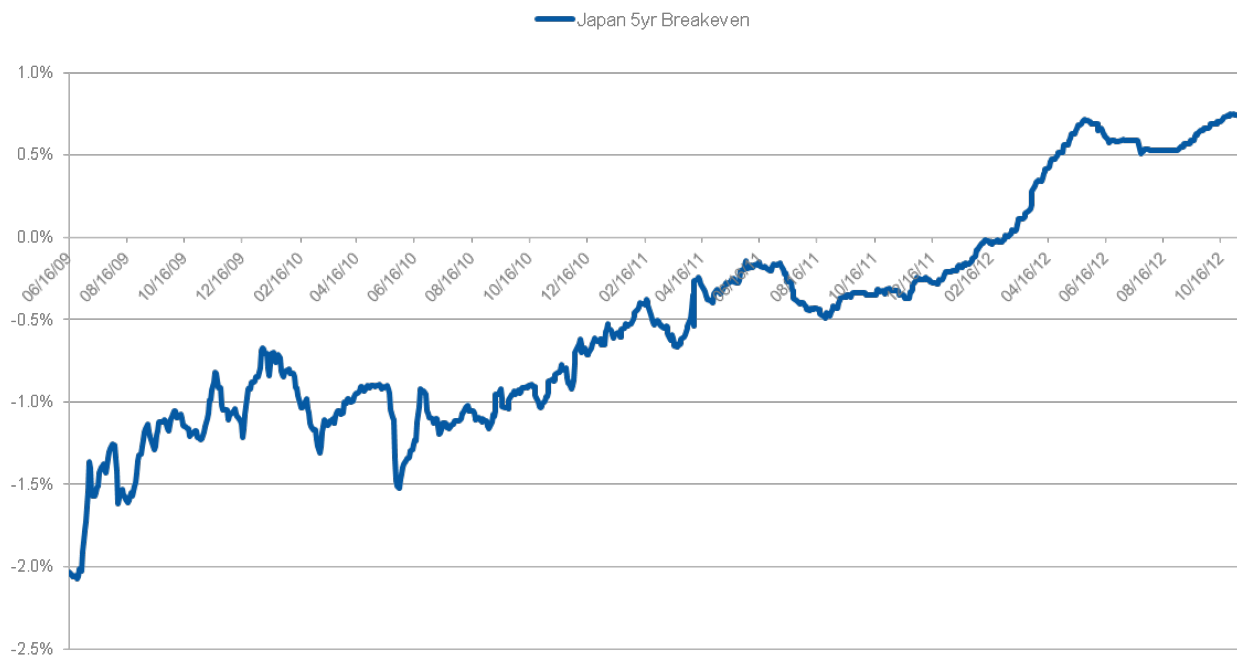
Data Source: Bloomberg

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## THE JAPANESE BOND MARKET IS STARTING TO COME AROUND TO OUR VIEW

Five year breakeven rates in the JGB market are at/near all-time highs. Expect this trend to continue if LDP Chief Shinzo Abe takes hold of the premiership and politically coerces the BOJ to adopt his proposed +3% long-term INFLATION target – a near certainty if current BOJ governor Masaaki Shirakawa is replaced with a dovish political puppet when his term expires in in APR '13.

### JAPANESE INVESTORS ARE PAYING UP FOR INFLATION PROTECTION



Data Source: Bloomberg

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# IS JAPAN MARCHING TOWARDS A CURRENCY CRISIS? WE THINK SO

## SUMMARY:

- We have a negative TREND and TAIL duration bias on the JPY vs. the USD
- From a long-term perspective, we see risk of a currency crisis in Japan, as defined by a peak-to-trough decline of 20% vs. the USD

## KEY CATALYSTS:

- Parliamentary elections tentatively set for DEC 16 that will likely result in the more-dovish LDP regaining control of the Diet
- BOJ governor Masaaki Shirakawa's term expires in APR '13; judging by the last two appointees to the BOJ board, his replacement will likely be directionally dovish
- BOJ foreign asset purchase program?

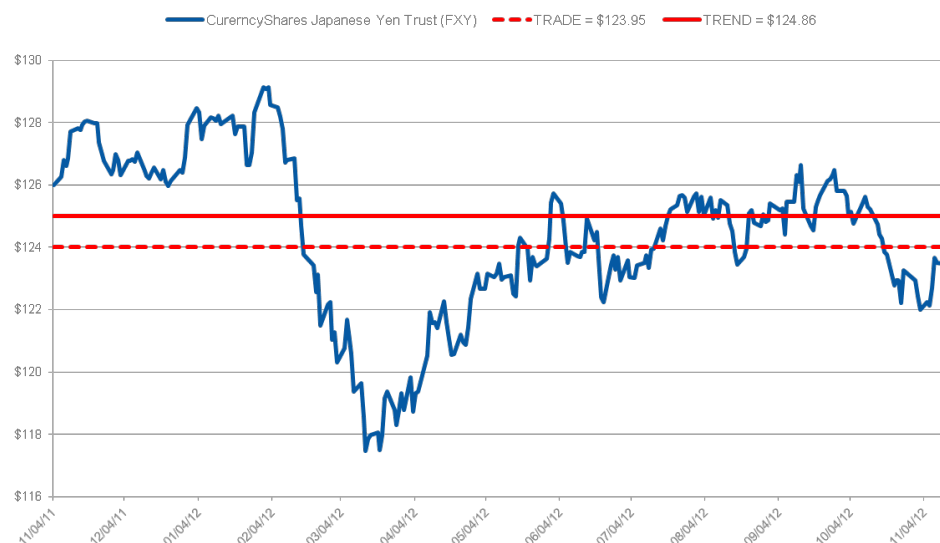
## WHERE WE COULD BE WRONG:

- Because of Japan's attractive real interest rates (relative to other G10 sovereigns) and its robust net international investment position (~54% of GDP), the yen tends attract capital – both repatriated and fresh – when "risk assets" broadly sell off
- For example, the yen has an inverse correlation of (0.77) to the S&P 500 Index on an immediate-term TRADE basis
- A potential US recession could force the Fed to get incrementally dovish in 2013 (USD bearish) – especially considering the pending changes to the FOMC board

## IMPLICATIONS:

- A demonstrable depreciation of the yen exposes the JGB market to inflation risk and the threat of capital flight as expectations for real returns diminish and foreign assets look increasingly attractive

OUR QUANTITATIVE RISK MANAGEMENT LEVELS ON THE FX



Data Source: Bloomberg

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THANK YOU

FOR MORE INFORMATION AND A COMPLETE LISTING OF RESEARCH PLEASE

VISIT: [WWW.HEDGEYE.COM](http://WWW.HEDGEYE.COM)

OR EMAIL: [SALES@HEDGEYE.COM](mailto:SALES@HEDGEYE.COM)

THIS PRESENTATION WAS PREPARED BY:

[THE HEDGEYE RESEARCH TEAM](#)

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