

Small Caps Showing Signs of Strength

Fellow Investor,

“The scars of others should teach us caution.”
– Saint Jerome.

I hope everyone had a marvelous Thanksgiving with friends and family as well as a happy holiday season. We are about to end one of the strangest years in investing I have seen in my investing career. Although the major indices are up slightly for the year, it has been a very narrow sector of stocks driving these minor gains. Through mid-November, the biggest 10 stocks of the S&P 500 by market capitalization were up an average of 13.8%. The other 490 names in the index were down an average of 5.8%.

This is concerning as most investors are down for the year despite the headline indexes. Also, because this mix of returns traditionally happens near market tops. We saw this sort of action near the end of the Internet Boom and also when the “Nifty Fifty” of the early 70’s came to an end.

On a brighter note, November did bring some good cheer to the small cap sector of the market which has significantly underperformed its larger cap brethren all year. Maybe we are getting the “January Effect” early this year but over the last month the Russell 2000 has outperformed the Russell 1000 by three percent while also beating the S&P 500 which is flat over the past month. Firms whose demand comes almost entirely from the domestic market should see faster earnings growth given tepid overseas growth, which is at the lowest levels since 2009, as well as the strong U.S. dollar. We may be in the weakest post war recovery on record, but we are still the best house in a bad neighborhood.

The energy and commodity sectors continue to be the weakest in the market as the collapse in prices seems to be unrelenting. Given an anemic global recovery and a strong dollar, I do not think we will see any sort of substantial turnaround in these sectors in 2016. If prices stay at these levels, bankruptcies in the smaller and even midcap names in these industries could be a major theme in the New Year.

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Bret Jensen's Small Cap Gems



On the other hand, after going through a sharp and deep decline starting in late July that put the biotech sector into an official bear market, biotech and biopharma stocks have behaved better recently as the sector seems to have bottomed in late September. The chart above using the Nasdaq Biotechnology Index as a proxy for the sector shows the past two years and you can clearly see the pullback in March 2014 followed by a nearly 100% gain in the sector. Then you see on the right side the pullback in July and bottom in late September followed by a 16% climb in just the past two months. Usually biotech goes through these selloffs every 12-18 months, so these sectors should have several quarters of tailwinds ahead of them.

Lastly, should you ever have a question or comment you can reach me at bret.jensen@investorsalley.com.

Thank you and Happy Hunting.



Bret Jensen

Editor

Bret Jensen's Small Cap Gems

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BioDelivery Sciences International: A Potential Blockbuster

We are adding a small cap pharmaceutical firm that has seen its stock cut by two thirds from recent highs. The decline is unwarranted and the company has upcoming catalysts that could cause the shares to regain a good portion of their recent losses. I recently picked up a small stake in this intriguing concern at approximately \$6.00 a share.

Company Overview:

BioDelivery Sciences International (NASDAQ: BDSI) is a small specialty pharmaceutical company based in Raleigh, North Carolina. The company engages in the development and commercialization of pharmaceutical products principally in the areas of pain management and addiction. The company provides its products based on its patented BioErodible MucoAdhesive (BEMA) drug delivery technology, which consists of a small, bi-layered erodible polymer film for application to the buccal mucosa.

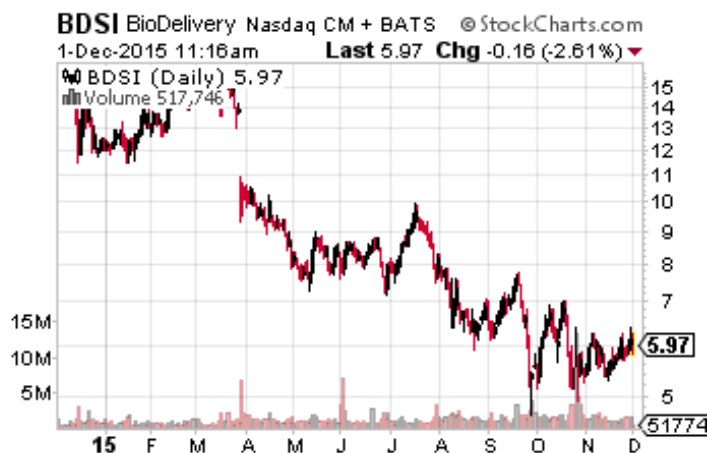
It is basically a company building a better delivery system. Think of its products as film strip you can use as a substitute for a breath mint. In that way, it reminds me of **Eagle Pharmaceuticals (NASDAQ: EGRX)** which provided an over 450% gain for our Small Cap Gems

portfolio earlier this year. By taking an existing drug and giving it a new delivery system, the development and approval process should be easier and expedited which has proved to work well with Eagle. It has also already attracted a deep pocketed partner who is helping with development, marketing, and distribution.

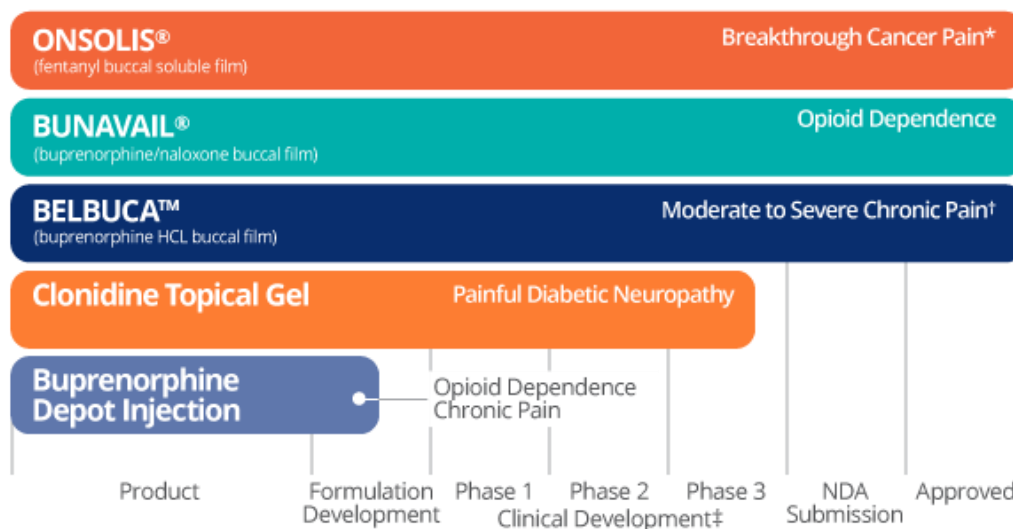
The stock has a market capitalization of just over \$300 million and enough cash on hand to fund itself through at least mid-2017. BioDelivery has one approved product on the market and two more that have been approved and should be marketed in the very near future. The company also has a couple of other products in its pipeline as well as some small but frequent insider buying in 2015. The stock trades at right around \$6.00 a share. The equity traded at \$18.00 a share earlier in the year to put its potential in perspective. The stock also seems to have built some technical support right under where it is trading which should hopefully mitigate downside.

Product Lineup & Pipeline:

In June of 2014 the FDA approved BUNAVAIL. The compound was BioDelivery's first approved product and has rolled out to the market. BUNAVAIL is the first mucoadhesive buccal film formulation of buprenorphine to compete directly with Suboxone sublingual film. In 2014, sales of Suboxone sublingual film totalled approximately \$1.3 billion in the U.S. while the total market grew to more than \$1.7 billion, driven by an 11 percent increase in prescriptions according to data from Symphony Health Solutions. BUNAVAIL has gotten off to a slow rollout but I am optimistic growth will pick up in the near future.



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* See warnings and full prescribing information. Marketed in the E.U. by Meda.

† Licensed worldwide to Endo Pharmaceuticals.

‡ All development phases not applicable for 505(b)2 regulatory filings.

In late October of this year the company’s second pain focused medication “BELBUCA” was approved by the FDA. This drug is a mu-opioid receptor partial agonist and a potent analgesic with a long duration of action that utilizes BDSI’s patented BioErodible MucoAdhesive (BEMA®) drug delivery technology. Through the BEMA delivery technology, buprenorphine is efficiently and conveniently delivered across the buccal mucosa (inside lining of the cheek).

This product will be marketed by partner **Endo Pharmaceuticals (NASDAQ: ENDP)**. Endo will also be responsible for any additional development costs for this product. FDA approval triggered a \$50 million milestone payment to BioDelivery and the company will also receive royalties in the mid to high teens depending on net sales. BioDelivery could also receive up to four sales milestones totaling \$55 million from Endo as well.

Stern Agee recently estimated peak sales of BELBUCA could reach \$500 million or better in annual sales. Royalties to BioDelivery would be around \$75 million a year which would be almost pure profit if this scenario

played out. If these projections come even close to fruition, BDSI is undervalued just on this one product alone given the current \$300 million market capitalization.

The FDA has also approved ONSOLIS®. This is an opioid agonist indicated for the management of breakthrough pain in cancer patients 18 years of age and older who are already receiving opioid therapy for their underlying persistent cancer pain. This product might one day contribute meaningfully to the company’s revenues but for the purpose of our analysis we will concentrate on BELBUCA as it should be the main driver of growth for the foreseeable future.

Market:

Opioid dependence is a significantly undertreated condition in the United States with approximately 2.5 million people dependent on prescription opioids according to the National Survey on Drug Use and Health, conducted by the U.S. Department of Health and Human Services. This dependence has costs for both the individuals that get addicted but society at large as well.

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National Vital Statistics System, 1999-2008; ARCOS, Drug Enforcement Administration (DEA), 1999-2010; Treatment Episode Data Set, 1999-2009.

Outlook:

The stock cratered earlier this year when a clonidine topical gel that BioDelivery was developing for the treatment of painful diabetic neuropathy (PDN) and potentially other indications failed Phase III trials. Clonidine is thought to relieve pain by decreasing the abnormal excitability of these functional nociceptors. This again is always why I recommend biotech firms with multiple “shots on goal” as most products do fail somewhere in trials.

The company plans to use the cash infusion from Endo to develop an injectable version of Bunavail and Belbuca. This would be delivered to patients in a sustained-release formulation. Patients could receive an injection as infrequently as once per month. Its current delivery method typically requires one or two doses per day. BioDelivery will also use these funds to develop an indication to treat opioid dependence.

The seven analysts that cover the company have a median price target of \$14.00 a share on BDSI, which is more than a double from its current price of \$6.00 a share. Insiders have also made small but frequent purchases of the shares throughout 2015, all at prices higher than the current level of the stock.

At these prices, the market seems to be severely undervaluing the drugs that BioDelivery already has approved, let alone its pipeline. Yes, the company had a disappointing phase III trial and a slow initial sales ramp of BUNAVAIL. However, it has strong underlying technology that should not be discounted. Thanks to the recent milestone payment from Endo its balance sheet is also in very good shape.

In addition to quickening sales growth, I would not be surprised if the company enters into further collaboration deals or perhaps gets bought out in the year ahead. Endo International seems like the perfect acquirer. It has been acquisitive in the past and certainly has the firepower to pick up bite-sized BioDelivery even with a hefty premium thrown in. It could then claw back its \$50 million milestone payment, forgo future sales milestone payouts and royalties while picking up BioDelivery’s underlying technology and pipeline for basically nothing. Regardless if that logical transactions occurs, it does seem an appropriate time to get involved with this undervalued company and stock.

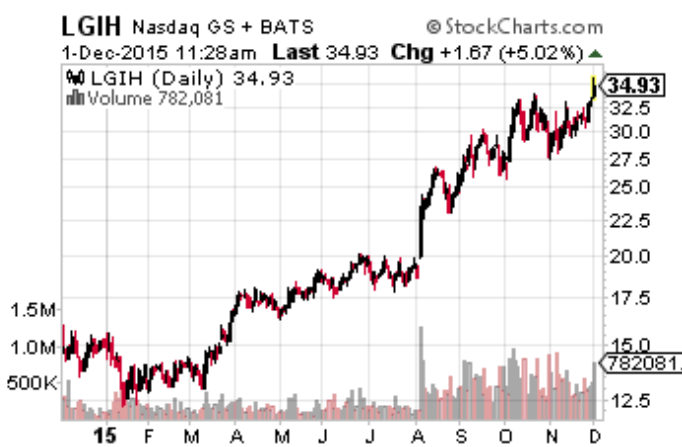
Recommendation: BUY BDSI up to \$7.50 a share

Position: Long BDSI

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Portfolio Update

The small cap sector performed well in November, easily outclassing its larger-cap brethren during the month. This has been a rare occurrence in 2015 and hopefully the start of a longer-term trend after a relatively long spell of underperformance.



We saw several pockets of strength within the Small Cap Gems portfolio this month. Despite the two steps forward, one step back nature of the housing recovery of late, we got strong performances from **LGI Homes (NASDAQ: LGIH)** and **UCP Inc. (NYSE: UCP)** this month. LGI Homes is the strongest performer within the homebuilders in 2015 and **has doubled since we added it in March**. It is still just priced at just 11 times forward earnings as profit estimates continue to increase. We were early on UCP, but that company crushed top and bottom line expectations when it reported earnings early in November. Hopefully this is the start of long upward march for this undervalued homebuilder. Housing related play **Walter Investment Management (NYSE: WAC)** also had a strong November adding over 15% during the month.

Out infrastructure/commercial construction plays of **Mastec (NYSE: MTZ)** and **Tutor Perini (NYSE: TPC)** also performed well in November. I think part of this is due to investors looking forward to a better 2016 for these

firms. The possible passage of a five year transportation bill in Congress and all the election driven talk of new infrastructure spending are certainly not hurting sentiment on this sector.

The portfolio also benefited as it appears the biotech sector bear market hit bottom in late September, and over the past few weeks the rally from has spread out to the smaller firms in the space. **Applied Genetic Technologies (NASDAQ: AGTC)** gained some 40% since our last update mainly on the improvement in sentiment on this sector. **OncoGenex Pharmaceuticals (NASDAQ: OGXI)**, **Agenus (NASDAQ: AGEN)** and **IntelliPharmaCeutics International (NASDAQ: IPCI)** also posted nice gains during the month.

Elsewhere in the portfolio **Ladenburg Thalmann Financial Services (NYSE: LTS)** was up some 20% in the month and beaten down **Power Solutions International (NASDAQ: PSIX)** gained 25% or so during November.

On a down note – and there were few this month, **Greenbrier Companies (NYSE: GBX)** had a down first month in the Small Cap Gems portfolio as manufacturing outside of auto production continues to be in contractionary territory. In addition, **Conatus Pharmaceuticals (NASDAQ: CNAT)**, **Endocyte (NASDAQ: ECT)** and **Threshold Pharmaceuticals (NASDAQ: THLD)** did not participate in the biotech rally this month as I would have liked.

As of this issue, we are going to remove Conatus Pharmaceuticals from our recommendations.

I will continue to hold it in my own portfolio as it still has “shots on goal” with Emricasan. However, the stock has been in the portfolio for over a year and has slowly grinded down. This stock will no longer be followed in Small Cap Gems.

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Current Portfolio

Company	Entry Date	Entry Price	Buy Up To	Target Price	Recent Price	Returns
BioDelivery Sciences International (BDSI)	11/30/15	\$6.13	\$7.50		N/A	N/A
Greenbrier Companies (GBX)	10/30/15	\$38.04	\$42.00		\$33.88	-10.9%
ANI Pharmaceuticals (ANIP)	09/29/15	\$37.54	\$45.00		\$43.82	16.7%
Taylor Morrison Homes Corporaion (TMHC)	08/28/15	\$19.43	\$21.00	\$26.00	\$17.50	-9.9%
Applied Genetic Technologies (AGTC)	07/30/15	\$18.16	\$20.00		\$17.04	-6.2%
Powerline Solutions Intl. (PSIX)	07/01/15	\$51.31	\$57.00		\$23.54	-54.1%
BioLineRx (BLRX)	06/25/15	\$2.27	\$3.00		\$1.33	-41.4%
iRobot (IRBT)	06/02/15	\$32.59	\$34.00	\$40.00	\$33.09	1.5%
IntellipharmaCeutics International (IPCI)	06/02/15	\$3.46	\$3.75	\$6.00	\$2.10	-39.3%
Ladenberg Thalman Financial (LTS)	04/29/15	\$3.46	\$6.00		\$3.15	-6.0%
Endocyte (ECYT)	03/31/15	\$6.26	\$7.00		\$4.63	-26.0%
LGI Homes (LGIH)	03/31/15	\$16.66	\$18.00	\$38.00	\$33.26	99.6%
Threshold (THLD)	02/27/15	\$4.37	\$5.00		\$3.49	-20.1%
Mastec (MTZ)	01/30/15	\$18.52	\$21.00	\$30.00	\$20.43	10.3%
OncoGenex Pharmaceuticals (OGXI)	12/30/14	\$2.23	\$2.50	\$5.00	\$2.58	15.7%
Agenus Inc. (AGEN)	11/28/14	\$2.96	\$3.50	\$9.00	\$5.11	72.6%
Progenics Pharmaceuticals (PGNX)	10/30/14	\$4.86	\$6.00	\$14.00	\$6.72	38.3%
Tutor Perini (TPC)	09/30/14	\$24.60	\$30.00	\$44.00	\$18.84	-23.4%
UCP (UCP)	07/30/14	\$13.00	\$14.00	\$20.00	\$7.80	-40.0%
Walter Investment Mgmt. (WAC)	07/18/14	\$27.27	\$35.00	\$60.00	\$14.54	-46.7%

Recent price is determined by the last "Close" price at the closing of the market on the day before publication; most recent update: 11/30/15.

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Closed Positions

Company	Entry Date	Entry Price	Close Price	Close Date	Return
Conatus Pharmaceuticals (CNAT)	10/30/14	\$7.55	\$3.19	11/30/15	-57.7%
Great Lakes Dredging & Dock Corp. (GLDD)	2/27/15	\$6.10	\$4.00	10/30/15	-34.4%
New York & Company (NWY)	04/29/15	\$2.76	\$2.37	09/29/15	-4.8%
Beazer Homes USA (BZH)	08/29/14	\$18.85	\$16.84	08/28/15	-10.7%
Summer Infant (SUMR)	12/30/14	\$3.33	\$2.08	07/30/15	-27.5%
Abraxas Petroleum (AXAS)	09/30/14	\$5.28	\$2.77	07/01/15	-47.5%
Eagle Pharmaceuticals (EGRX)	12/30/14	\$14.20	\$80.21	06/17/15	464.9%
RCI Hospitality Holdings (RICK)	07/18/14	\$11.23	\$12.18	05/29/15	8.5%
Big 5 Sporting Goods (BGFV)	07/18/14	\$11.51	\$14.53	05/29/15	26.2%
Sonus Networks (SONS)*	08/29/14	\$18.85	\$7.88	03/31/15	-58.2%
American Eagle Energy (AMZG)	07/30/14	\$6.36	\$0.18	03/31/15	-96.7%
Avanir Pharmaceuticals (AVNR)	07/18/14	\$5.39	\$16.96	12/05/14	214.7%

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: 11/30/15. Returns is share price appreciation or depreciation between entry price and recent price*SONS entry price based on 01/30/15 1 to 5 split.

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

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