February 2016 Vol. 2 Issue 8

Investors Alley
Small Cap Gems

Two New Picks to Jumpstart the Portfolio

Fellow Investor,

Investors have to be feeling somewhat like a coyote sitting in the middle of a desolate desert freeway being hit by every car that winds its way through that highway at night. The stealth bear market that small cap investors knew all so well throughout most of 2015 turned into a real correction to start 2016. The plunge has hit investors from all sides to begin the New Year.

In This Issue

The stock market got off to its worst weekly open to begin a year in the exchange's history. Markets improved a bit towards the end of the month and we had a nice rally on Friday to close out trading for the month. However, major indices lost five to eight percent during the month as January turned in the worst monthly performance for investors in nearly six years; since February 2009 to be precise.

The action in the market during the month reminds me of the old LBJ quote about getting stuck in Vietnam as being akin to being on a lonely West Texas highway during a heavy rainstorm "There is nowhere to run, nowhere to hide and you just can't make it stop." During the month small caps, biotech, and transports descended into official bear market territory. They joined the commodity and energy sectors which have been in purgatory for more than a year now.

Nothing seemed to work during the month. Even most of the so-called FANG stocks that were pretty much the only areas of outperformance in 2015 suffered deep declines in January, especially **Amazon (NASDAQ: AMZN)** and **Netflix (NASDAQ: NFLX)**.

However, there were some encouraging signs towards the end of January that might lead to a more stable February and market gods willing, maybe even a bit of a rally from oversold levels. First, the high-yield credit market stabilized and started to move up a bit towards the back end of the month. The previous spike in volatility in this $1.3 trillion junk bond arena has been a tremendous headwind to numerous parts of the market. These include small caps, real estate investment trusts, and just about any company that carries a good amount of debt.

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Second, after getting down to $27.00 a barrel early in January, oil staged a nice little rally and ended the month at over $33.00. This coincided with an improvement in the high-yield credit markets, and if crude can find a floor or even rise from here, it would be beneficial to the overall market. Some key members of OPEC have started to make noises that they would be willing to institute some sort of production cut to curtail the collapse in crude. Russia is rumored to be considering the same which makes sense considering the impact of low oil prices on these countries' economies.

Finally, the negative interest rate policy just announced by the central bank of Japan should help force the Federal Reserve to back off its current view that it will raise interest rates by a quarter point four times in 2016. Sticking to this plan would cause the dollar to strengthen even further which is something the Fed is wary of doing judging by recent comments from some governors of the central bank. This obviously would be welcomed by the market and might be exactly what is needed to start to recover from a horrendous start to the New Year.

That is my take on the market as we enter the second month of 2016. Hopefully it is much kinder to investors than January has been.

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

P.S. For those interested in learning more about my investment philosophy, I recently recorded a short video detailing my approach. I hope you'll find it beneficial. It's part of an online investment expert conference I'm participating in later this month. Click here for the video and more details.

P.P.S. Join me from March 31st to April 3rd in San Antonio, TX for InvestFest 2016. I'm a featured presenter and will give a presentation on "Successful Biotech Investing." I'll share with you my core principals of developing and managing an optimized biotech portfolio – much like I do each month in Small Cap Gems.

At the end of my presentation there will be a Q&A session for you to ask any questions you want. Throughout the conference I'll be available to talk directly with you and you'll get to meet nearly two dozen other investing experts and attend their presentations as well.

Normally this event is only open to ValueForum members, however I've secured a few free memberships to ValueForum for my subscribers. Click here to redeem your FREE three month pass to ValueForum (a $99 value) and register to join me at InvestFest 2016. Don't wait -- space is very limited!

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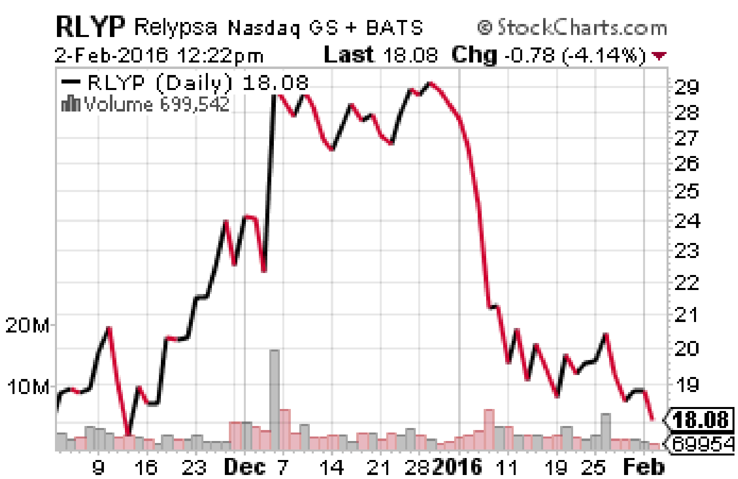
Relypsa: A Rare and Favorable Risk Profile Not Often Seen

Our next Small Cap Gems selection is a familiar name to any of our Biotech Gems subscribers. It is our first and only crossover from that service which speaks to how much potential this small cap biopharma has. It was added to the Biotech Gems portfolio in mid-October right around the same $19.00 a share level it trades at now. It quickly shot up right up to $30.00 a share. However, despite a rash of good news the stock has fallen back to previous levels due to the biotech sector being in a full-fledged bear market and small caps overall barely behaving any better. This gives us a great opportunity to add this potential huge winner at an attractive long-term entry point.

Company Overview:

Relypsa (NASDAQ: RLYP) is a biopharmaceutical company that focuses on the development and commercialization of non-absorbed polymeric drugs to treat disorders in the areas of renal, cardiovascular, and metabolic diseases in the United States.



Polymers are large molecules made up of repeating structural units. They exist in nature – in the form of proteins and starch, for example – but can also be manufactured in a laboratory for a variety of purposes and applications such as plastics and coatings.

Polymers have a long history in healthcare. They are found in many medical devices, such as cardiovascular stents and orthopedic fixation devices used for the treatment of fractures, soft-tissue injuries, or reconstructive surgery. They are also often used to improve the properties of certain medications – such as interferon alfa (Pegasys®) for chronic hepatitis, rGCSF (Neulasta®) for neutropenia, doxorubicin (Doxil®) for cancer, and therapies for rheumatoid arthritis and Crohn's disease.

Relypsa has a unique approach in that they are attempting to use the polymer itself as the medicine. The polymers developed with the company's underlying technology are designed to selectively recognize, target, and remove the molecule that is causing the disease.

Their evolving stable of polymer medicines are delivered orally but are not systemically absorbed. They are designed to act and stay only in the digestive tract – a localized approach to systemic problems in the body. Since many drug-related toxicities result from systemic exposure, Relypsa's polymer approach avoids side effects caused via systemic absorption.

The company's main and at this point only commercialized product "veltassa" was approved late in 2015 by the FDA to treat hyperkalemia in the United States and is just now hitting the market. Hyperkalima

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involves elevated concentration of the electrolyte potassium and symptoms can include malaise, muscle weakness, and palpitations among other symptoms. This condition can be potentially fatal and is frequently triggered by other medicines and happens a lot in a hospital setting.

There are 3 to 4 million patients in the United States alone with hyperkalemia, the vast majority of whom have underlying Heart Failure or Kidney Disease as the approximate cause of their hyperkalemia.

The peak market for treating hyperkalemina is generally believed to be around $2 billion annually. Relypsa has a current market capitalization of just under $800 million and a stock price just south of $19.00 a share.

Game Changing Merger:

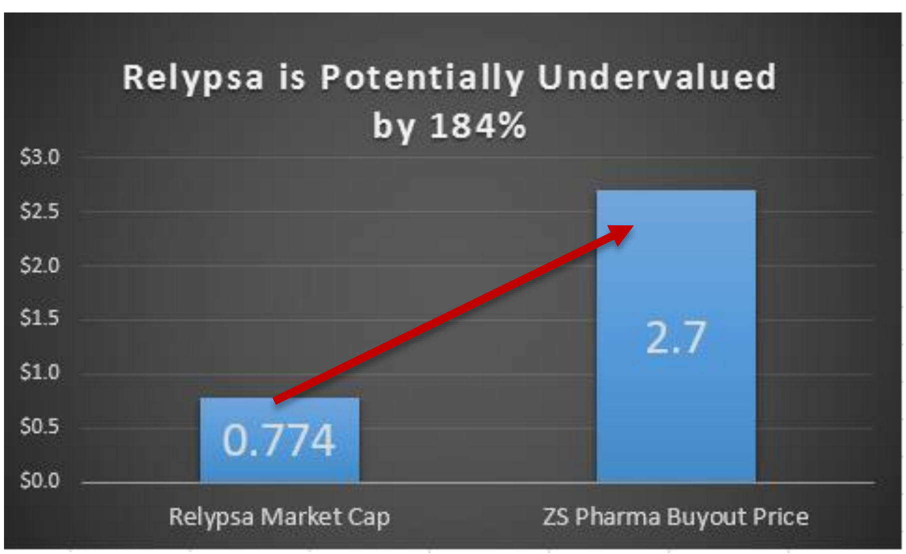
ZS Pharma (NASDAQ: ZSPH) whose main value is a competing treatment for hyperkalemina that should be approved in a few months and be on the market within six to nine months was bought out by giant drug firm **AstraZeneca (NYSE: AZN)** for $2.7 billion. The second biggest drug maker in the world believes "ZS-9" can reach peak annual sales of $1 billion for treatment of hyperkalemina. This purchase confirms the large potential for treatments of this condition.

Advantages to ZS Pharma:

The main attraction to both companies is their treatments for hyperkalemia. Obviously being first to market is a significant advantage for Relypsa even if its approved product does come with a "black box" warning. The black box label seems manageable as it is for interaction with other drugs and will just require the patient does not take veltassa with any other compounds for six hours. In addition, there is no guarantee ZS-9 if/when approved will not have the same requirement. ZS-9 also appears to have greater rates of peripheral edema and hypertension than veltassa, and Relypsa's offering does not appear to be quite as fast acting as ZS Pharma's compound.

It should be noted that Relypsa just completed a Phase I drug interaction or DDI study that showed extremely favorable results. Most of the drugs tested for interaction showed no impacts, others show interaction was minor and only lasted three hours and not six. This should make the FDA label even more irrelevant to prescribing physicians especially if these results are repeated in Phase II and III trials.

First mover advantage should not be underestimated especially since Relypsa has a good marketing partner in **Sanofi (NYSE:SNY)** who will help the company



*All numbers are in billions of dollars

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commercialize the product in the United States in addition to Relypsa's own sales force of just over 100 sales representatives. Outside the United States, the company is partnering with Vifor Fresenius Medical Care who paid Relypsa $40 million upfront for the privilege to sell Veltassa, and Relypsa could also earn just over $100 million in additional sales milestones. The company will receive up to 22% in sales consisting of royalties as well. Veltassa should be in the European market by early 2017.

From an investment standpoint, Relypsa's $800 million market capitalization with over $250 million in net cash on the balance sheet compares favorably with ZS Pharma's near $1.65 billion market capitalization and $200 million in the bank prior to being acquired by AstraZeneca for an approximate 40% premium.

Analyst Commentary:

Analyst commentary on Relypsa right after the approval of veltassa and Astra Zeneca's purchase of ZS Pharma was extremely positive. Citigroup reiterated their Buy rating on November with a $45.00 a share price target on Relypsa. Citi's analyst noted the merger "validates our bull thesis on the chronic hyperkalemia market where we see ZS-9 and Relypsa's Veltassa each achieving peak US sales of about $1B by 2023." Further, the analyst commented "that the valuation gap between ZS Pharma and Relypsa now stands at about $1.9B. This is embarrassing from a market efficiency perspective, since both ZS-9 and Veltassa are very similar. They both provide a fundamentally novel option for controlling chronic hyperkalemia."

Oppenheimer was more optimistic on November 8th and reiterated their Buy rating and $55.00 a share price target on Relypsa. Their analyst noted "With a large difference in valuation (Enterprise Value of $501 million and $2.01 billion for RLYP and ZSPH, respectively), we believe RLYP is an undervalued name. We continue to see the two drugs offer comparable efficacy but the edema rate of ZS-9 (7.7% per interim analysis) needs to be monitored (data still maturing)."

If anything, analyst coverage has gotten even more positive recently despite the big downturn in the biotech sector and the overall market in January. Over the past ten days, Oppenheimer, Wedbush, and Guggenheim have reiterated Buy ratings with price targets ranging from $53.00 to a whopping $86.00 a share.

Outlook:

The purchase of ZS Pharma definitely makes Relypsa a more likely takeover target, and partner Sanofi would make a logical acquirer among others. In addition, the company has over $250 million in net cash and will likely receive another $100 million in milestone payments. This means a potential acquirer is investing it the company with less than a $450 million net cost at the moment. Given the current outlook for veltassa, the company should eventually receive $200 million annually in high margin royalties.

The company is developing other polymers even if they are in early stage development. Shareholders are basically getting this technology and any subsequent products at a negative value right now. The shares traded for over $40.00 a share earlier in the year and the median price target by the 10 analysts that cover the company is $45.00 a share currently. Given this, Relypsa has a low risk/high reward profile one does not encounter too often in the small cap part of the biotech sector.

Recommendation: Buy RLYP up to $22.50 a share.

Position: Long RLYP

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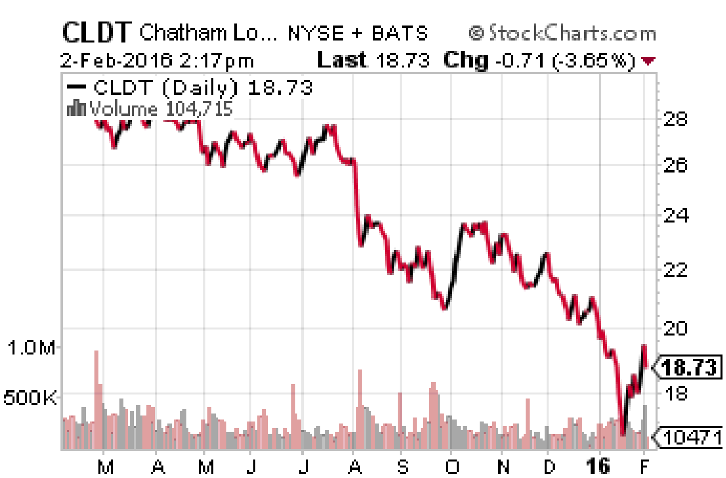
Chatham Lodging Trust: A Big Monthly Check and Lots of Upside

Our second Small Cap Gem selection for the month is an unusual one for our portfolio as one of the primary attractive features of this small cap real estate investment trust (REIT) is its over six percent dividend yield that gets paid out monthly. Given the horrid start to the market in 2016, a better than six percent guaranteed return looks pretty enticing at the moment. As importantly, the shares are dirt cheap and this REIT has a great management team and growth prospects.

Company Overview:

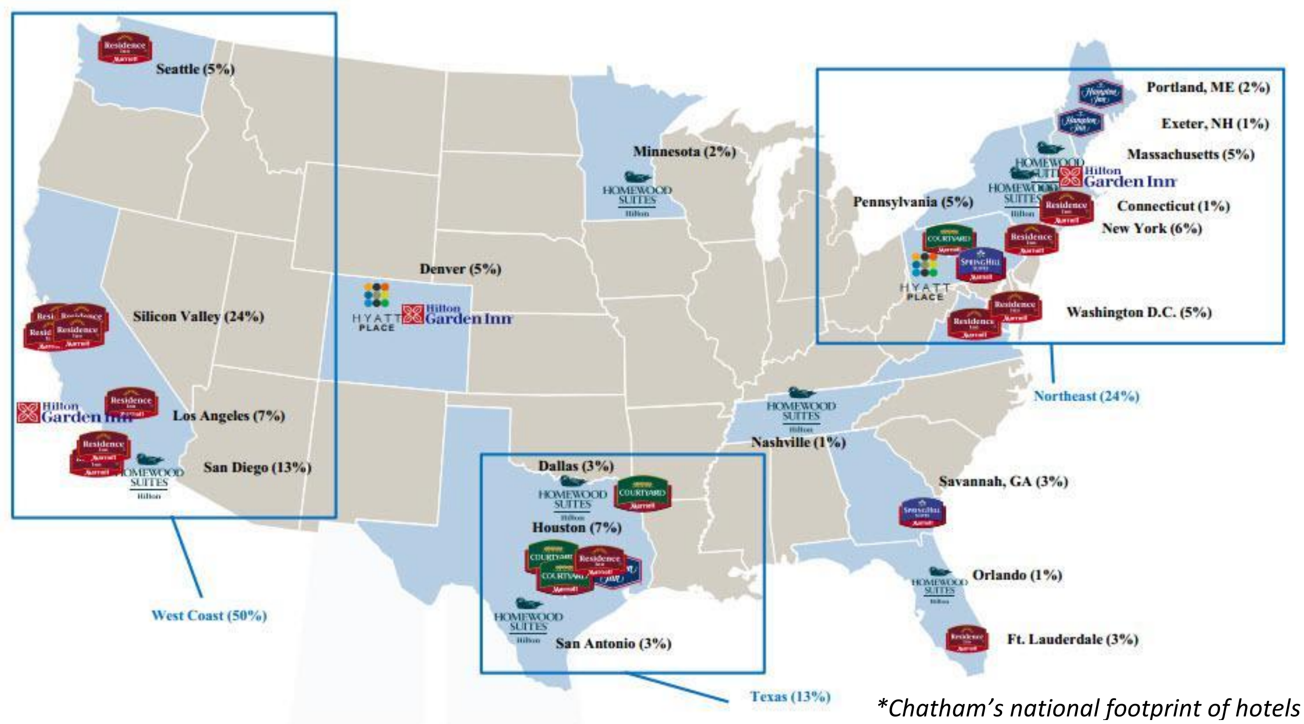
As of September 30th, the REIT owned 38 hotels, with an aggregate of 5,675 rooms located in 15 states and the District of Columbia. The company also has a 5% to 10% non-controlling ownership stake in several joint ventures with just over 12,000 rooms. Chatham focuses on premium brand select service hotels such as Residence Inn, Homewood Suites, Hyatt Place, Courtyard, and Hampton Inn. By concentrating on upscale Extended Stay properties, Chatham can generate a 10-15% occupancy premium over regular extended stay establishments. The REIT has a market capitalization of approximately $750 million and an enterprise value which includes debt of right around $1.3 billion. The stock currently trades for just over $19.00 a share. The stock traded 30% higher before the spike in the volatility in the high yield credit or "junk bond" market caused sentiment to go into extremely negative territory for myriad REITs.



Management:

One of the key reasons I have owned Chatham since it traded at just over $10.00 a share in 2012 is its management team. The CEO and some key members of his leadership team came over from Innskeepers Trust. They started running this small lodging concern in 1994 with seven hotels. They sold out in 2007 with almost 75 hotels and just before the financial crisis was entering its beginning – talk about good timing.

During those 13 years, Innkeepers Trust delivered a total return including dividends to shareholders of 318% or just over 13% on average annually over that time span. This was a 50% better return than the average of the FTSE NAREIT Equity Lodging / Resorts Index. Chatham reminds me of legendary ESPN anchor Chris Berman's description of future Hall of Fame receiver Chris Carter during his playing days "All he does is catch touchdowns." With Chatham, it seems all they do is grow and raise their dividend payouts. Since coming public in 2010, dividends have gone from 52.5 cents a share on an annual basis to $1.20 a share. This does not include special dividends like the 10 cent a share special dividend the company declared in January of this year. Chatman moved from a quarterly payment schedule to a monthly one starting in 2013.



Chatham's national footprint of hotels

In short, this management team knows how to buy, renovate, position, and operate these type of hotels. They consistently pick up new properties with a 7.5% to 8% capitalization rate or “cap rate” in the industry parlance which is much higher than their cost of capital. They then position them to provide a higher RevPAR (Revenue per available room) and occupancy levels than their peers.

Worries Overblown:

Many lodging REITs have lost 30% to 40% of their value over the past six months. Outside a tepid economy which has impacted about every sector of the market, these entities are facing three key worries right now. The first is the spike in volatility in the high yield credit or “junk bond” market. This is being triggered by the collapse in energy prices. This has escalated concerns that small and mid-tier producers that raised so much debt to expand their drilling programs in 2012-2014 will not be able to pay back their loans as they when they are due with oil prices hovering around $30 a barrel.

This is a legitimate concern. However, energy debt only makes up approximately 20% of the about $1.3 trillion domestic high-yield credit market. Nothing has changed about the ability of Chatham or any other concern in this space to pay back their liabilities. Eventually, these concerns will lessen outside of the energy space. With the Federal Reserve destined to back off its forecast to raise interest rates four times by a quarter point in 2016 due to an anemic global economy and actions by other major central banks, interest rates should stay lower for longer than what the central bank forecasted to begin the New Year. This will be good for high yielding sectors such as REITs. Chatham has a well-managed balance sheet with a staggered debt load and an average maturity of approximately eight years.

The second major concern around this part of the REIT market is that the strong dollar will continue to slow travel from overseas. This is a legitimate worry if you are managing high-end hotels in major destination cities like New York. However, Chatham's properties tend to consist of Courtyards in Altoona, PA or Addison, TX. It neither owns nor operates a single hotel in New York

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City. Its property portfolio will not be impacted by whether Mr. Underhill from Kent and family are coming to America in 2016 or not.

The final worry that I think is entirely overblown is the threat from Airbnb. This concern shows up in comments every time I write an article on any lodging REIT on SeekingAlpha or Real Money Pro. Airbnb is a great idea but right now it is a niche service. In addition, politicians are working hard to make its location pay “hotel tax” like any other lodging establishment, which would raise their prices and lower their appeal. Again, most of the volume from this service will be in major destination cities. Even in those cities, it is a niche. I did an inquiry while writing this analysis of what was available in Manhattan on Airbnb for the last week of March. I travel there often for business. My inquiry returned 18 available places in Manhattan and less than 40 in the five boroughs overall. Given Manhattan has over 80,000 hotel rooms, this hardly seems a threat to the hotel industry.

Valuation, Growth and Outlook:

Chatham posted FFO (Funds from Operations) of approximately $1.90 a share in FY2014. The REIT is tracking to $2.30 a share of FFO in FY2015 and its quarterly results will be announced in the last week of February. The range for FFO estimates in FY2016 is between $2.55 and $2.75 a share currently on an approximate 10% increase in overall revenues. This is very respectable growth of roughly 10% to 15% for the coming fiscal year. Over time, dividend payouts should go up approximately in line with FFO growth.

This means an investor is currently paying just 7.5 times forward FFO for an entity growing 10% to 15% annually and yielding 6.4%, closer to seven percent if you count the just announced special dividend. This is much, much too cheap especially given the low yield environment we live in these days.

A more realistic and still conservative multiple would be 10 times forward FFO. On the current range of FFO estimates for FY2016 gives us a price target range of $25.50 to $27.50 a share for CLDT. This is in line with current analyst price targets and the REIT consistently traded at the top end of that price target range before the recent breakdown in the REIT space. Once the market stabilizes, I think Chatham will slowly claw its way back to previous levels. Until then, we can be patient and collect a fat monthly dividend check.

Recommendation: Buy CLDT up to $22.00 a share.

Position: Long CLDT

Portfolio Update

It was an inauspicious start to the New Year to say the least. Major indices were down five to eight percent as equities turned in their weakest performance for a month in six years, and that was with a significant rally on the last trading day of the month. Small cap performance was even worse and this sector is now officially in a bear market. The market has gone into full “risk off” mode. Small caps have also been hit by the spike in the volatility in the high-yield credit markets which caused investors to ditch about anything with a decent amount of debt especially if it did not have a fortress balance sheet like the good majority of slower growing large cap companies do.

Over the last year, small caps have turned in their weakest performance since the financial crisis. The downturn has gotten to the point of being irrational in many parts of the market. Housing starts had a strong December to wrap up the best year for housing since 2007. Yet, homebuilders on average are down more than 20% over the past 12 months. Our plays on

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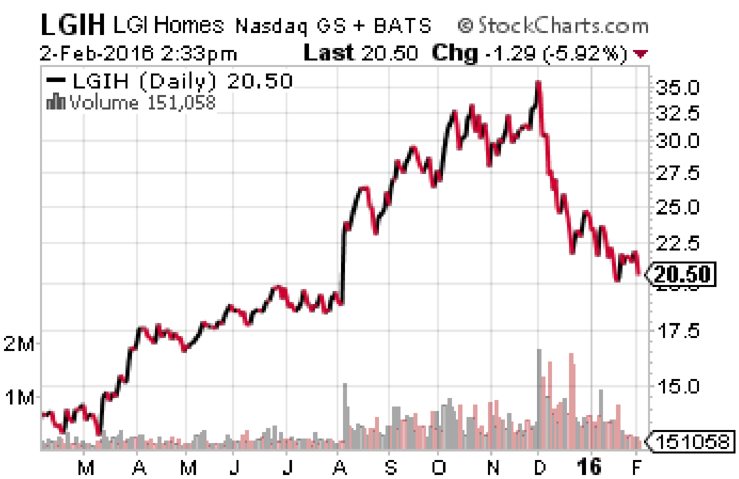
housing have not lived up to expectations even though we were accurate in believing that the housing market would continue to improve, a view I still have.

Other portfolio picks have gotten past the point of dirt cheap. **Greenbrier Companies (NYSE: GBX)** now trades at just over four times both this just completed fiscal year's earnings and what the company has guided to for profits in the current fiscal year. Greenbrier also posted quarterly earnings of $2.15 a share on January 7th, 52 cents a share above expectations. The stock did rally some 20% in the last two weeks of January after being down substantially in the first two weeks of the month.

LGI Homes (NASDAQ: LGIH) has lost some 30% of its value over the past three months. Over that same time span the consensus earnings per share estimate has gone from $2.91 a share for FY2016 to $3.11 a share for the coming fiscal year. The stock trades at seven times forward earnings and can be had for just over $20 despite its impressive growth trajectory.



Putting my optimistic hat on, the CEO of **Blackstone (NYSE: BX)** was interviewed by the Wall Street Journal last week. He is accelerating the deployment of his firm's capital as he is seeing bargains as if the country was in a recession with many good assets down 30% to 50% over the last year. I think his view is the correct one from a longer-term perspective but it does not diminish the pain the market is currently going through.

We are going to take advantage of the weakness in equities by ramping up our modifications to the Small Cap Gems portfolio to better position it for outsized returns when sentiment eventually improves on this sector of the market. We will be making two modifications per month instead of the usual one in the months ahead.

This month **IntelliPharmaCeutics International Inc. (NASDAQ: IPCI)** will be replaced by **Relypsa (NASDAQ: RLYP).** Relypsa has had its lead drug approved by the FDA and been a frequent rumored buyout target due to the potential of that compound in the $2 billion a year hyperkalima market. Thanks to the lousy sentiment of the market, the stock is actually down significantly over the past few months despite a rash of good news. I still like IntelliPharmaCeutics as a longer term play, but Relypsa's path to capital appreciation is much clearer at this point.

In addition, **Walter Investment Management (NYSE:WAC)** will be dropped from the portfolio and replaced by lodging real estate trust **Chatham Lodging Trust (NASDAQ: CLDT)**. Unfortunately, the standalone mortgage servicers like a few industries over the past five years have been killed by new regulations and overly aggressive regulators on the state and federal level. Thanks to a recent pullback in lodging REITs, Chatham is dirt cheap, showing solid growth, and yields some seven percent in monthly dividend payouts as well.

As of this issue, IntelliPharmaCeutics International Inc. and Walter Investment Management will no longer be a part of the Small Cap Gems portfolio. They can now be found in the "Closed Positions" section.

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Current Portfolio

Company	Entry Date	Entry Price	Buy Up To	Target Price	Recent Price	Returns
Chatham Lodging Trust (CLDT)	02/01/16	$18.70	$22.00		N/A	N/A
Relypsa (RLYP)	02/01/16	$18.25	$22.50		N/A	N/A
Sequential Brands Group (SQBG)	12/30/15	$7.91	$10.00		$6.04	-23.6%
BioDelivery Sciences International (BDSI)	11/30/15	$6.13	$7.50		$3.97	-35.2%
Greenbrier Companies (GBX)	10/30/15	$38.04	$42.00		$24.87	-34.6%
ANI Pharmaceuticals (ANIP)	09/29/15	$37.54	$45.00		$31.05	-17.3%
Taylor Morrison Homes Corportaion (TMHC)	08/28/15	$19.43	$21.00	$26.00	$11.75	-39.5%
Applied Genetic Technologies (AGTC)	07/30/15	$18.16	$20.00		$14.74	-18.8%
Powerline Solutions Intl. (PSIX)	07/01/15	$51.31	$57.00		$11.07	-78.4%
BioLineRx (BLRX)	06/25/15	$2.27	$3.00		$0.99	-56.4%
iRobot (IRBT)	06/02/15	$32.59	$34.00	$40.00	$32.74	0.5%
Ladenberg Thalman Financial (LTS)	04/29/15	$3.46	$6.00		$2.20	-34.3%
Endocyte (ECYT)	03/31/15	$6.26	$7.00		$3.22	-48.6%
LGI Homes (LGIH)	03/31/15	$16.66	$18.00	$38.00	$20.75	24.5%
Threshold (THLD)	02/27/15	$4.37	$5.00		$0.31	-92.9%
Mastec (MTZ)	01/30/15	$18.52	$21.00	$30.00	$14.85	-19.8%
Agenus Inc. (AGEN)	11/28/14	$2.96	$3.50	$9.00	$3.09	4.4%
Progenics Pharmaceuticals (PGNX)	10/30/14	$4.86	$6.00	$14.00	$4.22	-13.2%
Tutor Perini (TPC)	09/30/14	$24.60	$30.00	$44.00	$12.95	-47.4%
UCP (UCP)	07/30/14	$13.00	$14.00	$20.00	$5.54	-57.4%

Recent price is determined by the last "Close" price at the closing of the market on the day before publication; most recent update: 02/02/16.

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Closed Positions

Company	Entry Date	Entry Price	Close Price	Close Date	Return
Walter Investment Mgmt. (WAC)	07/18/14	$27.27	$10.16	02/01/16	-62.7%
IntellipharmaCeutics Intl (IPCI)	06/02/15	$3.46	$2.33	02/01/16	-32.7%
OncoGenex Pharmaceuticals (OGXI)	12/30/14	$2.33	$1.20	12/30/15	-46.2%
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: 02/02/16. 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.