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Three amigos

That we love 'em and leave 'em—our long ideas, that is—is a longstanding criticism of the management of these pages. Having once said "buy," we all too frequently fall silent (it would not have improved Shakespeare's reputation as a dramatist if he had left his fans to wonder whatever happened to Hamlet). Hence the following "where are they now?" analyses of a trio of *Grant's* names. We write without reference to the broad market, overvalued and monetarily manipulated as it is. Suffice it to say that the market risk is considerable. As for North Atlantic Drilling Ltd., iStar Financial and Horsehead Holding Corp., we call them, respectively, "hold," "hold" and "it's been nice—very nice—knowing you."

North Atlantic Drilling, you'll recall, does business in the freezing and inhospitable seabeds of the North, Norwegian, Kara and Barents seas (*Grant's*, July 12, 2013). Its offshore fleet consists of a drillship, three jack-up drilling rigs and four semi-submersible drilling rigs (of which one is under construction). Among the highlights of the past year was the January completion of an IPO, with 13.5 million new shares being offered at $9.25; you'll find them trading on the Big Board under the ticker NADL. At about the same time, $600 million of new 6.25% senior NADL notes of 2019 came to market; net proceeds were earmarked for paying down debt.

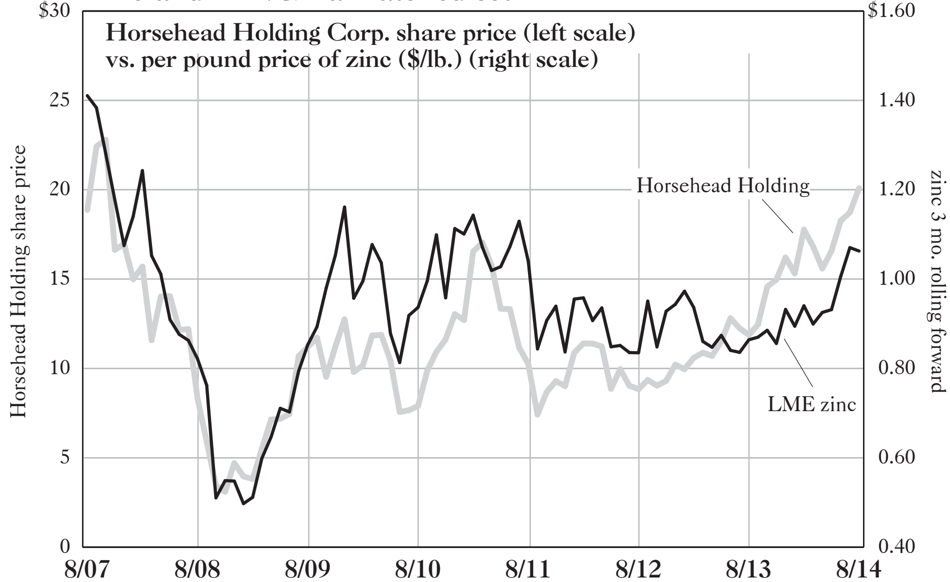
Other recent developments include a preliminary tie-up with Rosneft, the giant Russian integrated oil company (NADL popped on the May 26 announcement). Under terms of the transaction, Rosneft will acquire a 30% equity stake in North Atlantic, with Seadrill Ltd. continuing to hold the majority of NADL, leaving some 20%, or 71 million shares, in the hands of the public. If and when the deed is done, therefore, Rosneft, holding two of the seven seats on NADL's board, will become a large, but not controlling shareholder. The 69-year-old chairman, John Fredriksen, will continue to call the shots.

First fruits of the Rosneft collaboration took the form of a series of binding offshore drilling contracts. "Assuming the deal closes," observes colleague David Peligal, "this will assure NADL of long-term employment for its near-term available rigs. The contracts will commence in Russian waters from 2015 through 2017 and will include five-year commitments for the *West Navigator* drillship, the *West Rigel* and *West Alpha* semi-submersibles, and two new-build premium harsh environment jack-up rigs. Total revenue potential for the five undertakings is approximately $4.1 billion. An additional benefit is that of diversifying North Atlantic's exposure away from the Norwegian and U.K. markets.

"A little less exciting," Peligal continues, "was the Aug. 22 news that North Atlantic had agreed to acquire 150 land drilling rigs from Rosneft's

Just you wait

Zinc and ZINC—a matched set



source: The Bloomberg

land drilling fleet. Rosneft will agree to keep each rig employed for the next five years. It's not the kind of business that makes North Atlantic the desirable property that it is—it takes no exotic skill or equipment to punch holes in the ground. Just the same, one should not lose focus of the main chance. The real juice for NADL is the opportunity in the harsh Arctic environment, where Rosneft is the major player."

Second-quarter earnings featured $154 million of EBITDA (a fat 57% EBITDA margin) and a 98% economic utilization rating on the corporate fleet. Drilling markets in Norway and the U.K. are worryingly soft, management said, though this concern was leavened by remarks of Alf Ragnar Lovdal, CEO of North Atlantic, to dialers-in on the Aug. 27 conference call: "With a contract from Rosneft, we have added $4.1 billion to our contract backlog, so that our total backlog, as measured at the end of the second quarter, now stands at $6.3 billion. That is a record high, and we are very pleased to have achieved this in the current market. It is also a good sign of Rosneft's ambitions and ability to commit to their plans for developing the Russian Arctic. And as this cannot be said too often, our backlog is with an attractive margin, which should continue to support growth while we are still committed to creating profitable returns for our shareholders through our quarterly cash dividend distributions."

Quoted at $10.62 a share, NADL yields 9% on the current quarterly dividend rate of $0.24 a share. The $2.6 billion market cap roughly matches the size of the net debt. We judge that $1.80 a share in free cash flow in 2016 is within the realm of possibility—as are unpleasant surprises on the geopolitical front, Rosneft being a corporate citizen of Vladimir Putin's Russia. Peligal asked Jeffrey Schwarz, co-founder of New York-based Metropolitan Capital Advisors and a NADL shareholder—we quoted him in the opening analysis of NADL a year ago—how he viewed the risks.

"I would imagine it's the unknowable aspect of the sanctions, and how the geopolitical environment plays out," Schwarz replied. "I think it is causing people to say, 'It's too complicated. I simply cannot have an informed opinion about how that plays out.' In conjunction with that, the near-term prospects for the offshore market are not bright. So you don't have the safety net if the Rosneft deal unravels because of sanctions or because Rosneft cannot finance itself. You don't have the safety net of the strong North Sea market that has existed for many years now. As a contrarian, I'm okay with the second part of those concerns because I think that the harsh environment market that NADL serves is going to turn. I don't know whether it's next year or the year after, but there have been a lot of new discoveries in the North Sea and there's a relatively finite supply of rigs that are certified to work there."

In short, for the intrepid taker of a businessman's risk, NADL remains the high-yielding, special situation, under-the-radar long it was a year ago; we remain bullish.

On, now, or rather back to, iStar Financial (*Grant's*, Dec. 14, 2012, and Aug. 9, 2013), a company still unprofitable, still dividend-free and still the object of insider selling. "So why," as Peligal rhetorically inquires, "are we still interested with the stock now just under $15 a share, up from $7.88 when we first laid eyes on it? It's not because of the frequent and helpful interactions we've had with senior management, or because of the catchy new NYSE ticker, 'STAR.' It pleases us, to start with, that the company continues to do what it promised to do, including reducing its non-performing loans (down by 54% between the first and second quarters) and replacing bank borrowings with unsecured debt. As to the second item, a major refinancing in the April-June period liberated $2 billion of collateral from the clutches of its bankers; as a share of total borrowings, it reduced secured debt to 16% from 49%.

"In the second place," Peligal continues, "we like the company's $1 billion land portfolio, which—especially in this time of monetary meddling—is where we believe the upside lies. The portfolio, sprinkled far and wide, consists of 11 master planned community projects, 11 urban infill land parcels and six waterfront land parcels. The master planned community projects are entitled for 25,000 lots, the infill and waterfront parcels for 6,000 residential units. Since the majority of iStar's land projects are either in the development or pre-development phase, we're still probably in early days with regard to value realization. One doesn't see Jay Sugarman, iStar's chairman and chief executive officer, presenting at investor conferences. Perhaps he wants to speak with numbers, and he can't do that just yet in the case of the land assets. When he does start to make the rounds, touting the Ponte Vista development in San Pedro, Calif., with its 676 residences; the Wayfarer development in Long Beach, N.Y., with its 522 luxury rental apartments; the Grand Vista development near Phoenix; the Marina Palms 468-unit condo project in North Miami Beach, or the 1000 South Clark Street

469-unit luxury multifamily project in Chicago—when he finally takes his show on the road, that will probably be the signal to move on."

As the company vouchsafes few details on these real-estate assets, Peligal decided to perform some on-site due diligence. One recent sunny Tuesday, he drove out to Asbury Park, N.J., the formerly fading now brightening oceanfront resort town, to inspect the development roots that iStar is putting down. "Just as the company says," Peligal reports, "Asbury Park is on the upswing, though there are still some areas in which Sugarman, if he found himself walking alone at a certain hour, would probably pick up the pace. Undaunted, the company, in partnership with K. Hovnanian, is at work on a projected development of 28 luxury townhouses called 'South Grand'; it marks the first time a national homebuilder has entered the Asbury Park market since 1984. You need some imagination to share Sugarman's vision—for now, there's not much to see except for scattered patches of grass and dirt.

"A few short blocks north to the Fifth Avenue and Kingsley Street intersection," Peligal goes on, "is another iStar dream in the making. It's a former retirement home for ranking officers of the Salvation Army. This seven-story derelict, situated a couple of blocks from the beach, has been vacant since 2004 and it shows. What it's about to become, if iStar and the architects at Stonehill & Taylor have their way, is a boutique hotel with a rooftop bar. Might Sugarman be early? Possibly. There's not much of a reason for people to make an extended stay in Asbury Park. Then again, according to an employee at a Cookman Avenue coffee shop, Asbury Park, with its sizable LGBT population, is 'the new Fire Island, but on a smaller scale.' Probably not the worst spot, assuming you're in the right part of town, which iStar seems to be, to own a bunch of land."

Still and all, the equity ducks are quacking. Should we not feed them a morsel? Horsehead Holding (ZINC on the Nasdaq) is the proverbial piece of bread we proffer. The former New Jersey Zinc is an old flame of ours (*Grant's*, Dec. 16, 2011, and March 8, 2013). Now quoted at $20 a share, up from $8.62 a share in 2011, the shares remain dividend-free but are no longer without a following.

What's changed is the company's big, new, business-transforming, over-budget, risk-fraught plant in Mooresboro, N.C.; three years in the planning and building, the facility finally got up and running on May 21. Mr. Market has chosen not to fret over the final price tag of $525 million, some 40% higher than the first estimate. He has rather chosen to focus on a rising zinc price, now over $1 a pound.

The prices of zinc and ZINC tend to be tightly correlated. And as sentiment toward the metal has been hotting up (an Aug. 26 Bloomberg story quoted projections of a 15% rise in zinc quotations next year), so has bullishness toward the shares. Kindly fielding a pre-holiday e-mail, Jim Hensler, Horsehead's president and chief executive officer, commented on the zinc situation.

"I think zinc may finally be seeing its day in the sun and rightfully so," Hensler wrote. "The International Lead Zinc Study Group (ILZSG), who follows these things, has been reporting global deficits in zinc since the middle of last year. Most of the respected analysts are of a similar view. This is the natural result of relatively low zinc prices for the past five years slowing new mining activity while several large mines have closed or are expected to close over the next two to three years. Meanwhile, global demand has continued to grow steadily, primarily driven by Asia. I think the greatest risk factors to these forecasts are the real growth rate in Asia and the extent to which higher zinc prices today encourage some miners to try to extend the life of mines which are currently expected to close."

As for the Horsehead share price, Peligal next asked Hensler what might it be discounting? "I think," the CEO replied, "the market is pricing in three factors: (*a*) the expected benefit of the Mooresboro project discounted for individual perceptions of when the stated benefits will actually be realized, (*b*) the value of the expansion of Zochem and the consolidation of our zinc oxide business into a single, more-efficient location and (*c*) the higher current zinc price. I do not think the market is fully pricing in the potentially much higher zinc prices that some analysts are forecasting in 2015 and beyond or the potential return on the additional free cash flow that the business will generate once Mooresboro is fully ramped up and we begin investing the cash and/or paying down debt."

In other words, the transformational event has happened, and the market has noticed—has in fact, jumped to its feet to applaud. Not a bad time to slip away from the crowd to prospect for something new, we judge.

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