Oil Falls, Dollar Rises, and the Market Retreats

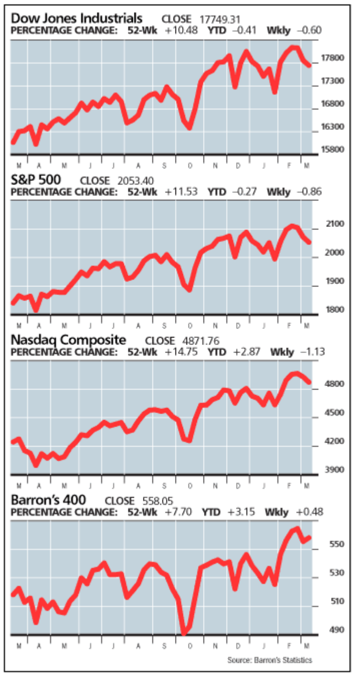
No rate hike is expected yet, but investors fear FOMC wording changes that spook the markets.

By VITO J. RACANELLI
March 14, 2015

Vital Signs

Stocks backpedaled last week, pressured on one side by a strengthening U.S. dollar and on the other by falling energy prices. Shares of large-cap firms in particular—thanks to foreign exposure—suffered most from the downward pressure, while more domestic revenue-oriented small caps bucked the trend and rose sharply.

Some investors lightened up on equities in anxious anticipation of the Federal Open Market Committee meeting this week. No rate hike is expected just yet, but investors fear wording changes in the FOMC's press release Wednesday that could spook the market. (For more on this, see this week's Up & Down Wall Street, "The Great Divide.")



Oil prices again lost ground, after a few weeks of stability, reigniting worries about energy stocks, which fell 3%, and deflation anxieties. Oil fell 10% to $44.84 per barrel. U.S. economic data ran the gamut from weak, like February retail sales, to good, like weekly jobless claims, but played a background role.

Last week, the Dow Jones Industrial Average lost 108, or 0.6%, to 17,749.31, while the Standard & Poor's 500 index fell 18 points, or 0.9%, to 2053.40. The Nasdaq Composite dropped 56, or 1.1%, to 4871.76. The small cap Russell 2000 index gained 1.2% to 1232.13.

"People are starting to think earnings will be flat this year," thanks to the dollar's potentially painful influence, says Benjamin Halliburton, chief investment officer of Tradition Capital Management. Negative first quarter earnings preannouncements will probably begin soon, he adds, and the March quarter at least will be "abysmal for energy companies, poor for most big companies, and weak in general."

A strong dollar is better for Corporate America long term, adds Halliburton, but "in the current world, investors are at most interested in the next 12 months." The dollar index is on course for a 13.8% gain in the first quarter, the largest quarterly jump since the 1992 European monetary crisis, according to Bank of America Merrill Lynch.

Headlines bemoan the dollar, but the U.S. is a net importer, so the average Joe and Jane see greater purchasing power and lower inflation. U.S. companies have to get leaner and meaner. While U.S. exports cost foreigners more and the translation hurts earnings comparisons in the short term, U.S. firms have more buying power overseas. A stronger dollar makes U.S. assets more attractive to foreigners.

The February producer price index released Friday declined 0.5%, weaker than anticipated.

Though the market expects a Fed hike around June, Scott Colyer, CEO of Advisors Asset Management, demurs. The PPI shows no sign of inflation. "The downside to the Fed of doing nothing is pretty minimal, while a hike could threaten the recovery," says Colyer, who believes the Fed won't raise interest rates until 2016.

Whether it's June or January, it's hard to see the market moving sustainably higher until the Fed drops the veil.

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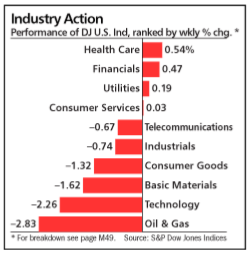
Pinnacle Not Yet Reached

Gaming and Leisure Properties will most likely have to raise its $36-per-share offer for the real estate assets of regional casino operator Pinnacle Entertainment by 10% to 25% to pass muster with a majority of Pinnacle shareholders. It probably will take $40 and possibly a few dollars more, according to large institutional owners of Pinnacle with whom *Barron's* spoke.

Last Monday, Gaming and Leisure (ticker: GLPI), a real estate investment trust, made the unsolicited proposal that it said values Pinnacle (PNK) at a roughly 30% premium to the previous closing price. Last week, Pinnacle stock rose 25%, to $34.39; GLPI's shares climbed as well, by 12%, to $36.02.

Pinnacle, which has 15 casinos in eight states, is splitting itself into an operating company (OpCo), which would own and operate its gambling assets, and a REIT (PropCo), which would own the underlying property. Pinnacle shareholders would get new shares of each company; such splits often lead to increased shareholder value on a combined basis. However, Pinnacle still needs IRS approval for the move, as well as equity financing, and a split is unlikely before 2016.



GLPI says its offer—0.5517 of one of its shares for each Pinnacle share—already has financing and could be effected before the end of the year. Pinnacle holders would get about 36 million GLPI shares and a 20% stake in the combined GLPI-PropCo entity.

Some Pinnacle shareholders, however, say the bid undervalues the PropCo and, by extension, Pinnacle's stock. The offer for the PropCo is about $4.1 billion, resulting in its having a pro forma ratio of enterprise value (EV, market cap plus net debt) to earnings before interest, taxes, depreciation, and amortization (Ebitda) of about 11.2 times.

In the proposal, notes one shareholder, GLPI says similar-sized REITs are valued at 13 times. Something like 12.5 to 13 times the PropCo's estimated $365 million annual Ebitda is more likely to succeed, he says, and that would bring the bid to at least $40 and as high as $45.

GLPI's proposal also puts the GLPI-PropCo combination at an EV/Ebitda ratio of 14.7 times, on a pro forma basis. That makes the offer for Pinnacle at the current level accretive to GLPI. The GLPI-PropCo combination would create the third-largest triple-net lease REIT. The rationale behind GLPI's offer is that the larger REIT, with a more diversified rent base, presumably will get a higher valuation. (In triple-net leases, the lessee pays rent, all taxes, insurance, and maintenance costs.)

It also means there's room for a higher bid, Pinnacle shareholders say. GLPI's letter to Pinnacle's board last week left the door open to an alternate structure, such as making cash part of the proposition.

An offer that valued Pinnacle's PropCo at 13 times EV/Ebitda would still be accretive to GLPI and could get the deal done, says another shareholder.

Even GLPI's shares jumped on the news of the proposal, suggesting investors think highly of the offer. "But it's not going to happen at this [bid] level," says one of Pinnacle's larger institutional holders.

Pinnacle declined to comment, and GLPI didn't reply to requests for comment. The offer is just a proposal and anything can happen, but GLPI will probably have to stump up some more money.

Sinclair's Appealing Assets

A report from Nielsen last week reconfirmed that streaming and video-on-demand services continue to eat into traditional TV watching by Americans. Among the findings: In 2014's fourth quarter, the amount of time people spent watching video on the Internet rose to 10.5 hours a month from 7.5 a year earlier, while traditional TV-watching time fell by six hours, or 4%, to 149.

Fear of folks "cutting the cord" and spending less time on traditional TV broadcasts has hurt shares of cable companies and broadcasters. The loss of viewers can have negative repercussions on broadcaster's advertising revenue and reduce the number of cable subscribers.

Sinclair Broadcast Group (SBGI), which owns and operates about 163 broadcast TV stations in 79 U.S. markets, has seen its stock drop nearly 25%, from a high of $37 last year to $28.02 recently. The company, which sports a steady, profitable track record and historically has grown through acquisitions, reaches about 37.5% of U.S. households with a TV. Consequently, it now bumps up against the regulatory size ceiling of 39%, so growth from additional stations would be difficult. Congress might revisit those limits in the next year or so, but it's unclear if any changes will be made.

Investors shouldn't ignore these risks, but Sinclair's stock might be discounting too much gloom and too little potential good news over the next 12 months. Once some of these positive catalysts occur, the stock could rise back toward the old high.

TV remains one of the best ways for many kinds of advertisers, both national and local, whether they be car makers or politicians, to reach a broad audience, says Eric Green, a portfolio manager at Penn Capital Management. Penn owns a 1% stake in Sinclair. Broadcast local news remains important to viewers, he adds, and a lot more people watch it than, say, ESPN.

The current stock price undervalues Sinclair's broadcast-spectrum licenses, among other things, Green contends. The value of such assets are rising fast. How much Sinclair's are worth—regardless of whether the company decides to sell spectrum or not—should become clear in the Federal Communications Commission-sponsored spectrum auctions expected next year. A recent Wells Fargo Securities report valued Sinclair's spectrum at a potential $3.7 billion to $5.1 billion, using a range of estimates prepared for the FCC by advisory bank Greenhill. Among its peers, Sinclair's spectrum assets were the most undervalued as a percentage of market value, the report asserted.

The $4.4 billion midpoint of Wells Fargo's range, Green notes, is far above Sinclair's stock-market value of $2.7 billion. Once the auctions crystallize the spectrum value, investors will begin to price Sinclair's assets more appropriately, Green avers. The Hunt Valley, Md.–based broadcaster has about $3.9 billion in total debt.

Green also argues that Sinclair should get significantly more cash in the next two years from retransmission fees. (These are paid by cable companies to TV broadcasters, in exchange for the right to include TV feeds in their cable bundles.) Such fees have been rising and while Sinclair doesn't disclose what it obtains, Green estimates its fees will rise to $1.50 to $2 per sub from roughly $1 to $1.25 currently. Much of the increase will drop straight to the bottom line, he adds. Sinclair's geographically diverse station base has affiliates with all the major networks.

The stock, meanwhile, is fetching just 16 times analysts' consensus earnings estimates of $1.69 this year, and 10 times the $2.72 expected next year—roughly a 25% discount to its peers. In 2014, EPS was $1.92.

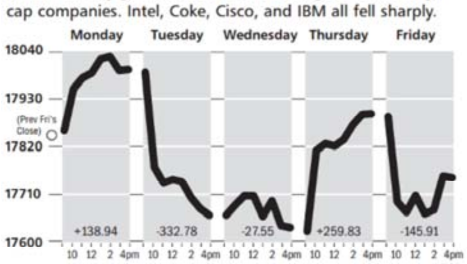
Since advertising for U.S. elections and global sports events, such as the Olympics, typically take place in even-numbered years, broadcasters' results often jump in those years—and 2016 will be such a year.

Sinclair's 2014 results were also boosted sharply by acquired stations. For now, Sinclair can't add too many more stations, but it's only just starting to get the accretive benefit of those it has acquired recently, says Green, who values the stock at $40.

With a large short position in the stock, Sinclair has few believers. However, over the next 12 months, the catalysts should force the market to focus more on its attractive assets.

FIVE-DAY DOW COMPOSITE

Dow Dollar Downer: The Dow fell 0.6% last week on worries the strong greenback will hurt earnings at some mega-cap companies. Intel, Coke, Cisco, and IBM all fell sharply.



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