7 Must-Buy Stocks for 2012

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Table of Contents

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Favorite Long-Term Picks from Zacks' Stock Analysts

1. Vertex Pharmaceuticals (VRTX)

by Kevin Cook

Vertex Pharmaceuticals Inc. (VRTX) has eight drug candidates in clinical development to treat viral diseases, inflammation, cancer, autoimmune diseases and neurological disorders. Vertex has created its pipeline using a proprietary information-based approach to drug design that integrates multiple technologies in biology, chemistry and biophysics aimed at increasing the speed and success rate of drug discovery.

The company just turned profitable late last year on the successful launch of Incivek, its blockbuster next-generation drug treatment for the hepatitis-C virus (HCV). This was accomplished in the face of competition from pharma giant Merck (MRK), which also succeeded in bringing a new HCV drug to market. Vertex achieved $420 million in sales (vs. Merck's $31 million for Victrelis) and is projected to top $2.5 billion and over $4 EPS with Incivek this year as they will dominate 70% of the HCV market. But the stock was beaten down in the final months of 2011 from above $50 to below $30.

How could such a success story be punished so badly by Wall Street? In a word: competition. A handful of other drug companies were also preparing to launch HCV treatments, many without the use of side-effect laden interferon required by Incivek. In November, Gilead Sciences (GILD) agreed to pay $11 billion for Pharmasset (VRUS), about an 80% premium. But Pharmasett's interferon-free drug candidate is only just entering its third phase III clinical study and may not be approved for US markets until 2014. Until then, Incivek will likely be the biggest selling HCV drug.

Other big competition facing Vertex's Incivek is the alliance of two other pharma giants. Johnson & Johnson's Tibotec Pharmaceuticals and Bristol-Myers Squibb recently announced that they have joined forces for the development of Bristol-

Myers' daclatasvir in combination with Tibotec's TMC435 for the treatment of chronic HCV. The partners are aiming to create an oral once-daily interferon-free cocktail treatment for HCV patients, where it is estimated that only 200,000 HCV patients out of a total of more than 12 million receive treatment each year in major markets like the US, EU, Japan, Australia, Turkey, Canada, etc.

Vertex Pharma has recognized the need to continually evolve the HCV treatment pattern and is developing an all-oral combination of VX-222 (a polymerase inhibitor) and Incivek without interferon. The company also has a cystic fibrosis drug, Kalydeco, on FDA "fast-track" approval that could launch as early as April. And Vertex recently brought a new CEO aboard who is focused on the rest of their pipeline, including treatments for epilepsy and rheumatoid arthritis.

I think VRTX is a buy below $40 and my year-end target is $50. On December 6, when VRTX was trading just below $30, the first trade of my newly launched Tactical Trader service was the purchase of VRTX April 30 calls for under $4. Since that purchase, others also caught on to the idea that VRTX was undervalued and the stock rallied above $34. As I write on January 9, Bristol-Myers has announced the acquisition of Inhibitex (INHX), a smaller next-gen HCV competitor for a 150% premium in a $2.5 billion deal. This competitive push in the HCV market was perceived as positive for VRTX, pushing the stock up nearly 5% to close solidly above $35.

2. Norfolk Southern (NSC)

by Steve Reitmeister

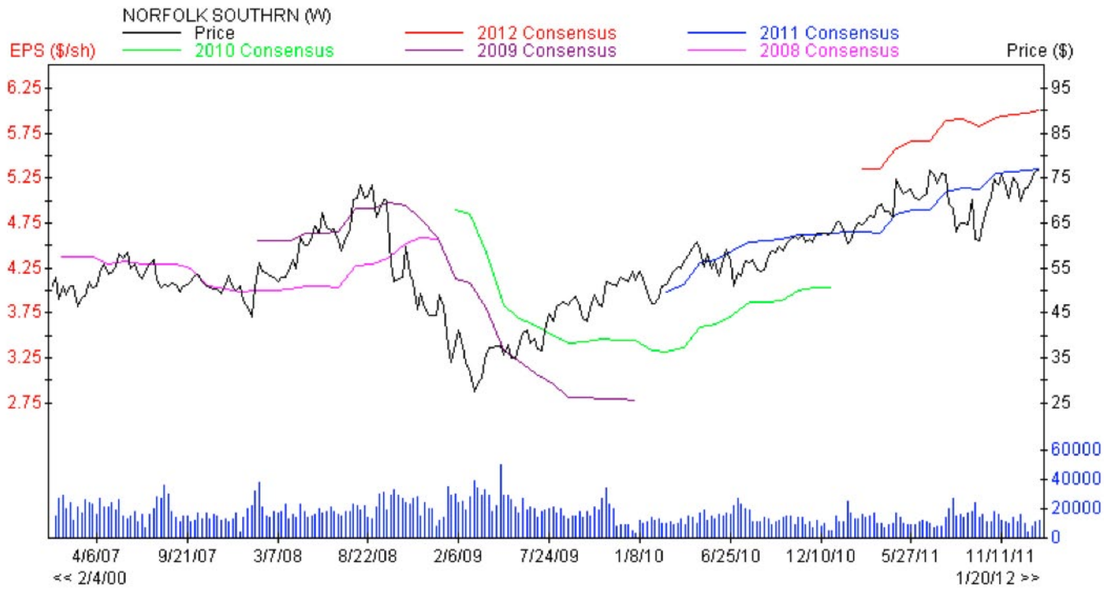
How do I love thee NSC? Let me count the ways…

1. Top Down View: Since August 2011 the market has been gripped by fears of a potential new recession. Yet while sentiment plummeted, economic activity in the United States actually accelerated. That can be seen clearly in the +1.8% GDP reading for the 3rd quarter (versus the first half growth rate of only +0.85%). Even better, the current estimates for the 4th quarter are in the 3% range with some experts calling for 4% growth.

2. Growing Economy = Growing Transport Profits: Few relationships in the investment world are truer than this equation. That's because if the economy is growing, then more goods are being shipped. And the more shipped, the higher the profits for the transport firms that usually translates into higher share prices.

3. Higher Oil Prices Benefits the Rails: The above paragraph shows why these times are good for all transport firms. Now let me tell you why the rails will pull away from their cousins in the trucking industry. Higher oil prices makes trucking more expensive. So with oil in the $100 vicinity once again, gas prices will soon be on the rise. That will have more producers opt to ship their goods via the rails in the future.

4. Earnings Momentum: For the last two years the firm has consistently beaten analyst expectations, leading to higher estimates and share price. The chart for NSC below paints that story very clearly as you can see the colored earnings estimate lines keep tailing up and to the right (as does the share price). Newton said that a body in motion tends to stay in motion. That is usually true for companies experiencing this form of positive earnings momentum that morphs into higher share prices.



5. Valuation: This is another great story that can be seen in the chart above. Look at the normal relationship between the earnings estimates and share price. Historically NSC trades at around 14-15X earnings. Yet given the false recession scare of the past several months, shares are now only trading at 12X earnings. So as investors become less concerned about recessions that don't exist, the share price will gravitate back towards its historical average, which provides ample upside for investors.

6. Dividend: With a growth story like this, an investor shouldn't need any more incentive to get on board. However, NSC also pays out a 2.3% dividend yield. Hey, that's better than your bank account!!!

Add it all up and there is a lot to love about Norfolk Southern.

3. Mitcham Industries, Inc. (MIND)

by Tracey Ryniec

Looking for a way to get in on the hot drilling sector in 2012?

Mitcham Industries, Inc. (MIND) is cashing in on the global drilling bonanza as its seismic equipment is in strong demand not just in the United States but also in Latin America.

Mitcham supplies rental or new seismic equipment to the oil and gas industry, seismic contractors, government agencies and universities. It also manufactures specialized seismic marine equipment through its Seamap brand.

You might not guess it, but international sales make up the majority of revenue for this Texas-based company. The international strategy is paying off. Latin America continues to see strong customer demand and increased utilization. Mitcham made a calculation to deploy more equipment to the region in the second quarter, which was then able to be put into action in the third quarter. The Pacific Rim and North Africa also saw strong demand.

In the U.S., there was increased activity due to demand for higher resolution 3D imaging in the challenging shale plays.

Huge Earnings Growth in 2011 and 2012

Mitcham is expected to grow earnings by 418% in 2011. The Zacks Consensus Estimate is looking for $1.76 per share. The company only made 34 cents in all of 2010.

But the growth isn't expected to die off in 2012. The Zacks Consensus Estimate has risen to $2.34 per share, which is further impressive earnings growth of 33.1%.

Shares at Multi-Year Highs But Valuations Attractive

Shares have been on a tear and recently hit multi-year highs. But Mitcham isn't very expensive. It has a forward P/E of just 12.7, well under its peers at 22.7x.

Mitcham also has a price-to-book ratio of 1.9. A P/B ratio under 3.0 usually indicates a company is undervalued.

With no signs of a slowdown in the oil and gas industries either in the U.S. or internationally, Mitcham has an attractive combination of both growth and value.

4. Lionsgate Entertainment Corp (LGF)

by Kevin Matras

If you go to the movies or watch TV (how's that for a wide net?), you've no doubt been acquainted with Lions Gate Entertainment, whether you know it or not.

Headquartered in Vancouver, British Columbia, Lions Gate produces and distributes motion pictures, creates and syndicates television programming, and engages in home entertainment, digital distribution, and new channel platforms.

LGF is a mid-cap growth company, with a 10.13% 5 year historical sales growth rate, a projected 3-5 year estimated EPS growth rate of 27.95%, and a below industry Price to Sales ratio of 0.8. At the time of this writing (January 1st, 2012), they have a Zacks #2 Rank (Buy).

They have an extensive movie catalogue that includes critically acclaimed hits such as *Crash* and *Monsters Ball*, as well as not so critically acclaimed (but no less profitable) hits like the *Saw* franchise, the *Hostel* movies, and *The Expendables* (their most profitable movie to date). This catalogue is about to get a whole lot more profitable with the highly anticipated 2012 release of *The Hunger Games*. Based on the best-selling book of the same name, the movie (along with all of the tie-ins and other promotions related to the movie) could literally double the amount of money that Lions Gate's other movies did in one year combined.

Needless to say, the company is expecting big things from this property. And with the book being a trilogy, they're expecting to roll out no fewer than two more sequels, if the first one is successful. In fact, reports suggest there'll be a total of four movies, as the studio will split the very last one into two parts, the same way Harry Potter and Twilight did with their franchises. That of course is great news if you're a fan (four movies are better than three), and more business for the studio (once again, four movies are better than three).

The feeling is that their potential success with such a big rollout will allow them to attract other big budget, high profile movies as well. And that's where the even bigger potential is.

But Lions Gate has more going for it than just *The Hunger Games*. They have a lot of movies in the hopper, not the least of which is the sequel to *The Expendables* (which as previously mentioned was their most profitable film so far).

But Lions Gate is also making all the right moves in TV (*Mad Men*, *Weeds*, *Boss*, etc.) and digital entertainment too. Inking deals to secure their ever growing spot in streaming content, they're positioning themselves in one of the hottest growth spaces. And not just in the U.S. but around the world.

They are not without their challenges however. Production costs are on the rise. And the movie business can be fickle. But their strategic moves, as demonstrated by both organic growth and growth through acquisitions, have proven to be profitable, as they surged back into profitability in the 2nd half of 2011, having posted 3 positive surprises in a row of 52.94% (Q1'11), 250% (Q2'11), and 25% (Q3'11).

I have a 12-month price target of $11, which would represent an increase of over 24% based on their closing price of $8.32 on 12/31/11.

However, long-term, I think it's quite possible to see LGF eclipse their previous all-time high of just over $12, and more than doubling over the next three years as they become a larger and more important player in the entertainment industry.

5. Aflac (AFL)

by Dirk van Dijk

Based in Columbus Georgia, Aflac actually does the bulk of its business in Japan. On both sides of the Pacific, it is the leader in supplemental health insurance, mostly sold through payroll deductions. It is well known for its duck ad campaign. AFL did have some exposure in its portfolio to European debt, but it has already taken that earnings hit. Otherwise, from an operating perspective, it has no exposure to Europe. The stock currently has a Zacks #2 Rank (Buy). It is a very cheap stock, trading for under 6x consensus 2012 estimates. Its average P/E over the last five years is 12.05x, and historically it has traded a lot more expensively than that.

It yields 3.2% and has raised its dividend every year for decades. The five year average dividend yield is 2.25%. The dividend is now $1.32 per year, but it is not hard for me to see that rising to $1.50 by the end of 2012. The current payout ratio is just 19% vs. a five year average of 24%. It might look semi expensive at 1.5x book value, but it produces an ROE of 24.9%, and that ROE has been stable over the years. Over the last five years it has grown its EPS at 18.7% per year, but the consensus slows to 10.5% per year over the next five years. I suspect they will do much better than that.

The same management has been in place for a very long time now, but the CEO is still relatively young, so he is not likely to leave anytime soon. I have met with the management personally, and I regard them very highly. At current valuations, I think the downside is very limited, but if I am right about the size of the dividend increase over the next year, and it trades just halfway between the current dividend yield and its five year average, it would be going for $72.60.

6. Mechel OAO (MTL)

by Todd Bunton

Arguably the least favorite of the BRIC countries over the last couple of years has been the ‘R’: Russia. Many solid Russian companies have gotten their teeth kicked in as investors shun the country. And in the case of Mechel, it could pay off to be greedy where others are fearful.

Although Russia still faces many challenges, the country is expected to see healthy economic growth in 2012. And one of the beneficiaries will be Mechel, the largest coking coal producer and sixth-largest steel producer in Russia.

The company operates in four segments: Mining (32% of revenue), Steel (58%), Ferroalloys (4%) and Power (6%). The Mining division focuses on the production and sale of coking coal concentrate, iron ore concentrate and coke, which are chief raw materials for the production of steam coal and steel. The Steel segment comprises the production and sale of semi-finished steel products, carbon and specialty long products, stainless flat products, and value-added downstream metal products including hardware and stampings. Its steel business is supported by its mining business, providing a high degree of vertical integration. The company is headquartered in Moscow and has a market cap of $4 billion.

Through the first 9 months of 2011, total revenue was up +38% year-over-year, with operating income up +40% despite a difficult pricing environment in the third quarter. The Mining segment saw revenue growth of +43% over the same period while operating income rose +42%. The Steel segment experienced top-line growth of +40% and operating income growth of +46%.

Total revenue declined from the previous quarter, but profits were higher. Mining revenue was up +4% as volumes increased. And management expects increased production from this segment going forward. Overall, operating profit increased +11% from the prior quarter while earnings before interest, taxes, depreciation and amortization (EBITDA) also rose +11%.

Despite solid business performance, the stock has gotten hammered as investors fear a global economic slowdown in 2012. As a result, the share price is now at levels not seen since the depths of the Great Recession. This split between price and value has led to some compelling valuations. Based on consensus estimates, analysts expect earnings per share of $2.62 in 2012. However, shares are trading at just 3.6x this amount (not a typo). This is well below an historically cheap industry median of 8.0x. On a price to book value multiple, Mechel is only trading at 0.7x.

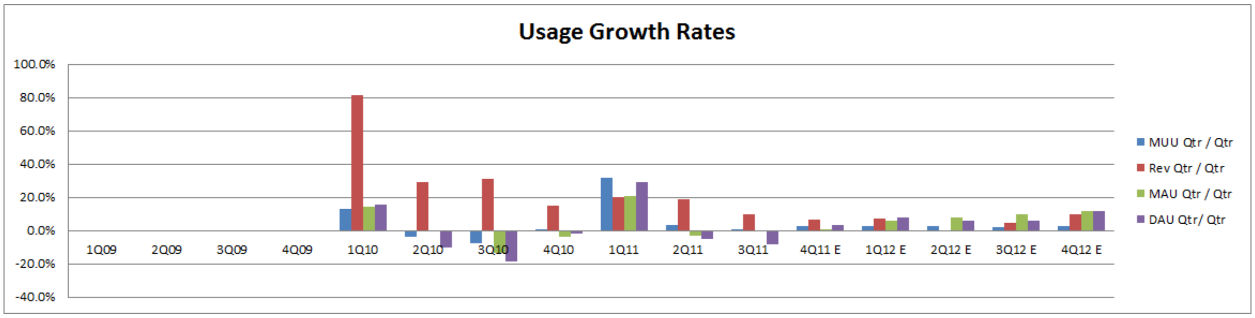
But hold onto your seats, because this one will be a bumpy ride! The stock has a beta of 2.7 and can swing wildly based on volatile commodity prices. But if the low expectations for the global economy improve, the ridiculously low valuation multiples could rapidly expand. And another potential catalyst: the Russian presidential election in March.

7. Zynga (ZNGA)

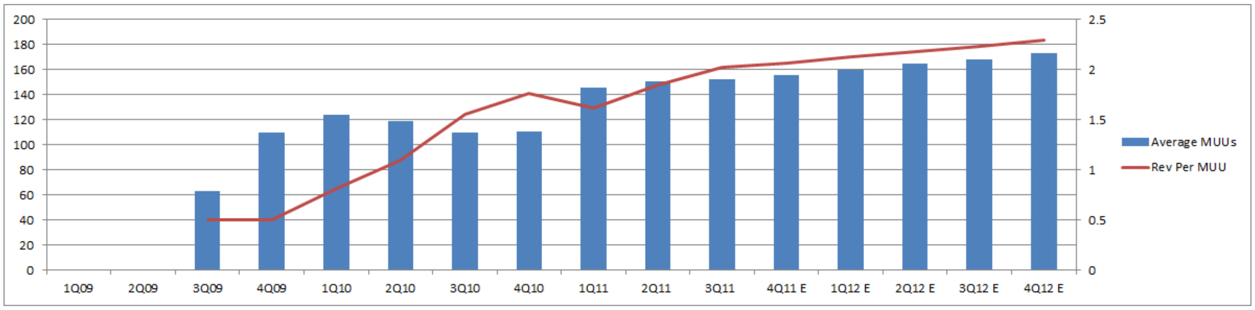
by Brian Bolan

Even before its IPO at $10 a share, Wall Street analysts were issuing reports on Zynga with sell ratings and warnings of hyper inflated valuations. At least one of those analysts sees earnings growth of 60% from 2012 to 2013 and this comes before the company has even had its first earnings conference call. To repeat, that is an IPO with expectations of 60% earnings growth, a phenomenon unlikely to be repeated anytime soon.

Zynga is the provider of online games that are delivered via social network platforms such as Facebook, Google+ and MySpace. The company also offers many of the games to consumers on their smart phones via apps on both Android and iPhone. Tablets aren't left out, as players can reach their Farm or their Castle or their City via Facebook or directly through apps on tablets as well.



With a “freemium” model, Zynga games are played by more than 50 million people every day. On a unique basis, Zynga attracts 152 million unique users each month and has a total non-unique reach of 227 million users. Of the 152 million unique users, 3.4 million are unique payers, meaning that only 2.2% of its users end up as paying customers. A slight increase in customers could have a meaningful effect on the income statement.



Zynga has chosen not to “promote” itself, much the same way many tech IPOs have done following the first few initial trades. Groupon spoke to investors before the end of the quiet period at an investor conference and noted that people were focusing on the “airplane crashes more than the safe landings”. The company was not slated to appear at an early January conference where it could paint its own picture of the market and Zynga CEO Mark Pincus didn’t even give interviews following the IPO. These are very curious moves by management, but again, Zynga is not the average tech company either.

Distractions before the pricing included stories of the company renegotiating options from existing employees, the stock structure that could see CEO Mark Pincus with a significant control position should existing shareholders sell. Other problems with the valuation were made as analysts designated price targets well below the offering price of $10 per share.

One of the major hurdles the company faced was that it did not sell real items, but rather virtual items to game players. These virtual goods are about as virtual as any of the digital books you would buy on a Kindle or iPad, but because they are used by game players, they are looked at as inferior revenue. To me, a dollar from a gamer is worth as much or maybe even more than a reader, as a game player that invests in the game is likely to continue to do so. Readers are not likely to purchase the same book again in the future.

Having a limited operating history and still looking forward to its first earnings release, investors may well take a wait and see stance on Zynga. I am a little more confident that consumers have seen the growth in the popularity of “Words with Friends” which will help with advertising revenue. My real concern is that online gambling is legalized in 2012 and the major casinos step in to compete with Zynga Poker. Poker is a major part of revenue for Zynga and should the casinos provide a free game that offers tangible rewards, Zynga would likely lose a significant portion of its paying customers.

Because of the limited downside for Zynga, lack of self-promotion, and real potential to see the paying user base expand, I believe Zynga will be the best performer for 2012.

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