STANSBERRY'S
CREDIT OPPORTUNITIES

September 2016

Make 11% a Year Investing in the Future of Warfare

His body was damaged... but recognizable.

At least that's how one eyewitness described it.

His exact birth date remains a mystery, but we do know when he died.

The leader of the Pakistani Taliban, Hakimullah Mehsud, barely spent more than a few hours in any given spot. He would split his time traveling between and sleeping in several different safe houses.

Pakistani officials claim that a year before he died, the CIA had launched at least four missiles at a compound he had built for himself in North Waziristan near the Afghan border...

Hakimullah Mehsud began his life as Zulfiqar Mehsud. He was born some time in 1979 (nobody knows exactly when) in a small village at the Afghanistan-Pakistan border called Kotkai. He dropped out of school – deciding to swap his education for an AK-47 assault rifle – and changed his name to Hakimullah as his *nom de guerre*. Charming and ruthless at the same time, he quickly built a reputation for bravery and recklessness.

Hakimullah climbed rapidly through the Taliban ranks. In 2007, at just 28 years old, he was responsible for kidnapping more than 200 Pakistani soldiers. He eventually let the hostages free in exchange for dozens of Taliban prisoners – but only after beheading the soldiers who followed the Shia branch of Islam. He had links to a Sunni extremist group responsible for the massacre of Shias in a nearby district.

He became the head of the Pakistani Taliban when a CIA drone strike killed the group's former leader, Baitullah Mehsud, in 2009. Hakimullah was barely 30 when he took over.

Once in charge, Hakimullah targeted civilians and soldiers in the northern regions of Pakistan – Punjab and Islamabad. He killed hundreds of innocent people.

And of course, he targeted Westerners, too. In January 2010, he sat beside a Jordanian suicide bomber who had killed seven CIA employees in Afghanistan just a few days earlier. No one knows Hakimullah's exact role in the murders, but some report that he orchestrated the attack. The spy agency also believes he was behind the failed car bombing in Times Square in 2010.

Hakimullah appeared in videos posing in front of stolen American military vehicles. He ambushed several NATO convoys along the Khyber Pass, which connects Afghanistan and Pakistan. And he burned vehicles owned by NATO in Peshawar – the capital of Pakistan's Khyber Pakhtunkhwa province.

His exploits made Hakimullah one of the world's most wanted men. The U.S. government placed a $5 million bounty on his head.

Hakimullah had proved he was no easy target. He was elusive... He had escaped several attempts on his life. For example, after a massive drone blitz in early 2010, local reports pronounced him dead. But a few months later, he popped up in a video vowing to send suicide bombers to American soil. In a 2012 drone strike, he was also reported dead... yet, once again, he resurfaced.

But in late 2013... Hakimullah made a gigantic, fatal mistake.

American officials tracking Hakimullah were almost certain of his location. He had returned to his small home village in North Waziristan, Pakistan. He thought he was safe with the upcoming peace talks between the Taliban and the government of Pakistan, and chose to relax in the comfort of his newly built home.

On November 1, 2013, Hakimullah had visited a mosque near his home. When his vehicle entered the gates that opened to his home compound, a U.S. drone fired two missiles into his four-wheel-drive vehicle. An eyewitness said his body was mangled. Various military and intelligence sources across the country confirmed that this time he was dead. One Pakistani official said three others also died, including his bodyguard.

One of the world's most wanted men had finally been killed.

As a quick scan of the daily newspaper will tell you... drone strikes like these have become a key tool in the U.S. military's efforts to combat terrorists. A single drone can carry a dozen Hellfire missiles, travel 650 miles, quietly hover over an area to gather intelligence, and then... strike.

These drones are extremely maneuverable. They can work in mountainous terrain or in dense city blocks. They can sneak into places where soldiers and spies – let alone fighter jets and helicopters – can't easily go...

The U.S. defense budget is massive ($560 billion) and it easily makes up the largest portion of the country's budget each year. A huge portion of that is spent buying equipment and services from private defense contractors. The larger players are companies you've probably heard of: Lockheed Martin (LMT), Boeing (BA), Northrop Grumman (NOC), and Raytheon (RTN). Supplying the U.S. military is big business. The top 20 companies earned $200 billion in sales last year.

These large companies play a smaller role in the small-but-growing subsector of the defense budget that focuses on drones... a subsector that is currently worth $4 billion in the U.S. and $10 billion globally. Midsized companies such as General Atomics and Dynetics also compete.

This month, we'll introduce you to a smaller U.S. defense contractor with a number of special features that set it apart. It has a diversified, steady business and recently expanded into the burgeoning drone market. It has won significant contracts in recent weeks.

We have an opportunity to buy its only outstanding bond at a reasonable discount to par value and earn double-digit annual returns to maturity in 2019.

It's time to invest in...

America's Growing Drone Business

Kratos Defense & Security Solutions (Nasdaq: KTOS) started out as a telecommunications company.

Under its former name, Wireless Facilities, it built and provided support for telecom infrastructure and networks. But in 2004, after hiring current CEO Eric DeMarco from another defense contractor, the board of directors changed its focus to providing products and services to the U.S. Department of Defense.

Kratos now designs and manufactures aerospace and defense products. It also provides services such as security and support for its systems.

Today, more than 60% of Kratos' revenue comes from contracts with the U.S. government, including the Army, Navy, Air Force, Marine Corps, and various intelligence agencies. The rest of its customers include international governments and domestic and international commercial customers. Around 90% of its revenue is generated in the U.S.

Kratos is diversified and organized into the following business segments:

1. **Unmanned Systems** makes drones that execute surveillance, training, and live combat missions. These drones are small, maneuverable, and difficult to detect. This segment currently makes up roughly 10% of total sales.

2. **Government Solutions** includes satellite communications, microwave components, and missile systems. This segment has historically been Kratos' core business. Going forward, demand is expected to grow at a steady pace due to Russian and Chinese satellite- and missile-technology advances.

3. **Public Safety and Security** provides products and solutions to homeland- and infrastructure-security needs. These include video surveillance, building automation and access control, fire and life safety, and communications. Public Safety and Security currently makes up slightly more than 20% of total company sales.

Kratos built these segments mostly by acquiring smaller defense contractors and technology companies. Between 2004 and 2012, it bought 15 companies for around a total of $1.2 billion. In that time, sales nearly tripled, from $330 million in 2004 to $969 million in 2012.

But recently, the company has stumbled. When looking at a stock chart, you'll note the company's share price has struggled. The acquisitions were expensive and the increase in sales didn't flow through to the bottom line.

Starting in 2011, the company hit a major speed bump. The U.S. government made significant cuts to the nation's defense budget, which hit the industry across the board – including Kratos. Sales have since plummeted... all the way down to $657 million last year, a 32% drop from Kratos' 2012 highs. Shares changed hands for almost $15 back in 2011. Today, they go for less than half of that.

The good news is that Kratos is correcting its past errors. It sold one of the larger operations within its Government Solutions segment in August 2015 for $265 million. It used some of the cash to reduce its debt. At the same time, the company shifted its focus to the Unmanned Systems segment, which offers much more upside potential.

You see, one of the businesses that Kratos picked up among its acquisitions was a company called Composite Engineering. It specialized in research and development (R&D) and the production of drones. Since the $155 million acquisition in 2012, Kratos has spent another $50 million on R&D and other drones-related infrastructure.

Kratos and various defense-related sources have pointed out that the continued growth of the drones subsector is due to the transformation of the U.S. armed forces into a higher-tech combat system, the emergence of Russian and Chinese armed forces, and the continuation of existing conflict zones in the Middle East. Kratos is one of the leaders in technology for this growing market.

On a recent earnings call, DeMarco noted that Kratos' drones differentiate themselves from the competition in that they:

- are made of a special composite material,
- are highly maneuverable, able to sustain more than nine Gs of force,
- can carry significant payloads (missiles) long distances, and
- can take off or land without a runway. The aircraft are launched from a rail and can be recovered via a special-purpose parachute, even in the case of water landings.

The company's ultimate objective is to secure drone-related combat contracts, which will likely lock in years of revenue. This will mean producing more units as demand grows, servicing drones, and funding R&D projects to ensure variations that support the growing needs of the customer.

The numbers here can quickly ramp up for companies like Kratos. For example, consider General Atomics' MQ-9 Reaper (commonly known as the "Predator B" drone) program. Since its inception in 2007, the U.S. Air Force has spent almost $7 billion in production and R&D on the Reaper alone.

Kratos currently has a drone-training-program contract with the Navy. And in August, the company announced that it won a $40 million contract with the Air Force's Low-Cost Attritable Strike Unmanned Aerial System (UAS) Demonstration (LCASD). Kratos beat out six other competitors, proving it can compete in the sector. This is a competitive, single-award contract to research and develop prototypes. And it has potential production volume worth more than $100 million.

Plus, just last week, Kratos won a $54 million contract to provide five helicopter simulators for the U.S. Marine Corps. The simulators will serve as training platforms for the enlisted crew of the Marine Corps' CH-53E (Super Stallion), MV-22B (Osprey), and UH-1Y (Venom) helicopters. Kratos will provide engineering, manufacturing, development, and initial support.

Management also announced recently that more business is on the way. Kratos has not yet revealed the customer's name (due to the sensitivity of these contracts), but has said that it will announce another newly signed deal later this year.

Kratos also just made the cut for Phase 1 of the Defense Advanced Research Projects Agency (DARPA) Gremlins program – a project to develop recyclable drone-combat systems. Kratos was awarded Phase 1 in May along with three competitors (Lockheed Martin, Dynetics, and General Atomics). DARPA plans to select two companies for Phase 2 in late 2017 and then award Phase 3 to the winner in late 2018.

General Atomics is the strongest competitor because it has experience with the MQ-9 Reaper and other drone programs. Lockheed has resources, but the company may not have the focus to go after a relatively smaller program. Regardless, Kratos has some tough competition on this project. But even if it does not win Phase 2 or 3 approval on this specific program, the Phase 1 selection increases its credentials for future projects.

And for those future projects, as mentioned earlier, there is currently $4 billion per year up for grabs in the U.S. and $10 billion globally.

If Kratos wins the contract for the Gremlins – the other UAS program – and the production phase of LCASD, it could mean more than $200 million of incremental revenues over the next two to four years. Of course, there is no guarantee on any of these. But these projects give us an indication of the upside available for the company. Winning these programs would lead to additional program follow-ons and would increase Kratos' reputation for future customer demands.

Even with strong competition, Kratos has the ability to capture a sizeable portion of the drones market due to its existing program and relationships with the U.S. military, especially the Navy.

Kratos' relationship with the Navy extends beyond a customer-supplier partnership. Its management team has a long and important history in the sector. Gerald Beaman, president of Kratos' Unmanned Systems segment, is a former U.S. Navy vice admiral and commander of the Third Fleet with responsibilities of more than 58,000 personnel. Beaman's assistant Mike Malone is another former U.S. Navy vice admiral. Together, they have helped Kratos secure the various Navy unmanned training programs.

Virtually all of Kratos' work is performed on military bases... And a significant number of its 2,900 employees hold national security clearances.

On the international front, Kratos has secured participation in several missile programs with Israel. Those should go into production in the next 24 months.

The drones business gives Kratos an exciting opportunity to begin growing at a fast pace again. It has the chance to transform the company into a leading drone manufacturer. But in order to put itself in this position, Kratos had to make significant investments in the drone business in recent years. These investments are only just beginning to pay off.

As a result of these investments, its cash flows have been suffering. That has led to its bond selling significantly below par.

But that gives us our opportunity this month...

We think brighter days are just around the corner for the company. And the good news – as we'll explain – is that Kratos doesn't even need its drones business to soar for bondholders to get paid. So today we're recommending the only outstanding bond of **Kratos Defense & Security Solutions (Nasdaq: KTOS)... its 7% coupon bond due in May 2019 (CUSIP No. 50077BAL2), which yields 11% to maturity**.

Stansberry's Credit Opportunities Deal Box

Action: Buy the Kratos Defense & Security 7% bonds due 5/15/2019 for $920 or less per bond (CUSIP No. 50077BAL2).

SUMMARY		
September 21, 2016	Amount Invested	$934.94
May 15, 2019	Total Principal and Interest	$1,210.00
	Profit	$275.06
	Current Yield	7.7%
	Annual Return	11.0%
	Total Return	29.4%
	Term	2.6 Years
	Issue Size	$625 Million
	Credit Rating (S&P)	B-
	Callable	Y

DETAILS		
September 21, 2016	Purchase Bond	$910.20
	Accrued Interest*	24.74
	Total Cost	$934.94
November 15, 2016	Receive Interest Payment	$35.00
May 15, 2017	Receive Interest Payment	$35.00
November 15, 2017	Receive Interest Payment	$35.00
May 15, 2018	Receive Interest Payment	$35.00
November 15, 2018	Receive Interest Payment	$35.00
May 15, 2019	Receive Princ. + Int. Payment	$1,035.00

*You will owe interest to the seller of the bond in the amount of $24.74 (from the date of the last interest payment – May 15, 2016 – through the purchase date – September 21, 2016). The interest is added to the price of the bond. The first interest payment you receive will be November 15, 2016 for $35.00.

**** DO NOT PAY MORE THAN $920 FOR THIS BOND ****

Please be careful and take your time accumulating positions. Remember, you only make one decision to buy, so please try to buy at the lowest price possible.

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By the Numbers

As we've explained, the U.S. government's defense-budget cuts had a big impact on Kratos' business. The company's period of fast-paced revenue growth ended abruptly in 2013. After peaking in 2012 at $969 million, revenue fell 2% in 2013. In the two years before that, revenue had grown 36% and 75%, respectively. Since 2012, sales have fallen every year... all the way down to $657 million last year. That's almost a third lower in just three years.

But government budget cuts are only part of the explanation of the declining top line.

Kratos' largest segment, Government Solutions, accounted for two-thirds of its revenues last year. The part of the business that Kratos sold in 2015, called the Electronic Products division, contributed around $100 million a year to that segment. The table below – which shows each segment's revenues since 2012 – shows the Electronic Products division as a separate segment in order to reflect the true changes in revenue in Government Solutions.

KRATOS' REVENUE BY SEGMENT

Revenue by Segment (millions $)	2012	2013	2014	2015
Unmanned Systems (Drones)	$92	$122	$82	$66
Government Solutions	$494	$513	$485	$446
Public Safety and Security	$186	$210	$196	$145
Electronic Products	$197	$107	$105	-
Total Revenue	**$969**	**$951**	**$868**	**$657**

% Total Revenue	2012	2013	2014	2015
Unmanned Systems (Drones)	10%	13%	9%	10%
Government Solutions	51%	54%	56%	68%
Public Safety and Security	19%	22%	23%	22%
Electronic Products	20%	11%	12%	0%
Total	**100%**	**100%**	**100%**	**100%**

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Source: Company SEC filings

As you can see, Government Solutions revenues have been declining since 2013... dropping 5% in 2014 and another 8% last year. Department of Defense budget cuts have hurt this segment more than any other.

The sale of the Electronic Products business last year explains most of the large drop in revenue for Kratos from 2014 to 2015. (Revenues from the beginning of the year through the sale date of the Electronic Products division were pulled out and disclosed separately as "discontinued operations" in Kratos' 2015 financial statements).

The next-largest segment, Public Safety and Security, is also in decline. Revenues fell 6% in 2014 and crashed 26% last year. But in this case, the drop is a good thing.

Even though it generates a significant chunk of Kratos' revenue, this segment struggles to break even each year. Many of the large government-security contracts are fixed-cost contracts that have very low margins. Any cost overruns can put the projects in the red.

So the company has been scaling back its security projects and only focusing on higher-margin work. We think that's a good move, even though the drop in revenue scares most investors.

Revenue in the smallest segment, Unmanned Systems, has been choppy. That's because the business is still in its prototype phase. As we explained earlier, the drones segment has the most upside.

As bondholders, we're happy to see the low-margin Public Safety and Security segment in decline. It contributes very little to operating profits each year. The higher-margin Government Solutions segment, on the other hand, has historically been responsible for much of the company's profits and cash flows.

Fortunately, the Government Solutions business appears to have brighter days ahead.

On an earnings call earlier this year, management noted that three out of four of the remaining "subsegments" within this business – including Satellite Communications and Missile Systems – will show revenue growth or stability in 2016 and 2017.

Management believes the U.S. defense budget is now expanding. The Bipartisan Budget Act of 2015 increased spending caps by $50 billion in 2016 and $30 billion in 2017. The discretionary defense budget in 2016 is more than 10% higher than it was last year.

That means Kratos' downward-revenue trend may finally be coming to an end. Kratos' numbers through the first six months of this year support this. Revenues so far in 2016 are up 1% over the same period last year.

Now, let's take a look at the rest of the business...

The company's overall gross margins are around 25%. (Gross margins are the profit margin after subtracting the direct cost of its products and services from sales.) We admit, 25% gross margins aren't great. We like to see gross margins well above 50%. Lean gross margins leave little to invest in other areas of the business, like sales and marketing and R&D.

The table below shows some key financial metrics for Kratos since 2011, including gross margins, operating profits, and cash flows.

KRATOS BY THE NUMBERS

Key Metrics	2011	2012	2013	2014	2015	2016E*
Revenue	$714	$969	$951	$868	$657	$659
Gross Profit	$191	$257	$240	$179	$162	$417
Gross Margin	27%	27%	25%	24%	25%	25%
R&D % Revenue	1%	2%	2%	2%	2%	-
SG&A % Revenue	20%	20%	20%	18%	23%	-
Operating Profit/Loss	$30	($50)	$18	$5	($5)	$5
Oper. Cash Flow (Cash Profits)	$5	$52	$23	$3	($30)	$5
Free Cash Flow	($2)	$36	$6	($9)	($41)	$0

All amounts in millions of U.S. dollars.
** Stansberry Research base case estimates.*

www.stansberryresearch.com Source: Company filings, Bloomberg

The small gross margins explain why Kratos struggles to generate operating profits. Last year, it posted an operating loss of $5 million.

You can see that Kratos historically doesn't generate a ton of cash from its operations – usually it's somewhere around 3% of its revenues. We like to call the cash it generates from operations its "cash profits." Last year was especially bad. Kratos posted a cash loss of $30 million. Its free cash flow – cash profits less capital expenditures – has been negative the past two years.

The problem can be seen if you study the table above closely. *Kratos spends far too much on selling, general, and administrative (SG&A) expenses*. These expenses totaled $151 million last year and ate up 23% of revenue. That's too much to spend when your gross margins are so small. If you have 25% gross margins, that means $0.75 of every dollar of revenue is spent on direct costs of the products and services delivered. That leaves only $0.25 to pay for everything else.

Kratos is spending $0.23 of that remaining $0.25 on SG&A costs. When you add the other $0.02 it has been spending in recent years on R&D (which totaled $16 million last year), you can see that almost nothing is left over for debtholders and equity holders. Even worse, the table shows that the amounts spent on SG&A and R&D have been *increasing* in recent years. That's a trend that has to reverse.

Next, let's turn to Kratos' balance sheet.

Kratos' capital structure is very simple. It has a $110 million credit facility that is untapped today. But because of its covenants, only about $50 million can be drawn if needed. The facility matures in 2019, the same year as the bond we are recommending.

The company's only outstanding long-term debt is our bond. The $625 million bond was issued in 2014 and matures in May 2019. That's 32 months from now. As we explained, the company used the proceeds from the sale of its Electronic Products division last year to pay down $175 million of the principal on the bond. That saves $12 million in annual interest payments moving forward. So the outstanding balance on our bond today is $450 million.

Kratos has assets that total $875 million – mostly goodwill and intangible assets resulting from its spree of acquisitions since 2010. So its debt-to-asset ratio is a little more than 50%. That's down from 60% last year.

Can It Pay Us?

Our first order of business before recommending any bond is to make sure our interest payments are safe.

The Kratos bond pays a fat 7% coupon. Interest on the $450 million balance costs Kratos $32 million a year. We want to be sure it can afford this interest. If a company's cash profits easily cover its interest cash costs, we know it's safe. We like to see cash profits before interest payments at least three times larger than the annual interest costs.

Last year, Kratos' cash profits were negative $30 million, factoring out $44 million in interest payments. So its cash profits before interest totaled $14 million. Clearly, Kratos didn't cover its interest costs last year.

On the surface, that's concerning. But let's look a little deeper...

Last year was the first time in seven years that Kratos had negative cash profits. We know that the defense cuts started hurting its business in 2013. In 2013 and 2014, Kratos managed to post cash profits that averaged $13 million. Adding back the average interest paid in those years of $60 million, it covered its interest 1.2 times.

That's not great coverage, we admit. But remember, interest costs are lower ($32 million) going forward, now that the company has repaid $175 million of the bond. If cash flows simply return to the 2013-2014 levels, interest coverage will be 2.3 times on its $32 million in interest due. That's a much safer ratio.

We believe the company can easily do that. But we expect it to do much better.

We know that Kratos invested heavily in the drones segment in recent years. Revenues from that section of the company have been spotty, as you'd expect in a startup business. The same can be said about operating profits. The drones segment lost $43 million over the last three years alone. But remember, the company spent $16 million on R&D last year and $75 million on R&D over the last four years. Most of this was spent on drones.

The good news is that Kratos shouldn't have to continue to make these large investments going forward. Instead, it should begin to reap the rewards of its past investments as it wins new government contracts. The contracts don't need to be huge to immediately improve the bottom line.

Even if the drones segment doesn't take off in the next year or two as we expect it will, we still think it will improve Kratos' cash flows. It just needs to stop losing money as it has done in the past. We think that's a very low bar to clear. By simply slowing its investment in R&D, Kratos can increase its cash flows by $14 million-$16 million a year.

And management isn't relying solely on the drones segment to improve its cash flows. It is now actively focused on cutting costs across the business. We already explained that it is abandoning low-margin Public Safety and Security contracts to improve the bottom line. It is also focused on the obvious sore spot in the company – SG&A expenses.

Management recently reduced its headcount by 120, which saves $8 million annually. This includes reorganizing the Public Safety and Security segment.

All told, we think these cost-cutting measures can produce operating cash flows of at least $40 million a year by 2017. Keep in mind, that's still well below the $52 million Kratos generated back in 2012. But $40 million of operating cash flows covers interest 2.3 times.

Even if our cash-flow projections fall short, remember that Kratos still has an untapped credit facility available.

Our interest is safe.

Liquidation Analysis

Of all the bonds we've recommended so far, we realize that this one has the smallest amount of interest coverage. But that doesn't mean the bond will default. We would never recommend a bond we believe will default.

Still, we always analyze the safety of our principal. That's why we prepare a liquidation analysis.

Kratos had $18 million of cash at the end of June, its last reported quarter. In a worst-case scenario, management won't be able to find any additional cost savings. So cash flows wouldn't improve from 2015 levels. If that happens, we project the company will run out of cash and default on its bond sometime in 2017.

The table below shows the estimated liquidation value of Kratos' projected assets in 2017, assuming a forced-liquidation bankruptcy scenario.

	Assets as of 6/30/2016*	Est. Assets on 12/31/2017*	Est. Recovery %	Est. Recovery Amount*
Cash	$18	$4	100%	$4
Accounts Receivable	$211	$200	100%	$200
Inventories	$50	$50	70%	$35
Property and Equipment	$51	$24	50%	$12
Goodwill and Intangibles	$513	$513	0%	$0
Other Assets	$31	$30	0%	$0
Total Assets	**$874**	**$821**	**31%**	**$251**

Est. Bankruptcy Proceeds From Liquidation (From Above)	$251
Less: Senior Secured Debt (Credit Facility)	($50)
Proceeds Available for Bondholders	**$201**
Principal of Bond	**$450**
Estimated Recovery Amount of Bond	**45%**

** All amounts in millions of U.S. dollars.*

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We estimate its assets will raise only around $250 million in a forced sale.

This bond is unusual compared with other bonds we've recommended previously in that it's secured on a first-lien basis by Kratos' assets. But the collateral that secures our bond is split with the credit facility. That means the claim on the company's assets is split between the bank lenders and the bondholders. The credit facility is secured by accounts receivable, inventories, and cash and securities. Our bond is secured by certain property and equipment, and intellectual property.

But as you can see, in a forced liquidation, most of the value of Kratos' assets is likely to be in receivables and inventories that will go first to the bank lenders. We estimate the credit facility will be drawn down by $50 million in 2017, so that will be paid first. The remaining proceeds pay bondholders (with limitations in regard to vendors and employees). We estimate that we'd collect 45% of our principal in this worst-case scenario.

As we like to remind you each month, a forced liquidation is very unlikely in the event of default. The much more likely default scenario is a Chapter 11 reorganization. In that scenario, a bankruptcy court decides how much creditors get paid. The bankruptcy judge determines how much debt the company can support based on its post-bankruptcy cash-flow projections.

That's why credit-ratings agencies like Standard & Poor's (S&P) evaluate the recoverability of a bond assuming a reorganization rather than a liquidation. We performed our own reorganization-recovery analysis, and it shows a recovery of 50%, slightly more than our liquidation analysis. S&P estimates a recovery would be in the range of 30% to 50%.

So for our analysis, we'll assume a recovery of 45%. In other words, we'd collect $450 on each $1,000-face-value bond we hold.

Adding two semiannual interest payments of $35 that we would collect between now and the date of default, we'd collect $520 on our initial $910 investment. That's a loss of 43% as our downside.

As we explained earlier, we think the interest payments are safe, so the company won't default.

But paying back the principal in 2019 is another matter.

Unless the drones business really takes off in the next few years, Kratos won't generate the $450 million in cash it needs to pay off our bond in 2019. The company then has two options: (1) It can refinance its debt before the bond and credit facility mature in 2019, or (2) It can sell more of its assets. Selling part of its business well before it is in danger of defaulting would raise far more cash than selling in a forced liquidation.

We believe refinancing the debt is much more likely. We don't think Kratos will need to sell any of its segments to pay us the principal of our bond. (Although we'd welcome the sale of its low-margin Public Safety and Security segment.) If cash flows improve to $40 million a year by 2017 as we expect, the company should have no problems refinancing its debt. Lenders want comfort that the company can generate sufficient positive cash flows to support the debt.

As an added measure of security, Kratos currently has an order backlog of $875 million. That's 1.3 years of revenue in booked business that is just waiting to be delivered and recognized as revenue in the future. That will help it weather any hiccups or missteps.

In reality, we think its cash flows could be much higher than $40 million a year.

If Kratos wins the contracts for the Gremlins and other UAS programs, there could be $200 million or more of incremental revenues in the next two years. These programs would in turn lead to additional follow-on programs and increase Kratos' reputation in this hot field. That would lead to even bigger projects.

Kratos' poor performance in 2015 scared off many bond investors. The bond traded for as little as $65 last November. Since then, it has come back to around $91 today. At that price, it still gives us a healthy 11% yield to maturity (YTM).

The company has already made the necessary investments in drones R&D and infrastructure. It's already winning contracts. Any new drones-program wins won't require much more in additional expenses... so dollars should fall to the bottom line. If the drones business takes off like we think it will, these bonds could easily return to par well before 2019. If that happens, we'd consider selling to increase our YTM.

And if Kratos gets bought by a larger competitor interested in its drones technology, our returns would be even higher. The bond indenture has a "change of control" provision that requires the acquiring company to redeem our bonds at $101 per bond.

Action to take: **Buy the Kratos Defense & Security Solutions 7% bond due May 15, 2019 (CUSIP No. 50077BAL2) up to $920 per bond**. There are no alternative bonds to purchase. This is the only one.

Please do not pay more than $920 for the bond. We can't stress this enough. In the days following our publications, we've noted that our recommended bonds tend to change hands at prices above our "buy up to" prices. Our buy-up-to prices are carefully thought out to give you an adequate return based on the risks of each investment. Do not chase prices higher.

As we always do, we called around to various brokerages to gauge availability, and you shouldn't have any trouble buying this bond. If your broker doesn't have it, don't give up. Call around to a few others. While we don't recommend any individual brokers, you can find a list of possible other brokers on our website, here.

Also, as we went to press today, we learned something very important that could have an impact on Kratos' liquidity. Kratos is in a "quiet period" right now. This means the company can't talk to investors. Normally, companies are in quiet periods in the weeks leading up to their quarterly earnings reports. But Kratos' next earnings report isn't scheduled until November 3. That means there is likely some other big event in the works.

Of course, we are just speculating... But given the company's current leverage, it's unlikely it will issue more debt. Issuing stock is the more likely scenario. That would be bad for stockholders, but it would be great for bondholders. The cash could be used to retire debt, which would make our bond safer and would substantially improve Kratos' liquidity.

Portfolio Update

Last month, we provided an extensive review of all of the positions in our portfolio. We encourage you to read it here if you missed it. We're currently in a quiet earnings period, so not much has changed since then. Because of that, we'll keep it short this month.

The $300 million bond we recommended from coal-royalty owner **Natural Resource Partners (NYSE: NRP)** is structurally subordinate to 10 privately placed bonds. That means those bondholders get paid before us. Those bonds total a little more than $600 million.

Recently, the company filed an amendment to these more-senior bonds, providing a formula for how cash from any future asset sales would be used to repay the bonds. This amendment doesn't change anything with our bond... We're still subordinate to this debt. But what's important for our purposes is that it *continues to demonstrate NRP is serious about paying down its debt*.

The market is getting the message. NRP's stock is up another 29% this month. The extra "juice" the stock gives us in our "synthetic convertible" position is working exactly as planned (remember, 25% of our initial investment was invested in NRP's stock). We're now up 52% on the combined stock and bond position.

Unlike NRP, our recommendation of the $246 million bond from biotech patent holder and financer **PDL BioPharma (Nasdaq: PDLI)** is the company's only outstanding long-term debt. Last month, PDL collected $58 million in interest and principal from one of the biotech companies it helped finance – Paradigm Spine. The payment fully satisfied all of the principal and interest on the note, which was due in 2019 before Paradigm decided to repay it early.

The early repayment of a loan is great news for bondholders. PDL hasn't said what it will do with the cash yet. But it's likely to use it to invest in new late-stage biotech companies. As we explained in January, PDL's management continues to look for promising new drugs and patents... structured either as notes receivable or royalty-rights investments.

Even if management decides not to retire any debt with the cash, we're not concerned. PDL should have no problem refinancing before our 2018 bond matures. PDL has $116 million in cash, so it only needs to come up with another $130 million over the next 17 months to pay off the principal of our bond. Most of the notes receivable and royalty assets – which total more than $600 million today – aren't due until well after that date.

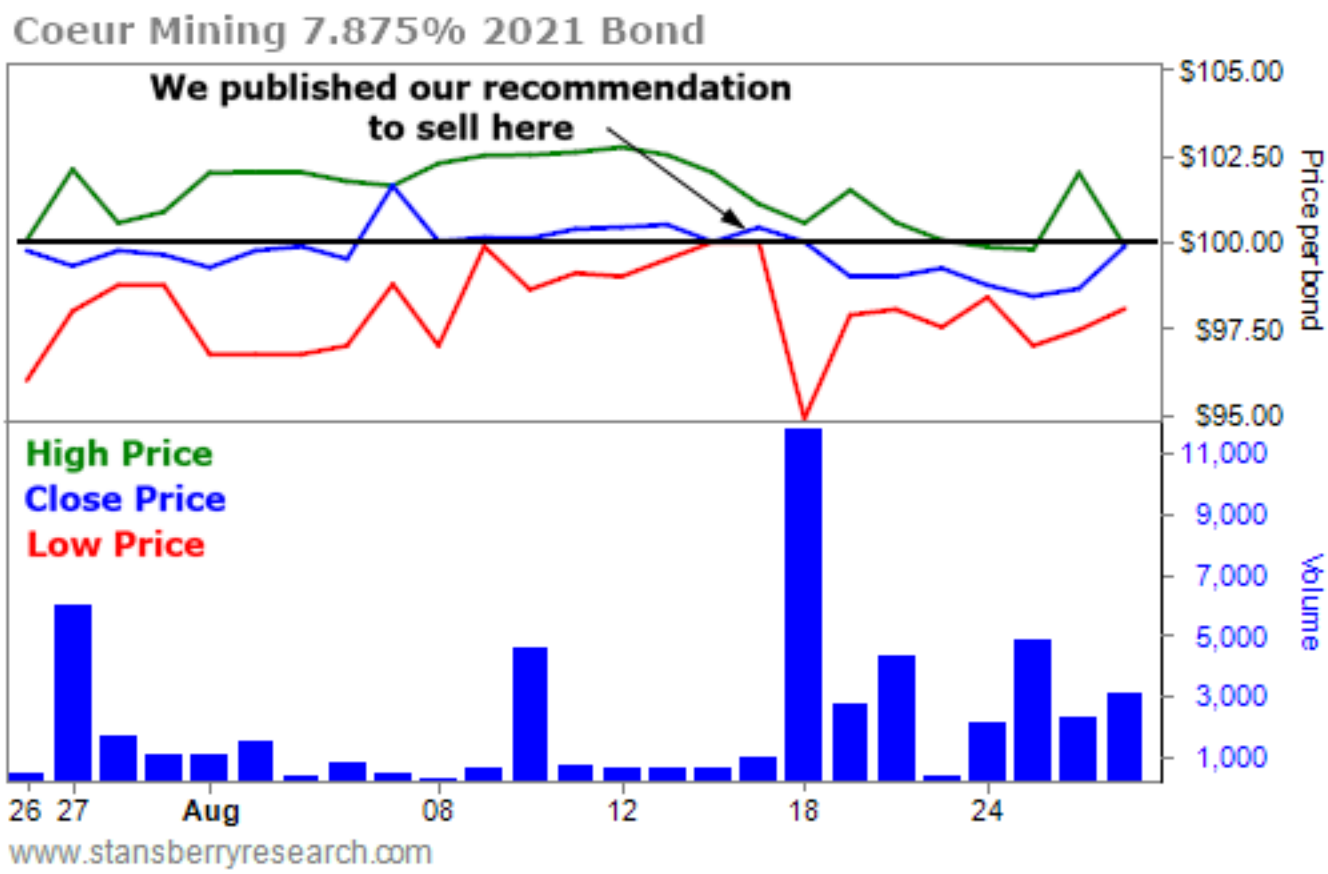
PDL just needs to prove to lenders that these assets aren't worthless. Early repayments demonstrate the quality of these assets. That will only make refinancing its debt easier, if that is even necessary. The price of our bond is up 3% in the past month... And we're up 26% so far on the recommendation.

We'll close out this month's portfolio update with another reminder... **Successful bond investing requires patience**.

This can't be overemphasized. Last month, we recommended closing out our "synthetic convertible" position in Coeur Mining (CDE). That meant selling the stock and the 7.875% February 2021 bond. We explained that it didn't make sense to wait until 2021 to collect the full principal on our bond when we could sell the bond for *more than par*. We're not sure all readers took our advice.

The bond had been trading as high as $102.74 in the days leading up to last month's publication. But the day after we published, the bond traded as low as $94.90. As you can see in the chart below, the volume on that day – August 18 – was more than 12 times higher than it was the previous day.

Below, you'll notice the close prices (blue line), high prices (green line), and low prices (red line) of the Coeur bond at the top of the chart. The daily volume is shown on the bottom.



You can see that investors sold all the way down to $95 in huge numbers the day after our sell recommendation. We hope that didn't include any *Stansberry's Credit Opportunities* subscribers.

In this case, you just needed to be patient.

You can see from the chart that the Coeur bond traded above par most days immediately following our recommendation to sell. It traded for as high as $102 just nine days later. Selling the bond for $95 would have cut your annualized return almost in half... from 50% to 28%.

Earning large returns on bonds requires that you buy at the right price and sell at the right price. Remember, the amount of principal and interest you get paid are fixed. You can only control how much you earn by the price you pay for each bond you buy. And when you sell a bond before maturity, ***it's critically important that you sell at the right price***. Our buy-up-to prices and sell prices are carefully thought out. We want you to earn the highest possible returns on the bonds we recommend.

So please... never pay more for a bond than our buy-up-to prices. And only sell your bonds at or above the prices we recommend.

Credit Opportunities Dashboard

With *Stansberry's Credit Opportunities*, you'll get much more than just a monthly recommendation. You'll get insight into what we're seeing in every part of the bond market. We sift through thousands of bonds, and rate each according to several key metrics, like consistency of cash flows and overall balance-sheet strength. Our proprietary ratings system automatically assigns a credit safety score from one to 10 for each of these bonds to reflect its potential for default. Our scores fall into four categories:

Ratings from 9-10: Safe

Ratings from 7-8: Moderate Risk

Ratings from 4-6: Distressed

Ratings from 1-3: Toxic

Every month, we'll show you broad pricing trends within the Safe, Moderate Risk, and Distressed categories, and call out several of the more interesting bonds we're monitoring in each sector. (We're staying away from anything Toxic.)

This is the same information we review internally as we make our recommendations. However, it's important to understand that the bonds we call out in the tables below <u>are not recommendations</u>. The data below represent the start of our research... not the final judgment. For various reasons, we might never be interested in the bonds of some of the companies that appear below. The goal of this screen is to provide you, our readers, with a snapshot of the kinds of opportunities available in the various corners of the bond market.

In *Stansberry's Credit Opportunities*, we're hoping to provide more than just monthly recommendations. We want to provide data, information, and insights on what we're seeing. If you're an experienced bond trader and comfortable investing on your own, you may find our research is a "jumping-off point" for your own due diligence.

The 10-year U.S. Treasury rate has risen from a record low of 1.37% in July to about 1.7% today. As yields rise, bond prices decline. It's important to keep an eye on these so-called "risk free" interest rates because many assets are moving up and down, in tandem, with Treasurys. Goldman Sachs recently noted that cross-asset correlations to 10-year yields have never been higher.

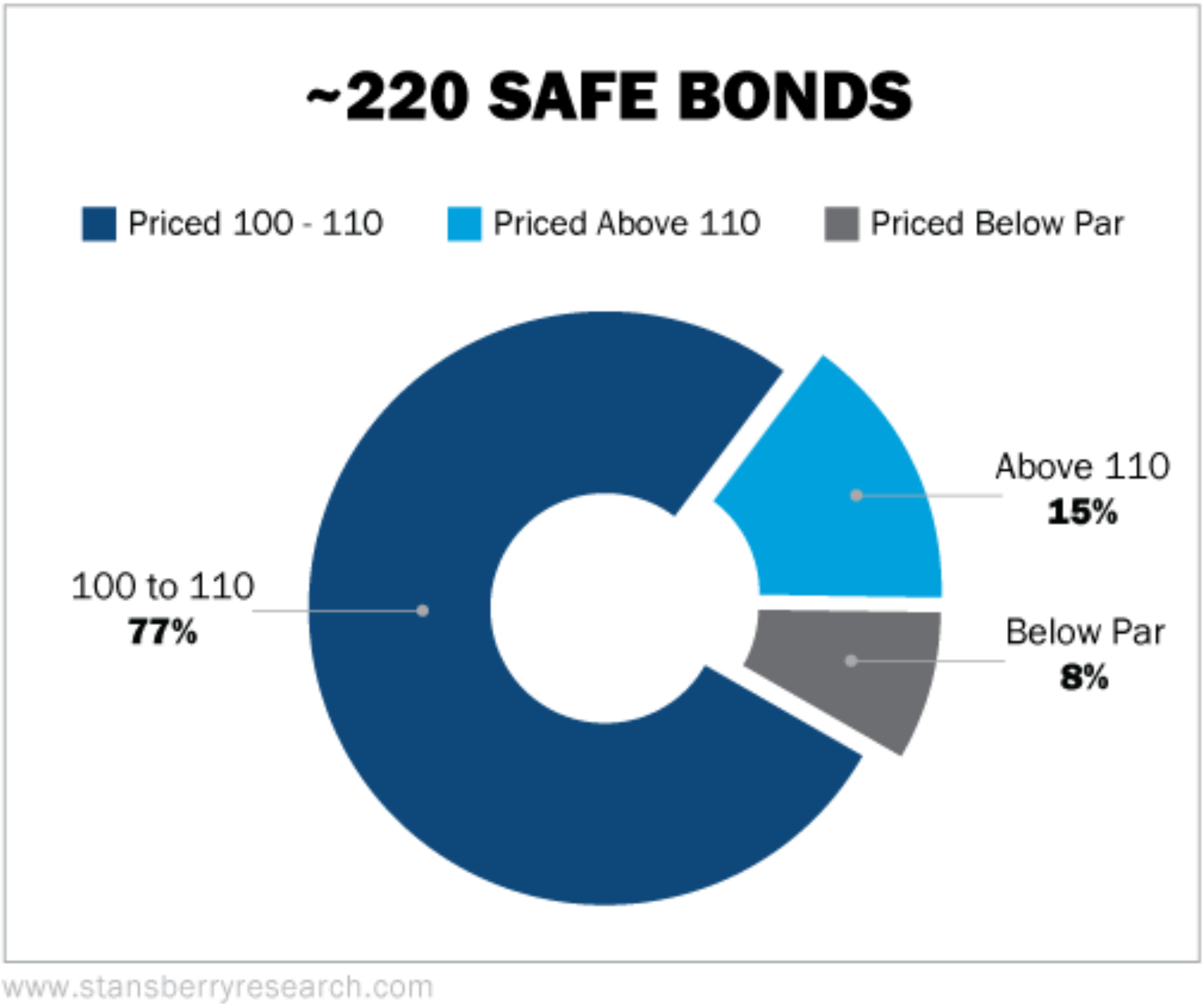
We like to keep our eye on the U.S. high-yield credit "spread" to gauge where we are in the credit cycle. The spread is the difference, in basis points, between the average yield of noninvestment-grade bonds – also known as "junk" bonds – and U.S. Treasurys. Remember, each basis point equals 0.01%. So when the spread is at 600, that means corporate bonds, on average, are yielding 6 more percentage points than Treasury securities.

As we said in August, a level at or above 700 basis points is a "buyer's market" for high-yield bond investors. The spread narrowed to 499 basis points a few weeks ago, its lowest level since July 2015. Since then, the spread has widened to 527 basis points. But the number is still much less than 700. That means there are very few bargains to be found. As bond investors, we need to remain patient.

Still, despite the froth in the high-yield market, there are still opportunities to find mispriced bonds – like the Kratos bond we recommend today. It's just harder to find them. It's like finding a needle in a haystack in the current market.

Safe

The average YTM of the 220 bonds we rate as "Safe" today is 1.5%. Approximately 8% are trading below par, down from 9% last month.



SAFE BOND WATCH LIST

Issuer Name	CUSIP No.	Coupon %	Maturity Date	Last Price	Yield to Maturity %	S&P Rating	Stansberry Rating
Amazon	023135AH9	1.200%	11/29/2017	$100.13	1.1%	AA-	9
Apple	037833CC2	1.550%	8/4/2021	$99.49	1.7%	AA+	9
Electronic Arts	285512AC3	3.700%	3/1/2021	$105.77	2.3%	BBB-	10
Express Scripts	30219GAH1	2.250%	6/15/2019	$101.39	1.7%	BBB+	9
Gilead Sciences	375558AU7	4.400%	12/1/2021	$111.83	2.0%	A	9
Nestle	LW7656710	1.375%	7/13/2021	$99.43	1.5%	AA	9
O'Reilly Automotive	67103HAA5	4.875%	1/14/2021	$110.95	2.2%	BBB+	9
Procter & Gamble	742718ED7	0.750%	11/4/2016	$100.03	0.5%	AA-	9
Texas Instruments	882508BA1	1.850%	5/15/2022	$100.33	1.8%	A+	10

Prices as of September 19, 2016

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Source: Bloomberg

Our Watch List presents our favorite Safe bonds today. Prices of these bonds are actually down slightly this month. It's hard to find any Safe bonds yielding more than 2% today. The bonds on our Safe Watch List are yielding 1.6%, on average, and most trade above par.

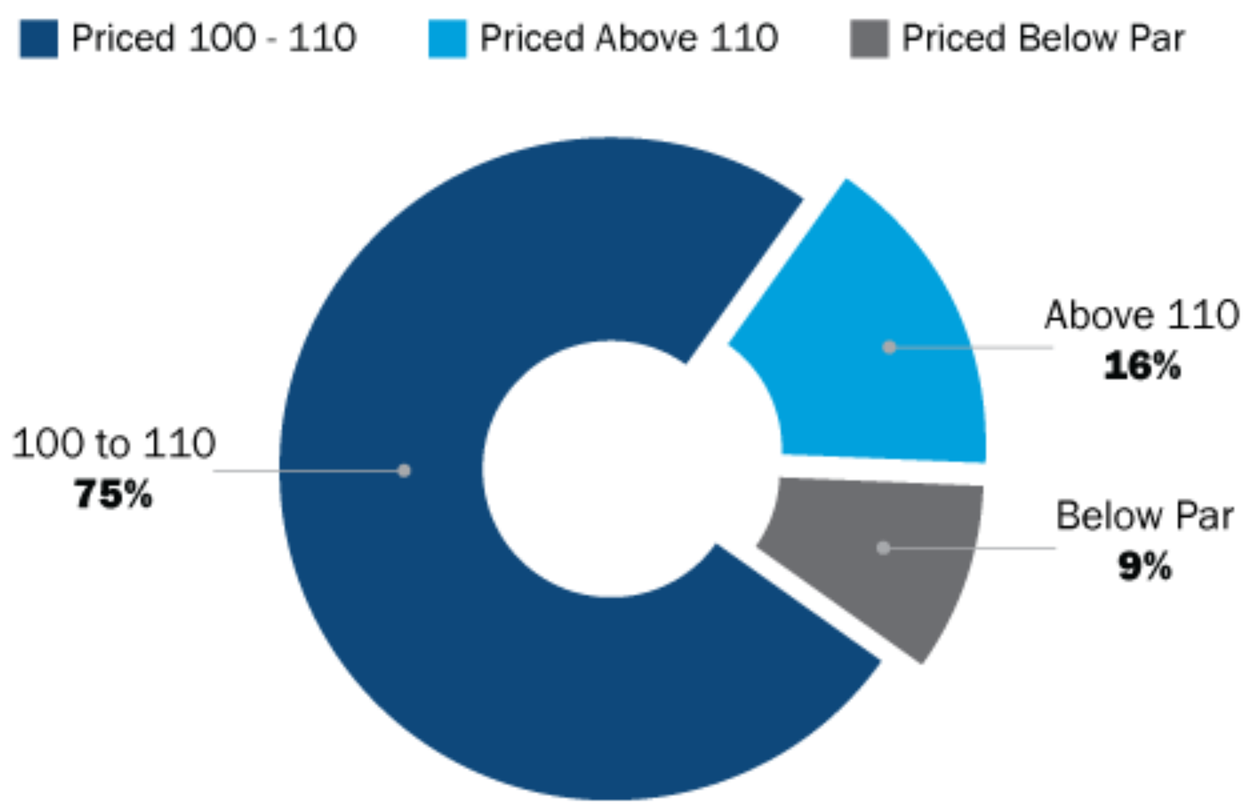
A few companies dropped off our Safe Watch List because, based on their latest financial results, we no longer consider them to be Safe: Biogen (BIIB), Carter's (CRI), and Microsoft (MSFT).

Moderate

Similar to our Safe category, only 9% of the "Moderate" bonds trade for less than par. That's unchanged from last month. The average YTM of these bonds is just more than 2%. That's not much higher than our Safe bonds.

The Moderate category does present a few more opportunities on higher-yielding bonds than the Safe category... just not nearly as many as we'd like. Investors have chased up the prices of these riskier bonds, making many of their yields less attractive.

~1,800 MODERATE BONDS



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MODERATE BOND WATCH LIST

Issuer Name	CUSIP No.	Coupon %	Maturity Date	Last Price	Yield to Maturity %	S&P Rating	Stansberry Rating
Atwood Oceanics	050095AM0	6.500%	2/1/2020	$77.88	15.1%	B+	8
Chart Industries	16115QAC4	2.000%	8/1/2018	$97.49	3.4%	NR	8
Commercial Vehicle Group	202608AL9	7.875%	4/15/2019	$102.00	7.0%	B	7
Corrections Corp. of America	22025YAM2	4.125%	4/1/2020	$96.29	5.3%	BB /*-	7
Enova International	29357KAC7	9.750%	6/1/2021	$87.90	13.3%	B	8
EZCorp	302301AB2	2.125%	6/15/2019	$94.25	4.4%	N/R	7
Genworth Financial	37247DAK2	6.515%	5/22/2018	$101.25	5.7%	B	8
j2 Global	48123VAB8	8.000%	8/1/2020	$104.50	6.7%	BB	8
Noble	655042AD1	7.500%	3/15/2019	$101.52	6.8%	BB+	7
Ruby Tuesday	781182AB6	7.625%	5/15/2020	$94.75	9.4%	B-	7
SuperValu	868536AV5	6.750%	6/1/2021	$92.94	8.6%	B-	7
Western Refining	959319AG9	6.250%	4/1/2021	$100.00	6.2%	B	7

Prices as of September 19, 2016

www.stansberryresearch.com

Source: Bloomberg

Our Watch List shows a handful of Moderate-rated bonds that are trading with some of the highest yields in this category. Their average yield is 7.7%, which is flat from last month.

These are the types of bonds we look at when searching each month for that needle in the haystack that we mentioned earlier.

You'll no longer find the Joy Global (JOY) 5.125% October 2021 bond or the Outerwall (OUTR) 6.0% March 2019 bond (both recommended in our March issue) on our list. As we explained last month, both companies were recently acquired and their bonds now trade well above par value. We don't expect either bond to trade close to our "buy" range again.

We've replaced these bonds with a couple of new additions to our Moderate Watch List: a 4.125% April 2020 bond issued by Corrections Corporation of America (CXW) and a 7.625% May 2020 bond issued by restaurant operator Ruby Tuesday (RT).

Corrections Corporation of America – which is organized as a real estate investment trust – is the largest owner of private prisons in the U.S., with a capacity of 88,500 beds in 20 states. It runs prisons for state and federal government agencies.

The company's stock and bond prices recently plunged when the U.S. Department of Justice directed the Federal Bureau of Prisons ("BOP") to reduce – and ultimately end – the use of private prisons for the federal inmate population. State prisons may follow suit.

On the announcement, Corrections Corporation of America stock dropped from around $27 to about $18. CXW's bonds also took a hit when credit-ratings agency S&P downgraded the company's credit rating from BB+ to BB and placed it on negative-credit watch. However, only about 11% of CXW's total revenues come from BOP contracts. And since the announcement, other customers have affirmed their continued use of private prisons.

The $325 million CXW April 2020 bond is the first of several of the company's bonds scheduled to mature. Corrections Corporation of America's operating cash flows were around $400 million in the past four quarters, but they will decline gradually. On the surface, it looks like the firm can repay the bond without refinancing. And with its healthy cash flows, refinancing shouldn't be an issue.

Today, the April 2020 bond yields 5.3%. We'd like to see the bond price fall even further before we'd be interested in recommending it. We're keeping a close eye on this one.

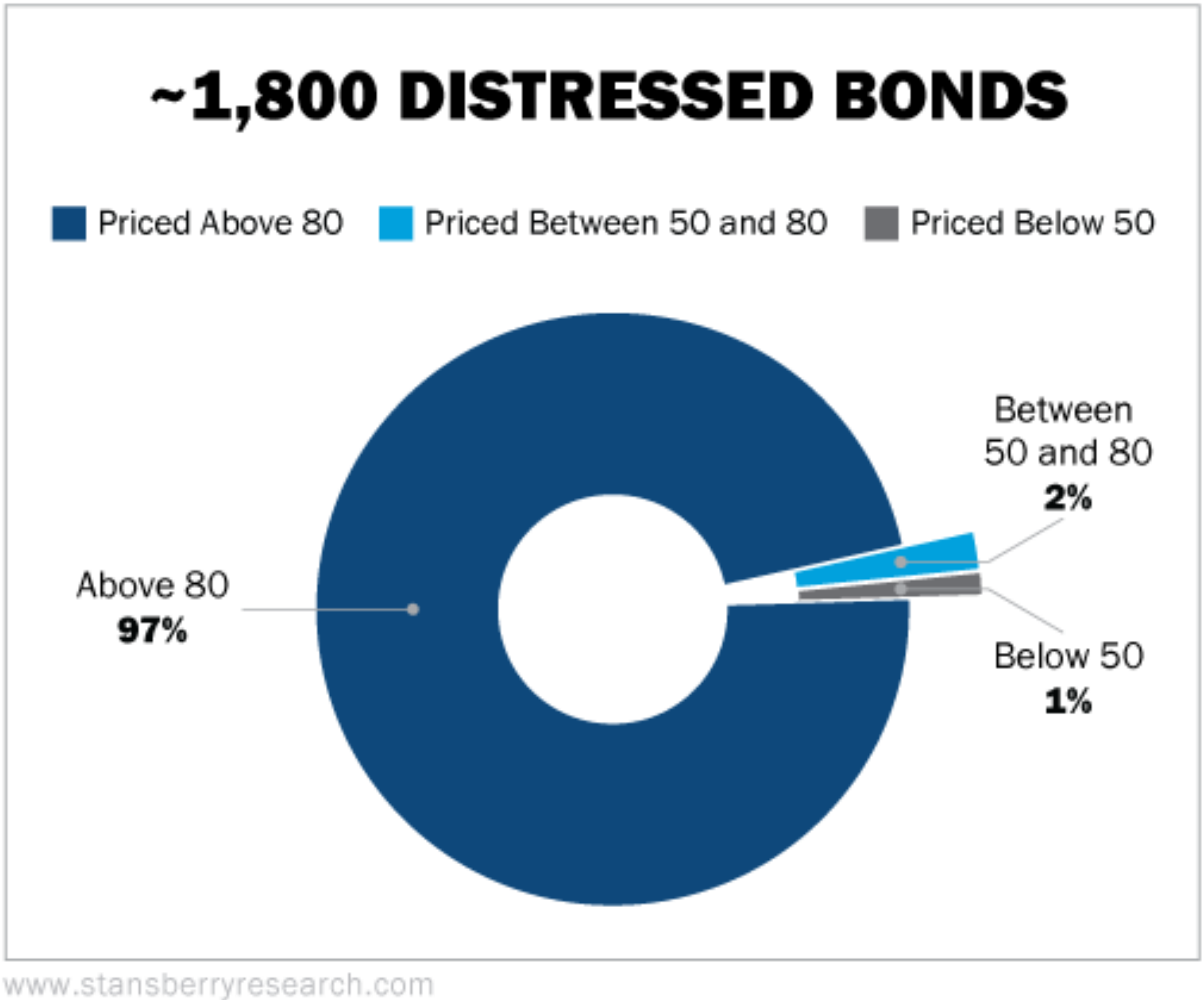
Ruby Tuesday owns and franchises casual-dining restaurants in 44 states. The May 2020 bond, totaling $213 million, is the company's only long-term debt. It yields 9.4% today and pays a nice 7.625% coupon. With a debt-to-asset ratio of 27%, on the surface it seems like it would be a manageable debt load.

But this is a business in decline. Revenue peaked for the company back in 2007 at $1.4 billion. It has fallen every year over the past four years and is expected to drop another 6% this year to just more than $1 billion. With $67 million in cash in its coffers, Ruby Tuesday only needs to come up with around $150 million in the next three-and-a-half years. But the company has managed to generate just $47 million in free cash flow over the past three years. At that pace, it'll fall short of what's needed.

Ruby Tuesday does have close to $700 million worth of property and equipment on its balance sheet that could be potentially sold to cover the shortfall. But there is real risk here... much more than with CXW. We'd like to see a higher yield before we'd be interested.

Distressed

Only 3% of the 1,800 bonds we rated "Distressed" this month are trading for less than $80. That's the lowest percentage we've seen since we launched this letter.



DISTRESSED BOND WATCH LIST

Issuer Name	CUSIP No.	Coupon %	Maturity Date	Last Price	Yield to Maturity %	S&P	Stansberry Rating
A. M. Castle	148411AH4	12.750%	12/15/2018	$76.25	27.7%	N/R	5
Accuride	00439TAE7	9.500%	8/1/2018	$100.50	9.2%	B-	6
Advanced Micro Devices	007903AU1	7.750%	8/1/2020	$102.15	7.1%	CCC	5
Aegerion Pharmaceuticals	00767EAB8	2.000%	8/15/2019	$57.80	22.6%	N/R	4
Bon-Ton Stores	09776NAF9	8.000%	6/15/2021	$58.60	22.7%	CCC	6
Centrus Energy	15643UAA2	8.000%	9/30/2019	$45.13	39.6%	N/R	4
Chesapeake Energy	165167BS5	6.500%	8/15/2017	$100.35	6.1%	D	4
Cloud Peak Energy	18911MAD3	8.500%	12/15/2019	$72.08	20.8%	B+	6
Cumulus Media	23109BAA5	7.750%	5/1/2019	$44.03	47.2%	CC	5
Elizabeth Arden	28660GAG1	7.375%	3/15/2021	$103.25	17.3%	NR	5
Erickson	29482PAB6	8.250%	5/1/2020	$43.68	38.3%	CCC	5
Harsco	415864AJ6	5.750%	5/15/2018	$101.75	4.6%	BB-	6
Hecla Mining	**422704AD8**	**6.875%**	**5/1/2021**	**$99.94**	**6.9%**	**B-**	**6**
Hornbeck Offshore	440543AL0	5.875%	4/1/2020	$63.81	20.9%	B-	6
Iconix	451055AF4	1.500%	3/15/2018	$85.50	12.5%	N/R	6
iHeart-Communications	184502BT8	10.000%	1/15/2018	$60.19	56.8%	CC	4
KEMET	488360AF5	10.500%	5/1/2018	$98.50	11.5%	B-	6
Scientific Games	80874PAK5	8.125%	9/15/2018	$100.46	7.9%	CCC+	5

Prices as of September 19, 2016

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Source: Bloomberg

Prices of the bonds in our Distressed Watch List are up 1.5% this month. The average YTM is 21%.

The **Hecla Mining (NYSE: HL)** bond we recommended in our April issue up to $89 (bolded in the table above) has traded down 2% this month. The price has bounced around between $98 and $103... Today, the bond trades at slightly below par, but still well above our buy-up-to price.

The biggest drop in price came from the 8.25% May 2020 bond of Aircrane helicopter maker Erickson (EAC). The bond is down 20% from $55 last month to $44 today. S&P cut the company's debt rating to CCC. The bond now yields close to 40% and is likely to default. The company hasn't managed to generate any free cash flows in the past three years. It only has $3 million in cash and owes close to $500 million in debt.

The Kratos bond we are recommending this month came from the Distressed category. It's only the third bond we've recommended that we have rated as Distressed. The first two – NRP and Coeur Mining – have produced our largest returns so far.

Finding distressed high-yield bonds that aren't likely to default is the key to great bond investing. As we've explained, there aren't many bargains out there today. But we'll continue to search the bond universe each month looking for the safest, highest-yielding opportunities available.

In the meantime, please take a minute to let us know how we're doing. We love to hear from our readers. Send your questions or comments to sco@stansberryresearch.com.

As you know, we can't answer individual e-mails or provide individual investment advice, but we assure you, we do read every e-mail. Thank you for joining us at *Stansberry's Credit Opportunities*.

Regards,

Porter Stansberry
with Brett Aitken, Bryan Beach, Mike DiBiase, Alan Gula, Bill McGilton, and David Xia
September 21, 2016

STANSBERRY'S CREDIT OPPORTUNITIES PORTFOLIO

PRICES AS OF SEPTEMBER 20, 2016

	CUSIP / Symbol	Maturity Date	Ref. Date	Ref. Price	Income Earned	Recent Price	Total Return	Cash Yield *	Yield to Maturity *	Action
					Open Positions					
NRP 9.125%	63902MAB4	10/1/18	11/20/15	$675.80	$45.63	$907.50	41.0%	13.5%	25.8%	Buy below $700
NRP stock (1)	NRP	-	11/20/15	$15.20	$1.35	$26.94	86.1%	-	-	Buy below $20
					NRP Bond/Stock Combined Position		52.3%			
Rent-A-Center 6.625%	76009NAH3	11/15/20	12/22/15	$845.00	$33.13	$985.00	20.5%	7.8%	10.8%	Buy below $850
PDL BioPharma 4.00%	69329YAF1	2/1/18	1/19/16	$780.00	$40.00	$940.00	25.6%	5.1%	17.3%	Buy below $800
Forum Energy 6.25%	34984VAB6	10/1/21	2/16/16	$730.00	$31.25	$960.00	35.8%	8.6%	13.2%	Buy below $770
Web.com 1.00%	94733AAA2	8/15/18	6/14/16	$915.00	$5.00	$930.00	2.2%	1.1%	5.2%	Buy below $950
Quad/Graphics 7.00%	747301AC3	5/1/22	7/19/16	$915.00	$0.00	$972.40	6.3%	7.7%	8.9%	Buy below $920
Kratos Defense 7.00%	50077BAL2	5/15/19	9/20/16	**NEW**	$0.00	$910.20	**NEW**	7.7%	11.0%	Buy below $920
					Closed Positions					
Iconix 2.5%	451055AE7	6/1/16	11/20/15	$887.50		$1,000.50	14.1%	-	-	SOLD
Coeur Mining 7.875%	192108AY4	2/1/21	5/17/16	$922.50	$39.38	$950.00	7.2%	-	-	SOLD
Coeur Mining stock (2)	CDE		5/17/16	$8.52	$0.00	$15.59	83.0%	-	-	SOLD
					Coeur Bond/Stock Combined Position		14.8%			
						AVERAGE	21.5%			
					Watch List					
Hecla Mining 6.875%	422704AD8	5/1/21	4/19/16	$927.50		$997.54	Waiting	-	-	Buy below $890
Hecla Mining stock (3)	HL		4/19/16	$3.85		$5.67	Waiting	-	-	Buy below $5
					Hecla Bond/Stock Combined Position		Waiting			

* Cash yield is the annual coupon payments divided by the purchase price of the bond. Yield to maturity is the annualized return of the bond – including both capital gains and interest – that you will earn if you hold it to maturity. Cash yield and yield to maturity figures do not change after you buy the bond. The yields are established by your individual purchase price.

(1) NRP stock was purchased on the same date as the NRP 9.125% Bond due 10/1/2018 (CUSIP No. 63902MAB4). Since the bond was trading above our "buy below" price on the day of our recommendation, the purchase date is the first date the bond price closed below our "buy below" price. We recommended that for every $1 invested, subscribers put $0.75 into the bond and $0.25 into the stock. The return on the combined position reflects that ratio.

(2) Coeur Mining stock was purchased on the same date as the Coeur Mining 7.875% Bond due 2/1/2021 (CUSIP No. 192108AY4) since both were trading below our "buy below" prices the day before our recommendation. We recommended that for every $1 invested, subscribers put $0.90 into the bond and $0.10 into the stock. The return on the combined position reflects that ratio.

(3) Since the Hecla Mining 6.875% Bond due 5/1/2021 (CUSIP No. 422704AD8) was trading above our "buy below" price on the day of our recommendation, the purchase date will be the first date the bond closes below our "buy below" price. We recommend that for every $1 invested, subscribers put $0.90 into the bond and $0.10 into the stock. The return on the combined position reflects that ratio.

This portfolio is not intended to represent the exact prices at which you could get in or out of a bond. Rather, it represents the value of our insights at the time our material is published.