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MUTUAL FUND SNAPSHOT

Today's Top 5 Stock Picks: Cash-Flow Gushing Values

Sandy Rufenacht of Aquila Three Peaks Growth finds hidden values by analyzing stocks like junk bonds.

By MICHAEL VALLO

The high yield bond market might not seem relevant to most stock pickers, but for Sandy Rufenacht, manager of the **Aquila Three Peaks Opportunity Growth Fund** (ticker: ATGAX), the junk bond market holds the key to finding good stories before the equity investors catch on. "The high yield market is much more focused on not just revenue but cash flow," says Rufenacht, a 25-year veteran manager. "Most importantly the high yield market understands covenants and how those covenants preclude a company from doing something shareholder friendly." Covenants are restrictions placed on bond issuers that limit their ability to take traditionally shareholder friendly actions such as paying dividends, buying back shares or making acquisitions.

Rufenacht looks for junk bond issuers that are using free cash flow to pay off debt quickly, making them ideal candidates for renegotiating their covenants to allow shareholder friendly actions. "We get these ideas in my opinion long before the equity market realizes this is eventually going to happen." Rufenacht uses debt to Ebitda – Earnings before interest, taxes, depreciation and amortization – as a key metric to evaluate companies' debt levels. Typically Rufenacht likes companies with debt around 5 times Ebitda that are on pace to reduce leverage to 3.5 times.

Among the companies with improving balance sheets he likes are Hilton Worldwide (HLT), Ball Corporation (BLL) and Aramark (ARMK)

Rufenacht used the strategy in separately managed accounts first at Janus, where he managed the Janus High Yield Bond Fund, and then at the firm he founded in 2003, Three Peaks. In 2010 Three Peaks became the sub-advisors of the Aquila Three Peaks Opportunity Growth Fund, then known as the Rocky Mountain Equity Fund, and applied the strategy to the fund.

Over the past three years the fund has topped its benchmark as well as 98% of its mid-cap growth peers with an average annual return of 24.89%, according to Morningstar. So far this year the fund is up 10.93%, well ahead of the 2.13% of its peers.

Barron's asked Rufenacht for his five top picks.

Hilton Worldwide: The hotel operator is using its free cash flow primarily to pay down the remaining debt from its 2007 leveraged buyout, and most of the proceeds from its record IPO last year were used to the same end. In the past two years the company has paid off $4 billion, leaving it with about $11 billion in debt outstanding, or 4.6 times Ebitda. According to Zach Miller, co-manager of the fund, the company should get debt to a level that would allow them to start returning cash to shareholders in the next 12 to 18 months. "They also have one of the best new growth pipelines of all the lodging companies," Miller adds.

Aramark: Rufenacht likes the food services company's focus on reducing its debt and expanding its Ebitda margin. In the past three years the company has paid of $800 million of debt. Leverage has declined from 5.7 times Ebitda in 2011 to 4.3 this year. Next year that figure should fall to 3.9, according to Rufenacht. He expects revenue growth to be in the mid-single digits. "They're still in the process of paying down debt, but it's in the later innings," says Miller.

Service Corp International: The $4.6 billion company offers funeral services and cemetery products. By acquiring its largest competitor, Stewart Enterprises, for $1.4 billion last year, Service Corp International (SCI) became the largest death-care provider in the country. Since the acquisition the company has paid down $230 million over the past 12 months. Miller says debt should fall to 3.7 times Ebitda next year, from 4.1 today, at which point the company could accelerate share repurchases. The company has also allocated about $50-100 million in free cash flow a year to continue to make tuck-in acquisitions and further increase its share of the fractured industry.

AmSurg Corp: The $2.4 billion company is the largest ambulatory surgery center operator in the country and also is a provider of outsourced physician services. In June AmSurg (AMSG) acquired Sheridan Healthcare, the largest anesthesia services provider in the country, for $2.35 billion in debt and equity. The acquisition should allow the company to reduce spending on anesthesiology and leverage Sheridan's relationships with large health systems. Miller expects double digit revenue and Ebitda growth in coming years, which should allow the company to rapidly deleverage. Debt should fall to 4 times Ebitda in two years, from 5.4 today.

Ball Corporation: With debt at just 3 times Ebitda, the $9 billion dollar packaging company is already in its "optimal leverage range" according to Miller. "We believe that companies that operate at an optimal leverage target can provide strong equity returns over an entire economic cycle, not just for a short period," says Miller. With a focus on share repurchases and growth investments, Miller says the company should generate earnings-per-share growth in the mid-teens despite revenue growth in the low single-digits.

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