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THE BIG SECRET ON WALL STREET

Beauty Is Way More Than Skin Deep

- AI Will Supercharge This Leading Makeup and Cosmetics Brand
- A "Forever Company" That Could Deliver 15% Compounded Returns

FROM THE DESK OF PORTER STANSBERRY

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#33

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A "Forever Company" That Could Deliver 15% Compounded Returns

Four-year-old Kasia didn't know it… but September 29, 1982 was the last time she would ever run an errand with her dad.

That morning, Kasia happily tagged along with her father, Adam Janus, as he stopped off at a Chicago-area Jewel-Osco drugstore to pick up a few items. One of those things was a red-and-white box containing a bottle of Extra-Strength Tylenol painkillers.

"I remember him picking up that box and putting it in the basket," she told NBC years later. "That was my last time with him."

Hours after the drugstore trip, 27-year-old Adam was dead. As police would later learn, he'd unknowingly swallowed a Tylenol capsule laced with cyanide.

Adam's cause of death was released too late for Kasia's 25-year-old uncle Stanley and his new wife Theresa. As family and friends gathered after Adam Janus' death – initially assumed to be a heart attack – Stanley and Theresa complained of headaches and each popped a capsule from the same red-and-white bottle in the Januses' kitchen.

Within two days, the newlyweds were also dead.

Over the next few weeks, investigators gradually pieced together a terrifying story: someone in the Chicago area had been entering drugstores (most frequently, the Jewel-Osco chain), opening random bottles of Tylenol, and dropping in poisoned capsules.

Seven people – including the three Janus family members, a young flight attendant, and a 12-year-old girl – died after swallowing one of the tainted pills. After the sixth and seventh victims were found, the *Washington Post* reported, "Investigators say it is possible that all the poisoned 'Extra-Strength Tylenol' bottles of capsules originated in shipments to the Jewel-Osco drugstore chain in the area."

In the mass panic that followed the "Chicago Tylenol Murders," Johnson & Johnson, Tylenol's manufacturer, recalled 31 million bottles of the painkiller and implemented the first-ever "triple-seal tamper-resistant packaging," which soon became industry standard. (Unfortunately, despite a $100,000 reward, the mysterious killer was never caught.)

And, in a roundabout way, the unsolved 1980s case launched one of the most successful "Forever Companies" of all time...

The Tylenol murders were the start of a long downward spiral for Jewel-Osco, a combined grocery and drug chain that sometimes appeared as a standalone Osco drugstore but more frequently in tandem with a companion Jewel grocery. Three years after the 1982 tragedy, the company was in the news again – this time, for supplying salmonella-contaminated milk to 20,000 unlucky customers, and eventually forking over $40 million in damages.

Along with the bad press, Jewel-Osco endured a rocky 1984 management shakeup and a hostile takeover by a larger company, American Stores – and then turned out to be a bad bargain for the aggressive buyer.

In particular, the Osco Drug side of the business was a disappointment. Eighteen months after the acquisition, Osco's operating results were consistently below expectations – ultimately spurring American Stores to sell 125 Oscos and Jewel-Oscos in 1991.

By 1989 – after almost a decade of bad headlines, operational challenges, and underperformance – Osco president Dick George had had enough. He decided to resign from the troubled company and strike out on his own.

And he'd cash in on the one part of the Osco business that did seem to work: cosmetics.

A Huge New Market That No One Else Noticed

During his time running the company, Dick George had paid special attention to the sales of Osco's highest-margin items: cosmetics, perfumes, and other beauty products. After studying this segment over time, he identified a critical shortcoming among the retailers serving this lucrative market.

Traditional beauty retailers were split into two camps. Grocery stores and drugstores sold discount brands. Meanwhile, mall department stores and specialty retailers exclusively sold higher-end, luxury brands. But George realized that most women bought beauty products across the value spectrum. The same consumer might buy value makeup or perfumes for day-to-day wear, and then switch to premium brands for weekend outings and special occasions.

Since retailers only catered to only one end of the market, shoppers had to visit multiple stores to buy their beauty products.

From this simple insight, a new retail concept was born. In 1989, George resigned from Osco and devised a business plan. He wanted to create the first cosmetics store that offered products across the value spectrum – from mass market to premium brands.

George introduced the concept to fellow Osco executive Terry Hanson. Hanson had just replaced George at Osco. But he didn't hesitate in relinquishing his lucrative presidential perch. As Hanson explained in a 2017 interview, he immediately joined the start-up because he "just believed in it so strongly."

In addition to a mix of product offerings, Hanson drew upon his 20 years in retail to introduce other innovative store features designed to create a better shopping experience. For example, Hanson knew that women were more likely to shop at locations with parking lots closer to store fronts. This led to the idea of building free-standing locations in strip malls, in contrast with big-brand retailers buried deep within shopping malls.

This not only saved customers time, but it boosted the bottom line. Leasing standalone stores in strip malls cost less than premium-priced locations in shopping malls.

Hanson also did away with the aggressive sales tactics commonly used by large department stores. As he explained to the Chicago-area *Daily Herald* in 2017:

> *"Women didn't want to be 'attacked' going into the store by clerks who would spray them with fragrances."*

Hanson and George trained employees as consultants who would offer expert help only when requested. They designed the stores to be open, inviting, and filled with displays that customers could peruse on their own. This was a critical distinction versus traditional department-store layouts, which kept merchandise behind glass enclosures. This forced customers to engage with commission-based salespeople, who pushed them to buy products that generated the highest commissions – not always the products that best met a customer's needs.

George and Hanson devised a brilliant alternative sales strategy with a much lighter touch. They built full-service beauty salons into each store, with the idea that customers would naturally inquire about (and eventually purchase) the products being used. This would pull customers toward new products, instead of pushing them through aggressive sales tactics. It also offered customers additional convenience, by providing a one-stop shop for both beauty treatments and products.

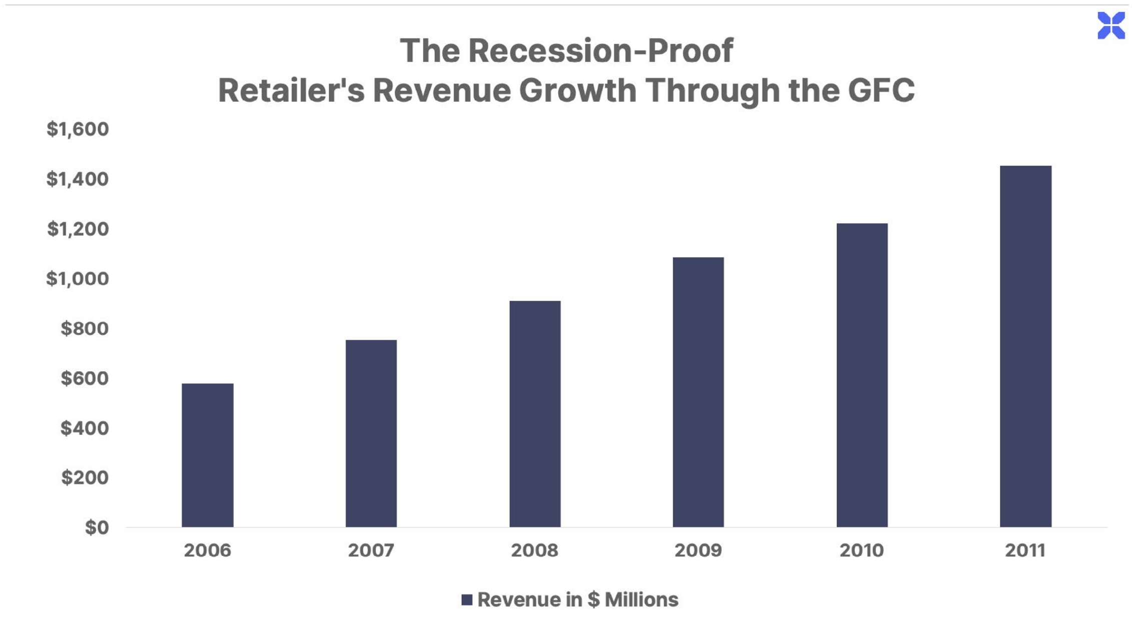
Each of these ideas were small, but powerful tweaks to the existing beauty retail concept. Combined, they offered a revolutionary change to the customer buying experience. Other industry experts recognized the brilliance of their approach. George and Hanson attracted another 11 former Osco executives to join the start-up. And within only four months of drafting the business plan, they raised $11.5 million in venture financing.

The first store opened in the northwest Chicago suburbs in 1990. It was an instant hit, leading to four successful store openings the following year. George and

Hanson continued refining the model with new stores, and growth accelerated throughout the 1990s and 2000s.

The Ultimate Recession-Proof Business

In October 2007, the company filed for an initial public offering ("IPO"). Unlike most retailers that suffered a collapse in demand during the Great Financial Crisis ("GFC"), the business grew sales consistently throughout the recession:



The company benefits from the "lipstick effect" – when consumers continue spending on makeup and other beauty products regardless of the economic climate. Looking your best never goes out of style, even in the worst economic crisis of a generation.

The business not only escaped the GFC unfazed, but it also shrugged off the rise of e-commerce that disrupted other businesses. Most brick-and-mortar retailers have suffered declining sales and shrinking profit margins because of Amazon and other online shopping alternatives. But this company has consistently taken market share from its traditional retail peers, while expanding its profit margins over the last decade.

That's how it became one of the best performing stocks in the market, delivering a 22-fold return since its 2007 IPO. That compares with a three-fold gain in the S&P 500 Index over the same period.

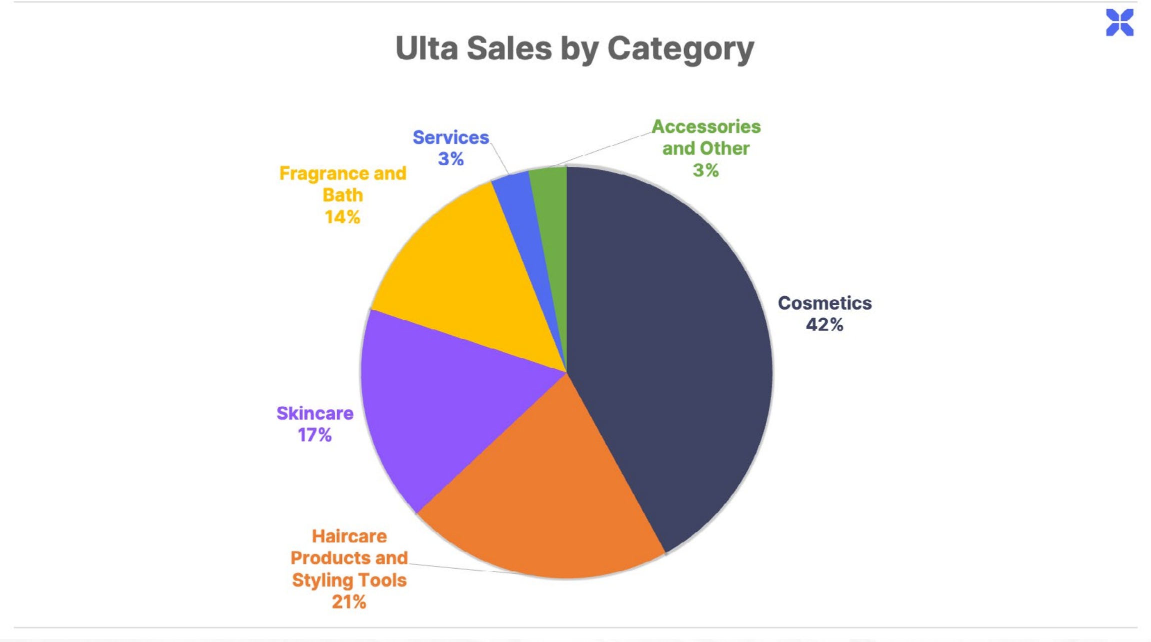
As we'll show in this issue, this share-price performance reflects the company's entrenched competitive advantages built into its clever business model. These advantages have grown stronger over time with the company's increasingly dominant size as America's number-one beauty retailer. It has also boosted its profitability and capital efficiency, putting the company's financial returns on par with today's leading technology companies.

Looking ahead, the company is poised to expand its competitive position through the development of cutting-edge artificial intelligence (AI) and augmented reality (AR) technologies. These offer the potential to supercharge sales and further elevate the company's already best-in-class profit margins and capital efficiency.

America's Largest Beauty Retailer

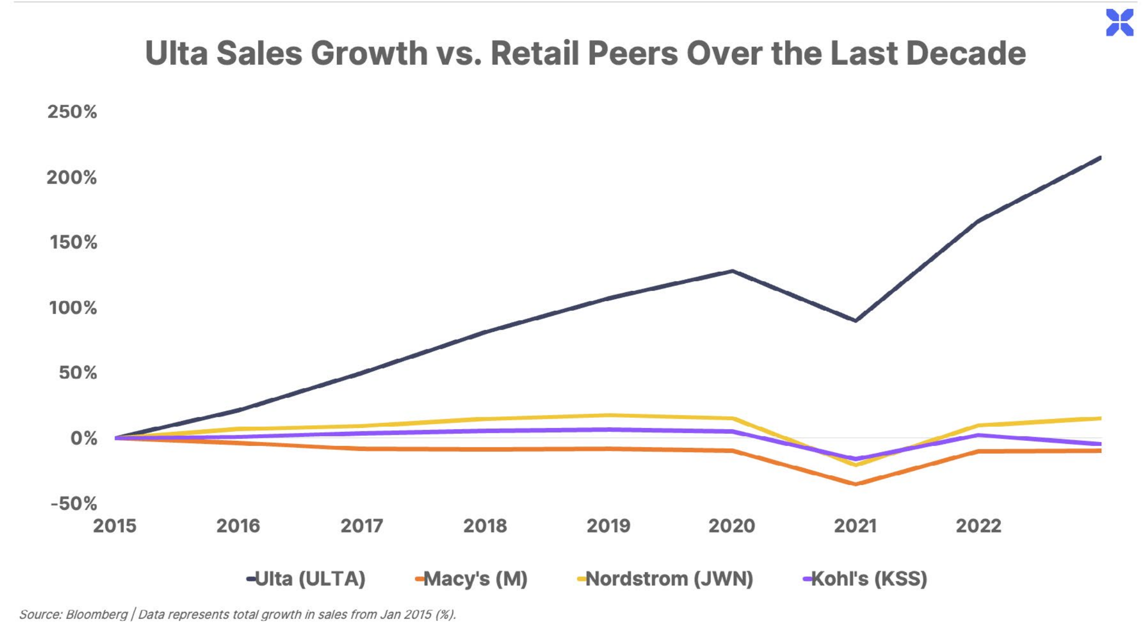
The beauty retailer founded by Dick George and Terry Hanson more than 30 years ago is today known as Ulta Beauty (Nasdaq: ULTA).

Ulta is now America's largest beauty retailer with 1,370 stores. The company's largest business segment is cosmetics, making up 42% of sales last year. Its other segments include haircare, skincare, and fragrance products – plus beauty services from its salons, as shown below:



Demand for U.S. beauty products generally grows along with the overall economy – or by 2% - 3% per year over the last decade. Ulta handily outpaces the broader industry through consistent gains in market share, with average sales growth of 16% per year over that period.

Ulta's biggest market-share gains have come at the expense of traditional department stores, including Macy's, Kohl's, and Nordstrom. The chart below shows the divergence in sales trajectories for Ulta versus its top department-store peers over the last decade:



Ulta's market-share gains have largely resulted from following the playbook founders Terry Hanson and Dick George developed back in 1990.

Ulta's Enduring Competitive Advantages

Just like in 1990 with the first Ulta store, the company's enduring competitive advantage is its superior product selection. It's still the only U.S. beauty retailer offering customers everything from high-end luxury brands like L'Oreal and Chanel, to mass-market products like Maybelline.

Drugstores and big-box retailers serving the value end of the market and department stores selling higher-end products all face one key challenge in competing with Ulta. That is, cosmetics make up only a small part of their business. This means limited shelf space, and thus limited product selection.

Ulta stores, on the other hand, offer 10,000 square feet dedicated purely to beauty products and salon services. It provides an unmatched array of more than 25,000 products across over 600 brands. Consumers place a high value on convenience, and Ulta offers one-stop shopping for all things beauty.

In addition to outcompeting its peers with better product selection, Ulta's larger-store footprint provides the shelf space to experiment more with new product offerings.

Consider the case of IT Cosmetics, co-founded by former Miss Washington and news anchor Jamie Kern in 2008. Kern developed a line of easy-to-remove makeup products that she couldn't find anywhere on the market. But she couldn't convince department stores to take on her products. Ulta was willing to take a chance, and in 2012 became the first brick-and-mortar retailer to stock her products. Within two years, Ulta helped propel IT Cosmetics sales to $117 million. In 2016, L'Oréal – the world's largest cosmetics company – bought IT Cosmetics for $1.2 billion.

Ulta has established a long track record of developing new brands over its history. The success of these deals provides a powerful draw for other up-and-coming beauty brands to form exclusive partnerships with Ulta.

Thus, the IT Cosmetics deal wouldn't be the last time Ulta transformed an upstart brand into a billion-dollar enterprise.

How Ulta Minted the World's Youngest Self-Made Billionaire

In 2015, Kylie Jenner – one of the personalities on hit reality show *Keeping Up with the Kardashians* – launched the Kylie Cosmetics beauty brand.

Jenner capitalized on her massive social media presence (currently over 380 million followers) to generate $300 million in sales by 2016, without spending a dime on paid advertising.

Most impressive – and threatening to the existing industry – was how the business model bypassed traditional brick-and-mortar retailers. Kylie Cosmetics sold direct to consumers through online platform Shopify. The company outsourced manufacturing and fulfillment to third parties. This allowed Jenner's entire operation to run with just seven full-time and five part-time employees.

Before Kylie Cosmetics, this "influencer" model of using social media personalities to sell direct to consumer was a tiny part of the overall beauty business. Kylie Jenner changed the game, as Shopify vice president Loren Padelford explained in a 2017 *Women's Wear Daily* article:

> *"We have never seen anyone who creates as much hype and throws crazy sales like her. We have over 2,000 influencers on Shopify, and she is bigger than all of them."*

In 2016, industry experts cited this lean, direct-to-consumer model as a disruptive threat to brick-and-mortar beauty retailers like Ulta. But as it turned out, there was a limit to this purely online approach – even for one of the world's most powerful social media personalities.

Kylie Cosmetics trajectory stalled in 2017 and 2018, when sales growth slowed to single digits. Her manager (and mother), Kris Kardashian, urged her to sell the brand before it flamed out. Instead, Jenner saw a better opportunity in partnering with Ulta.

In March 2019, Ulta became the exclusive brick-and-mortar retailer for Kylie Cosmetics. The power of Ulta's existing customer base and 1,200+ store footprint reignited the brand's growth. Within six weeks, Ulta sold $54.5 million of Kylie Cosmetics products. At an annualized rate of nearly $400 million, this new sales channel significantly outpaced the online-only sales of $300 million that the brand generated in 2015 - 2016.

The deal helped propel Ulta's earnings to new record highs throughout 2019. And it made 21-year old Kylie Jenner the world's youngest self-made billionaire. In November 2019, French cosmetics giant Coty bought a 51% stake in Kylie Cosmetics for $600 million.

The case of Kylie Cosmetics shows that even the most popular e-commerce brands still require a brick-and-mortar presence to flourish. Beauty products remain one of the few retail categories that customers prefer to see, touch, and physically interact with before buying. This is how Ulta has thrived over the last decade, even as other brick-and-mortar retailers have declined from e-commerce disruption.

The blockbuster partnership also showcases the strategic prowess of Ulta's management team. When making deals, it doesn't just look for short-term sales bumps from the hottest new trends. It seeks out partners who can expand the reach into new customer segments, which then leads to more long-term Ulta consumers.

The Kylie Cosmetics partnership brought in a new cohort of customers from the key teen demographic that makes up a major portion of the U.S. beauty market. By 2019, this influx of new customers catapulted Ulta into the number-one beauty retailer position, preferred by teens for the first time in its history.

That title was previously held by Ulta's top competitor, Sephora. Owned by the Paris-based luxury-goods conglomerate LVMH Moët Hennessy Louis Vuitton, Sephora is a specialty beauty retailer that caters to the luxury end of the market.

While Ulta has taken easy market share gains from its department-store peers over the last decade, it's long faced stiffer competition from Sephora. But more recently, Ulta's superior dealmaking has allowed it to leap past Sephora. And all signs indicate it's poised to further cement this lead going forward.

Savvy Dealmaking Cements Ulta as the Leading U.S. Beauty Brand

In 2006, Sephora signed a 15-year deal to introduce hundreds of Sephora pop-up locations inside JCPenny department stores. The new arrangement backfired when the rise of e-commerce depressed JCPenny sales. By 2017, Sephora found itself with 600 stores stuck inside a dying retailer with declining sales and falling foot traffic.

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Things went from bad to worse when JCPenny filed for bankruptcy in May 2020. Sephora used the opportunity to try to close its JCPenny stores before the expiration of its 15-year contract. However, JCPenny filed a restraining order that forced Sephora to keep these locations open through 2022.

Despite its struggles with JCPenny, Sephora doubled down on partnering with disrupted retailers.

In 2020, Sephora signed a deal to bring 600 pop-up locations inside Kohl's department stores. Kohl's has also suffered from e-commerce disruption, with sales falling from $19 billion to $17 billion over the previous decade. Over the same period, Kohl's net income plunged from $900 million to a loss of $100 million. One *Bloomberg* columnist used a colorful metaphor to explain that the deal made little sense for Sephora:

> *"Kohl's nabbing a 'long-term strategic partnership' with Sephora in 2020 was much like the high school nerd winning a date with the popular girl in a high school rom-com. It came out of nowhere, made little sense, and was seen as benefiting Kohl's more than the unit of chic LVMH Moët Hennessy Louis Vuitton."*

Despite Kohl's decade-long struggle to revive foot traffic, sales growth, and profitability, Sephora is moving full steam ahead with the partnership. The duo currently plans to expand Sephora into 900 Kohl's locations in the years ahead, up from the original 600.

Meanwhile, in November 2020, Ulta announced a major partnership with Target, one of America's largest retailers. The initial agreement included building 1,000-square-foot Ulta pop-up stores inside about 100 Target locations starting in 2021. The first series of stores proved remarkably successful for both companies, setting the stage for an expansion to 421 Ulta stores by Q2 2023. Now, the two companies plan on growing their partnership to place 800 Ulta stores inside of Target.

In contrast with Sephora's partnership with a stagnant-growth Kohl's, Target offers Ulta exposure to a large retailer with consistent growth. Target has increased revenues in nine of the last 10 years, growing sales by 50% – from $71 billion to $107 billion. The partnership has opened up a vast new audience of new Ulta customers, and is already paying dividends.

Less than a year after entering Target, Ulta surpassed Sephora as the top beauty brand among the entire American female demographic. In August 2021, a survey from The Benchmarking Company – a consumer research firm specializing in the U.S. beauty market – revealed that 59% of consumers had shopped at Ulta over the prior six months, compared with 47% for Sephora.

While management hasn't quantified the precise impact of the Target partnership, all signs indicate a remarkable success to date. Ulta's overall sales have grown by 75% since opening its first Target location.

And we're confident that Ulta will capture a new cohort of loyal, repeat customers from its Target partnership, just like it did with the Kylie Cosmetics deal. One brilliant feature of Ulta's partnership strategy can be found in a minor – but critical – deal term in its Target partnership. Ulta allows customers who purchase their products in its Target locations to earn loyalty rewards... but to redeem those rewards, they must visit a standalone Ulta location.

On the surface, this may seem like a trivial detail. But it's in fact a brilliant strategy designed to push customers into Ulta's ecosystem, where it can then sell them more products over time. Ulta's loyalty program is the ultimate secret weapon that's become the company's most powerful competitive advantage, while also unleashing incredible capital efficiency.

Here's how it works.

Ulta's Secret Weapon for Unlocking World-Class Capital Efficiency

One golden rule of business is that the most profitable customer is an existing customer. Acquiring new shoppers means spending on marketing, advertising, and new store openings. That's why great businesses are masters of customer retention. And the best businesses don't just retain customers. They find ways to generate additional sales from existing customers.

That's where loyalty programs come in. By offering rewards points on each purchase, loyalty programs create a powerful feedback loop that locks customers into repeat business while also driving additional sales from existing customers.

If a beauty shopper wants to buy the latest Rihanna Fenty makeup brand, she can purchase the same product at the same price at either Ulta or Sephora. But if she has accumulated rewards points through her Ulta loyalty program, she can buy the product cheaper at Ulta. That gets her in the door, where she's likely to spend more. This, in turn, provides her with additional Ulta rewards points that keeps the cycle turning.

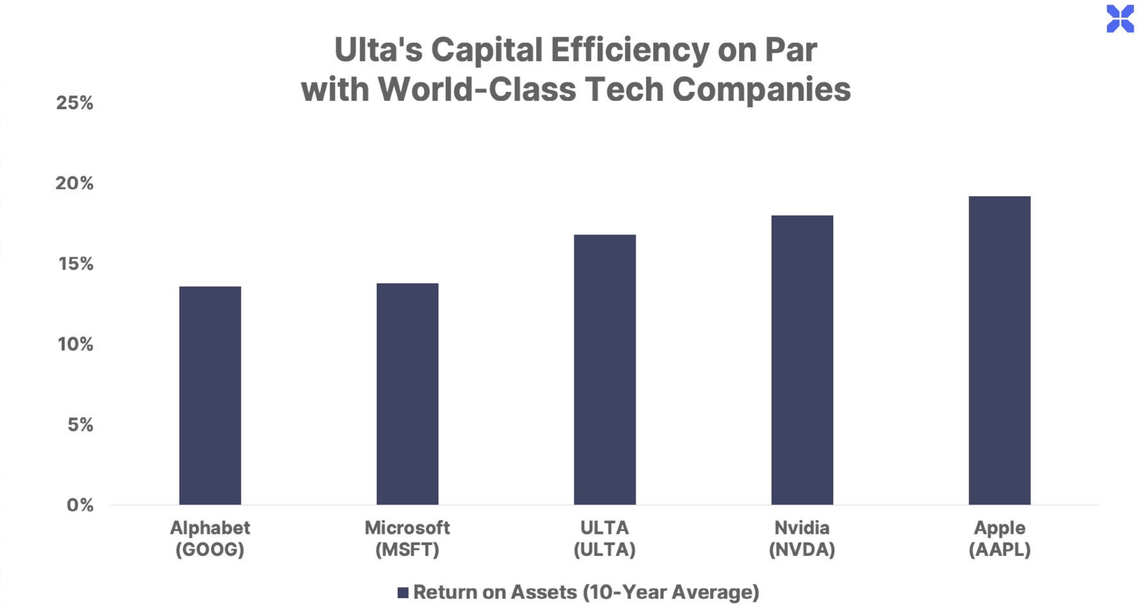
Ulta was one of the first retailers to introduce a loyalty program, launching the initial version in the 1990s. The program has since evolved into the wildly popular Ultamate Rewards membership – one of the world's most successful loyalty programs. Over the last three decades, Ulta has accumulated 41 million Ultamate Rewards members.

For frame of reference, Starbucks is widely respected for its successful Starbucks Rewards loyalty program. The coffee giant generates $35 billion in annual sales and has 31 million rewards members globally. With $11 billion in revenues, Ulta's business is less than one-third the size of Starbucks. And yet Ulta has 30% more rewards members.

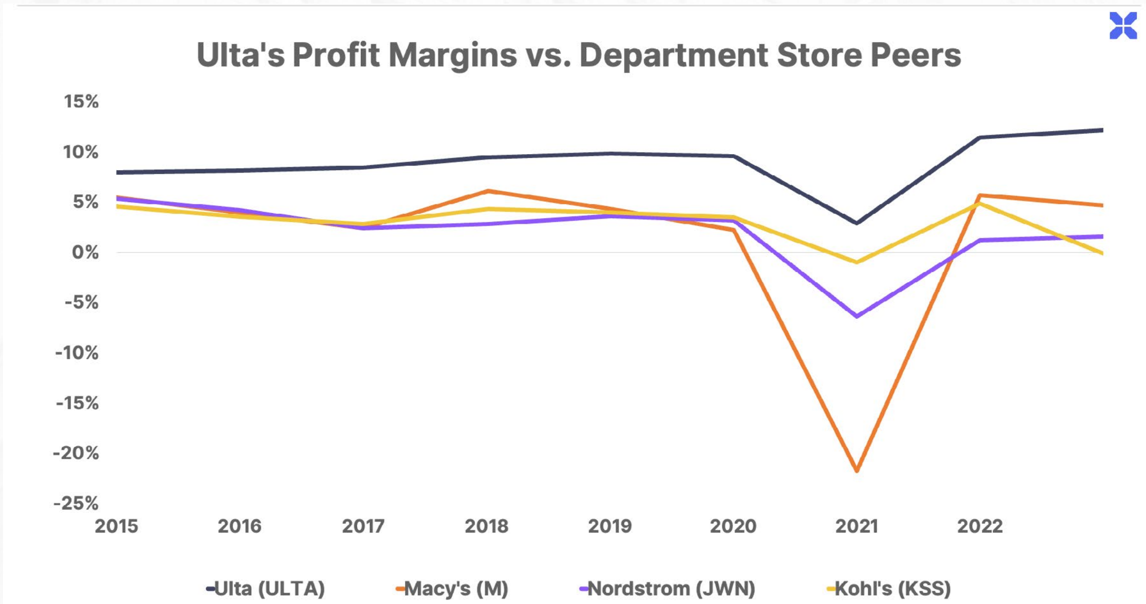
Ulta's robust rewards program makes it incredibly capital efficient, because of how effectively it boosts sales from existing customers. We can quantify this through a key retail-industry financial metric known as same-store sales ("SSS"). SSS measures sales growth at a company's existing store base versus the prior period.

Over the last decade, Ulta has generated an average of 10.1% SSS growth per year. That's more than double Starbucks' 4.9% average SSS growth over the past decade, which has made Starbucks one of the world's best-performing consumer stocks. Meanwhile, Ulta's department-store competitors have generally experienced declining SSS growth over the last decade.

Ulta's SSS growth translates into world-class capital efficiency. Whereas most retailers must invest heavily in new store openings to drive growth, Ulta unlocks 10% more sales each year from existing stores, translating into a 16% return on assets over the last decade. This blows away Ulta's retail peers. Its capital efficiency is on par with some of the world's most profitable, highly capital-efficient technology companies:



This capital efficiency translates directly to the bottom line. As Ulta drives more sales from existing stores, its business becomes more profitable over time. This is a result of positive operating leverage, where each dollar of additional sales gets spread over a relatively fixed cost base, driving higher profit margins. Ulta's profit margins have nearly doubled over the last decade, from 7% to 12%. This makes it one of the most profitable retailers in the market. Conversely, its department-store competitors have suffered from the reverse effect: negative operating leverage from declining sales over a fixed cost base, causing a steady erosion in profit margins:



Source: Bloomberg

As impressive as Ulta's results have been to date, we see more upside for SSS growth ahead.

The next big source of upside will come using artificial intelligence (AI) to harvest the company's unmatched data on consumer transactions.

Ulta's Big Data Advantage in the Age of AI

When a customer transacts through a loyalty program, the company captures the customer data behind the transaction. This allows retailers like Ulta to create hyper-specific marketing campaigns and promotional offers, targeted at individual customers.

For example, consider a scenario where an Ulta shopper purchases a certain makeup brand every four months. As the time approaches for that consumer to make her next purchase, Ulta can offer promotions for additional products, like eyeliner or skincare lotions. In this way, Ulta can generate additional sales when the customer goes in for her regular makeup purchase.

Optimizing exactly how, when, and which offers to make tests the limits of data mining. What worked for a 24-year-old consumer in a booming economy might be radically different for that same consumer, at age 30 during a recession.

Until recently, targeted marking was an inexact science. It relied on manual human data processing and a heavy dose of guesswork. In today's age of AI, the machines do the heavy lifting.

Since 2019, Ulta has partnered with tech giant Google to sift through its ocean of consumer data using cutting-edge, machine-learning algorithms. Ulta uploads customer-transaction data into the Google Cloud, which uses AI-based machine learning to organize and transform shopping patterns into actionable insights.

In this way, Ulta is a hidden beneficiary of the AI boom. As companies like Google invest billions into high-powered NVIDIA computing chips, AI-based processing power will increase exponentially. This will make Google's data-mining capabilities increasingly more valuable over time.

Because of this, data is now king in the age of AI. And therein lies another of Ulta's enduring competitive advantages.

Since Ulta has been driving customers into its loyalty program for the last three decades, it has a vast trove of customer data. It now captures 95% of sales through Ultamate Rewards. For comparison, Starbucks drives 57% of sales through Starbucks Rewards. This gives Ulta a nearly perfect view of customer shopping patterns that few other companies can match.

Since many of its competitors lack access to this level of data to feed into machine-learning algorithms, Ulta has a significant edge over them in driving customer loyalty and repeat business.

This AI advantage will allow the company to continue its SSS growth, profitability, and capital efficiency over time.

But it isn't the only AI trick in its bag.

The Rise of Virtual Beauty

Beauty products remain one of the key items consumers prefer to personally interact with before making a purchase. This has kept beauty retailing somewhat Amazon-proof – immune from e-commerce disruption over the last decade. However, the advancement of augmented reality (AR) could change how customers interact with beauty products.

AR is a powerful new AI-based computing software that creates computer-generated images to augment a user's view of real world surroundings. This technology promises to transform the experience of trying on various beauty products from the physical to the virtual realm.

Ulta has invested heavily into cutting-edge AR and AI-based technology for nearly a decade. In 2016, Ulta partnered with a leader in beauty-based AR technology, GlamStreet, to develop the GLAMLab Try On mobile application. GLAMLab's AR technology enables customers to virtually try on thousands of skin, nail, and hair products.

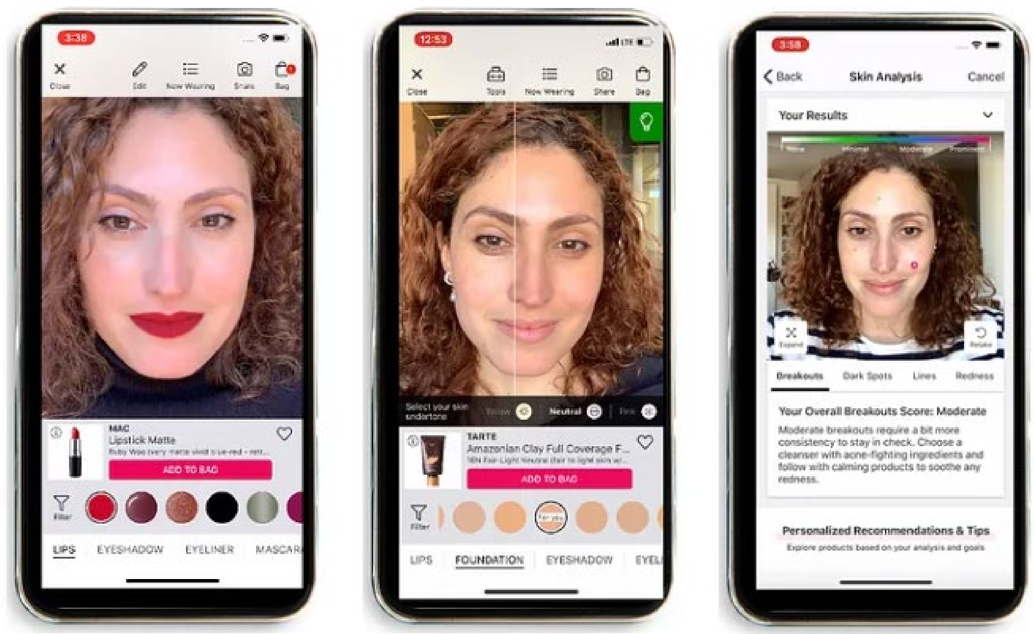
In Q3 2018, Ulta doubled down on its virtual technology push by acquiring partner GlamStreet along with AI startup QM Scientific, which brings expertise in AI-based computer vision and pattern recognition. These technologies amplified GlamStreet's AR to enable things like AI-based image scanning of skin color and complexion to custom-match a consumer with the right beauty product.

Over the next two years, QM Scientific worked with GlamStreet to create the Shade Finder and Skin Analysis AR mobile apps.

Ulta's Shade Finder app uses machine-learning AI software to train an algorithm across a diverse range of face images to develop specific skin tone categories. It draws upon this data, along with a scan of a user's face, to generate a recommended list of makeup shades customized for the user's skin tone. The algorithm also draws upon the history of prior user purchases to further enhance the accuracy of its recommendations.

Ulta's Skin Analysis app is designed to help users diagnose various skin conditions. Skin Analysis then recommends Ulta products to treat a range of conditions, including redness, breakouts, or dark spots.

Through these three products, Ulta offers the industry's most advanced line up of AR- and AI-based virtual beauty tools:



Try-on Shade Finder Skin Analysis

Ulta's management doesn't provide metrics for engagement on these AR apps. However, it has noted that GLAMlab usage surged five-fold during the pandemic, when brick-and-mortar retailers were shut down. And many of these users continued engaging on the app after the COVID-19 lockdowns. The company recently reported that users have tried on over 25 million makeup shades through GLAMlab post-COVID.

It's still early days for Ulta's forays into AR, and thus it remains unclear what impact these technologies will have on the bottom line. The extreme scenario is that AR could transform the beauty industry from brick-and-mortar retailing to purely virtual.

This could disrupt traditional beauty-store operators, while the winners benefit from the higher profit margins and greater capital efficiency of a purely e-commerce model. With nearly a decade of heavy investment into bringing cutting-edge AR products to market, Ulta has secured its leadership position in this promising new field. If AR and AI will transform the beauty business, Ulta is best positioned to lead that transformation.

Beyond developing its own virtual capabilities, Ulta has also positioned itself to get ahead of any future disruptive threats. In August 2022, Ulta launched the Prisma Fund – a venture capital fund designed to invest in early-stage startups at the forefront of AR and AI technologies.

The venture capital fund should further solidify Ulta's leadership in the emerging field of digital technology that's reshaping the beauty industry.

In the meantime, Ulta's existing business enjoys tremendous tailwinds from its entrenched competitive advantages.

A Capital Efficient Forever Stock

Ulta's longest-running advantage of offering beauty customers greater convenience through superior product selection remains in place today. With over 25,000 products across over 600 brands, no other competitor offers one-stop shopping for beauty products across the value spectrum.

After introducing one of the industry's first loyalty programs 30 years ago, Ulta's 41 million loyalty members that drive 95% of its sales has become another structural advantage. It's made Ulta's customer base incredibly sticky, allowing the company to increase sales like clockwork for the last two decades. Ulta's unmatched data on consumer shopping patterns has allowed the company to consistently drive more sales from existing stores. This has made the company increasingly profitable and capital efficient.

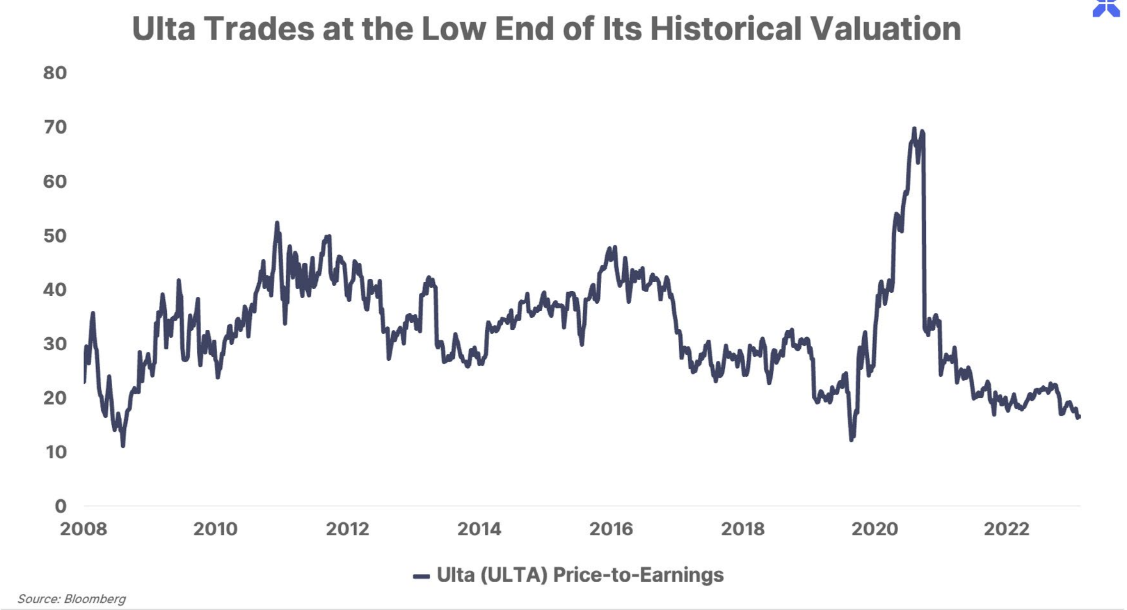
Over the last 10 years, Ulta has grown revenues nearly 400% from $2.7 billion to $11.2 billion. Over the same period, expanding profit margins have fueled an even greater rise in Ulta's net income – growing by 550% from $200 million to $1.3 billion.

Meanwhile, the company's greater capital efficiency has boosted its free cash flow margins by nearly three-fold, from 4% to 11% over the last decade. This has allowed Ulta to return a substantial portion of its profits to shareholders, through buybacks. The company has reduced its share count by 25% from 65 million to 50 million over the last decade.

The combination of its rapid profit growth and shrinking share count has boosted earnings per share from $3.17 to $24.17, or a nearly eight-fold increase over the last decade.

Over the last year, Ulta's share price has dropped by roughly 25%, mostly due to slowing growth. Following a post-COVID surge in beauty spending that sent Ulta's sales surging by 40% in 2021, growth has slowed to 15% over the last 12 months.

Analysts have forecasted a further deceleration in Ulta sales growth to 5% through year-end 2024, driven by a broader slowdown in consumer spending. As a result, Ulta's valuation has fallen from a historic price-to-earnings ratio of between 25 - 40 to just 17 today. This reflects one of Ulta's lowest valuations in its history as a public company, outside of prior crises like the 2008 GFC or the 2020 COVID-19 outbreak:



We believe investors have overreacted to a short-term slowdown in Ulta's growth rate. The company's depressed valuation has provided a tremendous opportunity for long-term investors.

We believe Ulta could deliver 15% compounded returns for long-term investors, even assuming a near-term slowdown in consumer spending.

Delivering World-Class Returns, Despite a Potential Recession

As we've **written previously**, we think a recession is likely. However, we expect Ulta's historically recession-proof business model will once again prove resilient.

Recall that Ulta generated positive revenues through the prior recession from 2007 - 2009. As an extra measure of caution, we assume Ulta will generate flat revenue growth as the economy slows over the next two years. We then expect a rebound in Ulta's revenue to 8% annual growth from 2026 - 2033. We believe this is a conservative assumption, given Ulta's historic ability to grow SSS by 10%, and the company's 16% average sales growth over the prior decade.

Next, we assume profit margins continue their prior trend of expanding as Ulta continues benefitting from positive operating leverage, starting in 2026 when sales growth resumes. We estimate Ulta can increase profit margins from 12% today to 14% by 2033.

We also expect the company will continue funneling excess free cash flow into share buybacks, reducing the share count by one-third to around 33 million by 2033. Finally, as Ulta's sales and profit growth increase starting in 2026, we believe the shares will command a valuation multiple of 20x earnings. Notably, this reflects a discount to Ulta's average valuation of roughly 30x over the last decade, and is also near where the S&P 500 trades today (at around 19x earnings).

Based on these assumptions, we expect Ulta could command a final share price of just over $1,700 by 2033, as detailed below:

Ulta 10-Year Outlook

	Revenue ($ Billions)	Profit Margins	Net Income ($ Billions)	Share Count (Millions)	EPS	P/E Multiple	Share Price
2023	10.8	12.00%	1.30	49	26.45	16	$423
2024	10.8	12.00%	1.30	47.04	27.55	16	$441
2025	10.8	12.00%	1.30	45.16	28.70	16	$459
2026	11.7	12.25%	1.43	43.35	32.96	20	$659
2027	12.6	12.50%	1.57	41.62	37.84	20	$757
2028	13.6	12.75%	1.73	39.95	43.42	20	$868
2029	14.7	13.00%	1.91	38.36	49.80	20	$996
2030	15.9	13.25%	2.10	36.82	57.10	20	$1,142
2031	17.1	13.50%	2.31	35.35	65.45	20	$1,309
2032	18.5	13.75%	2.55	33.93	75.00	20	$1,500
2033	20.0	14.00%	2.80	32.58	85.91	20	$1,718

A share price of $1,700 in 10 years would translate into a roughly 400% gain from current levels, or 15% compounded returns. This is a world-class investment result that we believe comes with a high margin of safety. And it could prove conservative if Ulta exceeds our estimates for sales growth, which we also believe is a likely outcome.

Plus, with the potential of introducing game-changing AI and AR technology, Ulta offers upside from a radical transformation of the beauty business in the years ahead. But even without this potential upside scenario, Ulta's existing business is a world-class enterprise that's delivered stellar returns over its history.

Since its IPO in 2007, Ulta has compounded investor capital at an incredible 22% annual rate. And even with its recent 25% decline, the company has delivered a 15% compound return for investors over the last decade.

Despite a near-term slowdown in consumer spending, Ulta's profitability, capital efficiency, and competitive position have never looked better.

Ulta's management team has a long history of making savvy investments and striking the right deals with the right partners. And it has acted as tremendous stewards of shareholder capital, including maintaining a pristine balance sheet with zero net debt.

Ulta is a perfect example of the capital efficient "forever stocks" we believe investors can safely own, well, forever, if purchased at the right price. While its current share price offers compelling value, we believe patient investors could buy shares at an even more attractive valuation in the coming months.

The U.S. consumer faces extreme near-term headwinds, as inflation remains sticky and higher interest rates start to bite. With record credit card debt and the COVID-era stimulus savings evaporating, we expect consumer spending to contract sharply in 2024. While Ulta's business will likely prove more resilient than most, the company's share price will likely suffer from short-term volatility in this environment – just as it did in 2008.

Given this outlook, we're placing Ulta on the watch list today. We believe patient investors will be able to buy shares at pre-COVID levels of around $350.

Action to Take: Put Ulta Beauty (ULTA) on your watchlist to buy below $350 per share.

New to the Porter & Co. Portfolio? Start with Our Top 3 "Best Buys" Today

Our goal at Porter & Co. is to bring you world-class investment research, focused on "inevitable" businesses that you can buy and hold forever. This is the surest and safest path to building permanent wealth.

While we don't believe in timing the market, we do keep a constant eye out for bargains. In each edition of *The Big Secret on Wall Street*, we highlight three current portfolio picks that are at an attractive buy point. In addition to today's recommendation, we suggest you focus on these:

1. **PayPal (PYPL)** is one of the world's largest digital payment networks, originally founded as X.com by Elon Musk in 1998. PayPal became the largest and most trusted digital-payment option on auction site eBay and other online merchants in the late 1990s and early 2000s. PayPal was later spun out into a standalone company, and today is the most widely adopted payment option among the world's largest online merchants, with over 430 million users. The business is highly capital efficient, with 20% free cash flow margins. Misplaced fears of rising competition have caused shares to trade at their lowest valuation on record, at just 12x earnings. PayPal's unmatched payments ecosystem has created an enduring competitive advantage, allowing the company to maintain a double-digit growth rate in payment volumes and earnings per share. PayPal's high capital efficiency allows the company to return a lot of cash to shareholders, including a $5 billion buyback in 2023 – or 7% of its current market capitalization.

2. **Credit Acceptance Corp (CACC)** is a leading subprime auto lender, which we call the **Goldman Sachs of White Trash**. The business of making subprime loans isn't glamorous, but it's tremendously profitable and highly capital efficient. CACC has generated 68% free cash flow margins over the last three years and today trades at just 12x current year earnings. (It's at a buy point of $510 per share, or less than 18x earnings.) Shares have recently sold off on fears of a subprime auto-lending meltdown, but as we explained in a recent **portfolio update**, CACC is uniquely positioned to benefit from spiking default rates – and that's already showing up in its latest quarterly earnings report. With lending standards tightening and auto delinquencies on the rise, more consumers are entering the subprime category. This was confirmed last quarter as CACC's loan growth surged by 13%.

3. **Viper Energy Partners (VNOM)** is an oil and gas royalty company – the best business in the energy sector, and the **Secret Behind T. Boone's Fortune**. Unlike oil and gas producers, VNOM never invests any capital searching for oil

Porter & Co.

or drilling holes deep into the earth. It simply owns the land upon which other companies drill – and collects a percentage of the cash flow. That makes it one of most capital-efficient businesses you'll find anywhere, with 80% free cash flow margins. VNOM funnels its profits directly to shareholders, instead of back into the ground. VNOM currently trades at a 15% free cash flow yield – the best valuation since the depths of the COVID-19 pandemic. The company is returning capital to shareholders through a 5.1% dividend yield and a repurchase program that has reduced outstanding units by 12% over the last 18 months.

Portfolio Update

Today, we are adding a new section in *The Big Secret* Portfolio: Forever Stocks.

Forever stocks are companies that have such valuable brands and such timeless business models that it is hard to conceive of an environment where their businesses would underperform the S&P 500 for any material period of time.

These companies are more than merely "battleships," which are durable businesses with solid balance sheets and resilient profit streams, like discount retailer Winmark (WINA) or drugmaker Novo Nordisk. They are economic juggernauts with impenetrable competitive moats. These businesses do not face eventual extinction because of technological change, shifting consumer preferences, or fluctuations in the world's economy. They are as close to a "sure thing" as exists in the financial world.

These businesses are among the highest quality and offer the longest "runway" of any possible investment. We urge subscribers to buy these businesses aggressively **when they can be acquired at reasonable prices** — and to never sell these positions. Over time you should seek to see this section of your portfolio grow relative to all other portions.

The Big Secret on Wall Street PORTFOLIO

ENERGY & COMMODITIES	Ticker	Description	Purchase Date	Cost Basis	Closing Price	Yield	Income Received	Total Return	Status	Risk Rating (1 - 5)
EQT CORPORATION	EQT	U.S. Gas-Focused E&P	06-03-2022	$47.99	$41.53	1.25%	$0.75	-11.90%	Buy Under $50	4
TELLURIAN INC.	TELL	U.S. LNG Exporter	06-17-2022	$3.53	$1.30	0.00%	$0.00	-63.17%	Buy Under $5	5
VIPER ENERGY	VNOM	Oil and Gas Royalty	09-02-2022	$30.58	$28.52	5.05%	$1.67	-1.28%	Buy Under $34	3
BWX TECHNOLOGIES, INC.	BWXT	Nuclear Power Equipment	12-23-2022	$58.24	$74.82	1.23%	$0.69	29.65%	Buy Under $80	3
BLACK STONE MINERALS	BSM	Oil and Gas Royalty	02-17-2023	$15.90	$17.34	11.07%	$0.48	12.04%	Buy Under $18	2
AMERIGO RESOURCES	ARREF	Base Metals	03-31-2023	$1.21	$1.03	7.77%	$0.02	-13.22%	Buy Under $1.35	4
BITCOIN	BTCUSD	Cryptocurrency	05-12-2023	$27,179.90	$26,421.60	0.00%	$0.00	-2.79%	Buy Under $35,000	4
PEABODY ENERGY	BTU	Coal Mining	06-23-2023	$20.69	$24.01	1.25%	$0.00	16.05%	Buy Under $25	4
BATTLESHIP STOCKS										
CREDIT ACCEPTANCE CORP	CACC	Consumer Finance	07-29-2022	$575.91	$504.17	0.00%	$0.00	-12.46%	Buy Under $600	3
NOVO NORDISK	NVO	Pharmaceuticals	10-28-2022	$106.67	$190.43	1.86%	$2.07	80.47%	Hold	2
WINMARK CORPORATION	WINA	Specialty Apparel Stores	09-16-2022	$218.96	$384.29	0.83%	$6.00	78.25%	Hold	1
FRANCO-NEVADA CORP	FNV	Precious Metals Streamer	05-12-2023	$154.74	$143.87	0.95%	$0.34	-6.80%	Buy Under $170	2
DREAM FINDERS HOMES, INC.	DFH	Homebuilder	04-28-2023	$14.83	$24.03	0.00%	$0.00	62.04%	Buy Under $30	4
FOREVER STOCKS										
ALTRIA	MO	Tobacco Maker	07-15-2022	$42.24	$43.53	9.01%	$3.76	11.96%	Buy Under $50	1
PHILIP MORRIS	PM	Tobacco Maker	07-15-2022	$90.18	$95.79	5.43%	$5.08	11.85%	Buy Under $100	1
DOMINO'S PIZZAS INC	DPZ	Restaurants	02-27-2023	$300.00	$388.48	1.13%	$1.21	29.90%	Hold	3
PAYPAL	PYPL	Payment Processor	07-21-2023	$73.02	$64.21	0.00%	$0.00	-12.07%	Buy Under $90	3
DEERE & COMPANY	DE	Agricultural Machinery	09-01-2023	$410.94	$412.11	1.21%	$0.00	0.28%	Buy Under $450	3
INCOME & DISTRESSED DEBT										
MICROSTRATEGY INC	CUSIP: 594972AC5	2025 Convertible Bond	10-14-2022	$758.00	$1,129.98	0.66%	$7.50	50.06%	Hold	4
QURATE RETAIL, INC.	QRTEP	8% Cumulative Preferred Stock	01-20-2023	$40.64	$33.24	24.07%	$6.00	-3.44%	Buy Under $50	3
ANNALY CAPITAL MANAGEMENT	NLY	Real Estate Investment Trust	02-03-2023	$23.75	$20.57	17.11%	$1.30	-7.92%	Buy Under $24	2
SABA CAPITAL & INCOME OPPORTUNITIES FUND	BRW	High Yield Bond Fund	03-17-2023	$8.07	$7.79	13.09%	$0.43	1.87%	Buy Under $9	3
OAKTREE SPECIALTY LENDING CORP	OCSL	Specialty Investments	03-31-2023	$18.57	$20.16	10.91%	$0.55	11.52%	Buy Under $22	2
PROPERTY & CASUALTY INSURANCE										
W.R. BERKLEY	WRB	P&C Insurance	05-26-2023	$56.10	$64.12	0.62%	$0.00	14.30%	Buy Under $62	2
PROGRESSIVE CORPORATION	PGR	P&C Insurance	06-09-2023	$131.08	$138.74	0.29%	$0.10	5.92%	Buy Under $160	2
CHUBB LIMITED	CB	P&C Insurance	06-09-2023	$191.63	$212.20	0.19%	$0.86	11.18%	Buy Under $220	2
SKYWARD SPECIALTY	SKWD	P&C Insurance	06-17-2023	$24.66	$25.78	0.00%	$0.00	4.54%	Buy Under $35	2
BETTER THAN THE MARKET										
CAMBRIA SHAREHOLDER YIELD	SYLD	Yield Focused ETF	01-06-2023	$61.22	$62.73	2.47%	$0.87	3.89%	Buy Under $65	2
WATCHLIST										
NVR, INC.	NVR	Homebuilder	NA	-	$6,076.59	0.00%	-		Buy Under $3,500	
FREEPORT-MCMORAN	FCX	Base Metals	NA	-	$40.37	1.49%	-		Waiting For Recession	
SOUTHERN COPPER CORP	SCCO	Base Metals	NA	-	$79.77	3.76%	-		Waiting For Recession	
SHERWIN-WILLIAMS	SHW	Specialty Chemicals	NA	-	$261.63	3.70%	-		Buy Under $150	
ULTA BEAUTY	ULTA	Specialty Retail	NA	-	$413.57	0.00%	-		Buy Under $350	
HALL OF SHAME										
ICAHN ENTERPRISES	IEP	Specialty Investments	12-09-2022	$50.39	$20.25	39.51%	$4.00	-51.88%	Sell	
ALTISOURCE ASSET MANAGEMENT	AAMC	Asset Management	07-07-2023	$58.00	$10.02	0.00%	$0.00	-82.72%	Sell	

Big Data Could Make PayPal One of the Biggest AI Winners

Global payments provider PayPal is making a big push into AI.

On August 28, PayPal's chief product officer John Kim spoke with the Associated Press about the company's new AI initiatives. He noted that PayPal plans on introducing three new products with AI capabilities in the next 120 days. These include new checkout tools that will help PayPal more accurately detect unusual purchase patterns to spot and stop fraudulent activity. In the interview, Kim explained how this works:

> *"We currently try to detect unusual patterns – for example, patterns where fraudsters are trying to test your stolen card out to see if it's good or not – and alert you through the PayPal wallet so you can get that card shut down with your bank quickly. But detecting these patterns can get really complicated, and the patterns can change on the fly, so AI we believe will help us anticipate these changes and keep us ahead."*

PayPal isn't a late comer to the AI revolution. For more than two decades, PayPal has used machine learning (a branch of AI that uses data and algorithms to imitate the way human brains learn through trial and error) in its fraud-detection algorithms. Since AI algorithms constantly learn and adapt with incoming data, the two limiting factors on their utility include 1) the richness of data fed into the AI algorithm and 2) the computer chips powering the AI algorithms.

The processing power of the latest semiconductor chips, like NVIDIA's H100, have unlocked a revolution in data processing abilities. Now, the biggest beneficiaries of this revolution in AI processing power will be those companies with the richest data sets to mine.

As we described in the original PayPal recommendation, the company has a two-fold data advantage over its peers. First, it has the longest history of customer transactions among all online payment providers. This provides the richest set of historical data used for comparing today's transactions against previous activity.

Second, PayPal's two-sided payment network provides an unmatched data set that spans both the consumer and merchant side of the transaction. Conversely, PayPal's peers that lack this two-sided network only capture data from one side of each transaction.

PayPal is now feeding this rich transaction data into its high-powered AI algorithms to improve its already best-in-class fraud detection capabilities. In the company's Q2 2023 earnings call, management explained:

> *"We capture 100% of the data flows, which really is feeding our AI engines... it's fueling our ability to have best-in-class authorization rates in the industry, and the lowest loss rates in the industry."*

Merchants foot the bill for fraudulent transactions, and it's one of their key costs when doing business online. PayPal's best-in-class fraud fighting algorithms have made it the most widely used payment processor among the largest global online merchants. It's also why PayPal can charge some of the highest transaction fees in the industry. The revolution in AI computing power will make PayPal one of the biggest winners, by advancing its already-superior fraud protection capabilities.

We continue to recommend that investors buy shares of PayPal (PYPL) up to $90 per share.

Novo Nordisk Stock Split Coming Next Week

On September 20, drugmaker Novo Nordisk (NVO) will perform a 2-for-1 stock split, meaning for every share of Novo you own, you will receive an additional share. This will result in a halving of the share price next Wednesday, September 20. Importantly, the stock split will not change the value of your existing investment. You will own twice as many shares at half of the pre-split price.

Companies often perform a stock split after a significant increase in their share price. Novo shares have nearly doubled over the last year, and are up 83% since our **original recommendation last October**. The company's blockbuster GLP-1 drugs have fueled tremendous growth in sales and profitability, propelling its share price to new record highs. In the next publication of *The Big Secret on Wall Street* on September 29, we will provide a full update on the company's latest developments.

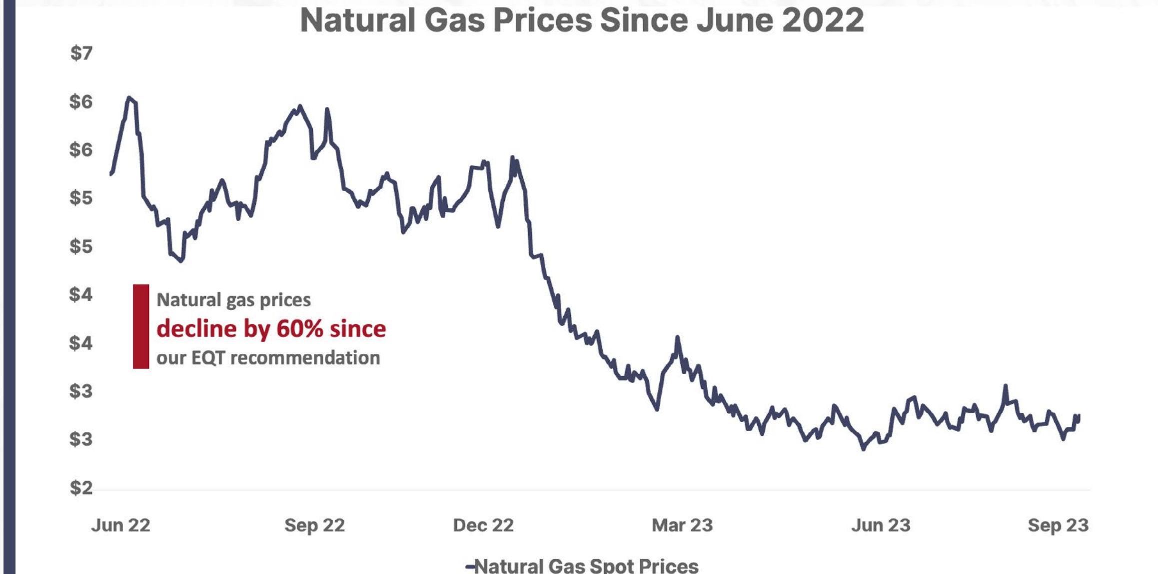
Mailbag

In *The Big Secret on Wall Street* mailbag, Porter answers letters from readers. He cannot offer individual investment advice, but can respond to general questions.

Please email us at **mailbag@porterandcompanyresearch.com** to have your questions answered. We'd love to hear from you!

Today's first letter is from D.S., who writes:

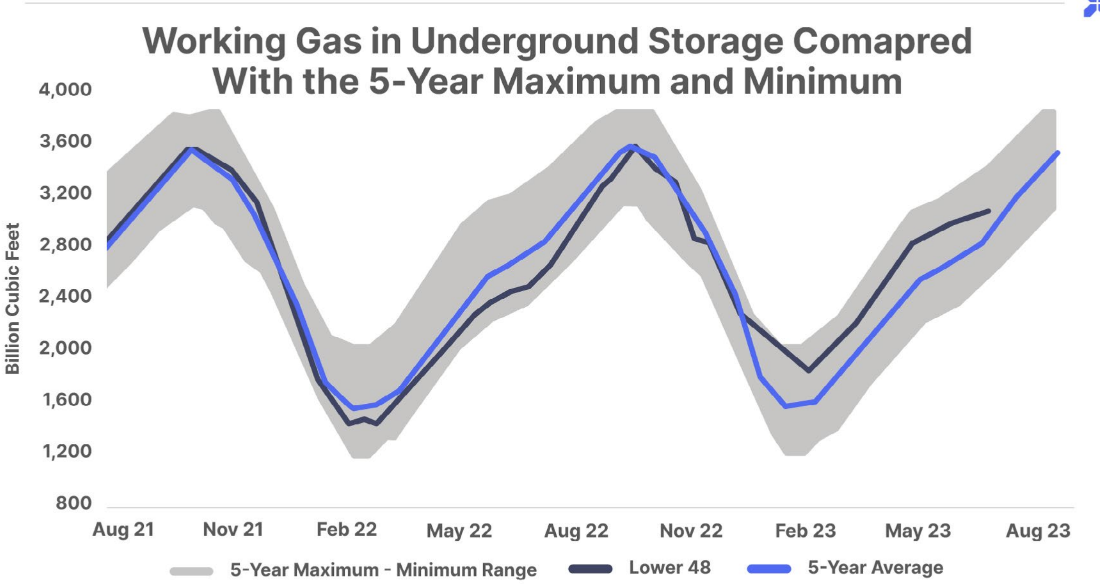
> *Why do "The Gods of Gas" appear to be going nowhere?*
>
> ***Porter: I can't know for certain.***
>
> ***Shares of EQT haven't done much since our recommendation. At around $43, we're down roughly 10% on the position to date. If I were going to guess why shares of EQT have underperformed, I would say:***
>
> ***Because the commodity it produces (natural gas) has declined in price by 30% this year and by about 60% since our recommendation.***



Source: Bloomberg

Why is natural gas down so much?

Because we had record warmth across much of the country last winter, and one of the gulf coast's major export facilities was shut down (because of fire). As a result, the natural-gas supply has been higher than normal, peaking at nearly 20% more gas in storage versus the five-year average earlier this year. However, the market is in the process of balancing, with the surplus shrinking to just over 7% above the five-year average currently:



Source: U.S Energy Information Administration

Does this change our thesis about the company? Not at all. We recommended EQT because it's the largest U.S. natural-gas producer with a huge amount of acreage in the biggest U.S. gas field (the Marcellus). And, while there's no question that lower gas prices aren't great for EQT, the company is led by the best management team in the industry. It hedges enough of its production to make sure that it can remain profitable even with these low gas prices.

Over the last 12 months, EQT produced $5 billion in operating income, which even after $1.6 billion in capital expenditures still produces excellent cash profits for shareholders and $3.5 billion in GAAP earnings. Free cash flow was almost $1 billion. And the company bought back $400 million worth of stock and paid $218 million in dividends... for a combined $618 million in payments to shareholders.

> ***At $43 per share, EQT's market value is $17 billion.***
> ***So… even in a bad year for its commodity price… the company still earned 20% of its market value (GAAP accounting). Or, said another way, the company is trading at 5x earnings.***
>
> ***I don't know for certain what natural gas prices will do in the future. And I don't know for certain what EQT's share price will do either.***
>
> ***But, as I've told all of the subscribers, my bet is that the world is going to need a lot more energy in the future, and, because EQT is one of the largest and most efficient producers of natural gas in the world, I suspect that its earnings (and thus, eventually, its stock) should perform very well.***
>
> ***Hope that helps***

The next letter comes from H.J., who writes:

> *First let me thank you for the services you are providing. I am honored to be part of a clientele that supports someone with the traditional values of a true American and more importantly, one who has the courage to speak his mind in these troubling times. Again, thank you very much for that!*
>
> *My question is this: In one of your papers, you suggest that nuclear microreactors will revolutionize the energy grid of the world. I agree. In several other papers, you recommend investment in LNG [liquid natural gas] – particularly EQT. How will we know when to get out of traditional oil, gas, and energy and go all-in on the nuclear play? While I think I understand the macro picture, the timing of moving from one to another is unclear. I'm investing in both at the present time as you recommend. It just seems that once the microreactors really take off, traditional oil and gas stocks will drop like a rock, and I don't want to be caught out!*
>
> ***Porter: Thanks for supporting our work.***
>
> ***Energy transitions take decades… so these aren't going to happen overnight.***
>
> ***My working hypothesis is that we will see natural gas replace coal as the most common source of base-load electrical power in many or most countries over the next 25 years.***
>
> ***What the future holds for microreactors is far more uncertain, but the range of applications is enormous. I doubt they will be used for base-load power for entire electrical grids. I think they'll be used for targeted applications like***

> ***specific developments or specific industrial areas – military bases, etc. I think it's likely that both of these forms of energy production will grow together.***
>
> ***We'll see.***

Porter & Co.

Stevenson, MD

P.S. If you'd like to learn more about the Porter & Co. team – all of whom are real humans, and many of whom have X (formerly Twitter) accounts – you can get acquainted with us **here**. You can reach me (Porter) personally via:

@porterstansb