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THE BIG SECRET ON WALL STREET

Shale Boom 2.0: This Time, It's Capital Efficient

- Less Gas, More Cash
- A "Forever Commodity Stock" with 17% Free Cash Flow Yield

FROM THE DESK OF PORTER STANSBERRY

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#34

Shale Boom 2.0: This Time, It's Capital Efficient

Less Gas, More Cash

A "Forever Commodity Stock" with 17% Free Cash Flow Yield

The coroner could only identify him by his teeth.

The Chevrolet Tahoe had slammed into a concrete overpass in Oklahoma City at 88 miles an hour… and the driver's body was charred beyond recognition. But the corpse's pearly whites were miraculously intact. Two days after the fiery crash in March 2016, a forensic odontologist dug through dental records to come up with a name: Aubrey McClendon.

To many Oklahomans – and others – the name sparked a double take. Wait, what… that Aubrey McClendon? The civic-minded oil baron who donated generously to local charities… was inducted into the Oklahoma Heritage Foundation's Hall of Fame… was a wine connoisseur with a 100,000-bottle collection… and owned 20% of the NBA's Oklahoma City Thunder franchise?

And also… the Aubrey McClendon who'd just been indicted for conspiracy by a federal grand jury?

Yep, *that* guy. All of the above.

The 56-year-old McClendon – who'd made a multibillion-dollar fortune in the Texas and Oklahoma oil fields during the early-2000s shale boom – had privately been unraveling for quite some time…

The company he co-founded in 1989, Chesapeake Energy, was an early pioneer of the hydraulic fracturing (fracking) and horizontal drilling techniques that launched the shale revolution. By 2005, Chesapeake was the second-largest natural gas producer in America, after ExxonMobil.

The success of Chesapeake earned McClendon a spot on the *Forbes* billionaire list that year. And then he got greedy: He started using Chesapeake's oil wells as a personal piggy bank.

He awarded cushy board positions to his close friends – who, in turn, voted to pay him the highest salary of any S&P 500 CEO: $112 million. He and his family flew around in company-owned private jets, funneled millions of dollars of catering for Chesapeake corporate events to a McClendon-owned restaurant franchise, and commandeered an entire division of Chesapeake to work on the family's personal home renovations.

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And when McClendon needed a little extra spending money, he convinced his compliant board to buy his antique-map collection for $12 million.

Even more concerning, a 2012 Reuters exposé revealed that he'd "operated a secretive, $200 million hedge fund from inside Chesapeake's offices, and received as much as $1.4 billion in loans against his well interests."

McClendon's self-dealing was so flagrant that even his hand-picked board couldn't overlook it. After the Reuters story came to light, the directors removed McClendon as chairman. (He stayed on as CEO for another year before resigning to start a new company, American Energy Partners.)

And then there was the conspiracy…

During the heyday of his Chesapeake years – around 2007, with the company's market valuation headed to all-time highs of $38 billion – McClendon reportedly colluded with other large oil and gas companies to keep Oklahoma land prices low… giving a new meaning to the term "oil rig".

One of the biggest problems with the shale boom was the flood of capital that bid up drillable acreage to unsustainable prices. High land costs meant shale economics could never work – companies wouldn't make enough money from drilling to offset the price of the real estate.

McClendon – eager to stay on the billionaire list – had a devilishly ingenious solution: artificially suppress the prices landowners could get at auctions during the peak boom period.

His method was simple: email his old buddy Tom Ward, the head of "rival" company SandRidge Energy. McClendon suggested that the two of them decide in advance who would win land auctions, and then the "winner" would parcel out an interest in the land to the "loser." He also emailed other companies suggesting similar deals, with comments like, "Should we throw in 50/50 together here rather than trying to bash each other's brains out on lease buying?"

A few years later, those emails would come back to frack things up for Aubrey McClendon.

Before then, though, the market did him in. An oil and gas glut sent prices sharply lower in 2014… and Aubrey's billion-dollar net worth was cut in half in a matter of months. His former company, Chesapeake Energy, which had racked up a $20 billion debt load under his leadership, saw its valuation plummet from a peak of $38 billion to less than $3 billion.

His next project, American Energy Partners, started hemorrhaging money, too. As big investors backed away from the privately-traded company, McClendon tapped into personal investments and called in favors to keep the company afloat. He even

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put up as collateral – and lost – the oil wells he'd retained as a legacy interest when leaving Chesapeake.

And in March 2016 – after a four-year investigation sparked by the 2012 Reuters piece – the Department of Justice ("DOJ") was ready to pounce.

The DOJ alleged that McClendon's bid-rigging antics had violated the Sherman Antitrust Act, a piece of 1890s legislation designed to break up unfair monopolies. "Executives who abuse their positions as leaders of major corporations to organize criminal activity must be held accountable for their actions," the Assistant Attorney General said in a statement announcing McClendon's March 2016 criminal indictment.

There was no friendly board to help him out of this one. The DOJ was pushing for hard time – up to 10 years.

So McClendon skipped a private dinner at Oklahoma City's ritzy Beacon Club... and disappeared in his silver Chevy Tahoe.

And a few days later, his only identifying feature was his teeth.

Aubrey McClendon's final hours remain a mystery. The autopsy showed that he'd taken the sedative drug Doxylamine and steered his SUV onto the highway at 9 am, the day after his indictment – without his seatbelt fastened. An Oklahoma City Police spokesman reported, "He pretty much drove straight into the wall... There was plenty of opportunity for him to correct and get back on the roadway, and that didn't occur."

The medical examiner ruled the death an accident, but it's not clear what really happened. We may never know if a drugged McClendon fell asleep at the wheel, took his eyes off the road... or drove into that wall on purpose.

It was an unsettling end to a life Reuters called "lavish and leveraged."

And it summed up everything that went wrong for investors during America's wild, debt-fueled shale boom.

Energy's Lost Decade

The decades-long shale boom established U.S. energy independence, pushed down prices for hundreds of millions of energy consumers, and was an economic boon to huge swathes of America.

But despite these benefits for society at large, shale was an unmitigated disaster for investors. It turned energy from one of the best-performing sectors in the stock market to its worst.

From 2010 to 2019, U.S.-listed energy stocks overall suffered their first "lost decade" in history, falling by 35%, even as U.S. energy production soared to record highs:

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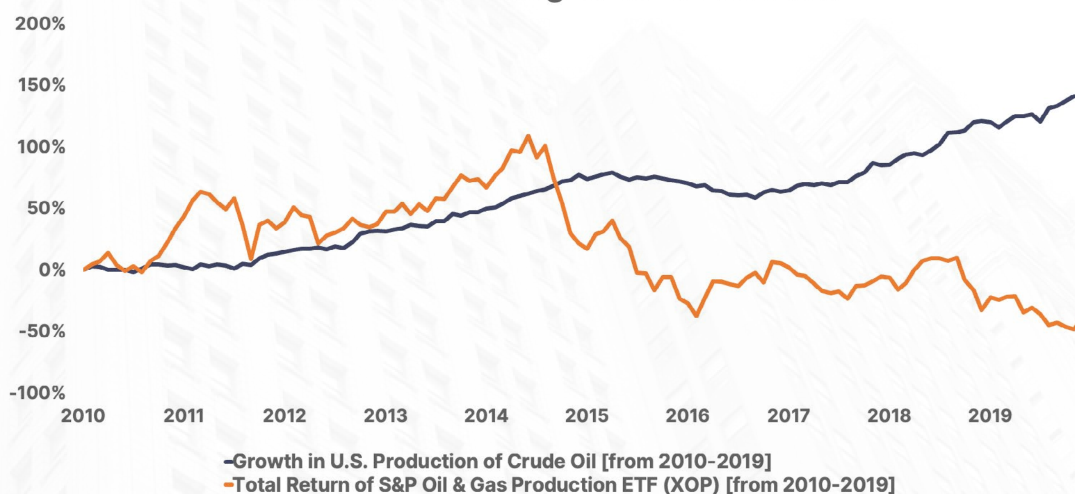

During the boom, shale CEOs touted their advancement of new fracking technologies and horizontal drilling. On the surface, the blockbuster production results of new shale wells blew away their conventional well counterparts – with the hope of generating future cash flow. But most of these prolific new shale wells never led to profits for investors. In reality, the production gains of the shale revolution came from pouring more money into the ground – and not getting enough back out. As the ***Wall Street Journal*** **explained in 2018**:

> *"Shale companies' profitability may also be threatened by rising costs for the immense amounts of sand and water needed for fracking. Modern fracking jobs now require 500 tons of steel pipe, enough water to fill 35 Olympic swimming pools, and enough rail cars filled with sand to stretch for 14 football fields, according to Rice University's Center for Energy Studies."*

And while overzealous CEOs like Aubrey McClendon deserve much of the blame, corporate greed didn't suddenly spring to life in the energy sector over the last decade. The new feature that did appear was the zero percent interest rate policy ("ZIRP") from the U.S. Federal Reserve.

More than anything else, cheap money fueled the shale revolution.

The ZIRP era of the last decade allowed shale drillers to raise hundreds of billions in cheap capital. Investors could no longer earn a safe yield from traditional fixed-income investments. The shale sector provided an outlet for billions of investor capital searching for a hot new growth sector. The flood of cheap money allowed companies like Chesapeake to raise new debt to plug the shortfalls in their cash flow statements.

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Shale drillers were given a greenlight to bid up the costs of land, labor, and drilling equipment in the ravenous pursuit of production growth. Cheap money papered over the supply-and-demand balancing act that would have otherwise kept the sector in check. Even when prices collapsed from oversupply, the industry continued spending with reckless abandon.

From 2014 to 2016, excess shale production oversupplied the market and sent oil and gas prices to multi-decade lows. Normally, this kind of price collapse would have caused a sharp pullback in capital spending. But the ZIRP era kept cheap money flowing, and the shale boom continued.

Consider the price of land in the Permian's Delaware shale oil basin from 2014 to 2016. Despite oil prices dropping from over $100 per barrel to less than $30, shale drillers bid up land prices from $3,000 per acre to as high as $48,000 per acre.

After a blip down in production from 2015 to 2016, shale producers went on to post record highs in production in 2017… followed by a record 30% growth in the two-year stretch from 2018 to 2019. Eventually, the combination of soaring input costs and depressed prices wreaked havoc on the sector's financial performance.

As the calendar turned on the first decade of the shale revolution, a record amount of capital had been destroyed in the energy sector. One study from consultancy firm Deloitte summarized the dismal outcome for energy investors over those 10 years:

> *"The U.S. shale industry registered net negative free cash flows of $300 billion, impaired more than $450 billion of invested capital, and saw more than 190 bankruptcies since 2010."*

It was one of the few cases where the Federal Reserve's cheap-money policies stole from the rich and gave to the poor. The losses sustained by shale investors provided a decade-long subsidy of artificially cheap energy for American consumers.

But now, that's all changed.

The Rise of Shale 2.0

The rise in interest rates has ended the cheap money era, helping restore a more rational allocation of capital in the energy sector. And today's energy investors have demanded an end to the previous regime of profitless production growth. This has unleashed the new era of Shale 2.0, where capital discipline and shareholder returns have become paramount. Investors are reaping the benefits, as the shale industry has begun to record positive free cash flows in recent years:

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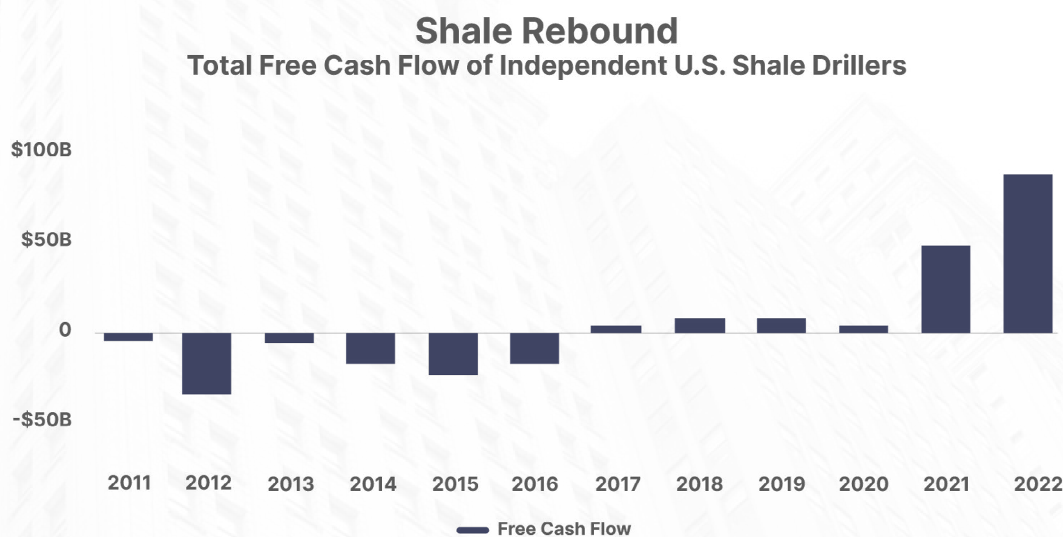

Source: Bloomberg Intelligence

This renewed focus on capital discipline has provided an uplift for energy companies across the board. But one company in particular is best positioned to win in this new era of Shale 2.0.

The company is led by the man who literally wrote the book on capital allocation – William Thorndike Jr., author of *The Outsiders: Eight Unconventional CEOs and Their Radically Rational Blueprint for Success*.

We **previously wrote** about one of the Outsiders that Thorndike profiles in his book – John Malone, America's greatest CEO. These Outsiders came from a range of industries, but they all shared a laser focus on capital allocation to drive world-class shareholder returns during their tenure.

Well ahead of the rest of the gas industry, Thorndike applied the Outsider playbook to America's shale patch. Over the last three years, the company Thorndike oversees has become one of the industry's most consistent cash generators.

Instilling Discipline in a World of Chaos

In May 2016, William Thorndike Jr. became chairman of natural gas and coal producer Consol Resources. Thorndike brought decades of experience as both a corporate leader and successful investor to CNX. He has served as a director of more than 30 companies, and also manages the private equity investment firm Housatonic Partners, which he founded in 1994.

Consol was formed as a coal mining company in 1860. In 2010, Consol acquired the natural gas assets of Dominion Resources, which included over 1 million acres in the heart of the Appalachian shale basin.

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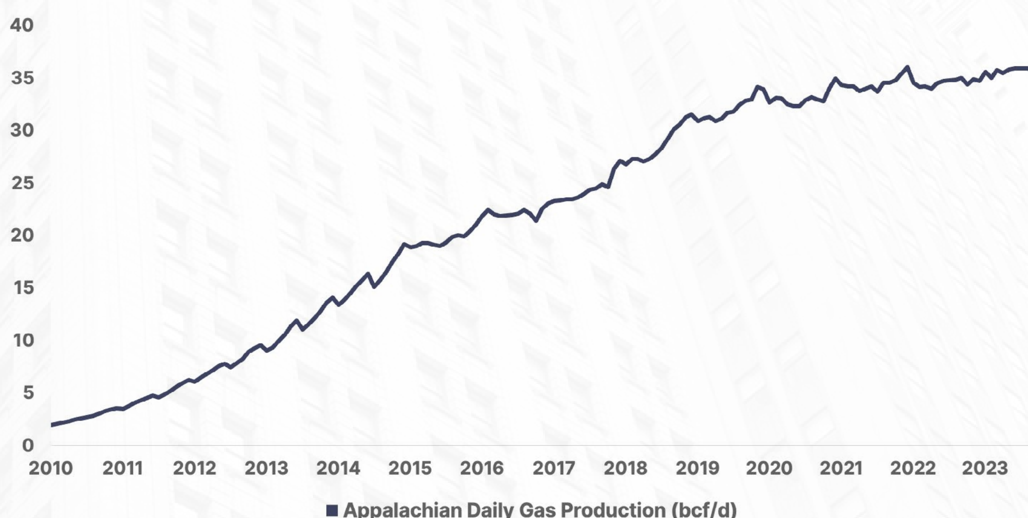
The Appalachian basin hosts the prolific Marcellus and Utica shale gas formations. Before the commercialization of technologies like hydraulic fracturing and horizontal drilling, the Marcellus and Utica gas reserves were inaccessible. But the shale revolution transformed Appalachia into the Saudi Arabia of natural gas, making it America's largest source of low-cost gas supply. Since 2010, shale drillers have unlocked an incredible 30 billion cubic feet per day (bcf/d) of gas production in the basin, or roughly one-third of total U.S. gas production.



Source: Bloomberg

But Consol and its Appalachian peers became victims of this rapid production growth. As U.S. gas production surged from 2010 to 2014, supply overwhelmed demand, and prices plunged. By 2016, U.S. natural gas prices fell below $2 per thousand cubic feet (mcf) – the lowest level in over two decades. Meanwhile, the shale investment boom pushed up the costs of production. Even the lowest-cost producers, including Consol, burned through billions of dollars in cash each year.

Following his 2016 appointment as chairman of the board, Thorndike began a multi-year process of restructuring Consol's business and capital allocation strategy.

Thorndike's first move was to separate Consol's legacy coal operations from the shale gas business. In 2017, Consol spun off its coal segment into CONSOL Energy (CEIX), and renamed the parent company CNX Resources (CNX). The spinoff transformed CNX into a pure-play Appalachian gas producer, with 531,000 acres in the Marcellus shale and 609,000 acres in the Utica formation.

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Cutting Out the Middlemen

Next, Thorndike began securing control of midstream infrastructure for CNX. Midstream assets include the pipeline and processing infrastructure that enable the movement of oil and gas from the wellhead (upstream) to end consumers (downstream). To fully understand the value of Thorndike's midstream strategy, let's first review how most exploration and production companies (E&Ps) approach this critical part of the business.

During the shale boom, most E&Ps outsourced midstream services to third parties. This approach reflected the "growth over profitability" mindset of the Shale 1.0 era. Shale drillers happily paid third-party midstream providers, because it freed up their capital budgets to drill more wells, instead of building pipelines. But this strategy ultimately backfired in Appalachia.

As Appalachian production surged 10-fold from 2010 to 2014, midstream infrastructure failed to keep pace. With production overwhelming pipeline capacity, Appalachian producers couldn't get their gas to market. This created a glut of gas trapped within the Appalachian basin, pushing local prices well below Henry Hub (the benchmark price commonly referenced in the gas industry). By 2014, Appalachian producers were selling their gas at discounts of up to 50% of Henry Hub pricing.

This sparked a scramble among Appalachian producers to secure future pipeline capacity with midstream companies. New pipeline deals would ensure producers could get their gas to market, without taking substantial discounts from the limited supply of existing pipeline capacity. But before midstream companies sink capital into expensive pipeline infrastructure, general industry practice is to demand long-term "take or pay" volume commitments from the E&Ps. This means E&Ps must commit to future production growth to fill up the future midstream infrastructure, or else pay fees for unused capacity.

The sudden gas glut gave the middlemen leverage when negotiating midstream deals. As a result, over the past decade many Appalachian E&Ps have entered into expensive long-term contracts (typically 10 to 15 years). The volume commitments in these midstream deals also locked E&Ps into years of future production growth, regardless of gas prices.

Another Smart Play by CNX

CNX was one of the few Appalachian E&Ps that avoided these long-term tie-ups. In 2014, CNX began taking ownership of its own pipeline and processing infrastructure. CNX formed a 50/50 joint venture with fellow E&P Noble Energy, which owned acreage in the same area as CNX. The two companies formed the CONE Gathering master limited partnership (CONE MLP), which provided the majority of pipeline and gas processing infrastructure for CNX's Appalachian gas acreage.

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In an MLP structure, general partners (GPs) control the capital allocation of the partnership. Limited partners (LP) are passive investors who receive cash distributions from the MLP's earnings. From 2014 to 2017, Noble and CNX were 50/50 GP owners in the CONE MLP – meaning Noble and CNX had equal say in the capital allocation decisions of the midstream network.

Thorndike pushed the CNX board to secure 100% of GP ownership in the CONE MLP in order to fully control its midstream destiny. In December 2017, CNX acquired Nobel's 50% GP stake in the CONE MLP for $305 million and renamed the entity CNX Midstream Partners. Following this deal, CNX owned 100% of the GP interest in CNX Midstream and 53% of the LP units. The remaining 47% of the LP units were publicly traded.

Then, in an all-stock transaction in September 2020, CNX acquired the remaining 47% LP units in CNX Midstream. CNX exchanged 37 million shares, or about 17% of its total share count, for all remaining 42.1 million publicly held LP units of CNX Midstream. This represented a $357 million purchase price for assets that generated roughly $100 million in annual free cash flow, or a less-than 4x free cash flow multiple.

This bargain-basement valuation reflected the depression in prices for energy assets across the board following the COVID-19 outbreak.

The transaction brought 2,600 miles of natural gas pipelines and numerous processing facilities under CNX's full ownership, saving the company hundreds of millions of dollars each year in midstream fees. While some peers own minority stakes in their own midstream infrastructure, CNX is the only Applachian gas producer that controls virtually 100% of its pipeline and processing assets (it still uses third parties for a minority of midstream services performed outside of CNX Midstream's network).

Producing natural gas requires more than just drilling wells. Transporting and processing gas is a key expense that E&Ps must absorb, one way or another.

As CNX CFO Don Rush explained in a July 2020 conference call, eliminating the expense of third-party midstream services significantly reduced CNX's operating costs, making it the lowest-cost Appalachian gas producer today:

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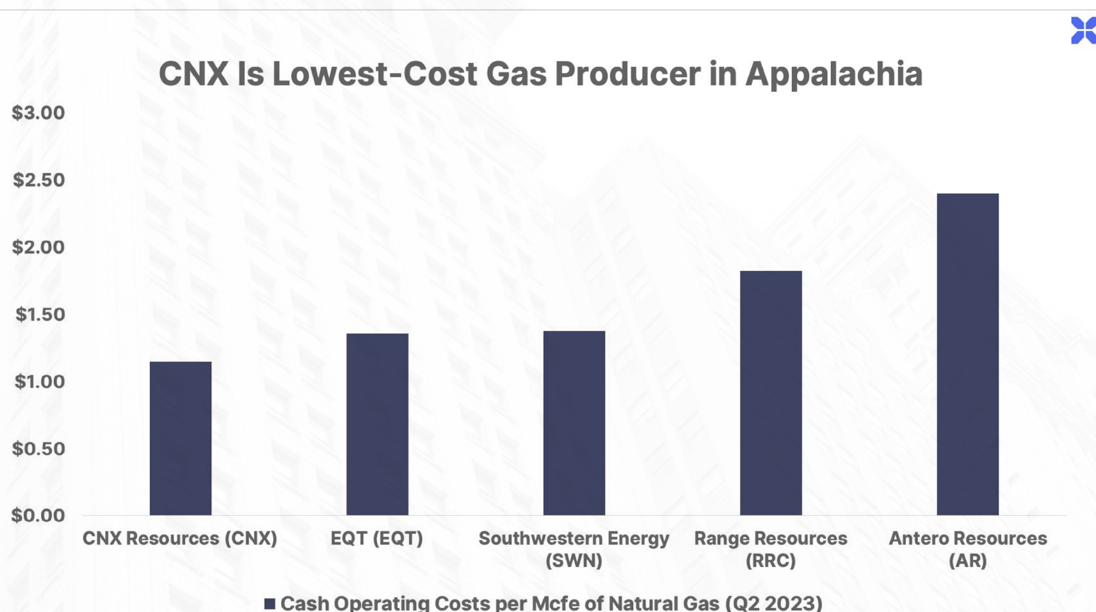

Note that CNX's closest peer on the cost curve is EQT, which we **first recommended** in *The Big Secret on Wall Street* in July 2022. Like CNX, EQT also transformed its business into a cash-flowing behemoth under new management in recent years (brothers Toby and Derek Rice, whom we dubbed the "Gods of Gas").

Lowering Costs through Operational Innovation

In addition to eliminating expensive midstream fees, CNX has also been a leader in driving costs down through operational improvements and innovation. This includes becoming the first of its Appalachian peers to invest in electric-powered hydraulic fracturing pumpers (frac pumpers), starting in 2018.

Frac pumpers inject fracking fluid (water based mixtures that contain sand and chemicals) into shale wells to release oil and gas from tight shale rocks. These shale-industry workhorses pump tens of thousands of gallons deep into the earth at pressures of up to 10,000 pounds per square inch. Traditional frac pumpers run on diesel motors that generate up to 5,000 horsepower (25x more powerful than the average car engine). The fuel consumed to power these supersized motors for the typical three-to-five-day fracking job makes up a significant cost of drilling each well.

In 2018, CNX partnered with oilfield service company Evolution Well Services to develop a 56,000-horsepower electric-powered fracturing fleet. The fleet runs on gas-powered turbine engines that generate electricity to power their motors. They're built to consume onsite natural gas that otherwise gets flared (i.e., burned off as excess waste gas).

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CNX's electric-powered frac fleets eliminate hundreds of gallons in fuel consumption per well. In June 2020, CNX reported saving $2.4 million in diesel fuel from a single Marcellus well pad – the RHL 99 – by using 140,000 mcf of onsite natural gas to fracture eight wells with its electric frac fleet. CNX estimates that it saves roughly $13 million a year in fuel costs from its electric frac fleet.

In addition to fuel savings, CNX's electric frac fleet also cuts back on labor needs and maintenance downtime. With no pistons or transmissions, electric motors operate with far fewer moving parts than traditional diesel engines. Evolution Well Services estimates that its electric frac fleets require 50% less manpower than a comparable diesel fleet.

CNX's Best-in-Class Hedging Program

CNX's focus on squeezing expenses from every angle of its business did more than make it the industry's low-cost leader. It also enabled CNX to implement a robust hedging program. CNX systematically hedges roughly 80% of its future gas production, even in bear markets, when prices fall into the mid-$2-per-mcf range. The company's rock-bottom cost structure allows it to lock in profits at these depressed prices.

CNX's higher-cost peers cannot justify hedging at similarly low prices, as that would mean locking in a guaranteed loss. This exposes CNX's peers to deeply negative cash flows during bear markets. These negative cash flows are often compounded by the need to grow production during low-price environments, as a result of midstream volume commitments.

As a result, most shale producers become victims of the commodity price cycle – overproducing when prices are low and not being positioned to protect their cash flows during downturns. Thorndike's long-running vision was to free CNX from the industry's erratic cash flow volatility. By securing control of the CNX's midstream assets, slashing costs, and systematically hedging production, he set the company up to generate stable cash flows through the price cycle.

It took several years for Thorndike's plan to work. But by 2020, all the pieces were in place for CNX to showcase its resilience through one of the worst commodity-price declines on record.

Appalachia's Most Consistent Cash Generator

In March 2020, the COVID-19 outbreak sent energy prices plunging as the global economy ground to a halt. Crude oil collapsed to lows of -$40 per barrel (yes, negative), and natural gas prices fell to multi-decade lows of around $1.50 per mcf.

On the company's Q1 2020 earnings call, CEO Nick Deluliis reviewed how the company's restructuring over the previous several years had positioned it to thrive amidst collapsing energy prices:

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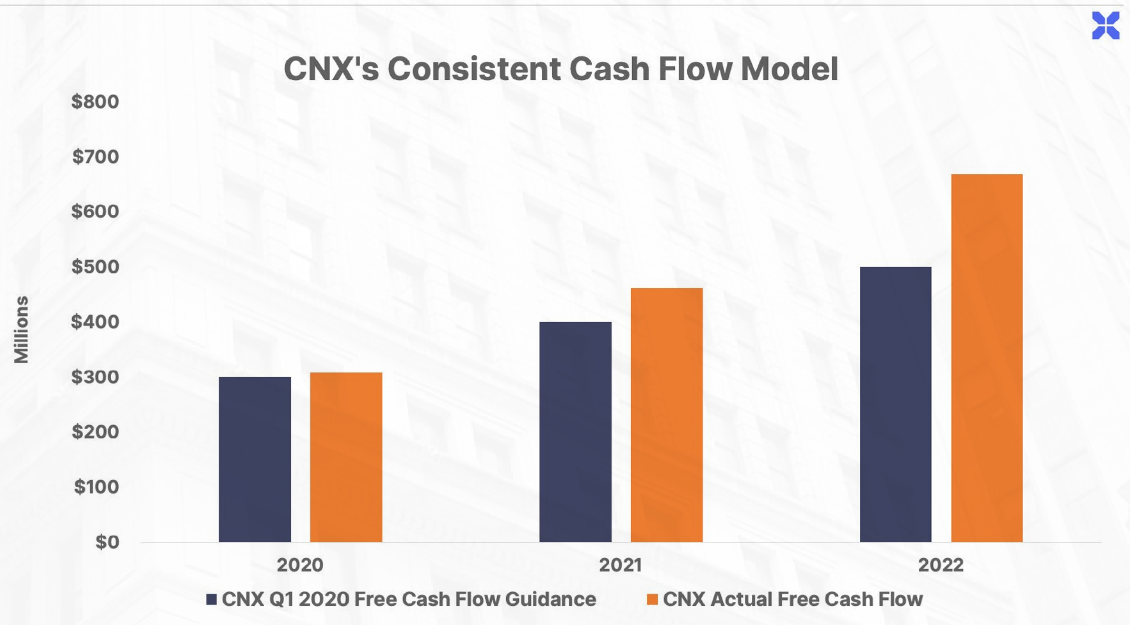
> *"We from day 1 were very wary of committing to long-term take-or-pay, onerous FTE [firm transport expense] that would hobble cash flows and the balance sheet. We reduced our overhead spend significantly before it was a necessity or too late. We were the first in-basin to adopt technology like electric frac fleets. We have been obsessing on being a low-cost producer for a number of years now. We realized the strategic importance of retaining control of our midstream assets."*

CNX responded to the price collapse by reducing production growth and slashing its capital expenditures to $500 million – down 60% from $1.2 billion in 2019.

Meanwhile, the company's hedging program allowed it to enter 2020 with 80% of its production hedged at $2.55 per mcf. As a result, CNX became the only Appalachian shale gas producer to generate positive free cash flow in every quarter of 2020. And the transformation of the business over the preceding years set the stage for CNX to become Appalachia's most consistent cash generator.

On that Q1 2020 earnings call, management outlined CNX's strategy for generating consistent cash flows going forward, regardless of price volatility. The company would continue hedging 80% of its production, and commit to holding production flat with minimal capital expenditures for as long as prices remain depressed. Only when prices rose to attractive levels would the company invest in production growth.

Management predicted that this plan would generate free cash flows of $300 million in 2020, $400 million in 2021, and $500 million in 2022 and beyond, regardless of natural gas price fluctuations. Despite extreme swings in gas prices since then, CNX has reliably met or exceeded this cash flow forecast:



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CNX is now one of the shale industry's most consistent cash generators. It's the only Appalachian gas producer with a perfect streak of positive free cash flow in every quarter since Q1 2020. The remarkable stability of its business is a testament to the Outsider playbook Thorndike instituted at CNX beginning in 2016.

As Thorndike said in a 2019 interview, a capital-allocation mindset can be a great source of competitive advantage. "Having the ability to be analytical and clear-eyed in… allocating capital at times, both of great industry distress and of great industry euphoria, I think can create an enormous amount of long-term value."

Taking Capital Allocation One Step Further

The final component of CNX's contrarian capital allocation approach lies in its share-buyback strategy. In the traditional E&P business model, most companies grow production through the commodity price cycle. But CNX's leadership saw no value in giving away its inventory when prices were low. Instead, the company invested in its own inventory during down cycles, through share repurchases.

On the surface, this may sound like a simple strategy that any of CNX's peers could replicate. But only CNX consistently has the free cash flow to put this plan into action. As the low-cost leader, and the only company with full control over its midstream assets, CNX can toggle its capital allocation between investing in growth during upcycles and in share repurchases during downcycles.

By reducing the number of shares outstanding, buybacks increase the ownership stake in the business among all shareholders. By reducing its share count during industry downturns, CNX enables investors to own a greater portion of future cash flows from the business when prices recover.

CNX became one of the first shale companies to implement an aggressive share-buyback program – starting in January 2018, when gas prices fell from $3 per mcf to around $2 by mid-2019. While CNX's Appalachian peers continued growing production by double-digit rates into the depressed price environment, CNX cut production growth to 6%. This freed up its cash to aggressively repurchase its discounted shares during the bear market. CNX reduced its share count by 20% from 2018 to 2019 as gas prices languished between $2 and $3 per mcf.

Since initiating its buyback program in 2018, CNX has reduced its total share count by nearly 30% – more than any of its Appalachian peers:

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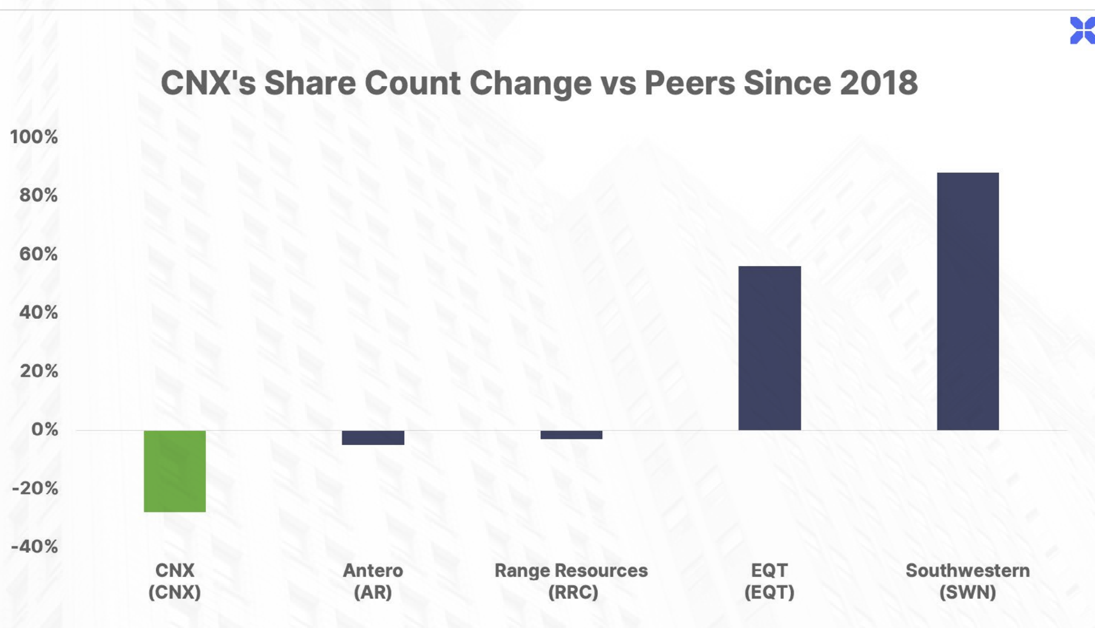

Looking ahead, CNX's unmatched cash flow consistency and contrarian approach to capital allocation positions it to win regardless of where gas prices go next.

The Closest Thing to a "Forever" Commodity Stock

CNX has generated $481 million in free cash flow over the last 12 months, in line with management's Q1 2020 forecast of $500 million in 2022 and beyond. Its current $2.9 billion market valuation reflects a 17% free cash flow yield, which is more than 3x the cash flow per share of the overall market, measured by the S&P 500.

Unlike many commodity producers, this rich cash-flow yield isn't a one-off feature of a cyclical upswing in prices. CNX is unmatched among its peers to generate steady free cash flows regardless if prices are up or down. The company's resilient business model is proving itself again in 2023's low-gas-price environment.

As we've written previously, the U.S. gas market is working through a storage glut created from record warmth across the globe last winter. With natural gas prices trading in a range of $2 to $3 in 2023, CNX's Appalachian peers have all recently dipped back into negative free cash flow.

CNX entered 2023 with 82% of its expected production volumes hedged, compared with 40% to 60% hedging among its peers. CNX's best-in-class downside protection, plus its low-cost operations, enabled it to become the only Appalachian E&P to generate consistently positive free cash flows in 2023.

As a result of its cash-flow consistency, the company significantly increased its share-buyback authorization by $1 billion in Q2 2023, for a total of nearly $1.3

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billion in potential future repurchases. At its $2.9 billion market capitalization, CNX's fully exercised buyback program could reduce its share count by nearly 50%.

Going forward, CNX is positioned to thrive regardless of where gas prices trade. In a low-price environment, CNX has the flexibility to lean heavily into share buybacks. And when prices recover, CNX can increase production to capture higher cash flows from an increase in volumes sold at higher prices.

In this way, the company remains positioned to boost its free cash flow on a per-share basis through the ups and downs of the commodity cycle. The company's enduring competitive advantage, created from Thorndike's masterful execution of the Outsider playbook, makes it the closest thing we've seen to a "forever stock" in a commodity business.

Action to Take: Buy CNX Resources (CNX) up to $30 per share.

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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 11x 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 8% 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 $467 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

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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 13% 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 roughly 12% over the last 18 months.

Portfolio Update

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	$40.44	1.25%	$0.75	-14.17%	Buy Under $50	4
TELLURIAN INC.	TELL	U.S. LNG Exporter	06-17-2022	$3.53	$1.16	0.00%	$0.00	-67.14%	Buy Under $5	5
VIPER ENERGY	VNOM	Oil and Gas Royalty	09-02-2022	$30.58	$28.40	5.07%	$1.67	-1.67%	Buy Under $34	3
BWX TECHNOLOGIES, INC.	BWXT	Nuclear Power Equipment	12-23-2022	$58.24	$75.06	1.23%	$0.69	30.07%	Buy Under $80	3
BLACK STONE MINERALS	BSM	Oil and Gas Royalty	02-17-2023	$15.90	$17.32	11.09%	$0.48	11.92%	Buy Under $18	2
AMERIGO RESOURCES	ARREF	Base Metals	03-31-2023	$1.21	$0.94	8.51%	$0.04	-19.01%	Buy Under $1.35	4
BITCOIN	BTCUSD	Cryptocurrency	05-12-2023	$27,179.90	$27,127.90	0.00%	$0.00	-0.19%	Buy Under $35,000	4
PEABODY ENERGY	BTU	Coal Mining	06-23-2023	$20.69	$25.66	1.17%	$0.00	24.02%	Buy Under $25	4
CNX RESOURCES	CNX	U.S. Gas-Focused E&P	09-29-2023	$22.82	$22.82	0.00%	$0.00		Buy Under $30	3
BATTLESHIP STOCKS										
CREDIT ACCEPTANCE CORP	CACC	Consumer Finance	07-29-2022	$575.91	$466.74	0.00%	$0.00	-18.96%	Buy Under $600	3
NOVO NORDISK	NVO	Pharmaceuticals	10-28-2022	$53.34	$91.52	3.86%	$2.07	75.48%	Hold	2
WINMARK CORPORATION	WINA	Specialty Apparel Stores	09-16-2022	$218.96	$384.96	0.83%	$6.00	78.55%	Hold	1
FRANCO-NEVADA CORP	FNV	Precious Metals Streamer	05-12-2023	$154.74	$133.83	1.02%	$0.68	-13.07%	Buy Under $170	2
DREAM FINDERS HOMES, INC.	DFH	Homebuilder	04-28-2023	$14.83	$22.37	0.00%	$0.00	50.84%	Buy Under $30	4
FOREVER STOCKS										
ALTRIA	MO	Tobacco Maker	07-15-2022	$42.24	$42.14	9.30%	$3.76	8.66%	Buy Under $50	1
PHILIP MORRIS	PM	Tobacco Maker	07-15-2022	$90.18	$93.05	5.59%	$5.08	8.82%	Buy Under $100	1
DOMINO'S PIZZAS INC	DPZ	Restaurants	02-27-2023	$300.00	$382.31	1.15%	$2.42	28.24%	Hold	3
PAYPAL	PYPL	Payment Processor	07-21-2023	$73.02	$58.18	0.00%	$0.00	-20.32%	Buy Under $90	3
DEERE & COMPANY	DE	Agricultural Machinery	09-01-2023	$410.94	$384.73	1.30%	$0.00	-6.38%	Buy Under $450	3
INCOME & DISTRESSED DEBT										
MICROSTRATEGY INC	CUSIP: 594972AC5	2025 Convertible Bond	10-14-2022	$758.00	$1,056.75	0.71%	$7.50	40.40%	Hold	4
QURATE RETAIL, INC.	QRTEP	8% Cumulative Preferred Stock	01-20-2023	$40.64	$28.99	27.60%	$6.00	-13.90%	Buy Under $50	3
ANNALY CAPITAL MANAGEMENT	NLY	Real Estate Investment Trust	02-03-2023	$23.75	$18.74	18.78%	$1.30	-15.62%	Buy Under $24	2
SABA CAPITAL & INCOME OPPORTUNITIES FUND	BRW	High Yield Bond Fund	03-17-2023	$8.07	$7.72	13.21%	$0.52	2.06%	Buy Under $9	3
OAKTREE SPECIALTY LENDING CORP	OCSL	Specialty Investments	03-31-2023	$18.57	$19.98	11.01%	$1.10	13.52%	Buy Under $22	2
PROPERTY & CASUALTY INSURANCE										
W.R. BERKLEY	WRB	P&C Insurance	05-26-2023	$56.10	$65.06	0.61%	$0.00	15.97%	Buy Under $62	2
PROGRESSIVE CORPORATION	PGR	P&C Insurance	06-09-2023	$131.08	$140.41	0.28%	$0.10	7.19%	Buy Under $160	2
CHUBB LIMITED	CB	P&C Insurance	06-09-2023	$191.63	$212.27	0.19%	$0.86	11.22%	Buy Under $220	2
SKYWARD SPECIALTY	SKWD	P&C Insurance	06-17-2023	$24.66	$27.93	0.00%	$0.00	13.26%	Buy Under $35	2
BETTER THAN THE MARKET										
CAMBRIA SHAREHOLDER YIELD	SYLD	Yield Focused ETF	01-06-2023	$61.22	$62.41	2.48%	$0.87	3.36%	Buy Under $65	2
WATCHLIST										
NVR, INC.	NVR	Homebuilder	NA	-	$6,061.92	0.00%	-		Buy Under $3,500	
FREEPORT-MCMORAN	FCX	Base Metals	NA	-	$37.33	1.61%	-		Waiting For Recession	
SOUTHERN COPPER CORP	SCCO	Base Metals	NA	-	$75.00	4.00%	-		Waiting For Recession	
SHERWIN-WILLIAMS	SHW	Specialty Chemicals	NA	-	$256.21	3.78%	-		Buy Under $150	
ULTA BEAUTY	ULTA	Specialty Retail	NA	-	$398.91	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%	Sold May 26, 2023	
ALTISOURCE ASSET MANAGEMENT	AAMC	Asset Management	07-07-2023	$58.00	$10.02	0.00%	$0.00	-82.72%	Sold August 18, 2023	

Disclaimer: this hypothetical portfolio should not be considered investment advice or a recommendation to buy/sell any financial instrument. For informational purposes only. Investors should perform their own due diligence before buying or selling any financial instrument. No express or implied guarantee of accuracy or applicability to real-world trading. Risk Ratings are based on a security's fundamentals and business model rather than its current valuation.

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GLP-1 Demand Continues to Rise, and So Does Novo Nordisk

Novo Nordisk (NVO) continues benefitting from robust demand for its blockbuster GLP-1 (glucagon-like peptide-1) diabetes and weight-loss drugs. During Q2, a 50% jump in GLP-1 drug sales pushed Novo's quarterly revenues to new all-time highs of $7.9 billion, a 32% increase from $5.9 billion in Q2 2022. Novo's net income grew 36% to more than $2.8 billion, compared to $2.1 billion in Q2 2022.

Between Ozempic and Rybelsus alone – Novo's two GLP-1 diabetes treatments – the company raked in $7.3 billion in sales in the first half of 2023, or 62% growth from the same period in 2022.

Novo's GLP-1 weight-loss treatment – Wegovy – also experienced rapid growth during the quarter, with sales surpassing $1 billion for the first time. Wegovy sales nearly eclipsed $1.1 billion during the quarter, up 367% from a year ago.

We expect the demand for Novo's GLP-1 drugs to continue to rise, especially as new research uncovers additional benefits of GLP-1 treatments. A recent study in the *New England Journal of Medicine* found that Wegovy reduces the risk of major cardiovascular events in obese people by 20%.

These and other similar findings indicate that the FDA could approve Wegovy for use in limiting heart attack or stroke risk among the obese population. This could open up an entirely new market of demand for Novo's GLP-1 drugs.

These additional health benefits also increase the likelihood that GLP-1 drugs could be covered under major insurance programs, including Medicare. The high

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cost of drugs like Ozempic ($900 per month) and Wegovy ($1,300 per month) is one of the main barriers preventing more widespread adoption.

Novo is investing heavily to promote expanded insurance coverage for GLP-1 drugs, including stepping up its lobbying efforts. Between May and August, Novo hired three lobbyist firms to raise awareness about the benefits of expanding GLP-1 access through Medicare coverage. The number of lobbyists on Novo's payroll have more than doubled since 2019, rising from 28 to 63 as of August 2023.

A 2003 law excludes coverage of weight-loss drugs under Medicare. But obesity science has come a long way since this law was created 20 years ago. In 2013, the American Medical Association officially classified obesity as a disease. Since then, a growing body of research has shown a direct link between obesity and a growing number of deadly diseases.

Given the progress in understanding obesity and the powerful benefits of modern GLP-1 treatments, we see growing odds that Medicare and other insurance programs will expand access to these drugs. The upside potential is vast, with obesity affecting 42% of American adults and 39% of adults around the world.

But even without expanded insurance coverage, GLP-1 demand is booming. According to research from investment bank Cowen, Wegovy prescriptions rose by 297% in June from the same month last year. Meanwhile, Ozempic prescriptions increased by 140% over the same period.

New Production Capacity Will Power Novo's Next Move Higher

As we've highlighted in previous **Novo updates**, the company has run into supply constraints over the past year as GLP-1 demand outpaced its production capacity. Novo is currently investing in more capacity to satisfy the market.

When we spoke with Novo management in mid-May, it noted that it anticipates building sufficient capacity for GLP-1 to prevent shortfalls in coming years. The company struck a deal with a second manufacturer for Wegovy in April 2023 and is on track to secure a third manufacturer by 2024.

Novo's investments into expanding production will set the stage for higher GLP-1 sales going forward. Analysts expect Wegovy alone could generate $7.9 billion in revenue for the company next year compared to $4.3 billion in 2023. Strong demand for GLP-1s combined with Novo's growing manufacturing capabilities gives the company confidence in raising its 2023 guidance from $31.8 billion to $32.6 billion, for 30% growth versus prior expectation of 27%.

Novo's growth runway extends well beyond 2023 as it expands into new markets. Wegovy was recently approved to treat obesity in several European countries, including Norway and Denmark. The drug was also recently launched in the UK and Germany.

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Looking ahead, further upside could come from the ongoing discovery of new benefits from Novo's GLP-1 drugs. And there's even greater upside from the potential of expanded insurance coverage, which could lower costs to patients and expand GLP-1 access to millions of new patients around the world.

Shares of Novo are up 75% since our original recommendation. We continue to recommend holding shares of Novo Nordisk (NVO).

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 R.E., who writes:

> *If you think most stocks will fall 50% or more during the coming recession, why don't you use stop loss points on your recommendations? Thanks!*
>
> ***Porter's comment: Fair question.***
>
> ***If the economic situation becomes more challenging, we may in fact decide to use some objective risk-management tools.***
>
> ***But… what I've learned is, if you've invested in a good business that's capable of producing a reasonable return on your capital, selling is almost always a mistake.***
>
> ***Look at the example of The Hershey Company (HSY) that we wrote about at length in The Big Secret earlier this month. We call it a "forever stock" because, in theory, you can hold it forever.***
>
> ***Thus, the primary purpose of our economic warnings is to prepare our readers – not to sell their investments, but to encourage them to deleverage and to avoid low-quality or risky investments. If a recession emerges as we still think it will, there will probably be great opportunities in very high-quality, high-return businesses.***
>
> ***You'll want to have cash or at least be ready to upgrade your portfolio by buying some of the highest quality names available.***

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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:

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