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THE BIG SECRET ON WALL STREET

A Top-Shelf Booze Maker At a Dive-Bar Price

- Centuries of Brand Power Drives This Industry Leader
- Massive Scale Creates the Ultimate Competitive Advantage

FROM THE DESK OF PORTER STANSBERRY

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#39

A Top-Shelf Booze Maker at a Dive-Bar Price

Centuries of Brand Power Drives This Industry Leader

Massive Scale Creates the Ultimate Competitive Advantage

Few things are scarier than a drunk Irishman brandishing a pickaxe.

And – *horrors* – using "very much improper language."

It wasn't surprising that the Dublin sheriff and his men backed down when Arthur, a brewer, came out swinging... and yelling the profane, 1770s version of "Get off my lawn."

But the officials' retreat from Arthur's property was only temporary. The sheriff planned to keep coming back until he got what he wanted: Arthur's river.

When Arthur had leased the modest, four-acre site for his new brewery business in 1759, he'd been delighted to discover that the land came with its own source of fresh, running water – perfect for high-quality stout.

And he quite naturally assumed the water rights were part of his original lease. But the Dublin government had other ideas.

Toward the end of the 18th century, the archaic and corrupt city administration, the Dublin Corporation, had started to collapse under the weight of heavy city debts and bad decisions. To drum up extra cash, it decided to take control of the water supply – mandating that Dublin citizens use (and pay for) piped-in "city water."

If, like Arthur, you had your own, non-city-controlled water source, you could expect a visit from the Corporation, which would divert your stream into city pipes, whether you liked it or not. (Ironically, the motto on Dublin's coat of arms was – and still is – "The Obedience of the citizens produces a happy city.")

Arthur was not happy with the Corporation's intrusion. Hence the pickaxe.

Hence, also, his ensuing legal battle against the Dublin Corporation... a struggle that dragged on for nine years.

In the end, likely out of sheer exhaustion, both parties gave in... a little. Arthur grudgingly consented to pay for his own water, but under very specific terms: He agreed to take out an additional lease on the property – £10 per year, just for the water.

The length of the lease? 8,795 years.

Essentially, forever.

In effect, the obstinate brewer was saying, "I and my 10 children, and their descendants, and their descendants will be here, on this four-acre property, long after the Dublin Corporation is a footnote in Irish history."

Over the next two centuries, the Corporation was razed, restructured, renamed, and reformed.

But nothing changed for Arthur's children, and grandchildren, and great-grandchildren. They stayed right where they were, paying their rent-controlled £10 per year, and using their own water to make superb beer. Even more remarkable, until the land contract was renegotiated in the 1980s, the original lease agreements stayed in place.

Today, you can still drink that beer… and invest in it, too.

Appropriately, it's now a cornerstone of a true "forever company"… shares of which this month we recommend buying, and holding (and passing on to your own descendants) for at least 8,795 years.

A Business Built on Brand Power

In the business of booze, brand power is destiny. Once consumers establish their favorite beer, wine, or spirit, they tend to stick to it for life. As new generations come of age, they mimic the favorites of their elders. As a brand becomes ingrained through generations of tradition, it becomes virtually impossible for competitors to displace them (that is, unless they hire a woke brand manager and self-destruct, as Anheuser-Busch recently showcased with the spectacular implosion of the Bud Light brand).

That's why many of today's biggest alcohol brands – across beer, wine, and spirits (liquors) – have been around for many decades, if not centuries. This includes the world's most valuable beer brand Heineken (established 1873), leading wine and Champagne maker Moët & Chandon (established 1743), and best-selling spirits like Smirnoff in vodka (established 1864) and Hennessy in cognac (established 1765).

This brand loyalty makes the business models of the top alcohol producers remarkably resilient, giving rise to the ultimate "forever stocks."

The company we're introducing today traces its roots back to 1759. Since then, the business has amassed an industry-leading portfolio including some of the most iconic and enduring alcohol brands. As people around the world gather for the upcoming holidays, many will be consuming its products, just as previous generations have done.

Beyond brand power, this company also enjoys a strong competitive advantage through its unmatched economies of scale. This allows it to acquire small brands and turn them into global giants. The business is highly capital efficient and recession-resistant, generating positive sales and earnings growth – even in down cycles, such as during the Great Financial Crisis from 2007 through 2009.

Normally, this company's premium business model commands a premium valuation. But temporary macro factors have caused a nearly 50% decline in the company's stock price. This has created a rare opportunity to buy shares at their cheapest valuation in over a decade.

A Forever Stock Goes on Sale

Based in London, **Diageo (NYSE: DEO)** is the world's largest spirits maker. Last year, the company generated $21 billion in sales from more than 200 brands sold in 180 countries. The company owns many of the world's best-selling spirits brands including Johnnie Walker scotch whisky, Crown Royal Canadian whisky, Smirnoff vodka, and Don Julio and Casamigos tequilas. It also owns the third largest beer brand globally, Guinness (founded in 1759 by Arthur Guinness, the angry Irishman).

(Amusingly, Diageo is famous for *porter*... and for a *Black Label* whisky product. How could Porter & Co. not recommend this business?)

Diageo was formed in 1997 from a merger between Guinness and London-based consumer-goods conglomerate Grand Metropolitan (founded in 1934).

At the time of the merger, Guinness had diversified beyond beer into spirits, through its 1986 acquisition of The Distillers Co. This gave Guinness ownership of leading scotch-whisky brand Johnnie Walker, as well as Gordon's (the best-selling gin brand globally). These two powerhouses formed the backbone of Diageo following the merger in 1997.

Grand Metropolitan had a diverse business line that included the fast-food chain Burger King and the leading global cake maker The Pillsbury Company. It also owned spirits brands Smirnoff vodka and J&B scotch whisky.

Following the merger, Diageo sold Grand Metropolitan's non-alcohol divisions. Today, the company focuses primarily on spirits, which make up 80% of its business. Only 15% of Diageo sales now come from beer, with the remaining 5% in ready-to-drink products (pre-mixed cocktails in a ready-to-drink can or bottle).

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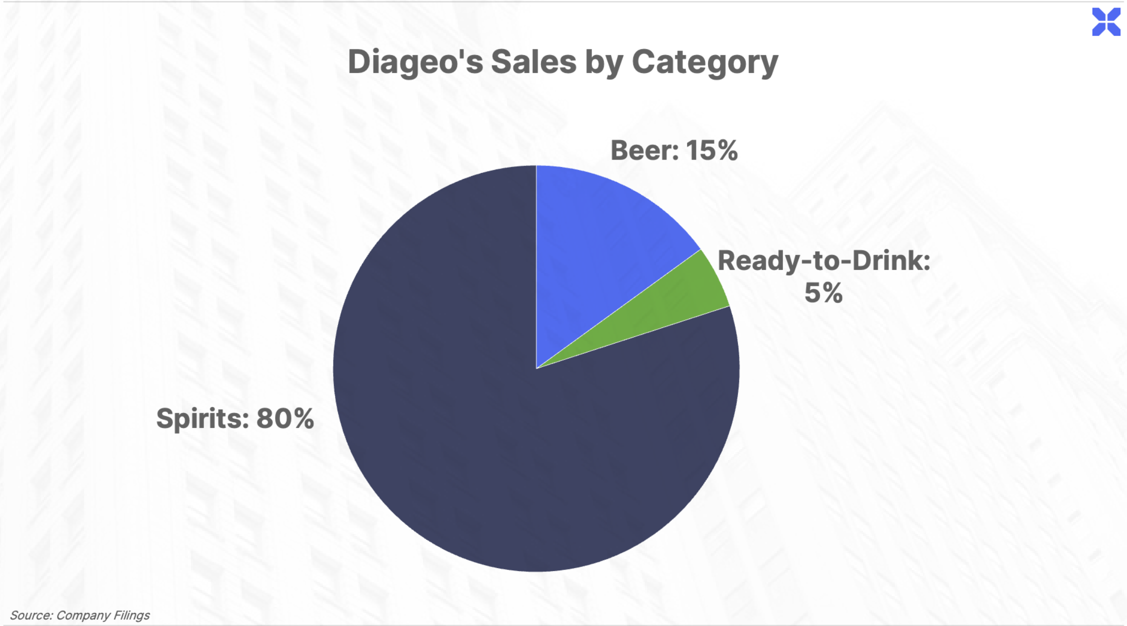


On the surface, Diageo's business model is a simple one. It manufactures various alcohol products and sells them to third-party retail distributors, who in turn sell alcohol to consumers. The complexity lies in understanding how the company capitalizes on the two key sources of competitive advantage available in this industry: brand and scale.

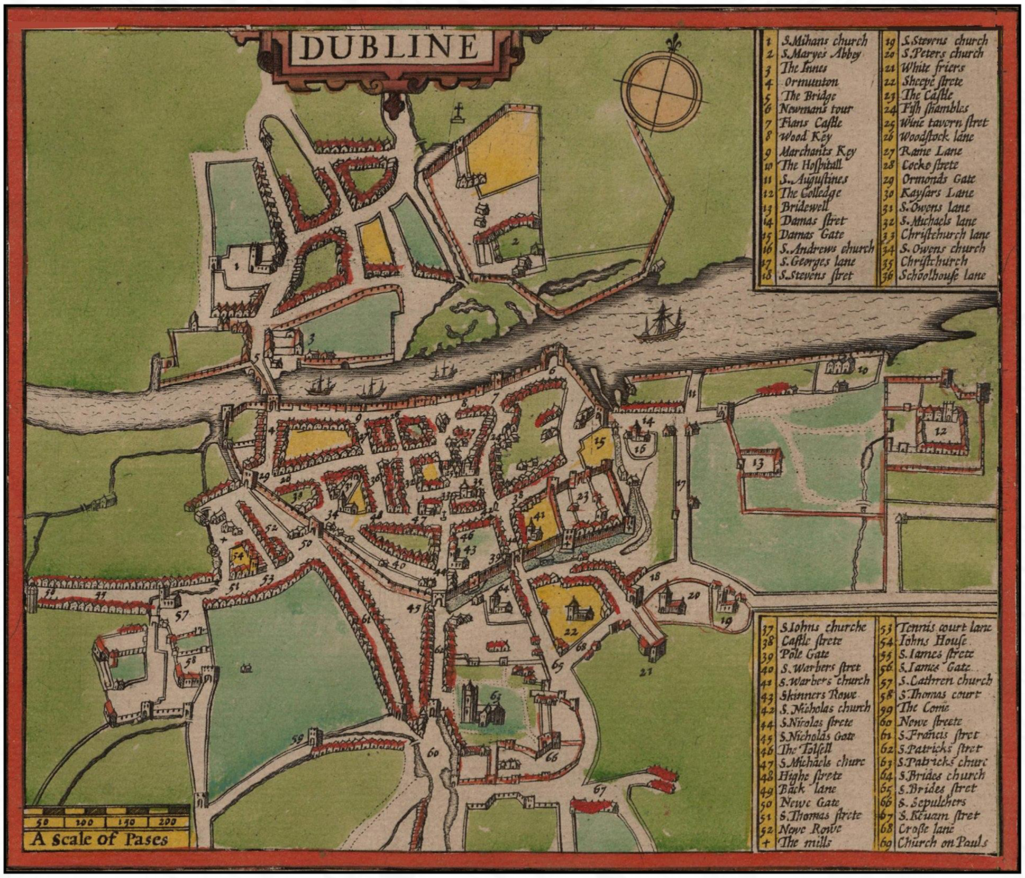
At the heart of Diageo's business is a core portfolio of "forever brands." These are long-established brands, often more than a century old, that provide a reliable source of consistent profit growth. Diageo's world-class marketing and distribution machine keeps these brands highly visible and selling around the world.

Along the way, the company reinvests a portion of profits from its core portfolio into emerging brands to capitalize on shifting consumer preferences. As the largest spirits maker in the world, Diageo uses powerful economies of scale to turbocharge the growth of these emerging brands into global powerhouses.

And the brand that started it all in 1759, Guinness, owes its great success in part to what is arguably the greatest real estate deals of all time.

A Centuries-Old Company With a 9,000-Year Lease

In the 1750s, a financial crisis crushed property values across Ireland. Arthur Guinness, a beer brewer in a small town just north of the capital city, Dublin, seized on the opportunity created by depressed land prices. He spotted a four-acre property hosting the St. James Gate Brewery, which became available to lease at the low price of just £45 per year (plus the £10 per year in water rights he eventually secured, with the help of his pickaxe).



From day one, Arthur Guinness set out to build an enduring legacy that he could pass down through generations. That's why when negotiating the lease he secured an unheard-of 9,000-year term on the St. James property. Years later, as discussed earlier, he was also able to secure a similar-duration lease to the water rights on the property.

At St. James, Guinness honed his craft over the next decade. Maniacal about product quality and innovation, he constantly experimented with new brewing methods and production techniques. This included making a new style of beer that became popular in London, the "porter," created from a happy accident when a London brewer burned the brown malt for one of his beer batches, which he balanced with extra hops to disguise the roasted flavor.

Because the brewing method called for a generous helping of hops – which act as preservatives – porter became the first beer that could be aged by breweries before it was distributed to taverns. Previously, the ale breweries could only produce pre-aged beer that taverns had to store and age on site (otherwise the beer would spoil in transit).

By creating a ready-to-drink beer, the porter brewing style allowed for lower distribution expenses and significantly greater economies of scale. Arthur Guinness saw the opportunity in porter beer to grow a global empire, and by the late 1790s shifted from producing ales, to exclusively brewing porters.

Arthur Guinness passed the business on to his son Arthur Guinness II, who expanded production and made St. James the largest brewery in Ireland, with global exports. The third generation, Edward Cecil Guinness, then grew St. James into the largest brewery in the world by 1880 with over a million barrels sold each year.

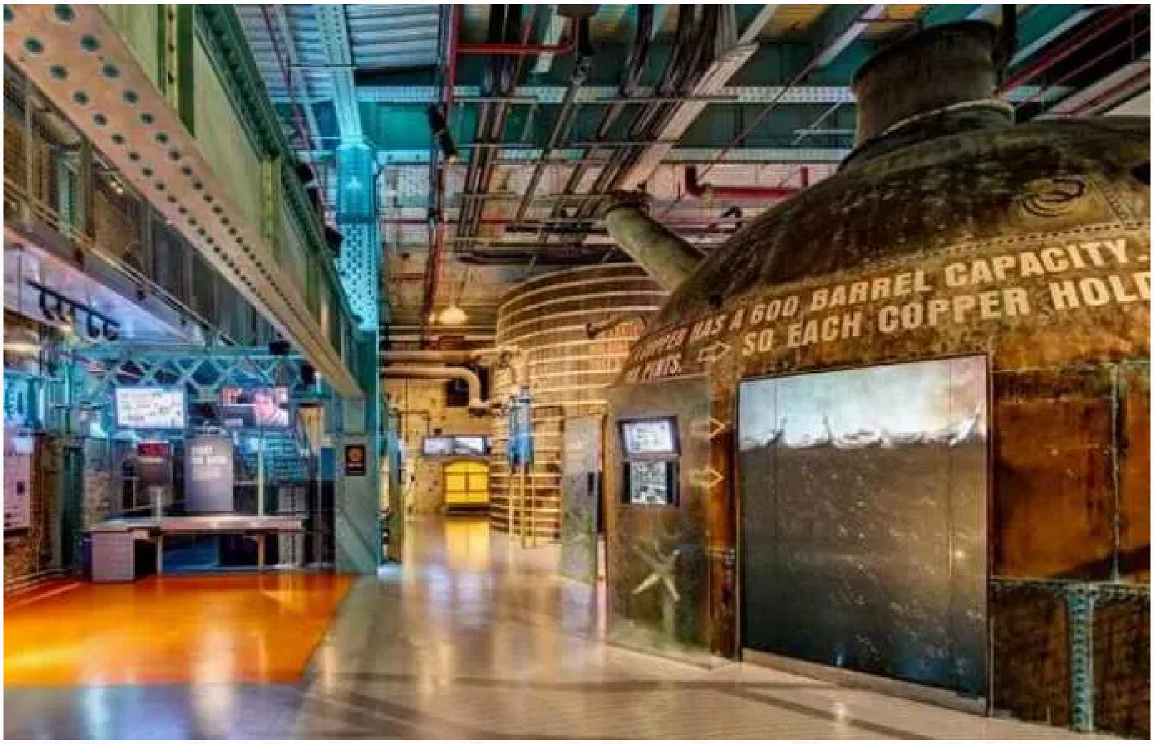
This growth came despite the company famously refusing to advertise, or sell its beer at a discount. Instead, Guinness focused on producing the highest-quality porter beer in the world, and let the product speak for itself. In 1901, the company hired a staff of chemists to establish the Guinness Research Laboratory, and began transforming the art of brewing into an industrial science.

One of Guinness's biggest production breakthroughs came from statistician William Sealy Gosset. While working for the company in the early 1900s, Gosset developed a mathematical method for determining whether the differences in each beer batch were random, or caused by specific factors in the brewing process. The framework he developed became known as the "Student's t-test," which has since become a staple of statistical analysis and industrial process control.

By leading the industry in brewing advancements and production quality, Guinness cemented its brand power and popularity around the world. The beer became particularly popular in the UK. In 1941, Britain imposed trade restrictions on Ireland in order to pressure the country to support the Allied powers. But Brits' demand for Guinness beer was so strong, it forced the UK government to relent and temporarily lift the trade restrictions in order to keep the Guinness taps open there.

Unlike its early days, when the company swore off advertising, the Guinness brand has grown into a global powerhouse through successful marketing campaigns over the last century. The company introduced the famous *Guinness Book of World Records* in 1955 that spread its brand awareness around the world. (Fun fact: the idea was spawned from a hunting trip, when a managing director of Guinness production couldn't settle an argument over which was the fastest game bird in Europe.)

In 2000, the company converted a portion of the original St. James brewing facility into the Guinness Storehouse – an immersive brewery, bar, and restaurant experience (home of the famous two-minute Guinness pour) that's become the country's second most visited tourist attraction.



More recently, under Diageo's stewardship, Guinness is heavily featured in mainstay national events across its key European markets. The brand has become a staple at events like St. Patrick's Day and European rugby, including an official sponsorship for the Six Nations – a European rugby league that hosts annual matches between England, France, Ireland, Italy, Scotland, and Wales.

These investments have paid off. In December 2022, for the first time ever, Guinness became the UK's number-one beer brand in "on-trade" (establishments like bars and restaurants that sell beer for on-site consumption). Across all markets, Diageo reported all-time highs in Guinness sales and 16% sales growth for its fiscal year 2023 (ending June 30, 2023).

Today, the Guinness brand is the world's third-largest beer brand. It's the key driver of Diageo's beer segment, which also includes smaller brands like Smithwick's, Kilkenny, and Harp Lager. Beer is the company's second-largest business line, making up 15% of total sales. Across all brands, Diageo's beer segment grew sales by 9% last year.

This growth is even more impressive in the context of the recent shift in consumer preferences away from beer toward spirits. From 2010 to 2020, beer's share of total beverage alcohol (TBA) fell from 52.1% to 46.9%. Over the same period, spirits rose from 20.8% to 24.7%. In 2023, spirits took the number-one spot with 42.1% of TBA market share in the U.S., surpassing beer's 41.9%.

While the beer category faces headwinds from the shift in consumer preferences toward spirits, Diageo's brands continue growing at a healthy pace. Meanwhile, the majority of Diageo's business – the 80% of its revenue coming from spirits – is thriving.

Diageo's Biggest Cash Cow

Diageo's largest business segment is scotch, making up 25% of sales. This includes the company's crown jewel, Johnnie Walker, which has held the title of the world's best-selling scotch whisky since 1945.

The brand dates back to 1820, when a 15-year old John Walker invested the inheritance from his father into a grocery store in the small Scottish town of Kilmarnock. One problem he encountered was that the single-malt-scotch brands he sold were inconsistent. The imprecise production techniques of the day meant that quality would vary widely from batch to batch.

Walker began blending different single-malt brands together to balance out their impurities. Over time, he developed popular whisky blends that his customers prized for their smooth and consistent flavor. In 1857, the business was passed down to his son Alexander, who grew the business into a global powerhouse selling 100,000 gallons per year by 1862. He then passed the business down to his sons George and Alexander II, who expanded the now-thriving product line to three blends, Old Highland (aged five years), Special Old Highland (aged nine years), and Extra Special Old Highland (aged 12 years). They distinguished the different aged blends with colored labels – white, red, and black.

Over time, the colors became the core branding feature of the different Johnnie Walker blends. Today, the core scotches range from Red Label (aged for a minimum of three years, selling for roughly $30 per one-liter bottle) all the way up to the super-premium Blue Label (aged between 28 and 60 years, selling for over $300 per bottle).

The brand has become steeped in history, as the spirit of choice among celebrities, presidents, and prime ministers.

This included British Prime Minister Winston Churchill, who famously started his day with a generous pour of Johnnie Walker mixed with club soda.

Churchill, a hobbyist painter, even created a painting in ode to his favorite scotch-whisky brand. Churchill's Jugs and Bottles piece, shown below, sold at a Sotheby's auction in November 2020. After a fierce bidding war, the painting went for $1.2 million, commanding five times its pre-sale estimate.

Churchill wasn't the only world leader that preferred Johnnie Walker. The super-premium Blue Label was a favorite of U.S. President Richard Nixon, who enjoyed it with ginger ale and a lime wedge.

The iconic brand has also infiltrated pop culture over the last half-century, particularly among the music industry. Johnnie Walker is featured in the lyrics of singers and bands ranging from Lady Gaga to ZZ Top and Elliott Smith. The heavy-metal band Black Label Society took its name after Johnnie Walker's Black Label Whisky.

While Johnnie Walker cemented itself into consumer mindshare through these organic endorsements, Diageo continues cultivating the brand through advertising and marketing campaigns today. A notable example includes its partnership with HBO's hit TV series Game of Thrones. The fantasy drama series became an international sensation from 2011 to 2019, generating record viewership while winning 59 Primetime Emmy Awards, the most by any drama series.

Johnnie Walker partnered with HBO to produce a limited-edition White Walker blend in 2018, with branding and promotion built around the show. The successful partnership led to two additional *Game of Thrones*-themed blends, A Song of Fire and A Song of Ice, which can be purchased as along with White Walker as a three-piece set for $239:

Diageo's Entrenched Competitive Advantages

Diageo's successful *Game of Thrones* partnership reflects one of its biggest competitive advantages. As the world's largest spirits maker, the company has the industry's biggest budget to spend on advertising campaigns and marketing partnerships with celebrities, event organizers, and media outlets.

Diageo's dominant size also provides another key advantage over the competition: one of the industry's best data sets to optimize its local advertising campaigns.

Diageo collaborates with its distributors and retail partners to harvest data on the latest spending trends across its portfolio. This includes the company's proprietary software and data analytics tool known as Demand Radar, which tracks 85% of the company's net retail sales across the globe. This provides a real-time feed into the company's sales trends at the individual store level, allowing it to adapt to shifting competitive dynamics and stay ahead of its rivals.

As just one example, Diageo identified what it called a "battleground" market for scotch whisky in New Jersey in 2021, where Johnnie Walker was losing share to competitors. The company used insights from its Demand Radar to develop hyper-local marketing campaigns across key zip codes and retail locations where sales were struggling. The end result: 20% growth in Johnnie Walker sales in the New Jersey market for 2021.

These structural advantages are how Diageo continues generating robust demand for centuries-old brands like Johnnie Walker. Today, 93 million consumers around the world sip Johnnie Walker each month. In each of the last three years, the brand has generated double-digit sales growth, including a 15% increase in Diageo's FY 2023.

This growth comes from a combination of taking market share from competitors, with growing volumes, plus strong pricing power. Last year, Johnnie Walker gained market share in eight of its largest markets, with volume growth of 9%. Price increases also delivered another 6% of sales growth.

The success of the Johnnie Walker brand is a testament to Diageo's enduring competitive advantages that keep its legacy brands as relevant as ever. Those same advantages allow the company to develop new brands and capitalize on shifting consumer preferences.

Over the last decade, Diageo flexed its data and scale advantages to identify and capitalize on one of the biggest trends in the spirits market, well before the competition caught on.

The Global Tequila Boom

In 2014, tequila was a minor part of Diageo's portfolio – its only major tequila exposure was through its 50% ownership of Don Julio, a super-premium tequila produced in Mexico.

That same year, Diageo's data analytics revealed that tequila consumption was rapidly growing across North America. This prompted the company to strike a deal to acquire the remaining 50% of Don Julio from the Beckmann family in Mexico. Diageo gave up 100% of its Bushmills Irish Whiskey to the Beckmann family in exchange for the full rights to the Don Julio brand. As part of the deal, Diageo also received a $408 million payment.

While Bushmills was popular, it was a cheaper value brand with relatively low margins. For a bit of context, Bushmills sold 800,000 cases in 2014, worth $91.2 million in retail sales. That same year, Don Julio sold 590,000 cases and generated $168 million in sales.

Don Julio is sourced from the rare and highly prized agave plants in the highlands of Atotonilco, Mexico. Making Don Julio is a tedious, time-consuming process that starts with aging the agave plant for seven years. Each plant is then harvested by hand, with special care given to properly cutting its roots and shearing off the spear-like leaves. The process pays off with a one-of-a-kind, award-winning tequila flavor, and juicy point margins (prices for the super premium Don Julio tequilas can range from $200 to $2,000).

Diageo's data insights into consumer spending trends indicated massive demand for super premium tequila... and a far larger market opportunity compared to the second-rate Irish-whiskey brand it exchanged for Don Julio. The trade turned out to be a grand slam.

Don Julio is now the world's number-two premium tequila (behind Patrón). The brand went from just over half a million in annual cases sold in 2014 to over 2 million cases sold in 2022. Despite its dominant size, it continues to grow fast, with 20% sales growth in FY 2023.

Diageo's success with Don Julio went beyond simply identifying and riding a new trend in spirits consumption. When the company took over 100% ownership of the brand, it gained control of marketing, pricing, and distribution as well. This allowed Diageo to turbocharge Don Julio's growth through the company's powerful marketing and distribution machine.

We previously highlighted how Diageo's scale gives it an industry-leading marketing budget. The other key advantage of Diageo's scale is an unmatched distribution network that can quickly boost new brands the company brings under its control.

Diageo's Distribution Advantage

In many markets around the world, including in most U.S. states, liquor cannot be sold directly to consumers. Instead, spirits manufacturers like Diageo must sell to intermediaries, like retail liquor outlets and grocery stores. These distribution intermediaries act as the gatekeepers for new products entering the market.

In order for a spirits brand to enter new retail locations, scale is key. The brand needs enough demand to sell in high enough quantities to justify precious shelf space. And the manufacturer must have sufficient production and logistics capacity to get the product to retailers, on time, every time. Finally, it helps if there's an existing and highly profitable relationship between the manufacturer and the retailer for bringing new products to market.

Because of its size, Diageo has an unmatched array of retail partners it can lean on to stock new products. As the world's largest spirits maker, with the industry's largest marketing budget, retailers can have confidence in Diageo's ability to juice demand on a national scale. It can also offer smaller retailers incentives like localized advertising campaigns to jumpstart demand in their specific markets, down to the individual store level.

This scale advantage means Diageo can offer a unique value proposition for its retail partners, as well as for brands it acquires. When the right opportunity arises, Diageo can afford to pay more than its competitors to acquire rising brands.

A case in point comes from another blockbuster tequila acquisition Diageo made when it purchased Casamigos in 2017. Founded by actor George Clooney and two friends in 2013, the start-up shook up the tequila world. Within four years, it became the fastest growing premium U.S. tequila brand. Diageo acquired it for $700 million in cash, plus up to $300 million in performance-linked future payments, for a total price tag of $1 billion.

Many industry commentators and investors scoffed at the price tag. When

Diageo made the acquisition, Casamigas was on track to sell 170,000 cases in 2017. But Diageo's marketing and distribution machine took the product into the stratosphere. By 2020, volumes had tripled to 450,000 cases. Last year, the brand grew 96% to reach 2.2 million cases and over $1 billion in annual sales.

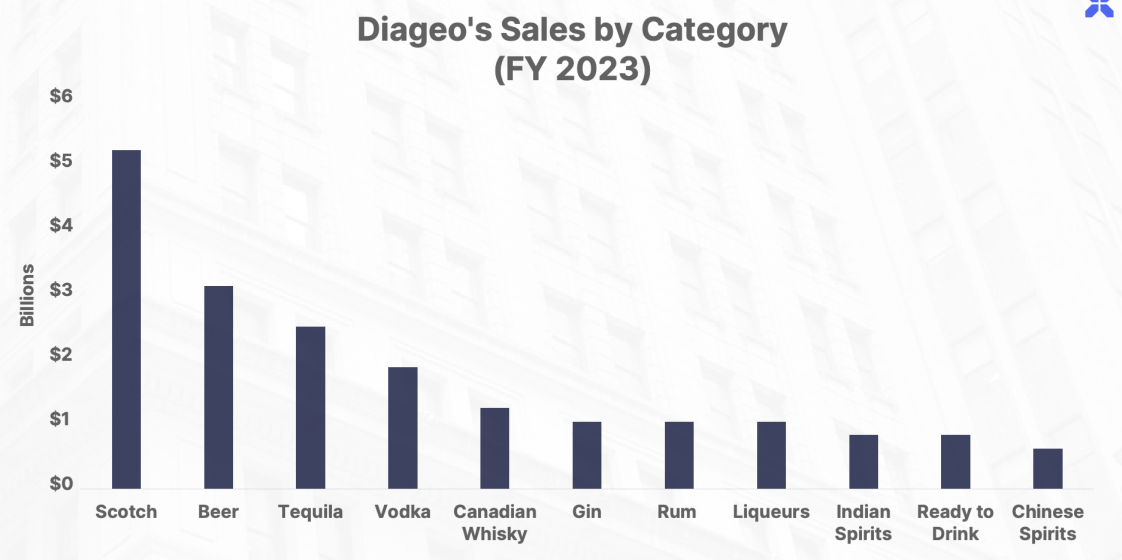
Today, Casamigos is the number-three selling premium tequila brand, behind Don Julio. It's become one of the greatest success stories in the spirits industry. Most spirits brands spend decades, even centuries, getting to the top of their categories. Casamigos, amplified by Diageo's scale advantages, went from a niche product to a global phenomenon in just five years.

With its acquisitions of Don Julio and Casamigos, Diageo has gone from a tiny presence in tequila eight years ago to the world's number-one tequila seller today. Over the past four years, Diageo's tequila sales volumes have grown by an average of 32%. And consistent gains in pricing have grown the company's tequila-based earnings even faster, at 43% per year over the same period.

All signs indicate a long runway ahead. North America currently makes up roughly 80% of global tequila consumption, but its popularity is quickly spreading around the globe. Tequila consumption across Europe has doubled in each of the last two years. The ravenous demand even caused a global shortage of the agave plant earlier this year.

Diageo is investing heavily to further its lead as the world's largest tequila producer, including a $500 million expansion of its production facilities in Jalisco, Mexico, that began in 2021.

With two of the world's top-selling premium tequila brands, the spirit now makes up Diageo's third-largest business line, behind scotch and beer.



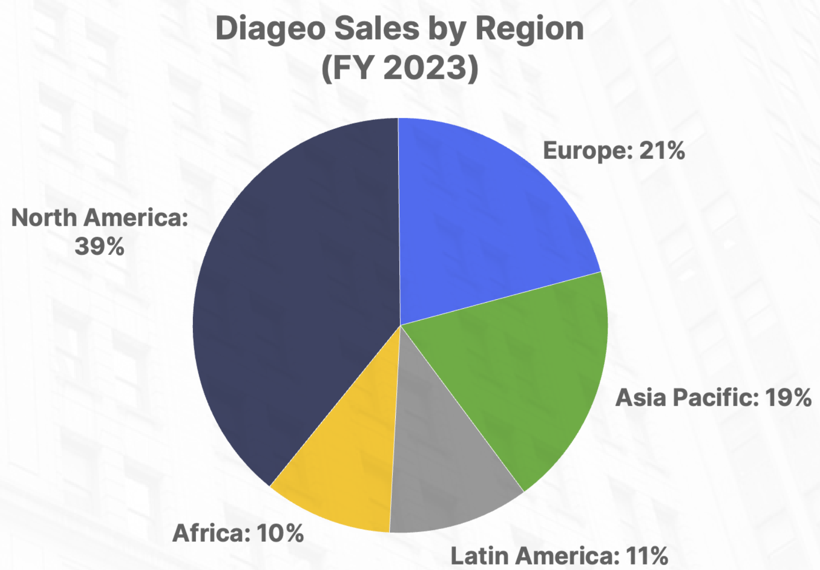
Source: Company Filings

A Dominant, Globally Diversified Business Model

Across all business lines, Diageo owns a potent portfolio containing many of the top-selling spirits brands. This includes Johnnie Walker (#1 scotch), Don Julio and Casamigos (#2 and #3 premium tequilas), Smirnoff (#1 vodka), Crown Royal (#1 Canadian whisky), Gordons and Tanqueray (#1 and #3 gins), Captain Morgan (#3 rum), and Bailey's (#1 cream liqueur). It also owns the iconic Guinness brand, the world's third-best-selling beer.

Diageo's dominant scale advantage amplifies the strength of its brands. The company's $20.6 billion in revenue last year exceeds the combined sales of its next two closest competitors, Pernod Ricard ($12.7 billion) and Brown-Forman ($4.3 billion). Diageo's successful track record in pressing this scale advantage gives us confidence that the company will retain its position at the top of the industry going forward.

This makes Diageo the ultimate forever company. It's diversified mix of category-leading brands are sold into over 180 countries, giving the business resilience from a disruption in any single product segment or geographic region:



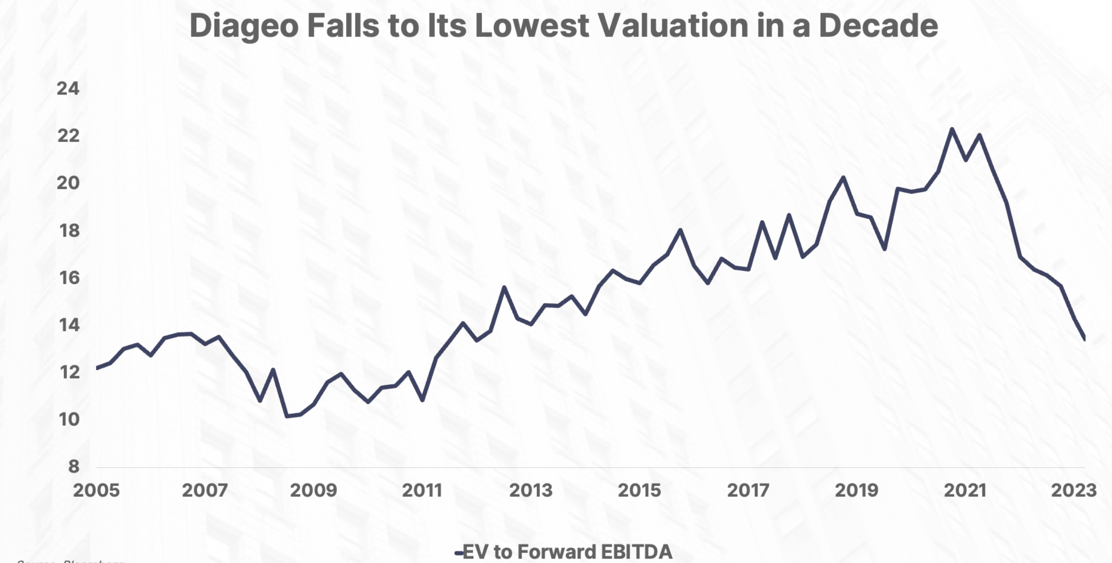
Source: Company Filings

The durability of demand for Diageo's products can also provide resilience against economic downturns. During the Great Financial Crisis, for example, Diageo grew revenue and earnings per share from 2007 to 2009.

The business is also capital efficient, as it outsources many of its lower-margin bottling and retailing to third parties. Over the last 10 years, Diageo has generated an average return on equity of 33.5%, and net income margins of 21.3%. For comparison, the median S&P 500 company averaged a 14.7% return on equity and 13.1% net income margin over the same period.

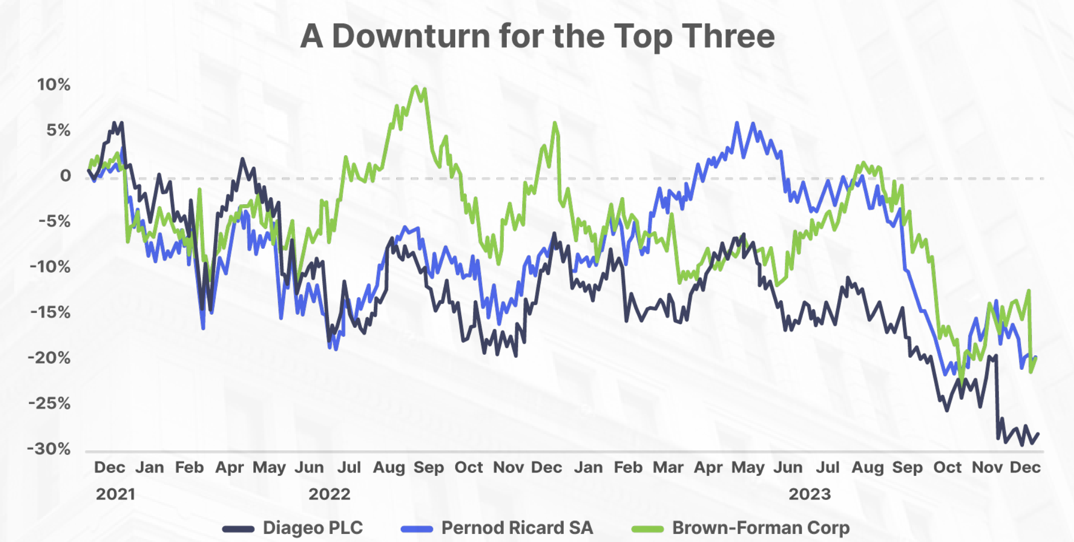
A Top-Shelf Business Hits the Discount Rack

Normally, Diageo's premium business model commands a premium valuation. But a recent sell-off has cut Diageo's valuation by 40% over the last 18 months. Today, at around $145 per share, it trades at a valuation multiple of just under 14x enterprise value to EBITDA (earnings before interest, taxes, depreciation, and amortization) – the cheapest level in over a decade:



Source: Bloomberg

The cause for Diageo's share price decline has not come from anything related to its long-term competitive position or growth trajectory. Rather, the entire industry has faced macro factors that have caused share prices to decline:



Source: Bloomberg / Total return since December 1, 2021

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The first factor dragging down Diageo's share price traces back to pandemic-driven supply-chain disruptions. The initial COVID-19 outbreak caused shortages of materials and labor, disrupting production facilities for alcohol producers across the board. When these disruptions were resolved, a boomerang effect followed as companies ramped up production in excess of demand. This caused inventories to build up across the industry, which then caused companies to discount their products.

A key benchmark for inventory stockpiles is measured as inventory days – the stock of inventory relative to the number of days worth of demand required to sell that inventory. By year-end 2020, Diageo's inventory days reached a record high of 445 days, up from 387 pre-COVID. The company then offered greater discounts and promotions to clear excess inventory, resulting in Diageo's profit margins falling from 24.2% in fiscal year 2019 to 21.7% in 2021, before rebounding to 22.2% in FY 2023.

Diageo has since sold its excess inventory, which fell back to pre-pandemic levels of 390 inventory days in its most recent financial report for FY 2023 (as a London-based company Diageo only reports its financials twice per year). With improved inventory levels, Diageo should now face less pressure to discount its merchandise.

The second factor pressuring the industry has been fears surrounding the rise of GLP-1 drugs for weight loss and diabetes, including Novo Nordisk's blockbuster Ozempic and Wegovy drugs.

A series of recent studies indicate that GLP-1s could cause a significant decline in alcohol consumption. As a result, the market has priced in the risk of lower future demand for beer and spirits. Similar GLP-1 fears have also pressured other "indulgence" brands recently, including McDonald's, The Hershey Company, and Domino's.

Though these drugs have not been around long, all available evidence indicates these fears are overblown. Even with the booming demand for GLP-1 drugs (evidenced by the skyrocketing sales and share price of Novo Nordisk), we have yet to see any meaningful impact on alcohol consumption in Diageo's business. Likewise, their impact has yet to show up in the financial results of companies like McDonald's, Hershey, and Domino's.

While GLP-1s represent a potential long-term threat that warrants monitoring, we see no meaningful threat to Diageo's business from these drugs today.

For now, the opportunity lies in the attractive valuation in Diageo's shares created from fears about a future threat that has yet to materialize. Even assuming no change in Diageo's valuation, we believe investors can earn a market-beating return on shares going forward.

How Diageo Could Generate 15% Compounded Returns

In 2020, Diageo's management outlined a plan to grow its share of global alcohol consumption from 4% to 6% by 2030. Only three years into the plan, the company is more than one-third of the way there – reaching 4.7% of global TBA (total beverage alcohol) market share in 2023.

Management's guidance over the coming years is to deliver profit growth of between 6% to 9% per year. Given the company's impressive portfolio of brands improving at double-digit rates, and its successful growth performance to date, we believe this forecast is achievable.

Meanwhile, Diageo's investors stand to do even better than this 6% to 9% growth. That's because of the company's high capital efficiency, which allows it to return a substantial portion of profits back to investors. Over the last five years, Diageo has reduced its share count by 12% while also growing its dividend by 12% over the same period. The company's U.S.-listed shares (under the NYSE's "DEO" ticker) currently pay out $3.93 in annual dividends, for a yield of 2.7%.

Looking ahead, we assume that management can hit its target of 6% to 9% profit growth, while continuing to reduce share count by 2% to 3% per year, and also paying out a 2.7% (and growing) dividend. Taken together, these three factors should combine to compound shareholder returns at rates of 12% to 15% per year through 2030.

Further upside could come from the company reverting back to its historical valuation of roughly 18x EV/EBITDA.

We're not the only ones spotting value in Diageo's shares. In the first quarter of 2023, Berkshire Hathaway acquired a small (227,000-share) position in Diageo at $172.40 per share.

With a leading global footprint of the world's largest and most iconic spirits brands, and the scale to acquire the next generation of up and comers, Diageo is a prototypical Buffett stock.

It's one of the few opportunities in today's market that checks all the key boxes we and Buffett look for:

- A collection of dominant global brands, with secular growth tailwinds
- Entrenched competitive advantages
- Recession-resistant business model
- High capital efficiency
- Compellingly low valuation

Action to Take: Buy Diageo (NYSE: DEO) up to $160 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*, 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. **Franco-Nevada (FNV)** – the "Gold Digger" That Gets Paid to Do Nothing – is the leading gold royalty company. Franco-Nevada provides financing for mining companies to do the capital-intensive work of pulling rocks out of the ground, in exchange for a percentage of the mine's output. As a result, FNV is highly capital efficient, generating 58% free cash flow margins. FNV's world-class management team has established one of the best track records in the industry. FNV shares have sold off since October, when the Panamanian government announced the shutdown of a large copper mine, which is one of FNV's largest royalty assets. The decline is overdone as the market capitalization of FNV fell by $5.6 billion while the mine is worth roughly $5 billion, effectively pricing in a total loss of the mine. Meanwhile, with gold prices approaching record highs, the rest of FNV's portfolio is firing on all cylinders.As a result, the shares trade near their lowest valuation on record. (We break down the latest developments in the Portfolio Update below.)

2. **Philip Morris (NYSE: PM)** owns the international rights to the world's leading traditional tobacco brand, Marlboro. Over the last decade, the company has invested heavily in less-harmful alternatives to traditional tobacco products. These investments have made Philip Morris the global leader in less-harmful nicotine consumption, including its hit IQOS and ZYN brands. Unlike most traditional tobacco companies suffering from declining sales, Philip Morris' smoke-free business is delivering double-digit revenue and earnings growth. The company is incredibly capital efficient, with 20% returns on equity and 40% returns on invested capital. It's also a recession-proof business, and trades at an attractive valuation of just 15x earnings, with a 5.5% dividend yield.

3. **Viper Energy Partners (Nasdaq: 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 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 7% dividend yield and a repurchase program that has reduced outstanding shares by roughly 8% 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	06-02-2022	$48.87	$38.82	1.23%	$0.91	-18.71%	Buy Under $50	4
VIPER ENERGY	VNOM	Oil and Gas Royalty	09-01-2022	$29.68	$30.65	7.44%	$2.24	10.82%	Buy Under $34	3
BWX TECHNOLOGIES, INC.	BWXT	Nuclear Power Equipment	12-22-2022	$58.05	$77.32	1.19%	$0.92	34.78%	Buy Under $80	3
BLACK STONE MINERALS	BSM	Oil and Gas Royalty	02-16-2023	$15.90	$16.34	11.63%	$0.52	6.05%	Buy Under $18	2
BITCOIN	BTCUSD	Cryptocurrency	05-11-2023	$27,011.85	$42,977.30	0.00%	$0.00	59.11%	Buy Under $50,000	4
PEABODY ENERGY	BTU	Coal Mining	06-22-2023	$21.29	$23.63	1.27%	$0.00	10.99%	Buy Under $25	4
CNX RESOURCES	CNX	U.S. Gas-Focused E&P	09-28-2023	$22.82	$20.21	0.00%	$0.00	-11.44%	Buy Under $30	3
BATTLESHIP STOCKS										
CREDIT ACCEPTANCE CORP	CACC	Consumer Finance	07-28-2022	$560.28	$517.24	0.00%	$0.00	-7.68%	Buy Under $600	3
NOVO NORDISK	NVO	Pharmaceuticals	10-27-2022	$53.30	$98.00	3.61%	$2.07	87.76%	Hold	2
WINMARK CORPORATION	WINA	Specialty Apparel Stores	09-15-2022	$217.60	$433.01	0.74%	$16.20	106.44%	Hold	1
FRANCO-NEVADA CORP	FNV	Precious Metals Streamer	05-11-2023	$154.77	$112.09	1.21%	$0.68	-27.14%	Buy Under $125	2
PAYPAL	PYPL	Payment Processor	07-20-2023	$73.02	$61.87	0.00%	$0.00	-15.27%	Buy Under $90	3
FOREVER STOCKS										
PHILIP MORRIS	PM	Tobacco Maker	07-14-2022	$89.62	$94.67	5.49%	$6.38	12.75%	Buy Under $105	1
DOMINO'S PIZZAS INC	DPZ	Restaurants	02-27-2023	$300.00	$402.85	1.09%	$2.42	35.09%	Hold	3
DEERE & COMPANY	DE	Agricultural Machinery	08-31-2023	$410.94	$388.42	1.39%	$1.35	-5.15%	Buy Under $450	3
DIAGEO PLC	DEO	Alcoholic Beverages	12-14-2023	$145.72	$145.72	2.70%	$0.00	0.00%	Buy Under $160	3
INCOME & DISTRESSED DEBT										
SABA CAPITAL INCOME & OPPORTUNITIES FUND	BRW	High Yield Bond Fund	03-16-2023	$7.70	$7.70	13.25%	$0.69	8.91%	Buy Under $9	3
OAKTREE SPECIALTY LENDING CORP	OCSL	Specialty Investments	03-30-2023	$18.57	$20.11	10.94%	$1.10	14.22%	Buy Under $22	2
PROPERTY & CASUALTY INSURANCE										
W.R. BERKLEY	WRB	P&C Insurance	05-25-2023	$56.10	$70.56	0.57%	$0.61	26.86%	Buy Under $62	2
PROGRESSIVE CORPORATION	PGR	P&C Insurance	06-08-2023	$131.08	$153.55	0.26%	$0.20	17.29%	Buy Under $160	2
CHUBB LIMITED	CB	P&C Insurance	06-08-2023	$191.60	$220.51	0.18%	$1.72	15.99%	Buy Under $220	2
SKYWARD SPECIALTY	SKWD	P&C Insurance	06-16-2023	$24.66	$32.42	0.00%	$0.00	31.47%	Buy Under $35	2
EXPONENTIAL GROWTH										
TELLURIAN INC.	TELL	U.S. LNG Exporter	06-16-2022	$3.82	$0.68	0.00%	$0.00	-82.20%	Buy Under $5	5
EVOLUTION AB	EVVTY	Casinos & Gaming	11-30-2023	$103.77	$114.39	1.89%	$0.00	10.23%	Buy Under $130	4
BETTER THAN THE MARKET										
CAMBRIA SHAREHOLDER YIELD	SYLD	Yield Focused ETF	01-05-2023	$59.67	$66.76	2.32%	$1.17	13.84%	Buy Under $65	2
WATCHLIST										
NVR, INC.	NVR	Homebuilder	NA	-	$6,934.40	0.00%	-		Buy Under $3,500	
FREEPORT-MCMORAN	FCX	Base Metals	NA	-	$41.97	1.43%	-		Waiting For Recession	
SOUTHERN COPPER CORP	SCCO	Base Metals	NA	-	$81.71	3.67%	-		Waiting For Recession	
SHERWIN-WILLIAMS	SHW	Specialty Chemicals	NA	-	$306.77	3.16%	-		Buy Under $150	
ULTA BEAUTY	ULTA	Specialty Retail	NA	-	$494.63	0.00%	-		Buy Under $350	
NIKE	NKE	Athletic Footwear & Apparel	NA	-	$121.02	0.00%	-		Buy Under $75	
HOME DEPOT	HD	Home Products Stores	NA	-	$351.81	2.38%	-		Buy Under $240	

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. Cost basis refers to the closing price the day before a security is recommended.

The Gold Standard of Gold Stocks Hits a Speed Bump

Franco-Nevada (NYSE: FNV) shares have dropped 22% since late October, when the Panamanian government shut down a copper mine that is the company's largest revenue generator. But we believe the resulting plunge in FNV's share price is overdone, making the stock a strong buy today.

On October 20, the Panama National Assembly approved a bill for First Quantum Minerals, which owns the lucrative Cobre Panama copper mine, to renew the mine's operating license for another 20 years. In response to the ruling, massive protests erupted in Panama, and environmental protesters blocked access to the mine, forcing First Quantum to reduce production and FNV to lower its 2023 guidance. On November 28, in response to public pressure, Panama's president announced that the Cobre Panama mine would be shut down indefinitely.

The mine is the largest part of Franco-Nevada's portfolio – it contributed 18% ($223 million) of its 2022 revenue. Recall that instead of exploring and digging for gold, Franco-Nevada provides financing for mining companies to do the capital-intensive work. In exchange, FNV earns a percentage of the mine's output, primarily through royalties and streaming deals.

First Quantum has already filed suit against the government. Although it may take years, FNV will likely receive a proportional share of any settlement. Some experts estimate that Panama would have to pay around $50 billion if it loses the case, equivalent to nearly 70% of the country's GDP.

Porter & Co.

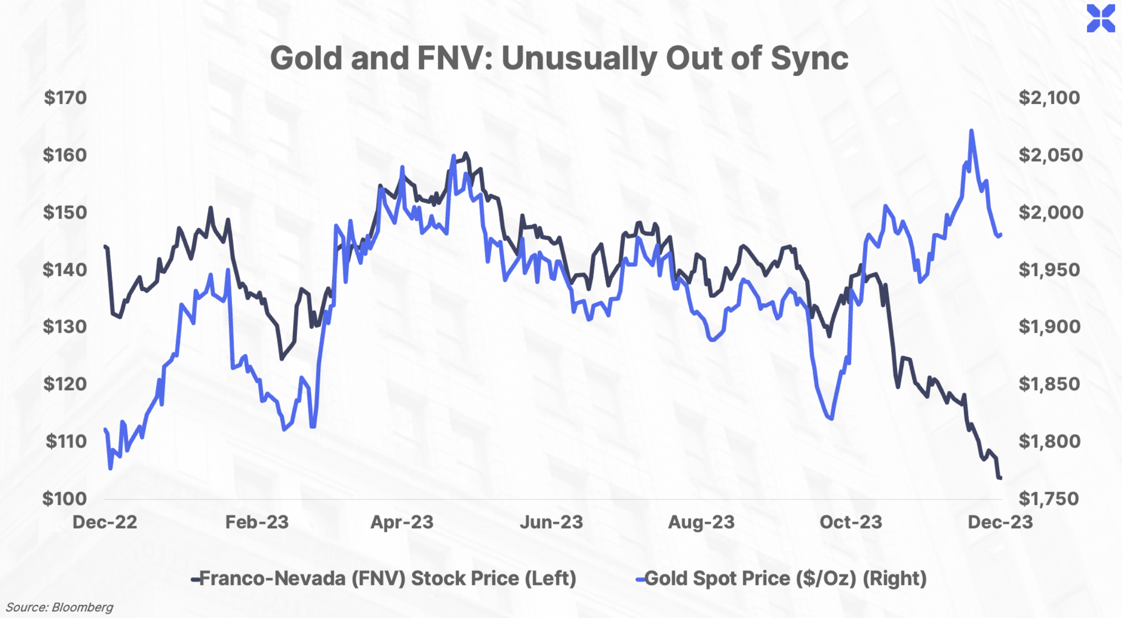
If the mine is shut down, there'd be significant damage to the nation's economy. The Cobre Panama mine accounts for roughly 5% of the country's GDP, 75% of its exports, and supplies 1% of the world's copper. The mine also employs 7,000 Panamanians. The country's National Council of Private Business claims that the protests have already caused losses of $1.7 billion for Panama, equivalent to 2.2% of the country's GDP.

All of this is unfolding ahead of Panama's May 2024 presidential election. A new president might be more open to negotiations.

What does this mean for FNV investors?

Since protests began, the value of Cobre Panama has been wiped out of FNV's stock – which has lost $5.6 billion of its market capitalization, $600 million more than its $5 billion balance-sheet valuation. The market has already priced in the worst-case scenario and then some, by assigning no value to Cobre Panama. However, there's still some chance that the new Panamanian government rules more favorably, or that FNV will receive a settlement from arbitration proceedings.

Meanwhile, investors have also given FNV little credit to the impact of rising gold prices for the rest of FNV's portfolio. When the price of gold goes up, FNV earns substantially higher profits. And gold has rallied recently, reaching an all-time high of $2,135/oz on December 4, which should benefit the rest of FNV's portfolio and be a tailwind for earnings, partially offsetting the loss from Cobre Panama.



Source: Bloomberg

The recent rally in gold prices is helping offset the impact of the loss of Cobre Panama. The company is only expected to suffer a modest decline in earnings per share next year. Current analyst estimates for 2024 indicate the company will earn $3.42 per share next year, down just 4% from its prior record high of $3.55 in 2021.

As a result of FNV's share price decline, and its resilient earnings outlook, FNV currently trades for just 32x next year's earnings estimates. This is just above its all-time low valuation of 28x earnings, and a 30% discount versus its five-year average valuation of 45x earnings.

Since going public in 2008, Franco-Nevada has grown into the leading gold royalty company based on revenue and asset base. With 115 revenue-producing assets, Franco-Nevada's diverse portfolio of mostly mines produces steady cash flows during up and down cycles.

FNV's management has established one of the best track records in the industry. And we don't believe this core strength has changed. Instead, the business is suffering from a one-off speed bump, creating a rare opportunity to buy a great business at a bargain price.

Today, we are adding Franco-Nevada to *The Big Secret*'s list of "best buys," replacing PayPal. Even if we were to assume the FNV doesn't recover anything from arbitration and the Cobre Panama is shut down forever, the company has no debt and a strong $1.3 billion cash position and is poised to benefit from the rising price of gold.

Investors have already priced in a worst-case scenario of a total loss at Cobre Panama, and then some. The remaining assets at FNV can now be purchased at a historically low valuation. Plus, there's still potential upside from the mine reopening, or if it remains closed and FNV is compensated for its investment in Cobre Panama.

Given FNV's deeply discounted valuation, we are making it one of our top three "best buys" in the portfolio today, replacing PayPal.

Action to Take: Buy Franco-Nevada (NYSE: FNV) up to $125 per share.

PayPal Gains Momentum

PayPal (Nasdaq: PYPL) is adding new robust features to its digital wallet and streamlining its online checkout as it aims to bolster its position against the competition.

The efforts are part of a project named Quantum Leap, PayPal's first major initiative under new CEO Alex Chriss, whose expertise in upselling software at Intuit could provide a boost for PayPal as it releases new features for both shoppers and merchants.

Streamlining the online checkout process will help the company compete with Stripe and Apple Pay, which have used new technologies to make it easy to pay with one click of a button. Customers no longer need to fill out their address or payment information because it's already saved to their digital wallet.

By making the integration onto their checkout pages simpler and more seamless for merchants, PayPal hopes Project Quantum Leap will attract new merchants to its platform.

PayPal's two-sided ecosystem, consisting of 400 million users and 35 million merchants, enables the company to use artificial intelligence ("AI") to power shopping recommendations to users while driving more sales to PayPal merchants.

By tying merchant and shopper data together leveraging AI, PayPal can connect shoppers with tailored rewards while also driving new sales to merchants and helping optimize their inventory.

For example, PayPal can identify stock levels in a merchant's inventory and suggest potential promotions using its consumer apps to determine which groups of consumers are more likely to purchase the goods in inventory.

The news of project Quantum Leap follows a solid Q3 report. Compared to Q3 2022, revenue grew 9% and earnings per share increased 20%. With share repurchases totaling nearly $7 billion over the past 12 months, PayPal has reduced its shares outstanding by nearly 8% since 2022. And with a strong cash position of $11.5 billion, there's plenty of runway for future repurchases.

PayPal shares have risen 20% since the report. But still, PayPal trades at a bargain, near its historic low valuation at 12x earnings. PayPal remains a strong buy in our view.

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 comes from T.G., who writes:

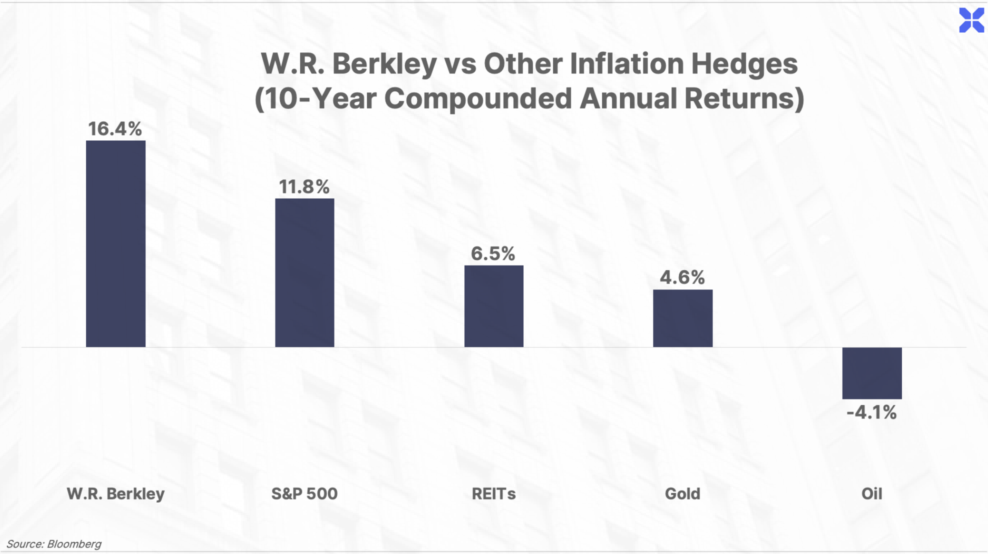
> *"I own W.R. Berkley and have for 10 years. My question concerns the financial nature of the company and the collapse of the dollar. How do you see the company surviving the collapse without a total loss of value? Think float."*
>
> **Porter's comment: Thank you, T.G., for a great question.**
>
> **One of the most important messages I've tried to deliver to subscribers over the last two decades is how to protect against the ongoing demise of fiat currency. The historical track record shows that highly capital efficient businesses offer the ultimate inflation hedge. These are very profitable businesses that can grow without requiring substantial capital, allowing their earnings power to increase at rates exceeding inflation.**
>
> **Exceptionally well-run insurance companies, like W.R. Berkley (NYSE: WRB), sit at the top of this list.**
>
> **To your point about float, let's review the mechanics of how this works. Insurance companies receive upfront cash payments (premiums) in exchange for paying out future liabilities (insurance claims). Along the way, they get to invest these premiums, which can grow their capital base before paying out the future claims. This is the ultimate inflation-fighting business model, because it takes in today's more highly valued dollars in exchange for paying out liabilities in future, depreciated dollars.**
>
> **In other words, insurance companies can grow their business using other people's money (i.e., policy-holders), thus requiring no additional capital of their own to increase their earnings power.**
>
> **Of course, the devil lies in the details – not every insurance company can do this well. The key to success is good underwriting, which means pricing insurance policies in a way that the future claims are less than the premiums. Companies that can do this effectively get access to what is effectively a negative cost of capital.**

W.R. Berkley is one of the best in the business in this regard. Over the last 10 years, the company has only paid out 93.7 cents on every dollar of premiums collected (known as the "combined ratio"). This means W.R. Berkley gets to keep 6.3 cents of every dollar of insurance premiums it takes in. Along the way, it also gets to invest the insurance premiums before paying out claims in future, devalued dollars.

This makes W.R. Berkley the ultimate inflation hedge, and the numbers back this up.

Over the last decade, according to the official government inflation statistics (measured by the consumer price index), inflation has averaged 2.7%. Based on real-world experience, and the inherent flaws with government statistics, I'd wager that the actual inflation rate has averaged something closer to 5% to 6%.

Over that same period, W.R. Berkley shares have generated a compounded annual return of 16.4%. This not only exceeds the annual inflation rate by double digits, but it also beats the overall overall stock market (the S&P 500) and hard assets like gold, oil, and real estate:

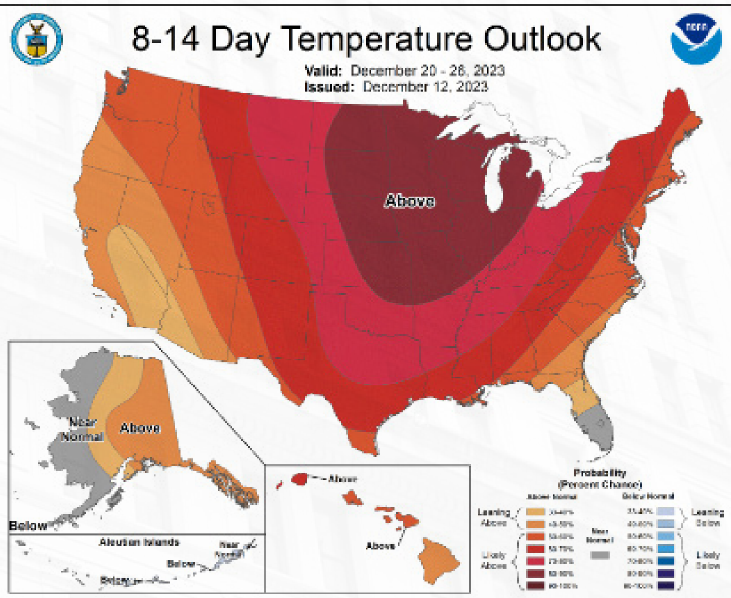


The conventional wisdom says that hard assets, like commodities and real estate, offer investors a hedge against inflation. But in reality, the best these assets can do is merely hold their value against declines in fiat currency. That's because they are non-productive, and thus merely keep your purchasing power running in place.

Productive assets, like the stocks in the S&P 500, offer a much better hedge against inflation. And highly capital efficient businesses, like W.R. Berkley, offer the ultimate protection against fiat currency debasement.

The next letter comes from B.A., who writes:

> *"What is happening to EQT? Do you still believe in the God of Gas?"*
>
> **Porter's comment: Yes, I still believe in EQT and the company's exceptional management under the Rice brothers ("The Gods of Gas").**
>
> **I also remain bullish on U.S. gas prices over the long term. The U.S. liquefied natural gas ("LNG") export boom will send new record volumes of cheap shale gas to energy-starved countries around the world over the coming decades.**
>
> **But in the short term, there's a reason why they call natural gas the "widow-maker" commodity. That's because the near-term price fluctuations are heavily influenced by the unpredictable vagaries of Mother Nature. This is particularly true from October through March, when natural-gas prices are driven almost entirely by how much of the fuel is consumed for heating. This year's El Niño weather pattern unleashed another record-setting heat wave across the globe, and has put 2023 on track for the hottest year ever.**
>
> **Unseasonably warm weather over the past few months has sent U.S. gas prices down from a high of $3.60 per thousand cubic feet (mcf) in late October to under $2.40 today. The drop in gas prices has pressured shares of EQT, along with those of other natural gas producers.**
>
> **I suspect the near-term pressure on gas prices and gas producers will remain in place. The latest outlook from the U.S. National Weather Service shows little respite from the unseasonably warm temperatures in coming days and weeks:**



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There's another factor compounding the near-term headwinds to U.S. gas prices from Mother Nature. Earlier this month ExxonMobil announced delays at its Golden Pass LNG export terminal. The 2.4 billion cubic feet per day (Bcf/d) facility was originally slated to come online in the second half of 2024, but is now delayed to the first half of 2025.

The capacity of this single facility represents about 2% of total U.S. gas production. For a commodity like natural gas, where prices are set at the margin, this presents another short-term headwind that will persist through the next 12 to 18 months.

That said, my bullish view on EQT and U.S. gas prices is a long-term thesis that will unfold over the coming decade. The fact remains that the global gas market will struggle to satisfy demand, and low-cost shale producers like EQT offer the cheapest source of supply to fill this growing need.

The occasional warm winter or LNG project delay doesn't change the long-term opportunity, and thus we plan on holding EQT through thick and thin.

Porter Stansberry

Porter & Co.
Stevenson, MD

P.S. If you'd like to learn more about the Porter & Co. team, you can get acquainted with us **here**. You can follow me (Porter) on **X (formerly Twitter)** here:

@porterstansb