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THE BIG SECRET ON WALL STREET

The Buyout Brothers' Profit Machine

- The Quiet Wealth Compounder That Beats Berkshire Hathaway
- These M&A Gods Defy All Odds and Grow, Grow, Grow

FROM THE DESK OF PORTER STANSBERRY

#46
MARCH 22, 2024

The Buyout Brothers' Profit Machine

The Quiet Wealth Compounder That Beats Berkshire Hathaway These M&A Gods Defy All Odds and Grow, Grow, Grow

"I made a costly mistake."

Warren Buffett, in his annual shareholder letter last month, admitted for the first time that his massive investments into regulated utilities and railroads have been disastrous for Berkshire Hathaway. In fact, Berkshire Hathaway Energy company is now at risk of bankruptcy because of wildfire liabilities, Buffett writes:

> *"the regulatory climate in a few states has raised the specter of zero profitability or even bankruptcy."*

Meanwhile, Berkshire's railroad is a terrible business, as it has been since Buffett bought Burlington Northern Santa Fe ("BNSF") Railway in 2009:

> *"BNSF must annually spend more than its depreciation charge to simply maintain its present level of business. This reality is bad for owners..."*

Many consider Buffett to be the greatest investor of all time. And for good reason: he has the numbers to back it up. In 2017, quantitative research firm AQR ranked the performance of Berkshire against all 186 investment funds and 1,111 U.S. stocks with a 40-year trading history. The results show that no other fund manager or single stock beats Berkshire's record of wealth compounding over the full period.

But there's a wrinkle in this 40-year comparison... the world-beating returns Berkshire generated *came from the first half of Buffett's investing career*.

The Big Secret

This business continuously boosts the profit margins of the companies it acquires, while also constantly upgrading the quality of its portfolio. This simple but powerful formula has created one of the greatest wealth creating vehicles of all time, even better than Berkshire Hathaway – compounding shareholder capital at more 20% per year for nearly four decades running.

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If we change the starting period and analyze Berkshire Hathaway over the last 20 years, beginning in 2003, Berkshire has merely matched the returns of the S&P 500 – including several stretches of prolonged underperformance:

The Big Secret about Berkshire Hathaway is that it's no longer one of the world's greatest wealth compounding vehicles… *and it hasn't been for two decades*.

But that's not a secret to long-time subscribers.

On March 2, 2018, in a hugely controversial *Stansberry Research Digest* ("The Massive Hidden Problem at Berkshire Hathaway"), Porter explained why Buffett had lost his Midas touch.

Porter said Buffett had broken Berkshire's "magic compounding machine" by placing a huge amount of capital into bad investments – specifically, into two highly capital-intensive, regulated businesses: MidAmerican Energy (now Berkshire Hathaway Energy) and BNSF Railway.

These investments were Berkshire's largest ever (at the time) and these businesses were a stark departure from the style of investing that made Buffett and Berkshire great.

Starting in the late 1960s, Buffett followed a simple but incredibly powerful investing formula – one that Porter himself has advocated for the last 25 years: Focus on highly capital efficient businesses (like property-and-casualty insurance companies and consumer-product brands), that can consistently grow earnings without sinking a ton of money into capital expenditures. Ensure these companies enjoy competitive advantages so dominant and so entrenched that their future success is "inevitable." Don't overpay for them. And re-invest all of the capital they provide. Rinse and repeat. The strategy was a perpetual money machine.

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Beating the market was virtually assured because so much of Berkshire's investment capital was provided, for free, by its insurance companies. Thus, all its investments needed to do was be capital efficient (send dividends to Omaha) and be "inevitable." Buffett piled into companies like American Express (AXP), Coca-Cola (KO), and McDonald's (MCD) – businesses that simply couldn't fail and wouldn't require much capital to grow.

But starting in the early 2000s, Buffett strayed from this proven approach. He began investing into low-margin industries that required enormous amounts of capital. And, even worse, these businesses were also highly regulated.

As Porter wrote back in 2018:

> *"In short, over the past 20 years, Buffett has gone from powering his incredible compounding machine with 'inevitables' – the greatest businesses ever built – to powering his empire with cash-eating, regulated utilities. And the future value of these investments, assuming he can actually turn the railroad around, rely on the honesty and integrity of our elected officials. Buffett has gone from investing with the 'inevitables" to investing at the mercy of the 'incorrigibles.'"*

And the real problem, something we don't believe the market fully appreciates, is that rather than providing Berkshire with capital, these huge companies continue to draw ever more capital into these woefully underperforming businesses. Although Buffett paid less than $2 billion for MidAmerican Energy in 1999, he has since invested tens of billions into the low-returning utility. Berkshire Hathaway Energy is now one of the company's largest subsidiaries, with $26 billion in revenue last year. And the company has never paid a single dime – not one penny – in dividends to Berkshire Hathaway.

Berkshire Hathaway Energy is the opposite of capital efficient. It required a total asset base of $124 billion to earn $940 million of pre-tax income in 2023, or a 3.6% pre-tax profit margin. That's an abysmal 0.75% return on assets (before taxes). Zero-risk government bonds beat BHE's returns on capital by a factor of more than six. Worse, BHE is a massive drain on Berkshire's own capital, requiring $9.1 billion in expenditures last year.

The other major investment misstep – that continues to get worse – came in 2009, when Berkshire purchased BNSF Railway for $44 billion. Like BHE, BNSF has become a major drain on Berkshire's capital. Buffett has pumped over $50 billion of capital expenditures into the railroad since 2009. By 2017 BNSF was contributing 29% of Berkshire's earnings – and demanding ever more capital. As Porter pointed out in his now famous 2018 *Digest*:

> *"The railroad is a terrible investment. Capital expenditures continue to grow, but the railroad's profits don't."*

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Since then, the railroad has continued consuming even more of Berkshire's capital with little to show for it. BNSF's capital expenditures rose from $3.2 billion in 2018 to $3.9 billion last year. Meanwhile, profits have declined, with pre-tax income falling from $6.9 billion in 2018 to $6.6 billion last year.

These investments broke Berkshire's formula – they put sand into the "magic compounding machine." They've stifled Buffett's ability to compound wealth in the wonderful businesses that built Berkshire's world-class track record. The end result is the subpar returns Berkshire investors have experienced over the last two decades. The once-vaunted Berkshire Hathaway has become no better than a garden-variety index fund.

Now, six years after Porter wrote that BRK was "*being overwhelmed by a series of disastrous investments*," Buffett has confirmed this thesis. As we quoted above, in his **shareholder letter** he admitted how bad the railroad and the power investments have been. But despite admitting his mistakes, Buffett makes no mention of taking corrective action. Thus, Porter's original prediction from 2018 remains true today: until he takes corrective action, Berkshire Hathaway investors will likely fail to outperform the S&P 500 going forward.

What should he do? It's simple. Regulated utilities and huge infrastructure businesses like railroads, should be financed primarily with debt. They will be slow-growing businesses, but they can pay huge dividends to their owners over time – if they're financed with debt. Berkshire, as the world's leading property-and-casualty company, can't hold that much debt on its balance sheet, which must remain pristine (with a AA-rating) to guarantee all of its insurance contracts.

To make Berkshire work again as the world's best compounding machine, the capital-intensive assets (like the power company and the railroad) should be spun-off into a new, dividend-paying entity that's financed primarily with debt. What would remain in Berkshire are the insurance companies, the equity portfolio, and the capital efficient businesses that it owns.

Until that happens, we don't recommend buying and holding Berkshire – although, when it's trading at a big discount to intrinsic value, it is a great trading opportunity.

What should you own instead?

We've found a serial acquirer – a holding company that grows primarily through acquisitions, like Berkshire. But this company, which I bet you've never heard of, has avoided Buffett's mistake. Instead of downgrading the quality of its portfolio, this company has only *improved* the quality of its holdings over its 40-year lifespan.

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This company has developed a way to systematically create efficiencies for supercharging profit margins and returns on capital, regardless of the business model or industry. Over the last four decades, this company has not only beaten the S&P 500, but it's outperformed Berkshire Hathaway too.

Given its stellar capital allocation – including selling underperforming businesses and reinvesting into increasingly higher-quality enterprises – we're confident this outperformance will continue.

We hope you'll make this firm part of your portfolio because it's better than Buffett – by far.

Better Than Buffett by Far

In this issue, we're finally recommending **Danaher (NYSE: DHR)**, a company we've admired since we first stumbled upon it back in 2001.

Porter and David Lashmet were visiting a tiny (less than $100 million) network-attached storage company called Microtest, which they recommended in their small-cap-growth stock research service. Danaher bought the entire company a few weeks later. That made a big impression on Porter and Dave: very few investors understood the potential in this tiny business.

Since then, Danaher has grown – a lot. Its shares are up 2,752%, or 16% a year. Today, with a market cap of $186 billion, Danaher owns 15 companies across three industry segments, generating $24 billion in annual revenue. And while it is a much bigger company now, we believe its formula for compounding wealth remains fully intact.

The notion of growing through acquisition is nothing new. Each year, corporations spend more than $2 trillion in mergers and acquisitions (M&A), including a record $3.9 trillion in 2023.

But the collective track record of these deals is abysmal. **Studies show** that 70% to 90% of M&A transactions fail, and wind up destroying shareholder value.

Danaher defies these odds because it doesn't just write a check when buying businesses. It ensures its money is put to good use. For example, it created a playbook for transforming good companies into great ones. It developed a way to systematically build efficiencies for supercharging profit margins and returns on capital, regardless of the business model or industry.

Since its founding in 1984, Danaher has acquired (and sold) hundreds of businesses across a vast range of industries. This includes hand tool makers, water-treatment companies, dental-equipment suppliers, and biotechnology firms.

The success of these acquisitions is reflected in Danaher's financial performance. Over its 40 years, the company has compounded shareholder capital at an incredible 21% per year. That's nearly twice the S&P 500's compounded annual return of 11.6% over the same period.

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It's rare for any company to compound capital at nearly double the market rate for any single 10-year stretch. Doing it for four decades is almost unheard of. And the cumulative effect snowballs into world-dominating returns.

An investment of $1,000 into Danaher in 1984 is worth $1.8 million today. That same investment in the S&P 500 is worth around $75,000.

After such an incredible run, it's tempting to think Danaher's best days are behind it. But, unlike what we are seeing with Warren Buffett and Berkshire Hathaway, Danaher's business model has only gotten better over time. And we believe the best is yet to come.

Finding Inspiration on the Danaher Creek

The story begins with brothers Steven and Mitchell Rales in the early 1980s. While fishing on the Danaher Creek in western Montana, the two – who'd spent time working for their father's real estate firm but had otherwise unremarkable backgrounds – passed the time talking through ways to capitalize on the biggest trend sweeping through financial markets: leveraged buyouts ("LBO").

In an LBO, companies raise debt to fund acquisitions of other companies. A series of favorable tax and regulatory changes under the Reagan administration sparked an LBO boom. From 1979 to 1989, over 2,000 LBOs were funded with an estimated $250 billion in debt.

Another factor fueling the boom was the rapid rise of junk bonds – high-yield debt raised to finance struggling or cash-strapped businesses. The junk-bond market grew from a small niche into a major asset class during the 1980s. The "king of junk bonds" Michael Milken fueled this growth by tapping into a large network of institutional investors searching for riskier, but higher-yielding securities.

On their fishing trip, the Rales brothers decided to launch a holding company designed to acquire manufacturing businesses, financed with junk bonds.

In 1984, the brothers did just that, buying an existing company and renaming it Danaher, in honor of the creek where they found the inspiration for the idea. Over the next two years, Danaher acquired 12 manufacturing businesses that sold everything from pneumatic pumps to power drills.

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In these early days, Danaher hadn't yet evolved into the shrewd makeover artist that it is today. The Rales brothers followed the 1980s corporate-raider playbook using hostile takeovers, bidding wars, and heavy servings of junk bonds (with Milken's Drexel Burnham Lambert as their banker).

The Rales brothers became infamous for their aggressive takeover style, including a high-profile showdown with none other than Warren Buffett over the fledgling consumer-products business The Scott Fetzer Co. (Buffett ultimately won that bidding war).

In 1985, *Forbes* headlined a Rales brothers feature article "Raiders in Short Pants." The author labeled the brothers as "cocky to the point of foolishness" and described them as "more like real estate speculators than industrialists." Neither Steven nor Mitchell has spoken to the media since.

By the late 1980s, the merger boom went bust. The junk-bond-financed LBO mania plowed lots of capital into subpar businesses. A cascade of corporate defaults culminated in the savings-and-loan (S&L) crisis, which wiped out 32% of small lenders (known as S&L thrifts) from 1986 to 1992.

Lenders tightened up on extending credit, and the LBO machine seized up. Danaher struggled under a heavy debt load, and lost access to additional bank funding. By sheer necessity of survival, the brothers turned their focus toward optimizing efficiency and boosting cash flows among its portfolio of businesses.

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Becoming Japanese

The Rales brothers found redemption from an unexpected savior, in the form of Jacobs Vehicle Systems ("Jacobs").

When Danaher acquired Chicago Pneumatic pump company in 1986, it also acquired Jacobs as a subsidiary division. Jacobs produced the Jake Brake, which transforms the compression energy created by diesel engines into stopping power. While the company was selling plenty of the popular Jake Brakes, it earned mediocre single-digit profit margins.

Unbeknownst to the Rales brothers, Jacobs had embarked on an efficiency-boosting effort starting in 1987.

In searching for a solution to boost the company's profit margins, Jacobs President George Koenigsaecker turned to Japan. In the 1980s, Japanese automaker Toyota emerged as one of the world's most efficient manufacturing companies. It began displacing the global auto leaders in Detroit – Ford Motor, Chevrolet, and Chrysler – a trend that continued for decades, turning Toyota into the world's most profitable global automaker today.

Toyota's manufacturing prowess came from its secret weapon: the Toyota Production System ("TPS").

TPS is based on the Japanese concept of *kaizen,* or "continuous improvement." The *kaizen* manufacturing approach involves constantly measuring every aspect of the production process in a never-ending pursuit of maximum efficiency. The basic idea is that small, but continuous tweaks compound over time to deliver powerful results.

More than a system, it's a cultural framework that empowers everyone from the CEO to the janitor to contribute efficiency-boosting solutions to every aspect of the business.

In 1987, Koenigsaecker learned that two TPS senseis (the highest level of TPS mastery), Yoshiki Iwata and Chihiro Nakao, who studied under the system's original creator, were visiting the area. Koenigsaecker invited the senseis to dinner, and asked if they would tour his production facility.

They agreed, and the trio left dinner and started the tour at 11 p.m. The senseis immediately spotted flaws in the production system and didn't hold back their criticism. They called it the "worst factory they'd ever seen."

They immediately went to work reinventing the factory floor, as Koenigsaecker recalled in **a 2016 interview**:

> *"We worked until 5 a.m.... This event launched a total transformation of our production system."*

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Compounding Small Gains Into Revolutionary Change

Koenigsaecker hired the senseis' consulting firm, Shingijutsu, to continue refining Jacobs factory layout and production processes. In typical *kaizen* fashion, they focused on small, incremental adjustments. As one example, they changed the lever on one machine to turn in a clockwise rather than a counterclockwise motion. This allowed workers to use their right arm, which on average is 3% stronger than the left arm.

A 3% productivity gain on one machine might seem inconsequential. But many small gains compounded over time can unleash a productivity transformation. And Jacobs continued implementing similar incremental improvements in the years that followed.

Over the next 10 years, Jacobs grew sales from $65 million to $220 million. And management accomplished this without adding any additional factory space, and only hiring an extra 25 workers. This boosted the number of Jake Brakes produced per man-hour of labor to surge 10-fold, from three to 35.

The *kaizen* overhaul went beyond the factory floor. It also improved Jacobs' supply chain and distribution network, helping it ship products faster. The company's lead times – the period between taking an order and delivering a product – collapsed from 85 days to just two.

This unleashed a tremendous upgrade in capital efficiency as well. The faster a business can deliver an order, the faster it gets paid. And the less time its capital sits idle, tied up in product waiting to be sold. One metric for measuring this capital efficiency is inventory turnover, or the number of times a company can sell its inventory per year. The *kaizen* logistics overhaul boosted Jacobs's inventory turnover from two to 25.

Selling more products faster, with less manpower per unit sold, delivered a productivity waterfall. The bottom line: Jacobs' profit margins soared six-fold, from 4% to 25%.

This remarkable transformation began in 1987, which coincided with the LBO bust and the Rales brothers' forced strategy pivot. In awe at Jacobs' improving financial performance, the Rales brothers visited the factory floor and invited Koenigsaecker to present his *kaizen*-based manufacturing strategy at Danaher's first corporate meeting in 1989.

Over the next year, the Rales brothers overhauled Danaher's strategy to replicate the Jacobs approach across its entire organization.

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From Corporate Raider to *Kaizen* Powerhouse

Danaher's company-wide transformation began with the hiring of a new CEO and fellow *kaizen* fanatic, George Sherman, in 1990. Sherman had previously led a successful turnaround of toolmaker Black & Decker. When Sherman joined Black & Decker in 1985, the business was failing in the face of an onslaught of Japanese companies using *kaizen* manufacturing. Sherman in turn adopted the *kaizen* practices to bring Black & Decker back to life.

The Rales brothers tasked Sherman with developing a system of operating principles that could be applied across Danaher's entire portfolio. They called it the Danaher Production System, and it went beyond simply making newly acquired businesses more profitable.

Sherman also unleashed efficiencies by overhauling Danaher's acquisition strategy. Previously, the Rales brothers acquired whatever businesses looked attractive on a standalone basis. This resulted in a sprawling collection of disparate companies across an assortment of industries.

Sherman pioneered a "platform-based" approach of buying businesses in the same or related industries. In this way, Danaher could produce cost-saving synergies across businesses, like buying input materials in bulk at lower costs. The related businesses could also benefit from the distribution improvements across the platform, allowing for faster shipping times and more rapid inventory turnover. Thus, a platform of businesses could deliver more cost-saving efficiencies and better customer service than any single company could achieve by itself.

For example, in the early 1990s, Danaher acquired several leading hand tool brands, including Easco Hand Tools and Armstrong Tools. He improved each business's operating efficiency, and that of the hand tool platform. This included overhauling the logistics and distribution network, ensuring speedy deliveries of customer orders.

This allowed Danaher to offer customers the widest selection of hand tool brands, with best-in-class delivery times. As a result, Sears, the leading retail giant of that time, made Danaher its exclusive hand tool provider in the 1990s.

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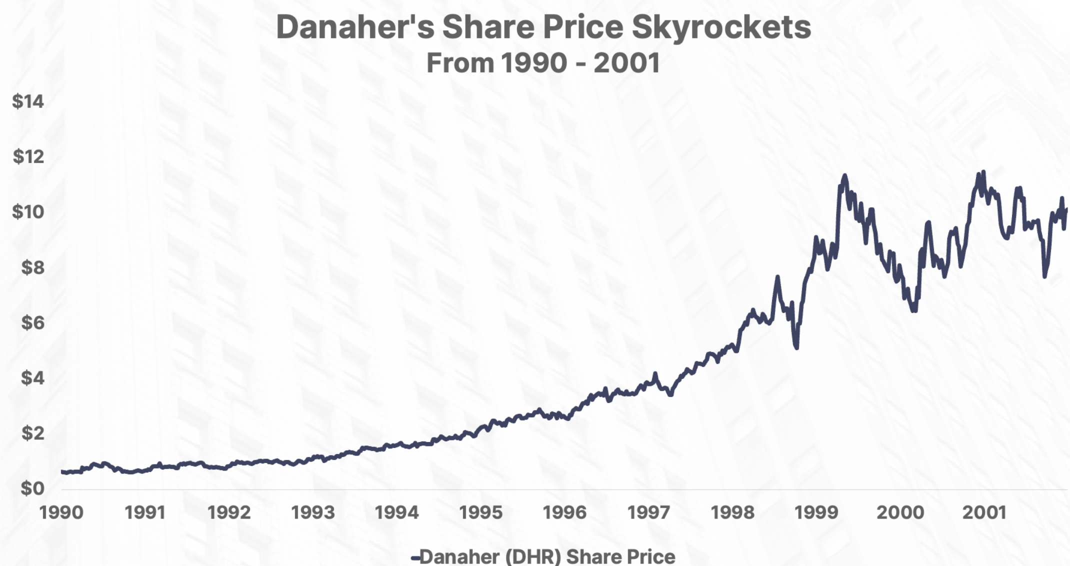
Sherman applied the same approach across the dozens of companies Danaher acquired during his tenure from 1990 to 2001. The results showed up in its rapidly improving financials. During that period, revenues grew 4.5x from $845 million in 1990 to $3.8 billion. Profit margins doubled from 4% to 8%, sending net income up nearly 10-fold from $36 million to $298 million. And Danaher's share price skyrocketed, compounding investor capital at an incredible 26% per year:



But that was just the start of a multi-decade run of market-crushing returns.

A *Kaizen* Approach to Capital Allocation

The beautiful part of Danaher's business model is that it gets better with time. That's because Danaher doesn't limit its *kaizen* principles to the companies it acquires. It applies the same framework of continuous improvement at the corporate level. This includes the biggest driver of Danaher's financial performance: the critical capital-allocation decisions that drive which companies to buy and which to sell.

During the 1990s, Danaher's management realized that the manufacturing businesses they acquired had limited profitability. No amount of efficiency can remove these companies' capital-intensity and highly cyclical nature.

So Danaher began shifting its focus to higher-margin industries, looking for companies with recurring revenue streams that remained stable through the economic cycle. Reflecting this new approach, the company changed the name of its core operating philosophy from the Danaher Production System to the Danaher Business System ("DBS").

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DBS chief architect Mark DeLuzio, who worked under Sherman in the 1990s, explained this new approach in **a 2020 interview**:

> *"Toyota is a better manufacturer, but when we set out to do the Danaher Business System, we did not set out to be the best manufacturing company. We set out to be the best enterprise. Now I'm not saying Toyota is a bad enterprise. They're just in a bad business... you cannot expect success by trying to optimize something that's suboptimal. And the auto industry to me is suboptimal. The airline industry is suboptimal... you just can't make money there."*

Toyota remains one of the best manufacturing companies in the world, but the business has never exceeded 10% net-income margins. Likewise, even as Danaher became a highly efficient manufacturer by copying Toyota's playbook, its profit margins averaged only 6% through the 1990s.

But that changed as Danaher moved away from buying cyclical, capital-intensive manufacturing businesses. Starting in the late 1990s, Danaher began buying businesses like Hach, a leader in water-testing equipment and chemicals; and Trojan Technologies, an environmental engineering company. It continued buying similar businesses within Danaher's environmental-science segment that grew larger throughout the 2000s and 2010s.

In 2004, Danaher entered the medical-diagnostics field with the purchase of Radiometer – a leading provider of blood-sample tests used in 16 of the top 20 U.S. hospitals. The following year, Danaher established its life-sciences segment with the acquisition of Leica Microsystems, a German microscope manufacturer.

As the 2000s progressed, Danaher expanded into dental-equipment makers. This included the 2009 purchase of PaloDEx Holding, a maker of dental-imaging equipment.

These industries had two things in common. First, they tended to generate recurring sources of revenue that remained stable regardless of economic conditions. Demand for clean water, medical diagnostics, and dental care don't go away during recessions. Second, these industries generated substantially higher profit margins than the capital-intensive manufacturing businesses Danaher had acquired in the late 1980s and early 1990s. And these new businesses became even more profitable as Danaher applied its *kaizen* playbook and DBS practices to each business it acquired.

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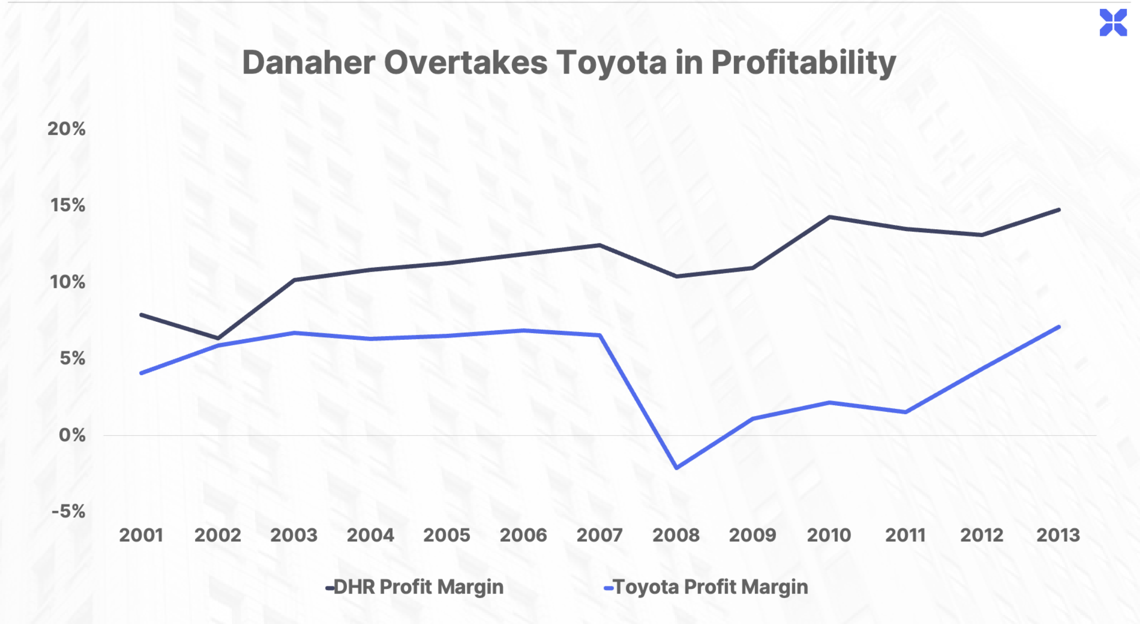
By 2001, the *kaizen* student became the *kaizen* master, as Danaher surpassed Toyota's profit margins and never looked back. By 2013, Danaher was generating 15% profit margins, double Toyota's 7% profit margins. Danaher remained highly profitable through the swings in the economic cycle – including the Great Financial Crisis from 2007 to 2009 – as Toyota dipped into loss-making territory:



Danaher's latest chapter has unleashed the biggest transformation in its history, delivering new record highs in profitability.

Betting the Farm on Biopharma

Over the last decade, Danaher has changed the makeup of over half of the businesses in its portfolio.

This includes spinning off its dental platform into a separate public company, Envista Holdings (NVST), in 2019. And last September, Danaher spun off its environmental-science segment into publicly traded Veralto (VLTO).

While these two segments produced good returns, Danaher identified an industry with substantially higher returns and faster growth: pharmaceutical research and manufacturing. Over the last 10 years, Danaher has invested more than $50 billion into this sector, through acquisitions by its life-sciences and biotechnology divisions.

As we'll see when we dive deeper into these investments, this change meant that Danaher is no longer an industrial conglomerate. For the first time in its history, Danaher is now a pure play in medical science and technology, split between three business segments: diagnostics, life sciences, and biotechnology.

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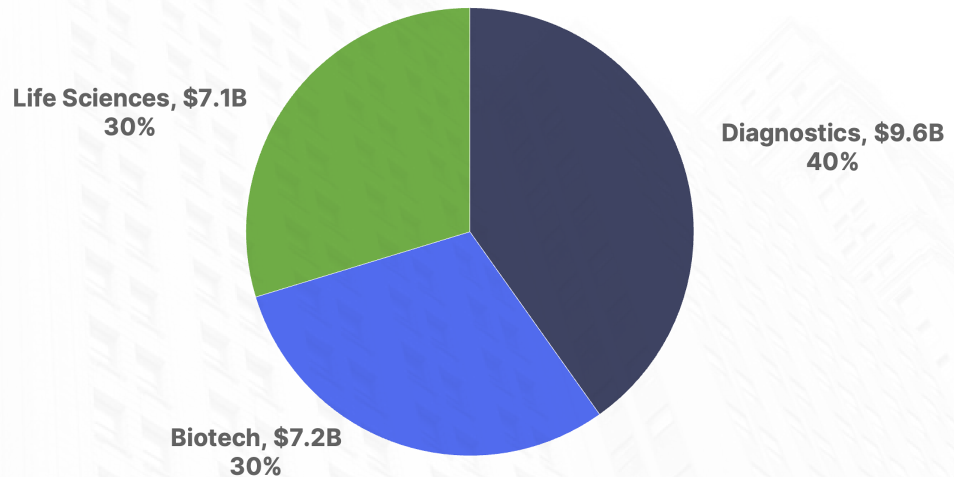

Source: Bloomberg

Danaher's key focus across its major acquisitions over the last decade is on biopharmaceuticals.

Biopharmaceuticals (biopharma) refers to drugs made from living organisms – the cells of plants, animals, fungi, or bacteria. Biopharma companies essentially hijack cellular machinery and transform them into miniature bioreactors. Huge vats of these bioreactors mass-produce the raw materials needed for large-scale biopharma drug production.

The biggest class of biopharma drugs involve genetic engineering, like recombinant DNA and RNA drugs. DNA and RNA are the genetic materials that contain the instructions for producing all known biological life. DNA and RNA molecules from all organisms share the same chemical structure – only differing in the sequencing of certain molecules. Researchers have learned to separate and recombine DNA or RNA fragments from various organisms to create custom-designed "recombinant" gene sequences.

These sequences can be programmed and packaged into pharmaceuticals to perform an endless variety of therapeutic functions. The applications range from cancer and auto-immune-disease treatments to vaccines and other applications. Another major class of biopharma drugs are monoclonal antibodies – genetically engineered clones of the body's natural antibodies designed to stimulate the immune system to attack diseases.

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Rapid advances in genomics research in the 1990s sparked a boom in biopharma drug research and development. This included the Human Genome Project, launched in 1990, which sequenced the human genome in 2003. Greater understanding of DNA and RNA molecules sparked the creation of more than a dozen blockbuster biopharma drugs (i.e., those crossing over $1 billion in annual sales) in the 1990s and early 2000s.

Traditional drug making using non-biological chemicals is a big challenge. But producing drugs from living organisms can be substantially more complex. Working with living cells means dealing with a high degree of variation from one biological cell (or fungi/bacteria) to the next. Further complicating matters, these living organisms can adapt to their surroundings. Thus, biopharma research labs and drug companies require the most stringent quality controls and processes.

The same challenges arise from generic biopharma drugmakers that create "biosimilar" copies of blockbuster drugs once their 20-year patent life expires.

As the patents expired from the wave of blockbuster biopharma drugs created in the 1990s and 2000s, biosimilars became another major opportunity over the last decade. Biosimilar drug production required a whole new regulatory framework, which the EU created in 2003 followed by the U.S. in 2010. This includes stricter requirements in everything from the manufacturing processes to the testing and analysis of the final products.

Danaher spotted a lucrative opportunity for applying its DBS operating philosophy to the booming field of both novel biopharmaceuticals and biosimilars.

The companies that supply the researchers and manufacturers of these drugs are held to the highest standards, and rewarded with fat profit margins. Plus, those that can meet these high standards benefit from sticky customer relationships. Once a biopharma drug maker or research lab dials in their process, it often becomes locked in to third-party suppliers of technology, consumable materials, and services.

This all adds up to an industry with high barriers to entry, and a steady stream of recurring, high-margin revenue.

Danaher made its first big splash in biopharma in 2015, with its $13.8 billion purchase of Pall Corporation. At the time, Pall was a global leader in the purification of gas, liquids, and solids. The business was split 50/50 between industrial and biotech applications. Danaher spun off the industrial segment and kept the biotech side of the business. The biotech assets it retained are critical in what's known as the "downstream" biopharma production process – the purification steps after the drug molecules are created.

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Next, Danaher expanded its presence in the upstream side of the business: biopharma drug production. In March 2020, it acquired the biotech division of General Electric for $21.4 billion. These assets covered a wide array of technology, manufacturing equipment, and services needed to produce biopharmaceuticals. Danaher has since combined these two acquisitions under a new brand, Cytiva, which makes up its biotechnology segment.

Together, the Pall and GE biotech acquisitions gave Danaher the broadest portfolio of biopharma-manufacturing capabilities in the world. By March 2020, Danaher offered a comprehensive suite of upstream and downstream solutions across all major biopharma drug-making production methods.

And the timing couldn't have been better.

COVID Outbreak Unleashes Biopharma Bonanza

On March 11, 2020, the World Health Organization officially declared the COVID-19 outbreak a global pandemic.

This sparked a mad scramble among governments, research organizations, and drug makers to find a vaccine. Scientists zeroed in on a technology based on messenger-RNA (mRNA), a genetic molecule that provides instructions to the body's cells to produce certain types of protein. They created a genetically engineered mRNA strand that instructs muscle cells to imitate the protein found on the surface of the COVID-19 virus. The vaccine then prompts the body's immune response to produce COVID-19 antibodies – killing the virus.

Pfizer released the first FDA-approved mRNA vaccine in December 2020. Similar vaccines soon followed from other drug makers like Moderna and Johnson & Johnson. Since then, 13.6 billion vaccinations have been distributed worldwide – or roughly 1.7 vaccinations for every person on Earth.

Danaher's aggressive investments in creating an end-to-end biopharma manufacturing platform paid off in a massive way. Virtually every COVID-19 vaccine maker used Danaher equipment, technology, or services in some part of their drug-development or production process.

The company also benefited from biopharma treatments for COVID-19, including monoclonal antibodies. And in Danaher's diagnostics segment, the $4 billion California-based diagnostics company Cepheid emerged as one of the biggest COVID winners.

Cepheid developed a 4-in-1 clinical assay that tests for COVID-19, Flu A, Flu B, and Respiratory Syncytial Virus (RSV). The 30-minute test enables rapid and accurate distinction between patients suffering from COVID, flu, or RSV – which often present similar symptoms. This multi-test capacity proved invaluable during the COVID-19 outbreak, when physicians needed quick and accurate diagnoses of whether patients were suffering from COVID or other similar respiratory illnesses.

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Danaher's big push into medical science and technology paid off across the board. Its business boomed during the peak of the COVID-19 outbreak in 2020 and 2021. From 2019 to 2021, sales grew 65% from $17.9 billion in 2019 to $29.5 billion. Profits grew twice as fast, with net income surging 131% from $2.8 billion to $6.2 billion over the same period.

Lasting Gains Despite Fading COVID Demand

Like many COVID-era winners, Danaher's business slowed as the pandemic came under control starting in 2022. With demand for vaccines, treatments, and tests falling, Danaher's revenue declined 20% from the record highs of 2021 to $23.9 billion last year.

But even with the reversal in peak-pandemic demand, Danaher retained much of the business it gained over the last four years. After sales declined in each of the last two years, Danaher's revenue at year end 2023 was 34% higher than pre-pandemic levels of 2019. Looking ahead, the business is poised for renewed growth as the post-pandemic slump appears near its end.

On the company's Q4 2023 earnings call on January 30, management told investors to expect a return to revenue growth starting in the second half of 2024. And, as we explain below, Danaher's long-term growth trajectory looks brighter than ever.

First, it's important to appreciate that Danaher's business quality improved dramatically over the last few years. Specifically, it has become substantially more profitable, with net income margins increasing from 14.9% pre-pandemic to 18.6% last year. This trend is expected to accelerate, with current analyst estimates projecting that profit margins will reach a record high 24% next year and expanding further to 27% by 2027.

The first major driver of Danaher's growing profit margins came from spinning off its lower-margin dental and environmental-science units, while investing heavily into its higher-margin biopharma platform.

Second, Danaher continues unlocking operational efficiencies from its *kaizen* manufacturing approach. From 2021 to 2022 at Cytiva, formed from the biotech assets at GE, Danaher completed over 400 manufacturing *kaizens*. These are weeklong productivity blitzes, where everyone across the organization works together to identify improvements in production quality, efficiency, and safety. The effort not only boosted Cytiva's profit margins, but also increased its rate of on-time project deliveries by an impressive 100%.

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In September 2022, Danaher began integrating Pall into the Cytiva brand to provide a single, unified biotech platform. The integration was completed in May 2023. Since acquiring Pall and integrating it and GE biotech within Cytiva, Danaher cut 50% of Pall's general and administrative expenses. This boosted the Pall portion of Cytiva's operating margins by over 10%.

Finally, Danaher's third source of margin expansion comes from its growing stream of recurring revenues, which typically generates higher profit margins for several reasons.

First, once customers get locked into a repeatable purchase, Danaher no longer needs to spend money on sales and marketing to generate that revenue.

Earlier, we explained why biopharma meets this first requirement. The precise research and production processes required in this industry means that, once a lab or pharma company sets up its system, it must maintain rigid controls to ensure consistency of its cellular bioreactors. Thus, once a customer begins working with Danaher, it tends to get locked into the customized products and services Danaher provides. Plus, it helps that Danaher's *kaizen* approach continues improving customers' performance – including things like doubling its rate of on-time project deliveries.

The second reason why recurring revenue is so profitable can be explained by the razor/razor blade business-model analogy. Razor companies make most of their money by selling replaceable razor blades. Compared with the razor, replaceable blades are lightweight, easy to manufacture, and can be sold at high profit margins.

Danaher's diagnostics business follows this model, with things like the Cepheid 4-in-1 test mentioned earlier. The more costly, capital-intensive part of this business is manufacturing the test analyzer box (shown below). Once Danaher sells the analyzer (razor) to a hospital or physician's office, it can then generate consistent high-margin revenues on the smaller, easy-to-manufacture test swabs and cartridges (disposable blades) that go into the analyzer:

Workflow: 3 Easy Steps

1 Obtain swab samples in the Cepheid Transport Reagent

2 Transfer sample to cartridge

3 Insert cartridge and start test

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Cepheid is just one example. Across the entire diagnostics segment, Danaher has increased its installations of devices by over 40% since the start of the pandemic. That represents a long tail of high-margin recurring revenue from a wide variety of consumable products to feed into its diagnostic equipment base in the coming years.

While COVID delivered an unexpected boost in recurring revenues, Danaher had previously already made this a key strategic focus. Since 2015, recurring revenues have steadily increased from 45% of sales to 80% today.

This is one of the many ways Danaher's business gets better over time. But we believe the best is yet to come.

Leaving the Pandemic Behind

Danaher reinvested its pandemic-era windfall to make an all-in bet on the future of biopharma.

Over the last two years, Danaher has spent $15 billion acquiring two leading suppliers of technology used in biopharmaceutical drug discovery, which went into its life-sciences segment.

This includes Danaher's $9.6 billion acquisition in August 2021 of Aldevron, a leading global supplier of plasmid DNA, mRNA, and proteins based in North Dakota. Aldevron sells these compounds and related technology and services to research organizations and pharma companies.

Through Aldevron, Danaher is also investing heavily into the next generation of biopharma technology. This includes the construction of a first-of-its-kind "sequence-to-vial" manufacturing facility in Fargo, North Dakota. This facility will enable the entire production of mRNA vaccines and therapeutics on-site, bypassing the third-party testing labs and manufacturers normally used in mRNA drug development.

By handling the full cycle of mRNA drug development, Aldevron's Fargo facility can eliminate the need to move molecules between different production facilities during drug development. This will eliminate costly downtime, and also reduces the risk of product impairment during transit. Aldevron expects this facility could reduce drug-development timelines by 30% to 50%.

Another big investment into the future of genomics research came from Danaher's $5.6 billion purchase of Abcam last December. Abcam is a leading global supplier of compounds used in scientific research and drug discovery. The Boston-based company produces high-quality reagents (used to accelerate a chemical reaction), biomarkers (used to identify which biochemical compounds react with targeted areas of the body), and antibodies. Abcam is considered the gold standard in drug discovery capabilities, with a consumer base including 750,000 researchers spanning academic, public, and commercial settings.

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Between its life-sciences (that includes Aldevron and Abcam) and biotech (Cytiva) segments, Danaher now offers the world's largest biopharma platform. It has exposure to every aspect of the industry, from drug-discovery research to the full scope of manufacturing – including upstream and downstream biopharma production.

This is all part of a giant play on one big idea… even though the COVID-era demand for vaccines and treatments has slowed, the surge in genomics research and future biopharma drug discovery is just getting started.

The Picks-and-Shovels Play on the Biopharma Boom

The U.S. government alone spent over $30 billion funding research and procurement of COVID-19 vaccines. Meanwhile, the total global spending on COVID-19 vaccines is estimated to reach $157 billion by 2025.

Learnings from all that spending on things like mRNA vaccines and monoclonal antibody treatments have been recycled into new biopharma drug research and development.

This is akin to how the rapid research into genomics during the 1990s, including the Human Genome Project, kickstarted a wave of blockbuster biopharma drug development over the following decade. Except on a much larger scale… and it's already starting to show up in the data.

Last year, the U.S. Food and Drug Administration ("FDA") approved a record-breaking 71 new therapeutics – normally there are only 43 approvals per year. And in the last two years, biopharma drugs made up a record share of these new drug approvals, including 48% in 2023.

Even before the pandemic, biopharma was one of the fastest-growing segments of pharmaceuticals, valued at $291 billion in 2020. It's now expected to reach nearly $1 trillion by 2030. For context, the entire global pharmaceutical market is currently valued at $1.5 trillion.

One of the more promising new biopharmaceuticals approved last year was a gene therapy treatment for Alzheimer's disease. The drug is Leqembi, made by a joint venture between U.S. pharma giant Biogen (BIIB) and Japanese drug maker Eisai. While it's just the beginning in assessing the effectiveness of this drug, Danaher's management has called out the potential of biopharma Alzheimer's treatments as a source of unexpected upside.

Even though it's on their radar, the potential of this new class of drugs is not baked into their financial projections. But it could unleash a surge in new biopharma activity if it's proven successful. Alzheimer's afflicts more than 55 million people worldwide, and this number is expected to double every 20 years – reaching 139 million people by 2050.

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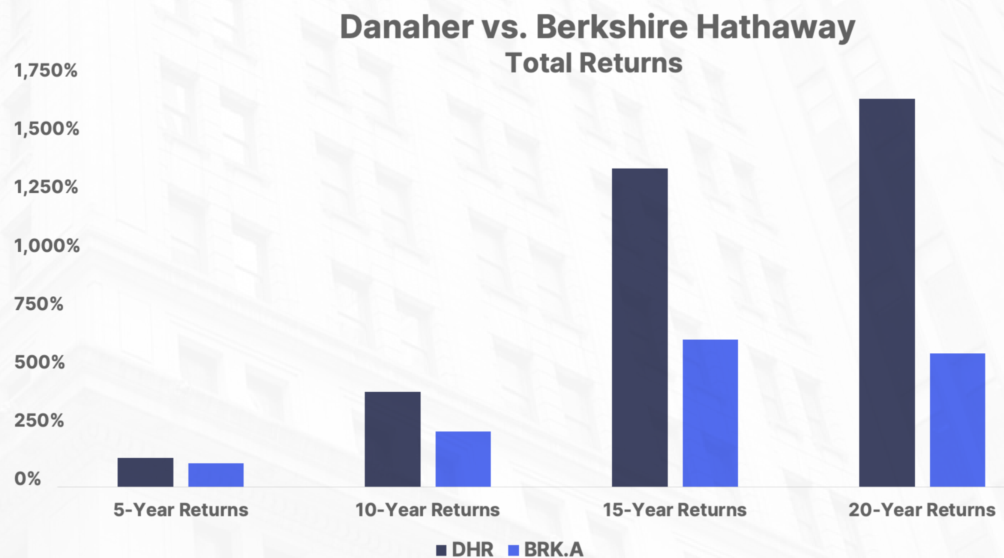
Whatever happens, Danaher is well positioned to ride the rising tide of biopharma drug research and development. The beauty of Danaher's business model is that it's not tied to any specific blockbuster drug, or even class of drugs.

Danaher has positioned itself as the picks-and-shovels seller for the coming biopharma gold rush. The picks-and-shovels sellers became the surest winners from the gold rush, because they didn't assume the risk of digging for gold. They received a steady stream of revenue from the gold miners who took the big gambles.

In the same way, Danaher's biopharma platform will prosper from the overall growth in the biopharma industry. It sells the technology, materials, and services needed across every stage of the biopharma drug development, from initial research and discovery to mass production of the drugs. Thus, Danaher will prosper regardless of which companies discover the next blockbuster biopharma drugs.

Longer-term, investors can have confidence in Danaher doing what it does best – shifting gears to allocate capital into the highest returning businesses and industries it can find. Danaher's business model has evolved several times over its history. It went from an industrial manufacturer in the 1990s to an environmental-science and dental-technology company in the 2010s to a leading biopharmaceutical manufacturer today.

Unlike Warren Buffett's Berkshire Hathaway, Danaher doesn't hesitate to dump underperforming assets and reposition its portfolio into the highest and best uses of capital. That's how Danaher has not only crushed the overall stock market for nearly four decades, but also consistently outperformed Berkshire Hathaway as well.



Source: Bloomberg | Returns through March 19, 2024

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Good merchandise rarely trades at a discount. As one of the world's greatest wealth compounders, Danaher is no different. Danaher currently trades at what some might consider to be an expensive valuation of 33 times earnings.

But remember, Danaher's business is just now bottoming out from the COVID slump. Starting this year and beyond, it should return to high-single-digit revenue growth of 7% to 9%. Meanwhile, the business is also becoming more profitable over time. With its relentless and ongoing use of *kaizen* efficiencies, and a growing stream of recurring revenue, Danaher is expected to reach 24% profit margins this year and increase to 27% over the next four years.

As a result, Danaher's earnings per share is expected to nearly double from around $6 in 2023 to over $11 by 2027. For a business with world-class profitability and this kind of earnings growth, paying a premium valuation typically delivers a better outcome than not owning it at all.

Danaher is the ultimate "forever" business. Our advice: don't make the mistake of waiting to buy at a bargain price, because that day may never come. Just buy it and own it forever. If the share price drops, and the business continues performing as expected, buy even more. Over any reasonable time horizon of five years or longer, we expect this simple strategy should handily outperform the overall stock market.

Action to Take: Buy Danaher (NYSE: DHR) up to $270 per share.

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New to the *Big Secret* 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. Howard Marks is a legendary debt investor. **Oaktree Specialty Lending Corporation (Nasdaq: OCSL)** is a subsidiary of Marks’ Oaktree Capital Management and is capitalizing on higher-yielding private loans. Oaktree Specialty Lending makes primarily floating-rate loans to private middle-market companies. Because private companies aren’t required to report the same level of disclosure as public companies, they are considered higher risk, and must pay higher rates to issue debt. Oaktree’s expertise in analyzing the risks of these private companies gives it an opportunity to capitalize on higher yields from these private market loans. The weighted-average yield on the company’s debt portfolio is 12.2%, which it returns to shareholders through an enticing 11.4% dividend. Best of all, Oaktree offers a chance to capitalize on what’s likely to be an explosion in the opportunity set for distressed-debt when today’s credit cycle turns. Investors would also benefit if the economy remains strong and rates stay higher for longer, since 84% of Oaktree Specialty Lending’s loans are issued at floating rates.

2. **Franco-Nevada (NYSE: 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, Franco-Nevada is highly capital efficient, generating 56% free cash flow (“FCF”) margins. Its 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 shut down a large copper mine that is one of the company’s largest royalty assets. The Cobre Panama mine contributed 20% of Franco-Nevada’s revenue and 16% of net asset value in 2023 but FNV shares have dropped even more – by 18% – effectively pricing in a total loss of the mine. Meanwhile, with the price of gold at all time highs, the rest of Franco-Nevada’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.)

3. **Philip Morris (NYSE: PM)** owns the international rights to Marlboro, the world’s leading traditional tobacco brand. 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 40% operating margins and a 24% average return on capital. It’s also a recession-proof business, and trades at an attractive valuation of just 14x earnings, with a 5.6% dividend yield.

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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	$34.33	1.29%	$1.07	-27.57%	Buy Under $50	4
BWX TECHNOLOGIES, INC.	BWXT	Nuclear Power Equipment	12-22-2022	$58.05	$108.00	0.85%	$0.92	87.63%	Buy Under $110	3
BITCOIN	BTCUSD	Cryptocurrency	05-11-2023	$27,011.85	$65,220.90	0.00%	$0.00	141.45%	Buy Under $50,000	4
PEABODY ENERGY	BTU	Coal Mining	06-22-2023	$21.29	$24.47	1.23%	$0.23	15.99%	Buy Under $25	4
CNX RESOURCES	CNX	U.S. Gas-Focused E&P	09-28-2023	$22.82	$22.62	0.00%	$0.00	-0.88%	Buy Under $30	3
BATTLESHIP STOCKS										
CREDIT ACCEPTANCE CORP	CACC	Consumer Finance	07-28-2022	$560.28	$566.49	0.00%	$0.00	1.11%	Buy Under $600	3
NOVO NORDISK	NVO	Pharmaceuticals	10-27-2022	$53.30	$130.01	0.48%	$0.74	145.30%	Hold	2
WINMARK CORPORATION	WINA	Specialty Apparel Stores	09-15-2022	$217.60	$348.38	0.92%	$17.00	67.91%	Hold	1
FRANCO-NEVADA CORP	FNV	Precious Metals Streamer	05-11-2023	$154.77	$116.71	1.17%	$1.02	-23.93%	Buy Under $125	2
PAYPAL	PYPL	Payment Processor	07-20-2023	$73.02	$66.22	0.00%	$0.00	-9.31%	Hold / Stop Loss at $50	3
FOREVER STOCKS										
DOMINO'S PIZZAS INC	DPZ	Restaurants	02-27-2023	$300.00	$455.78	1.33%	$4.84	53.54%	Hold	3
DEERE & COMPANY	DE	Agricultural Machinery	08-31-2023	$410.94	$397.60	1.48%	$2.82	-2.56%	Buy Under $450	3
DIAGEO PLC	DEO	Alcoholic Beverages	12-14-2023	$145.72	$146.33	3.43%	$0.00	0.42%	Buy Under $160	3
DANAHER	DHR	Medical Technology	03-21-2024	$253.69	$253.69	0.43%	$0.00	0.00%	Buy Under $270	3
PROPERTY & CASUALTY INSURANCE										
W.R. BERKLEY	WRB	P&C Insurance	05-25-2023	$56.10	$86.02	0.47%	$1.33	55.70%	Buy Under $62	2
PROGRESSIVE CORPORATION	PGR	P&C Insurance	06-08-2023	$131.08	$205.92	0.19%	$1.05	57.90%	Buy Under $160	2
CHUBB LIMITED	CB	P&C Insurance	06-08-2023	$191.60	$256.55	0.16%	$2.58	35.25%	Buy Under $220	2
SKYWARD SPECIALTY	SKWD	P&C Insurance	06-16-2023	$24.66	$36.88	0.00%	$0.00	49.55%	Buy Under $35	2
EXPONENTIAL GROWTH										
TELLURIAN INC.	TELL	U.S. LNG Exporter	06-16-2022	$3.82	$0.65	0.00%	$0.00	-82.98%	Hold	5
EVOLUTION AB	EVVTY	Casinos & Gaming	11-30-2023	$103.77	$131.05	1.65%	$0.00	26.29%	Buy Under $145	4
INMODE	INMD	Medical Devices	01-11-2024	$20.19	$21.25	0.00%	$0.00	5.25%	Buy Under $25	5
BURFORD CAPITAL	BUR	Litigation Finance	02-08-2024	$14.37	$14.99	0.83%	$0.00	4.31%	Buy Under $20	4
CELSIUS HOLDINGS	CELH	Energy Drinks	03-07-2024	$89.56	$90.67	0.00%	$0.00	1.24%	Buy Under $100	5
HIGH YIELD										
PHILIP MORRIS	PM	Tobacco Maker	07-14-2022	$89.62	$92.27	5.64%	$7.68	11.53%	Buy Under $105	1
VIPER ENERGY	VNOM	Oil and Gas Royalty	09-01-2022	$29.68	$37.63	6.06%	$2.24	34.33%	Buy Under $34	3
BLACK STONE MINERALS	BSM	Oil and Gas Royalty	02-16-2023	$15.90	$15.71	12.09%	$1.90	10.75%	Buy Under $18	2
SABA CAPITAL INCOME & OPPORTUNITIES FUND	BRW	High Yield Bond Fund	03-16-2023	$8.01	$7.20	14.17%	$1.06	3.06%	Buy Under $9	3
OAKTREE SPECIALTY LENDING CORP	OCSL	Specialty Investments	03-30-2023	$18.57	$19.34	11.38%	$1.72	13.41%	Buy Under $22	2
BETTER THAN THE MARKET										
CAMBRIA SHAREHOLDER YIELD	SYLD	Yield Focused ETF	01-05-2023	$70.49	$70.39	2.20%	$1.30	1.70%	Buy Under $65	2
WATCHLIST										
SHERWIN-WILLIAMS	SHW	Specialty Chemicals	NA	-	$346.83	2.79%	-		Buy Under $150	
ULTA BEAUTY	ULTA	Specialty Retail	NA	-	$523.88	0.00%	-		Buy Under $350	
NIKE	NKE	Athletic Footwear & Apparel	NA	-	$100.96	0.00%	-		Buy Under $75	
HOME DEPOT	HD	Home Products Stores	NA	-	$395.02	2.12%	-		Buy Under $240	
PAYCOM SOFTWARE	PAYC	Application Software	NA	-	$193.50	0.78%	-		Buy Under $150	
THE HERSHEY COMPANY	HSY	Consumer Luxury Staples	NA	-	$199.57	2.75%	-		Buy Under $165	

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.

CLOSED POSITIONS	Ticker	Description	Purchase Date	Cost Basis	Sell Price	Yield	Income Received	Total Return	Status
HOVNANIAN ENTERPRISES	HOV	Homebuilder	06-30-2022	$42.79	$36.50	0.00%	$0.00	-14.70%	Sold Sept. 29, 2022
ACTIVISION BLIZZARD	ATVI	Video Games	03-02-2023	$77.71	$90.99	0.00%	$0.00	17.09%	Sold July 11, 2023
AMERIGO RESOURCES	ARREF	Base Metals	03-30-2023	$1.21	$0.91	8.84%	$0.04	-21.90%	Sold Oct. 12, 2023
DREAM FINDERS HOMES, INC.	DFH	Homebuilder	04-27-2023	$14.89	$20.69	0.00%	$0.00	38.95%	Sold Oct. 12, 2023
QURATE RETAIL, INC.	QRTEP	8% Cumulative Preferred Stock	01-19-2023	$40.64	$29.28	27.32%	$6.00	-13.19%	Sold Oct. 12, 2023
ANNALY CAPITAL MANAGEMENT	NLY	Real Estate Investment Trust	02-02-2023	$24.12	$17.78	19.80%	$1.30	-20.90%	Sold Oct. 12, 2023
MICROSTRATEGY INC.	CUSIP: 594972AC5	2025 Convertible Bond	10-13-2022	$758.00	$1,371.14	0.55%	$7.50	81.88%	Sold Nov. 9, 2023
ALTRIA	MO	Tobacco Maker	07-14-2022	$41.63	$42.03	9.33%	$4.74	12.35%	Sold Nov. 30, 2023
HALL OF SHAME									
ICAHN ENTERPRISES	IEP	Specialty Investments	12-08-2022	$50.65	$20.63	38.78%	$4.00	-51.37%	Sold May 25, 2023
ALTISOURCE ASSET MANAGEMENT	AAMC	Asset Management	07-06-2023	$58.00	$10.02	0.00%	$0.00	-82.72%	Sold Aug. 17, 2023

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Franco-Nevada's Weakness Is a Golden Opportunity

Despite the recent closure of its largest revenue-generating mine, **Franco-Nevada (NYSE: FNV)** maintains a profitable portfolio of royalties and streams from more than 100 other assets that will continue to propel the company's growth in the coming years.

Prior to the closure of the Cobre Panama copper mine last fall – which was generating $249 million in revenue from its production of gold for the company – Franco-Nevada earned $695 million in net profits in 2023. The mining royalty company is on track to earn $611 million (12% less) in 2024 and to return to 2023 levels by 2026 with $705 million in net profits. As a result of strong earnings and a battered share price, FNV now trades near its lowest valuation in the past 10 years – making FNV an attractive buy.

Franco-Nevada operates a diversified portfolio of 116 mining assets that produce steady cash flows during up and down cycles – with only three individual assets each contributing more than 10% of company revenue. Additionally, the company has a strong pipeline of future projects with over 300 royalties or streams on assets not yet in the production stage (it typically takes a mine more than 15 years after discovery to begin producing any precious metals).

Rather than exploring and digging for gold itself, Franco-Nevada provides financing for gold companies to do the dirty, capital-intensive work of pulling metals from the ground. In exchange for providing financing, FNV earns royalties on the mine's output. For instance, Franco-Nevada has recovered nearly 50% of the $1.36 billion it has invested into the Cobre Panama mine over the last 12 years, compared to First Quantum, the operator of the mine which invested approximately $10 billion in the mine over the last decade.

In addition to a strong pipeline and diversified portfolio, management maintains a clean balance sheet – Franco-Nevada has no debt and $2.4 billion in liquidity ($1.4 billion in cash plus $1 billion in available credit) for future acquisitions of royalties or streams, or to return to shareholders through buybacks or dividends.

Outside of Cobre Panama, Franco's gold-equivalent ounces (equivalent ounces factor in revenue from other precious metals) increased 1% in 2023 compared to a 1% decline the prior year, while revenue was within the company's revised guidance. Three new major mines are set to come online in 2024 – Greenstone in Ontario, Canada, Tocantinzinho in Brazil, and Salares Norte in Chile. Franco has a strong pipeline of mines set to come online thereafter, including Antamina in Peru, Candelaria in Chile, and Detour Lake in Canada.

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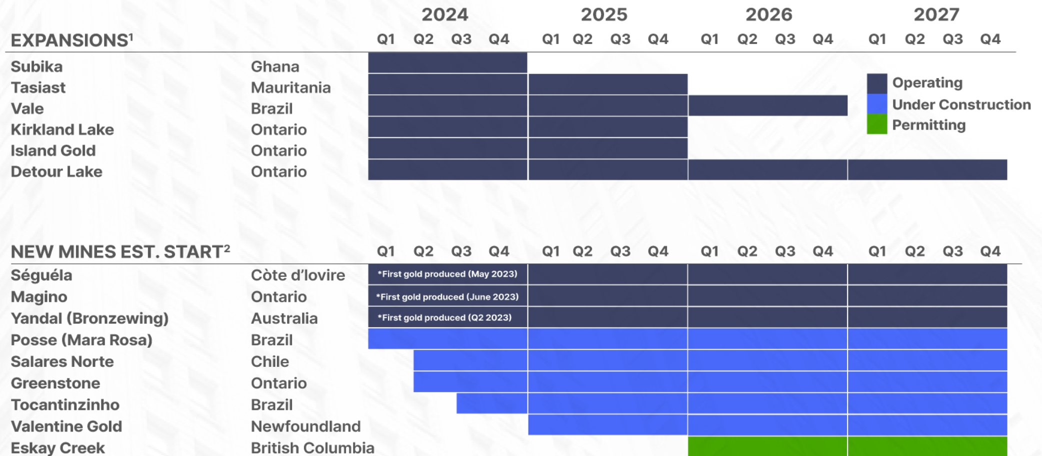
Organic Growth Pipeline



1. Expansion periods are based on operators' indicated period of ramp-up 2. Indicated start periods are based on operators' guidance and FNV best estimates

These new mines will lead to upwards of 10% growth in gold-equivalent ounces through 2028. This growth assumes no contribution of Cobre Panama, which we believe will reopen and be contributing. If Cobre Panama does reopen or Franco-Nevada gets a significant payout in litigation, there's upside for FNV shares.

The Cobre Panama mine contributed 20% of Franco-Nevada's revenue and 16% of net asset value in 2023 but FNV shares have dropped even more – by 18% – on the news of its closure. Though shares have bounced back a bit, the market is assigning zero value to the Cobre Panama.

As we reported in December, in response to widespread environmental protests, the Panama government shut down the Cobre Panama mine on November 28, 2023. As a result of the shutdown and drop in share price, Franco-Nevada took a $1.17 billion impairment charge – a write-down of the asset's value – for the Cobre Panama mine at the end of 2023. Franco-Nevada assumes no recovery amount from the impairment charge.

There are a number of reasons we believe the Cobre Panama copper mine will reopen. The closure of the mine poses substantial economic risks for Panama. It contributes 5% of the nation's GDP, 75% of its exports, and 1% of global copper supply while employing 7,000 people. If it does not reopen, Franco-Nevada will likely sue the government, claiming a loss of $5 billion to its business. Panama's presidential and legislative elections are scheduled to take place in May 2024. A new regime could allow the mine to reopen.

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With the loss of the mine factored in to the price, shares of FNV are currently trading at 32.4 times earnings – well below its five-year average multiple of 48.7 times earnings. An investor today is buying FNV at a discount – even with no future contributions from Cobre Panama.

FNV shares declined 26% after the shutdown, but have rebounded 13% since then. They are still down 27% from the most recent highs on May 9, 2023.

Franco-Nevada has a strong balance sheet with $2.4 billion in liquidity and no debt. On January 30, the company increased its dividend for the 17th consecutive year. And with the price of gold at all time highs above $2,100 per ounce – up 10% since November – FNV shares should rise throughout 2024.

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

The Gods of Gas Strike Again

On March 11, **EQT (NYSE: EQT)** announced it will acquire its former pipeline business Equitrans Midstream. The acquisition will add more than 2,000 miles of pipeline infrastructure to EQT's peer-leading inventory of more than 4,000 drilling locations across the Appalachian Basin.

Adding pipeline capacity is part of EQT's mission to become the world's first large-scale, vertically integrated natural-gas company. This new pipeline business will transform EQT's cost structure, lowering breakeven gas prices to less than $2.00 per million British thermal units (MMBtu) compared to $2.50 per MMBtu today. This would further separate EQT from its peers, making it the lowest-cost U.S. gas producer by a wide margin. It will also reduce EQT's dependence on third-party pipeline infrastructure.

Owning the Supply Pipeline Reduces EQT's Cost Structure

Source: EQT Equitrans Acquisition Presentation

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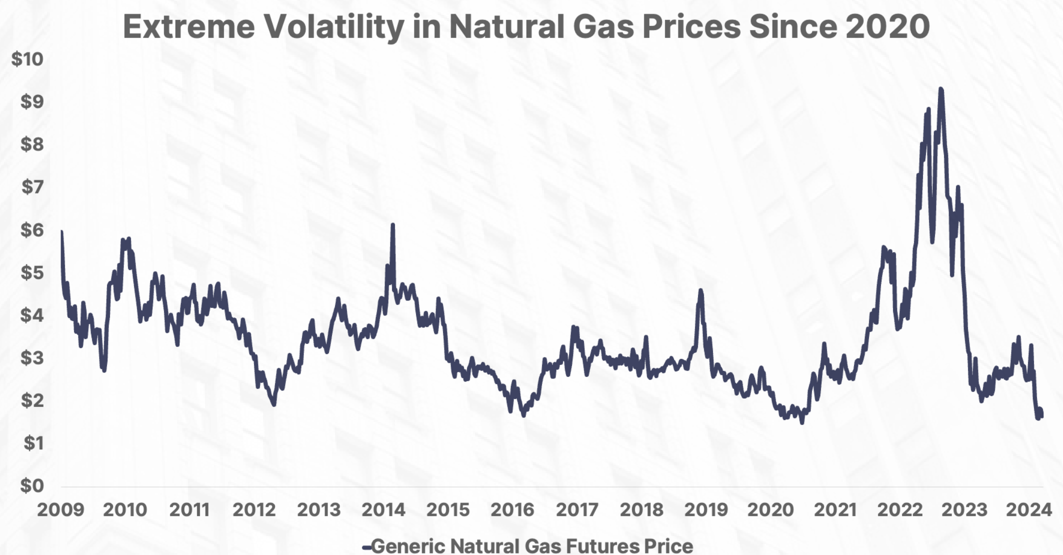
Lower breakeven prices lessen the need for EQT to hedge against lower gas prices. As a result, EQT benefits when gas prices are high while taking less risk when gas prices are low.

Demand for U.S. natural gas has grown 50% over the past 15 years. Over that same period, gas storage capacity has increased only 25% while pipeline capacity is up just 10%. This lack of **infrastructure** makes the market less efficient, by preventing suppliers from bringing gas to market and accumulating inventories to buffer against supply and demand shocks. As a result, natural-gas markets have become highly volatile, with supply gluts followed by extreme shortages in recent years.

Prices have fluctuated wildly since 2020, plummeting during the COVID-19 pandemic, and surging to decade highs following the breakout of Russian-Ukraine war. However, the pendulum has turned, as prices fell after two consecutive warm winters. Today, natural-gas prices are the lowest since the depths of the COVID-19 outbreak.



In November, EQT's CEO Toby Rice warned that the wild price swings will persist without the necessary storage and pipeline infrastructure. The lack of infrastructure could cause prices to surge as much as 350% to $8 per MMBtu:

"The industrial world that we enjoy now is severely compromised because of the lawsuits, the pushback, and the movement to cancel energy infrastructures and modern society. We've run out of flexibility."

But now, by acquiring Equitrans Midstream, EQT owns a major pipeline that can get EQT's gas to more markets, more efficiently.

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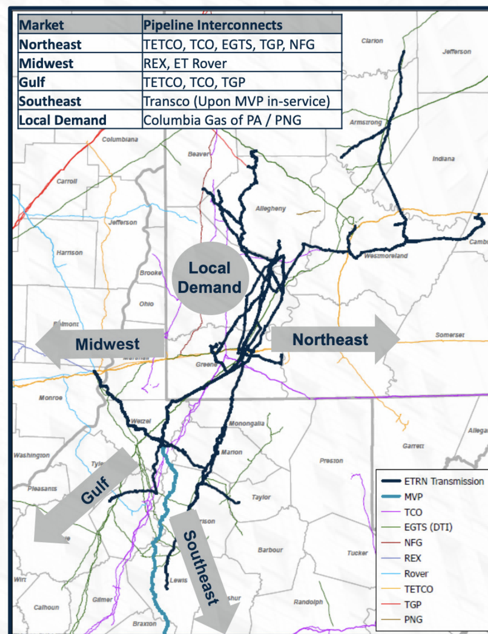
EQT is led by two brothers, Toby and Derek Rice (we featured them in "**The Gods of Gas**" in June 2022), who are transforming the global energy markets. In 2018, two activist shareholders, Jana Partners and D.E. Shaw, pressured EQT to spin off its Equitrans Midstream to separate it from EQT's capital-intensive production business. Activists assumed that by separating the two entities, Equitrans would attract a new class of investors and demand a higher valuation.

Since the spin-off in October 2018, Equitrans has generated a total loss of 7%. Nine months after EQT sold the pipeline, Toby and Derek Rice won control of EQT's board, and now the Rice brothers are getting an important piece of the puzzle back: its old pipeline infrastructure.

The more-than-2,000 miles of pipeline infrastructure Equitrans owns includes some of the most interconnected pipelines in the northeast that will deliver EQT gas from the landlocked Appalachia to the northeast and potentially out west. As seen below, Equitrans transmission pipelines connect the Appalachian basin to a diverse set of markets giving EQT the ability to deliver gas to many markets:



Market	Pipeline Interconnects
Northeast	TETCO, TCO, EGTS, TGP, NFG
Midwest	REX, ET Rover
Gulf	TETCO, TCO, TGP
Southeast	Transco (Upon MVP in-service)
Local Demand	Columbia Gas of PA / PNG

Bringing Equitrans back into EQT will result in at least $250 million in annual cost savings – and possibly much more.

For now, shareholders have reacted negatively to the deal. Shares of EQT fell 8% on the news, because EQT issued new shares and took on Equitrans debt as part of the purchase. Longer-term, we remain bullish on EQT's prospects as America's largest, fully integrated, low-cost gas producer. EQT expects to generate $16 billion in cumulative free cash flow between 2025 and 2029 – making the stock a long-term value at its current market capitalization of $15.1 billion.

We continue to recommend buying EQT up to $50 per share.

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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 letter comes from K.N. who writes:

"Hello, folks,

My question is about natural gas producer EQT – the position is down substantially and it appears as if the intermediate and possible longer term (5 to 7 years) prospect for nat gas is not good due to plentiful supply.

Still a buy or hold?

Thanks."

> **Porter's comment:** *Thank you for the question.*
>
> *As we discuss in more detail above,* **EQT (NYSE: EQT)** *remains a core holding. In the long run, America's shale gas and LNG export industries are two of the country's greatest assets. Together, they will create billions of dollars in wealth and secure U.S. energy independence for decades to come. And EQT is leading the race... it's America's largest, most efficient natural gas producer. Every year, it finds new ways to unlock more efficiencies and drive its costs down further, including the recent Equitrans purchase.*
>
> *Long-term, we expect U.S. LNG exports will continue growing, and eventually bring U.S. gas prices in line with higher overseas prices. However, the market must first clear through a supply overhang before prices can rise in the near term.*
>
> *Two consecutive winters of extreme warmth have sent the natural-gas market into its deepest bear market since the depths of the COVID-19 shutdown. But this weakness should only last for the next six to 12 months as supply and demand begin to rebalance. With gas prices trading near three-decade lows and storage levels 37% above the five-year average, producers are cutting production. Several large producers are reducing drilling and production including EQT and CNX Resources.*
>
> *The EIA projects dry gas production will ease from a record 103.79 billion cubic feet per day (Bcfd) in 2023 to 103.35 bcfd in 2024. This will mark the first output decline since 2020, when the COVID-19 pandemic shut down the economy.*

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> *Meanwhile, demand for LNG continues to rise. Feedgas demand, the dry natural gas used as the raw production for LNG, will nearly double from 13 Bcf/d in 2023 to 25 Bcf/d by 2028. Plus, domestic demand will also get a boost from the artificial-intelligence ("AI") boom. S&P Global estimates that U.S. data center power demand is expected to increase 30% from 23 gigawatts in 2023 to over 30 gigawatts by 2030. Natural gas will play a big role in meeting that new demand for electricity generation.*
>
> *The Equitrans pipelines that EQT recently acquired will deliver EQT's natural gas to Data Center Alley, the world's largest concentration of data centers in Virginia. Toby Rice recently mentioned in* ***an interview*** *that one Nvidia chip requires the same amount of energy as a Tesla. With Nvidia releasing 2,000 chips per year, some analysts estimate that by 2030, AI power use could be bigger than residential power demand. This would reflect a 20% total increase in U.S. electricity demand. And there's no better company to fulfill this demand than America's largest, most-efficient energy producer: EQT.*

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** here: **@porterstansb**

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