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THE BIG SECRET ON WALL STREET

AMERICAN VICE #5

THE AMAZON AND RECESSION RESISTANT RETAILER

FROM THE DESK OF PORTER STANSBERRY

SPECIAL REPORT

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The Amazon and Recession Resistant Retailer

> *"The key force of economic advances is the entrepreneur, who on his own, without governmental cues or expert consultation or even a defined market, creates new goods, services, business plans, and projects. Economic growth and progress, job and welfare, markets and demand all stem from this creativity of the entrepreneur. Population growth, capital accumulation, economic efficiency, and even scientific advances are all less important than entrepreneurial creativity. And governmental interventions in the economy are distractions – "noise on the line" – that nearly always retard expansion. Failing to see the centrality of entrepreneurial creativity, economists everywhere have counseled governments to attend to the money supply, aggregate demand, consumer confidence, trade imbalances, budget deficits, capital flows – to attend to everything except what matters most: the environment for innovation."*

- George Gilder, Knowledge and Power

The two most important entrepreneurs in the world's energy markets today are Charif Souki and Toby Rice.

Twenty years ago, Souki founded and led **Cheniere Energy (NYSE: LNG)**. He built the first successful, large-scale LNG export facility in the United States. After a dispute with Carl Icahn he left the company. His next task was to build the first fully integrated gas field, gas pipeline, and lined LNG facility in the United States – **Tellurian (NYSE: TELL)**. See our **June 17, 2022, issue** for details.

Toby Rice and his two brothers built, from scratch, the leading gas producer in the Marcellus Shale, Rice Energy. They then engineered a hostile takeover of venerable producer **EQT (NYSE: EQT)**, transforming it in about a year into America's leading producer of natural gas via massive increases to drilling efficiency and huge, incredibly attractive, acquisitions. The story of the Rice brothers and the rise of the economic dynamo they've built, EQT, is the greatest entrepreneurial success of the 2020s. It was the subject of the first issue of this publication.

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But the Rice brothers are just getting started. Like Souki they realize the future of the world's economy depends on "unleashing" U.S.-sourced natural gas. Their plan is to lead the U.S. to produce an additional 50 bcf (billion cubic feet) of natural gas a day, enough to power the world.

> *"The Marcellus as a whole has more gas reserves than Russia. So it's an absolute powerhouse ... this is like the Saudi Arabia of energy... With a $3.75, gas price the Marcellus Shale has the opportunity to increase natural gas production an incremental 35 BCF a day and be able to do that over a 10-year period of time and hold that ball, hold those lines flat for over 30 years. The biggest gas field in the world can be the biggest gas field in the world two times over. And the only thing that needs to make that happen is pipelines. And then also the LNG facilities to create the demand for that for that incremental volumes."*

– Toby Rice, CEO of EQT, on *The Power Hungry Podcast* June 3, 2022

EQT announced its latest acquisition, $5.2 billion for Tug Hill, a mid-sized producer in the Marcellus, whose assets and pipelines are adjacent to EQT's.

EQT is getting almost another bcf a day of additional production, from 300 drilling locations. That's a 15% increase from EQT's current daily production of 5.5 bcf. Tug Hill also owns 100,000 acres in the core of the Marcellus basin. *This acreage has enough proven reserves to provide 11 years of continuous production with only maintenance level amounts of capital spending*. EQT is also buying the associated pipeline gathering systems (95 miles of pipelines), which will allow EQT to reduce its own capital spending on gathering systems by 75%.

The deal, which was priced extremely attractively at only 2.3x the next 12 month's estimated operating profits (27% free cash flow yield), implies a long-term price of gas at $3.00, which is a 40% discount to the current long-term futures "strip" prices.

EQT is making the purchase with cash on hand, with half of the deal paid for in stock. Thus this deal requires *no additional leverage* and is massively accretive in terms of cash flows, driving an estimated 10% increase in cash flow per share.

On the back of this deal, EQT's forecasted share buybacks doubled, to $2 billion, and its debt repayment through 2023 to increased to $4 billion.

The deal also reduces EQT's production cost basis by $0.15 per MMBtu, increasing its margins and driving down its "breakeven" price of gas. The deal increases EQT's forecasted long-term free cash flow to $5 billion annually.

In short, like its deal to purchase Chevron's Marcellus assets, this is a major acquisition that Toby Rice has engineered that will materially improve the company's profitability, reserves, and production – without taking on any new long-term debt. Deals like this wouldn't be possible without EQT's industry leadership, as the CEO of Tug Hill emphatically explained.

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> *"EQT is the face of the new energy paradigm," Tug Hill CEO Michael Radler told Hart Energy. "Toby Rice's vision around U.S. LNG is something we believe in and because of our significant ownership position, are excited to be a part of that vision."*

There's a concept Porter Stansberry calls "***economic gravity***." It exists when there's a dynamic, visionary leader in an industry that's able to rally the best people and the best assets to work together. That scale, that energy, and that vision then draws more and more entrepreneurs towards it, to work together, creating even more "gravity," and drawing still more economic energy towards it. Today you see "economic gravity" most obviously with Berkshire Hathaway, where, with Warren Buffett's genius, an enormous conglomerate was created across a vast array of different industries. Historically, in energy, you saw this most dramatically with Standard Oil. And today we're seeing it with EQT.

If you haven't bought EQT yet, it's not too late. A company producing reliable free cash flows of more than $3 billion annually with a proven growth strategy should be worth at least $100 billion. EQT's current enterprise value is only $21 billion. In other words, absent the volatility of natural gas prices, EQT should be worth 5x more than its current value. And we believe that higher natural gas prices are inevitable as more and more of the world's electrical generation switches from coal to natural gas, which gives even more upside to EQT.

The key to growing production and capturing the highest prices for energy is reaching global markets, via LNG exports. That's the same strategy Souki pursued at Tellurian before he left the company at the end of 2023, linking the Haynesville shale directly to the world's markets with its huge Driftwood LNG project. And, while, for now, Tellurian is ahead in this race (its LNG facility is under construction), EQT is the country's largest gas producer and the leading acreage holder in the world's largest gas field.

That's not to say that with an enterprise value of only $2 billion, Tellurian isn't a great investment. It is, because it is currently at a much earlier stage of development than EQT, and thus much cheaper to buy. The returns on Tellurian should be at least 10x over 10 years.

But, in our eyes, EQT is the best possible mix of reserves, acreage, pipelines and management. In terms of scale, no other energy company in the world has more to gain by linking its production to the world's markets via LNG. And by the end of this year, we expect the Rice brothers to announce their biggest and most strategic deal yet, a major investment in a LNG facility to move additional, new production into foreign markets, where prices for gas can be 10x what they are in the U.S.

When that deal is announced the future implied value of EQT's production will soar. And its "economic gravity" will impact the entire industry, globally.

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EQT's Coming Out Party: Europe's Energy Crisis

During its war with Ukraine, Russia officially halted all natural gas exports to Europe.

The Kremlin announced that it would keep the gas taps shut off until the collective "west" lifted sanctions against the country. In other words, absent an immediate resolution to the Ukraine conflict, and a thaw in geopolitical tensions, **40% of EU natural gas supply is now offline indefinitely.**

As EU spokesperson Tim McPhie told ***Newsweek,*** Russia's "weaponization of energy supplies" means that the continent will "phase out Russian fossil fuels in Europe." There's just one problem: Replacing 40% of Europe's natural gas supply won't happen overnight. The European Commission estimates a total cost of $210 billion into infrastructure supporting new gas supplies, including new LNG import terminals, to eliminate the continent's energy dependence on Russia. But even these aggressive investments won't allow Europe to fully replace Russian energy supplies until 2027.

More immediately, **Goldman Sachs** estimates that spiking energy prices costed European households a whopping $2 trillion in 2023. In a note to clients, the bank explained that Mr. Market has underestimated the scope of fallout from this energy crisis: *"In our view, the market continues to underestimate the depth, the breadth and the structural repercussions of the crisis… We believe these will be even deeper than the 1970s oil crisis."*

While European asset prices have begun pricing in the fallout from the worst energy crisis in modern economic history (a free fall in European stocks, bonds and currencies) U.S. markets have, so far, mostly shrugged off this energy crisis as a purely European problem.

That's a big mistake.

One of the central themes we've tracked since starting this publication is the rise of America as an energy exporting superpower. Specifically, the rise of American LNG exports, which will increasingly link the U.S. domestic gas market to international prices. That's why in 2022 U.S. natural gas now traded at the highest levels since 2008, at over $8 per thousand cubic feet (mcf). And since natural gas provides the key fuel source for American electricity generation, this price spike is crushed households with crippling utility bills. ***Bloomberg*** reported that an incredible one in six U.S. households are late on their utility bills. That's 20 million American families, ***the largest number ever recorded.***

Things will only get worse as peak demand season for natural gas hits this winter. Prepare to see more **headlines** like this in the coming months:

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NEWS

NJ heating bills in line for double-digit increases after state OKs big rate hikes

Daniel Munoz
NorthJersey.com

Published 4:02 p.m. ET Sept. 8, 2022 | Updated 8:28 a.m. ET Sept. 9, 2022

The article goes on to explain...

> *"After enduring months of rising prices from the gas pump to grocery checkouts, New Jerseyans could see their annual heating bills soar this fall and winter as inflation and global tensions drive up natural gas prices. State regulators on Wednesday approved double-digit rate increases for four gas providers serving millions of customers in the state, with prices expected to rise by hundreds of dollars on an annualized basis for some people."*

As Toby Rice explained recently, abundant energy supplies are the basis for modern life:

> *"Simply put, the more energy you can give people, the better the quality of life. And so if you want to make an impact, provide the world with cheap, clean, reliable energy... if people think that they can attack oil and gas, and it's only going to be felt by the oil and gas producers, wrong, you attack a company, you're attacking that company's customers and you attack our pipelines, you prevent our ability to reinvest in drilling and bring more supply to the world that's going to translate to higher prices, like exactly what is going on in the country, and what is going to what is really going to be happening in New England this winter.*

– Toby Rice, *The Power Hungry Podcast*, June 3, 2022

The ripple effects go beyond just higher heating and utility bills. Energy impacts every economic activity on earth.

The world's "supply chain" problems don't have anything to do with transportation anymore. Shipping prices (Baltic Dry Freight Index) are down 75% from their recent peak. Supply chain issues are now constrained because of energy prices.

In Europe, shortages of electricity and natural gas have forced shutdowns of everything ranging from steel to plastics to chemical manufacturing. But the bigger problem is going to be food.

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in 2022, more than 70% of European ammonia production (the critical ingredient in nitrogen fertilizers) were offline. At the start of 2021, farmers in Western Europe could buy ammonia for about $250 per ton. **In 2022, that same ton of fertilizer costed $1,250**. If European gas supplies remain disrupted and these sky-high fertilizer prices persist, the International Fertilizer Association estimates a 2% drop in global corn, wheat, rice and soybean production.

For perspective, that would be equivalent to OPEC announcing an oil production cut of 2 million barrels per day. Prepare for a *global* shock in food prices to go along with crippling costs for energy, heat and utility bills.

The energy crisis won't be contained in Europe.

In September 2022, the U.S. Bureau of Labor Statistics reported a hotter than expected inflation number, when it reported CPI rose 8.3% in August. A big driver was spiking food costs, which rose 11.4% in 2021, the highest increase in 43 years. The report showed prices of staples like bread increasing by 16.2%, chicken costs up by 16.6% and milk jumping 17.0%.

The inflation report sent stocks into a tailspin, with the S&P 500 plunging by over 4% in a day, the biggest decline since the pandemic of 2020. Higher interest rates were coming: the market implied odds of a 75 basis point increase at the next Fed meeting increased from 69% to 91%.

Many sectors of the U.S. economy were already in a recession.

> *"People keep saying, are we going to be in a recession? We're in a recession. Anybody who thinks we're not in a recession is crazy. The housing market is in a recession and it's just getting started. So it's probably going to be a difficult 12 to 18 months in our industry"*

Restoration Hardware CEO Gary Friedman

The biggest problems for investors are still several quarters away and are likely to stem from much higher consumer and corporate default rates. Reports surfaced recently that borrowers in Goldman Sachs' credit card portfolio were falling behind on their payments and defaulting at rates "well above subprime lenders." Deutsche Bank credit strategists likewise predict non-investment grade bonds will see average default rates over 10% in 2024, and will include default rates above 40% for the lowest (CCC) ranked bonds.

Given that the U.S. economy relies upon consumer spending, the weak consumer will soon start hitting corporate profits. This will eventually lead to layoffs, creating further weakness in consumer incomes, driving a self-reinforcing recessionary cycle. It's no coincidence that, in the same week Goldman reported a spike in default rates on its credit portfolio, that the company also announced its largest round of layoffs since 2008.

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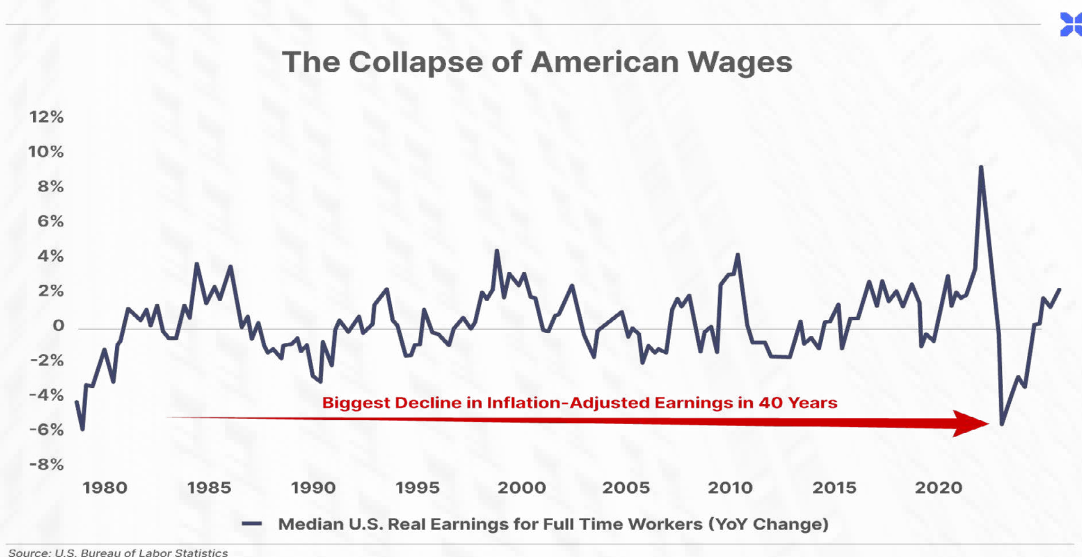
The bottom line: The shockwaves from the European energy crisis are spilling over onto American shores. The early signs of economic distress we're seeing now will soon snowball into a full-blown recession. Inflation is crushing real consumer incomes, compounded by higher borrowing costs, pushing more and more Americans out of the middle class. No data series shows this better than the collapse in real (i.e. inflation-adjusted) wages, which plunged the fastest rate in 40 years:



The bottom line: the stage is set for a repeat of the 1970s style stagflation.

Investors should prepare for a period of slowing economic growth and persistently high inflation, which will require an entirely different investment approach from what's worked over the past 40 years.

A 1970s Investing Playbook

The 1970s was a lost decade for most financial assets, with the exception of commodities. The conventional wisdom says investors can seek shelter from inflation in the natural resources sector, like oil and gas producers or gold miners.

But there's a far better way to beat inflation, and it's one of the most important and valuable secrets in all of finance.

The greatest wealth compounder of all time, Warren Buffett, first explained the real secret to beating inflation with investments in his 1983 chairman's letter.

> *"For years the traditional wisdom – long on tradition, short on wisdom – held that inflation protection was best provided by businesses laden with natural*

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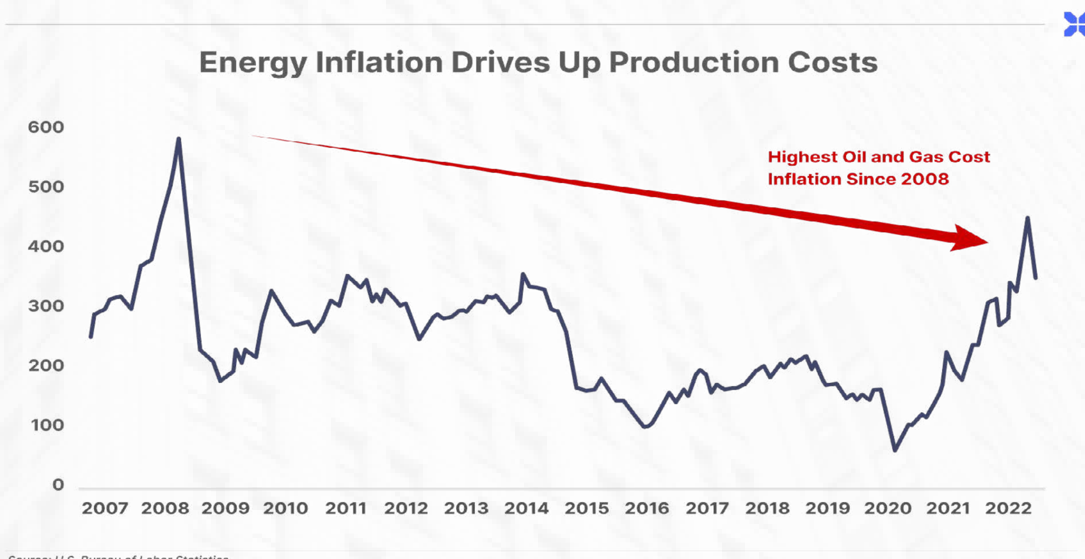
> *resources, plants and machinery, or other tangible assets ("In Goods We Trust"). It doesn't work that way."*

Warren Buffett's 1983 Letter to Berkshire Hathaway Shareholders

As Buffett explains, capital-intensive businesses, like those involved in natural resource extraction, may on the surface appear to generate a strong return during inflationary periods... but those earnings get sucked right back into the business via heavy capital requirements.

In other words, it's not what you earn, it's what you keep.

And when prices for commodities rise, so too do the costs of producing those commodities. We saw this in 2022 - where the highest oil and gas prices since 2008 corresponded with the highest input costs since 2008 for oil and gas production:



Source: U.S. Bureau of Labor Statistics

The other issue that resource extraction companies face is an even bigger challenge: they have to constantly rebuild their asset base. Resources companies are constantly liquidating their balance sheets. Those assets have to be replaced to grow production. But, in the face of rapid inflation, the cost of acquiring new reserves inevitably eats up a very large percentage of the firm's cash flows. That's why we **recently recommended Viper Energy Partners** – it's the capital light way to invest in the Permian Basin's oil production.

But what about EQT...? It's true, EQT will not be able to replicate its asset base at anything like the prices it is buying proven reserves for now. However, the company's plan to reach international markets (and garner vastly higher prices for its production) will dramatically change the economics of the business, making the value of its existing reserve worth far more (5x-10x more) than before. It's also true

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that the size of their asset base (and the very long-lived nature of these gas wells means that their capital spending, while growing, won't need to keep pace with their revenue growth. In fact, over the last five years the company's proven reserve base has almost doubled, to 23 trillion million cubic feet (Tcf), while its capital spending has fallen 50% from around $2 billion to around $1 billion. And… there's a lot more gas that EQT is sitting on already that hasn't been developed or "proven" yet. The company has over a million acres of land in the Marcellus that remains undeveloped, compared to the half a million acres that's developed currently.

In our view, EQT is a unique situation, a once-in-a-generation kind of business that can likely grow production for the next 30 years, without having to acquire any additional resource.

But, there aren't many resource extraction businesses like EQT.

Generally, the far better solution to profit from a rapid growth in inflation is to own businesses that rely mostly on *intangible* assets, things like timeless consumer brands, or patent protected pharmaceuticals, or companies that have already spent the capital required to develop virtual monopolies, like companies that own critical pieces of infrastructure (toll roads, for example).

Buffett says companies like these possess "economic goodwill": the value of their intangible assets grow, year after year, without corresponding increases to capital spending. That's why Buffett's biggest investments have, historically, all been "asset-lite" and brand rich. Businesses like Coca-Cola, American Express, Apple, and See's Candy.

We have, of course, noticed the same unique financial advantages in certain companies. No offense to Buffett, but we think his description – "economic goodwill" – confuses more than it helps.

We describe these firms' incredible ability to increase cash profits over time without corresponding increases to capital spending, "*capital efficiency*." Their business models allow them to earn more, on each dollar of revenue over time, as the value of intangible assets grow – *with inflation*.

We've long pointed out how extraordinary these investments can become over time. The best example is Porter's long-ago (2007) recommendation of Hershey, which he predicted at the time would be his best "no risk" recommendation ever, growing at 15% annually. Today, 17 years later, Hershey's shares have increased by 400%. With dividends reinvested, the total return tallies to 635% – 13% a year. It's incredible investors can earn these kinds of outsized, marketing beating returns from such a stable and slow-growing business. That's the "magic" of capital efficiency.

Hershey doesn't have to re-invent the Hershey process, which turns fresh milk into chocolate that won't spoil. It doesn't have to build new factories every year, or create new brands. It merely has to maintain its positive appeal in the mind of the

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public, which it does primarily by making the same product it has been making for well over 100 years. That appeal allows it to raise prices continuously, more than keeping pace with inflation.

It's the unchanging nature of the product that gives the business a nearly unbeatable advantage for investors. Whether you call that *capital efficiency* or *economic goodwill*, companies with these unique characteristic are the best way to hedge against periods of high inflation, as Buffett explains:

> *"...a disproportionate number of the great business fortunes built up during the inflationary years arose from ownership of operations that combined intangibles of lasting value with relatively minor requirements for tangible assets... During inflation, Goodwill is the gift that keeps giving."*

Warren Buffett's 1983 Letter to Berkshire Hathaway Shareholders

As the European energy crisis unleashes a stagflationary tsunami across the globe, we're looking for capital-efficient businesses that will survive - and thrive - during the coming financial and inflationary storm.

As more and more Americans slip out of the middle class, because of spiking inflation and a slowing economy, there's one trend we can count on: **growth in discount retailers**.

Earning A Royalty On Poverty

Amazon has all but wiped out the retail sector in the United States.

Over the last 10 years, retail stocks – measured by the SPDR S&P Retail exchange traded fund (XRT) – have lagged the S&P 500 by roughly 135%. Amazon, meanwhile, is up an astounding 7906% (24% annually).

However, there's one kind of retail that's Amazon-resistant: *used goods*.

Selling used goods is a very different kind of retail business.

First, it requires knowledgeable staff to gauge whether used goods are in acceptable condition and purchase them, usually one piece at a time, from customers. That's impossible online.

Second, customers selling goods are typically acting with urgency – they need cash, right now. A physical presence enables immediate transactions. Likewise, the buyer is a bargain hunter or doesn't know precisely what he's looking for, but is shopping for bargains. This kind of browsing is easiest to do in a physical location.

Alas, that's a big problem for investors. Physical locations are expensive. They also require a lot of overhead – staffing, maintenance, taxes, etc.

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If only there was a way to own a high margin, Amazon-resistant retail business that catered to Americans suffering from declines in real wages…

Retailing? No Way. Franchising? All Day.

Macy's owns a store footprint of 725 locations. The "Resale Company," has 1,271 franchised locations. Those are stores that are operated under a license, using The Resale Company's brands, such as Play It Again Sports.

Since Macy's owns and operates all of its stores, the company brings in a lot of revenue - $23.8 billion in 2023. By comparison, The Resale Company only collects 5% of every dollar flowing through the registers of its stores. Total revenue was only $83.2 million in 2023.

But you can't eat topline revenue. Each year, Macy's spends billions in operating expenses for things like rent, utilities, and a mammoth staff of 90,000 full and part-time employees. The Resale Company, on the other hand, lets its franchisees do all of this heavy lifting. They incur 100% of the costs of running the stores. Franchisees even have to set aside 5% of sales to pay for advertising. The Resale Company's overhead is limited to its 90-person corporate office.

So, even though Macy's generates over 300 times more in sales, it requires 1,000 times more employees. Macy's produces $26,466 in operating profit per employee… but with its vastly more efficient business model, the Resale Company earns $641,934 per employee. Likewise, the Resale Company generates operating margins of 64% compared with just 1.6% for Macy's.

In addition to overhead for staff, rent and utilities, retailers like Macy's tie up massive amounts of capital into inventory. This presents a major financial headwind to returns on capital, because inventory involves spending cash up front to stock merchandise that will sit on shelves or in warehouses, waiting - sometimes months - to be sold. Worse, if products don't sell quickly enough, the retailer is forced to "move inventory" by marking down the price - and crushing margins. Macy's currently has $4.6 billion in capital tied up in inventory.

Finally, retail store owners also spend significant capital to open, update and maintain physical store locations. This cost Macy's an average of $531 million per year between 2018 and 2021.

The Resale Company doesn't spend a dime opening new stores or maintaining the existing locations. Again, that's the job of the franchisee, who spends up to half a million dollars or more on each location.

In short, the Resale Company has structured its business to make all of the money off of selling used goods, but has found a way to offload virtually all of the operating costs. This makes the business extraordinarily capital efficient. Over the

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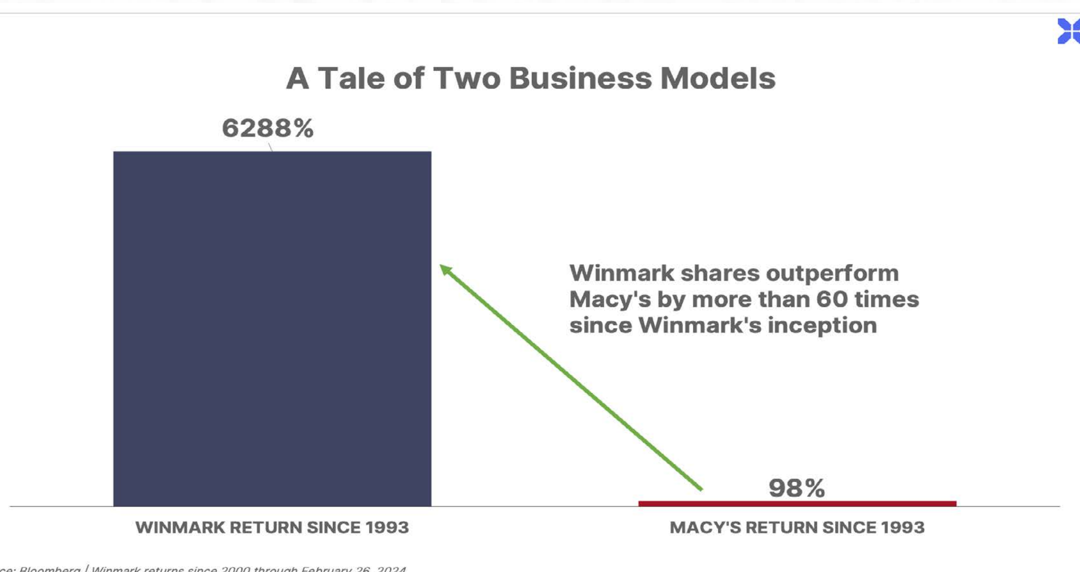
last five years, Winmark's free cash flow margins averaged 56% compared with Macy's 3% over the same period. These incredible free cash flow margins translate directly into one of the most aggressive share buyback programs in the market. The company has reduced outstanding share count by more than 30% over the last decade.

So... which business would you rather own?

Let's ask the stock market. Here's the total return of both companies since the Resale Company began operations in 1993:



All the Profits, None of the Headaches

Why haven't you ever heard of the Resale Company?

Because it is incorporated with a totally anonymous name: the Winmark Corporation.

The company doesn't trade under its corporate name, which seems deliberately anodyne, but I'd bet you are familiar with at least one of its brands: *Plato's Closet*, *Once Upon a Child* and *Play It Again Sports*. Despite Amazon crushing virtually every other kind of retail, Winmark has seen its franchise revenues almost double over the last 10 years, from $38.7 million to $74.5 million in 2022.

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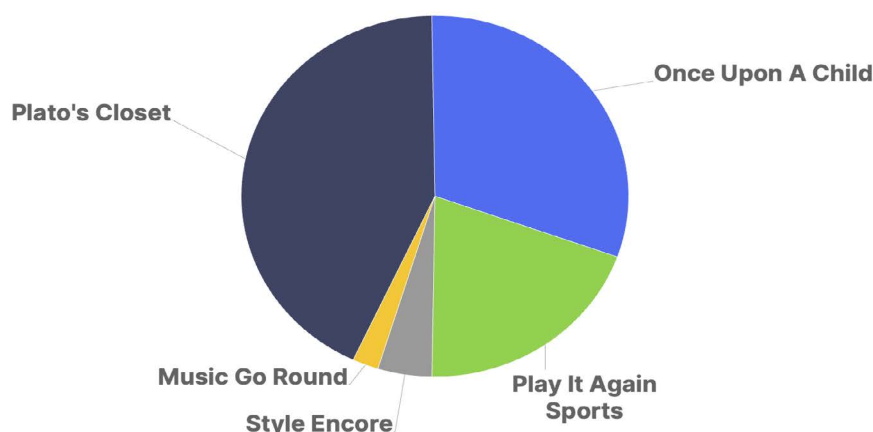

Source: Winmark's 2022 Annual Report

Winmark's business began with the original acquisition of Play It Again Sports in 1988. Since then, the business has expanded from a small regional chain to a national brand, with over 300 locations in the U.S. and Canada.

Its best businesses, Plato's Closet and Once Upon a Child, were both founded by the same husband-and-wife team. In 1985 Dennis and Lynn Blum were raising three boys in Perrysburg, Ohio. As every parent knows, the boys quickly outgrew their clothing, shoes and toys. The Blums started Once Upon a Child to solve this problem, both themselves and their neighbors. Winmark acquired the business in 1992, and since then, it's been the largest and fastest-growing reseller of children's goods and apparel in North America. Since 2013, the store count has grown from **968** to 1,295 which has boosted the royalty and franchise fee income from $10.8 million to $18.9 million by 2021.

As the Blums' children grew from toddlers to teens, the couple ran into a slightly different problem - the rapidly changing fashion trends among teens and young adults. That inspired the launch of their next venture - Plato's Closet, which Winmark acquired in 1998 and grew into the company's largest brand with 489 locations across the U.S. and Canada.

Plato's Closet is in many ways an upscale version of Goodwill or Salvation Army. You can walk into any of their locations and sell your lightly used clothing on the spot for cash. The company then resells that clothing at discounts of up to 70% off new prices.

The demographic target for Plato's Closet are teens and young adults, between the ages of 12 and 24. Like many of Winmark's brands, the business model thrives in good times and bad. Former CEO John Morgan described in a 2009 interview

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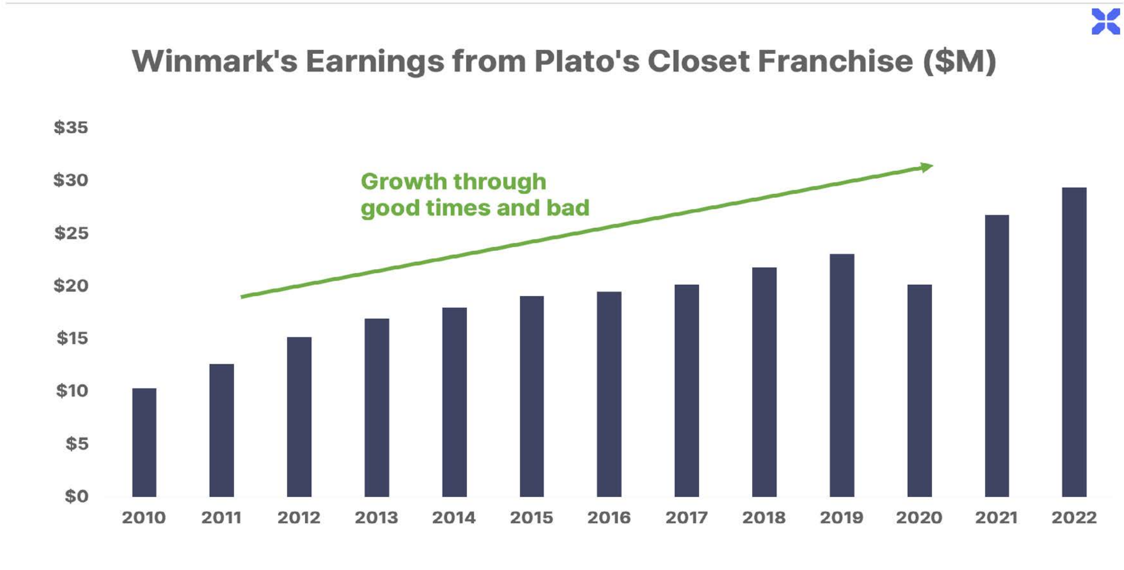
how Plato's Closet "*did the best during the Great Recession among Winmark's franchises because people were more likely to sell used clothing to make money and to buy used clothing to save money*."

That's why 2008 was a great year for Winmark, which saw revenue growth of 14% in 2008 as the Great Financial Crisis motivated consumers to trade down into the discount sector.

We can also see from the trajectory coming out of the Great Financial Crisis that Plato's Closet thrives in the good times, too - despite taking a short term dip from closures during the 2020 pandemic lockdown, before recovering to new highs in 2022.



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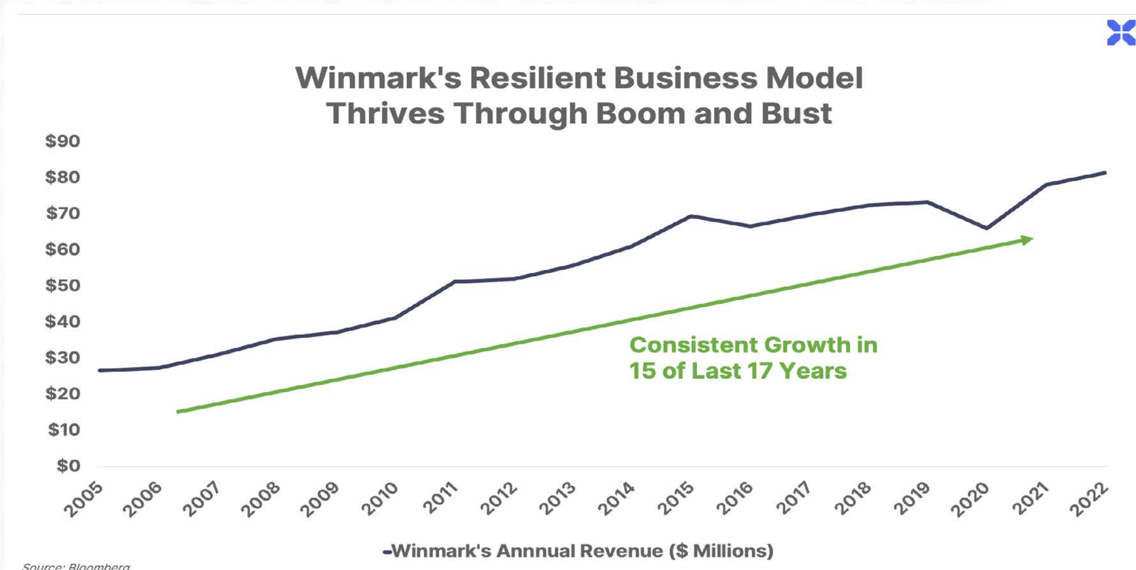
A Business Built for Booms and Busts

Winmark doesn't require a recession to thrive, but it helps.

The company has posted revenue gains in 15 of the last 17 years, with a drop in 2020 caused by the Covid lockdowns.



But the company's results were not always good…

Founders Ron Olson and Jeffrey Dahlberg founded the company in 1988 as a retail franchise business, Play It Again Sports Franchise Corporation, that collected a 5% royalty on all sales.

During the 1990s, Olson and Dahlberg also began to operate stores themselves – big mistake.

On the upside, this meant owning 100% of the sales that flowed through the cash registers, instead of only a 5% royalty fee. On the downside, it meant incurring 100% of the operating expenses, and 100% of the capital expenses of opening new stores. Those capital expenses began to eat up all of the cash being generated. In order to help fund these capital requirements, they took the business public in 1993 – and kept opening and operating new stores. By 1999, only 30% of the business sales came from franchise revenue.

As the business model shifted further away from the franchise model, profits turned into losses, and the share price collapsed:

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By 1999, the company was losing $8 million a year and shareholders had suffered an 80% wipeout. The business was teetering on the brink of bankruptcy... until John Morgan came to its rescue. Morgan had previously co-founded Winthrop Resources, a successful equipment-leasing business, which operates on similar "capital-light" features as the franchise business model. Morgan and his partners sold the business for $340 million in 1997, allowing him to walk away with an 8-figure payout, and set the stage for his next big win at Winmark.

Morgan took over the CEO role at Winmark CEO in early 2000, and immediately began transforming the company. He shut down all of the stores that the company itself owned and operated, and returned the business to its roots as a pure franchisor. That stemmed the red ink, and in time transformed Winmark into one of the best performing stocks in the market - earning over 20% compounded returns for the last two decades running:

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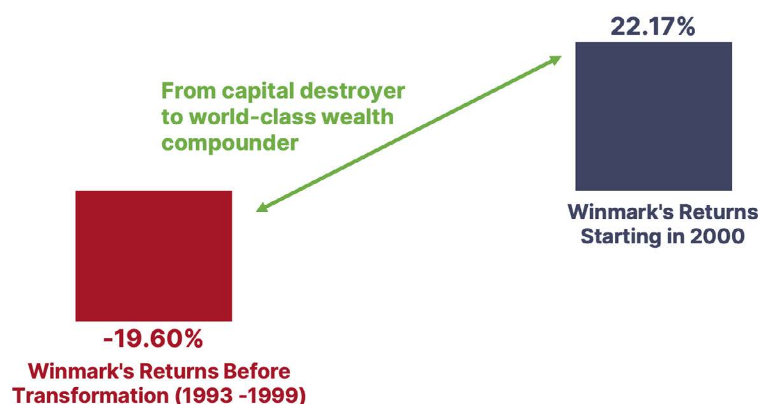

Investors who bought shares on the eve of the company's transformation in January of 2000 would have grown a $10,000 investment into an incredible $958,100 today. Meanwhile, the same investment into the S&P 500 would have grown to just $35,504.

The whole key to this business is the franchise model. And, fortunately, after learning its lesson, the management of Winmark understands that fully. The company does an incredible job of supporting its franchisees to help them succeed. Most importantly, they gain access to Winmark's pricing software, which draws upon decades of retail sales data in each stores' local market. This provides Winmark's franchisees with a critical competitive edge in determining the optimal prices to offer for used goods and for setting the prices they can charge. Winmark's pricing software also speeds up operations, making decisions about pricing instantly. That gives their franchises a powerful competitive advantage over the local mom and pop resale shops.

The benefits of being a franchisee are demonstrated in the company's renewal rates. Winmark's franchise agreements have 10-year terms after which there's an option for renewal. Winmark has enjoyed rock solid franchise renewal rates over its history, never falling below a 97% renewal rate over the last decade.

In summary, Winmark's business model satisfies a large and growing consumer demand – low priced retail goods. The company typically does better in recessions.. And, for investors, Winmark's franchise model makes the business virtually inflation-proof.

The company's shares having been trading at the low of their historical valuation range – at just over 19 times earnings, compared with a more typical 20 to 25 times earnings.

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We believe the company is going to be an exceptional investment for our subscribers. Capital efficient companies like this tend to increase their returns on invested capital over time. This is the kind of business, assuming management keeps the existing strategy, that you should never sell.

Action to Take: For the latest updates on our open positions, please visit our live portfolio **here.**

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