Porter & Co.

THE BIG SECRET ON WALL STREET

The 50% Compounder You've Never Heard Of

- A Low-Cost Player in a High-Profit Industry
- Capturing Riches in a Niche Insurance Sector

FROM THE DESK OF PORTER STANSBERRY

#50
MAY 17, 2024

The Big Secret

System-wide automation and other operational efficiencies give this insurance company a major cost advantage over its peers. This allows it to price its policies at highly attractive rates, driving rapid growth and market-share gains, while delivering industry-leading profitability.

The 50% Compounder You've Never Heard Of

A Low-Cost Player in a High-Profit Industry

Capturing Riches in a Niche Insurance Sector

It was a lean Christmas for the Borel family.

In rural 1940s Texas, it cost a lot to feed and clothe six kids. But dad Clarence had landed a modest but steady job installing insulation. And one December night, he brought home a bag full of sparkling "snow" crystals to decorate the family's meager Christmas tree.

It was asbestos dust from the insulation company where he worked… the closest thing you'd get to snow in Texas.

And there was plenty of the snowy-white material… enough to take to school to dust the trees in the Borel kids' classrooms, too.

It was a Christmas "miracle."

It also killed Clarence Borel – and, ultimately, nearly destroyed one of the most venerable insurance organizations in the world.

Clarence – who later died of pulmonary asbestosis and mesothelioma at age 57 – was one of the first individuals to sue an asbestos company in a landmark 1969 case, *Borel v. Fibreboard Paper Products Corporation*. He argued, rightly, that the insulation company was aware of the dangers of the toxic flame-retardant, and purposely failed to warn its employees. Clarence testified during his court case that he and his fellow workers thought the dust was harmless and would "dissolve as it hit your lungs." (Asbestosis, a fatal lung condition, had been medically documented since the 1930s.)

Clarence Borel passed away before the Texas court ruled in his favor and awarded his widow $1 million in damages. But his posthumous victory opened the floodgates…

With *Borel v. Fibreboard*, the court set a precedent that companies should be held liable for exposing workers to asbestos. Over the next decade, about 25,000 asbestos-related lawsuits swamped the judicial system nationwide, resulting in payouts of about $540 billion between 1970 and 1995.

In mid-20th-century America, asbestos – once hailed as a "miracle" fireproofing substance – was everywhere: insulation, popcorn ceilings, plaster, caulk, vinyl, roof tar, blankets. As a company owner, if you'd used the deadly mineral in any of your products, you could now expect a giant lawsuit from a customer or employee dying of lung disease.

Of course, *you* likely wouldn't be paying those damages. Your insurance company would.

And that's how Lloyd's of London almost went bankrupt.

Just Because You Can Doesn't Mean You Should

You've likely seen Lloyd's of London mentioned in the news – it's a long-standing British institution with a reputation for insuring almost anything. In its early days in the late 1600s Lloyd's was a marketplace for marine insurance, and later branched out into a field known as E&S, for excess and surplus insurance – covering the specialty risks that standard carriers often avoid. Lloyd's issued both the first auto-insurance policy in 1904 (back when cars were an exotic new invention) and the first spacecraft insurance policy in 1965.

Many of Lloyd's weirder policies are likely publicity stunts, but they make for entertaining reading. Rock stars Bruce Springsteen and Bob Dylan insured their money-making voices with Lloyd's for millions of dollars, and a score of famous leading ladies (Betty Grable, Tina Turner, Jamie Lee Curtis…) have taken out policies on various valuable body parts. Rock group Kiss lead man Gene Simmons has insured his iconic tongue. Perhaps one of the oddest Lloyd's insurance policies protected silent-film comedian Ben Turpin's permanently crossed eyes. If they ever became *un*crossed, Lloyd's would have to pay $25,000. (The eyes remained crossed until Turpin's death at age 70.)

But… as Lloyd's discovered when American asbestos claims began rolling across the pond… just because you *can* insure something doesn't mean you should.

Eager for a slice of the burgeoning American insurance market during the 1930s and ’40s, Lloyd’s sold general liability policies to U.S. companies like candy (or, like sacks of sparkly asbestos “snow”). These policies were remarkably vague and covered all manner of disasters.

Then a bona-fide disaster – in the form of asbestos poisoning – struck.

Too late, Lloyd’s learned the hard way one of the non-negotiable principles of underwriting: **exclusions aren’t optional**. Especially for E&S insurers. To offset the greater risks from the non-standard insurance it carries, an E&S insurer must be extremely specific about what risks it will and will not cover – a precise and delicate dance through a minefield.

Lloyd’s insurers had been aware of the growing medical concerns about asbestos as far back as the 1930s, but policies were easier to sell without exclusions. Lloyd’s chose to write broad policies and not to exclude for asbestos… and, in 1970, was left holding the (fireproof) bag.

As one insurance analyst put it, “Unlimited claims were about to come calling on unlimited liability.”

Because of the way Lloyd’s is organized, it took a few years for the massive insurance claims to move down the chain and officially reach the accounting department. When the full impact hit in 1991, it was devastating. That year, Lloyd’s announced its biggest single-year loss in history: $800 million. By 1995, cumulative losses from 1988 through 1992 were recorded at $14 billion.

Lloyd’s high-net-worth individual backers, who’d pledged to accept financial risk in exchange for a steady stream of premiums, now had to make good on that promise. Thousands went bankrupt, and 30 of them committed suicide.

Lloyd’s began writing asbestos and “environmental risks” exclusions into their new policies. But the damage was done.

The unfortunate insurer continued to hemorrhage billions of dollars a year as more asbestos claims rolled in (some aren’t expected to be fully settled until 2050). Eventually, insurance giant and famed investor Warren Buffett stepped in and bailed Lloyd’s out in 2006.

The lesson that investors and E&S insurers all learned – besides not licking the walls or playing with insulation – was clear: Sloppy underwriting can kill. Specialty-insurance companies should pay eagle-eyed attention to inclusion and exclusion, or risk adding *more* risk to an already chancy business.

That brings us to the recommendation in this issue: a capital efficient specialty insurer that, unlike Lloyd’s, has turned precision underwriting into an art form. (Last year, it roused the ire of several clients for insuring vapes, but specifically *excluding* vape batteries, which it saw as an unnecessary fire hazard.)

How it fine-tunes this process has a lot to do with why we recommend it…

The Wonderful World of Negative-Cost Capital

The company we're recommending in this issue is property and casualty (P&C) insurer **Kinsale Capital (NYSE: KNSL)**. Kinsale focuses on a subsegment of P&C insurance known as excess and surplus (E&S), a specialty market that insures against risks that standard P&C carriers won't cover.

These include insurance against extreme events with significant loss potential, like terrorist attacks, natural disasters, and oil spills on deep-sea drilling rigs. E&S policies can also cover smaller, but hard-to-predict risks, like damage or theft of a vintage wine or gem collection. E&S policies have even been used to cover celebrity body parts, like the $35 million contract singer Mariah Carey once took out to insure her vocal chords. (Shades of Lloyd's!)

Kinsale was founded in 2009 by Michael Kehoe, who is CEO and chairman of the board. Before starting Kinsale, Kehoe spent 15 years in leadership positions at other specialty P&C insurers, including a stint as CEO of James River Insurance Company (NYSE: JRVR) from 2002 to 2008.

Kinsale went public in July 2016. Last year the business generated $1.2 billion in revenue, up 50% from 2022, and $291 million in net income, an increase of 24%. It's a highly capital efficient business model, with 24% profit margins in 2023, a 31% return on invested capital, and 34% return on equity.

Long-time followers of our work know that we like the insurance industry for one key reason: it's one of the most capital efficient types of business out there. Unlike virtually every other business that must pay to borrow money, well-run insurance companies can access zero-cost capital in the form of "float" – the money known as premiums insurers collect upfront from writing policies. They don't pay out the money collected from premiums to policyholders until a claim is filed. Between when it's collected and when paid out, insurers invest this float and earn a return.

And we like the P&C business for another reason: because P&C claims can take years or decades to materialize and pay out. In some cases, claims might never materialize at all. Take homeowners insurance as one example. Many people pay their home-insurance premiums for decades and never file a single claim. Compare this to something like life insurance, where the policy payout is inevitable (until scientists crack the code on immortality).

For well-run P&C insurers that collect more in premiums than what they pay out in claims, this float essentially becomes a source of negative-cost capital – where the insurance company gets paid to invest the capital provided by policyholders.

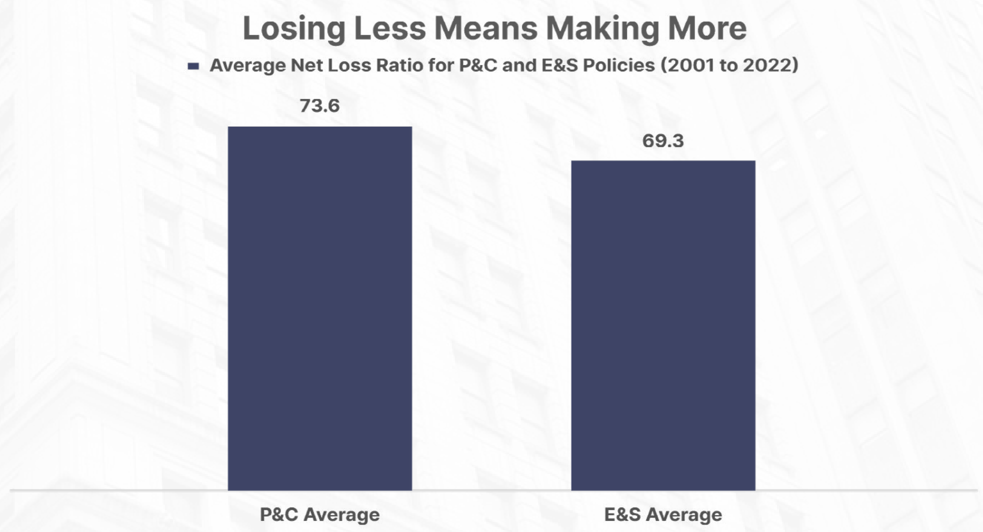
Turning High-Risk Policies Into a Low-Risk Business Model

While E&S policies insure against high-risk events, this doesn't necessarily make for a riskier business model. The upside for E&S insurers lies in their ability to write "non-standard" policies. Because of the idiosyncratic nature of the risks involved in E&S policies, regulators allow these companies greater leeway in structuring the terms of non-standard policies. Standard P&C policies, meanwhile, insure against well-known risks, and thus must follow strict regulatory parameters on their policy terms.

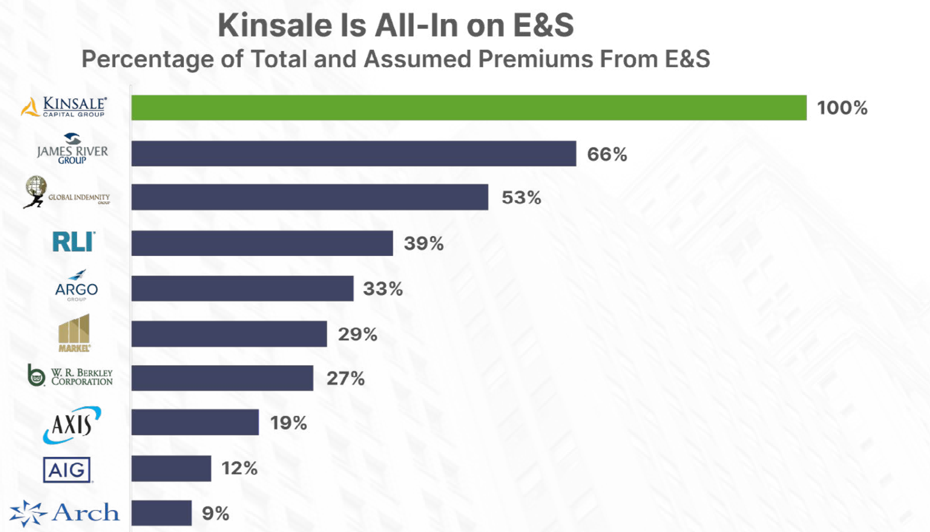
As a result, E&S insurers enjoy greater flexibility in creating contracts that limit their risk exposure. This includes structuring contracts with higher deductibles and lower coverage limits relative to standard policies. E&S insurers can charge higher premiums to compensate for the higher claims they may pay out over time.

That's how E&S insurers can offer coverage for riskier events, while also limiting their losses on these policies. We can measure this through one key insurance-industry metric known as the **loss ratio** – or the percentage of every dollar in premiums that gets paid out in claims over time.

The chart below compares the loss ratios on E&S and standard P&C policies, provided by the leading insurance-industry data provider AM Best. The figure shows that, from 2001 to 2022, E&S policies have generated 4.3 percentage points less in losses compared with standard P&C policies:



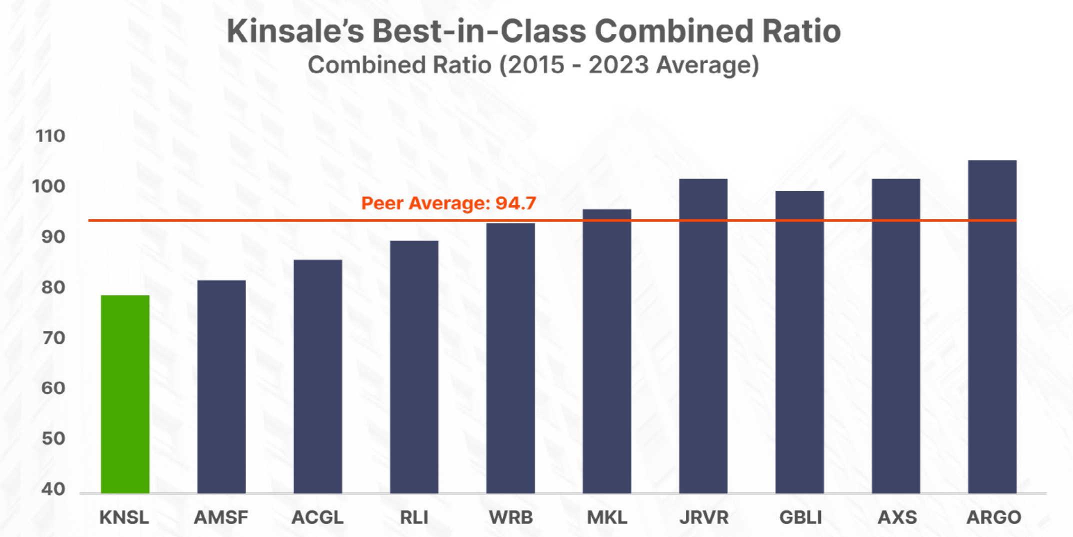
The lower loss ratios in the E&S market make it a particularly lucrative segment of P&C insurance. And it's particularly profitable for Kinsale, as it's the one company among its peers that issues only E&S policies and no other type. Most of its top competitors generate less than half of their premiums from this lucrative niche, with only two generating more than 50% of revenue from it:



Managing losses is only half of the battle in the insurance industry. The other half is operational efficiency, measured by the **expense ratio** – the expense incurred per dollar of premiums collected.

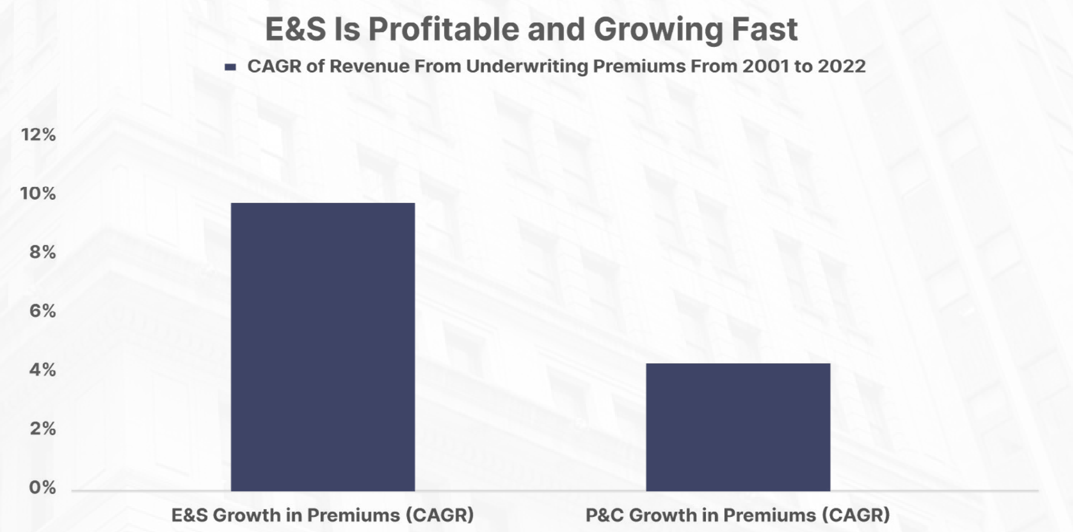
The profitability measure for insurers that captures both losses and expenses is known as the **combined ratio**, which is the sum of the loss and expense ratio. A combined ratio below 100 indicates profitable underwriting, and a combined ratio above 100 indicates unprofitable underwriting.

Kinsale is the most profitable underwriter among its E&S peers, with its best-in-class average combined ratio of 78.5 for the years from 2015 to 2023 (the full length of Kinsale's public operating results). That's an incredible 16.2 points below its peer average of 94.7 over the same period:

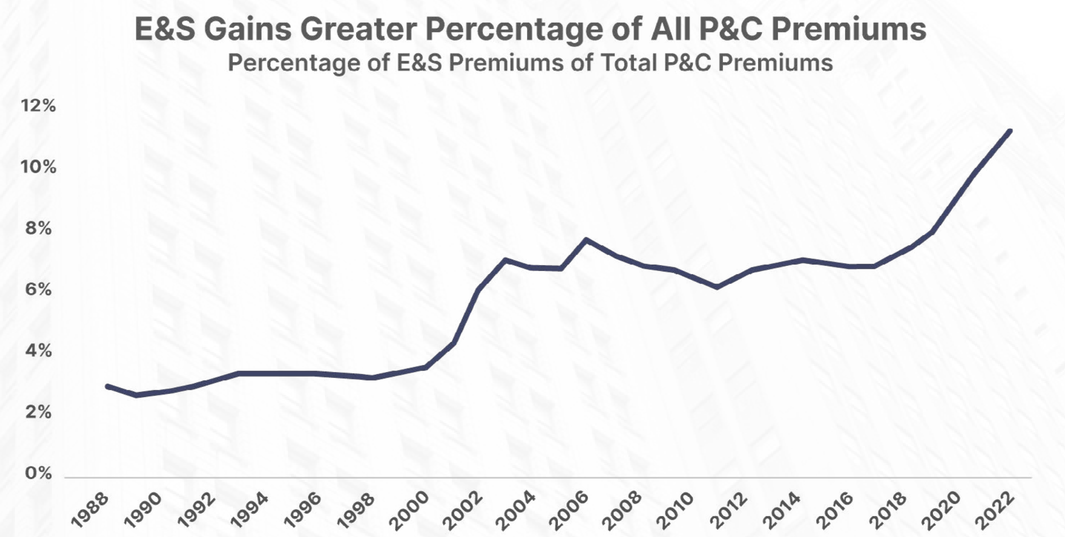


Taking Market Share in a Fast-Growing Market

Being totally focused on the lucrative E&S market, Kinsale enjoys another massive benefit to its business beyond high profitability: rapid growth. From 2001 to 2022, growth in premiums in the E&S market has increased at an 9.6% compounded annual growth rate ("CAGR"), more than twice the 4.2% CAGR of premium revenue generated in the P&C market:

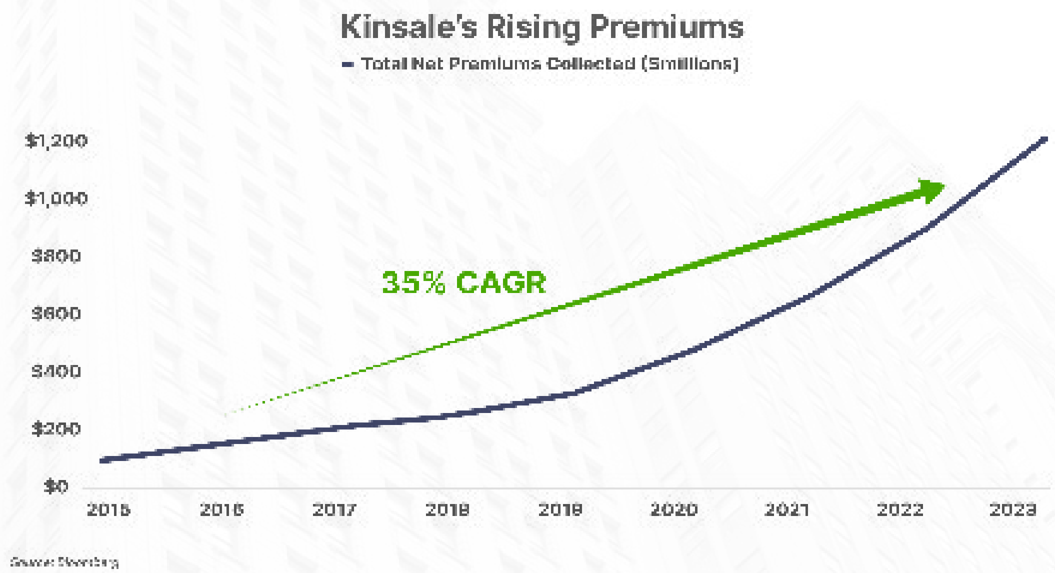


This growth is driven by a multi-decade trend of standard P&C insurers pushing a greater proportion of riskier policies onto the E&S market. The trend shows no sign of slowing anytime soon, with E&S insurers continuing to gain a growing slice of the premiums in the overall P&C market:



The increasing share of E&S policies within the P&C market is a powerful boost to Kinsale's business model. And one that's amplified by the fact that Kinsale is outpacing the overall E&S industry, by aggressively taking market share from its competitors.

Kinsale has increased its premiums at a 35% CAGR since 2015. That's roughly 3x the growth rate of the overall E&S market, indicating the company is taking significant market share from its competitors. And it's more than twice the rate of the next fastest-growing competitor, Arch Capital Group (ACGL), which increased premiums at a 14% CAGR over the same period.



Despite its rapid growth in premiums and gains in market share, the future opportunity for Kinsale remains vast. With $1.6 billion in premiums collected last year, Kinsale currently holds less than a 2% share of the $100 billion market for E&S policies. Later, we'll show why we believe Kinsale could ultimately grow into one of the largest players in the E&S market, with a 10% to 15% share.

First, let's dive deeper into Kinsale's business model to understand the types of policies it writes, and how it's taken market share and generated higher underwriting profits than its peers.

Small Accounts, Outsized Profits

Kinsale primarily sells its P&C insurance policies to small- and medium-sized businesses, which made up 97.5% of the premiums last year. The other 2.5% of its business comes from policies issued to individuals, including auto and homeowners insurance. The company specifically focuses on serving small accounts, with an average annual premium of $15,200 per policy across its entire portfolio last year. Founder and CEO Michael Kehoe explains the simple reason for targeting these small accounts:

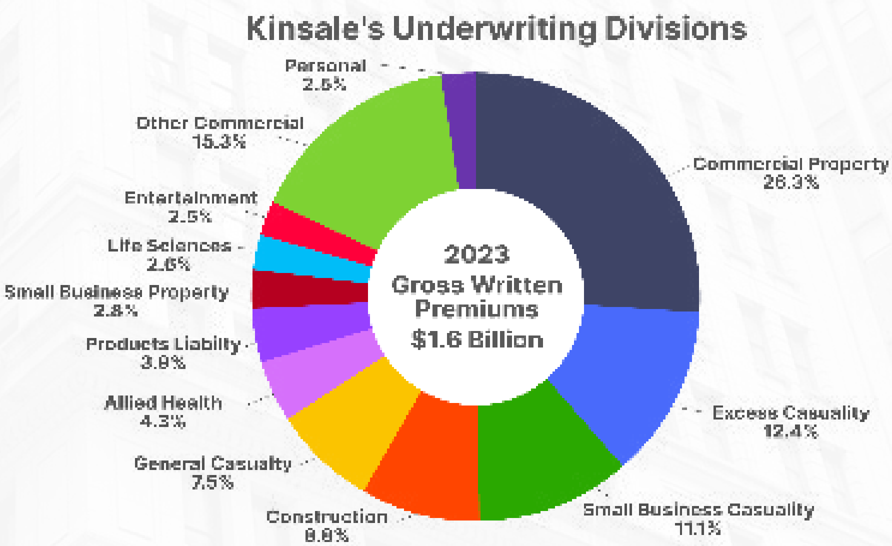
> *"As accounts grow in size, competition rises exponentially, and the margins for the risk-bearer compress... for that reason we focus on smaller accounts in the $15,000 range."*

Last year, 67% of Kinsale's business came from casualty policies and 33% from property. In both segments, these policies provide coverage not available from standard P&C insurers. In some cases, this is because a new business or industry has a limited operating history. Think of things like cannabis dispensaries – a relatively new industry, where the limited operating history creates challenges in estimating claim liabilities. Or businesses in higher-risk industries with harder-to-predict or larger potential claims, like construction, adult entertainment, or convenience stores in high-crime areas. For its personal lines, Kinsale offers higher-risk auto- and home-insurance policies, like protecting exotic cars or homes in disaster-prone areas.

Kinsale focuses exclusively on market segments where its underwriters have extensive experience. It has 24 underwriting divisions that each specializes in a particular niche of the E&S market.

Kinsale's largest underwriting division is in commercial property (26% of premiums), which provides insurance against property loss in commercial buildings from rare but extreme events, like hurricanes or floods. The next largest division is excess casualty (12% of premiums), providing insurance for businesses against injury or death of an employee or customer, in excess of the coverage limits offered from standard P&C policies.

Other offerings include small-business casualty and small-business property (13.9% in combined premiums), which specifically cater to small businesses that standard P&C insurers will not underwrite. Kinsale also offers product-liability insurance (3.9% of premiums) that covers the loss of life or property from flaws in a manufacturer's product. Finally, it writes policies dedicated to specific industries like construction (8% of premiums), entertainment (2.5% of premiums), and life sciences (2.6% of premiums).



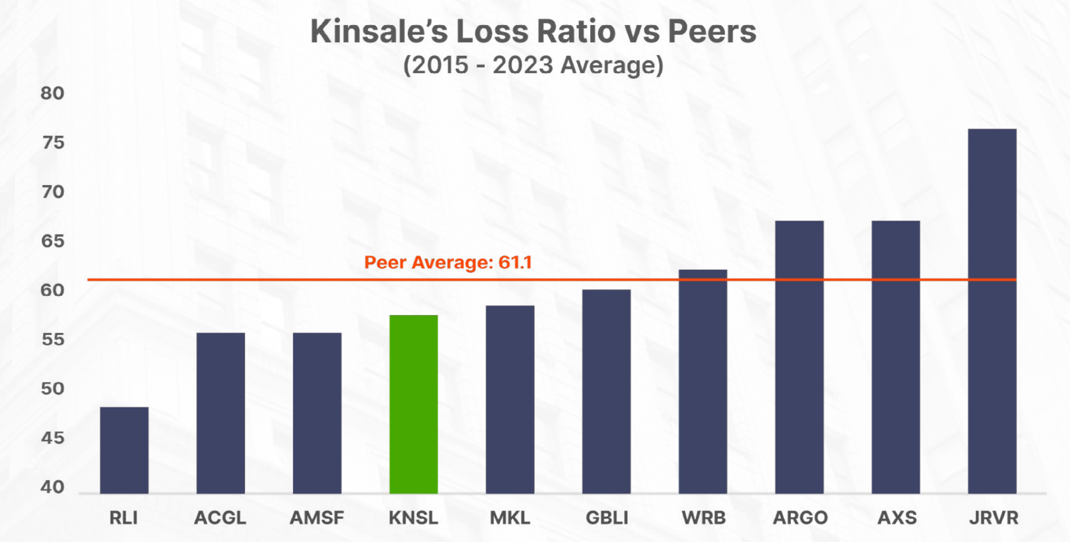
More important than the type of insurance Kinsale issues is the way it underwrites each policy. Kehoe designed the business to overcome the many shortcomings he encountered while working at larger, more-established insurance carriers.

A DIY Approach to Risk Underwriting

One approach CEO Kehoe has implemented at Kinsale is keeping 100% of the policy underwriting in-house. This goes against the traditional industry practice of outsourcing underwriting to third-party insurance brokers. Kehoe realized that this outsourcing creates conflicts of interest between insurers and brokers, which can lead to higher loss ratios, as he explained in an interview last year:

> *"... brokers get paid on premium volume, not profitability. So when you delegate underwriting authority to commissioned salespeople you do create a misalignment of interests. And that shows up sometimes in the form of a higher loss ratio. So Kinsale is able to maintain absolute control over our underwriting, we never ever delegate that outside of our company."*

Keeping all of its underwriting in-house is one key way Kinsale keeps its loss ratio at the low end of its peers. From 2015 to 2023, Kinsale generated an average loss ratio of 57.7, or 3.4 points lower than its E&S peer average of 61.1 over the same period:



While Kinsale's loss ratio is at the low end of its peers, that's not what makes the business special. The ultimate competitive advantage driving its impressively low combined ratio comes from Kinsale's unmatched operational efficiency.

Superior Data Management as the Ultimate Cost Advantage

At its root, insurance is an exercise in data management. From the beginning steps of underwriting a policy all the way through to honoring claims, data lies at the heart of the business. Consider a simplified example of an auto-insurance policy.

When issuing a new auto policy, underwriters must factor in a list of risk variables – the driver's average mileage, accident and ticket history, and the estimated repair costs for the insured vehicle. Insurers can also draw upon historical third-party data from drivers that fit a similar profile. Underwriters analyze this data to estimate the future likelihood and cost of potential claims. They then come up with a premium amount sufficient to cover potential claims, the costs of issuing the policy, and a profit margin.

The data-management process continues through the life of the policy. As circumstances change (i.e., vehicle value depreciates, repair costs rise from inflation, etc.) these new data points go into updating the premiums for renewal policies. If an accident claim is filed, the insurers must estimate a fair payment, and manage the claim through the repair process. The details of each claim are recorded into the insurer's data library, which will inform future underwriting standards.

That's just at the individual policy level. The far more complex task lies in managing the vast trove of data across an entire insurance company. As premiums are collected and claims are paid, shifting capital levels determine how much risk exposure the company can take on when issuing new policies. Along the way, insurers track loss and expense ratios across divisions and the entire organization. This informs management of whether its underwriters are taking on excess risk and operating with efficiency. And it all happens in real time, with new information coming in each day.

One of the biggest industry shortfalls Kinsale founder Kehoe identified during his time working at other insurance companies was their rudimentary, unorganized systems for managing all this data. Many of Kinsale's competitors were formed before the digital age. And as the industry moved from paper to computers, it often did so in piecemeal fashion.

For example, the claims department might have developed its own software system that operated independently of the underwriting department. So as new claims get filed, new information is manually input into the historical data set used by underwriters when issuing new policies. Likewise, the risk department might have its own software system for managing capital levels and risk budgets that didn't link to the underwriting department. The same problems arose when insurance companies grew through acquisitions, which involved bringing in non-compatible software systems from the acquired business.

As these legacy systems grow in complexity, overhauling them becomes increasingly expensive, and most companies have kept the legacy systems in place. The end result: a hodge-podge of independent software systems that stifles the transmission of data across the organization.

Kinsale avoided this problem by building its own fully-integrated information management system. When Kehoe launched Kinsale in 2009, he took advantage of the latest software and cloud-computing technology to create a customized, web-based platform designed and built by Kinsale's own developers and insurance analysts.

This customized, fully-integrated, end-to-end platform compiles data from every aspect of the business into what Kinsale calls its data warehouse. Every new policy feeds the data warehouse, capturing an array of statistical data. This data is collected and labeled in a consistent format, providing easily searchable information across the organization. In this way, underwriters can access historical data on prior policies to inform the risk and pricing of future policies. It also helps manage the exposure Kinsale has among its different business segments. This provides easy access to the information each division needs to determine its own risk budget, expense, and loss ratios – making for easy and fast pricing of new policies.

Most important, the system enables the digitization of every new policy and supporting documentation. In this way, Kinsale eliminates the need for thousands of paper documents to be printed, processed, mailed, and filed. The system's high level of automation eliminates the errors and labor expense associated with manually transmitting information internally and externally.

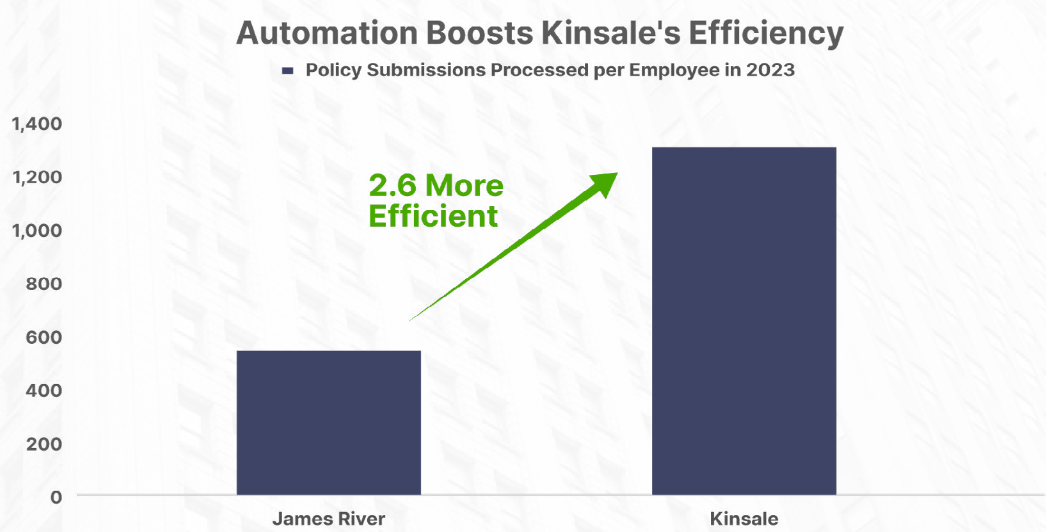
As one example, consider Kinsale's web-based portal created for brokers to submit proposals for new insurance policies. Legacy insurers typically hire employees to answer broker phone calls or emails. They then input the data manually into a software program for underwriters to process the submission. Kinsale eliminated this step with its digital web portal designed for brokers to submit this information themselves, from which the data feeds directly into Kinsale's underwriting application.

Brokers appreciate Kinsale's automated system because it enables significantly faster turnaround times on submissions. In the sales business, time is money. By setting up an automated system that eliminates the friction of manual data processing, Kinsale allows brokers to get a rapid response to new business submissions, resulting in greater volumes and more profits for Kinsale and its brokers. As Kehoe explained in an interview with industry data provider AM Best:

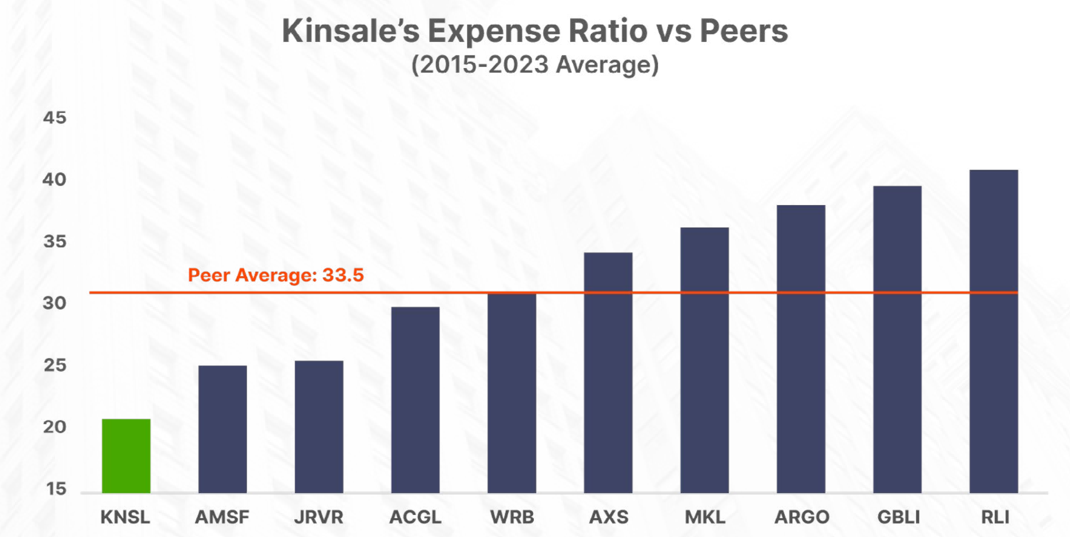
> *"The E&S market is renowned for atrocious levels of service. And we think that's a great opportunity for us to distinguish Kinsale. We've put enormous focus on turnaround times. And we're at the point now where 30% of submissions, we're able to respond to our broker within one hour of the submission being cleared. And for 70% of those submissions, we respond within one day. So those high levels of service allow us to distinguish the company."*

The labor-saving impact of automations also keeps Kinsale's operating costs low, by cutting back on the biggest cost center in the insurance business: employees.

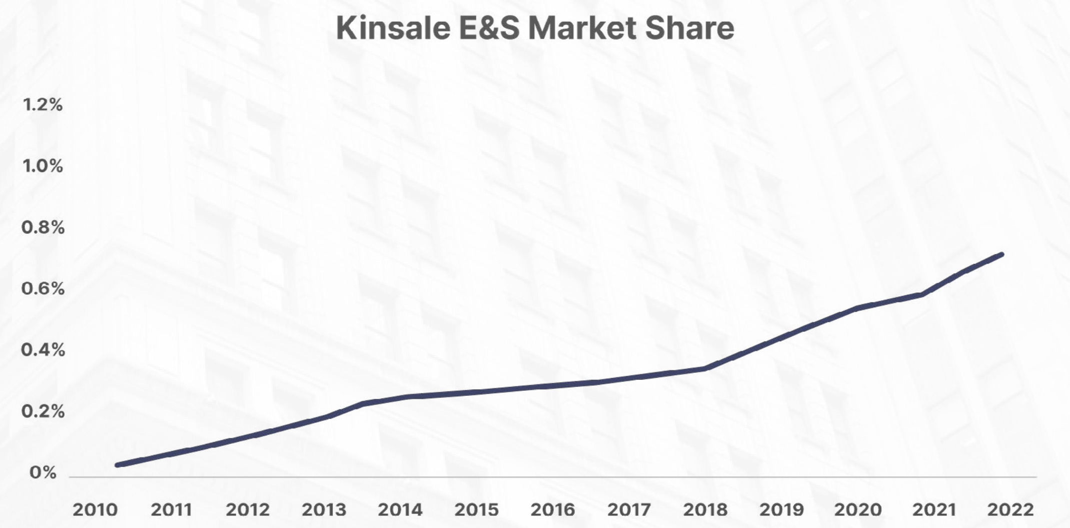
Consider the headcount of Kinsale versus its most comparable peer, James River, which is a competitor with a similar concentration in small- and medium-sized businesses in the E&S market. Last year, Kinsale processed 735,000 new business submissions from its brokers with 561 employees, translating into 1,310 submissions per employee. James River, on the other hand, processed 321,000 submissions with 649 employees, or 495 submissions per employee. Thus, Kinsale is 2.6x more efficient than its top competitor in terms of the volume of new policy proposals it handles per employee:



Kinsale captures similar savings across its entire business from its highly automated data-management systems, from underwriting to claims management and capital allocations. And that's the big secret that unlocks Kinsale's single most powerful competitive advantage: its best-in-class expense ratio – the expense incurred per dollar of premiums collected – which has averaged just 20.8 over the last nine years, or a massive 12.7 points below its peer average:



Kinsale's stellar operational efficiency provides it with a massive, structural advantage against competitors. In the business of insurance, where one company's policy is indistinguishable from another, insurers compete heavily on price. And Kinsale's slim expense ratio gives it the power to price policies at more attractive rates, and thus take market share from its higher-cost rivals:



Source: AM Best

These market-share gains have fueled a 15x increase in Kinsale's revenue over the last nine years, from $81 million in 2015 to $1.22 billion last year. And whereas most high-growth companies often sacrifice profitability for market-share gains, Kinsale has done no such thing. It's been consistently profitable since its first year of publicly available financial data in 2015, generating an average of 20.2% net income margins over the last nine years. That's the highest among all of its peers, and more than double its peer average of 9.2% net income margins over the same period.

This combination of rapid growth and industry-leading profitability has delivered stunning returns for investors. Since going public in July 2016, Kinsale shares have delivered a 2,236% total return, or 50% compounded annual returns. And these incredible returns come despite a recent 30% drop in its share price, which has created a rare opportunity to buy shares at a near record-low valuation.

Growth Slowdown Creates Buying Opportunity

In Kinsale's Q1 earnings report on April 25, the company reported a "disappointing" 25% year-on-year increase in new premiums. While this 25% growth rate still makes Kinsale one of the fastest growing E&S insurers in the U.S., the number broke a previous 20-quarter streak of premium growth exceeding 30%. Shares fell 17% on the news of the growth deceleration. This followed a 20% share-price drop in April – likely part of a decline in the broader market.

Down roughly 30% from a high of $550, Kinsale's $375 share price reflects a 25x forward earnings multiple, nearly 30% below its historic average forward multiple of 35x. Outside of the initial trading when Kinsale first went public, the shares have only traded for less than 25x forward earnings at one other time in its history – February 2018. Shares have returned more than 700% since then.

Source: Bloomberg

There's no reason to suspect that Kinsale's slower rate of growth reflects any loss in its competitive position. Premium growth across the E&S industry fell to 7% in Q1, down from the double-digit pace the sector has experienced over the prior six years. The modest slowdown in premium growth for the overall E&S market is primarily driven by the property E&S market, where rates soared for several years and have now begun to level out. Amidst this overall slowdown, Kinsale continues growing at roughly four times the rate of the overall E&S market. And it has maintained its best-in-class combined ratio, which came in at 79.5 in Q1 – well below the peer average of 88.7 in Q1.

Kinsale's operational efficiencies and underwriting profitability continue to position it as a low-cost leader. This provides it with the ability to lower policy prices, and continue taking market share from its higher-cost competitors. In the following exchange with an analyst on Kinsale's Q1 earnings call, Chief Operating Officer Brian Haney noted that the company may pursue this strategy of competing more aggressively on price to jumpstart its growth:

> *"Analyst: As the industry's low-cost producer, do you think Kinsale is leveraging its competitive advantage to the extent possible? How much room is there for Kinsale to potentially nudge pricing a little bit lower to sustain longer growth?*

> *"Haney: … in certain areas, we are looking at cutting rates to grow faster. In certain areas in some of the lines we don't need to do that because we're growing fast enough as it is. So yes, division by division we're looking at that exact calculation regularly… the goal is to drive as much value to the company and the investors as we can. But there is definitely room and you're right. Being a low cost operator provides us a leeway I think that our competitors don't have."*

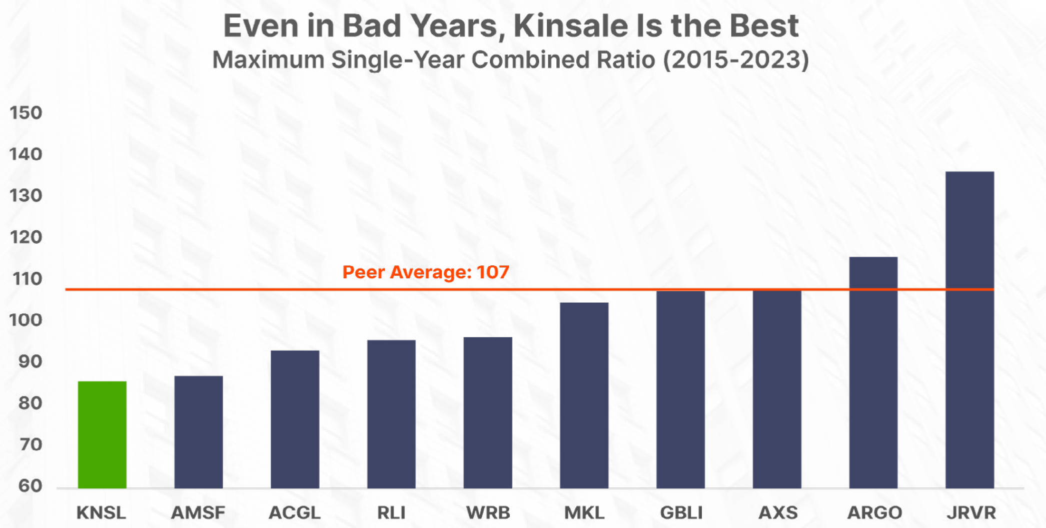
With that in mind, let's consider what the future might hold for Kinsale's growth, profitability, and shareholder returns.

Charting a Future Path for Kinsale

Before modeling a series of future possibilities for Kinsale's business, it's important to note one key feature of the insurance business. Many insurance companies have historically boosted short-term premium growth by reducing prices too aggressively. This inevitably results in excessive future losses, when lax underwriting generates claim liabilities that exceed the premiums earned. Only the top-tier insurance companies can generate above-average premium growth, while also keeping their combined ratios well below 100.

Kinsale is among the rare breed of insurers that has achieved exceptional growth while maintaining industry-leading underwriting profitability. We can see this by looking at its worst year of operating results, measured by its highest annual combined ratio (i.e., the lowest underwriting profitability) in the publicly available data over the last nine years.

Kinsale's highest combined ratio came in at 86.7 over that period. This means that, even in its worst year of underwriting results, it still earned more than 13 cents on every dollar of premium growth it collected. In the table below, we compare Kinsale's worst years of underwriting profitability among its peers over the same period. Note that Kinsale's worst year is still the best among all of its peers, and 20 points better than the average of worst years among its peers:



Kinsale's always-low combined ratio is a reflection of its conservative management team, and its commitment to keeping all underwriting in-house. Kinsale also maintains a high level of reserves against its claims, and a clean balance sheet, giving it a financial strength rating of "A" from insurance-rating agency AM Best – indicating an "excellent ability to meet ongoing obligations to policyholders."

Given Kinsale's history of stellar risk management, and its industry-leading operational efficiency, we believe the company can continue growing at above-market rates without taking on excessive risks.

That said, the company needs to compete more aggressively on price going forward. As Kinsale's E&S market share grows, it will naturally move beyond the relatively profitable niche market of the small $15,000 average-sized policies it historically focused on. As it moves toward larger account sizes, it will face a more competitive market and thus greater pricing pressure. However, it's also worth noting that the company will also likely benefit from greater economies of scale in writing larger policies. The same amount of overhead is required to write $15,000 policies as $50,000 policies. Thus, we don't believe Kinsale will need to sacrifice much in the way of profitability, or expose itself to excess risk, to continue taking market share.

Finally, we also have confidence in Kinsale's management team to act as prudent stewards of shareholder capital. Founder Kehoe has grown the business and generated solid shareholder returns without exposing the company to excessive risks. It helps that he has a significant amount of skin in the game – owning 892,000 shares or nearly 4% of the business. And management has kept share-count dilution at relatively low rates for a high-growth company, with shares outstanding growing by just 1.35% per year.

With all of these factors in mind, we make the following assumptions about Kinsale's prospects over the next decade:

- Kinsale's profit margins will decline modestly from its previous five-year average of 21.5% to 18% going forward. This should give Kinsale the breathing room to price its policies more aggressively, while maintaining a combined ratio in the low-80s – still highly profitable, and at the (good) low end of the industry.
- Revenue growth will decline from the peak growth rates of the past decade: we envision three scenarios for revenue growth rates over the next decade: 20%, 25%, and 30%. For a frame of reference, Kinsale increased its revenues at a 40% annual growth rate over the last nine years.
- The pace of share-count dilution follows its previous path, with shares outstanding increasing by 1.35% annually to reach 26.5 million shares by year-end 2033.
- Kinsale shares will trade at a price-to-earnings ("P/E") multiple of 25. This is 30% less than its previous average P/E multiple of 35, and this lower multiple reflects our expectations of a slower growth rate.

As an additional data point for context, we also show what percentage of the E&S market share Kinsale will occupy in each revenue-growth scenario. In determining the total market size, we assume that the E&S market grows 8% annually over the next decade. For context, the volume of E&S policies grew at a 9.6% annual rate over the last 20 years.

The table below summarizes each of these assumptions over a 10-year period, under the three revenue-growth scenarios. In the 20%-growth scenario, Kinsale increases to 3.5% market share and delivers a 237% total return, or 12.9% CAGR through 2033. The 25% scenario brings the market share to 5.2%, generating a 472% total return, or 17.6% CAGR. Finally, in the 30% scenario, Kinsale grows to 7.7% market share and generates a 650% total return, or 22.3% CAGR:

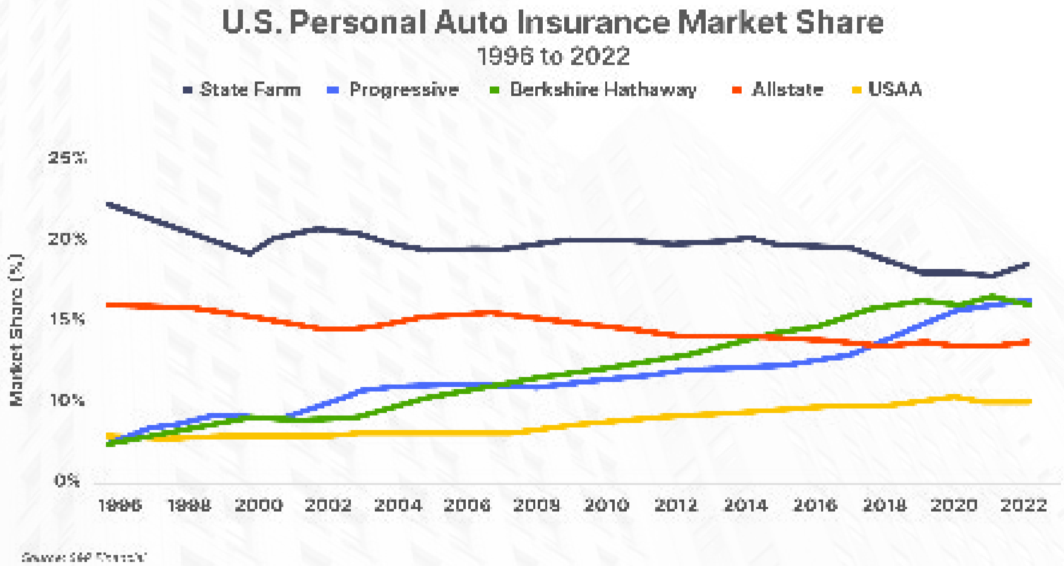
10-Year Kinsale Bull Case Scenarios

Annual Revenue Growth	Revenue ($M)	E&S Market Share	Net Income ($M)	Share Count (M)	Earnings per Share	Share Price	Total Return (from $375 per Share)	Compounded Annual Return
20%	$7,449	3.5%	$1,341	26.53	$51	$1,264	237%	12.9%
25%	$11,205	5.2%	$2,017	26.53	$76	$1,901	407%	17.6%
30%	$16,586	7.7%	$2,985	26.53	$113	$2,813	650%	22.3%

Looking beyond these 10-year scenarios, we see even further upside longer-term. Kinsale CEO Kehoe has likened the company's business model to insurance leaders GEICO, owned by Berkshire Hathaway (BRK-A), and Progressive (PGR). Like Kinsale, both of these companies have focused on low-cost leadership to aggressively take share in their market of personal-auto insurance. In an interview last year, Kehoe explained:

> *"It's [Kinsale's business model] analogous to what GEICO and Progressive have done in the personal auto space. For 30-plus years they've used efficiency to not only deliver best-in-class returns but also to take market share from competitors. If you look back 25 years ago, Progressive may have been 2.5% of the personal auto market, and today they're approaching 15%."*

The company notes that it aims to replicate the success of Progressive's business model in particular – as the chart shows, Progressive has more than tripled its share of the market since 1996:



We believe Kinsale has all of the key ingredients to replicate the success of companies like Progressive and GEICO in the E&S market. The management team has a strong track record at keeping loss ratios low, through conservative underwriting and by fully maintaining risk management in-house. Its fully-integrated, custom-built data-management system enables a high degree of automation that has unlocked a structural cost advantage, making it the low-cost industry leader. Together, superior risk management and operational efficiency have produced an unmatched track record of industry-leading profitability for nine years. That's how the company has delivered solid growth and shareholder returns, without taking excessive risk along the way.

Given these structural advantages and strong track record, Kinsale could become an E&S market leader with a 10% to 15% share of the overall market. And with the shares trading near an all-time low valuation, we see massive upside potential from today's prices.

Action to Take: Buy **Kinsale Capital (NYSE: KNSL)** up to $425 per share

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. **Burford Capital (NYSE: BUR)** is the leading global provider of litigation finance, managing a $7.1 billion portfolio of assets. Burford funds lawsuits and when it wins, it takes a cut of the payout. These cases can turn small investments into supersized paydays. Now, with the courts fully reopened in 2023 after the COVID-19 shutdowns, Burford's backlog of cases are slowly coming to trial and reaching final judgment. Many of those judgments are in Burford's favor, with net income surging 55% to $610 million in 2023. Plus, there's additional upside from a multibillion-dollar ruling in Burford's favor that's not priced into shares today. See our recent Portfolio Update **here**.

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 57% free cash flow ("FCF") margins. Its world-class management team has established one of the best track records in the industry. FNV shares sold off in 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. FNV shares regained some of what they lost in October, but they remain 18% lower than when we recommended them on May 11, 2023, effectively pricing in a total loss of the mine. Meanwhile, with the price of gold near its all time high, the rest of Franco-Nevada's portfolio is performing well. Still, the shares trade near their lowest valuation on record. (We provided more details of the latest developments in a recent **Portfolio Update**.)

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 highly capital efficient, with 40% operating margins and a 27% average return on capital. It's also a recession-proof business, and trades at an attractive valuation of just 16x earnings, with a 5.2% dividend yield.

Portfolio Update

The Big Secret on Wall Street PORTFOLIO

Ticker / Latest Update Link	Description	Entry Date	Cost Basis	Latest Close	Yield	Income Received	Total Return	Status / Risk Rating
ENERGY & COMMODITIES								
EQT EQT	U.S. Gas-Focused E&P	06/02/2022	$48.87	$40.51	1.56%	$1.22	-14.61%	Buy Under $50 / 4
BWXT BWX Technologies	Nuclear Power Equipment	12/22/2022	$58.05	$88.64	1.08%	$1.40	55.11%	Buy Under $110 / 3
BTC/USD Bitcoin	Cryptocurrency	05/11/2023	$27,011.85	$65,260.88	N/A	$0.00	141.60%	Buy Under $50,000 / 4
BTU Peabody Energy	Coal Mining	06/22/2023	$21.29	$22.56	1.33%	$0.30	7.37%	Buy Under $25 / 4
CNX CNX Resources	U.S. Gas-Focused E&P	09/28/2023	$22.82	$24.28	N/A	$0.00	6.40%	Buy Under $30 / 3
BATTLESHIP STOCKS								
CACC Credit Acceptanc	Consumer Finance	07/28/2022	$560.28	$498.41	N/A	$0.00	-11.04%	Buy Under $600 / 3
WINA Winmark	Specialty Apparel Stores	09/15/2022	$217.60	$373.90	0.96%	$17.90	80.06%	Hold / 1
NVO Nordisk Sp ADR-B	Pharmaceuticals	10/27/2022	$53.31	$133.04	1.40%	$2.55	154.36%	Hold / 2
FNV Franco-Nevada	Precious Metals Streamer	05/11/2023	$154.77	$125.75	1.15%	$1.74	-17.63%	Buy Under $125 / 2
PYPL PayPal Holdings	Payment Processor	07/20/2023	$73.02	$64.10	N/A	$0.00	-12.22%	Hold / Stop Loss at $50 / 3
FOREVER STOCKS								
DPZ Domino's Pizza	Restaurants	02/27/2023	$300.00	$513.30	1.18%	$6.35	73.22%	Hold / 3
DE Deere & Co	Agricultural Machinery	08/31/2023	$410.94	$394.43	1.49%	$4.29	-2.97%	Buy Under $450 / 3
DEO Diageo Sp ADR	Alcoholic Beverages	12/14/2023	$145.72	$142.95	2.27%	$1.62	-0.79%	Buy Under $160 / 3
DHR Danaher	Medical Technology	03/21/2024	$254.11	$264.84	0.41%	$0.27	4.33%	Buy Under $270 / 3
NKE NIKE -B-	Athletic Footwear & Apparel	04/18/2024	$95.74	$91.77	1.61%	$0.00	-4.15%	Buy Under $100 / 2
HSY Hershey	Consumer Luxury Staples	04/18/2024	$184.86	$208.17	2.63%	$1.37	13.35%	Buy Under $200 / 2
HIGH YIELD								
PM Philip Mrrs Int	Tobacco Maker	07/14/2022	$89.62	$100.66	5.17%	$8.98	22.34%	Buy Under $105 / 1
VNOM VIPER ENERGY-A	Oil and Gas Royalty	09/01/2022	$29.68	$37.24	N/A	$3.30	36.59%	Buy Under $34 / 3*
BSM BLACK STONE MIN	Oil and Gas Royalty	02/16/2023	$15.90	$15.94	9.41%	$2.28	14.56%	Buy Under $18 / 2
BRW SABA CAP INM & OPP	High Yield Bond Fund	03/16/2023	$8.01	$7.26	14.05%	$1.31	6.99%	Buy Under $9 / 3
OCSL OKTR SPCLY LNDG	Specialty Investments	03/30/2023	$18.57	$19.38	11.35%	$2.27	16.59%	Buy Under $22 / 2
PROPERTY & CASUALTY INSURANCE								
WRB W.R.Berkley	P&C Insurance	05/25/2023	$56.10	$78.59	0.56%	$1.44	42.66%	Buy Under $62 / 2
PGR Progressive (Ohi	P&C Insurance	06/08/2023	$131.08	$207.01	0.19%	$1.15	58.80%	Buy Under $160 / 2
CB Chubb N	P&C Insurance	06/08/2023	$191.60	$264.88	N/A	$3.44	40.04%	Buy Under $220 / 2
SKWD SKYWARD SPEC	Specialty E&S Insurance	06/16/2023	$24.66	$36.26	N/A	$0.00	47.04%	Buy Under $35 / 2
KNSL Kinsale Capital	Specialty E&S Insurance	05/16/2024	$383.87	$383.87	0.16%	$0.00	0.00%	Buy Under $425 / 3

EXPONENTIAL GROWTH								
TELL TELLURIAN	U.S. LNG Exporter	06/16/2022	$3.82	$0.52	N/A	$0.00	-86.36%	Buy Under $5 / 5
EVVTY Evolution UnSp ADR	Casinos & Gaming	11/30/2023	$103.87	$110.66	N/A	$0.00	6.54%	Buy Under $145 / 4
INMD INMODE	Medical Devices	01/11/2024	$21.19	$18.64	N/A	$0.00	-12.03%	Buy under $25 / 5
BUR BURFORD CAP NPV	Litigation Finance	02/08/2024	$14.36	$14.24	0.87%	$0.00	-0.84%	Buy Under $20 / 4
CELH Celsius Holdings	Energy Drinks	03/07/2024	$89.56	$92.57	N/A	$0.00	3.36%	Buy Under $100 / 5
CPNG Coupang Inc	E-commerce	04/04/2024	$18.32	$22.87	N/A	$0.00	24.84%	Buy Under $25 / 4
ATKR Atkore	Electrical Infrastructure	04/18/2024	$171.18	$153.60	0.83%	$0.00	-10.27%	Buy under $200 / 4
BETTER THAN THE MARKET								
SYLD CAMBRIA SHHLDR YLD	Yield Focused ETF	01/05/2023	$59.67	$70.48	2.93%	$1.82	21.16%	Buy Under $65 / 2

**Viper Energy (VNOM) pays out a $0.45 quarterly dividend for a 4.5% annual yield at $40 per share.*

The Big Secret on Wall Street WATCHLIST

Ticker	Description	Latest Close	Initial Analysis	Yield	Status
PAYC Paycom Software	Buy Under $150	$181.07	01/26/2024	0.83%	Application Software
HD Home Depot	Buy Under $240	$342.73	11/10/2023	2.63%	Home Products Stores
SHW Sherwin-Williams	Buy Under $150	$314.02	04/14/2023	0.91%	Specialty Chemicals
ULTA Ulta Beauty	Buy Under $350	$401.04	09/15/2023	N/A	Specialty Retail

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

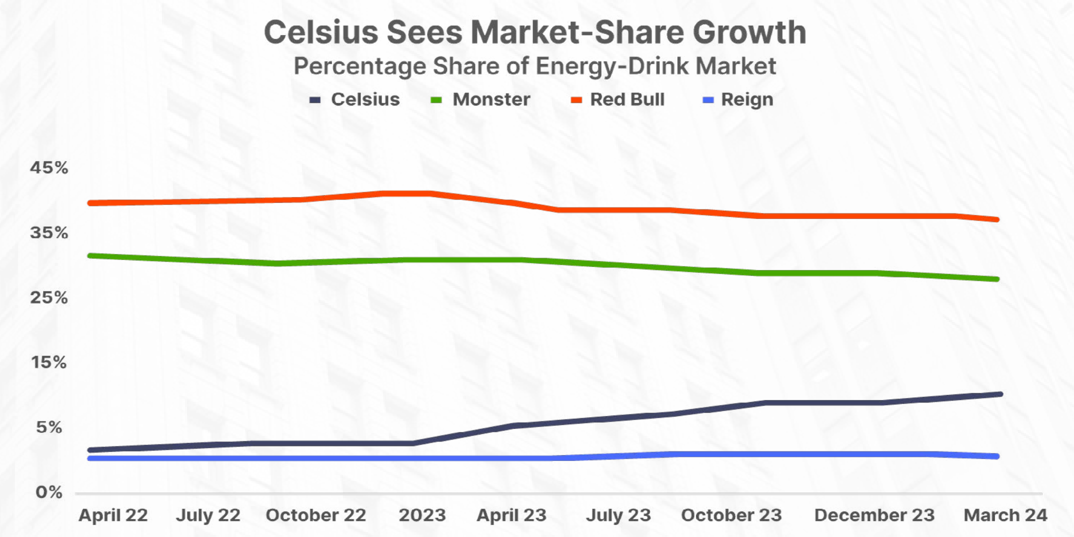
Market-Share Gains and Higher Profits Propel Celsius

Celsius (Nasdaq: CELH) shares closed down 2% on May 9 after the company reported weaker-than-anticipated first quarter 2024 revenue of $355.7 million – an increase of 37% over Q1 2023, but below the market's expectations of 50%. The slower revenue growth stemmed from year-over-year inventory variations from Celsius's largest global distributor, PepsiCo, which accounts for 62% of its North American business. Pepsi placed fewer orders in Q1 2024 compared to the prior year due to overstocking in Q4 of 2022.

Despite the disappointing growth in Q1, Celsius remains one of the fastest-growing energy drinks of all time. For historical context, when energy-drink giant Monster Beverage (MNST) first eclipsed the $1 billion revenue mark in 2011, as Celsius did in 2023, Monster grew revenue 30% the following year. Celsius is currently outpacing Monster's growth rate at a similar point in its history, with its 37% year-on-year revenue increase in Q1.

So while it missed Wall Street's lofty expectations, Celsius is still performing well. It continues to gain market share while driving growth in the entire energy-drink market. In Q1 2024, Celsius was responsible for 47% of the growth *of the overall energy-drink category*.

Celsius's "Live Fit" slogan has evolved into a brand centered around living a healthy, fit lifestyle. With no preservatives and zero sugar, Celsius appeals to consumers as a cleaner, more healthy energy drink. This is bringing in a new demographic of consumers, with 42% of Celsius' growth coming from those who are new to the energy-drink category. The company is also retaining its existing customers and driving repeat business, with 35% of Celsius' growth coming from its core customers buying more of its products. This combination of strong retention rates and selling to a new demographic is driving rapid market-share gains for Celsius.



In the span of 12 months ending in March 2024, Celsius' U.S. market share rose from 7.5% to 11.4%. Continued strong sales in e-commerce, club sales (such as Sam's Club, Costco Wholesale, and BJ's Wholesale Club), and the food-service channel (restaurants, lodging, recreation, and gaming locations) helped drive market-share gains. Celsius again led energy-drink sales on Amazon, capturing 20.2% ($28 million in sales) market share in the first quarter, up from 19.7% the prior quarter. Its partnership with PepsiCo helped in the food-service channel – approximately 12% of Celsius sales generated by Pepsi were to the food-service industry.

As we reported in our initial recommendation, in August 2022 PepsiCo acquired an 8.5% stake in Celsius for $550 million. As part of the deal, Pepsi agreed to distribute Celsius through its massive global distribution network that drives over $90 billion in annual sales. This arrangement provides Celsius with access to 50,000 to 60,000 new coolers across Pepsi's massive footprint of convenience and grocery stores.

During the quarter, Celsius expanded its incentives program with Pepsi. The expanded incentive program will increase Pepsi's average margins on Celsius sales if it sells a certain number of Celsius products. The deal encourages Pepsi to prioritize Celsius's long-term growth. Now that Celsius is the number-three player in the energy-drink category – behind Monster and Red Bull – it warrants greater priority within Pepsi's portfolio. The extended agreement is a win-win for both parties: Celsius will have better visibility and more shelf space at Pepsi distributors, while Pepsi reaps higher profits if it sells more Celsius.

The company is still in its early days of international expansion, which represents another long-term runway for growth. Celsius generated $16.2 million in international revenue in the first quarter, which is 4.5% of the company's total revenue. In comparison, Monster and Red Bull generate roughly 40% of sales from international markets – a disparity that represents a significant opportunity for the company. Celsius has several international rollouts planned through the end of 2024 and is already beginning to take market share in Canada where Celsius was introduced in January.

Celsius' distribution partnership with Pepsi will drive Celsius sales across international markets where Pepsi has a presence. This is already playing out in Canada, where Pepsi aided the rollout of Celsius in January. By the end of February, beginning with no presence in the country, Celsius had 5.5% market share there.

It began selling in the UK and Ireland in April and expects sales in France, Australia, and New Zealand to begin in the fourth quarter of 2024.

The first quarter also demonstrated Celsius's impressive unit economics, generating its highest gross profit margin in company history – 51.2% ($182.2 million). Net-income margins also neared all-time highs at 18.2% (a slight decline from the previous high of 18.3% in Q3 2023). In comparison, Monster's 2023 gross profit margin was 53.1% and net income margin was 22.8%, but Monster only grew at 13.1% for the year (versus Celsius' 37%). As Celsius sells more energy drinks across more distribution channels, its fixed costs are spread out over more units thereby lowering the cost per unit – cost of goods sold decreased 4.7% over the quarter – thus increasing profit margins. These cost savings enable Celsius to invest more in sales and marketing, which should help drive further growth and market share gains.

The long-term opportunity for Celsius remains vast. The company has a long growth opportunity ahead, from expanding the demographic of consumers in the category,

Porter & Co.

while also growing into international markets. And with this growth, the company is starting to gain significant economies of scale, unlocking higher profit margins.

Given the high volatility in the share price, we reiterate our risk rating of 5 (our highest level), and we urge investors to size their initial positions accordingly. And we continue to recommend using short-term declines in the share price as an opportunity to add to your position.

Action to Take: Buy **Celsius (Nasdaq: CELH)** up to $100 per share

Atkore's Decline Pushes Shares Into Value Territory

Shares of electrical-infrastructure manufacturer **Atkore (NYSE: ATKR)** declined 10% following a disappointing Q2 earnings report on May 7 (for the three months ending March 29).

Atkore's Q2 revenue of $792.9 million came in $15.3 million below consensus analyst estimates of $806.3 million, representing a 2% miss. The company's Q2 earnings per share ("EPS") of $4.08 beat estimates of $3.82, but it modestly revised down its fiscal 2024 guidance to $16.50 (at the midpoint) versus prior guidance of $17 for 2024 EPS.

The culprit for the modest slowdown in revenue and earnings-growth guidance came from two business lines: the HDPE conduit (used to protect fiber optic cables) and its solar torque tube (the metal tubes that rotate solar arrays to match the angle of sunlight).

Atkore's management noted that the slower-than-expected release of funds from the Infrastructure Investment and Jobs Act contributed partially to HDPE's sluggish performance. While federal-government stimulus funds often hit administrative roadblocks, the money eventually gets spent. Atkore reiterated its long-term growth outlook for this segment.

Meanwhile, demand for Atkore's solar tube segment remains robust, but there were production delays at its Hobart, Indiana, manufacturing facility. The company expects to fix these production challenges through 2024, and return to its previously guided growth outlook by 2025.

Atkore cut its 2024 revenue outlook for both segments by 10%, or $80 million, which were the drivers of its lowered 2024 earnings outlook. However, the company reiterated its expectations to deliver $18 in EPS for 2025, noting on the call:

> *"Given the challenges to HDPE and solar in FY 2024 are primarily timing-related, we remain confident in our ability to deliver $18 EPS in our fiscal 2025."*

Action to Take: Buy **Atkore (NYSE: ATKR)** up to $200 per share

Mailbag

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

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

Today's first letter is from B.M., who writes:

> *"Greetings, Porter, and thanks for your great contribution to my financial well-being and that of many others.*
>
> *I've been reading your work since the Pirate Investor days of 1999. I believe you once advised your readers you might reconsider a stopped-out position but not until the situation had had six months for the smoke to clear. I'm wondering if you might revisit Qurate Retail (QRTEP) that dropped precipitously to $19 last year without any cause I could discern, and then recovered. Any thoughts these days on this, 'Best Risk-to-Reward Investment Opportunity We Have Ever Seen'?*
>
> *Thanks as always for sharing your thoughts."*
>
> ***Porter's comment: Thanks for your long-time support.***
>
> ***Regarding Qurate Retail (Nasdaq: QRTEP), the decision to sell in October 2023 was based on two key macro factors. The first was our view that inflation would remain higher for longer, causing a further increase in interest rates. While inflation has surprised us to the upside in recent months, interest rates have been contained below the highs seen last October.***
>
> ***The other factor was our expectation of a sharp slowdown in consumer spending, which would weigh on Qurate's profitability and cash flows. This has proven directionally correct, although not quite by the magnitude we expected in a worst-case scenario we outlined in our sell recommendation. Specifically, we noted:***
>
> ***"In the coming 12 to 18 months, we expect consumer spending will take a major turn lower. That means Qurate's business will likely suffer a significant decline in sales, and begin generating negative free cash flows once again.***
>
> ***In this scenario, Qurate's business will begin consuming a portion of Qurate's $3.3 billion in liquidity. This also means the company's leverage ratios will move higher (as earnings fall and debt and interest expense remain elevated), which could threaten its ability to refinance its 2026***

credit revolver. In that environment, Qurate could be forced to suspend dividend payments on its preferred shares in order to prevent any potential solvency issues.

While this is not our base-case scenario, it's a high enough probability that we believe selling is the prudent course of action. We believe there will be many more compelling distressed-debt and income opportunities that arise in the coming months, without taking on the same level of risk that we see in QRTEP today."

While this worst-case scenario hasn't materialized, recent data indicates that things are quickly moving in that direction. As we wrote on May 10, the U.S. consumer has come under increased pressure in recent months as inflation continues eroding real wages, and the excess savings from COVID-era stimulus have evaporated.

The latest figure for U.S. retail sales in April surprised Wall Street with a flat month-on-month reading, significantly missing economists' expectations for a 0.4% increase. Importantly, the retail-spending data is reported on a nominal basis, meaning it's not adjusted for price increases. With inflation increasing by 0.3% month-on-month in April, inflation-adjusted retail sales declined by 0.3% in April.

Meanwhile, cracks are emerging in the labor market. The U.S. unemployment rate rose to 3.9% in April, while recent data on initial jobless claims in early May rose to 239,000 – the highest level since August 2023.

But by far, the most concerning sign on the state of the U.S. consumer lies in credit-card delinquencies. As we've written about previously, consumers have turned to plastic to make up for rampant inflation eroding their real wages, racking up a record $1 trillion in credit-card debt. That debt became a lot more expensive following the Fed's rate-hiking campaign, pushing the average interest rate up to a record 21.6%. Now, consumers are beginning to default on this debt at an alarming rate. The latest data from the New York Fed shows that the percentage of credit cards in serious delinquency (90 days late) has surged to its highest level since 2012.

The bottom line: we continue to believe that the growing weakness in consumer spending presents a key risk going forward. And while Qurate's business appeared to turn the corner late last year, it returned to generating negative cash flows in its latest earnings report in Q1. While we believe it's possible that Qurate's turn around plans may bear fruit, we continue to believe that the risks are too high to make a recommendation in this security.

Porter Stansberry

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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: **@porterstans**