

We the People of the United States, in order to insure domestic Tranquility, provide for the common defence, promote the general Welfare, and secure the Blessings of Liberty to ourselves and our Posterity, do ordain and establish this Constitution for the United States of America.

Porter
& CO.

THE BIG SECRET ON WALL STREET

Intellectual Compounders

- The All-American Way to Exercise Your Right to Wealth



FROM THE DESK OF PORTER STANSBERRY

SPECIAL REPORT

Intellectual Compounders

The All-American Way to Exercise Your Right to Wealth

One careless tap of a tobacco pipe. One tiny spark falling on the hay.

No one knows what set the stables in Newmarket ablaze – and ultimately, burned down the whole English country town – on a windy night in March 1683.

But we know that 66 thatched-roof buildings went up in flames, and that merry King Charles II (who loved the Newmarket horse races, and a Newmarket wench named Nell Gwynn) fled the smoldering hamlet in a right hurry.

He left a week ahead of his official schedule, and arrived back in London before anyone at his court expected him home... and before the Green Ribbon Club had a chance to put an arrow through his eye.

A secretive group of anti-monarchists who wore “bobs” of green ribbon as an identifying badge, the club had spent months planning the King’s murder (while tippling at the King’s Head Tavern in London, no less).

The plot hinged on Charles’ homeward route from Newmarket past a certain lonely castle in Hertfordshire. But the assassins hadn’t bargained on a fire changing the King’s travel plans.

Or on what happened next.

In a fascinating series of “butterfly effects,” the spark that lit the Newmarket fire brought us the Declaration of Independence... and, ultimately, America as we know it...

It was the uneasy aftermath of the 1642-1651 English Civil War – a conflict between the “parliamentarians,” who wanted a republic, and the “royalists,” who wanted to stick with the monarchy. (Long story short: eventually, they met in the middle and formed a parliamentary monarchy.)

But in the meantime, there was bloodshed. King Charles I lost his head, and his son, Charles II, fled to France at the end of the war. Dour puritan Oliver Cromwell (“Lord Protector”) took over the country and ran a rocky proto-republic for 11 years. After Cromwell died, young King Charles returned from exile and resumed the reins of government in 1660 – a period called the “Restoration.”

Charles loved feasts, fun, and frolicking with ladies – and was quick to re-institute horse racing as a national pastime. (Cromwell had outlawed it on the grounds of its not being a “useful” sport.) Charles’ friend Lord Rochester (while sharing mistresses with him) lampooned him in a good-natured poem:

*"Restless he rolls about from whore to whore,
A merry monarch, scandalous and poor."*

A large faction of the British, however, weren't happy with the Merry Monarch. The parliamentarians – who became known as Whigs – were still determined to end the monarchy once and for all and reboot the republic. Exiling the heir to the throne hadn't worked, so in 1681, a radical Whig faction (the Green Ribbons) decided to kill him.

The Green Ribbons planned to lie in wait, with ammunition, at the Rye House, a solitary, moated castle that commanded a perfect view of Charles' return route from Newmarket. A contemporary account noted the site's fortress-like attributes: "Towards the garden it has high walls, so that twenty men might easily defend it against five hundred."

Charles was scheduled to return from Newmarket on April 1. His younger brother James was with him at the races, so the conspirators could shoot two royal birds (code-named Blackbird and Goldfinch) with one crossbow.

But due to the fire killing his fun, Charles rode past the Rye House a week early, before the assassins even arrived. The ambush didn't take place. The British monarchy remained intact (and still does to this day).

And a month or two later, Josiah Keeling, one of the minor players in the Rye House conspiracy, snitched on his fellow Green Ribbons.

That's where John Locke... and, ultimately, the Declaration of Independence... came in.

Natural Rights, And Where We Get Them

The crackdown came swiftly. Keeling, who'd turned King's evidence, escaped with his neck – but many of the other Green Ribbons weren't so fortunate.

Eight conspirators were hanged, drawn, and quartered; four were beheaded or hanged; 11 were imprisoned, one tortured, and one cut his own throat while awaiting trial in the Tower of London.

Not surprisingly, a number of others fled England altogether... Among the refugees: Enlightenment writer, philosopher, and freedom-lover John Locke.

Locke is the father of what we call **classical liberalism** – not to be confused with the American "liberalism" of today. It's the belief that humans have God-given rights – to life, freedom, religious expression, possessions, and self-defense – and that no earthly ruler can give or take these rights away. This fundamental liberty – not any sort of authoritarian, governmental control – is the basis for a functioning society. (If this sounds a lot like libertarianism to you, you're on the right track.)

Locke had been mulling these revolutionary ideas for years – and growing more and more dissatisfied with England’s monarchy. Not surprisingly, he eventually got mixed up with the Rye House crowd.

No one knows exactly how much John Locke had to do with the plot to kill King Charles. But he was a known republican and an associate of the Green Ribbons. He was friendly with head conspirator Robert West – enough to arrange a place for West to stay at his own Oxford lodgings – and chummy with several of the lesser group members (including one of the men who was hanged, drawn, and quartered).

Locke was in plenty deep enough to worry. So he packed up his books and writing equipment and sailed for the Netherlands.

It was there – fed up with King Charles’ excesses, and with England’s interminable class and religious warfare – that he penned his *Two Treatises on Government*, the seminal work that directly inspired the Declaration of Independence and much of the way the Western world thinks today about government, freedom, law, and individual rights.

Locke’s concept of “natural rights” may sound familiar:

The state of nature has a law of nature to govern it, which obliges every one: and reason, which is that law, teaches all mankind, who will but consult it, that being all equal and independent, no one ought to harm another in his life, health, liberty, or possessions...

That’s because Thomas Jefferson – a student of Locke who often quoted directly from the great thinker’s works – drew heavily on those concepts a little less than a century later in 1776, as he created our nation’s founding document, the Declaration of Independence:

“We hold these truths to be self-evident, that all men are created equal, that they are endowed by their Creator with certain unalienable Rights, that among these are Life, Liberty, and the pursuit of Happiness.—That to secure these rights, Governments are instituted among Men, deriving their just powers from the consent of the governed,—That whenever any Form of Government becomes destructive of these ends, it is the Right of the People to alter or to abolish it, and to institute new Government, laying its foundation on such principles and organizing its powers in such form, as to them shall seem most likely to effect their Safety and Happiness.”

John Locke wasn’t able to dismantle the English monarchy. But he laid the groundwork for the American republic... or, maybe, we should credit the careless pipe smoker who burned down Newmarket.

Locke's Forgotten Right

Interestingly, Locke's fundamental "natural rights" differ slightly – but crucially – from the version we see in the Declaration of Independence...

Woven throughout Locke's Treatises, we see three God-given rights listed: rights to **life, liberty, and property**. Locke's Second Treatise on Government makes man's right to property clear:

Though the Earth, and all inferior Creatures be common to all Men, yet every Man has a Property in his own Person. This no Body has any Right to but himself. The Labour of his Body, and the Work of his Hands, we may say, are properly his. Whatsoever then he removes out of the State that Nature hath provided, and left it in, he hath mixed his Labour with, and joyned to it something that is his own, and thereby makes it his Property.

Jefferson, following Locke, originally listed "life, liberty, and property" as the three fundamental natural rights of humankind while writing the Declaration of Independence.

But he eventually tweaked it to "life, liberty and the pursuit of happiness," after a disagreement with Ben Franklin and John Adams – both staunch abolitionists who thought that Americans might assume "property" meant slave ownership.

Obviously, property has nothing to do with slavery, and everything to do with material wealth. Locke describes it as what comes from the work of your hands, and is thereby your own. In some ways, Locke's – and Jefferson's – original phrasing is even more powerful. "Happiness" isn't concrete. "Property" is.

And (final draft or not)... the idea that we, as Americans, have a God-given "**right to wealth**" has been built into the very fabric of our nation from the beginning.

If you've read much history, you know that America was created by a select group of businessmen, who (thanks to their own hard work) were among the wealthiest people in the world. The country was never really ruled by a king. There was no "tribe" of Americans who settled here and fought to keep everyone else out of their territory. Instead, America was a nation created by an idea, an idea that drew people here from all over the world, from virtually all nations and all tribes.

The idea of America is that man was created by God and thus is equal to all other men and entitled to his liberty and therefore (as Locke and Jefferson believed) his wealth.

That idea was carried forward by the industrial revolution that swept through both England and America from the 1750s onward, fueled by coal, which began to replace timber as the dominant power source. Coal power, which contains 10 times more energy than timber of equal weight, led to countless innovations in machinery, engines, locomotives, and ships... and created fortunes unlike anything seen previously in human history.

The “elites” who established America were an accident of history. They were brilliant, well-educated men, who, freed from the yoke of manual labor and (mostly) protected from the depravities of the King of England by a giant ocean, built vast new global businesses. They dominated global trade in everything from apples to whale oil. They became a new kind of elite – an economic elite. And they built their country to enshrine what they perceived as every man’s right to wealth.

Of course, that America’s foundations were built on free enterprise and trade doesn’t mean that every American will automatically become wealthy. It simply means, more so than in any other country in the world, you have the **right to property – the right to wealth**.

Time Is Wealth – But Do You Have Enough?

Every one, as he is bound to preserve himself, and not to quit his station wilfully, so by the like reason, when his own preservation comes not in competition, ought he, as much as he can, to preserve the rest of mankind, and may not, unless it be to do justice on an offender, take away, or impair the life, or what tends to the preservation of the life, the liberty, health, limb, or goods of another.

– John Locke, *Second Treatise of Government*

You have one, God-given lifetime to build wealth, and, as Locke emphasizes in the quote above, no one has the right to cut that time short or take it away from you unjustly.

In a very real sense, time is money. Without the fundamental natural right to use your own time as you see fit, you won’t be able to build wealth (or, as Jefferson added, pursue happiness).

You, however, only have 24 hours in a day. Even if you can exchange every working hour of your day for a handsome sum, say \$500 an hour – that’s a limited and finite amount of time to create wealth.

But what if you had unlimited time? Imagine if you could work a thousand hours in a single day, all billable at \$500 an hour.

That sounds silly, but historically it’s exactly what the great business owners, like the Rockefellers, Carnegies, and others, have done – **they bought other people’s time**. They hired the railroad workers, the factory workers, the builders, the drivers, the engineers. In effect, they extended the hours available in their own day by the hundreds and thousands. And that’s how they created vast amounts of generational wealth for themselves and their descendants.

You may not *think* you have the resources to buy thousands of hours worth of time to create more wealth. But thanks to a series of unusual investment vehicles that fly under the radar, you actually do.

In this compendium, we'll show you a lesser-known way that America's billionaires add years of money-making time to their lives – and it's much simpler and cheaper than hiring teams of steelworkers and mining engineers.

What's in A Name?

Let us introduce you to the wonderful world of **intellectual compounders**.

These are some of our favorite – and relatively little-known – capital efficient companies at Porter & Co. In much the same way as insurance companies enjoy a vast pool of “free” capital from premium payments, intellectual compounders trade on their intellectual property to rake in a swath of low-effort royalties. They're **licensing and franchising** businesses that give other companies the right to sell their product or their name, in exchange for an upfront payment and royalties on sales.

Essentially, these companies are letting other people put their intellectual property to work for them. The other folks put in the long hours and do the legwork of marketing and production, and the licensing company sits back and reaps the benefits.

Best of all – the overall cost of buying all these people's time is incredibly low.

With other businesses, the overhead never goes away. The owner must often continue to pay for expensive buildings and equipment, as well as the daily cost of his employees' time. But with intellectual compounders, over the long term, the business owner only has to provide one thing: *a name people want to use*.

Of course, a lot goes into achieving a “good name” in the first place. Any intellectual property that has worldwide recognition is a household name for a reason (usually one that involves tons of thought, creativity, and a sizable marketing budget).

But once a company *has* that good name, it can leverage it to buy incredible amounts of man-hours... and reap huge dividends... with barely any ongoing cost.

Think about McDonald's (a capital efficient business we like a lot!), where the franchisees eagerly pay to use McDonald's name to make money. The franchise owner provides the man-hours and pays for the equipment, and McDonald's corporate reaps the benefit in the form of substantial licensing fees.

Or take Michael Jordan, who's made far more money simply licensing his name and image to Nike than he ever did as a professional basketball player. In the process, he's also catapulted Nike to stardom, with shares that have compounded investor capital at an incredible 17.5% per year since its 1980 IPO. (We like Nike, too.)

That's why businesses that monetize intellectual property are the most capital efficient enterprises on the market. They require very little cash to operate and grow, and therefore produce excess cash that they can return to shareholders.

Of course, as an investor in these intellectual compounders, you reap the benefits of all this time and money in the easiest way possible – by buying shares and collecting a hefty dividend.

As an investor, the whole trick lies in understanding which companies are capital efficient and have excellent long-term prospects. Once you know that, you wait until these companies' shares become so cheap that they essentially carry very little risk.

In this compendium, I'm about to show you the details of six reports (plus one bonus) of my favorite intellectual compounders... capital efficient companies that will compound your money-making time and your wealth, and put other companies' names and brand power to work for you.

This is one of the simplest and most efficient ways to exercise your Right to Wealth – and I'm proud to share it with you.

To your success,

Porter

A handwritten signature in black ink that reads "Porter Stansberry". The signature is written in a cursive, flowing style.

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Intellectual Compounder #1

The High Roller

Making Internet Casinos Fun... and Profitable
Innovative Tech Provides Huge Advantage

Generating better than 50% net income margins on \$2 billion in annual revenue, this intellectual compounder has a simple, highly profitable business model. It licenses its games to casinos in exchange for a cut of each game's profits – typically around 10% – plus licensing fees. But the key to its capital efficiency is that it doesn't operate any casinos or take any bets from players.

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The High Roller

Making Internet Casinos Fun... and Profitable

Innovative Tech Provides Huge Advantage

"Shoot the tires!"

It was 1906, and San Francisco's horse-and-carriage-driving population hated the new-fangled automobile, derided in local papers as "a menace to man and beast."

Cars weren't *banned*, exactly, but they were frowned upon as a vice. At the time, fewer than 500 personal autos were registered in northern California, and the drivers who dared to take one on the road were constantly harassed and pulled over for minor speeding infractions. (Terrifyingly, the Golden Gate Park superintendent recommended that sharpshooters be positioned along park roads to pop the tires of speeders.)

In those days, Buick dealer Charles Howard couldn't sell a car to save his life.

The young would-be salesman – stuck with three expensive models gathering dust in his San Francisco showroom – started to wonder if he'd come to the wrong city to seek his fortune.

Then, just after 5 a.m. on April 18, 1906, opportunity arrived... in the form of the deadliest earthquake in U.S. history.

As the first shockwave hit, an eyewitness wrote, *"Power and trolley lines snapped like threads. The ends of the power lines dropped to the pavement not 10 feet from where I stood, writhing and hissing like reptiles. Brick and glass showered about me. Buildings along First Street from Howard to Market crumbled like card houses. One was brick. Not a soul escaped. Clouds... obliterated the scene of destruction. The dust hung low over the rubble in the street."*

Three decades before the advent of the modern Richter scale, the exact magnitude of the 1906 San Francisco earthquake couldn't be calculated. But

the human cost was clear: as many as 3,000 people died and 80% of the city was leveled in the quake and subsequent fire, leaving three-quarters of the 400,000-person population homeless.

And the despised automobile suddenly looked a whole lot better.

As thousands of panicked citizens struggled to escape the burning city, horses passed out from smoke, carriages splintered... and “frivolous” autos became the most reliable vehicles on the road.

As another eyewitness wrote, “Before the fire most of us had thought of the car as a wealthy man’s plaything and one of doubtful reliability. The fire-fighting had demanded the use of all available vehicles – horse-drawn and mechanical – and most of the automobiles in San Francisco, including new ones still in dealers’ showrooms, had been pressed into service... Cars quickly proved their superiority to horses. They were much faster and could be operated twenty-four hours a day. I often heard it said that the San Francisco fire of 1906 established the reliability of the automobile.”

In the wake of the earthquake, Charles Howard repurposed his mini-fleet of Buicks into ambulances and moving vans... for a sizable rental fee. In the days after the disaster, it cost \$5 a day to rent a horse-drawn carriage... but an automobile fetched \$100.

With 250,000 souls fleeing the city, the money was good... but the publicity for Howard’s dealership was better.

A few years later, San Francisco had been rebuilt from ashes, and the auto had become a respected mode of transportation. And Charles Howard had risen from a failed salesman to the country’s most well-known Buick dealer... with one out of every 10 Buicks sold in the U.S. rolling out of his fancy four-story showroom.

Then he spotted an even bigger opportunity, wrapped up in another disaster: gambling.

After the 1929 stock market crash, the Great Depression plunged the country into gloom for a solid decade. In an effort to drum up a little extra cash, in the early ’30s, state governments legalized betting on horse racing, and the gambling industry (much like escapist Hollywood) blossomed. Across the country, careworn Americans flocked to the track to put down a few dollars on steeds like Bold Venture or War Admiral... and watch the thoroughbreds’ owners take home glittering thousand-dollar sweepstakes prizes.

By 1935, the *Saturday Evening Post* reported, “the number of states having racing and betting has risen from seven to 27... (and) the money handled in legalized wagering has risen to about \$500,000,000 annually” (that is, about \$11 billion in today’s money).

Once again, “vice” saved the day. And Charles Howard smelled more money (and fame) in the air. So he bought a racehorse of his own: Seabiscuit.

Even people who've never been to the racetrack have heard of Seabiscuit: the bowlegged underdog who unexpectedly beat champion racer War Admiral in the 1938 "Match of the Century," held at Baltimore's Pimlico Race Course. A third of the U.S. tuned in to the radio to listen as the upstart edged out the Admiral by four lengths. That year, Seabiscuit got more press column inches than either Adolf Hitler or President Franklin D. Roosevelt. (The Academy Award-nominated [movie](#) about his life hit theaters in 2003.)

Along the way, Seabiscuit became one of the all-time leading money winners in the history of horse racing, which meant another fortune (\$9.5 million in 2023 dollars) for Charles Howard.

Despite his success at Pimlico (and earlier, in San Francisco), Howard wasn't just lucky. He was smart.

He repeatedly cashed in on a fundamental truth about human nature: people are willing to pay to escape.

Whether that's literally renting vehicles to get out of a burning city... or blowing a paycheck at the track to forget their sorrows... humans are all trying to run away from something. And running away costs money.

Today, millions of Americans are being crushed by the [unbearable weight of inflation](#). As prices spiral out of control, the average U.S. salary can no longer support the basic middle-class dream of home ownership and a secure retirement (and the recession hasn't even started yet...). It's no surprise that Charles Howard-esque gambling venues are popping up in many forms to offer a momentary distraction (for a price, of course). We'll be examining one of those businesses in this issue.

Americans Are Running Away From Inflation

As I (Porter Stansberry) have [written previously](#), inflation does far more damage than simply eroding living standards. Debasing the currency eats away at the very foundation of a productive society.

For economies to grow, people need the ability to produce more than they consume. This generates savings. Savings enable investment, which is the foundation of all economic vitality. But with today's cost-of-living crisis, savings and investment have become impossible for most Americans.

According to a survey from the consumer-financial-services firm Bankrate, more than one-third of U.S. adults have more credit card debt than cash – the highest level on record. And 57% of adults don't have enough cash to cover an unexpected \$1,000 expense.

Unable to cover their basic costs of living, younger generations are increasingly putting off saving and investing for the future. Two-thirds of Gen Zers believe they may never make enough money to retire. And a recent survey from online real-

estate marketplace Zillow indicates that 52% of Gen Zers and 57% of millennials believe they need to win the lottery in order to become homeowners.

As more Americans face greater uncertainty over their financial future, they're increasingly turning to get-rich quick schemes in place of long-term investing. The average holding period for U.S. stocks has fallen from five years in the 1970s to less than 10 months today. Meme-stock speculation has replaced buy-and-hold investing. And America has turned into a nation of gamblers.

Betting on an American Pastime

Forty years ago, Americans looking to gamble in a casino had only two real options: Las Vegas or Atlantic City. Since then, nearly every U.S. state has legalized gambling. Today, there are roughly 1,000 casinos across the country, and business is booming. In 2022, Americans forked over a record \$60.4 billion to the country's legal gambling establishments. That was up 14% from 2021's \$53 billion, the previous all-time high. Industry experts estimate that 70% of the U.S. population participated in some form of gambling in 2023.



Today, sports-betting apps and online casinos offer the chance to place wagers online – even via a smartphone. Gamblers no longer need to trek to the nearest bricks-and-mortar casino. They can get all the action they want from the comfort of their couch, 24 hours a day.

From the casino's perspective, online gambling offers the chance to dramatically expand their potential customer base. In a brick-and-mortar casino, the number of players is limited by physical floor space. In the online-gambling world, a digital slot machine can be streamed over the internet to an unlimited number of gamblers.

Given the added convenience for players, and the larger market of customers for casinos to tap into, online gambling is booming. The global market for online gambling reached \$65 billion in 2022, and industry experts project it will grow at an average of 12% per year from 2023 to 2030 – roughly four times faster than the expected growth rate of the global economy.

As an investor, the secret to profiting from a booming new industry lies in finding the right business model. This often means avoiding the companies participating directly in the boom itself. Instead, the easier money is made by providing supplies and services to those companies chasing the frenzy. As legendary Fidelity Investments fund manager Peter Lynch once explained:

“During the Gold Rush, most would-be miners lost money... but people who sold them picks, shovels, tents, and blue jeans made a nice profit.”

The same dynamic is at play in today's online-gambling boom. The popular sports-betting apps and online-casino operators are capital-intensive businesses, with low or negative profit margins. So today, we're taking a page from Lynch's playbook to introduce a “picks and shovels” equivalent in the gambling industry.

This company is one of the most capital efficient businesses in any industry, with 40% returns on equity and profit margins approaching 60%. Since going public in 2015, this business has grown its revenues by an average of 50% per year.

Despite the company's incredible economics and growth trajectory, the stock trades near the lowest valuation level since going public eight years ago.

The Picks and Shovels Play in Online Gambling

Based in Stockholm, Sweden, **Evolution AB (OTC: EVVTY)** is one of the world's largest developers of online casino games and software. Generating better than 50% net income margins on \$2 billion in annual revenue, the company has a simple, highly profitable business model: It licenses its games to casinos in exchange for a cut of each game's profits – typically around 10% – plus licensing fees. But the key to its capital efficiency is that it doesn't operate any casinos or take any bets from players.

Evolution was founded in 2006 by Jens Von Bahr and Fredrik Österberg, with an initial focus on the fast-growing online-gambling market in Europe. One year earlier, the UK legalized online gambling, kicking off a broader movement across Europe, and then globally.

The early forms of online gambling were limited to computer-generated games. Evolution founders Bahr and Österberg saw several flaws in this early iteration. First, the experience of playing against a computer was dull compared with playing against a live, human game host.

Plus, playing against computers created trust issues with gamblers. The players couldn't see a physical deck of cards in computer-generated blackjack games, or a roulette ball spinning on an actual table. Thus, many assumed the computers

were programmed to stack the odds heavily in the house's favor (more so than the typical house advantage built into live casino games).

Evolution's founding vision was to revolutionize online gambling by creating the world's first live-streamed table games run by a human host. The company built a live online gaming studio in Riga, Latvia. The initial set up consisted of a young woman operating a roulette table, with a mounted camera streaming the action through an internet feed to online gamblers.

While Evolution's early gaming technology was rudimentary by today's standards, the live-streaming aspect was a giant leap forward in the online-gaming experience – and a key to the company's success to this day. Evolution earned the



respect of online gamblers by promising (and delivering on) an authentic, honest gaming experience that it described "as real as it gets."

Evolution published the players' statistical odds of each game to show the house edge. And in its original studio, the company even ran a BBC newscast in the background to prove that the game was played in real time.

Evolution's live games rapidly took market share from the existing, computer-generated games on the market. And it enjoyed a first-mover advantage in a number of European countries that legalized online gaming. It was the first live online-gaming provider in Italy in 2011, Denmark in 2012, and Spain in 2013.

In the face of rising competition, Evolution continued taking market share by staying at the leading edge of gaming innovation. It introduced one of the industry's first mobile gaming apps in 2012, and was the first live-gaming company to produce high-definition live streams in 2016. Evolution developed social-gaming features such as live chats, allowing gamblers to communicate with each other during game play.

It also built custom studios to deliver a first-of-its-kind entertaining gaming experience. As one example, Evolution created a 1920s underground speakeasy environment for its live craps table, where dealers used 1920s terminology while running the game.

By far, Evolution's biggest step forward in gaming innovation came in 2015, with the hiring of Chief Product Office (CPO) Todd Haushalter.

The World's First Live Gambling Game Shows

Todd Haushalter has been a self-described gambling fanatic all his life – starting at age 10 when he organized neighborhood dice games. After earning his MBA in hotel administration from the University of Nevada, Las Vegas, he worked his way up from a high-stakes table dealer to the vice president of gaming operations at MGM Resorts International. He brought this wealth of experience in the live land-based gaming environment to Evolution in 2015.

When Haushalter joined Evolution, the company produced only online versions of the regular table games found in land-based casinos (blackjack, baccarat, roulette, and poker). Haushalter set out to revolutionize the industry by pioneering new live-gaming concepts built around TV-style game show formats.

In 2017, Evolution launched the world's first live online-casino game show, *Dream Catcher*. In this game, the host spins an upright wheel with a flapper on top, and players guess which number the wheel will stop on. The wheel contains a series of numbers ranging from 1 to 40. Players who correctly name which number the wheel lands on win the payoff associated with the number (i.e., if the wheel stops on 10, the bet pays out 10 to 1).



The first thing to note is how far the production value had come from Evolution's early days of a woman spinning a roulette wheel in a cubicle. *Dream Catcher's* high production value was amplified by an engaging live host, offering a gaming experience that players couldn't find anywhere else. Topping it all off was the

chance to win supersized payouts, with no limits on bonus rounds, resulting in payoff potentials of thousands of times on their original wager.

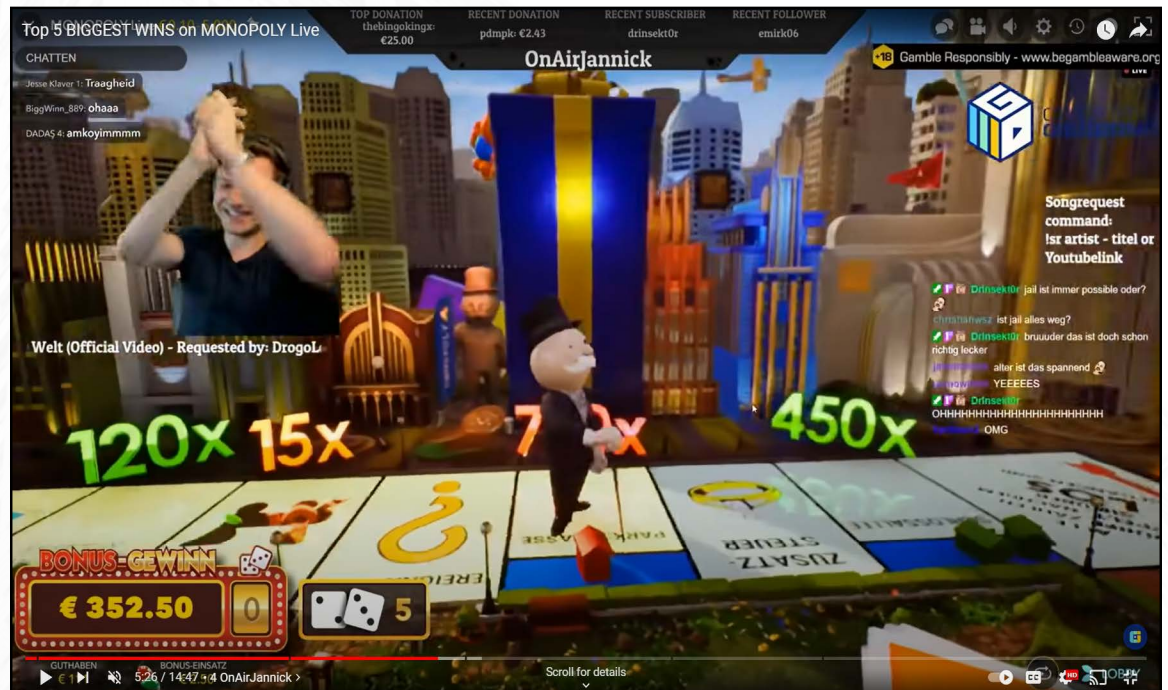
The end result: a uniquely entertaining gaming experience that replicated the excitement of a TV game show, while offering gamblers the chance to bet small and win big.

Dream Catcher quickly became one of the industry's most popular games. Evolution followed *Dream Catcher* up with the 2018 launch of *Lightning Roulette*, a turbocharged version of traditional roulette that offers up to 500x payouts (versus 35x in traditional roulette). Evolution's *Lightning Roulette* became the largest live roulette table in the world. It also won multiple industry awards, including the 2018 Product Innovation of the Year at the Global Gaming Expo in Las Vegas, one of the industry's largest conferences.

Riding the momentum, Evolution doubled down on gaming innovation with 10 new product launches in 2019. Two notable hits included a replica of the hit TV game show *Deal or No Deal*, and a live game show built around one of the world's most popular board games, *Monopoly Live*.

In *Monopoly Live*, a host spins an upright wheel like the one found in *Dream Catcher*. When certain segments of the wheel are selected, it activates a Mr. Monopoly digital character who springs into action to step around the board collecting prizes and bet multipliers. The game became wildly popular for its first-of-its-kind immersive graphics and multi-layered game play. And the largest payouts reach in excess of 6,400x the original wager.

These highly entertaining live game-show formats, with the chance to win massive payouts, make Evolution's games fun just to watch. This has led to gamblers uploading videos of their exploits on Evolution's game shows onto various social media platforms, like YouTube and Instagram. Searching for any of Evolution's top games will bring up videos with hundreds of thousands of views, including a YouTube video titled "Top 5 BIGGEST WINS on MONOPOLY Live" that's been viewed half a million times.



Even celebrities have gotten in on the action. To offer one example, in January 2022, a viral video surfaced of hip-hop star Drake playing one of Evolution's live roulette games, where he scored a \$354,000 payout.

This organic enthusiasm from players around the world spreading Evolution's brand awareness on social media provides an incredibly powerful – and free – sales force. As Warren Buffett once explained...

"Any business with delighted customers has a sales force they won't have to pay. You don't see them, but they are talking to people all the time."

And for Evolution, this popular success has resulted in financial success.

And the Money Rolls In

By delighting players with its best-in-class gaming experiences, Evolution's business has provided meteoric growth for itself. Since going public in 2015, Evolution's revenue has grown at a compounded annual rate of 50%. Even more impressive is the consistency of this growth – generating steadily higher revenue in every single quarter for the last 10 years:

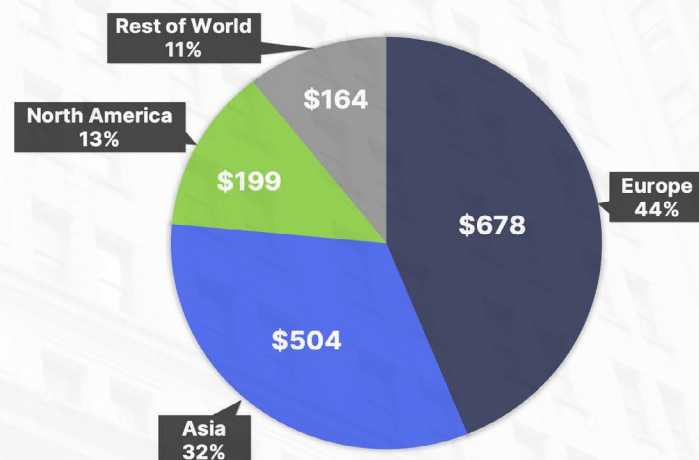
Evolution Revenue – Steady as She Grows



Source: Bloomberg / * Indicates data is an estimate.

Today, Evolution is one of the largest and fastest-growing providers of live online casino games. The company operates more than 1,300 live casino tables across six continents, serving over 600 casino operators globally. The company's largest market is in Europe, followed by Asia and North America:

Evolution's Revenue by Geography (FY2022, in Millions)



Unlike many companies producing profitless growth from the online-gambling boom, Evolution generates a robust and fast-growing profit stream. From 2017 through 2022,, the company's net income has surged nearly 15-fold, from \$83 million in 2018 to \$1.1 billion in 2023.

A key advantage of Evolution's business model is that it avoids one of the biggest costs associated with online gambling: customer acquisition. That's because it doesn't distribute its games directly to the end customer. As a business-to-business ("B2B") supplier of games for online-casino operators, Evolution benefits from its casino partners spending billions of dollars on marketing and acquiring customers.

To see how this works, let's compare Evolution's B2B model with a business-to-consumer casino operator, like DraftKings (Nasdaq: DKNG), one of Evolution's biggest customers.

A Royalty on the Rise of Online Gambling

DraftKings is one of the leading providers of live-sports betting and fantasy-sports betting in the U.S. The company also operates an online casino that hosts many of Evolution's hit games including *Dream Catcher*, *Lightning Roulette*, and *Deal or No Deal* (all custom designed around the DraftKings brand).

DraftKings has posted incredible growth since its founding in a spare bedroom in 2012 to a \$3.3 billion business today. The company has over 2 million monthly active users and has become one of the most popular stocks of the online-gambling boom. Its growth has even exceeded Evolution's since 2015, generating an incredible 90% compounded yearly revenue growth.

But despite generating nearly twice as much revenue as Evolution, DraftKings lost nearly \$1 billion in 2022. That's because its growth has required massive spending on marketing and advertising, categorized under the "sales, general and administrative" (SG&A) expense on DraftKings financials. DraftKings spends 50% of every revenue dollar on SG&A expenses.

Evolution, on the other hand, spends almost nothing on advertising – because it doesn't have to. It only needs to create the most compelling games that generate the most player interest. By doing so, it allows casino operators like DraftKings to generate considerable revenue. That's how Evolution benefits from tapping into DraftKings user base, without spending a dime on directly acquiring those customers.

In this way, Evolution's business model is similar to a royalty on the cash stream of online gambling. This royalty model is vastly more profitable and capital efficient than engaging in the never-ending fight to acquire customers in the world of online casinos.

After Evolution invests in the upfront cost of developing a hit game, it then streams the game to hundreds of its casino partners and taps into their hard-won customer base. Evolution earns money from the casinos by taking a percentage of each game's winnings, known as commission fees. These commission fees range between 4% and 17% of winnings, depending on the game type, number of tables, and active hours the game runs. Evolution also charges casino companies a one-

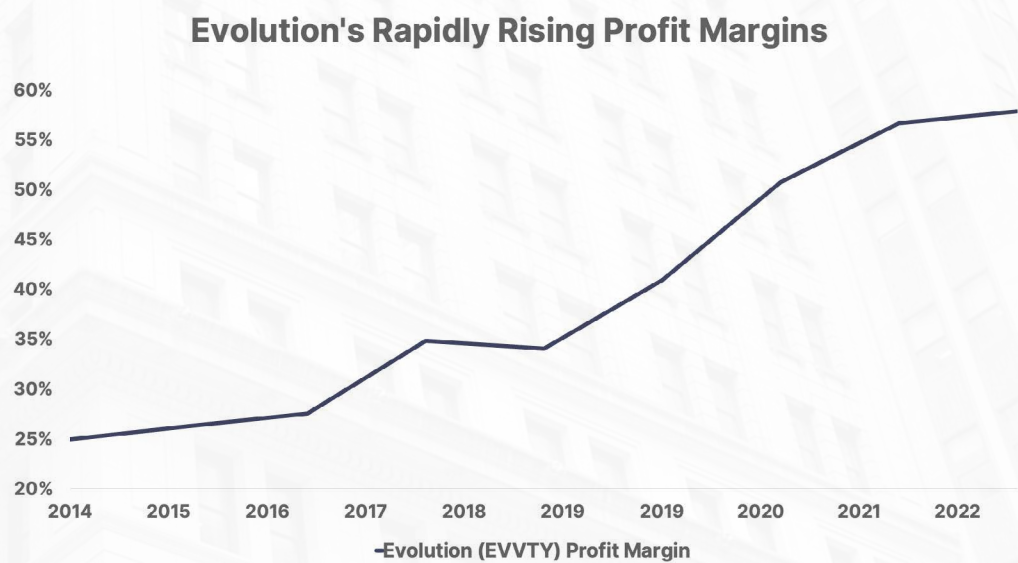
time setup fee of €50,000 (about \$55,000), plus a monthly service fee of €20,000 (about \$22,000) per game.

When Evolution produces a hit game, the company doubles down on sequel concepts, introducing slight modifications at minimal development expense. Some examples of variants on successful concepts include extending the *Lightning Roulette* concept to similar games like *Lightning Baccarat* and *Lightning Dice*. The company also develops minor modifications that adjust the speed and volatility of game play, like *XXXtreme Lightning Roulette*, which bumps up the maximum payouts from 500x to 2,000x.

Regular readers will recall that this is a similar strategy developed by one of the world's leading video-game makers, Activision Blizzard (which Microsoft recently acquired). [In our recommendation](#), we showed how Activision unleashed its capital efficiency when it began emphasizing long-running sequels of hit games such as *Call of Duty*, instead of constantly reinventing new gaming concepts.

Evolution shares another feature of the video-game business model: massive scalability. After developing a hit game, the incremental costs of distributing these games to new customers is minuscule – leading to tremendous profit margins on each new customer. In the case of Evolution, many of its games are designed to be streamed to an unlimited number of gamblers. So after making the upfront investment to develop its games, Evolution earns extremely high profit margins as its casino partners grow their customer bases – and, thus, Evolution's.

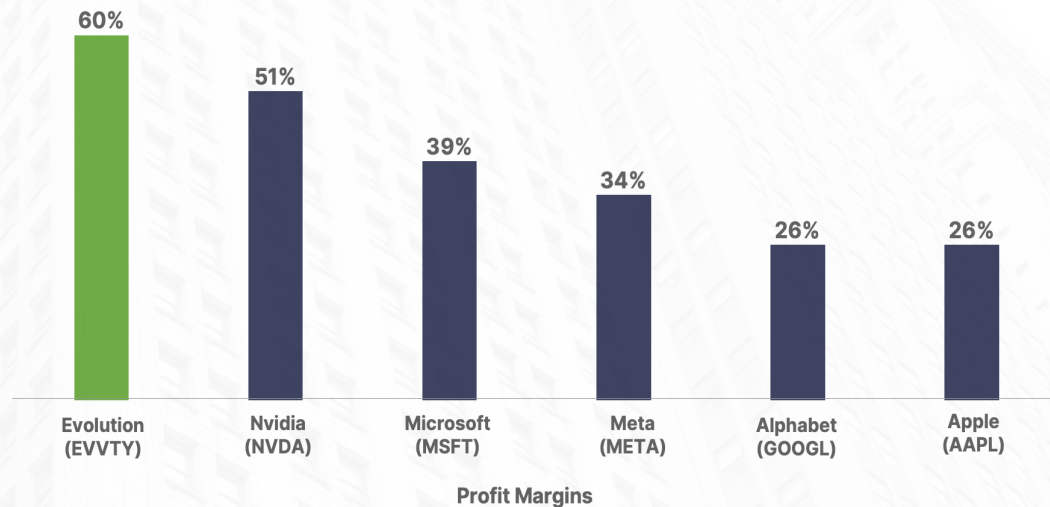
This gives the company tremendous operating leverage, whereby revenue grows much faster than expenses, leading to rising profit margins over time. Evolution's profit margins have more than tripled from 18% in 2014 to 57% today:



Source: Bloomberg

Evolution's profit margins not only blow away its gaming peers, but they exceed many of the world's dominant technology giants like Google, Microsoft, Apple, Meta, and Nvidia.

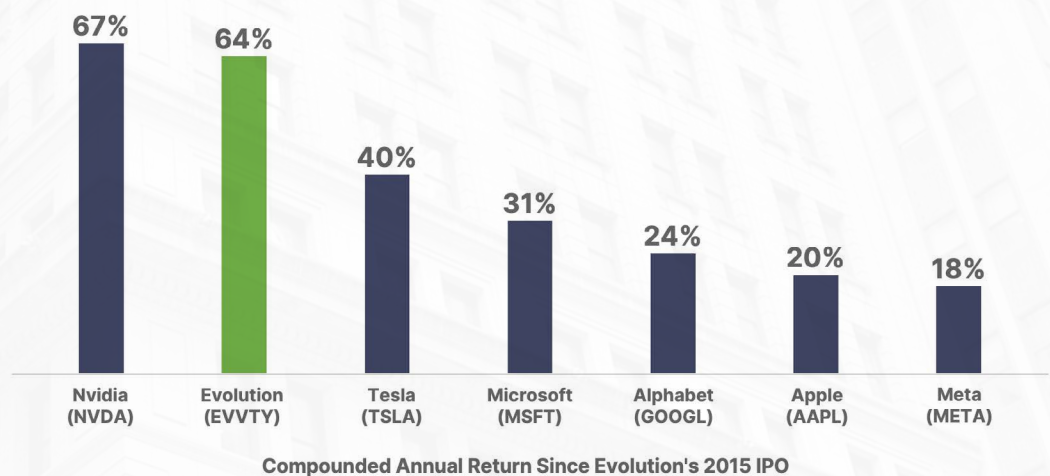
Evolution's World-Class Profit Margins



Source: Bloomberg

While the "Magnificent 7" mega-cap tech stocks have made headlines for their strong performance in recent years, Evolution shares have outperformed most of these market leaders since going public in 2015:

Evolution Outperforms Many Mega-Cap Tech Leaders



Source: Bloomberg

Of course, these world-beating financial results inevitably attract imitators. Since Evolution pioneered the live online-gaming model in 2006, more than 40 competitors have emerged. But Evolution has only furthered its lead against them.

And there's one key reason why Evolution continues to remain the leader despite a growing array of competition: culture. And as the legendary corporate management guru Peter Drucker once said, "Culture eats strategy for breakfast."

Culture as a Competitive Advantage

Evolution's world-class business model is a direct reflection of its world-class management team. CEO Martin Carlesund and the company's board have proven to be highly effective at fostering a culture of innovation. And this culture has allowed the company to lead the industry in both game development and financial performance.

In a 2021 interview with *Gaming Intelligence*, Carlesund explained how the company fosters a "creative, innovative hub of game creation." He said that it starts by attracting the best and brightest talent, which has become easier over time as Evolution has emerged as the best-in-class operator. Carlesund has found employees who share in the company's vision to not just create the best *gaming* company – but the best company of *any kind* anywhere in the world.

This includes key hires like CPO Haushalter, the Las Vegas casino exec who revolutionized the industry with the introduction of the live game-show format found in many of Evolution's most popular games. But hiring great talent is only part of the equation. As management author Tom Peters describes in his 1982 best-seller *In Search of Excellence*, creating a culture of innovation means giving employees the freedom to fail:

"You cannot innovate unless you are willing to accept mistakes. Tolerance for failure is a very specific part of the excellent company culture – and the lesson comes directly from the top."

In a 2020 interview with *iGaming NEXT*, Haushalter explained how Evolution's CEO and board gives him the permission to "miss" when developing new games:

"I have the best CEO in the world... my boss is serious about innovation... and so is our board. They're like 'we have to be innovative; we have to push new products.' And if we miss a deadline or the game doesn't hit, we try to learn from it, but we don't get in trouble for missing on things."

In many companies, spending heavily and failing on new product development often leads management teams to pull back on investment because, they say, "it's not working." This might improve quarterly earnings results, but it stifles long-term competitive advantage.

Throughout its lifetime, Evolution has taken its failures in stride and continued pushing the boundaries on gaming innovation. It went from introducing a handful of new games each year in 2019 to releasing over 100 new titles in 2023.

Not every game is a hit, but it only takes a few big winners to generate outsized payoffs. Consider the case of *Crazy Time*, Evolution’s multi-layered game show that contains a core game, plus four additional games within the game that are unlocked through bonus rounds. This creates an elaborate gaming experience – and the multiple bonus rounds allow for the opportunity to earn a payout of 100,000 times an initial wager.

In February 2020, Haushalter unveiled *Crazy Time* at a gaming exhibition in London, describing it as the most expensive game ever developed in the industry:

“It’s a carnival of activity, with a wheel loaded with bonuses. There are shows within a show. Crazy Time is the most fun casino game ever made and the most expensive!”

The investment paid off. *Crazy Time* became the most popular game show in the online-casino world. As it’s done with its other hit games, Evolution enjoyed a free viral marketing campaign from players uploading videos of their supersized payouts that circulate widely on YouTube and other social media platforms.

Several competitors have since rolled out *Crazy Time* knockoffs, but none has come close to replicating the success of the original. Nearly four years after its unveiling, *Crazy Time* remains at the top of the industry, by a wide margin. The website livecasino.watch posts player statistics of the most popular game shows among online casinos. The data below shows the average daily players of the top 10 most popular game shows in the 30 days through November 25. *Crazy Time* ranks at the top of the leaderboard, beating number 2 by 250%.

**Top Game Shows at Online Casinos
(30-Day Average Through November 25)**

Rank	Game (Producer)	Average Daily Players
1	Crazy Time (Evolution)	11,108
2	Mega Wheel (Pragmatic)	4,452
3	Monopoly Big Baller (Evolution)	3,414
4	Funky Time (Evolution)	3,033
5	Sweet Bonanza CandyLand (Pragmatic)	2,790
6	Monopoly Live (Evolution)	2,571
7	Crazy Time A (Evolution)	2,570
8	Lightning Roulette (Evolution)	2,534
9	XXXtreme Lightning Roulette (Evolution)	1,962
10	Adventures Beyond Wonderland Live (Playtech)	1,885

Evolution games make up seven of the top 10 most popular online game shows, with a combined total of 27,192 daily average players in November 2023.. Evolution is nearly four times ahead of its next closest competitor, Pragmatic, with just two games in the top 10 and a combined total of 7,242 average daily players in the last month. Playtech is a distant third, with just one game in the top 10 averaging less than 2,000 daily players over the same time period.

Next, we'll dive deeper into the competitive landscape to show how Evolution's industry lead continues growing stronger over time.

Assessing the Competition

Founded in 1999, London-based Playtech is one of the oldest online-gaming providers in the industry. Based on revenue, Playtech is Evolution's largest competitor. The company generates roughly the same amount of revenue as Evolution – producing an estimated \$1.9 billion in revenue for 2023. But Playtech is only expected to earn \$190 million of income on that revenue, or a 10% profit margin. Meanwhile, Evolution generated 60% profit margins on \$2 billion in revenue, translating into \$1.1 billion on the bottom line.

The reason for this huge earnings disparity comes down to the type of games each company produces. Playtech's original focus was on computer-generated online games, which have become increasingly commoditized over time. Evolution, on the other hand, has focused almost exclusively on live games. The massive popularity of Evolution's live games means more wagers placed per game, and thus much higher profit margins.

After Evolution's success in pioneering live games, Playtech has tried to catch up by introducing its own live games. But as the table above shows, Playtech has yet to produce the same level of engagement as Evolution – with just one live game show in the top 10, versus Evolution's seven. Because Evolution's live games attract many more players, it enjoys substantially higher profit margins on the games it produces.

The failure of Playtech to generate anywhere near the same level of Evolution's player engagement and profit margins is a testament to the power of Evolution's innovation prowess – the let-them-fail culture outlined earlier that has led to so many successes over the years.

Behind Playtech, privately held Pragmatic is number three in the live-gaming space. Pragmatic started in 2015, and has produced a few hit live games, including *Mega Wheel* and *Sweet Bonanza Candy Land*. Yet it remains a distant third in terms of revenue. As a private company, Pragmatic's financial statements are not publicly available. However, industry estimates indicate the company generates around \$100 million in annual revenue. Under the generous assumption that Pragmatic earns similar profit margins as Evolution did when it was at a similar size, then we can roughly estimate that Pragmatic earns somewhere in the range of \$35 million annually.

That means Evolution earns roughly three times the annual profits of its next two closest rivals combined. And that puts Evolution in a position of strength to continue widening its competitive advantage over the competition going forward.

Evolution's Dominant Scale Advantage

Because Evolution is the most profitable online gaming provider in the world, it has more money to invest in new games each year. This will only feed Evolution's best-in-class culture of innovation: with more money to invest, the company can take more shots on goal each year versus its competitors, increasing the likelihood that it will develop the next *Monopoly Live*, *Lightning Roulette*, or *Crazy Time*.

Meanwhile, Evolution's unmatched profitability and player engagement has unlocked another key competitive advantage: Evolution can afford to offer gamblers the best odds in the industry.

The odds players get from casino games are measured by the return to player ("RTP") metric. RTP is the average percentage of an initial wager that gets returned to players. Since casino games always have a house edge, the RTP is always less than 100%. This reflects the fact that gamblers, on average, get back less money than they put at risk. So a 95% RTP means players will typically lose five cents of every dollar they wager in each game.

Evolution's leading profit margins allow it to offer players the highest RTP in the industry. Top Live Casino is a website that tracks RTP across the online-casino industry. The table below shows games with the highest RTP numbers, with Evolution games making up four of the top six, including several games above 99%.

Evolution's Return to Player

1st place: Infinite Blackjack by Evolution: **99.51%**

2nd place: First Person Blackjack by Evolution: **99.21%**

3rd place: 2 Hand Casino Hold'em from Evolution: **99.18%**

4th place: Prestige Mini, Mini and Grand Baccarat Live by Playtech: **98.94%**

5th place: Golden Baccarat Live by Playtech: **98.77%**

6th place: Free Bet Blackjet by Evolution: **98.45%**

Source: *Toplivecasinos*

Many gaming providers focus on the highest short-term profits by offering a low RTP. But players recognize and reward companies that offer a generous RTP with higher game play, which makes for better long-term success. In that 2020 interview with *iGaming NEXT*, Haushalter explained how offering the industry's highest RTP is part of the company's culture of putting the customer first:

"Our company has the highest RTP of any gaming company in the world. Slot companies, land based, probably have a blended average of a 10%-house-edge 90% RTP. Online slot companies are probably 95%. And we're quite a bit above 95%, and players notice that. And it's always a debate in the industry. Maybe we should make the game more casino friendly. But players figure that out; they always do... So we always design with the thought of 'if your mother would play this game, how would you make it? Would you jack the speed up and RTP down?' No you wouldn't. You would make it so it would delight her."

By investing heavily in developing the most compelling gaming experiences, and by offering best-in-class RTP numbers, Evolution's customer-centric culture is the ultimate competitive advantage that will contribute to its long-term command of the market.

Evolution brings that same philosophy to its casino partners.

Even though Evolution is playing from a position of strength – online casinos have very incentive to partner with Evolution to make the most money – CEO Carlesund doesn't take their position for granted. In the 2021 interview with *Gaming Intelligence*, Carlesund noted that he's not interested in using Evolution's dominant competitive position to force casino operators into exclusive agreements. Instead, he wants to constantly earn their business by being the best possible partner to casinos:

"We want to be a good partner, we want to give our partners a good product that lets them earn a lot of money. I don't want to be a big powerhouse that forces them to go a certain way. We want to earn their business."

Evolution invests heavily into ensuring its casino partners can deliver a world-class playing experience for their customers, the gamblers. The company has a 30-person development team focused exclusively on optimizing the playing experience across all devices and operating systems around the world. So when the newest Apple iOS or Google Chrome updates are released, Evolution adjusts to the software changes, and its casino partners keep earning money. This is how Evolution achieved an industry-leading 99.8% continuous runtime of its games in 2023.

Then, there's fraud detection. Casinos foot the bill for any losses incurred by third-party gaming providers due to fraud. Evolution invests in state-of-the-art systems to detect and stop fraud through both manual and automated software systems. Evolution's 55-person game integrity and risk department tracks every single game and transaction in real time. This ensures that casinos continue to make money by keeping away the cottage industry of cheats looking to exploit weak games.

By providing the best support and service to its partners, Evolution has secured a winning reputation among casino operators. This includes 12 consecutive years of winning the EGR B2B “Live Casino Supplier of the Year” Award – the premier honor in the e-gaming industry – from 2010 to 2021.

In order for competitors to catch up with Evolution, they not only have to replicate the company’s unmatched gaming experience for gamblers, they also have to replicate this world-class service to casino partners.

As Evolution’s CEO Carlesund often says in regard to competition in online gaming,

“Barriers to entry are relatively low, but the barriers to success are considerably high.”

The best part is, those barriers become larger over time as Evolution grows.

Pouncing on an Attractively Low Valuation

As Evolution’s profit stream grows faster than its competitors, it can afford to out-innovate in new games, while delivering best-in-class player odds. Meanwhile, the massive infrastructure that goes into supporting its casino partners also requires scale to replicate.

This presents a chicken-and-egg problem for new entrants. The competition needs profits to invest in achieving the scale needed to beat Evolution, but those profits only come after achieving sufficient scale in the first place.

This is why we expect Evolution to continue its historic trend of gaining market share and growing faster than the online-gaming industry as a whole. Since 2015, the global market in online gambling has expanded at a 39% compounded annual rate. As we said before, over that same period, Evolution has ballooned at a 50% compounded annual rate.

Like many online businesses, the online-gambling market experienced a boom in demand during the COVID-19 lockdowns. Since then, a mean reversion in consumer spending has caused Evolution’s annual revenue growth to slow from 90% in 2021 to a more sustainable 24% in 2023.

As a result, Evolution’s valuation has plunged from a peak of 80x enterprise-value-to-EBITDA (earnings before interest, taxes, depreciation, and amortization) to less than 20x today. This reflects one of the lowest valuations Evolution has traded at since going public in 2015:

Evolution's Recent Plunge in Valuation



Source: Bloomberg

Since April 2021, the stock has fallen 47% – from \$197 to \$125 on March 5, 2024. This presents an attractive valuation for new investors – given Evolution's world-class profit margins and capital efficiency. As the market for online gambling matures, growth is expected to slow. Yet, this growth slowdown has been priced into Evolution's drop in valuation – and then some.

Looking ahead, industry experts project online gambling will grow at a roughly 12% annual rate. As mentioned earlier, Evolution has historically grown at rates well above the overall industry. Assuming a conservative case where Evolution simply grows in line with the industry, while maintaining its current profit margins, we expect the company could deliver a 15% compounded annual return for investors.

This will come from 12% growth on the top line – plus the capital return investors will earn through dividends and share buybacks. Starting in 2016, Evolution's management committed to returning 50% of earnings to investors through dividends. Since then, the dividend has increased 20-fold, and we expect further growth in the payout as the company's earnings continue to increase. Evolution currently pays \$2.18 in annual dividends to holders of its over-the-counter shares (EVVY), which reflects a 2% dividend yield.

Earlier this month, Evolution announced a buyback authorization of \$437 million, reflecting roughly 2% of the company's \$20 billion market capitalization. Given the company's high capital efficiency and stellar profit margins, Evolution will likely continue rewarding shareholders with ongoing share repurchases and dividend growth. Given the additional returns available from reinvesting dividends and a shrinking share count, we believe investors can achieve a compounded annual return better than 15%, even under a conservative future growth outlook of 12% going forward.

The management team also runs the business with a pristine balance sheet. Evolution has maintained zero net debt (i.e., total debt minus cash) for most of its history, including a current net cash balance of \$1 billion. Plus, insiders have skin in the game, owning 12% of the shares outstanding. Adding to that insider confidence comes from the very top: In November, CEO Carlesund purchased 10 million shares in the open market.

Action to Take: For the latest updates on our open positions, please visit our live portfolio [here](#).

INTELLECTUAL COMPOUNDER #2

The Amazon and Recession Resistant Retailer

Earning A Royalty On Poverty

This extraordinarily efficient intellectual compounder has structured its business to make all of its money off of selling used goods, but has found a way to offload virtually all of the operating costs. It doesn't spend a dime opening new stores or maintaining the existing locations... that's entirely the job of its franchisees. Over the last five years, the company's free cash flow margins averaged 56% compared with Macy's 3% over the same period.

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First published on September 16, 2022

The Amazon and Recession Resistant Retailer

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 7,906% (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.

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.

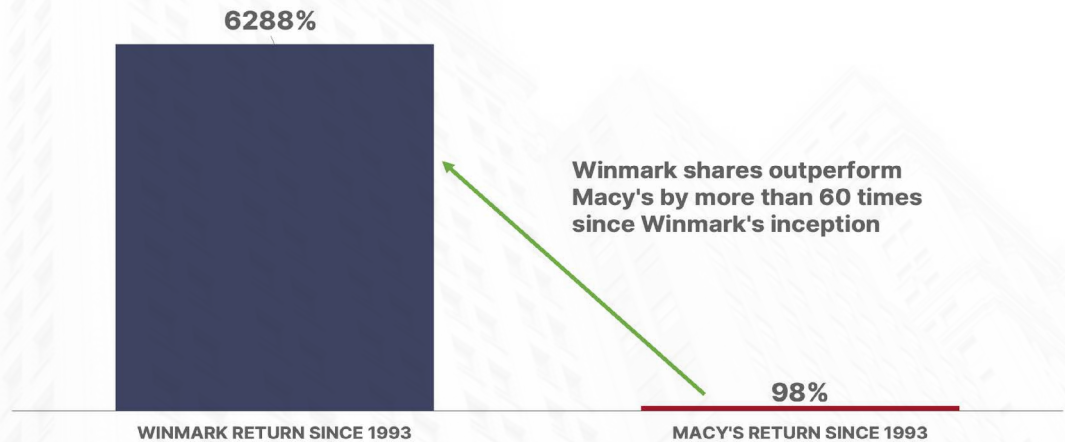
The Resale Company doesn't spend a dime opening new stores or maintaining the existing locations. Again, that's the job of the franchisee, who spends up to half a million dollars or more on each location.

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 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:

A Tale of Two Business Models



Source: Bloomberg | Winmark returns since 2000 through February 26, 2024

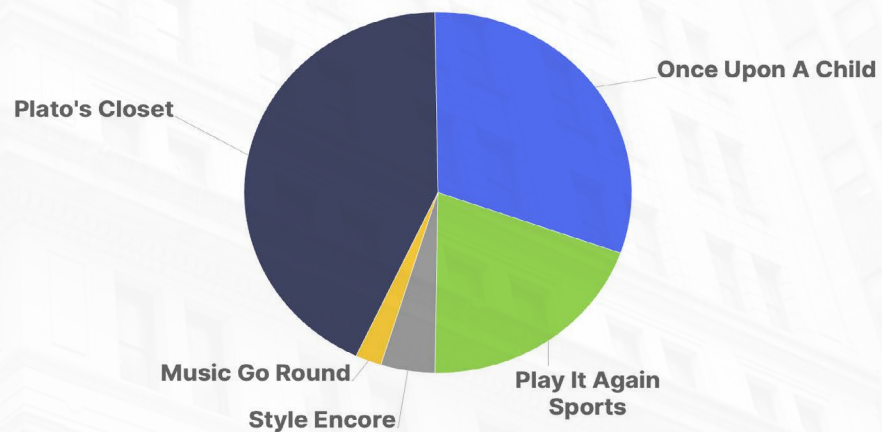
All the Profits, None of the Headaches

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.

Winmark's Profit by Brand



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.

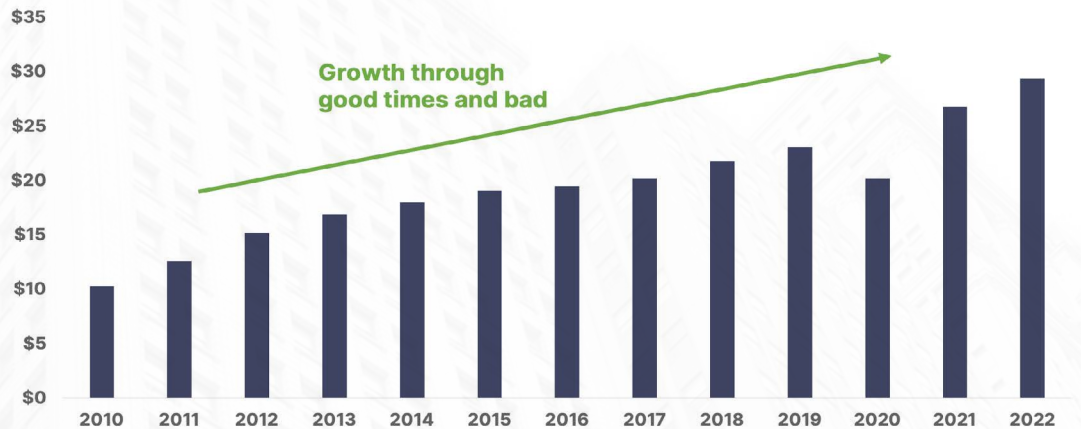
Plato's Closet is in many ways an upscale version of Goodwill or Salvation Army. You can walk into any of their locations and sell your lightly used clothing on the spot for cash. The company then resells that clothing at discounts of up to 70% off new prices.

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 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.

Winmark's Earnings from Plato's Closet Franchise (\$M)

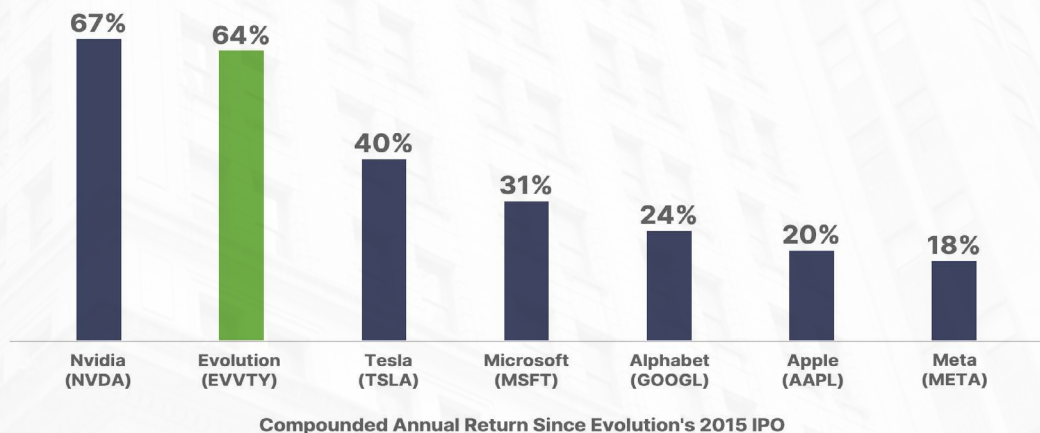


A Business Built for Booms and Busts

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.

Evolution Outperforms Many Mega-Cap Tech Leaders



Source: Bloomberg

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:

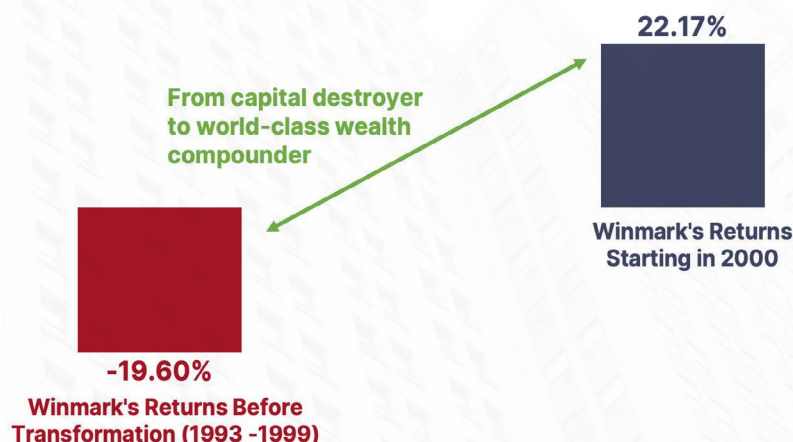
Winmark Faces Bankruptcy Before Changing its Business Model



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:

Becoming a Pure Franchisor Transformed Winmark's Returns Starting in 2000



Source: Bloomberg / Winmark returns since 2000 through February 26, 2024

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.

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](#).

Intellectual Compounder #3

The Big Secret Behind T. Boone's Fortune

How to Buy the Best Resource Acreage in Texas at a Discount –
Without Any Production Costs or Risks

This intellectual compounder isn't really a "company" – it's a legal fiction that generates enormous wealth for shareholders. It's an "energy royalty company" that buys mineral rights and leases them to miners. All capital and operating expenses lie with the operator. And that means, as inflation continues to drive energy prices higher, the rights that this company acquired in the past become more and more valuable...

Editor's Note: Please remember, these are informational reports only. Porter & Co. is not necessarily recommending this stock, and what we present here is solely investment research. Subscribers to *The Big Secret on Wall Street* (or our Partner Pass membership) receive updated analysis and active recommendations. For the latest updates on our open positions, please visit our live portfolio link [here](#).

First published on September 2, 2022

The Big Secret Behind T. Boone's Fortune

How to Buy the Best Resource Acreage in Texas at a Discount – Without Any Production Costs or Risks

California Energy Idiocy is Back – This Time, On Steroids. Now, You Can Supersize the Same Trade That Made T. Boone 9,000%. “Like a Coin Where Both Sides Are Heads...”

“Why don’t we fly to Aspen for lunch...?”

About 10 years ago, we visited T. Boone Pickens at his famous ranch, Mesa Vista.

The ranch, at 100 square miles, consumes a little over 10% of Roberts County, Texas. It has 18 miles of manmade lakes for duck hunting and bass fishing. There are more than 100 different fields for hunting quail and over 1,000 wild quail feeders.



There are also enormous homes. Several of them. T. Boone (everyone called him “T. Boone”) was married five times... and each new wife got to build a house at Mesa Vista. The house T. Boone built for himself, The Lodge, is over 30,000 square feet. And in the living room, looming over an enormous fireplace is a life-sized, full-length portrait of... himself.

On the second day of our visit, a snowstorm ruled out quail hunting. Fortunately, T. Boone had his own airport at Mesa Vista and a nicely appointed Gulfstream V. The pilots circled the ranch as we took off. The landscape was covered in oil and gas wells.

"It's the damndest thing, Porter... I spent most of the 1960s and 1970s looking for oil in Canada and Libya... if I'd only known how much oil I had right here, on my own ranch!"

Boone was, for most of his life, an ardent believer in "Peak Oil." He believed that oil production in the U.S. had peaked in the early 1970s and that, in only a few more years, all the oil would be gone.

He believed nuclear and wind power should be used to produce electricity for the power grid, so that all the remaining oil and natural gas could be conserved for use as a transportation fuel. He was convinced that the country was heading for a disaster because we were going to run out of oil within a decade or so.

In 2008, Boone announced a major investment in wind power. He ordered 667 1.5-megawatt turbines from General Electric – a \$2 billion turbine order. Boone was going to cover his Mesa Vista ranch in wind turbines.

"I lost my ass on that wind deal," Boone complained.

By 2010, the entire project was scrapped. Among the hurdles and economic realities T. Boone didn't anticipate: It would have cost \$5 billion just to connect Mesa Vista's windmills to the regional power grid. Worse, the entire premise of his massive investment into wind energy and his "Pickens Plan" was dead wrong.

We'd first met T. Boone because we were extremely vocal opponents of his "Plan" and had mocked Peak Oil as yet another nonsense Malthusian fantasy. At a 2014 Stansberry Research Conference event in Dallas, T. Boone conceded that he'd been dead wrong about Peak Oil and that his "Pickens Plan" would have been an economic disaster.

In a wonderful example of how truth is often stranger than fiction, a huge amount of oil and gas was discovered directly underneath Boone's own ranch. By 2014, oil and gas production in Roberts County exceeded 3 million barrels annually. Easing the sting of his losses in Wind Energy, even today – a decade after they were completed – several of T. Boone's new Mesa Vista wells (#008888 #008543, and #008991) are still among the most productive wells in the country. T. Boone's BP Operating Company LLC is still the third-most prolific producer in the county, even three years after T. Boone's death.

We learned much from T. Boone over the years, but the most important lesson he taught us was that commodity industries – like oil and gas – that require huge capital investments are fraught with risk. T. Boone very nearly bankrupted himself

by investing heavily in an economic myth: Both Peak Oil and the idea that wind power can reliably and affordably produce baseload power are economic fallacies. T. Boone also showed us the trick to avoiding 90% of those risks.

The Real Story Of T. Boone: A Fortune Made On A Myth

Most people think T. Boone made his fortune developing Mesa Petroleum, which by the early 1980s was America's largest and most successful independent oil and gas company.

But that's not so...

Boone's unfailing belief in ever-higher prices for fossil fuels led Mesa Petroleum into serious financial distress in 1996. Legendary dealmaker Richard Rainwater bought it for pennies on the dollar in 1997, and turned it into one of America's best independent oil companies, Pioneer Natural Resources.

Boone, meanwhile, was forced out of the company. He was 67 years old and virtually broke. He took his last \$8 million and raised another \$30 million from friends to start a hedge fund, BP Capital.

What did he invest in? Natural gas, of course! He kept pyramiding leveraged bets on higher prices for natural gas, essentially same strategy that led to ruin at Mesa. Within 18 months, he'd lost more than 90% of his fund, which dwindled to under \$3 million.

What happened next was the greatest speculative triumph in the history of the financial markets.

T. Boone continued to bet on natural gas going higher, using the futures market. And in 2000, his commodity fund rose by \$250 million, generating a 9,000%-plus return.

The gains came, in large part, because of the California state energy crisis and the subsequent spike in natural gas prices. It's worth understanding what happened, because the same thing is about to happen again – but on a much bigger scale – in Europe.

California "deregulated" electricity in 1996, creating a market structure that could have only been built by politicians. Baseload providers (Mirant, Reliant, Williams, Dynegy, and AES) were to supply power on a competitive basis to the California Power Exchange.

But to ensure competition, they could only sell power to the system the day before it was to be delivered to the customer by one of California's three retail electrical utilities. Worse, the regulators demanded caps on wholesale energy prices for a decade and based the caps on prices for energy that existed before deregulation began, on the theory that competition would increase efficiencies.

As a result of these caps, there were no additional power plants built in California between 1990 and 1999. Meanwhile, the population grew by 13%. Where did the state get the additional power it needed? All of the additional demand for power was supplied by importing electricity from Oregon and Washington, which normally came from hydro-electrical plants.

In 2000, the stage was set for a huge crisis when California finally deregulated wholesale prices – but continued to regulate retail prices. A drought led the hydro-sourced power to leave the market, causing a massive shortage. That, along with an absence of any long-term market for power, led to skyrocketing wholesale electrical prices, which the retail utilities had to pay because long-term contracts were not allowed.

The result? The power went out all over California with rolling blackouts as the retail utilities – which couldn't pass the price increases on to consumers – were forced to balance supply with demand by rationing power.

Eventually the governor, Pete Davis, resigned himself to the inevitable, signing long-term supply agreements with Enron and other major natural gas-based suppliers of energy. The crisis cost the state of California an estimated \$40 billion, as natural gas prices soared on anticipation of increasing demand.

Where did all of that money go? A lot ended up at T. Boone's hedge fund, which had been buying natural gas futures throughout 1999 and 2000 and continued to do so through 2007.

By early 2008, as oil soared to around \$150 per barrel, T. Boone's fund had earned more than \$8 billion in profits, leaving him with a multibillion fortune.

T. Boone spent 40 years looking for oil and producing millions and millions of barrels of it. But what made him a billionaire wasn't producing anything. BP Capital didn't own a single oil field or gas well. It merely owned the rights to energy other companies had to produce.

As he told us, "I sure wish I'd thought of that earlier."

California All Over Again

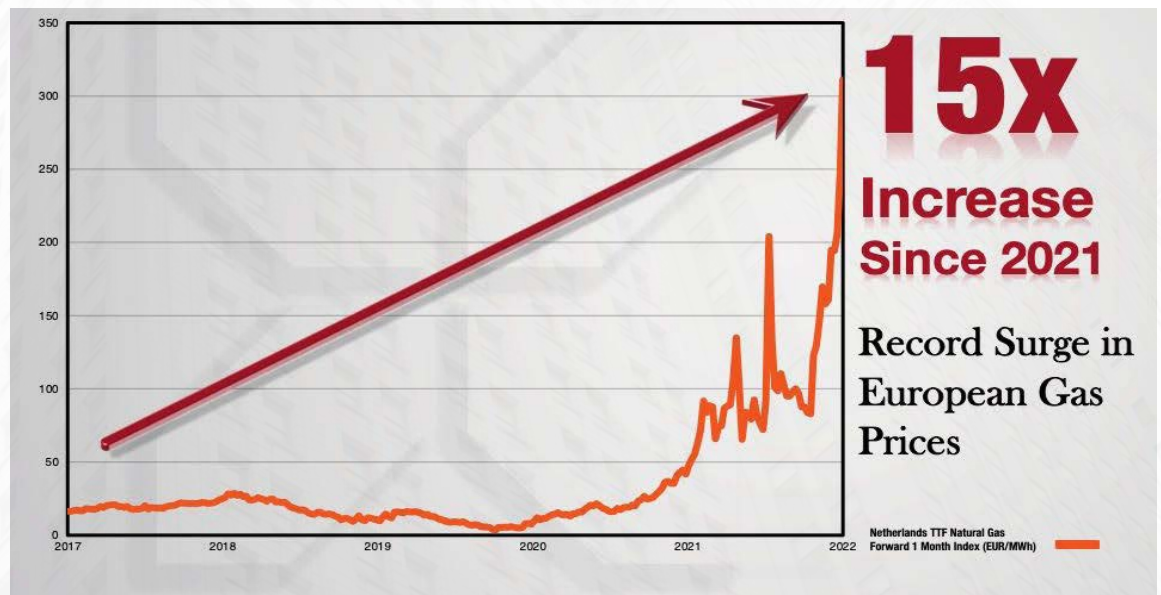
Just imagine what T. Boone would think of the opportunity being created by European politicians today.

Just like California in the 1990s, Europe has regulated itself into a severe energy shortage. Bans on hydraulic fracturing and political decisions to abandon nuclear power led to dependence on Russian natural gas.

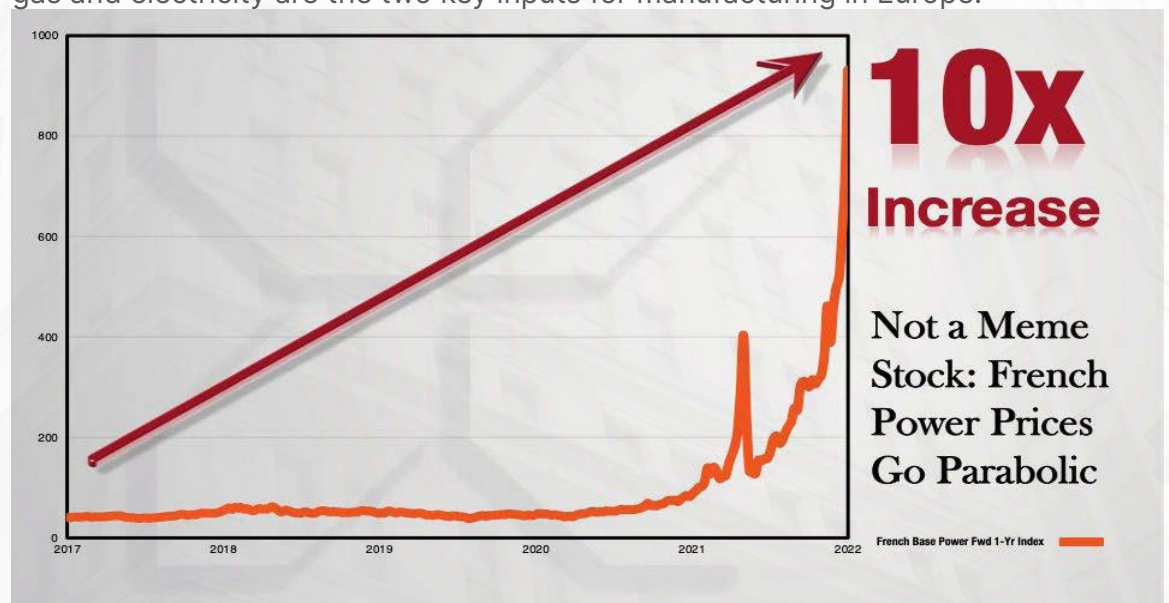
Then Russian President Vladimir Putin turned out to be even less reliable than wind and solar power. The result: Europe is spiraling into an economic collapse, with severe consequences for the entire global economy. The only solution: Much higher prices for natural gas.

Fears of a halt in Russian energy flows this winter have sent European natural gas prices spiking into previously unimaginable territory, approaching \$272 per thousand cubic feet (mcf) this past summer. (For reference, U.S. gas prices traded around \$3-\$4 per mcf for much of the last decade.)

Without any easy or immediate replacement for disrupted Russian volumes, the market is pulling the only remaining lever to balance the market: a demand-destroying price rally.



That's how Europe finds itself in a situation with power prices trading like a meme stock stuck in a short squeeze. This isn't only hurting consumer demand. Natural gas and electricity are the two key inputs for manufacturing in Europe.



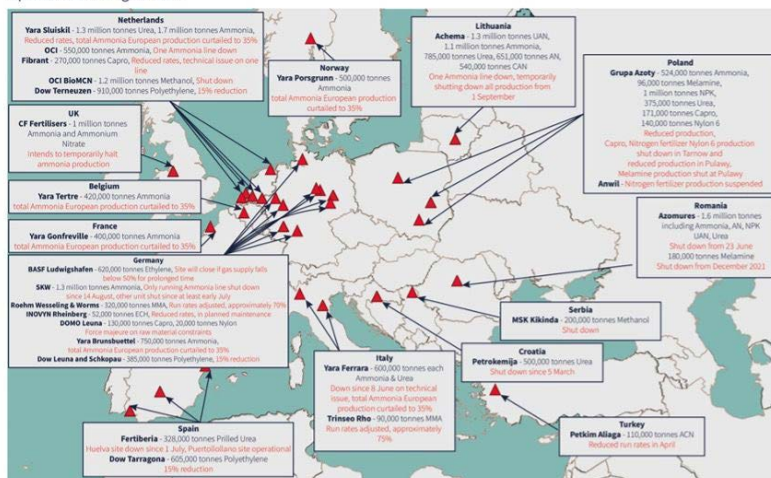
We should note that the combination of mild weather and ample gas storage in Europe has caused spot natural gas prices to plunge in fall 2022. However, despite the short-term price weakness, the lack of Russian volume leaves Europe vulnerable. With the Nord Stream Pipeline shut down and no signs of a resolution in the Ukraine conflict, Europe's energy supply remains dependent upon the whims of mother nature.

The charts above show price spikes as they occurred in summer 2022. Even though prices have come back to earth since the 10x and 15x increases shown above, the threat of a shortage remains...

Absent a resolution in Ukraine and return of Russian gas supply, Europe will face the ongoing risks of a crippling gas shortage until new sources of LNG come online starting in 2025. The tight supplies of gas and soaring electrical prices will push the European economy into chaos. Each day, it seems we hear of another new announcement of production cuts or outright shutdowns in manufacturing plants.

Soaring gas prices hit Europe fertilizers, chemicals

Updated on 25 August 2022



SOURCE: ICIS, Natural Earth

For now, the wholesale power market is the focal point of the European energy crisis. But it's only a matter of time before wholesale prices hit consumers in the retail market. An executive director at one UK power company recently issued a shocking warning that **"more than half of UK households will likely be in fuel poverty by January."**

And yet, politicians show no signs of addressing the real problem – a rational approach toward energy policy. The political solution? Print more money and attempt to manipulate the market with price controls! (A recent series of UK parliament resolutions called for "energy price freezes, solidarity taxes, and social tariffs that lower bills for lower income households.")

Likewise, across Europe, governments continue to regulate retail prices of electricity, while subsidizing utility companies (with printed money) that have been bankrupted because they cannot pass on the new, vastly higher cost of energy.

These policies will cause a hyper-inflationary environment in Europe and, sooner than most people expect, fuel and electrical rationing there. The only solution is producing or importing a lot more natural gas.

BP Capital made \$8 billion when these exact same things happened in California. How much will you make on Europe's crisis, which will be even bigger and last even longer? The situation is like a coin where both sides are heads.

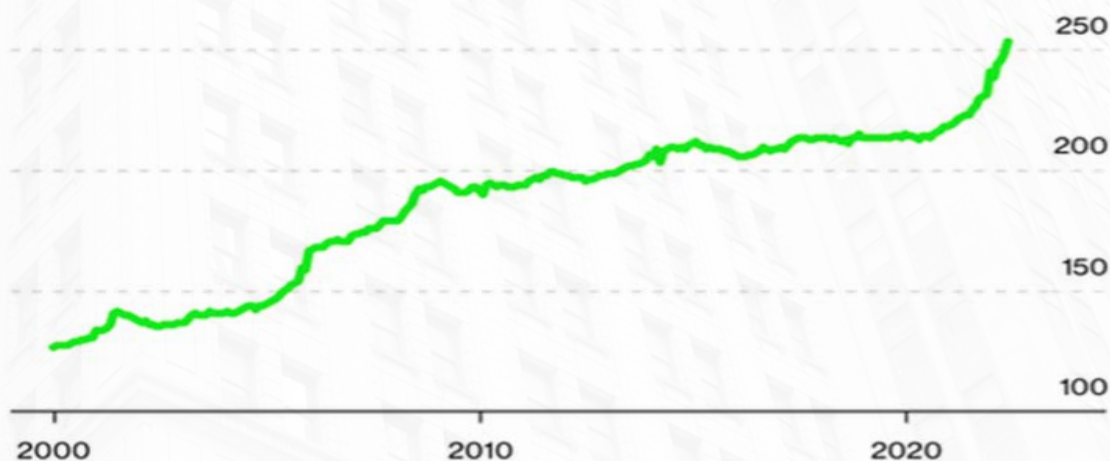
Winter Is Coming: The U.S. Will See Vastly Higher Natural Gas Prices Too

As Russian energy supplies leave the world's markets, global demand for American energy will continue to grow, pushing up the price of energy that can be exported from America, like oil, coal, and liquefied natural gas ("LNG"). That will, in turn, lead to higher electrical prices here, too.

And in places like New England, which rely heavily on natural gas – but which lack new natural gas infrastructure – the price spikes will look more and more like Europe's:

Electricity Gets a Jolt

US electricity consumer price index for all urban consumers



Source: US Bureau of Labor Statistics
Note: Index 1982-1984=100

The only cure to these problems is increases to baseload power generation.

And the fastest and quickest way to accomplish that in Europe is building natural gas-fired power plants. That will mean big increases to American LNG exports over the next decade. There's truly no other solution.

In America, that will mean more natural gas pipelines, more drilling, and more production. And that gives us tremendous confidence in the American LNG investments in our portfolio, EQT (NYSE: EQT) and Tellurian (NYSE: TELL). But these companies have one problem: They require huge amounts of capital to grow. Natural gas production and LNG exports are highly capital inefficient. Tellurian will have to raise and invest between \$6 billion and \$10 billion in capital to build out its oil and gas wells, pipelines, and the Driftwood LNG export facility.

Likewise, eventually EQT will have to reinvest billions of dollars in drilling new wells and building new pipelines to expand its production. These investments will create a lot of risk, as natural gas prices are incredibly volatile. The capital required could also significantly reduce the amount of profit that eventually reaches investors if it is invested unwisely or even just at the wrong time. That's what happened to T. Boone at Mesa. He was about four years too early. It wiped him out.

As Warren Buffett's longtime right-hand man Charlie Munger once explained:

"There are two kinds of businesses. The first earns 12%, and you can take it as cash. The other earns 12%, but all must be reinvested. It reminds me of the guy who looks at his equipment and says, 'There's all of my profit.' We hate that business."

As T. Boone Pickens discovered the hard way, it's much better to simply own the hydrocarbons. Let other folks do the heavy of producing and distributing the energy. And what's the best way of buying a huge amount of energy in the ground?

Owning The Energy, Not The Production Costs

Once again, we owe an intellectual debt to T. Boone.

In 1979, T. Boone Pickens created the first publicly traded "MLP" – a publicly traded partnership – that would own only mineral rights. He took most of the proven assets of Mesa Petroleum – huge oil and gas fields in Kansas, New Mexico, Colorado, and Wyoming – and he spun them off into a separately listed partnership, the Mesa Royalty Trust (NYSE: MTR, \$16).

The idea was to separate the income streams from proven and operating fields from the costs of finding and developing additional fields. Doing so was much more tax efficient, as partnerships are not taxed like corporations are. Creating the trust meant shielding most of Mesa's income from corporate taxes. Mesa Petroleum, meanwhile, could take the capital from selling the assets, and continue to explore and develop more fields, activities that would generate tax-losses.

This structural innovation turned T. Boone into a “corporate raider” – as he couldn’t figure out why much larger oil companies, like Gulf Oil, didn’t do the same thing. Create royalty trusts to shield their income from taxes. T. Boone bought nearly 10% of Gulf Oil and demanded these changes be made, or else. The company was “in play” and through a series of mergers became Chevron. T. Boone made over \$700 million on the investment for his partnership in two years’ time.

Since those days, MLPs (master limited partnerships) have become a major segment of the stock market. They provide tax-efficient income for energy investors, much like REITs do for real-estate investors. We think they are an outstanding investment vehicle for conservative investors who want income and exposure to higher energy prices and growth in production. Investing in the sector is tricky, however, as these partnerships normally have tax accounting requirements (a 1099) and because you have to avoid buying into a trust when it’s trading at a value that’s above the value of its proven assets.

Looking at the sector today, our top pick is **Viper Energy Partners LP (VNOM)**.

The company’s assets were developed by Diamondback Energy Inc. and are in the heart of Texas’ leading field, the Permian Basin. But now these proven assets are owned by Viper Energy Partners. If an oil company – Diamondback or anyone else – wants to produce oil from land that Viper owns mineral rights on, it must get Viper’s permission. That means striking a deal where Viper extends a lease for the development of the resource in exchange for a cut of the profits.

T. Boone created the first energy trusts for tax reasons, but the advantages of these kinds of businesses go well beyond tax benefits. The key to understanding these businesses is that they don’t have to pay any of the production costs or take any of the developmental risks: Viper just owns the mineral rights. The only cost Viper incurs is the upfront acquisition of the mineral rights. Once it owns them, all capital and operating expenses lie with the operator.

And that means, as inflation continues to drive energy prices higher, the rights that Viper acquired in the past become more and more valuable.

Viper transforms a capital-intensive industry into a capital-efficient business that’s virtually guaranteed to produce increasing returns across time. In fact, Viper really isn’t a business at all: it’s mainly a legal fiction that generates enormous wealth. Well-run mineral rights businesses like Viper are truly one of Wall Street’s greatest secrets.

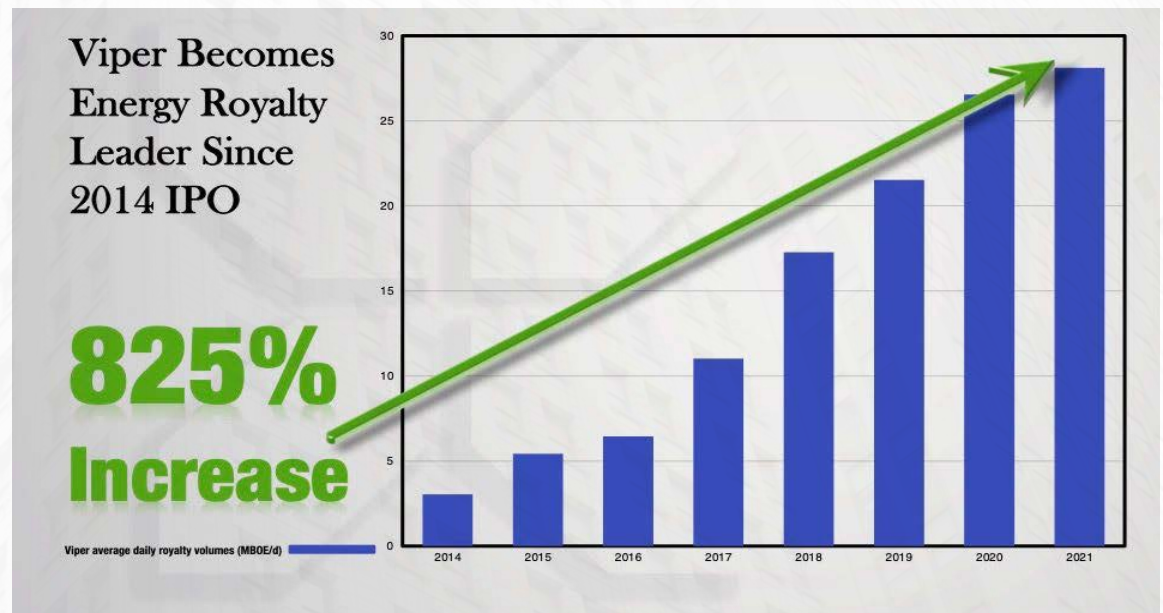
Consider: our standard rule of thumb when seeking out capital-efficient companies is finding businesses capable of converting at least 10% of sales into free cash flow, or a 10% free cash flow margin. **Over the last five years, Viper has averaged an incredible 77% free cash flow margin.**

Another metric of capital efficiency we look for are businesses that can earn \$500,000 or more in operating income per employee. Well, Viper pushes the theoretical limit here. **The company has zero employees. You read that right – zero.**

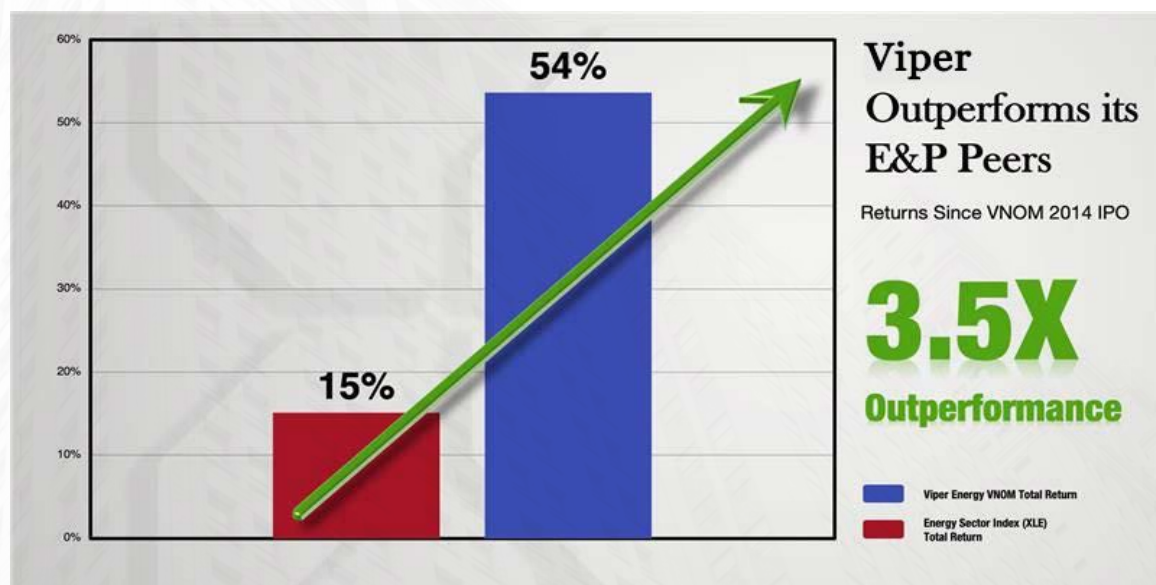
Zero capital expenditures and zero employees is how Viper offers one of the most capital-efficient businesses – not just in the shale patch – but in the entire stock market. But before explaining how this unique business model churns out gobs of cash with zero employees and zero capital expenditures, let's begin with the company basics.

Viper was created as a spin-off from Diamondback Energy in 2014. Viper was one of the first pure-play energy royalty businesses in the Permian and leads the market in consolidating royalty acreage – investing over \$2.5 billion acquiring mineral rights over the last several years.

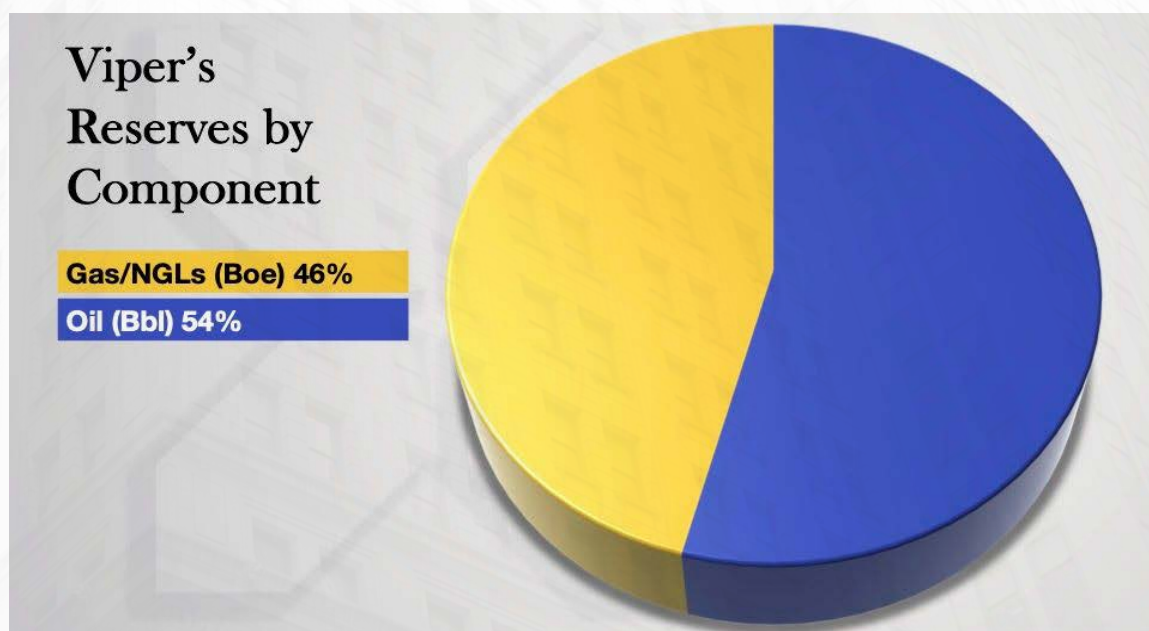
Since going public in 2014, Viper's royalty volumes have grown nearly 10-fold, from average daily volumes of 3,000 barrels of oil equivalent ("BOE") eight years ago to 28,000 last year:



Investors have reaped the benefits, with Viper shares outperforming the broader energy sector by a factor of 3.5 to 1 since its inception as a public company:



Viper owns mineral interests spanning across 930,871 gross acres and over 9,000 producing wells, with net production of 31,359 barrels of oil equivalent per day ("BOE/d"). The company's total proven reserves stood at 128 million BOE as of year-end 2021, including 54% oil and 46% natural gas and natural gas liquids ("NGLs"):



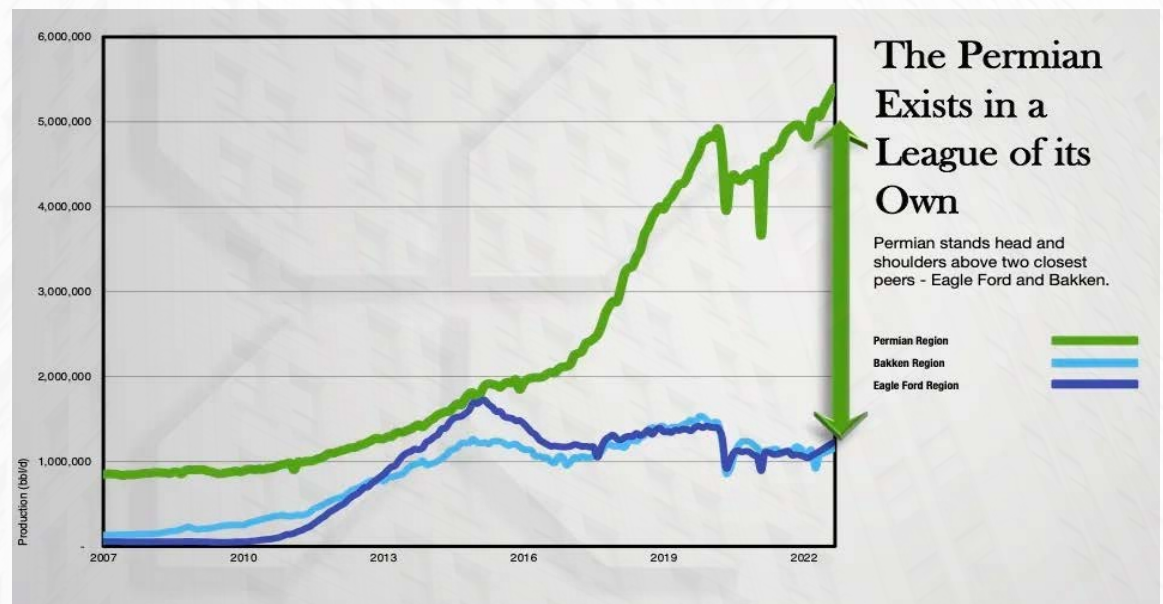
This reserve mix provides us with hedged exposure to a general bull market in fossil fuels – including oil and natural gas.

But more important than the what is the where. You see, the value of mineral rights goes beyond the cash flows that the existing oil or gas wells produce today. The real upside comes from buying the right acreage that has substantial upside from additional development in the future.

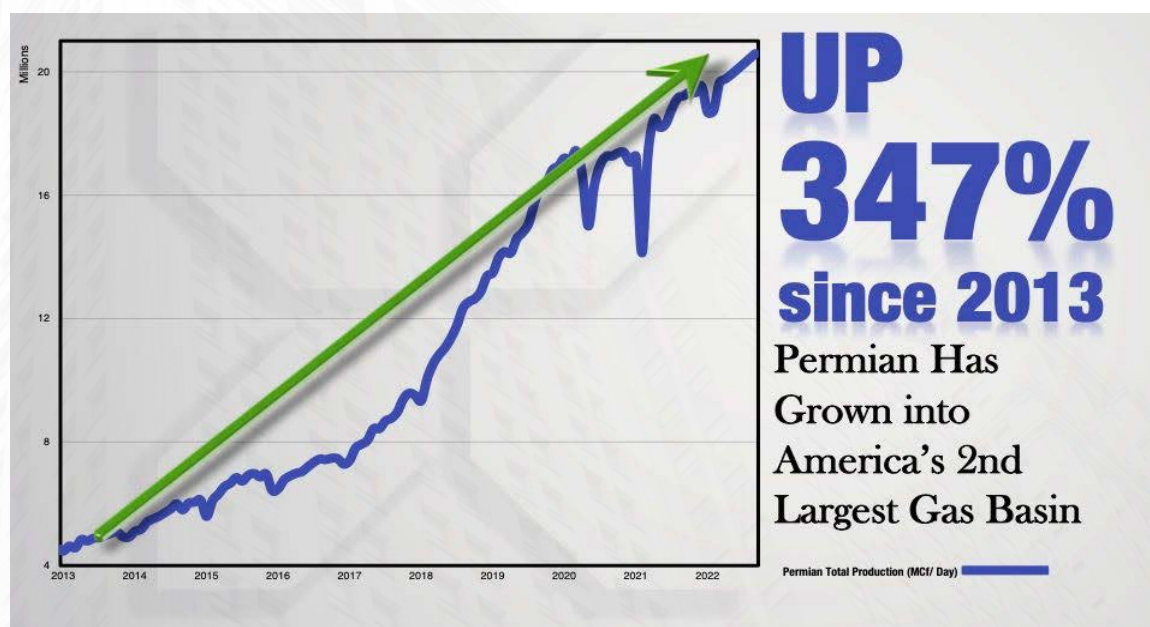
Buy The Permian, Now

Viper's asset base is concentrated in the heart of the Permian – America's most prolific oil and gas deposit. The Permian spans across 75,000 square miles in West Texas and New Mexico, and it's one of the oldest producing formations in America. Unlike its next two closest peers – the Eagle Ford and the Bakken, which only sprang to life during the last decade's shale revolution – the Permian has produced oil and gas since the 1920s. The depth and quality of reserves are simply unmatched, as we can see in the data.

During each of the previous oil bear markets, including 2016 and 2020, the Permian suffered a shallower decline and faster recovery compared with the Eagle Ford and Bakken. And only the Permian has reclaimed new highs in output during each subsequent recovery, compared with the Bakken and Eagle Ford, which both remain below their production peaks reached back in 2014:



Going beyond oil, the Permian also hosts one of America's largest deposits of low-cost natural gas. Over the last decade, explosive growth in gas production has pushed the Permian into America's second-largest gas basin, trailing only the Marcellus formation in the Appalachian shale:



Finally, even more important than the what and where is the who.

Powerful Partnership

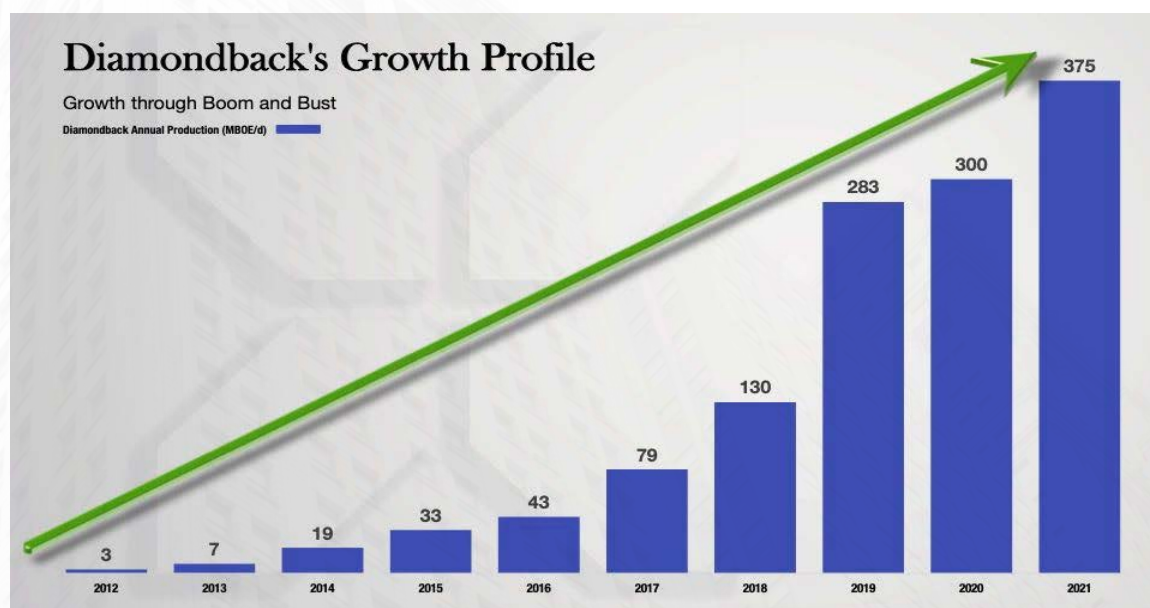
You see, owning mineral rights on great acreage is only half the battle. After all, mineral owners only get paid when oil and gas gets produced. That's why it's critical to partner with the right operators to maximize the value of that acreage. And that's where Viper's biggest edge comes from, through its strategic partnership with Diamondback Energy (NYSE: FANG), one of the best operators in the Permian, operating more than half of Viper's acreage.

Diamondback was formed in 2007. Back then, T. Boone Pickens and just about everyone else believed that the Permian's best days were behind it... and for good reason. For the previous 35 years, production entered into secular decline, from a prior peak of 2.2 million barrels per day (b/d) in 1972 down to a low of around 750,000 b/d in 2008.

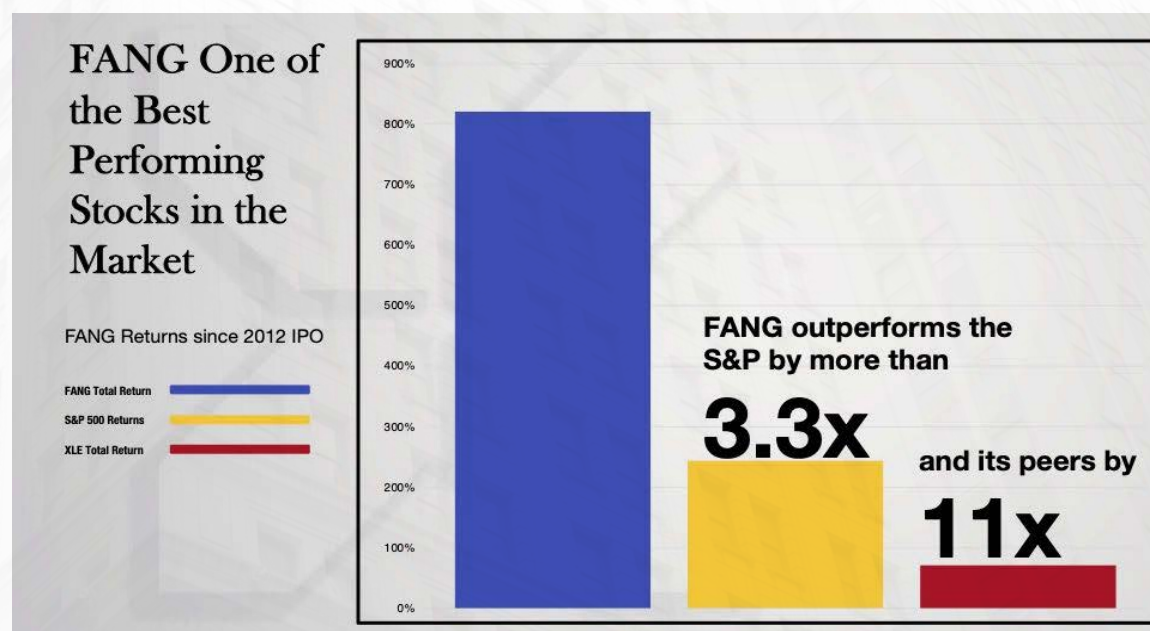
But operators like Diamondback, along with the new production and completion techniques of the shale revolution, brought the basin back to life. Today, the Permian is America's largest low-cost oil basin, producing over 5 million b/d.

Diamondback was ahead of its time with a concentrated focus on the Permian from day one, starting with over 4,000 acres in 2007 and expanding from there. Because Diamondback began leasing up the Permian years before the shale boom, the company secured a leading acreage position that paved the way for incredible growth in oil and gas production over the last decade.

Meanwhile, management is among the best in the business, maintaining a disciplined approach to capital allocation and a conservative balance sheet. That's how Diamondback posted consistently impressive growth through the ups and downs in energy prices over the last decade:



In an industry that largely destroyed shareholder capital during the last decade, Diamondback became one of the best-performing stocks – not just in energy, but in the entire stock market. Shares compounded at an incredible rate of 24% since going public in 2012, handily outperforming the energy sector and the overall stock market:



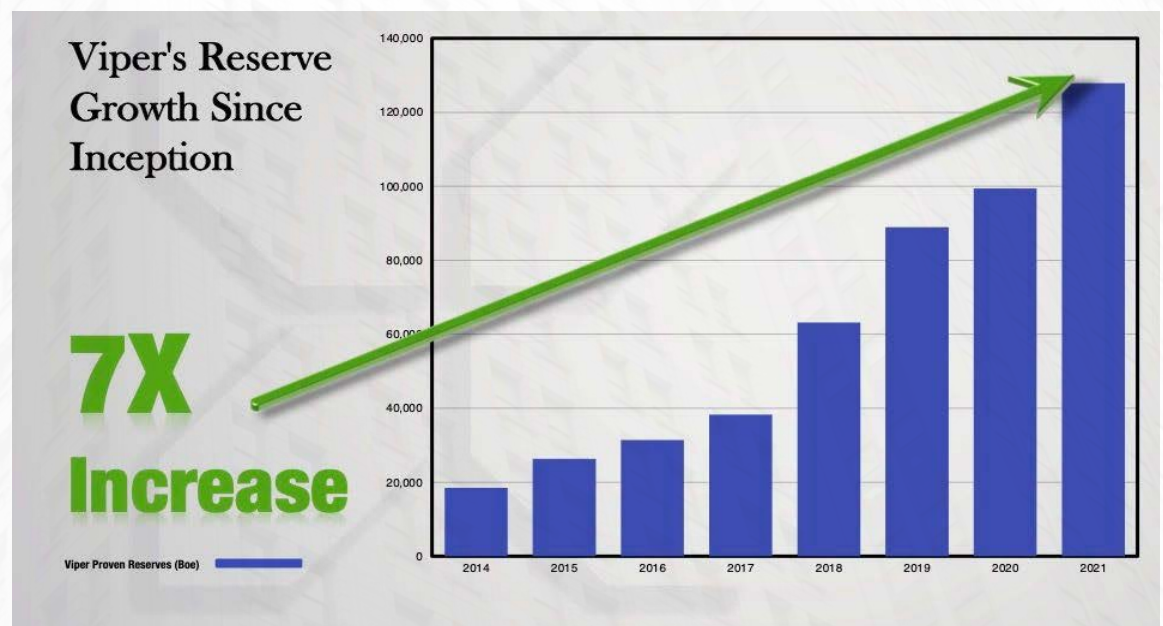
With record profits and production and more than a decade of tier-one inventory in the heart of America's top oil and gas basin, Diamondback's prospects look brighter than ever. This, in turn, is great for Viper.

That's because Viper enjoys a unique relationship with Diamondback, which unlocks tremendous capital efficiency in a way that we haven't found anywhere else in the shale patch.

Diamondback is the majority owner of Viper, holding 54% of all outstanding units. This aligns Diamondback and Viper's incentives, ensuring that both parties profit from Viper's success. And it's this relationship that makes Viper's unit economics so compelling. Diamondback allows Viper to draw upon its internal staff and resources to the point where Viper requires zero of its own employees.

Viper leans on Diamondback to identify the best Permian oil and gas acreage – something Diamondback has already done for the last 15 years and will continue to do going forward. Viper uses this information to strike deals that involve an upfront payment to acquire mineral rights on highly productive acreage.

We can see clear evidence of the success of this model through Viper's track record of growing oil and gas reserves since inception, which has grown by an incredible 7-fold from 18 million BOE in 2014 to 128 million at the end of 2021:



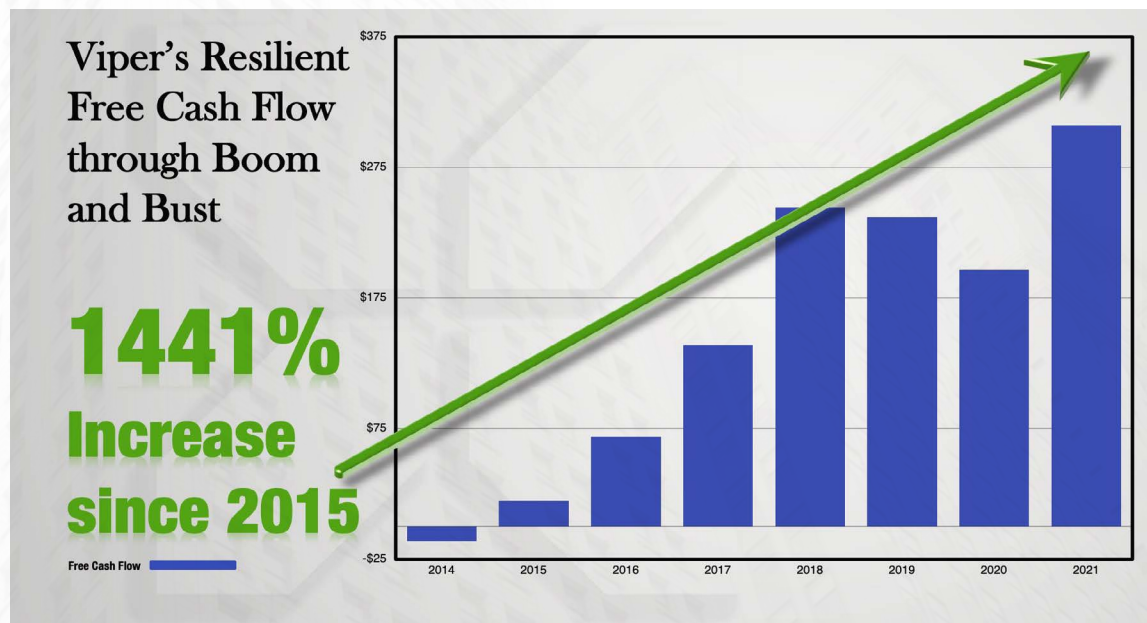
Viper is simply the publicly listed portion of Diamondback's huge royalty book. It allows investors to buy hydrocarbons directly, without the risks and capital requirements of production. In that way, Viper is more like a financing company than an energy company.

A Uniquely Safer Bet

Viper's unique business model offers remarkable resilience against the inherent volatility of oil and gas prices.

This is another feature of the company's capital efficiency. The cash flow statements for most commodity producers plunge deep into negative territory during commodities bear markets because the prices of the things they sell goes down, while operating costs and capital expenditures remain stubbornly high.

Viper's business model is designed to be immune from this defect. The following chart shows how Viper sailed through 2020 energy price collapse with barely more than a blip in its cash flow trajectory:



Take another look at the chart above. You can see how Viper is enjoying substantial upside from today's high-price environment... Free cash flow is surging, thanks to the combination of higher prices on its royalty volumes along with its longer-term trend of volume growth.

In other words, Viper provides all the upside from higher energy prices, with only a fraction of the downside compared with traditional oil explorers and producers.

For such a compelling business model, you would expect Viper to command an exorbitant valuation premium. And yet, with a market capitalization of roughly \$5 billion, the company trades at less than 10x free cash flow today.

The best part? Without needing to recycle earnings back into expensive equipment and other operating costs, that cash flows right back to investors. That's how the company pays out a current distribution of \$1.96 annualized, or a yield of nearly 7% on the current unit price of around \$30 per share.

Of course, if energy prices fall, so, too, will the company's cash flow – and the distribution. Plus, because Viper is technically an "energy" company, the unit prices can fluctuate wildly, along with the overall volatility in the energy sector.

That's why anyone owning these units should be able to separate short-term market volatility from the true risks in the underlying business. For all the reasons we've discussed today, we view Viper as one of the lowest-risk businesses in the energy sector. No capital requirements, no operating costs, high and stable cash

flows (even during energy bear markets), and a clean balance sheet. In terms of business risk, you can't do much better... in energy or elsewhere in the market.

Why We Think It's Safer

One final note on the "safety" of the business at current prices.

The valuation for a mineral company like Viper can be broken down into two basic factors:

1. Value of existing assets
2. Upside from asset growth

To consider an extreme downside scenario for Viper, let's assume the business stops all future growth tomorrow and enters into "liquidation" mode. Let's also assume crude oil prices crash to \$66 per barrel (from around \$90 now) and stay there indefinitely as the company cashes in its royalty streams.

What would the business be worth?

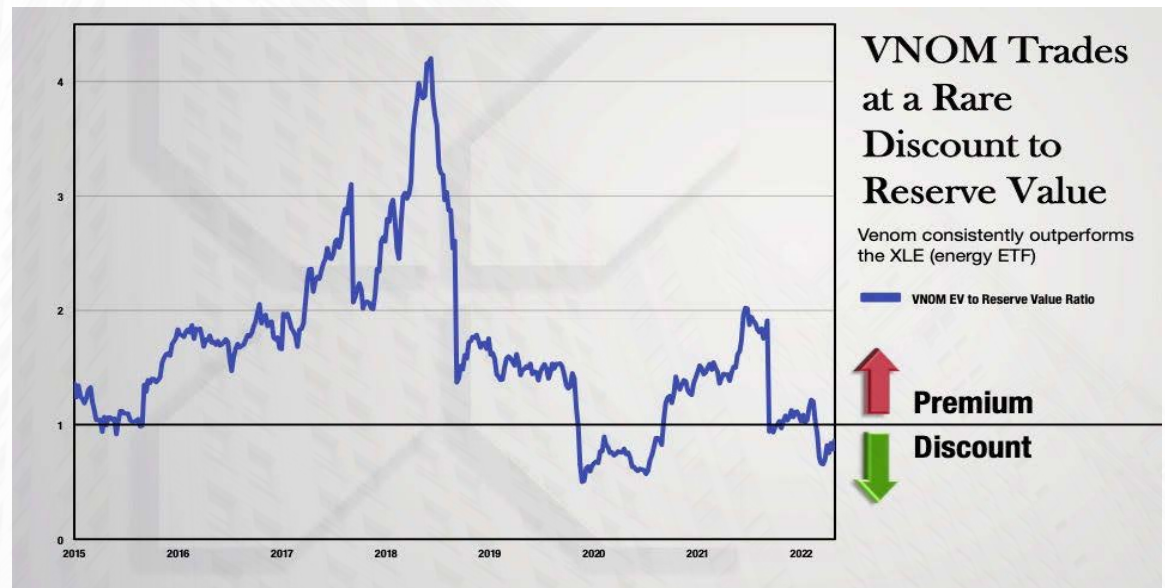
Well, we have an answer in the company's official SEC filings, via the audited, third-party report of the company's reserves. reserve report.

Reserve values provide the closest thing to book value you can find in the energy world. Reserve reports provide standardized measures of "proven reserves". A proven reserve is a volume of economically viable oil (or natural gas, or NGL) deposit that sits within a certain distance from already-producing wells. This allows engineers to extrapolate the reservoir characteristics of the existing producing wells to the yet-to-be-produced "reserves" located underground.

When companies file reserve reports in their annual reports, the SEC requires the volume of these reserves as well as an estimate of the future cash flows the company will earn as these reserves get produced.

Historically, energy companies tend to trade at premium valuations to their proved reserve values. The reason for this is that the SEC definitions are considered conservative regarding future reserve development, and because most energy companies will grow their reserve values over time.

The chart below shows how this was the case for Viper, whose enterprise value traded at a historical premium to its proven reserve value – reaching as high as 4x in late 2018. Today, the company trades at a roughly 12% discount to its proven reserve base:



Here's the kicker – the company's current reserve value was calculated for year-end 2021, using \$66 oil as the price assumption.

In other words, oil prices could plunge to \$66 per barrel – and stay there indefinitely – and investors buying Viper units today would still be getting the company below fair value.

So as you can see, even in the hard-to-imagine scenario of perpetually depressed energy prices and a rundown of Viper's existing asset base, investors buying at current prices are getting a fair deal.

Meanwhile, if you believe that Viper and Diamondback will continue thriving in America's best oil and gas basin – as they have for the last decade – then it's all upside from here.

Plus, if you buy into the view that energy prices will remain inflated at much higher values going forward (even despite some volatility and a potential recession along the way), well, Viper is the ultimate vehicle for capturing that upside without taking big risks along the way. In the meantime, you can collect a nearly 11% yield while you wait to see how it all unfolds. That's about as safe a bet as you can get anywhere in today's financial markets.

Action to Take: For the latest updates on our open positions, please visit our live portfolio [here](#).

Intellectual Compounder #4

Cashing In at the Courthouse

How To Profit From the \$7 Billion Leader of Financial Litigation

You've likely never heard of this intellectual compounder, but it's the leading global provider of litigation financing. It's a large company that funds lawsuits and then, when it wins, takes a cut of the payout. Think of it as the venture-capital approach to lawsuits. Like venture-capital companies, which fund small startups and cash in on their eventual success, litigation finance can turn a small investment into a super-sized payday.

Editor's Note: Please remember, these are informational reports only. Porter & Co. is not necessarily recommending this stock, and what we present here is solely investment research. Partner Pass members and subscribers to *The Big Secret on Wall Street* receive updated analysis and active recommendations. For the latest updates on our open positions, please visit our live portfolio link [here](#).

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Cashing In at the Courthouse

How To Profit From the \$7 Billion Leader of Financial Litigation

Charlotte and Julian Savage couldn't drink their own tap water anymore.

The elderly North Carolina couple once operated a small but thriving farm. But in the early 1990s, a Smithfield Foods pork-processing plant came to town... and a cocktail of pig poop, rotten meat, and toxic chemicals started flowing downhill into the Savages' well water and through their bathtubs and kitchen spigots. "I try not to drink it," Charlotte said. "We mostly just drink drinks, sodas and things."

Six inches deep in Smithfield runoff, Charlotte and Julian's farm crops eventually withered and died. By 2006, when *Rolling Stone* interviewed them, the couple were hiding indoors most of the time to avoid the downwind factory smell, which had knocked Julian unconscious in their front yard one day.

Julian's take on Smithfield's chemicals was simple: "(Y)ou go out and smell it one time and your ass is gone."

We've all heard horror stories about what goes into the hot dogs. And Virginia-based Smithfield Foods – the world's biggest pork producer, which processes over 18 million pigs a year for customers in 40 countries – generates a lot of hot dogs and a *whole* lot of horror stories.

In addition to its waste-filled drainage pools (euphemistically termed "lagoons"), Smithfield is frequently in the crosshairs for animal cruelty. Pigs don't have easy lives or deaths at the pork factory... and undercover activists document everything from unsanitary birthing pens to "gas chambers" that slowly suffocate pigs before slaughter.

As I (Porter) have written before, [I love meat](#). I *don't* love pig torture or toxic waste. (And judging from a spate of high-profile lawsuits, settlements, and pork-plant closures in recent years, other folks feel the same way.) But abused sows and chemical-soaked farmland aren't the whole story at Smithfield Foods.

Smithfield (and many other Big Pork stalwarts) have a secret, life-saving side gig... one that squealing activists conveniently ignore.

I'm willing to bet many PETA (People for the Ethical Treatment of Animals) folks have never visited this unobtrusive office-park-style building near Cincinnati, Ohio...



This is Smithfield BioScience, a lab that repurposes extra pig parts (the kind that are too gross even to make it into hot dogs) to try to save human lives.

Pig glands, mucosa, skin, organs, and tissues (known as “offal,” or refuse) make for bad bacon, but good medicine. All told, around 20 vital medical products come from pigs – which are genetically closer to people than many of us would like to acknowledge.

In its modest Ohio lab, Smithfield processes pigs’ intestinal mucus to create the life-saving anticoagulant heparin... harvests an effective arthritis treatment from piggy pituitary glands... peels off pigskin to use as wound dressings... and pops out healthy pig heart valves to replace faulty human ones. Johnsonville, the largest sausage producer in the United States, runs an in-house medical lab, too. So do a score of other major hog farmers.

Turns out, Big Pork isn’t so “offal” after all.

That’ll Do, Pig

This story starts with the battle for the heart and soul of the American pig – a battle for the heart valve, anyway. And most importantly, the “Fixer” who stepped in and restored justice.

You likely know someone with a pig-heart-valve replacement. Pig valves work better than mechanical valves for many older heart-disease patients, because the organic tissue means patients don’t have to take side-effect-heavy blood thinners like warfarin.

The implant procedure, known as TAVR (transcatheter aortic valve replacement) has been around since the late 1960s, and hasn’t changed much since then. The pig valve... sourced from places like Smithfield Foods... is painstakingly sewn onto a round framework, snaked up through the femoral artery via catheter, and then inflated in place once it reaches the right spot.



The trouble was, for many years, once TAVR valves reached Destination Heart, they inflated *instantly*, like an umbrella with a broken spring. There was no adjustment, no second chance – just a “pop” and a prayer. If the valve didn’t unfurl correctly, the patient faced instant complications, and possibly open-heart surgery (which the TAVR procedure aimed to avoid in the first place).

That’s the problem that Colibri Heart Valve, LLC, a small, private Colorado research company, set out to solve in the early 2000s. In 2002, Colibri filed several original patent applications for a “controlled release” mechanism that would let doctors gradually insert and adjust the pig valve.

And then, mega medical-device corporation Medtronic stole their idea.

Sometime in 2014, Medtronic employees attended a Colibri presentation that included slides about the proprietary controlled-release mechanism. The Medtronic crew signed a non-disclosure agreement, but apparently took great notes.

Lo and behold... later that year, Medtronic came out with a TAVR controlled-release system called CoreValve. It worked the same way as Colibri’s, and the language used to describe it came straight out of Colibri’s playbook. The invention netted Medtronic billions of dollars... and Colibri got nothing.

It was a cut-and-dry patent-infringement lawsuit, but Colibri didn’t have the money to sue. What could a tiny private company do against a \$31 billion publicly traded biotech powerhouse?

The only thing they *could* do: They called the Fixer.

The Fixer is the leading global provider of *litigation financing*... a large company that funds lawsuits and then, when it wins, takes a cut of the payout. You might think this sounds like the Mafia, and you’re not wrong. But it’s an extremely effective business model.

Think of it as the venture-capital approach to lawsuits. Like venture capital companies, which fund small startups and cash in on their eventual success, litigation finance can turn a small investment into a super-sized payday.

In Colibri's case, the Fixer funded a top-notch legal team, handled the grueling three-year patent-infringement lawsuit... and, in 2023, left the mega medical-device company with egg (and ham) on its face.

At the end of a seven-day trial, a jury found Medtronic guilty of patent infringement and ordered it to pay Colibri \$106.5 million in damages. That's peanuts to Medtronic, of course... but to the little Colorado research company, it was huge.

Way to bring home the bacon.

Of course, the Fixer has far bigger cuts of meat to fry. In 2015, the firm purchased the legal claims to sue a South American country for the improper nationalization of an oil company in 2012. It spent \$16 million acquiring a portion of claims, plus another \$50 million waging a long legal battle on behalf of its clients.

In 2023, a U.S. federal judge awarded *\$16 billion* in damages for the case, which remains ongoing. We estimate the company could ultimately receive \$2 billion to \$3 billion for its share of these damages.

The best part: the Fixer is valued at just \$3.3 billion today. And the potential multibillion-dollar windfall represents just one winning ticket within the company's portfolio containing over 800 legal claims. This is the company we are highlighting in this issue.

The Lucrative Business of Lawsuits

The company is **Burford Capital (NYSE: BUR)** – incorporated in 2009, in the Bailiwick of Guernsey, a self-governing jurisdiction of the United Kingdom. Burford's U.S.-based co-founders, Christopher Bogart (CEO) and Jon Molot (CIO), work primarily from New York City and Washington, D.C.

Burford is the world's largest provider of litigation finance, managing a \$7.1 billion portfolio of assets. These assets include a variety of legal claims the company has acquired and agreed to fund. The business is highly profitable and capital efficient. In 2023, \$1.1 billion in revenue and \$611 million in net income, representing a world-class 55% net income margin.

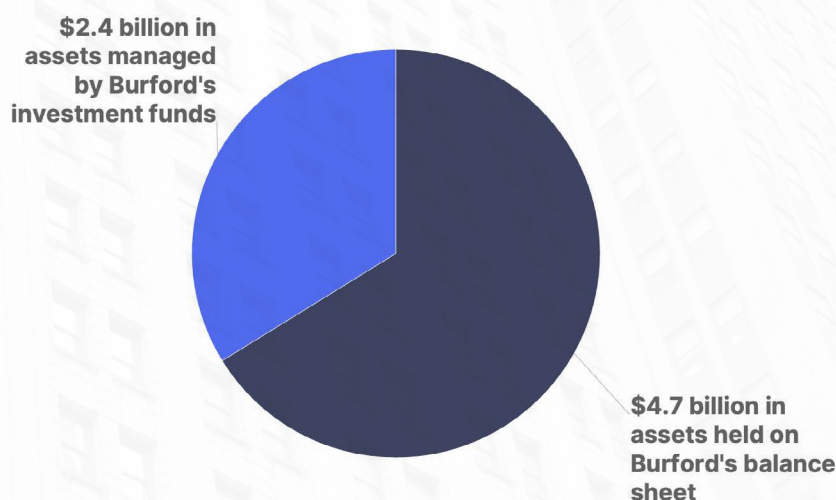
The company provides litigation financing in two ways.

The first is through its own balance sheet, which contains \$4.7 billion in legal assets. These assets include settlements of legal cases that are currently paying out cash that Burford can use to fund future cases. They also include cases still in litigation that have an estimated value that can be used as collateral to borrow funds.

These include cases like a \$140 million portfolio of antitrust claims Burford acquired from global food distributor Sysco in 2023. These lawsuits were filed against a group of meat suppliers – the suits allege that the suppliers conspired to illegally inflate prices over many years. For cases funded through Burford's balance sheet, the company takes on all of the risk and captures all of the potential upside from capital invested in pursuing legal claims.

Burford also finances litigation through an asset-management business, which manages \$2.4 billion across nine private funds. Following this path, Burford allocates investor capital into the same types of cases it funds through its own balance sheet. The difference is that the investors take on all of the risk, and Burford captures a smaller portion of the upside. On this capital managed for investors, the company earns management fees and a percentage of the returns generated – typically a 2% annual fee on assets, plus 20% of profits.

Burford's Asset Management by Segment (2023)



Source: Bloomberg / Data as of Q3 2023

Burford benefits from this dual-pronged, capital-allocation approach in two ways. First, it allows the firm to manage its risk more effectively when tackling large cases. Some of Burford's biggest clients bring a portfolio of cases – like the group of antitrust lawsuits mentioned earlier that Sysco filed against its meat suppliers – that can require hundreds of millions of dollars in funding for research, pre-trial maneuvering, and ushering each case through the legal system. Instead of putting all of its own money at stake, Burford can share a portion of the risk with the investors in its managed funds.

This risk transfer – and larger capital pool – in turn allows Burford to take on cases that many of its smaller competitors can't invest in. Burford's primary competition comes from small to mid-sized hedge funds, as well as several publicly traded asset-management firms. The largest of these competitors, Australia-based Omni

Bridgeway, has \$1.7 billion of balance-sheet capacity and generated \$56 million in earnings in 2023, or roughly one-tenth of what Burford generated.

Next, let's examine the value Burford provides for the clients it partners with in pursuing litigation.

Capturing Upside by Limiting Downside for Law Firms

Burford primarily deals in legal cases for corporations, and avoids pursuing litigation claims involving individuals (like personal-injury cases, for example).

It pursues these claims through one of two pathways.

1. Burford partners with a law firm that has an existing arrangement with a corporate client to pursue a legal claim on a contingency basis. Contingency means the law firm doesn't get paid unless it wins.

For law firms, contingency cases can create substantial cash-flow challenges and financial risks. These firms must pay their high-priced lawyers and overhead costs out of their own pockets – potentially for years before resolving a case – prior to receiving payment. And if the litigation attempt fails, they aren't paid.

Most law firms are privately held, with limited access to outside capital. Thus, they often don't have the funds or risk tolerance to pursue large contingency cases that require millions of dollars up front. Burford can address this capital need and shoulder the risk burden, in exchange for getting a substantial cut of the future awards from litigation – which is typically around 50% of the proceeds from successful case resolutions.

2. Burford also assumes the funding for legal claims from corporations directly. In these cases, Burford provides the capital for a third-party law firm to pursue litigation in exchange for a share of any potential payout. In certain cases, Burford also pays a one-time upfront fee that allows corporations to immediately get paid for their legal claim. In exchange, Burford will take an even larger percentage of the future payout (up to 100% in some cases).

These corporate clients range in size and sector – from small private manufacturing firms to \$50 billion publicly listed food conglomerates.

On one end of the spectrum are businesses that can't afford the cost of litigation – like Colibri Heart Valve, which we mentioned earlier, or, say, a cash-strapped technology startup defending against intellectual-property infringement from a competitor. Or a small manufacturing company that was forced into bankruptcy due to faulty equipment from a vendor. These companies have potentially valuable legal claims but little or no cash to pursue them.

On the other end of the spectrum are larger, publicly traded corporations that have the funds to pursue legal action, but whose stakeholders might consider it a poor use of capital. The investors, analysts, and corporate boards of these companies might frown upon seeing cash flow diverted to legal expenses – and for good reason.

In fact, a public company's share price can suffer as earnings sink from the expense of a years-long legal battle. Meanwhile, the market typically won't assign any value to a potential future payout, nor will it even price into a stock the positive impact from a one-time legal victory. Thus for many corporate managers, putting money behind litigation is all downside and little upside.

Burford solves this problem by taking on all of the risk and all the financing needs of litigation. Plus, the upfront fee – a guaranteed cash payment – provides an added incentive for corporations. Instead of getting penalized for diverting resources toward costly litigation with an unknown outcome, Burford enables corporations to immediately get paid for what can be a hidden asset on their balance sheet.

Thus, Burford acts as both a capital provider and a risk reducer for law firms and corporations. In exchange, both parties are happy to surrender a significant portion of the potential upside to Burford.

Burford manages the risk it incurs from funding these claims through several mechanisms. As mentioned earlier, the company transfers a portion of cases to investors, through its asset-management arm. This allows the company to spread its exposure across a highly diversified portfolio of hundreds of lawsuits. It also manages risk through rigorous due diligence, drawing upon its hundreds of successfully completed cases to accurately estimate the timeline, costs, and potential rewards of litigation. And it only selects a minority of cases that meet a high threshold of prospective returns.

This allows Burford to minimize the impact of the inevitable losses. Meanwhile, its diversified portfolio provides many shots on goal to capture the outsized winners.

The end result is a lopsided risk/return proposition, with limited down risk and substantial upside.

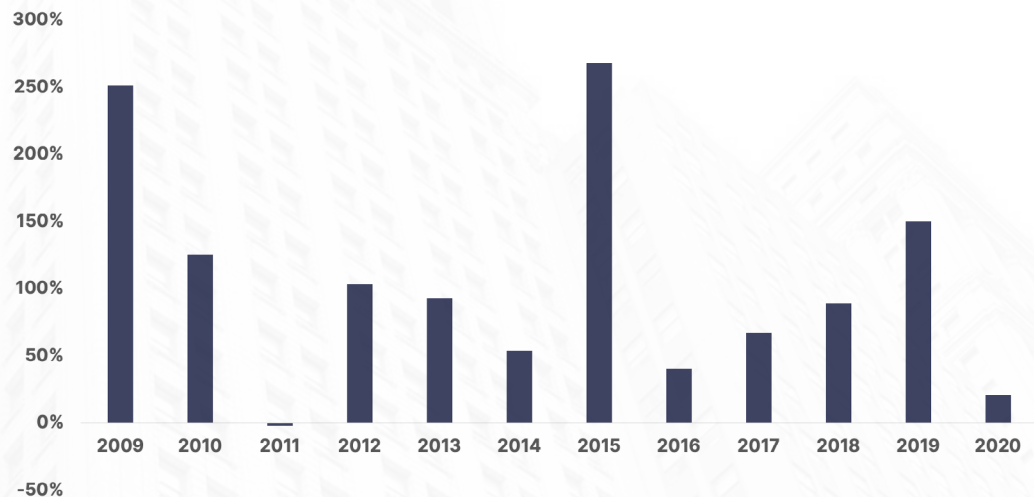
Burford's Asymmetry: High Returns, Limited Risk

Since its inception, Burford has earned profits on 84% of the total capital deployed. For the 16% of capital deployed that resulted in losses, Burford recovered 32% of the invested capital. The majority of its capital (58%) has generated returns ranging from 0% to 99%. On 12% of deployed capital, Burford has earned returns between 100% and 199%. And on 14% of its capital, the returns have exceeded 200%.

Importantly, these returns aren't the result of a one-off outlier success. The company has delivered the same "win big, lose small" return profile consistently throughout its history.

The table below shows a comprehensive list of Burford's return on invested capital ("ROIC") earned from concluded cases for each year of its history (referred to as "vintage year" returns) through 2020. Because less than 5% of cases initiated after 2020 have been resolved, we exclude the 2021-2023 vintage years – Burford's average time of litigation across its portfolio is 2.5 years.

Burford ROIC by Vintage Year



Across all vintage years, through 2020, Burford has achieved an average of 105% ROIC since inception. The only losing year was in 2011, when it generated a loss of 2% ROIC. This shows that Burford consistently generates outsized returns, while keeping downside limited.

Next, let's dive deeper into Burford's investment process to see how it achieves these results.

Carefully Calculating Returns

As with any successful investment approach, Burford's search for legal assets begins by turning over a lot of rocks. The company analyzes 1,000 to 1,500 cases each year, ultimately selecting 4% to 8% of the most compelling opportunities.

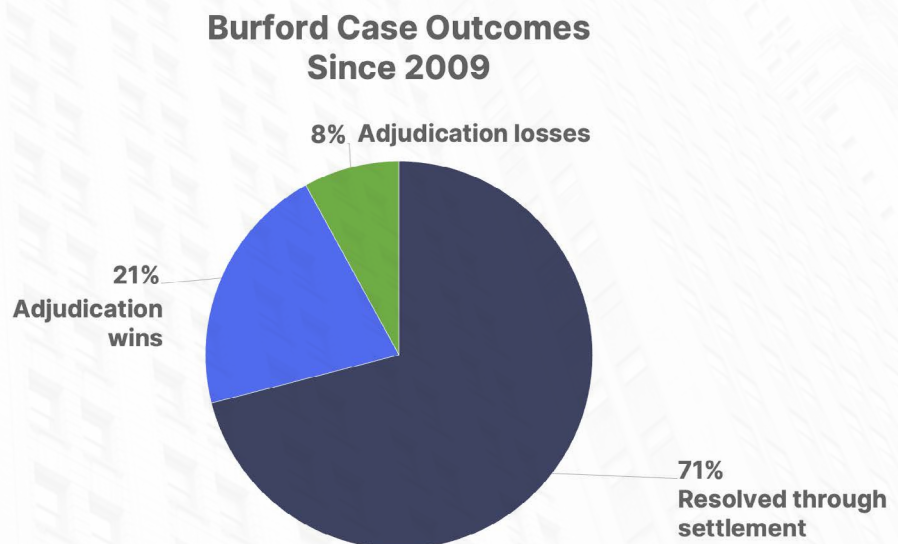
The company performs both legal and financial due diligence on each potential case. The key factors at play include the estimated odds of successful litigation, the potential payout, and the expected time and expense of pursuing each case. Burford requires its team of legal and financial analysts to submit lengthy written arguments on the merits of each opportunity to an investment committee. It also uses proprietary software that draws upon data from prior cases to help inform the outlook for future cases.

Burford's investment committee makes the final decision on whether to proceed with a case, as well as the terms of the proposed payment structure it will submit to clients. The payment structure can vary significantly from case to case, but Burford aims to achieve a return on capital of 80% to 90%. It also calculates an internal rate of return ("IRR") target, which factors in a discount rate and the anticipated time between outlying capital and receiving cash back. The company targets IRRs in the mid-20% to low-30% range.

The same due diligence and return thresholds apply regardless of whether funding comes from Burford's balance sheet or through its asset management arm.

When Burford and its client agree to proceed with a legal claim, a case typically resolves in one of three ways: settlement before it reaches adjudication, when a judge or jury issues a ruling; a win from adjudication; or a loss from adjudication.

Since Burford's inception, the company has resolved 71% of cases through settlement, 21% from adjudication wins, and 8% through adjudication losses.



Source: Company filings

In cases that resolve through settlement, the litigation will proceed through a series of preliminary legal steps like discovery, depositions, and pre-trial hearings. But before reaching the final stage of argument before a judge or jury, the opposing parties chose to end litigation for a mutually agreed upon monetary award.

Settlements generally result in smaller rewards than cases won through adjudication. But they also come with several advantages, including: 1) fewer legal expenses devoted to the case, 2) removal of any risk associated with going to trial, where the case can be lost, and 3) a shorter time frame between deploying capital and earning a return.

Since Burford's inception in 2009, the company has deployed \$937 million into cases that ultimately settled. It received a total of \$1.5 billion in rewards from these cases, translating into a 60% ROIC. The average litigation time for these settled cases is 2.2 years, delivering a 22% IRR.

Adjudicated cases required \$392 million of the capital Burford has deployed since inception, or 30% of the total. These cases proceed through all litigation steps to a final trial or arbitration hearing, resulting in either a win or loss. In the event of a

loss, Burford typically loses 100% of the capital invested. In some losing cases, the deal terms allow Burford to earn a nominal recovery of capital from its clients.

Since Burford's inception, \$278 million of the \$392 million allocated toward adjudicated cases have resulted in a win. These investments have generated total cash proceeds of \$965 million, or a 247% ROIC. The average litigation time is 2.9 years, translating into a 49% IRR.

The remaining \$114 million in cases resolved through adjudication have resulted in a loss. Burford ultimately recovered \$18 million in cash, or a -84% ROIC.

Across its entire portfolio of completed cases, Burford has deployed \$1.3 billion and received cash proceeds of \$2.5 billion since inception – \$1.2 billion over and above what it invested. This translates into a comprehensive ROIC of 87% and a 27% IRR.

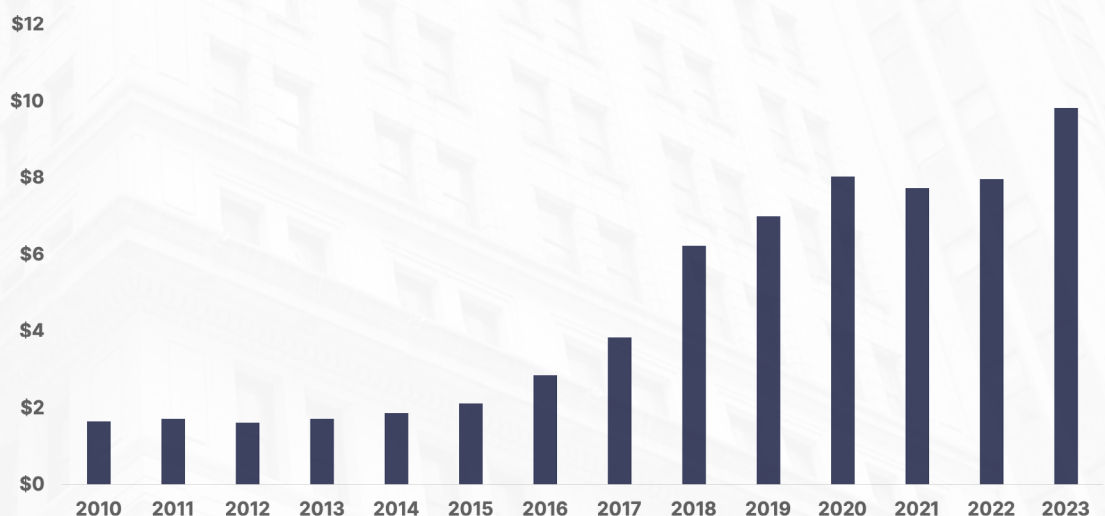
The IRR is a useful metric because it indicates the rate at which Burford can compound capital.

If Burford could immediately recycle every dollar earned into new cases, a 27% IRR would translate into 27% compounded growth in capital. However, as with any investment process, there's a time lag between generating returns and finding the next opportunity for capital deployment.

Since its inception, Burford has done an excellent job recycling capital into new opportunities and increasing its asset value. This shows up in the company's rapid growth in book value – the total value of its assets, net of liabilities. Burford's book

value has increased from \$1.60 per share in 2010 (its first full year in business) to \$9.85 per share by the end 2023. That works out to a compounded annual growth rate of roughly 15%.

Burford's Book Value per Share



Recession-Proof, But Not Pandemic-Proof

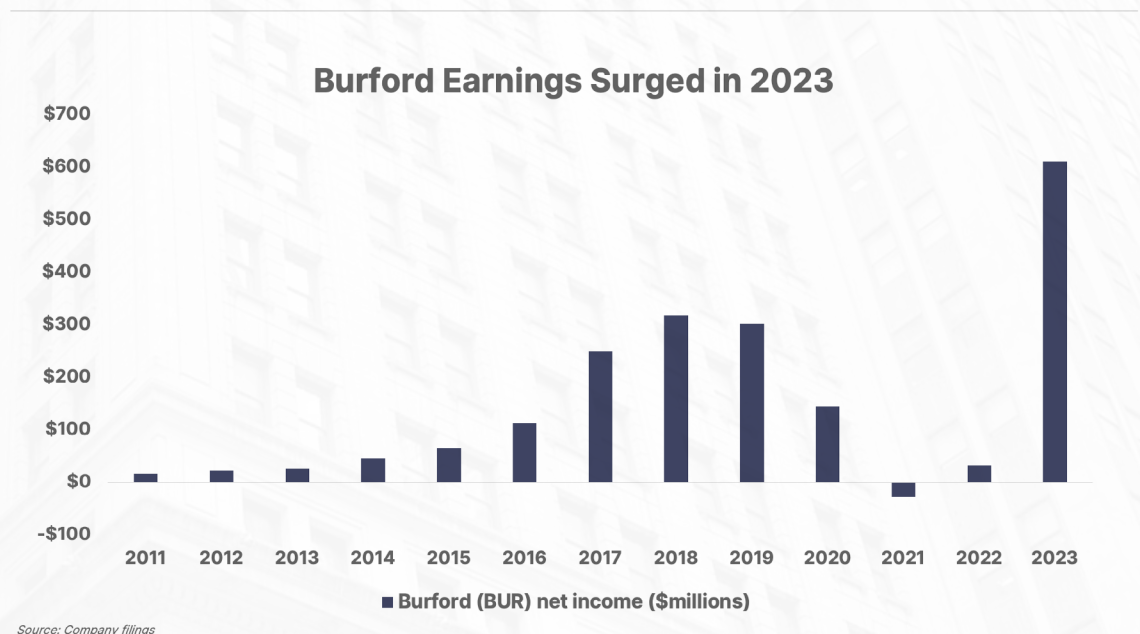
One of the attractive features of Burford's business model is that it's not correlated to overall economic growth or financial market volatility. The primary driver of Burford's book value and earnings growth is the ability to deploy capital into legal cases, and push those cases through the legal system. Since the number of legal cases it can invest in does not rise or fall with the overall economy, this makes Burford the ultimate recession-proof business model.

But the last few years have shown that Burford is not pandemic proof. When the COVID-19 lockdowns struck, court systems around the world ground to a halt. Many were shut down completely, while others operated at a fraction of their normal capacity due to social distancing and other health precautions.

This caused a sharp drop off in the amount of capital Burford could put to work, which fell by nearly 50% from \$481 million in 2019 to \$257 million in 2020.

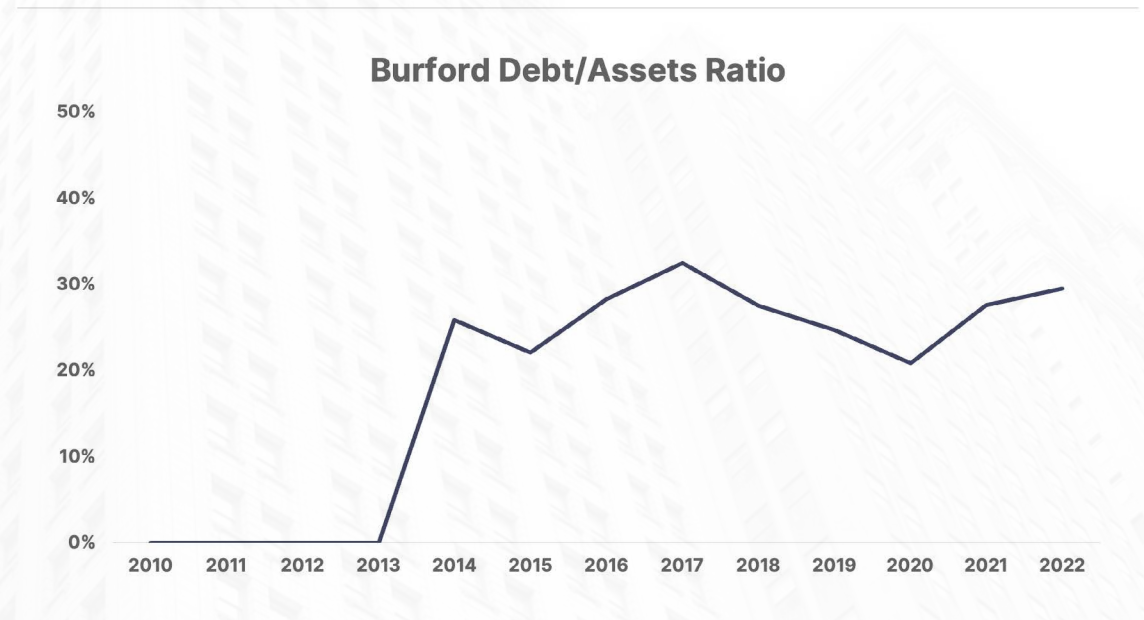
But even after courts gradually reopened, litigation progress was slow, plagued by a long backlog of cases. As a result, Burford's earnings fell from \$301 million in 2019 to a loss of \$27 million in 2021.

As the courts began clearing their backlogs, Burford's earnings moved into positive territory by 2022. In 2023, earnings surged to a new all-time high of \$610 million.



Absent the one-time loss from a global pandemic, Burford has been consistently profitable since 2011, when its first cases originated in 2009 and 2010 began to be resolved. Since then, the company's net income has grown more than 30-fold, from \$15 million in 2011 to \$610 million in 2023.

Burford has achieved this impressive growth while maintaining a conservative balance sheet, measured by its favorably low debt-to-asset ratio. Since inception, Burford has kept its debt-to-asset ratio below 50%, meaning it has less debt than assets:



Culture, Leadership, and Litigators

Burford's conservative approach to the business is a reflection of its culture, and of the fact that the insiders benefit personally if the company succeeds. Every employee owns shares of Burford stock, including its two co-founders who each own roughly 4% of the company. As a whole, insiders at Burford own 10% of the business, collectively making them the company's largest shareholder.

In a [2021 interview](#), Burford co-founder and CEO Christopher Bogart explains how this heavy insider ownership translates into a culture focused on steady, profitable growth, while maintaining a conservative leverage profile:

"We're employee owners of this business. We use a conservative leverage structure. We insist that the business be profitable. And we invest only moderately in growth, instead of explosively."

Burford's leadership is a critical part of the company's success to date.

Bogart and fellow co-founder, CIO Jon Molot, are both titans of the legal profession, with long track records of success before launching the company.

Bogart earned his law degree from top-rated Western University in Ontario, Canada. He began his career as an investment banker for JPMorgan Chase, focusing on bankruptcy workouts. In the late 1990s, he became general counsel of Time Warner. At just 34 years of age, he managed one of the largest legal teams

in the world, overseeing a team of more than 350 lawyers. He then served as CEO of Time Warner Ventures, a \$9 billion division focused on investments and acquisitions of new digital technologies.

From there, he moved further into the investment field as the managing director of Glenavy Capital, where he made venture capital ("VC") investments. He also oversaw the Glenavy Arbitration Investment Fund, an early pioneer in litigation financing, in the early 2000s.

At the time, litigation financing was a niche of the investment world, relegated to small private hedge funds. But over time, Bogart saw that litigation finance had several key advantages over the VC world. It generated the same lopsided risk/reward proposition, but with substantially shorter holding periods – two to three years versus five or more for VC investments.

Meanwhile, VC investments typically require a bull market for an exit event – where a private company is either sold or taken public through an initial public offering ("IPO"). Litigation finance, on the other hand, only relied on progress through the legal system – which occurs regardless of whether financial markets go boom or bust.

Bogart (pictured, right, below) saw the opportunity to extricate the legal finance industry out of the private fund world into a separate business, operating as a public company. In 2009, Bogart brought John Molot in to help launch Burford as the company's chief investment officer.



Molot (above, left) graduated at the top of his class at Harvard Law School. In addition to his work at Burford, he teaches at Georgetown Law School in Washington, D.C. Molot is widely cited on litigation finance in academic law journals.

Before co-founding Burford, Molot advised hedge funds and investment banks on litigation risk during mergers, acquisitions, and private equity deals. He also served as a senior advisor to the Treasury Department during the Obama administration.

Among his many achievements at Burford, Molot was the architect of a landmark U.S. case that resulted in a \$16.1 billion judgment against the country of Argentina, and one that could add billions of dollars in shareholder value to Burford.

How Burford Could Turn \$66 Million Into \$3 Billion

The case in question stems from the government of Argentina's 2012 nationalization of YPF SA, one of the country's largest oil companies. One clause in YPF's bylaws required that the government offer to purchase the outstanding shares from U.S. investors in the event of a nationalization. When Argentine authorities failed to make this offer, it effectively wiped out the existing shareholders.

At the time of the nationalization, YPF was listed on the New York Stock Exchange. This gave YPF investors the right to pursue litigation against the Argentine government in the Southern District of New York ("SDNY") – part of the U.S. federal court system.

Two of YPF's largest shareholders were investment funds Petersen Energía Inversora and Eton Park Capital Management, which together owned more than 25% of the company's shares. Petersen ultimately went bankrupt due to the loss from its YPF investment. Both companies filed suit against Argentina for breach of contract.

In 2015, Burford paid \$16 million to Petersen and Eton Park to acquire a share of their litigation claims against Argentina. It also agreed to fund the litigation, which would total around \$50 million. In exchange, Burford would receive 35% of any proceeds awarded to Petersen and 73% awarded to Eton Park.

In March 2023, SDNY presiding Judge Loretta Preska ruled that the Argentine government was at fault for failing to offer to purchase the YPF shares owned by Eton Park and Petersen. On September 28, the court ruled that the government owed damages of \$14.4 billion to Petersen and \$1.7 billion to Eton Park.

This \$16.1 billion ruling represents the single largest judgment awarded against a foreign country in the history of the U.S. legal system. In total, Burford's share of the judgment equates to \$6.2 billion.

While these rulings are a major win for Burford, it's not yet a complete victory. The Argentine government is appealing the case, and the ruling on that decision is expected in the second half of 2024. Argentina's new President, libertarian Javier Milei, recognizes that Argentina expropriated YPF illegally and that the obligation should be paid.

Still, even if the appeal goes their way, there's also the challenge of collecting the money. Argentina has defaulted on its debts three times in the last 25 years, driven by the mismanagement of its economy and finances. In 2023, the inflation rate exceeded 200%, and the company has few foreign reserves.

Most likely, Burford will need to cut a deal with Argentine authorities and accept a discount. And it will likely also need to stretch any payments out over several years, or possibly more. In which case, the payment could be feasible, even for Argentina.

Analysts from investment bank Jefferies estimate Burford will ultimately recover around \$3 billion of the \$6.2 billion judgment – roughly \$13.70 per share. For a frame of reference, Burford's entire business trades for less than \$15 per share today.

In other words, the market has assigned very low odds that Burford will collect even 50 cents on the dollar of the YPF judgment. While we agree that investors shouldn't bank on this outcome, it does represent a source of massive upside potential that's not currently priced into the shares.

Even in the worst-case scenario where Burford collects nothing from YPF, the case has already been a huge win. That's because, in order to reduce its risk, Burford already secured a triple-digit return from selling a portion of its YPF stake to other hedge funds for \$236 million. So no matter what happens from here, Burford is playing with house money on YPF.

Plus, Burford is benefitting from the massive exposure from its successful litigation of the case. The record-setting YPF judgment has resulted in more than a 400% increase in article mentions of Burford or litigation finance in 2023 from the prior year. Burford is becoming widely recognized as the market leader in litigation finance, which should set the stage for growing demand in the future.

Though it's an unusually large potential payout, the YPF case highlights a key aspect of Burford's business – volatility is a feature and not an aberration.

Big Upside Comes With Big Volatility

Burford's business model is based on its willingness to assume the risks that its clients can't or don't want to bear in pursuing legal claims. Burford charges a healthy premium for taking on these risks, and over the long run, it consistently generates high returns. Along the way, the company will incur its share of volatility from the inevitable cases that don't pan out.

As a result, the company's earnings profile is highly erratic – with big quarterly swings between outsized profits and large losses. Investors should not view Burford as a normal operating business that produces reliable earnings, as the company noted in its 2019 annual report:

"Burford is not a business for those focused on short-term profits or for those who eschew volatility and seek predictability. Quarterly earnings are both irrelevant to understanding the value of our business and outside our control. We finance large, complex commercial claims. Our cash flows come from their resolution. There is no 'normal' for such claims; they are inherently idiosyncratic. We have had cases resolve in less than a week, and we have matters from 2010 still going strong. That is the opportunity in our business, and it is why we are able to generate the returns we have historically delivered. If litigation were predictable as to outcome and duration, banks could finance it; there would be no need for Burford."

For investors who can look past short-term earnings and share-price volatility, the opportunity is vast.

The Dominant Leader in a Large, Fast-Growing Market

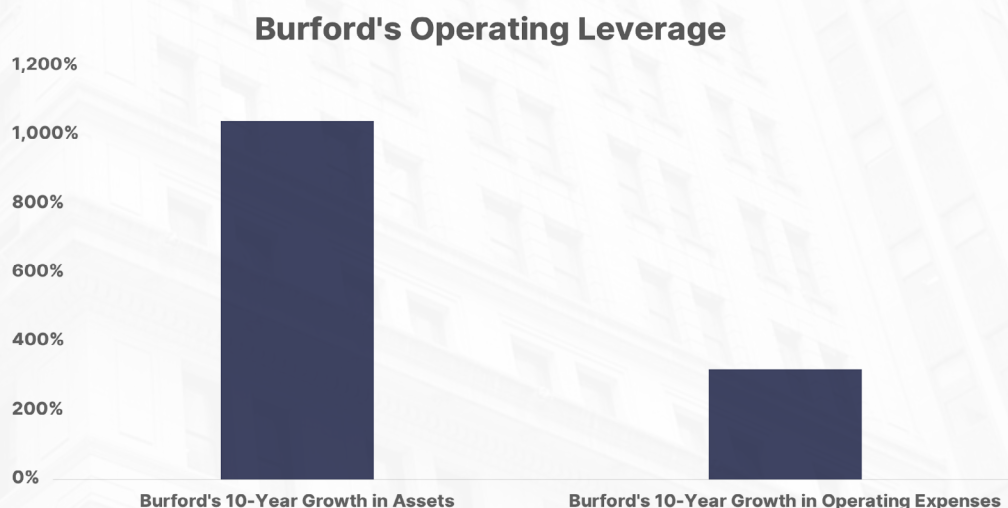
Litigation finance is still in its infancy. Burford is the largest player by a wide margin, and yet its \$7.1 billion portfolio of assets represents a small fraction of the total addressable market. Each year, \$1 trillion is spent pursuing litigation, and a substantial portion of this spending goes to contingency-based cases that Burford could take on.

The scope of opportunity among its corporate clients could be even larger. Today, there's an unquantifiable amount of potential legal assets sitting idle on corporate balance sheets going unmonetized – mainly because of the risk and cost involved in chasing the claims. Burford's research indicates that a majority of corporations have claims worth \$20 million or more that have not yet been pursued.

A decade ago, most corporate executives didn't realize companies like Burford existed. But that's begun to change. Burford has brought greater awareness to the industry through its success in high-profile cases, like the YPF deal, which generated headlines across the financial and business media. With awareness growing, the number of legal claims Burford sources directly from corporations has grown more than 10-fold over the last decade, and now represents half of its total business.

These corporate clients allow Burford to put more capital to work at a time, with some clients offering deals with dozens of related claims in one case. When Burford first started out and dealt exclusively with law firms, the average case size was less than \$10 million. Today, it has single corporate clients with case sizes exceeding \$300 million.

Undertaking larger corporate cases has allowed Burford to gain tremendous operating leverage. The same lawyers and financial experts that once litigated \$10 million cases can now tackle \$100 million cases. As a result, over the last 10 years, Burford's asset size has grown at nearly three times the rate as its operating expenses:



This is contributing to Burford's expanding profit margins, which came in at a record 76% in 2023. Meanwhile, as Burford grows larger, it's also creating a powerful competitive advantage over its peers.

Brand Power, Scale, and Data Create the Ultimate Competitive Edge

Over the last three years, Burford has grown its total portfolio more than 50% per year. Its total balance-sheet capacity of \$8 billion exceeds that of its next closest competitor by more than four-fold. This means Burford can take on larger cases that its smaller competitors can't afford to touch. Its dominant size also means clients can have faith in Burford's access to its own funds or those of its investors to make good on its promises to back their litigation claims.

Plus, as Burford logs more wins, it's establishing a track record of success and wider brand-name recognition. Burford counts 94% of the top 100 law firms in the U.S. as previous clients. And in a survey among lawyers, 86% of respondents identified Burford as either the leading or the only litigation financier by name.

Finally, Burford's biggest competitive advantage lies in its unmatched data set for underwriting deals, and one that its competitors can't replicate.

Recall that Burford settles roughly 70% of its cases. This is common throughout the industry, as most legal cases end in settlement. In jurisdictions like the Southern District of New York, for example, 90% of cases end in settlement. By law, most of these settlements are confidential.

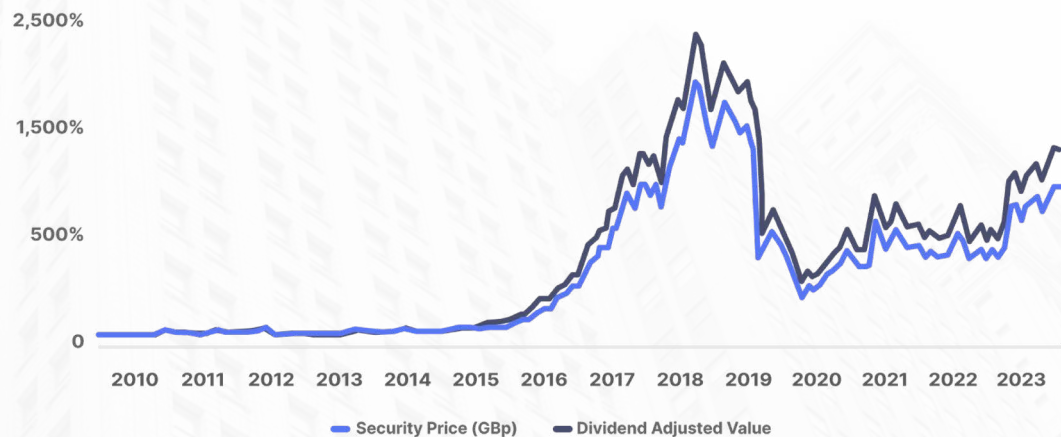
This means that the payouts resulting from these settlements remain sealed. Estimating the payoff is a critical part of the underwriting process. Because Burford has been involved in so many settled cases over the last 14 years, it has insights into both the payoff and costs involved that few others do. Burford feeds this information into its proprietary modeling software, which helps it make competitively priced offers to clients, while ensuring it is properly compensated for the risks incurred.

Any new entrants hoping to compete for cases in jurisdictions like SDNY are forced to underwrite business without knowing 90% of the outcomes. Poor underwriting ultimately means either taking on too much risk, or setting the wrong price.

Burford's brand power, scale, and its data insights are all structural advantages that become more powerful as the company grows larger and completes more cases. It's also bringing more awareness to the industry, helping unlock the potential of the overall market. That gives us confidence that the company can continue delivering world-class returns and maintain high rates of growth.

Since first going public on the London Stock Exchange in October 2009, Burford has generated a total return of 1,383%, or a compounded annual gain of 21%.

Burford's High Rates of Return



Source: Bloomberg

This chart shows Burford's trading history on the London Stock Exchange, which began in 2009. Burford also began trading on the NYSE in 2020 – listed on both exchanges under the ticker symbol BUR.

Burford's dominant industry position, competitive advantages, and large addressable market indicate a long runway ahead for profitable growth. The company's heavy insider ownership and conservative culture also gives us confidence that management will act as responsible stewards of shareholder capital.

And with the business generating over \$600 million in annual profits, it's trading at an attractive price of less than 7x earnings.

Action to Take: For the latest updates on our open positions, please visit our live portfolio [here](#).

Intellectual Compounder #5

Cold War 2.0 and the Coming Global Energy Wars

America's Rise as a Natural Gas Superpower

This is another mineral rights company that provides upside exposure to higher energy prices, but without the heavy capital requirements associated with drilling holes thousands of feet into the earth. By owning mineral rights, this intellectual compounder is entitled to receive a percentage of the oil and gas produced from the wells drilled on its acreage.

Editor's Note: Please remember, these are informational reports only. Porter & Co. is not necessarily recommending this stock, and what we present here is solely investment research. Partner Pass members and subscribers to *The Big Secret on Wall Street* receive updated analysis and active recommendations. For the latest updates on our open positions, please visit our live portfolio link [here](#).

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Cold War 2.0 and the Coming Global Energy Wars

America's Rise as a Natural Gas Superpower

CIA director William Colby sighed as he picked up the telephone.

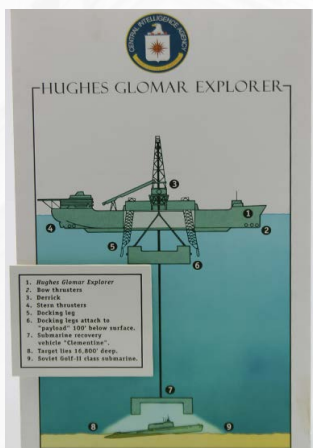
It was March 1975, and Colby had a tiresome task in front of him: Call every major national news outlet and beg them not to publish a "top secret" story... that they all already knew.

Deep in the throes of the Cold War, America's top intelligence agency had the clever idea to dredge up a sunken Soviet submarine to study its nuclear trappings.

One problem: the sub was three miles underwater off the coast of Hawaii.

How to retrieve it? Easy. Trap it in a huge globe of gas – imagine a really big soap bubble, and think of it underwater, with a submarine inside of it – and float it to the surface.

Naturally, that didn't work. So instead, the CIA built a 618-foot ship outfitted with a giant claw underneath – like an arcade prize machine. The claw itself was codenamed "Clementine."



A diagram of the ship's claw retrieval mechanism on display at the International Spy Museum.

The ungainly ship – launched under the pretense of deep-sea mining – was under construction for months. It was about as secret as Victoria's Secret. And crack investigative journalist Seymour Hersh had a full expose ready to publish in the *New York Times*.

CIA Director Colby dutifully contacted news organizations

in the know to tell them to keep quiet. As *Time* Magazine explained,

The Washington Post, NBC, ABC, Newsweek and the Washington Star all got wind of the project. In each case, after a call or visit from Colby there was a decision not to go ahead."

Eventually, with reporters pointedly excluded from the launch, the "Hughes Glomar Explorer" set to sea, dragging its massive claw like a crippled, one-armed Tyrannosaurus Rex.

And after all that brouhaha... the mission was a New Coke-level flop.

About halfway through the initial recovery operation, one of the grabber arms on the giant claw broke – and much of the just-retrieved Soviet sub sank back to the ocean floor. In the end, the CIA only recovered about 40 feet of the 300-foot vessel...along with the remains of six Soviet soldiers, whom they immediately buried again...at sea.

Hersh later released his story anyway (and went on to become a Pulitzer Prize-winning journalist over a fifty-year career). And the CIA added another entry to its long list of botched cover-ups – compounded by a botched operation in the first place.

The U.S. government has never been good at keeping secrets.

For a more recent example... take the Nord Stream pipeline.

Officially... on September 26, 2022, Russia blew up the pipeline that's the major artery for transporting natural gas from its fields in Siberia and elsewhere, into western Europe.

Russia is opening a new front on its energy war against Europe," squawked the *Washington Post*.

The Washington Post
Democracy Dies in Darkness

ENERGY

Is Putin Fully Weaponizing the Nord Stream Pipelines?

"First, it (Russia) weaponized gas supply, halting shipments, including via the Nord Stream pipeline. Now, it may be attacking the energy infrastructure it once used to ship its energy,"

the paper continued.

Following the bombing, President Biden (always a bastion of clear-headedness) announced he was working with U.S. allies to *“get to the bottom of exactly – precisely what happened.”* Never mind that it didn’t make sense for Russia to slit its own throat – that is, to blow up the vehicle of a major source of revenue.

Less than five months later, the real story came to light. (By comparison, Colby got the mainstream media to sit on the “claw ship” story for more than a year.) And, funnily enough, it was Seymour Hersh who broke the Nord Stream story, too.

Seymour, now 85, published a bombshell report on the Substack platform on February 8, 2023.

He claimed that the U.S. Navy, under authorization from President Biden, carried out the Nord Stream attack... *not* Russia.

Hersh reported that the attack was planned in December 2021 – three months before Russia launched its invasion into Ukraine. In June 2022, Hersh said, during a military training exercise, U.S. Navy divers planted remote-controlled explosives on three of the four Nord Stream pipelines. The bombs were remotely detonated three months later.

If Hersh’s reporting is accurate – and a lifetime of prize-winning exposes under his belt, including Watergate, suggest he’s rarely incorrect – the reality is that America was purposely weaponizing global energy markets. What’s more, it suggests that the U.S. was planning this energy war well before Russia invaded Ukraine, in February 2022. And the Nord Stream blowing up was just another example of misdirection (if not downright lying) by Uncle Sam.

What this means is that Cold War 2.0 is here – and global energy markets are the battlefield. America wants to replace Russian gas supplies to Europe with American shale gas, through liquefied natural gas (LNG) exports... and won’t let anything get in the way.

This reinforces one of the most important investment themes of the next decade.

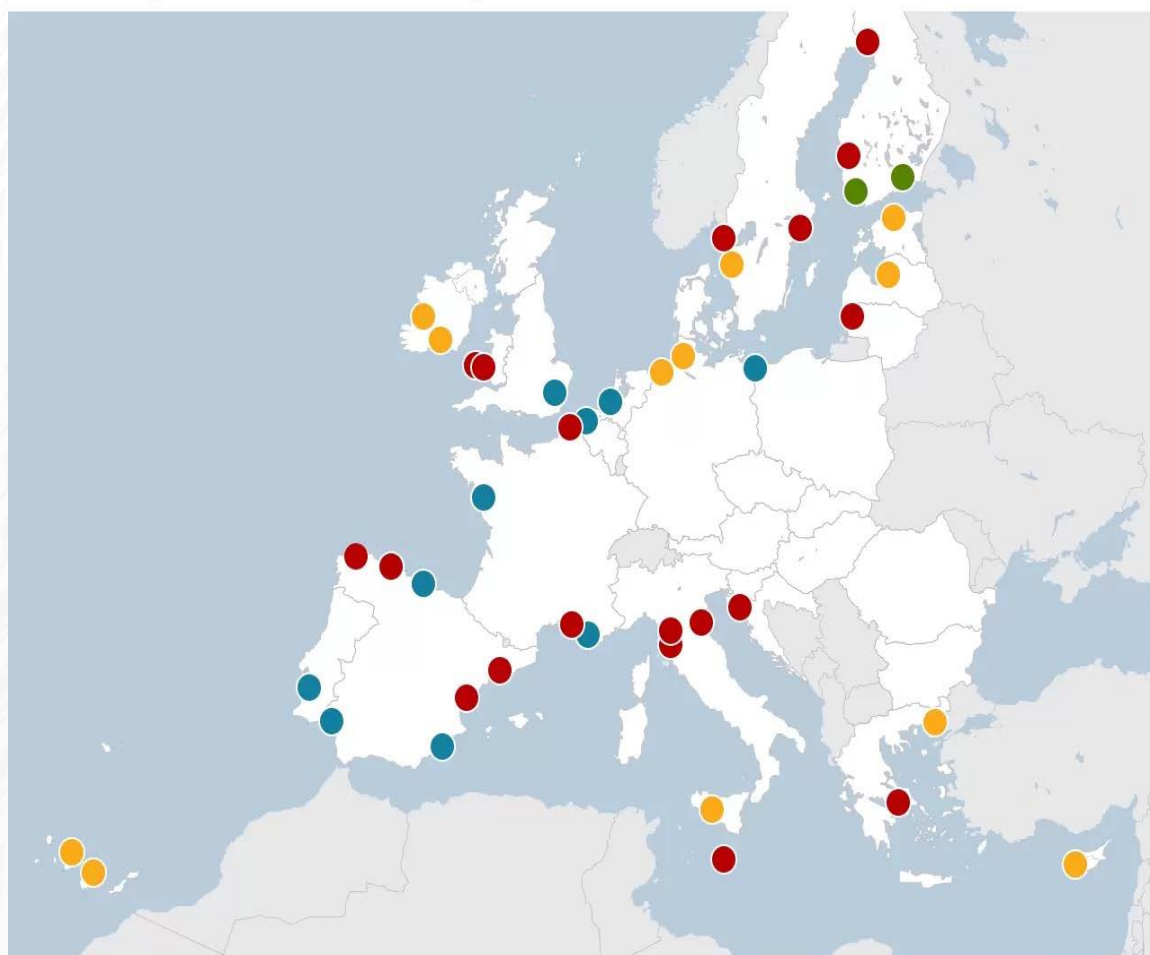
America’s Rise as a Natural Gas Superpower

Before Russia invaded Ukraine in February 2022, the European Union relied on Russia for about 45% of its natural gas. After the geopolitical flareup between Russia and the West, the EU announced plans to stop using Russian gas by 2030.

As we’ve [written before](#), this means Europe will need to source its energy somewhere else... and that’s where American LNG (liquefied natural gas) comes in.

The map below shows more than a dozen new LNG import terminals planned or under construction across the European continent, as of December 2022:

LNG ports in Europe



Terminals for LNG

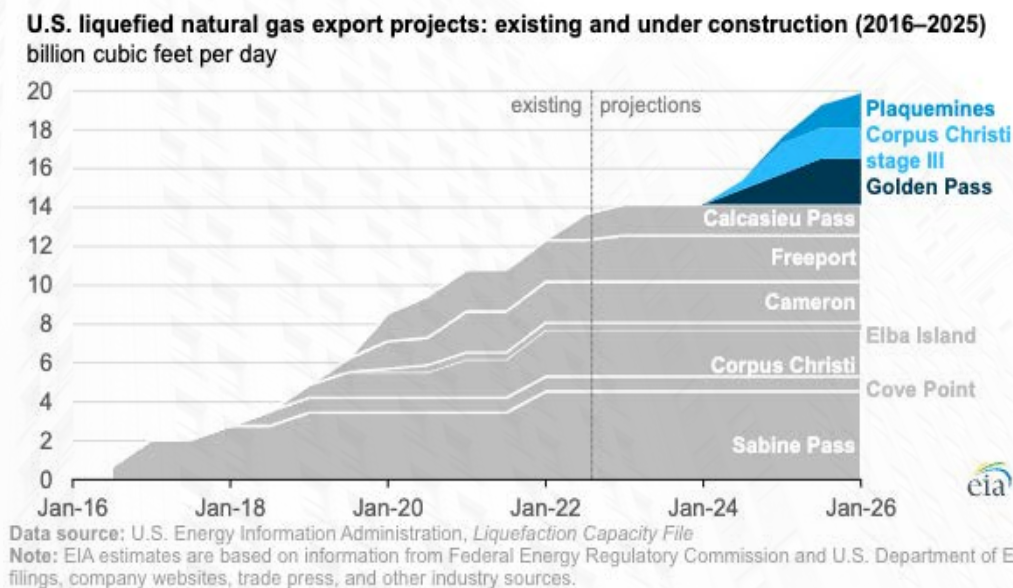
- | | |
|-------------------------------------|----------------------|
| ● Operational | ● Under Construction |
| ● Operational and expansion planned | ● Planned |

Source: European Commission, December 2022

America has the export facilities – and the plentiful shale gas reserves – to feed those import terminals over the next decade. The U.S. is the leading supplier of LNG to Europe, with U.S. LNG shipments to Europe surging by more than 137% in 2022 versus 2021.

And over the next three years, a series of new LNG export facilities will boost U.S. LNG exports by roughly 40%, from 14 billion cubic feet per day (Bcf/d) of capacity today to 20 Bcf/d by 2026.

U.S. LNG export capacity to grow as three additional projects begin construction



Moreover, a second wave of 15 U.S. export projects is officially approved and waiting on funding. These new facilities represent a combined export capacity of approximately 19 Bcf/d, or nearly 50% more than current U.S. export volumes, and we expect many of them to come online by the second half of the decade

Tellurian's Driftwood LNG terminal is one of these projects. Although the company has faced challenges securing financing for its project, the scramble to lock in low-cost U.S. LNG supplies gives us confidence that a deal will eventually get struck.

Looking beyond Europe, American LNG remains in high demand across major Asian economies, including Japan, China and India...

Earlier this month, Indian Prime Minister Narendra Modi announced plans to increase the country's share of natural gas for power generation from 6% today to 15% by 2030, by increasing its LNG imports. Indian LNG importers are now in the market for long-term contracts, and we expect other countries will follow their lead. Research from energy consulting firm Wood Mackenzie projects that the global LNG market will tighten by 2026, and grow increasingly tighter through 2033.

Tellurian is in talks to pick up some of those very contracts. (See the Portfolio Update below.)

Right now, U.S. gas prices are among the lowest in the world. But as America increasingly expands its LNG export infrastructure, U.S. natural gas prices will increasingly converge with much-higher international prices. And the companies that own low-cost gas reserves today will reap a windfall.

The bottom line: the stage is set for a supercycle in U.S. natural gas... for decades to come.

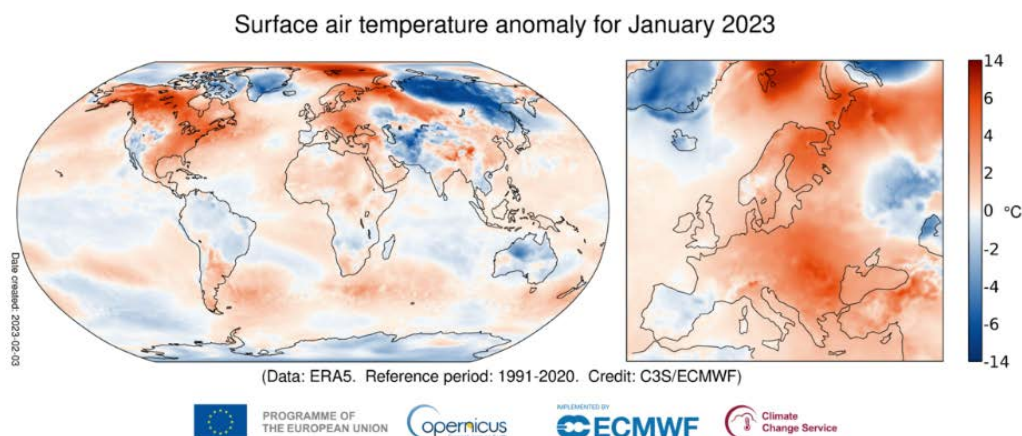
Despite this bullish backdrop in the long run, both European and American gas prices have recently fallen, thanks to a curveball from Mother Nature.

Gas Supercycle Delayed by Balmy Winter

Last winter, extraordinarily warm weather crushed natural gas demand for heating around the globe. Following a mild autumn, a record-shattering heat wave swept across Europe at the end of December. This extreme end-of-year warmth capped off the hottest year on record in France, Spain, Ireland and the UK. The European continent as a whole registered its second-hottest year on record, going back to 1950.

New Year's Day then set the tone for the rest of the month, when eight European countries broke new records for the hottest January 1 temperatures on record by wide margins. This was followed by above-average January temperatures – the single biggest month for gas heating demand – across the European continent. Meanwhile, the U.S. experienced its sixth- warmest January on record... concentrated in the heavily populated northeast, which is normally the highest-demand heating region.

The graphic below shows extreme warmth across much of the globe in January:

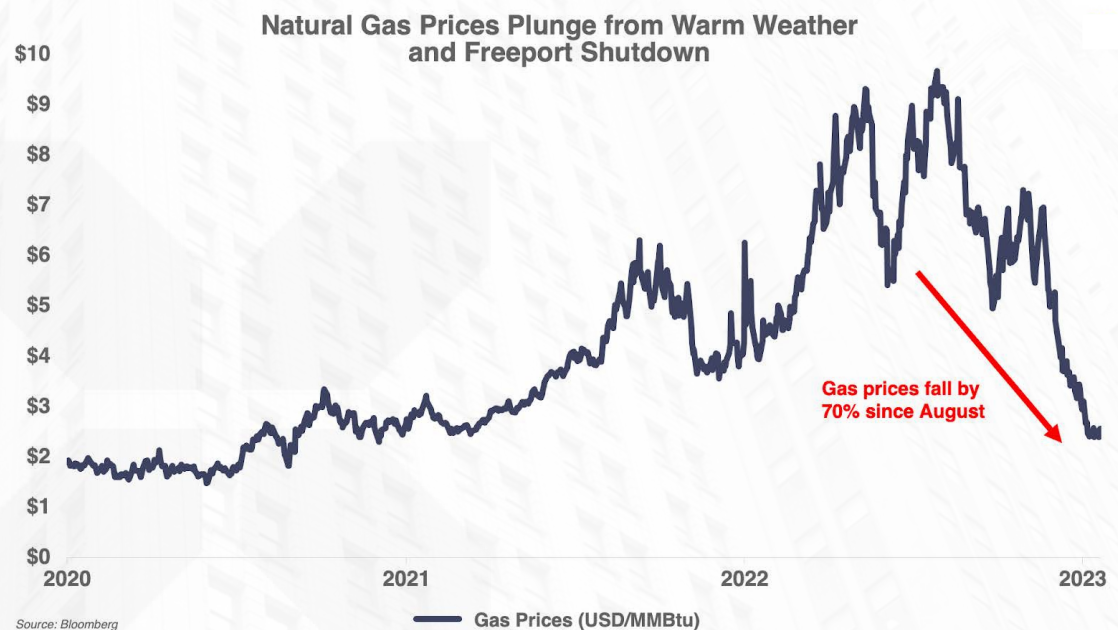


Surface air temperature anomaly for January 2023 relative to the January average for the period 1991-2020. Data source: ERA5. Credit: Copernicus Climate Change Service/ECMWF.

February followed a similar pattern, with continued extreme warmth across the globe. As a result, European gas inventories have ballooned to 66.5% of capacity, or 23.2 percentage points above the five-year average storage capacity for this time of year.

Adding a little molten chocolate to the hotcakes, the U.S.'s second-largest LNG terminal, Freeport, was shut down for months after an explosion at the facility in summer 2022. With Freeport offline, gas demand for U.S. LNG exports fell by roughly 15% from July 2022 through January 2023.

The one-two punch of warm weather, and lost Freeport demand, flipped U.S. gas inventories from a 10% deficit in July 2022 to a 5% surplus to start 2023. This sent prices reeling from a 15-year high of \$10 per million British thermal units (MMBtu) in August 2022 to as low as \$2.00 per MMBtu in early 2023.



Freeport was gradually brought back online starting in February, and reached fully operational status by April, restoring roughly 2 Bcf/d of demand back onto the U.S. gas market.

But the demand losses from extremely warm weather, amplified by the previous disruption at Freeport, have resulted in a storage overhang that will likely keep pressure on U.S. gas prices for the remainder of 2023. And that positions us for a tremendous buying opportunity in top-tier U.S. gas companies, whose shares have sold off across the board... for 2024 and beyond.

Today's Low Gas Prices Set the Stage for Tomorrow's Supercycle

Most public exploration and production companies (E&Ps) decide on their capital budgets in the first quarter of each year. Given the collapse in prices to as low as \$2.00 per MMBtu (well below break-even for many gas basins) to start the year, corporate boards will likely hesitate to outlay capital for much, if any, growth in production this year.

Here's the problem...

U.S. gas drillers *need* to grow production, and fast.

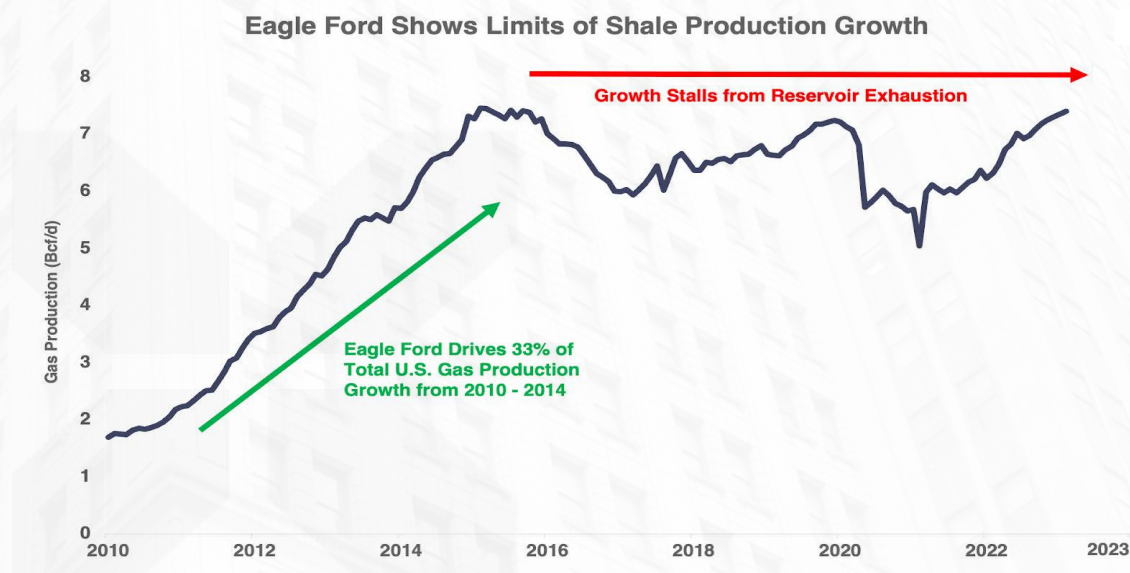
Remember all those new export facilities set to come online by the start of 2024? They all need gas to ship overseas. Absent meaningful production growth in 2023, E&Ps will need to add an average of 3 Bcf/d in 2024 and 2025.

This wouldn't have been a problem during the heyday of shale production from 2010-2019. During those years, U.S. natural gas production grew by an average of 4.2 Bcf/d.

But since then, drillers have exhausted their best drilling locations in many U.S. gas basins... and growth has dramatically slowed to just 1.3 Bcf/d each year, or a 70% decline in growth rates.

Consider the case of the formerly fast-growing Eagle Ford shale, which was responsible for one-third of the growth in U.S. gas production during the early days of the shale revolution.

The graph below shows how Eagle Ford gas production growth stalled starting in 2015. Even though gas prices reached as high as \$10 per MMBtu last year, Eagle Ford production has yet to reclaim its prior peak:



In addition to depleted resources, the oil industry is also battling the PC police. These days, draconian ESG mandates siphon money out of fossil fuels... a far cry from the shale revolution, when a virtually endless flood of cheap capital poured into the sector.

The combination of inventory depletion and capital constraints won't be solved without much higher prices.

To meet the massive new demand for U.S. gas hitting the market in 2024 - 2026, the rate of production growth will need to more than double from the previous three-year average of 1.3 Bcf/d to at least 3 Bcf/d starting next year.

That means oil prices will skyrocket no matter what. They'll either rise high enough to encourage a flood of new investment today... or shoot up later from a crippling gas shortage tomorrow.

In either case, top-tier E&P companies with leading acreage positions in low-cost basins will be the biggest winners.

EQT is one of these companies, with the dominant acreage position in the largest low-cost natural gas basin in the world – the Appalachian shale. EQT is led by two brothers – **The Gods of Gas** – who are transforming the global energy markets. In the fall of 2020, the Gods of Gas struck a huge deal with Chevron to acquire 800,000 acres in Appalachia for pennies on the dollar.

This deal was struck in the wake of the collapse in energy prices during the early days of the COVID-19 outbreak. EQT paid just \$735 million, while Chevron was forced to take an \$8 billion write-off on the same land two months prior to the sale to EQT.

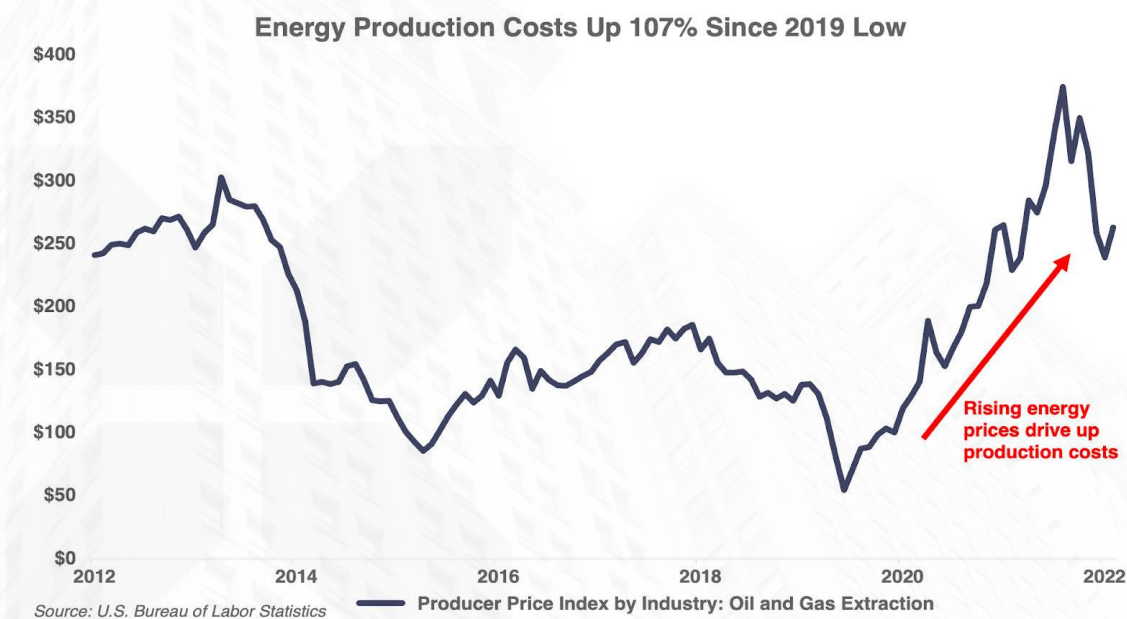
By making a big acquisition when the rest of the market was in panic, EQT set the stage for a cash flow windfall when prices recovered. In 2022, EQT returned over \$1.65 billion in capital to investors in the form of share buybacks (\$422 million), cash dividends (\$204 million), and debt retirement. With a \$2 billion share repurchase in place and the company guiding for \$12 billion of free cash flow between 2022 and 2027, EQT remains one of the best-positioned E&Ps.

EQT has recently sold off along with the temporary declines in gas prices. If you haven't bought shares of this company yet, it's a tremendous buy today.

EQT has proven to be a master of managing the commodity cycle, buying acreage cheap during bear markets (like its Chevron deal in 2020), and reaping a cash flow windfall during bull markets (like it did last year). Few other E&Ps have the discipline to act like true contrarians, and instead remain victims of the commodity cycle.

One of the challenges in the E&P business model comes in the form of heavy capital requirements. Drilling thousands of feet into the earth to tap oil and gas deposits is an expensive proposition. (We are reminded of the CIA's ill-fated claw operation.) And because each well begins depleting shortly after it's tapped, E&Ps are constantly on the capex treadmill.

During an inflationary environment, the cost of everything rises – including the inputs that go into drilling oil and gas wells. We're seeing this dynamic at work today, where rising energy prices have weighed down E&Ps with higher input costs.



Today, we're introducing a business model that offers the best of both worlds. This company provides upside exposure to higher energy prices, but without the heavy capital requirements associated with drilling holes thousands of feet into the earth.

Instead of drilling for oil and gas, this company owns the mineral rights to the land upon which other E&Ps drill their oil and gas wells. By owning mineral rights, this company is entitled to receive a percentage of the oil and gas produced from the wells drilled on its acreage.

The beauty of this royalty model is that it produces cash flows from oil and gas production, but without putting up any of the capital required to drill those wells.

These low capital requirements make energy royalties one of the most capital efficient businesses you'll find anywhere. **In September** 2022, we recommended an energy royalty company focused primarily on oil in the Permian basin. Today, we're doubling down on this business model, with an energy royalty company focused primarily on natural gas.

This company has a dominant acreage position in the heart of America's two fastest-growing gas basins. While other regions like the Eagle Ford have exhausted their core acreage, these basins are firing on all cylinders today. In each case, these basins barely suffered a hiccup during the COVID-19 meltdown in energy prices, and have since set new all-time production highs.

Best of all, the management of the company we're recommending today has a lot of skin in the game (insiders collectively own more than 25% of the business). They have proven to be world-class capital allocators, by establishing a leading acreage position in some of the most prolific gas basins in America. They manage

the business like it's their own, using very little debt and pursuing a conservative hedging program that protects the downside.

Despite the recent collapse in gas prices to around \$2 per MMBtu, this company will be earning more than \$5 per MMBtu on the majority of their 2023 production, thanks to their proactive hedging program.

That's how, despite the recent collapse in U.S. gas prices, the company just announced an increase in its distribution, and now sports a juicy 12% yield.

The Perfect Way to Play the Coming Natural Gas Supercycle

Black Stone Minerals (NYSE: BSM) is one of America's largest oil and gas mineral owners, with an asset base spanning 20 million gross acres across 41 U.S. states. The company has an estimated reserve base of 60 million BOE (barrels of oil equivalent), made up of 68% natural gas and 32% oil reserves.

Importantly, Black Stone is structured differently from standard equities. It's a master limited partnership (MLP), which means that an investor purchases "units" instead of shares, and receives "distributions" instead of dividends. Also, investors who buy MLPs are considered limited partners in the business. This unique business structure brings tax benefits, but also potential complications come tax time.

MLPs are considered "pass-through" entities, which means they pass through cash flows and tax liabilities to their limited partner investors. This is different from a regular corporation, which pays corporate taxes, and acts like a separate entity from the investor. The pass-through structure means MLPs avoid corporate taxes. Instead, the investors (as limited partners in the business), are responsible for their portion of the company's taxes.

So at tax time, investors receive a K-1 form instead of the more common 1099 form for stock dividends. While K-1s are more complicated than 1099s, most tax software programs are set up to process these forms in a matter of minutes these days.

Historically, Black Stone focused on making two types of acreage acquisition deals: purchasing both royalty interests, and working interests.

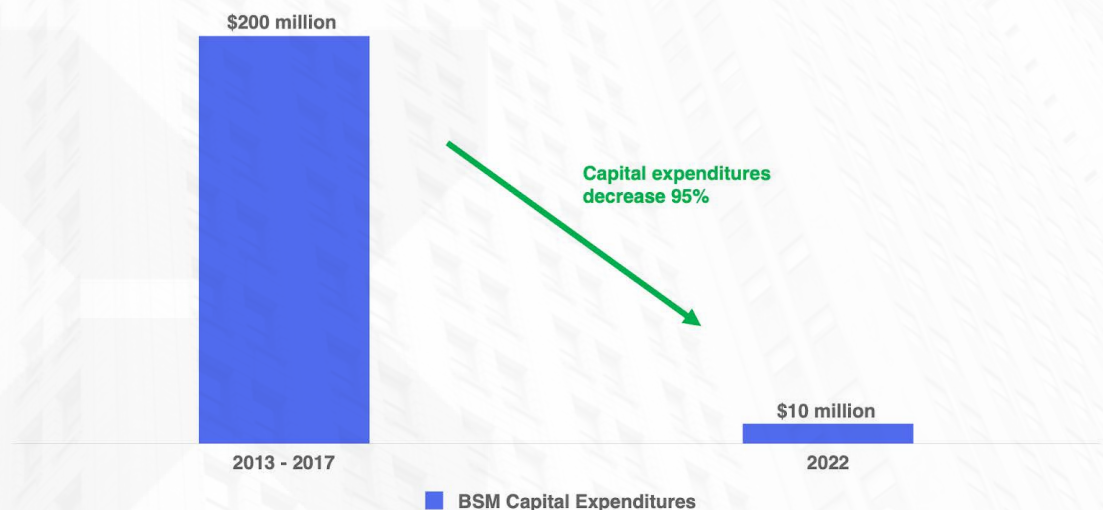
The capital efficient royalty business model is compelling. As the owner of mineral royalties, Black Stone doesn't spend a dime of the capital expenditures associated with producing oil and gas. Instead, Black Stone receives a portion of the production from E&P companies that drill the oil and gas wells on the land it owns.

Working interests, on the other hand, are investments into wells that require payment for a proportion of the costs associated with drilling and operating those wells.

Starting in 2017, Black Stone began cutting its exposure to working interest acreage, transitioning towards a royalty pure play. Today, roughly 93% of Black Stone's acreage holdings are royalty interests versus just 7% for working interests.

This transition away from working interests has dramatically improved Black Stone's capital efficiency. In the five years from 2013 - 2017, the company averaged roughly \$200 million in annual capital expenditures. But over the last three years, Black Stone's capital expenditures have fallen to less than \$20 million on average, including \$12.6 million in 2022.

Black Stone's Improving Capital Efficiency



This shifting business model has boosted Black Stone's free cash flow margins from an average of 35% from 2013 - 2017 to 60% over the last three years. Likewise, Black Stone's return on equity has more than doubled from 17% in 2017 to an all-time high of 40% today.

Finally, another key measure of capital efficiency we analyze is the profitability per employee. A good company might earn a few hundred thousand dollars per employee, whereas world-class businesses might earn a million or more.

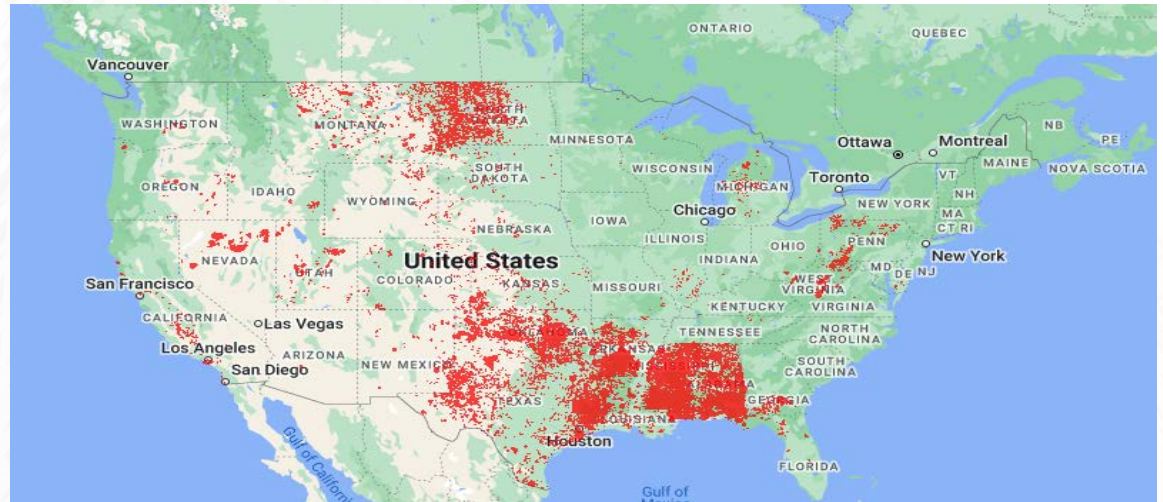
Black Stone has 93 full-time employees, plus 15 contractors, for a total of 108 workers. In 2022, the company earned \$391 million in net income, or nearly \$4 million in profit per employee. This makes Black Stone one of the most capital efficient businesses anywhere in the public markets.

Despite Black Stone's stellar economics, the company today trades at a discounted valuation of just 8x free cash flows – a roughly 50% discount versus 2017, before the company transformed into the beacon of capital efficiency that it is today.

The secret to Black Stone's strong financial performance is that its key acreage lies in the heart of America's two most prolific – and profitable – gas basins.

Black Stone's Acreage Holdings

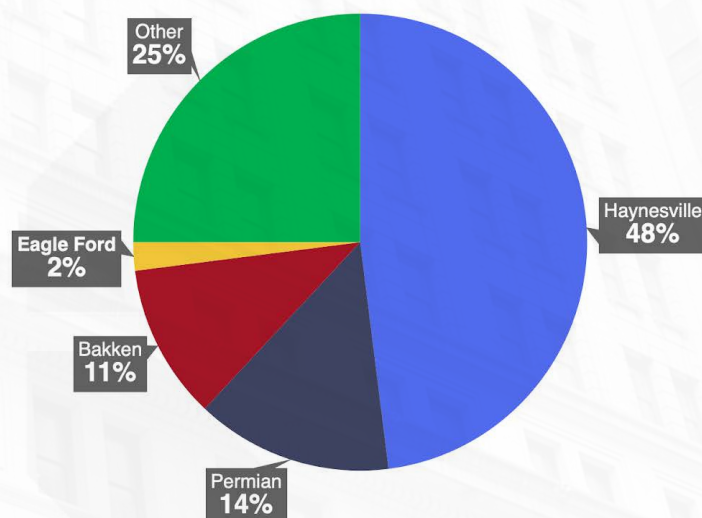
Black Stone's acreage spans across every major onshore U.S. oil and gas basin, but most of the land it controls is concentrated along the Gulf Coast region:



This puts Black Stone's key acreage in close proximity to America's booming LNG export infrastructure along the Texas and Louisiana Gulf Coast.

Approximately half of the company's royalty volumes come from the Haynesville shale formation, which stretches from east Texas and into Louisiana. The company's next biggest basin exposure is in the mid-continent/Delaware basin, which includes the Permian basin in West Texas and New Mexico, followed by a minority of exposure in the Bakken, Eagle Ford and smaller basins along the Gulf Coast.

BSM Production by Region



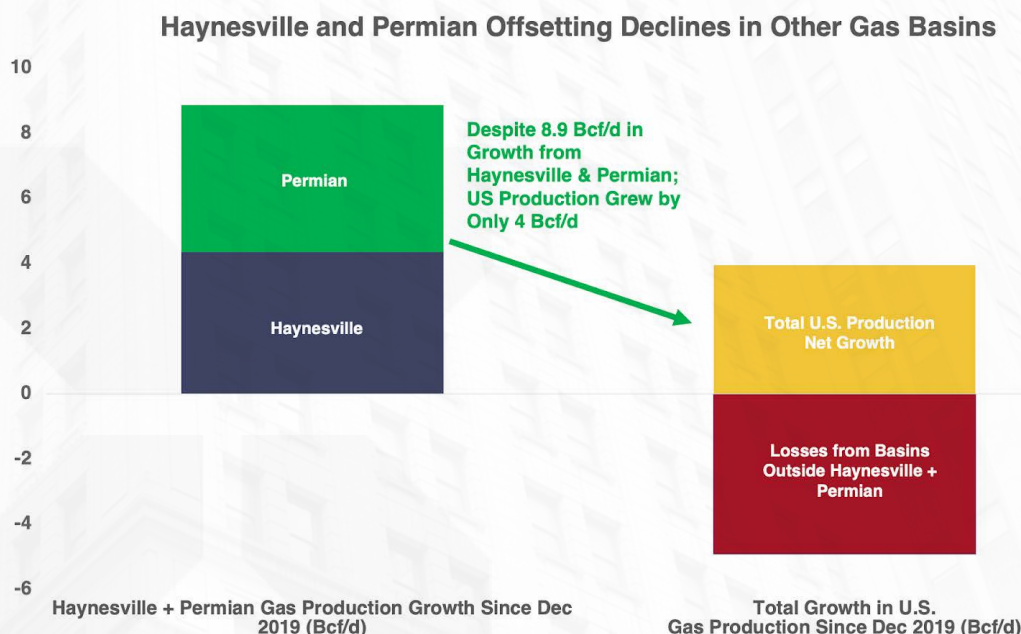
Together, the Haynesville and Permian make up nearly two-thirds of Black Stone's production volumes. This positions Black Stone squarely in the heart of America's two key natural gas production powerhouses.

Oil production generates a lucrative byproduct: natural gas. And the Permian, America's leading oil producer, naturally leads the pack in gas, with output increasing by 4.5 Bcf/d over the past three years.

The Haynesville is a close second behind the Permian, which has grown gas production by 4.4 Bcf/d over the past three years. The Haynesville shale hosts the second largest source of gas reserves in America, behind the Appalachian shale. But unlike Appalachia, where growth is constrained by lack of pipelines, the Haynesville feeds an expanding suite of LNG export terminals along the Gulf Coast.

Many of America's gas basins are past their peak production. In contrast, the robust growth in the Haynesville and Permian shales offsets declines elsewhere across the U.S.

In fact, the combined growth in these two basins has exceeded total U.S. production growth over the last three years:



Black Stone's concentrated exposure in these two dominant U.S. gas basins makes it the perfect company to play the coming natural gas supercycle. And it's already firing on all cylinders today...

The Cutting Hedge

In 2022, Black Stone set new records in and operating results, ending the year with royalty volumes of 40 million barrels of oil-equivalent per day (BOE/d) – a new record high. The company also generated a record \$486 million in net income, up 60% from the previous record high of \$302 million in 2021.

Black Stone attributed most of this volume growth to rising drilling activity in the Haynesville and Permian. The number of active drilling rigs across its acreage jumped by 14% from 90 in 2021 to 108 in 2022. This is a trend we expect to continue, as the Permian and Haynesville remain the two fastest growing oil and gas basins in America.

Thanks to Black Stone's capital efficiency, the business returns capital to investors, instead of sinking it back into the earth. In 2022, Black Stone paid out total distributions of \$1.75 per unit, an 85% increase from 2021.

Black Stone currently pays out \$1.9 in annual distributions, or a nearly 12% yield.

How will Black Stone manage to support this 85% increase in its distribution in 2023, even despite the collapse in gas prices?

The answer lies with the company's conservative management team, who hedged Black Stone's 2023 price exposure during last year's rally in prices. As shown in the table below, the company locked in gas prices of between \$5.07 - \$5.15 for every quarter of 2023, for approximately 70% of its gas production:

Black Stone's Gas Hedges

Quarter	Volume (MMBtu)	Weighted Average Price (MMBtu)
1Q 2023	9,000,000	\$5.07
2Q 2023	8,190,000	\$5.15
3Q 2023	8,280,000	\$5.15
4Q 2023	8,280,000	\$5.15

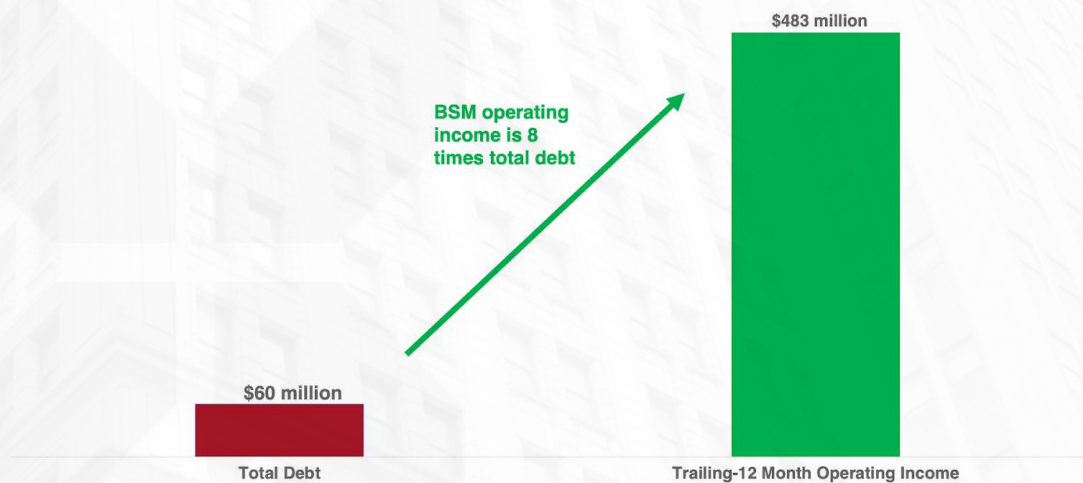
Black Stone's hedging program limited its upside in 2022, as the company locked in prices of around \$3 per MMBtu. As such, the company failed to reap the windfall that unhedged gas producers earned from last year's price rally.

But the purpose of hedging is to provide insurance against bear markets, even if that means paying a price (i.e., surrendering some upside) during bull markets. Today, the tables have turned. Any gas producers not sufficiently hedged are now suffering in today's bear market, while Black Stone's hedging program pays off in a big way.

And therein lies the final key piece of this story. *Black Stone is run and managed by owners with skin in the game.* Insiders own more than 25% of the company. They're not interested in putting the business at risk in order to chase every last penny of short-term upside. With millions of dollars of their own personal wealth at stake, they're focused on protecting the business above all else.

We can see further evidence of management's conservative approach to capital allocation through the balance sheet. Black Stone has just \$60 million in total debt versus operating income of \$483 million over the last 12 months. With a net leverage ratio of just 0.13x, Black Stone has a pristine balance sheet.

Black Stone's Conservative Balance Sheet



Looking ahead, Black Stone is positioned to thrive even in today's depressed pricing environment. With roughly 70% of its gas production volumes hedged at over \$5 per MMBtu for 2023, the company will likely continue reporting record operating results this year. Then, as the natural gas supercycle kicks into high gear with booming LNG export demand in 2024 and beyond, Black Stone could reap a true windfall from both higher production and higher prices.

In the meantime, investors get paid a 12% dividend to wait, supported by a growing earnings profile and a robust balance sheet.

We're not the only ones who see a bright future for the company. Recently, Black Stone's CEO Thomas Carter has purchased over three million of the company's units in the open market, at prices ranging from \$16.85 to \$19.46.

Action to Take: For the latest updates on our open positions, please visit our live portfolio [here](#).

Intellectual Compounder #6

Better Than Gold

Your Buying Guide Featuring Porter & Co's #1
Capital Efficient Royalty and Streaming Company

This gold royalty company is more like a bank than a mining company.

It doesn't have to sink capital into expensive mining equipment, maintenance, and land claims... or hire geologists, engineers, and mining operators. This intellectual compounder has long-standing partnerships to provide royalty and streaming financing deals to the largest mining companies on the planet, and its shares have outperformed the overall stock market, gold, and gold stocks since going public in January 2008.

Editor's Note: Please remember, these are informational reports only. Porter & Co. is not necessarily recommending this stock, and what we present here is solely investment research. Subscribers to *The Big Secret on Wall Street* (or our Partner Pass membership) receive updated analysis and active recommendations. For the latest updates on our open positions, please visit our live portfolio link [here](#).

First published on May 12, 2023

Better Than Gold

Your Buying Guide Featuring Porter & Co's #1 Capital Efficient Royalty and Streaming Company

In America, inflation began with violence.

In October 1690, the Puritans of the Massachusetts Bay Colony launched a raid on their prosperous (and French Catholic) neighbors to the north. Led by Sir William Phips, the colonists' expeditionary force numbered 2,500 and traveled to Quebec aboard 32 ships.

Phips was a man of his time. As a sea captain and treasure hunter, he recovered a huge treasure from a sunken Spanish galleon, which made him rich and powerful. What made him popular was killing witches.

The previous spring, Phips had seized Port Royal, the Acadian capital (present-day Nova Scotia), on behalf of the British Crown, with 700 soldiers. Even though the town surrendered without a fight, Phips allowed his men to sack and plunder the town... which made a substantial economic impact on the Massachusetts economy.

In the fall, the colonists launched a larger expedition to raid Quebec. Confident in their ability to plunder the French, they hired thousands of additional soldiers, on credit.

Alas, Quebec's leader, Count Frontenac, knew they were coming. He prepared the city's defenses, building a stockade and mounting cannons. When Phips demanded the town's surrender, Frontenac famously replied: "I have no reply to make other than from the mouths of my cannons and muskets."

What followed was the typical fog of war. The colonists' attack was stymied by, among other challenges, "a lack of rum." Phips' flagship Six Friends was heavily damaged when it ran out of ammunition, leading to the end of the assault. After two days of fighting, a prisoner exchange was negotiated, and the colonists' fleet returned to Boston, empty-handed. While only 150 soldiers died of their wounds, more than 1,000 died of smallpox.

The survivors were hungry, cold, and armed. They were also owed a lot of money. The expedition racked up 5,000 pounds in debt (roughly 10,000 ounces of silver) – a fortune at the time.

Phips tried to borrow the money to pay his men from Boston's merchants, but they doubted the Colony's credit, and wouldn't lend. Instead, in December 1690, the colonial government printed 7,000 pounds worth of paper money and paid off the soldiers. To gain acceptance of this new form of money (the first paper money ever issued in the New World), the Massachusetts Bay Colony made a two-fold pledge: first, that the notes would, in time, be redeemed for specie (silver or gold) at full face value, and, second, that absolutely no more notes would be printed.

What happened next is instructive. It has been repeated, in one way or another, by every subsequent government that has chosen to print money to pay its debts.

At first, the new notes gave the local economy a big boost. But... strangely... after a short boom of around two months, there was a terrible crash. All the gold and silver in the colony seemed to disappear. And, as the exchange value of the notes plummeted, there was an economic crisis.

To quell the panic, another issue of new notes had to be printed in February 1691. This issuance, because of the falling value of the notes, had to be much larger (40,000 pounds) to achieve the same economic impact as the first.

Facing a growing crisis, Phips and the head of the church, Increase Mather, went to England to negotiate for more support with the new British monarchs, King William and Queen Mary. They needed a new charter, as the former King James II had been deposed. And they were hoping for a charter that would bolster their own authority. They returned to New England in the spring of 1692 with additional financial support. And Phips was named Governor. But the new charter greatly expanded the right to vote, granting the franchise to virtually every man in the colony.

How did Phips and Mather adjust to the new political reality? What's the best way to manipulate voters? Fear.

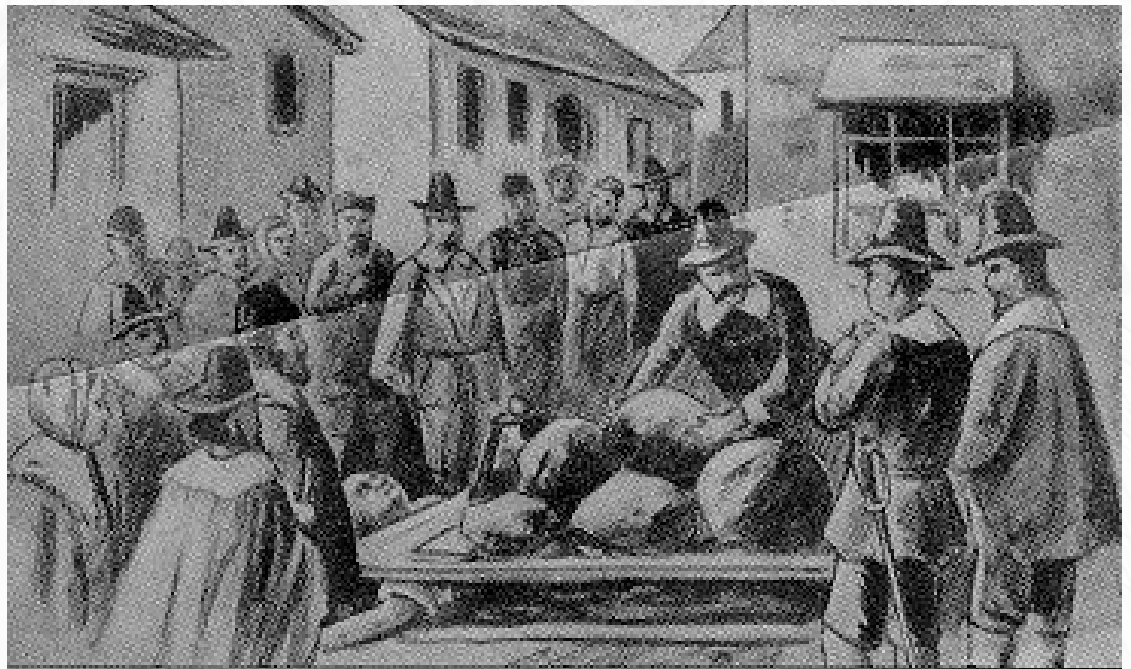
Phips and Mather needed to focus the electorate on something they feared more than poverty. But the colonists dealt with real and terrifying threats every day – like smallpox, Indian raids, and pirates. What's scarier than these things? What did the Puritans fear more than anything else? The devil. Puritans were consumed with a fear of going to hell. To them, the devil was a very real threat. They ascribed natural phenomena – like sickness – to witches and demons. Mather had come to power with a book about witchcraft that he published in 1684. Time to dust it off...

Phips and Mather got back to Boston on May 14, 1692.

Phips – an orphan, a treasure hunter, and a soldier of fortune – was not a religious man. But now, new royal charter in hand, Phips made ostentatious displays of piety: he halted his swearing-in ceremony to faithfully observe the Sabbath. And

on May 27, less than two weeks after returning from England, Mather and Phips created a special new court, with jurists selected from the leaders of the new colonial government, to deal with the rising specter of... witchcraft.

In June the new court began hanging witches, mesmerizing the colony. Among the gruesome deaths that followed was that of Giles Corey, an 81-year-old man who was pressed to death by Captain John Gardner. It took him three days to die as heavy irons were laid on top of him, slowly crushing him. He was crushed, as opposed to hung, because he refused to cooperate with the court. That meant he couldn't be convicted of a felony, which prevented the government from seizing his land. (Killing witches was good business for the government.)



Before the Phips raid on Quebec, there was approximately 200,000 pounds of silver money in the colony. By 1711, 740,000 pounds of paper money had been issued by various colonial governments, including an enormous 500,000-pound issue by Massachusetts to pay for, you guessed it, another failed expedition to sack Quebec!

Prices continued to rise. And, despite various efforts to control the money supply, by 1748, 2.5 million pounds worth of paper money had been printed in the colonies. Prices had increased 10-fold.

Sound familiar?

Government takes on debt it cannot finance with legitimate means. Government prints money, which provides a short-term economic boom. And Gresham's Law ensues: the bad money forces out the good, as people wisely hoard bullion and spend paper.

Another crash follows. And still more money must be printed.

The cycle continues. And each cycle causes more and more economic dislocation. The government is trapped: if they stop printing, the economy will collapse. If they keep printing, inflation will destroy civil society.

The Beginning of the End of America

Our current spate of money printing began in 1998 with the bailout of hedge fund Long-Term Capital Management.

A modern-day Phipps, the founder and leader of LTCM, John Meriwether, was powerful because he'd found treasure – not off the coast of Florida, but in the financial markets. Meriwether earned billions for Salomon Brothers trading bonds. Together with two Nobel Prize-winning economists, Myron Scholes and Robert Merton, the founders of LTCM were widely recognized as being the smartest men in finance.

And their hedge fund was wildly successful – at first.

They earned 40% a year, seemingly without any volatility. How? They capitalized on having access to very low-cost sources of funding. (Many of the investors in the fund were the leading executives of Wall Street's top banks.)

By using enormous position sizes, enabled by extreme amounts of leverage (LTCM was responsible for roughly 5% of the global trading in fixed income), LTCM could make reliable profits through arbitrage. The firm would simultaneously sell and buy bonds with similar financial characteristics to capitalize on tiny differences in prices across the world's markets.

No one else *could* make these trades because no one else had the capital (hundreds of billions), the computing power, the database of global bond inventory, or the algorithms to scan for relative value trades across virtually every market in the world, in real time.

Oh, and no one else would make these trades, because in virtually every position, the upside was infinitesimal... but the downside, in the event of a default, was cataclysmic.

One of the many repeating themes of paper money is the inevitable decline of liquidity as Gresham's Law inevitably requires more and more money to be added to the system, and bad money forces out good.

In the 1990s, the "bad money" was emerging market bonds.

In the 25 years prior to 1998, the 22 countries known as "emerging" economies had seen their external debt loads grow 10-fold, far outpacing economic activity. Beginning in 1995 with the Mexican peso crisis, virtually every emerging market in the world suffered a currency collapse, a debt default, or both. Long Term Capital Management held a highly leveraged position in Russian domestic government bonds when the Russian government defaulted in August 1998, leading to massive losses.

So... what happened? Much like when the colonial army got back to Boston, instead of suffering their losses, LTCM's backers appealed to the government. And \$3.6 billion in new money was created by a consortium of 14 banks, led by the Federal Reserve.

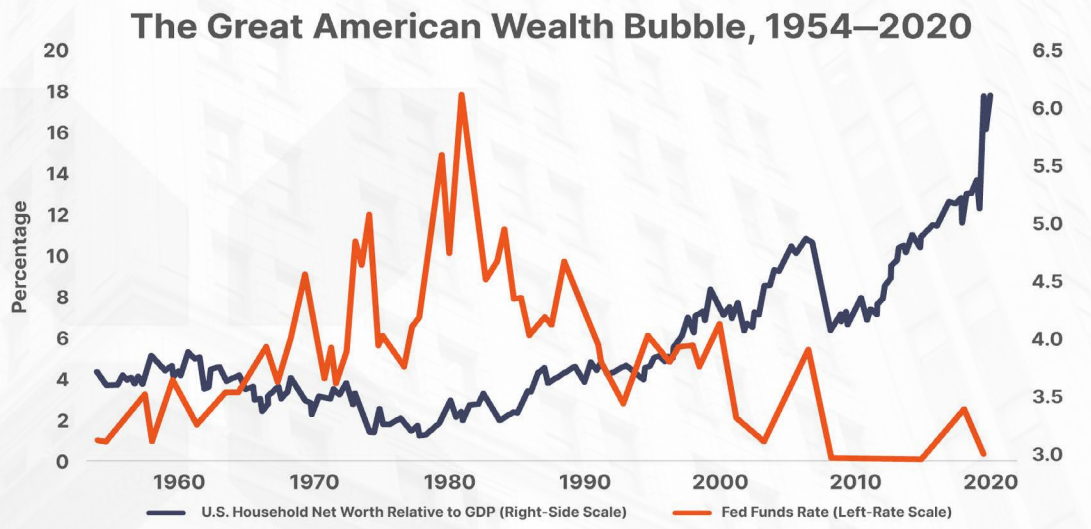
It was the first time the U.S. government had intervened directly to prevent credit losses by private investors since the creation of the world's current monetary regime, the all-paper, U.S. dollar standard. It would not be the last.

About ten years later, in 2008, the "bad money" was subprime mortgage bonds, on which Wall Street banks had gorged themselves over the previous several years, creating an enormous economic boom led by real estate prices.

The resulting bailout was 10,000 times bigger than that of Long Term Capital Management. Looking at all of the direct bailouts, debt guarantees, mortgage purchases, and central bank swaps, the mortgage crisis saw \$30 trillion in new money and credit.

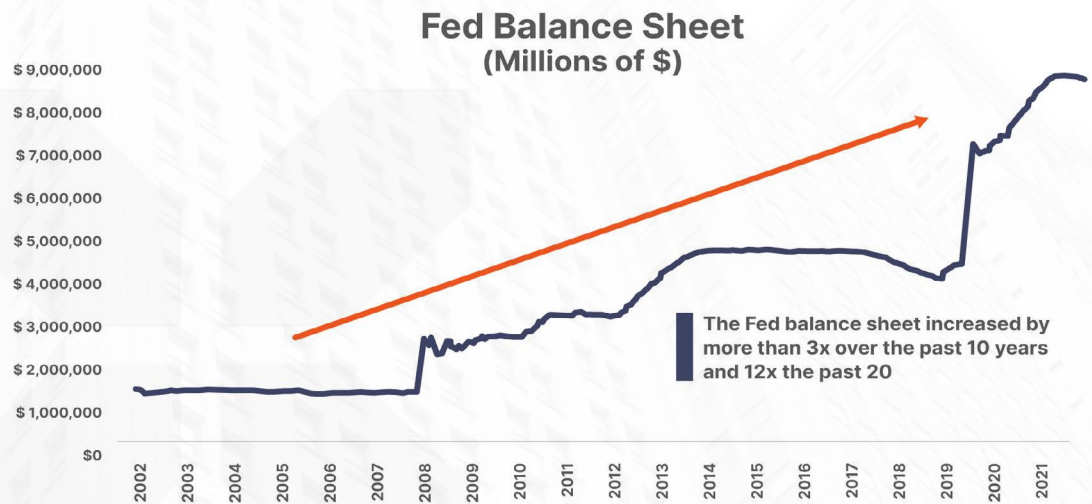
Judging from history, we all should have known what would happen next.

As the chart below (from *The Price of Time* by Edward Chancellor) shows, the late 1990s (and the bailout of LTCM) marks the beginning of America's "super bubble," where household net worth, as denominated in dollars, became completely untethered to any real, underlying economic activity. And with each new cycle of boom, bad money, and bust, the resulting printing of new money would grow ever larger.



The scale of the printing is most apparent in the growth of the Federal Reserve's balance sheet.

Our central bank printed trillions over the last 20 years to finance the bailout of Wall Street in 2009, then again in 2011 to help solve the European debt crisis, and then, most recently, to finance the COVID-19 lockdowns. And each successive wave of printing has grown bigger and bigger.



*Fred Economic Data

Meanwhile, our government's debt burden has risen more than five times, from less than \$6 trillion in 2000 to more than \$31 trillion at the end of 2022.

More importantly, the size of these debts relative to the size of our underlying economy – as measured by gross domestic product (GDP) – has soared from 58% to well over 120% during this time. And no country in history has ever survived a debt load of more than 100% of GDP without a massive devaluation or an outright default.

More than 400 years of history suggest U.S. policymakers will ultimately choose the former – and tap the printing press to paper over America's unsustainable debt burden.

It's simply a matter of time.

That's why we believe every American should begin to diversify into assets that will soar in value against inflated paper money in the years ahead. And gold is the ideal place to start.

Three Reasons to Own Gold Now

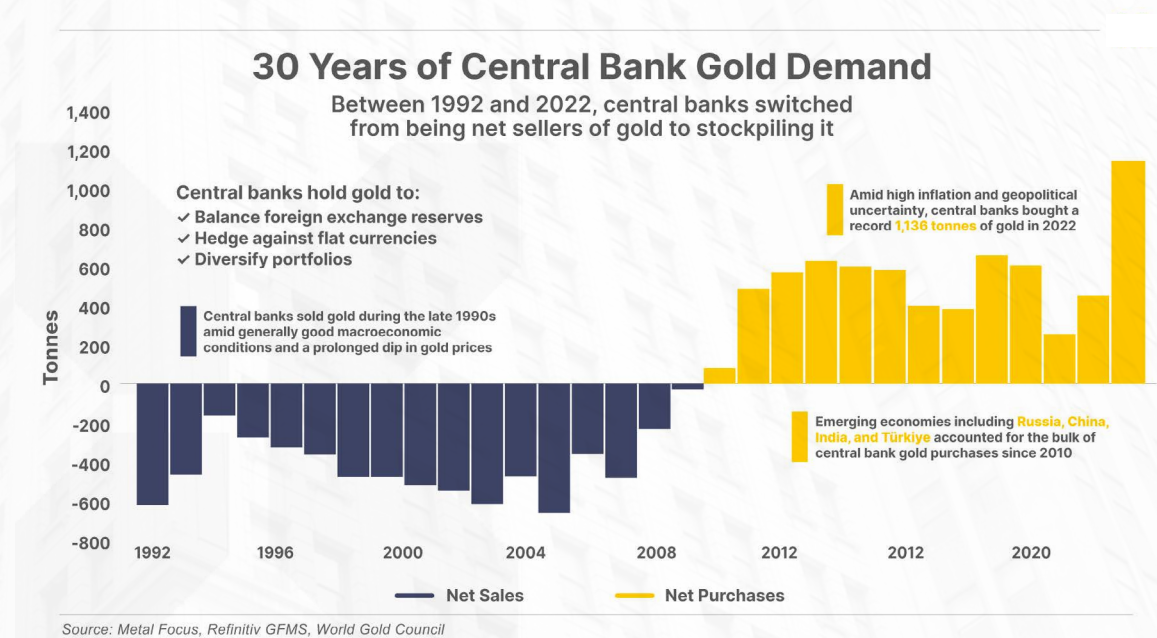
1. Central Banks Are Quietly Hoarding Gold...

Since the 2008-2009 financial crisis, many foreign central banks – including those of China, Russia, India, and Turkey – have been gradually shifting their reserves away from the U.S. dollar (and fiat currencies more generally), and into gold.

But this trend dramatically accelerated in 2022 following surging inflation from COVID money-printing and rising geopolitical uncertainty.

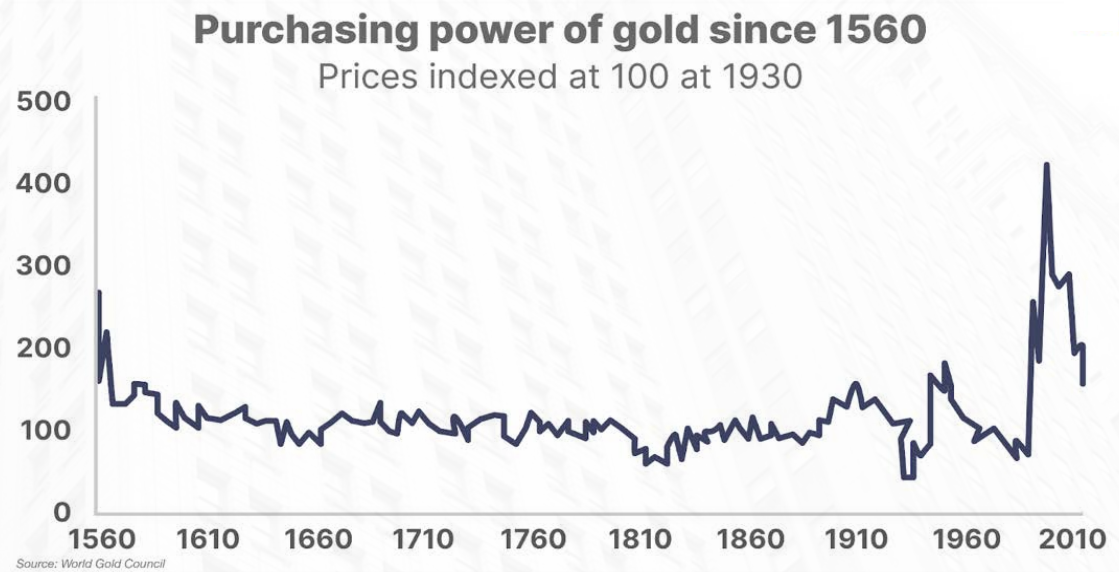
In 2022, global central banks bought a record 1,136 tons of gold – more than double their purchases of any other year in recent decades – in what can best be described as the ultimate hedge against their own failed policies.

Rising central bank demand will likely add significant upward pressure on gold prices in the years ahead. Meanwhile, the growing shift away from U.S. dollar reserves will only hasten the need for further currency debasement, as the U.S. must finance ever more of its spending with debt.



2. Gold is the World's Most Enduring Form of Money...

Various items have served as money throughout human history: shells, beads, salt, rocks, livestock, and countless paper or “fiat” currencies. But only gold has maintained its monetary value for thousands of years.



That is not a coincidence.

Gold is still here because it meets all the characteristics of good or “sound” money, as explained by the Greek philosopher Aristotle nearly 2,500 years ago:

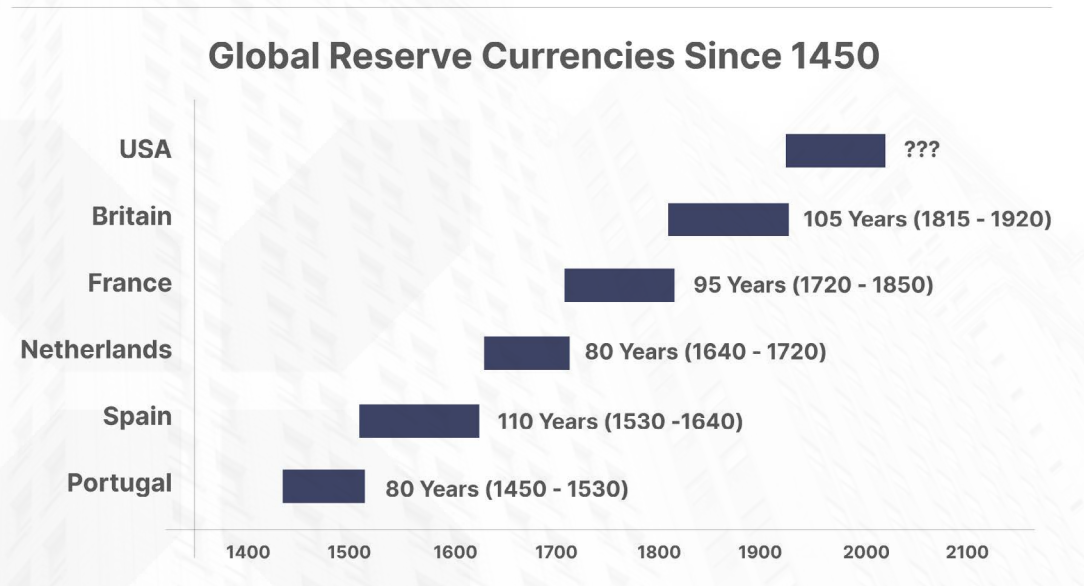
- **Scarce:** Sound money must be limited in quantity and difficult or energy-intensive to produce.
- **Durable:** Sound money must not tarnish, decay, or change through time or exposure to the elements.
- **Portable:** Sound money must be easy to transport and store.
- **Divisible:** Sound money can be split into smaller units if necessary.
- **Fungible:** Individual units of good money must be identical and interchangeable.

Gold isn't perfect money. But it alone has stood the test of time because it meets these requirements better than anything else we humans have tried so far.

Gold is among the rarest elements on Earth. It's virtually indestructible – every ounce that's ever been mined still exists (and is worth just as much as gold that's mined today). If necessary, you can transport a few million dollars of gold in a suitcase. You can split, clip, or melt it into smaller units. And one ounce of pure gold is identical in value to any other, regardless of where it comes from or how old it is.

Gold is the closest thing we have to permanent value in this world.

The following chart shows that the average lifespan for global reserve currencies is roughly 100 years.



Yet, gold has maintained its purchasing power for thousands of years – and will continue to do so long after the U.S. dollar and other paper currencies are gone.

But it's not just great money – it's also great *insurance*, as we'll explain below.

3. Gold provides powerful portfolio diversification benefits you can't get anywhere else...

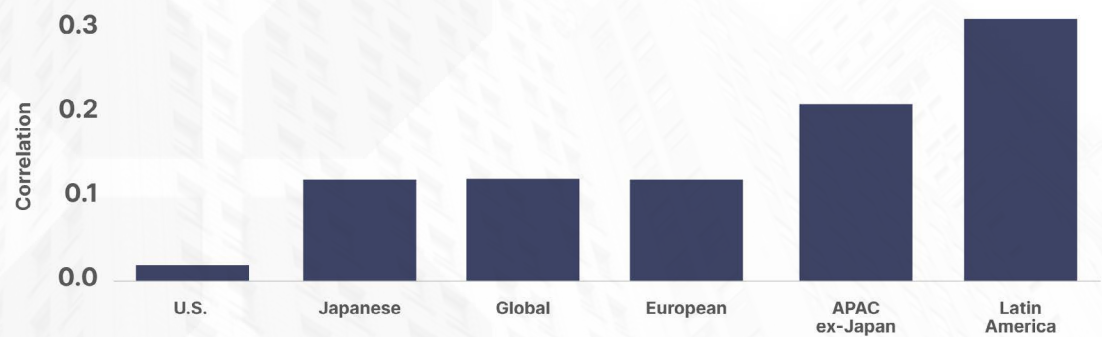
Diversification refers to the strategy of holding your wealth in a mix of different assets – like stocks, bonds, real estate, etc. – to reduce your overall risk. It's the practical application of the age-old advice to "avoid placing all your eggs in one basket." And gold serves this role particularly well.

One way to measure diversification is to calculate the correlation between assets. This measure refers to the degree to which different assets have similar price changes.

A positive correlation means that two or more assets tend to move in unison (up or down together). A negative correlation means assets tend to move inversely (if one moves up, the other moves down). And a correlation of zero means assets tend to move independently of each other.

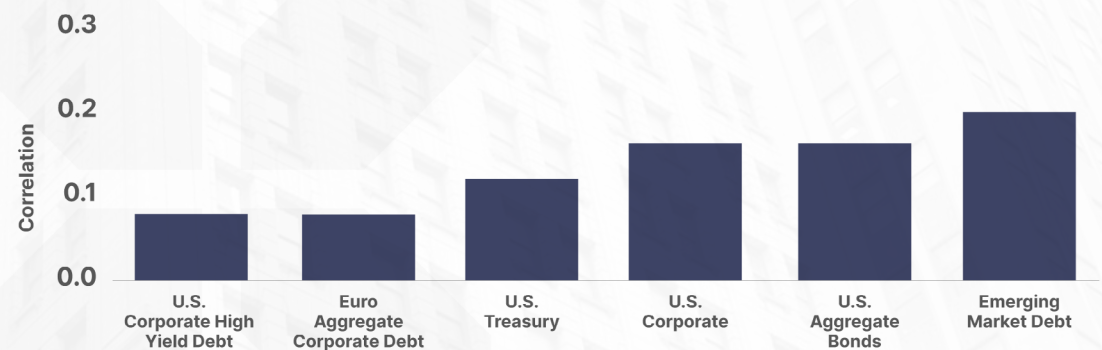
The tables below show gold's correlation with equity and credit markets. As you can see, gold historically has had a low or even negative correlation to both stocks and bonds.

Gold Has Had Low or Negative Correlation With Major Equity Indices Since 2000



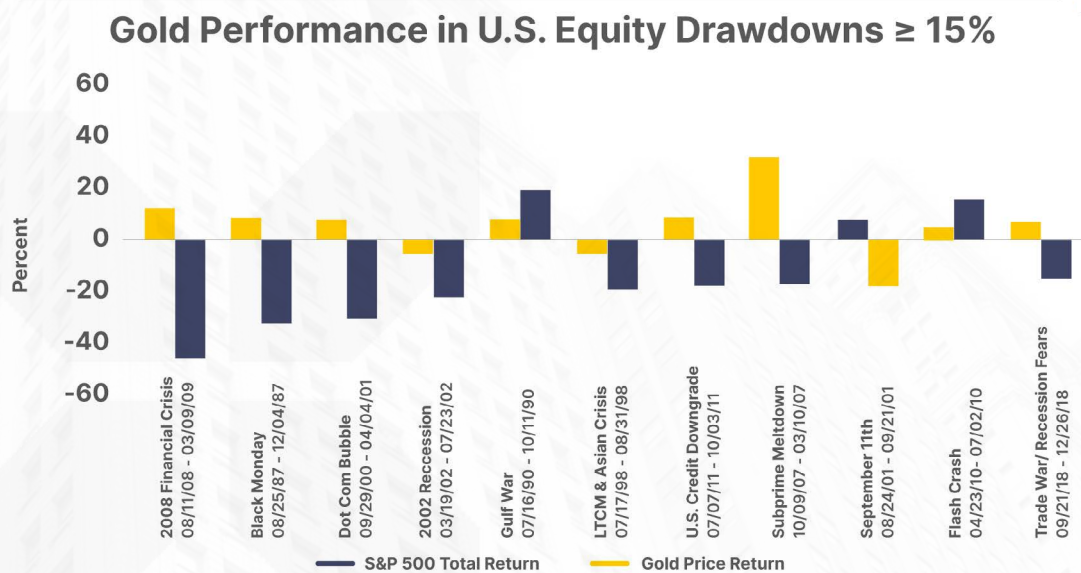
Source: Bloomberg

Gold Has Had Low or Negative Correlation With Major Bond Indices



Source: Bloomberg

Better yet, gold's correlation with other assets tends to be lowest during periods of heightened market stress and volatility, making gold an ideal form of crisis "insurance" that often increases in value when just about everything else is declining in value.



In other words, in addition to acting as the ultimate store of value, gold can dramatically reduce your portfolio's overall risk and volatility.

Given these facts, we believe every investor should consider owning gold today. Exactly how much is a function of your investment horizon, risk appetite, and portfolio profile, but a good general guideline is between 5% and 20% of your investable net worth.

Porter & Co.'s #1 Gold Stock Recommendation: A Capital Efficient Gold Royalty and Streaming Company

Right now, you have a tremendous opportunity to invest in the best company in this industry.

Franco-Nevada (NYSE: FNV) is a gold royalty company headquartered in Canada, in Toronto, Ontario.

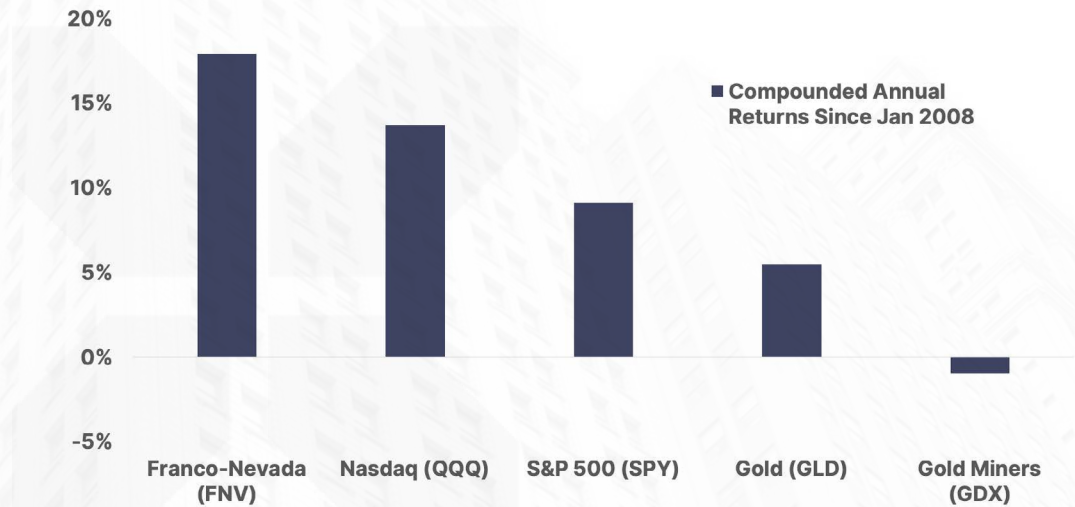
Since going public in January 2008, FNV has grown into the leading global gold royalty company based on revenue and market capitalization.

It has long-standing partnerships to provide royalty and streaming financing deals to the largest mining companies on the planet. That includes the top three global gold miners – Newmont, Barrick Gold, and Agnico Eagle – as well as the leading diversified miners, including Glencore and Vale, along with dozens of smaller public and private miners.

The company's slogan is "the gold investment that works." Unlike most empty corporate slogans, FNV backs up this claim with performance.

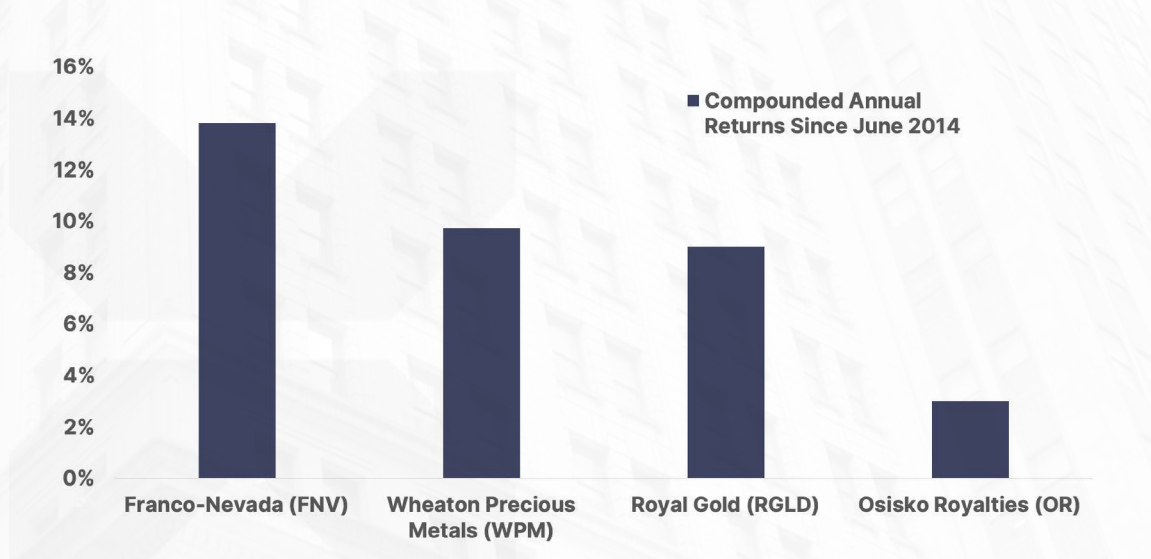
FNV shares have outperformed the overall stock market, gold, and gold stocks since going public in January 2008:

FNV Outperforms Gold, Gold Miners and the Overall Market



FNV also outperforms its fellow gold royalty peers, including Wheaton Precious Metals, Royal Gold, and Osisko Royalties, since their common inception date as publicly traded companies in June 2014:

FNV Outperforms its Gold Royalty Peers



This performance is a testament to the extreme capital efficiency of FNV's royalty business model. Because – here's the best part – FNV works without doing any work at all.

Franco-Nevada's World-Class Capital Efficiency

FNV is more like a bank than a mining company. It doesn't have to sink capital into expensive mining equipment, maintenance, and land claims... or hire geologists, engineers, and mining operators.

FNV runs its entire business with just 40 full-time employees and five part-time contractors. With just those 45 employees, the company generated \$1.3 billion in revenue in 2022 and \$652 million in net income.

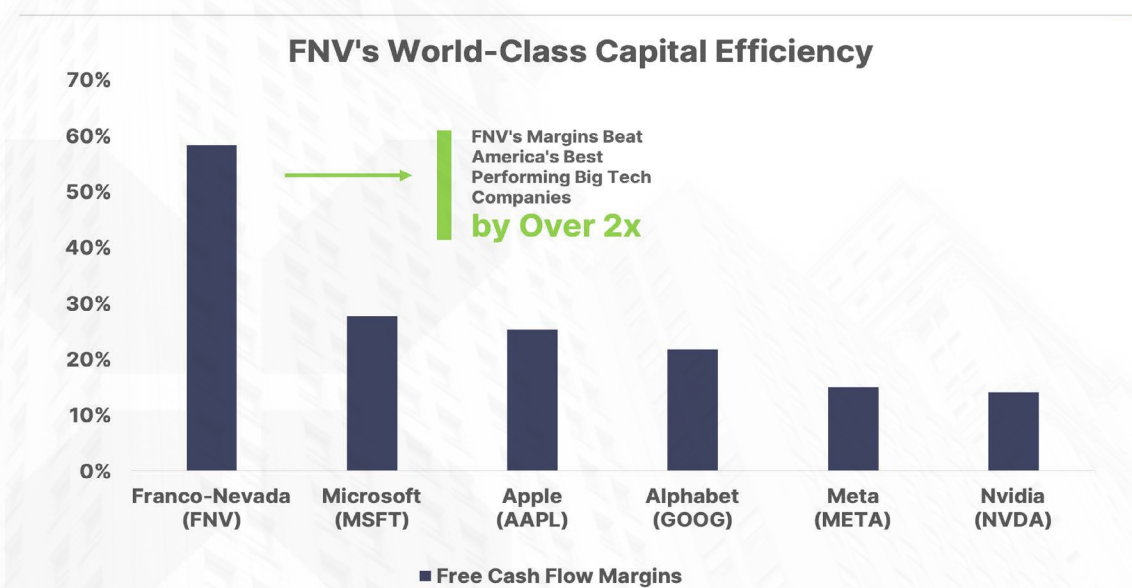
That's more than \$14 million in net income per employee – making it one of the most capital-efficient businesses in the world.

Capital efficiency describes how well a company transforms profitability into shareholder returns.

Virtually all companies have to reinvest some portion of their profits back into their businesses to maintain, replace, or upgrade fixed assets such as property and equipment (capital expenditures). Those that are able to spend less – that are efficient with their capital – are therefore able to pass along a greater proportion of their profits to shareholders.

Unlike mining companies that must funnel most of their earnings back into the business through capital expenditures, FNV's capital efficiency converts a high percentage of revenues into free cash flow (the amount of cash flow available after subtracting out capital expenditures).

In 2022, FNV generated \$731 million in free cash flow for a 58% free cash flow margin. As a frame of reference, that's more than twice the 27% free cash flow margins of Microsoft – one of the best businesses in the world – and also better than the rest of the mega-cap tech cohort that has led the market in recent years (it also beats the 7% free cash flow margins of the world's two top gold miners, Barrick Gold and Newmont).



The secret to success in the royalty business comes from having a management team that underwrites deals at the right price.

FNV has a proven track record of striking deals with a wide margin of safety against downside price movements while retaining unlimited upside to higher prices.

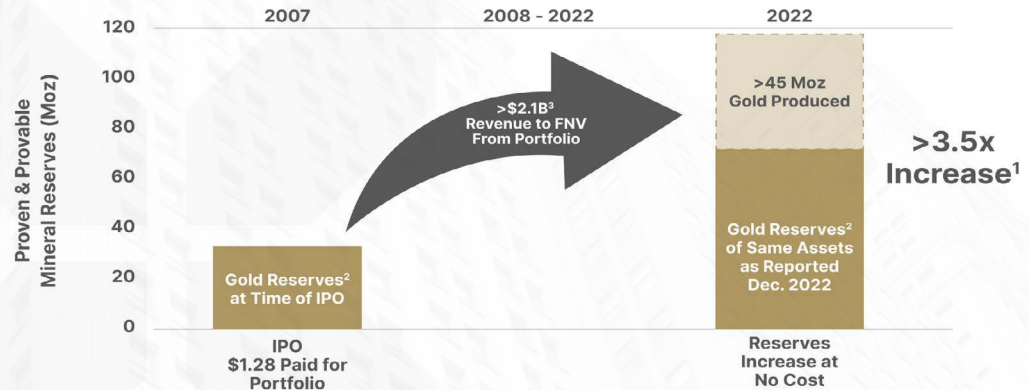
A “Gold Digger” That Doesn’t Have to Dig

The long-term history of FNV’s portfolio shows how deal-savvy the management team is when finding the right mines and operators to grow reserves over time.

When FNV first went public in 2008, the company had a \$1.2 billion portfolio of assets with an average proven reserve base of more than 30 million ounces of gold.

Since then, that portfolio of assets has produced 45 million ounces of gold and generated \$2.1 billion in royalties to FNV. And thanks to ongoing development and exploration at the mines which support those royalties, the reserve life of that same original portfolio has increased to roughly 70 million ounces as of year-end 2022, with no additional costs incurred by FNV:

Royalty Optionality



Source: FNV Investor Relations

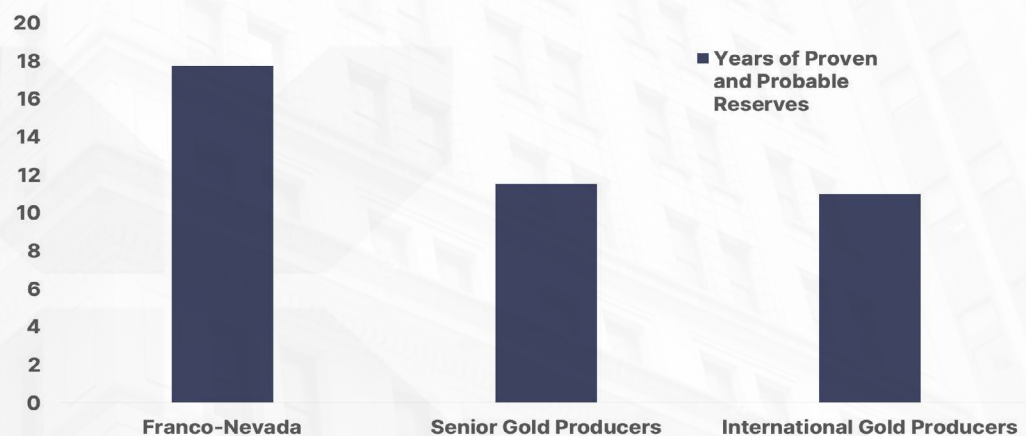
And that's where FNV's business model really shines. FNV strikes deals designed to recoup its original investment plus a double-digit rate of return while retaining future upside in perpetuity.

Most importantly, this future upside comes at no additional cost to FNV – its mining company partners foot the bill. When these miners sink money into the ground to grow their reserve base, FNV simply comes along for the ride.

Today, FNV owns a portfolio of more than 100 producing assets.

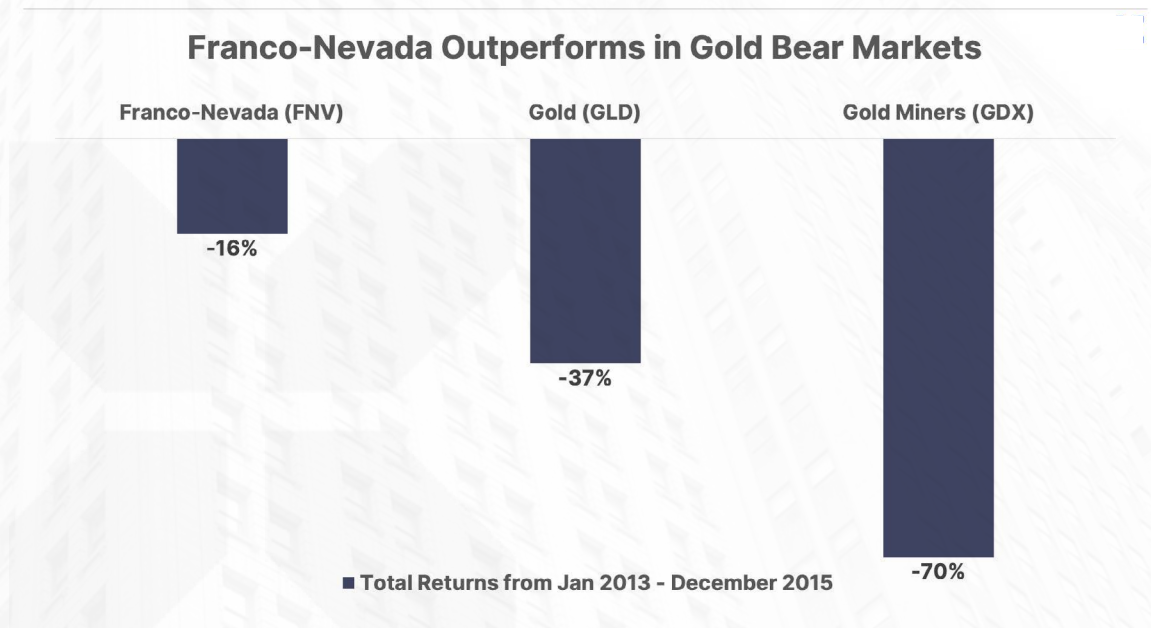
This asset base will likely continue firing on all cylinders for many years. The table below shows that FNV has a longer mine life than its average gold mining peer and grows faster, despite "doing nothing."

Franco-Nevada's Superior Reserve Base



The Lower-Risk Way to Invest in Gold

The other advantage of FNV's capital-efficient royalty model is that it protects against the downside. During the previous gold bear market from 2013 - 2015, FNV suffered losses of just 16% compared with a 37% decline in gold prices and a 70% drop in gold mining shares:



The company's outperformance in gold bear markets traces back to its capital efficiency.

The most significant input cost for mining companies is labor. When gold prices fall, workers don't take kindly to pay cuts. Thus, gold miners get squeezed in bear markets when their operating costs remain elevated, and gold prices fall.

FNV, on the other hand, continues receiving its share of the gold produced, no matter how low gold prices go.

Consider the change in net income for FNV versus two world-class gold miners, Newmont and Barrick Gold, during the previous bear market in gold.

From 2012 to 2015, Barrick Gold's net income fell by 99%, while Newmont suffered a 97% decline in profits. Meanwhile, Franco-Nevada's profitability declined by a relatively modest 51%.

The same factors benefit FNV during bull markets, when input costs for fuel, equipment, and labor rise during periods of high inflation.

In 2022, gold prices rallied back to 2012 levels approaching \$2,000 per ounce. During the same time, miner Newmont's profits remained 63% below 2012 levels, and Barrick Gold's profits were 21% below 2012. FNV, on the other hand, earned 329% more last year than it made in 2012.

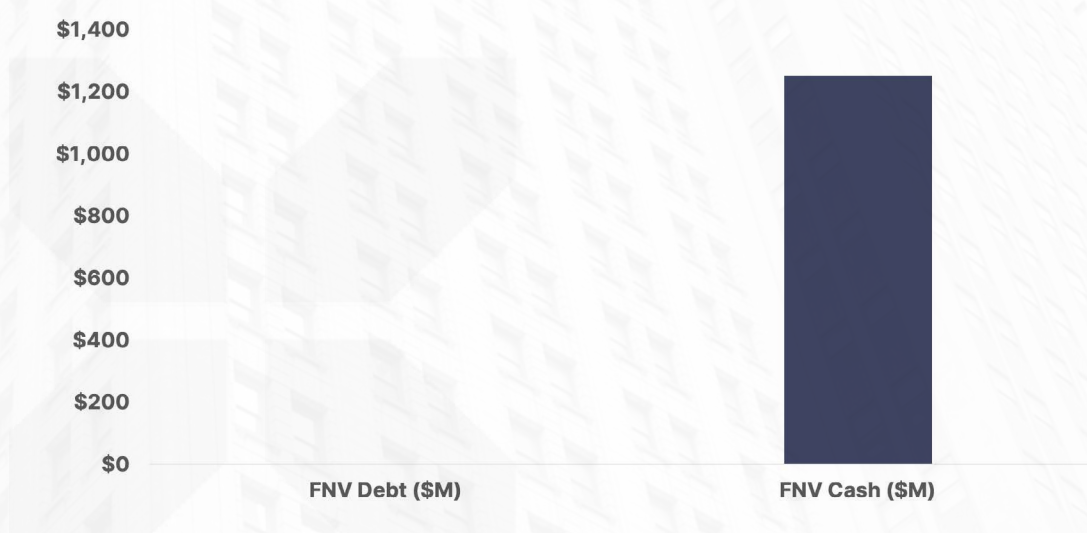
So while FNV takes a modest hit from lower gold prices, it doesn't suffer the same margin contraction miners incur during bear markets. And on the upside, FNV emerges from bull markets with substantially higher profits versus its mining peers.

The final downside protection in FNV's capital-efficient business model comes from the company's ability to fund most of its growth through free cash flow, avoiding the risk of taking on excess debt.

For most of its history, FNV has maintained a pristine balance sheet with very little debt and lots of cash. Today the company has zero debt and \$1.25 billion of cash on its balance sheet.

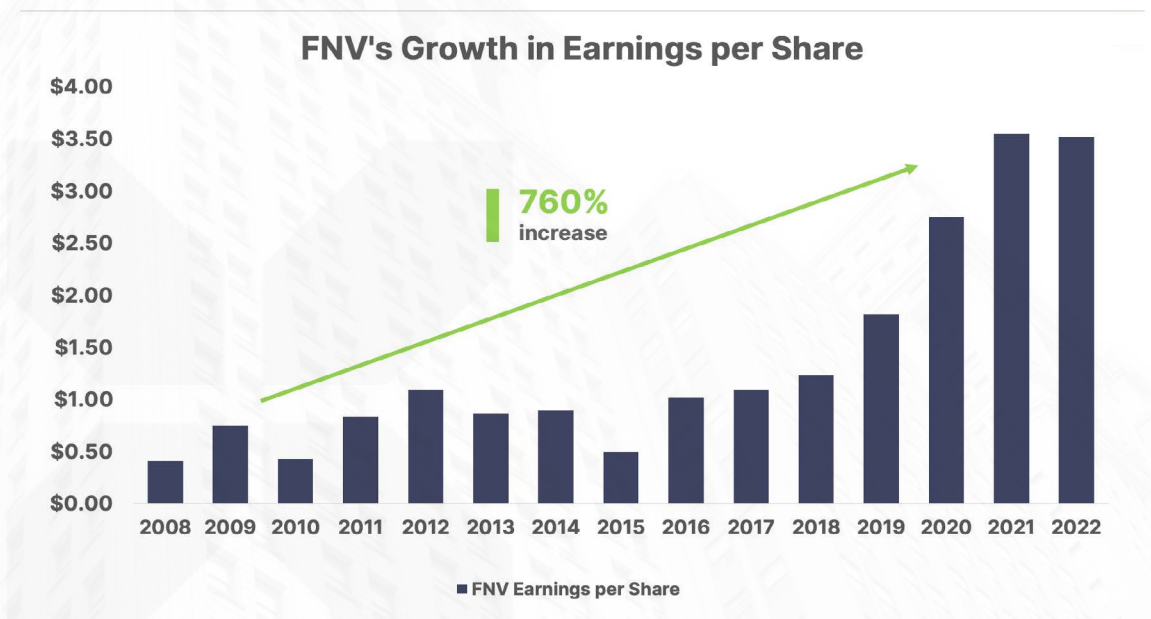
When FNV raises capital to accelerate growth, it typically issues shares.

Franco-Nevada's Pristine Balance Sheet



Since going public in 2008, FNV has increased its share count by roughly 90%, from 100 million to 191 million shares outstanding as of year-end 2022. And the return on that capital raised has been spectacular.

Over the same period, the company's net income has increased 16-fold, resulting in earnings-per-share growth exceeding 700%:



Looking ahead, we expect this earnings trajectory to continue, based on our view of higher gold prices and FNV's ability to make great deals at the right mines with the right partners.

FNV offers the ultimate form of insurance against the growing risks of U.S. dollar devaluation.

The company's world-class capital efficiency and deal-savvy management team allow investors to both protect wealth and grow it over time, making it an ideal complement to your physical gold portfolio.

Action to Take: For the latest updates on our open positions, please visit our live portfolio [here](#).

Bonus Report: Roivant

Finding Winners in the Discard Pile

Playing Pharmaceutical *Moneyball*

\$2 Billion in Hidden Balance Sheet Assets

This biotech company is not what you think. It invests in pharmaceutical drugs that other pharma companies have thrown onto the discard pile. Think of it as the venture-capital approach to pharmaceutical drugs that were put on the back shelf by Big Pharma. Like venture-capital companies, which fund small startups and cash in on their eventual success, this company buys the rights to clinical stage drugs that were forgotten about. Since its founding, this company's distinctive approach to buying Big Pharma's rejects has yielded six FDA-approved drugs and 10 consecutive positive Phase 3 clinical trials for compounds that it licensed.

Editor's Note: Please remember, these are informational reports only. Porter & Co. is not necessarily recommending this stock, and what we present here is solely investment research. Partner Pass members receive updated analysis and active recommendations.

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Finding Winners in the Discard Pile

Playing Pharmaceutical *Moneyball*

\$2 Billion in Hidden Balance Sheet Assets

Kevin Youkilis did not look like a future Major League Baseball ("MLB") All Star.

His high-school coach described him as "roly poly"... his college coach called him "pudgy"... and the general manager of a franchise who scouted him in the minors dubbed him a "fat kid." Apart from his unathletic physique, Youkilis also had a highly unconventional batting stance, an extreme crouch over the plate that looked nothing like the classic stances of successful baseball hitters.

Nonetheless, there was one clue in Youkilis's early performance on the field that caught a few people's attention – but only those few who themselves had a strange way of evaluating future baseball talent: Youkilis had an incredible knack for earning walks. This gave him an unusually high on-base percentage, not so much because he was hitting the ball well, but because he was patient enough not to swing at pitches that were outside the strike zone.

If you've read Michael Lewis' classic best-seller *Moneyball*, seen the Hollywood adaptation starring Brad Pitt, or if you're a die-hard Boston Red Sox fan, you know what happens next.

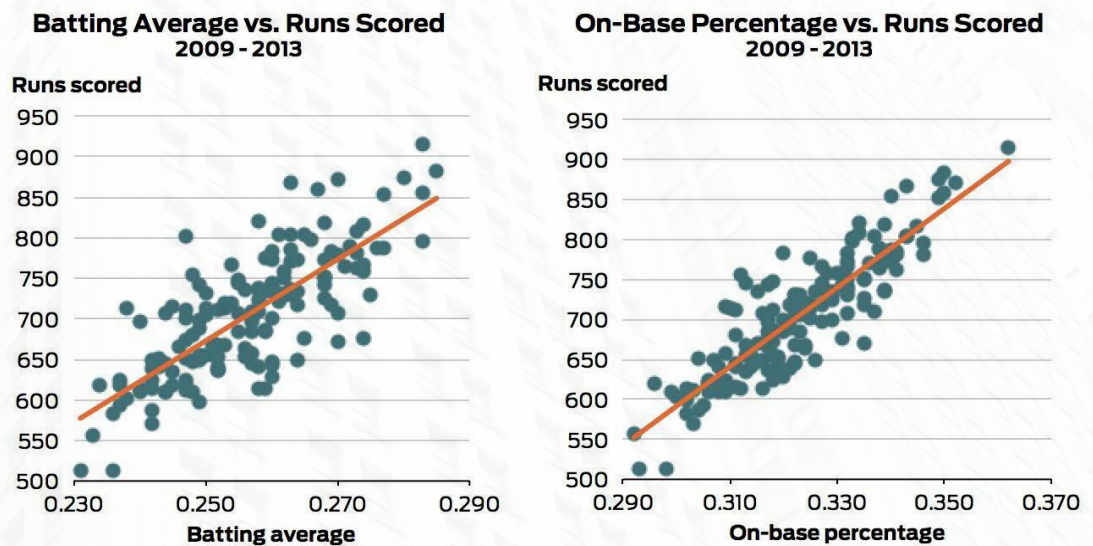
Despite his downright weirdness as a baseball prospect, Kevin Youkilis was selected in the eighth round of the MLB draft by the Red Sox, who swooped in to pick him ahead of the Oakland A's – my team, who had hoped Youkilis would fall even further down in the draft.

Youkilis would go on to have a storied career with the Red Sox – making three MLB All Star teams, being part of two World Series championships, and winning a Golden Glove fielding award as the team's first baseman.

But it was Youkilis's high-profile appearance in Lewis's *Moneyball* that would make him famous among an entirely new audience – finance, statistics, and investment geeks.

Let me explain...

Moneyball describes the disruptive approach that a handful of data-driven analysts used to turn professional baseball upside down. Crunching data and adapting statistical tools that had never been applied to pro sports, these analysts devised a new lens for evaluating baseball talent. This lens enabled them to see prospective players in a totally different way. Factors like a player's physique or batting stance no longer mattered. Nor did the opinions of the crusty pro scouts who had dominated baseball's player assessment for decades. Instead, these brash young analysts cared only about the "sabermetrics," advanced statistics that predicted a player's probable impact on wins and losses.



Moneyball is so compelling because at its heart it's a story of David versus Goliath. The book explains how one of baseball's smallest, poorest franchises – the Oakland A's – put together a multi-year-long streak of improbable successes against their rich rivals like the New York Yankees... simply by drafting players that most of the other MLB teams thought didn't have a place in professional baseball and belonged in the discard pile.

In this chapter of *Intellectual Compounds*, we're going to focus on an upstart company that's playing "pharmaceutical moneyball" – like the gritty Oakland A's, it looks at the drug-development gameboard through a new lens and uses its novel approach to turn things upside down in its favor. As we'll make clear when we adjust its balance sheet properly, this company also trades at a negative enterprise value, which most of Wall Street hasn't seemed to notice... and which makes the company a compelling value with an exceptional margin of safety.

The company is **Roivant Sciences (Nasdaq: ROIV)**. And, as we'll routinely do, we'll apply the seven-part framework we laid out in the [*Biotech Frontiers Investment Guidebook*](#) to explore why it merits a place in our portfolio.

I. The Science

In our second Biotech Frontiers issue, we wrote about a quintessential scientific breakthrough – the discovery of Tumor Infiltrating Lymphocytes (“TIL”) and how to expand them *in vitro* – as well as the scientific giant who made these discoveries, Dr. Steven Rosenberg. As I described in the *Investment Guidebook*, tracking breakthrough science and the scientists behind it will often be at the heart of our hunt for compelling investment opportunities. But sometimes, game-changing innovation can happen not so much in the fundamental science itself, but instead in how one approaches *sifting through the science* to search for promising new medicines. That’s the crucial innovation at Roivant.

The Big Pharma Discard Pile

Big Pharma – the Eli Lillys, Johnson & Johnsons, and Mercks of the world – spends about \$350 billion *per year* on the research and development (R&D) of new medicines. This enormous financial investment churns a flywheel that puts roughly 15,000 novel therapies into Big Pharma’s research pipeline at any given time. Yet in 2023, the U.S. Food and Drug Administration (“FDA”) approved only 55 new drugs... in 2022, only 37... in 2021, only 50.

So there is a staggering mismatch between the number of novel therapies under development, and those actually approved for use in the clinic. What happens with all the unapproved compounds in Big Pharma’s pipeline? The answer is: Many of them are, literally and figuratively, sitting on the shelf. Conducting clinical trials and pursuing regulatory approvals are expensive, with costs often running into the hundreds of millions of dollars per drug. As a result, even well-resourced Big Pharma companies can only focus on advancing a small number of candidate drugs for FDA approval.

Imagine a giant chessboard, with thousands of rows instead of the standard eight. Each compound in Big Pharma’s pipeline is a pawn. Big Pharma focuses intensively on the few pawns that are getting close to the far side of the game board, knowing that if they make it all the way across, they’ll become queens. The rest of the pawns? Most of them sit there doing nothing.

Indeed, like the MLB player scouts, Big Pharma has its own discard pile. The discard pile consists of compounds that Big Pharma companies have explicitly given up on – say, because of a shift in strategic priorities (e.g., a turn away from a specific disease area), or because a key scientific sponsor at the company leaves, or because the early data about a compound isn’t as convincing as the company had hoped. Once a compound gets placed in Big Pharma’s discard pile, it’s available for purchase... often at a fire-sale price. Think of these as the pawns Big Pharma has decided to sacrifice.

Biotech Frontiers subscribers are already familiar with a compound that made a spectacular comeback from the discard pile. Ibrutinib – the first Bruton’s tyrosine kinase (“BTK”) inhibitor, which became a transformative therapy for deadly

B-cell cancers and drove Big Pharma giant AbbVie's \$21 billion acquisition of Pharmacyclics – began its life as a compound called CRA 032765. It originated at Celera (hence the abbreviation CRA), the once high-flying biotech company helmed by human-genome-mapping pioneer Craig Venter. When Celera fell on hard times and had to liquidate most of its portfolio, Pharmacyclics' founding CEO, Dr. Richard Miller, swooped in and bought CRA 032765, along with two other drug candidates in Celera's discard pile, for a measly \$6.6 million. The rest is history.

My favorite Big Pharma discard-pile story, though, concerns a compound that escaped being tossed onto the pile by the slimmest of margins. Merck's PD-1 inhibitor Keytruda, approved to treat 17 different tumor types, is currently the best-selling drug in the world. In 2023, Keytruda generated \$25 billion in revenue – nearly half of Merck's total sales of \$60 billion. To put this into context, Merck's second most valuable drug, the HPV vaccine Gardasil, generated \$9 billion in 2023, about a third as much as Keytruda did. It's not much of an exaggeration to say that Keytruda *is* Merck.

What most people don't know is that Merck did not invent Keytruda. The compound that became Keytruda was invented at a Dutch company called Organon, which was bought by Schering-Plough, which Merck in turn acquired mainly for its nasal spray Nasonex. What's more, the Organon PD-1 that became Keytruda was put into Merck's discard pile and reached a point where Merck had actually negotiated a term sheet to sell the drug for peanuts. Someone at Merck stepped in to cancel that deal before it closed – but it's bracing to realize that Merck came close to giving away Keytruda for next to nothing.

Sifting the Discard Pile for Value

With this context in mind, let's circle back to Roivant Sciences.

After several years managing the biotech portfolio at hedge fund QVT with great success, Vivek Ramaswamy asked a series of potent questions: What if there were a biotech company focused on identifying the unrecognized gems in Big Pharma's discard pile? Moreover, what if that biotech company approached the task of identifying these unrecognized gems in a highly data-driven way, similar to the rigorous methods QVT applied to picking biotech stocks?

For example, what if that biotech company invested in building a massive database of *all* the drugs in Big Pharma's pipeline, and could analyze each one across several dimensions – such as the drug's competitive landscape, potential market size, and probability of success? Finally, what if this new biotech company then used its database, and its proprietary analysis, to cherry pick the most promising compounds in Big Pharma's discard pile – and especially the ones that it could buy at dirt-cheap prices?

Ramaswamy's thought experiment became Roivant's business plan.

But it's one thing to come up with a clever, potentially disruptive business plan... and quite another to execute it. So how has Roivant done on the execution?

We'll get to some aggregate metrics on Roivant's performance in a bit. I want to start with a story about Roivant that tells us all we really need to know about the company's ability to execute.

100x in 10 Months

Inflammatory Bowel Disease ("IBD"), a category that includes Crohn's disease and ulcerative colitis, describes a group of gastrointestinal ("GI") disorders that afflict 8 million people globally. People with IBD suffer from chronic inflammation of their GI tracts that often have a devastating impact on quality of life and life expectancy. Unfortunately, existing medicines for IBD have limited effectiveness – only about 20% of patients treated with approved therapies experience remission.

In 2021, Roivant identified a compound in Big Pharma giant Pfizer's discard pile dubbed PF-0648065. This compound belonged to a promising new class of monoclonal antibodies called TL1A cytokine inhibitors, which work to modulate the body's inflammatory response. Despite this promise, the compound was stuck on the shelf at Pfizer. The Big Pharma giant chose instead to prioritize a different therapy for IBD in its pipeline called etrasimod, which was closer to regulatory approval. Etrasimod was the pawn further across the gameboard and therefore attracted Pfizer's resources. PF-0648065 languished.



Roivant struck a deal with Pfizer to license PF-0648065 through a joint venture ("JV"). Under the terms of the deal, Roivant and Pfizer would form a new company called Televant, which would be a Roivant subsidiary. Televant would own the rights to develop and commercialize PF-0648065, which would be renamed RVT-3101. Roivant would own 75% of Televant, Pfizer 25%. For its 75% stake, Roivant would pay Pfizer \$45 million – not as low as the \$6.6 million that Richard Miller paid Celera for the drug that became ibrutinib, but as we'll see, still a bargain.

Roivant would invest an additional \$5 million in RVT-3101 to fund the completion of an important Phase IIb clinical trial on this compound, called the TUSCANY-2 study. Just seven months after Roivant struck the deal with Pfizer, the TUSCANY-2 trial topline results became available, and they were jaw-dropping: RVT-3101 induced a 36% remission rate in patients with ulcerative colitis, with 50% of patients showing endoscopic improvement. RVT-3101's efficacy in the trial was nearly two times better than the existing standard of care. To top it off, the trial suggested that RVT-3101 has an immaculate safety and side-effect profile.

In October 2023, a mere 10 months after Roivant inked the deal with Pfizer that for \$45 million gave it 75% ownership of RVT-3101, Big Pharma player Roche bought Televant for \$7.1 billion. Roivant's three-quarters share of the payout was \$5.3 billion – **a greater than 100x return on investment in less than a year.**

When he founded Roivant, Vivek Ramaswamy explained that the "Roi" in the company's name stands for "return on investment." Roivant's coup with RVT-3101 proves that the name choice was no gimmick.

A Track Record of Success

Skeptics dismiss the Televant story as a lucky break... but Roivant's track record picking winners out of Big Pharma's discard pile suggests otherwise. Since its founding, Roivant's distinctive approach to buying Big Pharma's rejects has yielded six FDA-approved drugs and 10 consecutive positive Phase 3 clinical trials for compounds that Roivant in-licensed. The company's R&D spending productivity – at roughly \$85 million spent per Phase 2 or Phase 3 clinical-trial readout – makes it between 5x and 10x more efficient than its Big Pharma peers. (A readout is when trial results are made public.)

Roivant's pipeline features several compounds that could prove to be as valuable as RVT-3101. Moreover, as we'll discuss later, Roivant's balance sheet now gives it the financial wherewithal to significantly accelerate the innovative process it's already demonstrated can deliver blockbuster wins. All this suggests we've only begun to see the success Roivant can achieve on the infinitely large pharmaceutical chessboard with its own distinctive strategy.

II. Sizing the Prize: The Opportunity

"If you're right, you've got to get paid." *Biotech Frontiers* subscribers are likely to hear me repeat on a monthly basis my old mentor Julian Robertson's mantra... It's a useful reminder that we aim for the investments we explore to pay us a multiple of our money if they work.

We can then turn Julian's mantra into a question: *How* are we going to get paid? To answer this question, we size the market our company is pursuing and make some reasonable assumptions about its probability of success. That arithmetic gives us an expected value ("EV"). In the last step, we compare the company's current market capitalization to its EV.

Valuing Roivant's Pipeline

Roivant Sciences currently has at least three drugs in its pipeline that have blockbuster potential – i.e., the potential to generate at least \$1 billion in sales.

The first is Vtama, a topical cream used to treat inflammatory skin conditions such as plaque psoriasis, atopic dermatitis, and others. Vtama is a first-in-class therapy that belongs to a novel category called aryl hydrocarbon receptor agonists. The most important practical differentiator of drugs in this category is that they aren't steroids... and therefore have none of the unpleasant, dangerous long-term side effects that steroids have.

While Vtama has so far been approved by the FDA only to treat plaque psoriasis, the emerging clinical trial data on its efficacy for other inflammatory skin conditions such as atopic dermatitis is striking. This data gives Roivant well-justified confidence that Vtama will eventually win approval for a much broader class of skin disorders. And the ultimate addressable market for the drug is huge: 137 million patients in the U.S. alone.

Vtama is already on track to generate \$100 million in annual revenue for Roivant. But it's reasonable to imagine that five to seven years from now, these sales will grow 10x to 50x. Vtama could eventually be a \$1 billion to \$5 billion drug. Vtama has already proven itself from a scientific, regulatory, and commercial standpoint. What's left is execution... and as we've already established, Roivant knows how to execute.

A reliable rule of thumb is that a blockbuster drug's value is at least 3x its peak sales. Let's take \$2.5 billion, the midpoint of the \$1 billion to \$5 billion range, as a reasonable estimate of Vtama's peak. That implies about \$7.5 billion of value for Roivant.

Roivant's two other potential blockbusters both target autoimmune diseases, which occur when the immune system attacks the body itself. These are some of the most awful diseases we know of – virtually always devastating to a patient's quality of life, and in many cases life threatening.

Roivant's more-advanced autoimmune-disease candidate, Batoclimab, is already in Phase III clinical trials for Myasthenia Gravis and for thyroid eye disease, and in Phase II trials for Graves disease and for CIDP. Roivant's second drug candidate in the autoimmune category, RVT-1402, is at a much earlier stage – still in Phase I trials. But the data on RVT-1402 suggests that it may be a best-in-class molecule – in effect, a more effective version of Batoclimab, with an equally benign safety profile.

Roivant believes that, across the full range of autoimmune diseases that these drugs can treat, Batoclimab and RVT-1402 together can eventually generate at least \$10 billion in annual revenue. I've studied the available data on these compounds as well as the indications they target, and I don't think Roivant's estimate is off the mark. But I'm inclined to reduce the probability of success to 50%. Three times \$5 billion in probability-adjusted peak sales is \$15 billion of value. But here we need to make one further adjustment: While Roivant owns 100% of Vtama, it only owns about 55% of Batoclimab and RVT-1402 through its subsidiary Immunovant (IMVT). That 55% ownership implies \$8.25 billion in value to Roivant from these two autoimmune drug candidates.

We can now estimate the expected value ("EV") of Roivant's three most identifiable potential blockbusters:

Roivant Potential Blockbusters

Drug	Disease Targets	Stage Phase	Estimated Peak Sales	Probability Factor	Roivant Ownership	EV to Roivant
Vtama	Inflammatory Skin Diseases	Commercial and Phase III	\$2.5 Billion	100%	100%	\$7.5 Billion
Batoclimab and RVT-1402	Autoimmune Diseases	Phase III and Phase II Phase I	\$10 Billion	50%	55%	\$8.25 Billion
					Total EV:	\$15.75 Billion

Roivant's current market capitalization is \$9.3 billion. The company has \$7 billion of net cash... and a hidden asset on its balance sheet that is conservatively worth another \$2 billion to \$5 billion. Let's leave that hidden asset for the moment. It's still appropriate to back out Roivant's net cash from its market cap to zero in on how the market is valuing Roivant's business. Take \$9.3 billion less \$7 billion of net cash to get \$2.3 billion of cash-adjusted market cap – versus our EV estimate of \$15.75 billion. That implies a 6x to 7x return... more than enough to satisfy Julian's instruction to "get paid."

Roivant's Alpha

There's another way to think about Roivant's value.

On Wall Street, the term "alpha" refers to the return from active stock picking versus the overall market. Positive alpha is the increment over and above the market's return that a money manager creates by picking winners. Negative alpha describes the value destruction relative to the market that results from poor stock picking.

Alpha is a useful way to quantify a money manager's skill. The best-known example of this is probably Warren Buffett at Berkshire Hathaway. Every Berkshire annual report provides the average annualized return of Berkshire stock and compares it to the S&P 500 since Buffett assumed control in 1965. This year, the comparison appears [on page 17 of Berkshire's annual report](#), and shows Berkshire's average annual gain from 1965 to 2023 to be 19.8% versus the S&P's 10.2%. Nearly doubling the S&P's performance over a 60-year span is a staggering achievement – one that offers a quantitative anchor for Buffett's reputation as an investor.

It's revealing to perform a similar calculation for Roivant. The number is likely to fall short of being perfectly precise because we lack the data we would need for such precision. But I think it's directionally correct.

Roivant was formed in 2014 with about \$100 million in seed capital. The company's market capitalization today is \$9.3 billion – or 93x its initial value. Appreciating 93x over a decade translates into a 57.3% annualized return. Over the same period, the S&P 500 has returned 12.5% annualized, and the S&P 500's flagship biotech ETF (XBI) 8.5%.

Let's pause for a moment to appreciate these figures: Over its 10-year life, Roivant has outperformed the overall S&P 500 by an average of 4.5x and the large-cap biotech sector by 6.7x *annually*. I am going to make an educated guess that these figures match Buffett's during the very best investing decade of his storied 70-year career.

What can they tell us about Roivant's future value? Although I have a lot of respect for what Roivant has achieved to date, I don't believe that earning 57% returns annually is sustainable over the long term. For starters, Roivant now has a lot more capital to deploy, and as Buffett has rightly observed, deploying larger sums of capital is harder. So let's assume that over the second decade of its life, Roivant's annual returns get cut by more than half, from 57% to 25%.

Compounding its value at 25% per year, Roivant would double in slightly more than three years and triple in about five... more than fast enough to satisfy Julian's exhortation to "get paid."

III. The Capitalization Table

Roivant's Cap Table is not a significant driver of our recommendation, but it does contain some valuable clues that support owning the stock. The company's largest shareholder, at nearly 14%, is QVT Financial. Originally a large, multi-strategy hedge fund, QVT converted into QVT Financial, a family office, in 2018 and mainly manages the wealth of its own principals – with the biggest piece belonging to CEO Dan Gold, a Harvard-trained physics major who pursued a successful career on Wall Street. I like QVT's family-office conversion, because it means the firm is now betting largely with its own skin in the game, not with other people's money. Furthermore, while it's hard to get precise data, QVT's total assets under management appear to be around \$4 billion. Its Roivant position is about \$1.27 billion, making it a huge, concentrated investment for QVT that is by far the firm's largest, at about 30% of assets. That is a positive signal that speaks powerfully to QVT's level of conviction about Roivant's value.

There's also the history between Roivant and QVT. Vivek Ramaswamy worked at QVT from 2007 to 2014, making partner there in just three years and managing QVT's biotech portfolio. He left QVT to found Roivant, and when he did, QVT as a firm as well as its principals were among his earliest financial backers. But what's notable to me is the length of time QVT has been invested in Roivant – 10 years and counting – and that QVT has grown its position over time.

QVT knew about Roivant when it was still an unfunded business plan. Sticking around for a decade and growing the investment over that period suggests to me that QVT sees Roivant executing on its promise. When he founded Roivant, Ramaswamy spoke about aspiring to build a "biotech Berkshire Hathaway." Berkshire, of course, is famous for winning over shareholders that stay for life. It's an auspicious sign that Roivant's largest shareholder has been a shareholder from the very start... and has all the history at its disposal to assess whether Roivant is doing what it set out to do.

What about Ramaswamy himself? He still owns 6.4% of Roivant, making him the company's sixth-largest shareholder. Ramaswamy has been selling down his stake, most recently in January 2024 when he sold 3 million shares to leave him with 52 million. His remaining Roivant investment is worth well over \$500 million, making it a meaningful part of his net worth. Ordinarily, we don't like to see founders and former CEOs selling – it's usually a bearish sign. But given Ramaswamy's transition from Wall Street to politics (he ran unsuccessfully in this year's Republican primaries aiming to be the party's presidential candidate), his sales make sense, and I don't read them as a negative signal.

I care more about two other key people at Roivant – CEO Matt Gline and President and Chief Investment Officer Mayukh Sukhatme, who like Gline sits on Roivant's board. Together, these two have been responsible for virtually all of the major decisions at Roivant since Ramaswamy left in 2021. They were arguably more important decision makers than Ramaswamy himself in the years prior.

Both have impressive pedigrees: Gline (pictured left) is a Harvard-trained physicist who joined Roivant at its founding, served as the company's chief financial officer, and was promoted to CEO as Ramaswamy's successor. Sukhatme (pictured right) earned his undergraduate degree at MIT before earning an MD from Harvard Medical School. He joined Roivant a year after its founding and has been the company's chief dealmaker ever since. Sukhatme, more than anyone, deserves credit for the astonishing transactions in which Roivant acquired from Pfizer for \$45 million a compound that became RV-3101 and sold it to Roche less than a year later for \$7.1 billion. Happily for us, both Gline and Sukhatme own a meaningful amount of Roivant stock: Gline 1 million shares, Sukhatme 4 million – and these figures do not include their options packages, which would take their shareholdings up materially. It's a terrific sign that Roivant's two most important people, like its largest investor QVT, have a lot of skin in the game.



IV. The Balance Sheet

In the first issue of *Biotech Frontiers*, we did a “deep dive” into negative-enterprise-value opportunities in the biotech sector... and recommended buying a basket of negative-enterprise-value biotech stocks. Most of the stocks in that basket are relatively small – only one features a market capitalization above \$1 billion. This trend makes sense: We would not expect the larger, well-known biotech players to trade at a negative enterprise value. And with only a few exceptions, they don't.

I was genuinely surprised to learn that Roivant is a negative-enterprise-value stock, once we understand its balance sheet properly. Let me explain...

Roivant has three significant assets on its balance sheet.

The first is the simplest: \$7 billion of cash, with no offsetting debt on the liabilities side.

The second is Roivant's 55% stake in its publicly traded subsidiary Immunovant (IMVT), the company that holds the two previously mentioned potential autoimmune blockbusters Batoclimab and RVT-1402. Immunovant's market capitalization is \$5.5 billion, making Roivant's stake worth \$3 billion.

Together, Roivant's cash (\$7 billion) and its stake in Immunovant (\$3 billion) exceed Roivant's market capitalization (\$9.3 billion) by nearly \$700 million. To put it differently, these two assets by themselves give Roivant a negative enterprise value of \$700 million.

But Roivant also has a third important asset that few observers are paying attention to: Its patent-infringement lawsuits against Moderna and Pfizer, asserting that these Big Pharma giants infringed on key Roivant patents in developing their COVID-19 vaccines.

In the argot of Wall Street, these lawsuits comprise a "litigation asset." We call them litigation assets because their value depends on the outcome of litigation: If Roivant wins its lawsuits or settles them favorably, it could reap billions and even tens of billions of dollars. If it loses, the litigation could be worth nothing. The value of litigation assets is always probabilistic, meaning that it requires us to make some educated guesses about the probable outcomes to assess the asset's expected value.

As an aside, I love litigation assets embedded within investment opportunities. Why? Because most investors, and especially mainstream Wall Street institutions, are terrible at analyzing them. To form a view on a litigation asset's value, we must carefully wade through hundreds (sometimes thousands) of pages of legal filings and make nuanced judgments about esoteric questions of law. This is simply not an exercise most investors have either the appetite or capabilities to do. But *their* blind spot... creates *our* opportunity.

To help us get a handle on Roivant's litigation asset, I reached out to Mr. X, who would only agree to assist us if I could ensure his anonymity.

Mr. X and I attended Yale Law School together a little over 25 years ago. Since that time, Mr. X has established himself as one of the foremost intellectual property ("IP") lawyers in the world. He currently teaches IP law at one of America's top law schools. On the side, he is frequently asked to consult on the highest-stakes IP litigation happening. For example, when Microsoft finds itself engaged in patent litigation with billions of dollars at stake... Mr. X gets a call. We've been friends since our days in school and have worked together several times over the years. I've observed that when it comes to high-stakes IP litigation, Mr. X is rarely wrong.

I also want to be clear – I didn't ask for Mr. X's help by calling in a favor. His time is extraordinarily valuable, and Roivant's lawsuits against Moderna and Pfizer are exceptionally complex. So he and I came up with a budget that would enable him to get a reasonable handle on the cases. And I talked Porter & Co. into paying his bill.

So what did we learn from Mr. X?

Let's start with a brief description of what these cases are about. As most people know, Moderna's and Pfizer's COVID-19 vaccines are part of a novel, emerging therapeutic category called mRNA vaccines. mRNA, which stands for messenger RNA, is the chemical relative of DNA that directs cells to make specific proteins. Arguably the hardest technological challenge in developing mRNA medicines is engineering a safe, effective way to deliver the mRNA into human cells.

In 2018, Roivant and a partner named Arbutus formed a JV, Genevant, with Roivant owning 51% of the JV. Genevant in turn developed and refined a technology called Lipid Nanoparticles ("LNP") that has become the most effective mRNA delivery system. LNP technology surrounds mRNA with microscopic globules built from four carefully selected types of fat-like molecules. These globules shelter the mRNA and enable it to travel safely through the human body until it reaches a target cell's membrane. The LNPs then cross the cell membrane and release the mRNA. Without LNPs – which Arbutus and Genevant played a significant role in perfecting – mRNA would quickly degrade in the body and be ineffective.

Genevant's and Arbutus' lawsuits against Moderna and Pfizer – from which Roivant stands to benefit as Genevant's 51% owner – assert that the two Big Pharma giants' COVID-19 vaccines infringed upon key patents protecting innovation in LNP technology, without which these vaccines could never have delivered mRNA into the body successfully.

The details of Roivant's lawsuits against Moderna and Pfizer could easily take up an entire issue of *Biotech Frontiers*. They are fascinating and provide a kaleidoscopic look into the importance of IP law in the development of novel medicines. Perhaps we'll revisit them in detail in a future issue.

For now, let me distill the most important things we need to know:

- Moderna's and Pfizer's first line of defense against Roivant was to attack the patents and try to have them declared invalid. In IP law, the validity of underlying patents is a crucial threshold issue. If the patents are invalid, the lawsuit is dismissed. But crucially for Roivant, the court upheld the validity of its patents. This ruling was an important victory.
- In 2021 and 2022 alone, the Moderna and Pfizer COVID-19 vaccines generated over \$110 billion in sales. If a plaintiff prevails in a patent-infringement lawsuit, the damages that result are usually granted in the form of a "reasonable royalty" on past sales. If Roivant ultimately prevails here, even a small royalty would translate into billions because of the size of those sales.
- At least 90% of high-stakes IP lawsuits that involve valid patents settle. That makes sense because a settlement reduces risk for both sides. If the trend holds true here, the key questions then become when will a settlement happen, and at what amount? Mr. X believes that a settlement in these lawsuits is probably at least a year away... and that interim rulings in the coming year will have a major impact on the likely settlement amount.

In a famous scene in Quentin Tarantino's classic film *Pulp Fiction*, Winston Wolfe (played by Harvey Keitel) tells Jimmie (played by Tarantino himself): "I'm an Oak man myself, Jimmie... I like Oak. How about you?"

If I were Wolfe, my line would be: “I’m a numbers man myself, Jimmie... I like numbers.” And so I asked Mr. X to help come up with an expected-value analysis on Roivant’s lawsuits based on what information we have available now. Bear in mind, these numbers aren’t meant to be a precise prediction. Instead, their purpose is to help us understand, at an order of magnitude, the potential outcomes for Roivant.

In the Upside Case, for example, we figure a \$670 million contribution by taking Roivant’s 51% of the \$6.6 billion in potential royalties and multiplying that by the 20% probability of this outcome ($.2 \times \$6.6 \times .51 = \0.67 billion). Here is our EV:

How the Patent Fight Plays Out

Scenario	Description	Probability	Royalty Granted	Total Sales (\$billions)	Royalty (\$billions)	Roivant's Share	EV Contribution
Downside Case	No settlement and Roivant gets nothing	20%	0%	\$110	\$0	51%	
Base Case	Settlement with 3% royalty	50%	3%	\$110	\$3.3	51%	\$0.84
Upside Case	Settlement with 6% royalty	20%	6%	\$110	\$6.6	51%	\$0.67
Blue Sky Win	No settlement, Roivant wins and gets a 10% royalty	10%	10%	\$110	\$11	51%	\$0.56
Expected Value (\$billions):							\$2.1

With an expected value of \$2.1 billion for Roivant’s litigation asset, the total balance sheet suggests the company currently trades with a compelling negative enterprise value of \$2.8 billion.

V. The Catalysts

Biotech Frontiers subscribers are already familiar with the importance of catalysts in unlocking value. First, a liver-disease company – part of our initial 10-stock negative-enterprise-value portfolio – delivered Phase IIb clinical-trial results that caused the stock to appreciate more than 200%... before the company’s own capital raise, followed by Eli Lilly’s announcement of results for its competitor drug, caused the stock to fall back near its previous level. Then, another recommendation received accelerated approval from the FDA for its path-breaking therapy for advanced melanoma, causing the stock to appreciate 100%.

Over 2024 and 2025, Roivant offers us a rich slate of catalysts that fall into three key categories:

Potential drug approvals and clinical-trial readouts: In 2024, Roivant will seek approval from the FDA for its Vtama topical skin cream to treat atopic dermatitis, with an FDA decision anticipated in the second half of the year. Approval would significantly expand the patient population that Vtama can reach. In 2024 and 2025, Roivant will have at least five major Phase II or Phase III clinical-trial readouts for promising drugs in its pipeline, including heavily anticipated Phase III results for its potential autoimmune blockbuster Batoclimab.

Balance sheet cash and Immunovant stake: As we've seen, Roivant's balance sheet features \$7 billion of net cash as well as a 55% stake in subsidiary Immunovant, worth \$3 billion. Over 2024 and 2025, Roivant will make some important decisions about what to do with these assets. It could decide to return some of this cash to shareholders by buying back stock or declaring a special dividend. Or it could deploy some of this cash to purchase new assets, such as the RVT-3101 asset that returned 100x in 10 months. Roivant's CEO has also stated that the company has received multiple overtures to buy Immunovant. A sale, if it happened, would only be likely at a significant premium to Immunovant's current stock price and would give Roivant an even larger cash pile with which to grow shareholder value.

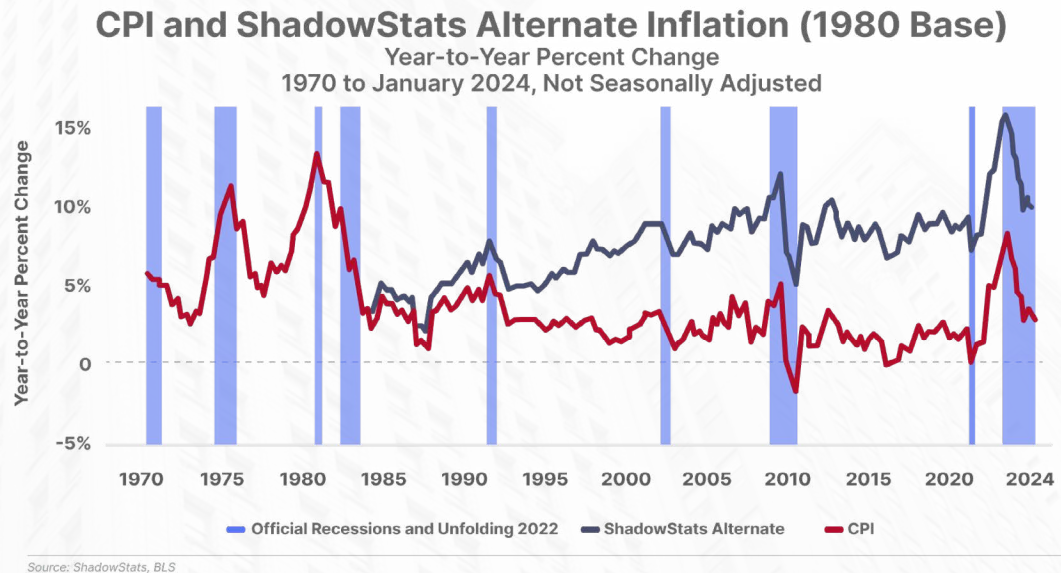
LNP litigation asset: 2024 and 2025 will also likely see meaningful progress in Roivant's patent lawsuits against Moderna and Pfizer. While it's unlikely these cases would be tried to a final judgment much less to the point of final appeals, they could conceivably settle... or Roivant could benefit from favorable rulings that increase the lawsuits' EV.

Each of these categories gives us reason to believe we won't need to rely on hope to drive appreciation in Roivant's share price over the coming years.

VI. The Big-Picture Backdrop

The March consumer price index (CPI) report, released on April 10, showed that inflation rose to 3.5% annualized – higher than consensus had expected. Wall Street promptly rolled back the probability of the Federal Reserve announcing rate cuts at its June meeting and reduced its expectations of the central bank's total rate cuts in 2024 to a figure approaching 50 basis points versus previous expectations of 150 basis points.

The deeper problem, I believe, is that actual inflation in the U.S. is running a lot higher than the CPI data reflects. I subscribe to economist John Williams' excellent [Shadow Statistics service](#), which aims to adjust the government's economic data so that it more accurately captures what ordinary Americans experience in their lives. The chart below compares the government's CPI data (in red) with Shadow Statistics' adjusted inflation metric (in blue):



As the chart suggests, the government may claim that inflation is running at about 3% annualized. But many Americans are experiencing inflation closer to 10% to 12% annualized, one reason the polling data indicates they're so dissatisfied with the Biden administration's economic track record.

Fed Chair Jerome Powell may be many things but I don't think he's a dummy. In particular, I don't think Powell wishes to be remembered in the same breath as the infamous Arthur Burns, the Fed chair who ushered in years of economic calamity in the 1970s by cutting rates before inflation was truly gone. For these reasons, I suspect the Fed is going to exhibit caution before cutting rates this year... And that by the time the year is done, the market is more likely than not to be disappointed by the total amount of rate cuts.

If I'm right, the biotech market will likely experience a pullback. I would welcome that pullback, because it would give us a terrific opportunity to load up on our favorite biotech opportunities. However, this outlook also means we will make a point to book profit on some of our biggest winners, so that we don't experience regret if we watch these names soar and then fall back amid an interest-rate-driven short-term retreat.

VII. Expected Value and Risk/Reward

In the final piece of our analysis, we synthesize everything that's come before and distill it into three capsules: a Premortem statement, a Parade statement, and an Expected Value tree for the proposed investment.

In our **Premortem**, we engage in the following thought experiment: Imagine it's three to five years from now and our investment has not worked out. Why did it fail? By answering this question, we force ourselves to reckon with what could go wrong.

Here is our Premortem for Roivant Sciences: The company's streak of 10 consecutive positive Phase III clinical trials is broken. Instead, Roivant experiences bad luck, and the next several Phase II and Phase III clinical-trial readouts are disappointing. Out of keeping with its history to date, the company's capital allocation also veers into disappointment – for example, Roivant invests in a few compounds that quickly prove to be a bust, leaving the impression that the company has lost its touch or become careless with its capital. Finally, Roivant suffers setbacks in its patent lawsuits, perhaps even receiving an interim ruling that appears to foreclose a successful settlement.

A **Parade** statement is the mirror image of a Premortem: We invite ourselves to imagine it's three to five years from now and our investment has been a spectacular success. What went right? Here, too, we are seeking to clarify the likely drivers of our upside so we can reflect on them alongside what could go wrong.

Our Parade statement for Roivant goes something like this: The company's winning streak in its Phase II and Phase III clinical trials continues, and the market begins to give more credit to Roivant's own prediction that its autoimmune franchise alone is capable of generating \$10 billion in annual revenues after 2026. In the meantime, the superb capital allocation Roivant has demonstrated so far continues, yielding visible results. For example, the company invests in another compound such as IBD treatment RVT-3101 that it flips back to Big Pharma for another striking return. Finally, Roivant reaps a series of positive rulings in its patent lawsuits, perhaps compelling Moderna to push for a settlement at a multibillion-dollar number.

Our **Expected Value Tree** distills everything that's come before into simple arithmetic. We begin by encapsulating our entire investment thesis into a downside scenario, a base-case scenario, and an upside scenario. We assign a probability and a stock price to each. And we derive our EV for the stock based on the sum of these three probability-weighted scenarios and their respective contributions. Here is my Expected Value Tree for Roivant:

EV Tree for Roivant Sciences

Scenario	Summary	Probability	Stock Price	EV Contribution (per share)
Downside Case	Setbacks in clinical trials, capital allocation, lawsuits	20%	\$8	\$1.60
Base Case	Continued strong execution	60%	\$24	\$14.40
Upside Case	Continued strong execution and some good luck	20%	\$36	\$7.20
			Expected Value (per share)	\$23.20

Action to Take: For the latest updates on our open positions, please visit our live portfolio [here](#).