High Conviction
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How Sweet It Is

Double-Digit Returns As Far As The Eye Can See

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In Porter & Co.'s *High Conviction*, we recommend what we consider the ultimate "no-brainer" investment ideas.

These are opportunities where our conviction level is so high that we'd be prepared to invest 100% of our capital into a single *High Conviction* recommendation (though we do not recommend this approach to asset allocation). These businesses aren't merely good, or even great… they're fantastic. Demand for their products is so entrenched – the moat, whatever form it assumes, is so broad and deep – that their success is not just likely – it's inevitable.

"Inevitable" is how Warren Buffett defined the investments that built Berkshire Hathaway into the world's greatest wealth-compounding machine. These "inevitable" companies have competitive advantages so clear and compelling that it's hard to imagine even the most well-financed competitor making much of a dent in their margins or market share.

High returns on invested capital and a wide moat insulating their businesses from competition means that Inevitable companies can compound at faster rates and outperform over the long term. That is… with one important caveat – that you pay a sensible price to own them.

And therein lies the challenge…

These long-term wealth compounders make up the core Forever Stocks category in *The Big Secret On Wall Street* portfolio. These are world-class businesses, and because of that, they generally trade at premium valuations.

But every once in a while, an outside event – like a financial panic or a deep recession – provides the rare chance to buy top-shelf merchandise at bargain-bin prices.

To be clear, a high-conviction opportunity isn't necessarily about *how much* a share price might appreciate – but rather, the *probability* that a share price will rise steadily over time. Sometimes, these situations may only result in a modest average annual gain… but it comes with far less risk than your average investment.

We added **Philip Morris International (NYSE: PM)** as **our first *High Conviction* position** in August 2024. We explained why like this:

> *"The "new" Philip Morris is disrupting the status quo and leading the tobacco industry toward a new era of safer nicotine consumption. The company owns the world's most popular, less-harmful alternatives to cigarettes and chewing tobacco, known as "smoke-free" nicotine products. And unlike the traditional tobacco business of selling "cancer sticks," which is in long-term decline, Philip Morris' smoke-free business is booming. The sales from this segment have exploded from zero in 2014, to nearly 40% of the company's $35 billion in total revenue last year. This has transformed Philip Morris from a stagnant, old-economy tobacco company into a growth stock."*

The opportunity we're presenting in this issue is also one of the world's most well-known and established brands. The company was founded in 1894, and has generated double-digit returns for decades. And because of a recent rise in the price of one of its main ingredients, its share price has come down to a level that makes it an attractive buy.

Porter first recommended this company in 2007, and Porter & Co. issued our first report in February 2024, but rather than recommending the shares, we added the stock to the watchlist until it fell to a more reasonable valuation. That happened two months later, **in April 2024**, and we recommended it in *The Big Secret On Wall Street*. And now it's an even more compelling opportunity.

Throughout its 130-year history, the company has survived the Great Depression, two world wars, and the Great Financial Crisis. In each case, it went on to regularly increase its annual revenue number and generated double-digit returns for shareholders. We believe the upside will be market-beating returns, with minimal downside risk, for many years.

A High Conviction Trade Happens Rarely

The Hershey Company (NYSE: HSY) owns a portfolio of some of the most iconic candy brands of all time, including Hershey Bars, Hershey Kiss, Reese's Peanut Butter Cups, Kit Kat, Twizzler's and Almond Joy. These brands have become household names over the last century and their enduring value enables Hershey to consistently increase sales volume, while also raising prices.

We're adding Hershey to the *High Conviction* portfolio for a number of reasons.

Hershey's business model is straightforward: it transforms sugar, milk, and cocoa into premium-branded chocolate, candies, and other snacks. That's what it's done, for decades – consistently growing revenue, earning thick profit margins, and returning a steady (and growing) share of profits to shareholders through dividends and share buybacks.

Brand power is what powers the Hershey profit machine. Over the last century, Hershey has established one of the most dominant consumer brands of all time. This gives it the ability to consistently increase prices each year, at rates well above the pace of inflation.

In 2023, for example, Hershey raised prices 6.5% compared with a 3.3% increase in the U.S. consumer price index (“CPI”).

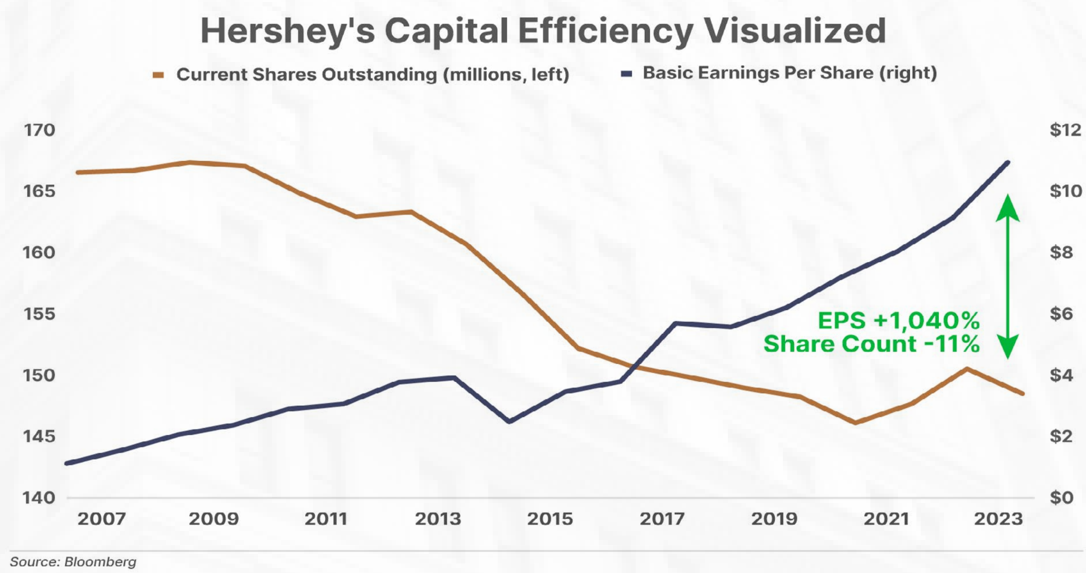
When Hershey raises prices faster than the rate of inflation, the company doesn’t incur additional operating expenses, or adding production staff. As a result, the incremental revenue from higher inflation-adjusted prices flows directly to the bottom line.

Analyzing the business through the lens of this capital efficiency reveals a high-powered business model capable of rapid profit growth. As Porter first explained in his original Hershey recommendation in 2007:

> *“First, this is a slow-growth business. Sales have only increased 24% over seven years. That, surely, will turn off most investors. Most people simply don’t understand the impact of even slow growth over time in businesses that are extremely capital efficient.”*

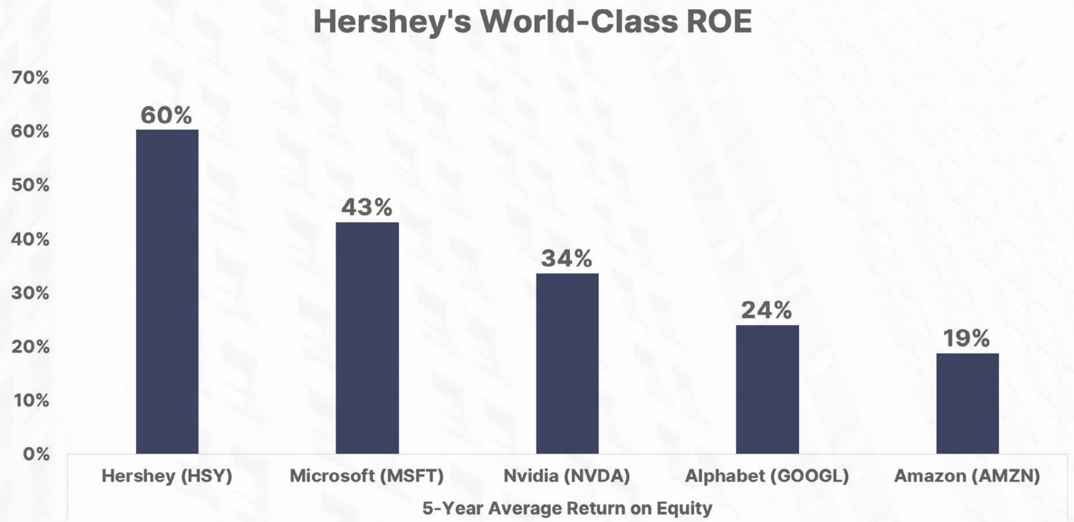
Since that original recommendation in 2007, the company has grown revenue by 126% or 5.2% annually. However, what is so impressive is that during this period, Hershey’s earnings per share (“EPS”) increased a phenomenal 1,040%, or 16.4% annually.

The reason why Hershey’s earnings increase at rates well above its revenue growth is because the company consistently reduces its share count through buybacks. This is a function of its capital efficiency – since the business doesn’t require much investment into new plant and equipment, it can instead return its growing earnings stream to investors, through share repurchases. In fact since 2007, the company has purchased about 19 million shares, reducing the count 11% to 147 million.



Hershey doesn't need to spend a lot of money each year on buying new chocolate-making equipment. It also doesn't need to reinvent the wheel – a Hershey Bar or Reese's Peanut Butter Cup hasn't changed much over the past 20 years.

By turning cheap, raw commodities into branded products with pricing power, Hershey generates world-class, 18.2% net income margins on roughly $11 billion in annual revenue. The company is also highly capital efficient. Over the last five years, it's produced an average of 60.3% annual return on equity ("ROE"), which measures the amount of profit earned relative to shareholder equity. These returns put Hershey on par with some of the world's most dominant, money-minting enterprises:



Source: Bloomberg

But there's one critical difference between Hershey and today's high-growth, capital efficient tech leaders: staying power. Rewind the clock 25 years, and consider the world-dominating tech giants that led the dot-com bull market of the late 1990s – Cisco Systems (CSCO), Intel (INTC), and Nokia (NOK) to name a few. None of these one-time tech heroes remain on top today.

And who knows where today's tech heroes will be in 20 years. It's likely that some of today's members of the Magnificent 7 – Apple (AAPL), Amazon (AMZN), Alphabet (GOOG), Meta Platforms (META), Microsoft (MSFT), Nvidia (NVDA), and Tesla (TSLA) – could also fade away.

But there's one thing we can bet on with a high degree of conviction: our children and grandchildren will continue consuming Hershey's bars, Kit Kat Bars, and Reese's Peanut Butter Cups – just like our parents and grandparents have done for generations.

Forever Brands Create Generations Of Growing Demand

The Hershey Company's iconic brands have become household products over the last century. It started with the original milk-chocolate Hershey's bar, created in 1900, followed by Hershey's Kisses in 1907. More than a century later, they remain two of the top-10 best-selling chocolates in America.

Over the last 100 years, Hershey expanded its empire by buying equally enduring brands with generational staying power.

Consider the Reese's Peanut Butter Cup. Half a century after Hershey acquired the brand from H.B. Reese Candy Company, it still reigns as one of the best-selling chocolate candies in America. And despite its age, demand for the product hasn't slowed a bit – in fact, it's currently Hershey's fastest-growing product line.

Hershey also acquired the U.S. rights to distribute the Kit Kat Bar from the H.B. Reese company (Swiss chocolate maker Nestlé owns the overseas rights to Kit Kat). The Kit Kat Bar became another staple of American chocolate consumption, and today ranks among the top-10 most-consumed U.S. chocolates.

The Kit Kat Bar and Reese's Peanut Butter Cup each brings in more than $2 billion in annual revenue for Hershey. Those are just two names in Hershey's portfolio of more than 100 branded products – making it the largest chocolate maker in America. Some of its most enduring brands are Milk Duds (established 1928), Almond Joy (established 1946), Twizzlers (1929), Jolly Rancher (1949), and York Peppermint Pattie (1940). These classic candies remain as popular today as they were generations ago.

In recent years, Hershey has expanded beyond its traditional focus on chocolate and sugary candies (labeled as its Confectionery segment) into a new product line of salty snacks (its Salty Snack segment).

Hershey's New Salty Bets

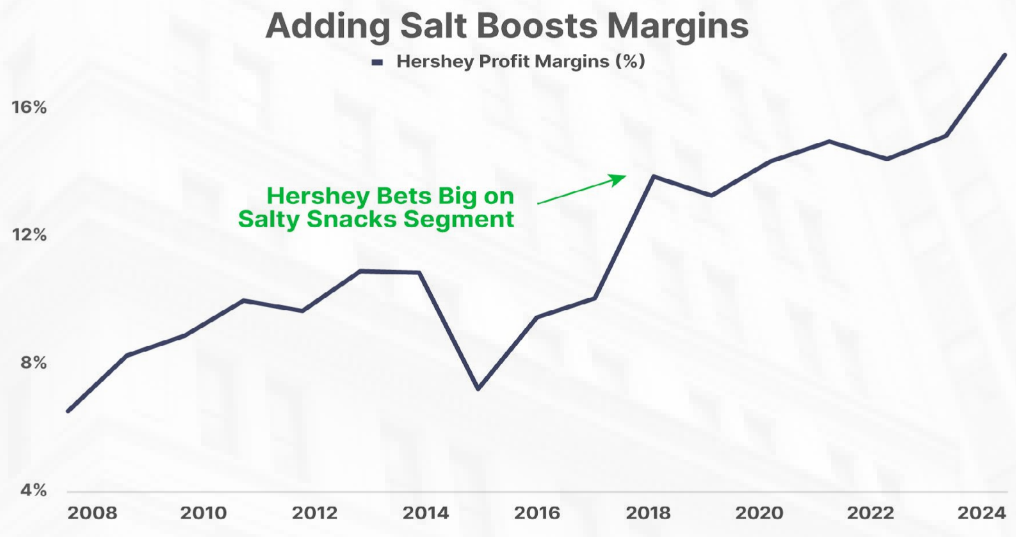
Hershey CEO Michele Buck engineered one of the company's biggest strategy shifts in its history with an aggressive push into the Salty Snacks segment. Shortly after her promotion from COO to CEO in March 2017, she oversaw Hershey's largest acquisition in its history – the $1.6 billion purchase of Amplify Snack Brands. This brought, among other products, the Skinny Pop brand of premade popcorn into the Hershey portfolio.

Next, Buck oversaw the $420 million purchase of Pirate Brands in September 2018, which gave Hershey ownership of the popular Pirate's Booty puffed corn and rice snack. This was followed by the $1.2 billion purchase of Dot's Pretzels in December 2021.

Buck's big bet on salty snacks has paid off with stellar results, boosting Hershey's growth. Since entering this segment seven years ago, Hershey's pace of revenue growth has nearly doubled to 7% in 2023, up from 3.7% annual growth rate in the seven years prior.

Salty Snacks currently make up two of the company's top-10 best-selling products. And while the key brands in this segment are younger than those in Hershey's Confectionery portfolio, the premium brands have delivered just as much pricing power. Over the last three years, Hershey has raised prices of Salty Snacks by an average of 7.7% annually compared with 6.4% for Confectionery.

The combination of robust volume growth and potent pricing power of Hershey's Salty Snacks segment now accounts for 10% of company sales – or $1.1 billion. And it has delivered a substantial uplift in profit margins. In its first full year after the acquisition of Amplify Snack Brands, Hershey's net profit margins soared to a new high of 14.7% in 2018, compared with 13.7% in 2017. Margins have continued trending upward since then:

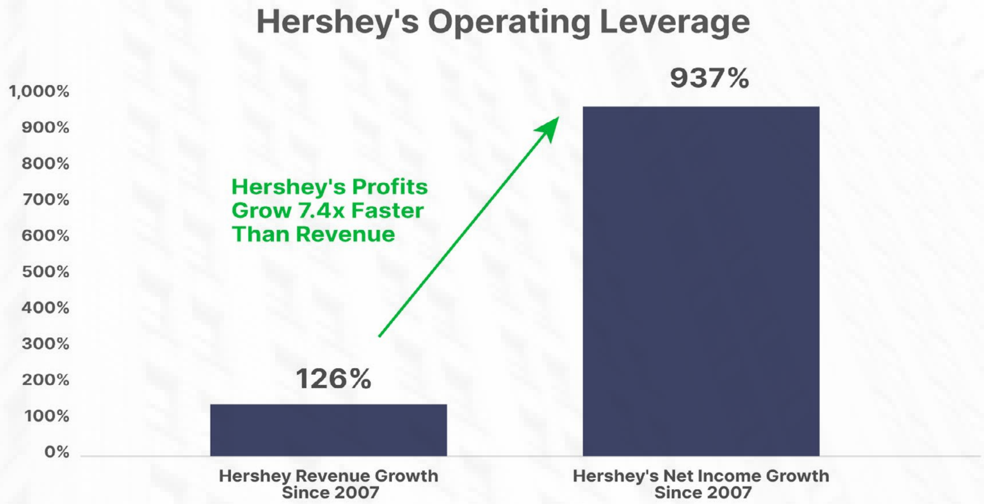


Source: Bloomberg

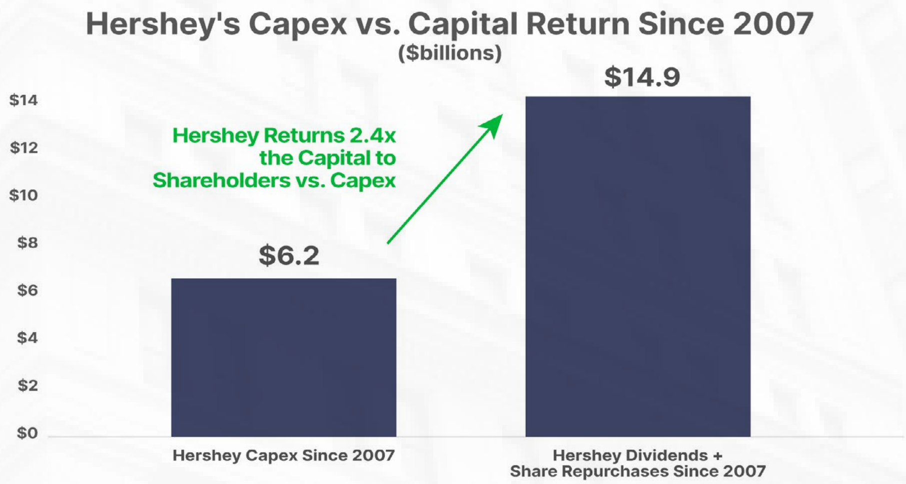
The Compounding Power Of Capital Efficiency

Consider the following two key metrics of Herhsey's business since Porter's original recommendation 18 years ago. From that point, Hershey has grown revenue 126%, or 5.2% annually. Pretty boring, right? But over the same time period, Hershey's profits have increased by a stunning 937%, or 15.7% annually.

Few corporations in the world can increase profits more than 7x faster than their rate of revenue growth. This is a function of Hershey's world-class operating leverage, where each incremental dollar of revenue comes with a fraction of additional operating expenses.



This capital efficiency means Hershey can send a substantial portion of its profits to investors, instead of sinking it back into the business for capital expenditures (capex). Since 2007, for every dollar of investment into capex, Hershey has returned $2.4 to investors through dividends and share repurchases.



This capital returned to investors has reduced HSY share count by roughly 11% since 2007. That means that today's investor owns 11% more of the company versus 2007, without adding a single dollar of new investment capital. Meanwhile, the company has boosted its dividend by 361% over the same period. Shareholders who consistently reinvested these dividends also own, all else equal, 48% more shares than they did in 2007, at the time of Porter's recommendation.

A $100,000 purchase of Hershey shares on the date of that recommendation would have grown to $553,350 today, assuming dividend reinvestment along the way. That compares with a similar $100,000 investment in the S&P 500 that's now worth $453,630.

The real challenge for investors is having the patience to wait for the right purchase price. The market is mostly efficient most of the time. So it normally prices Hershey's premium business model at a premium valuation of between 25x and 30x earnings.

However, the market is unforgiving when short-term quarterly results disappoint. Hershey hardly ever disappoints. But on those rare occasions when it does – typically due to macroeconomic factors beyond its control – long-term investors can buy the shares at a virtually no-risk price.

That's the opportunity unfolding today, as Hershey faces two short-term macroeconomic factors weighing on its business.

Lower Consumer Spending, Higher Cocoa Prices

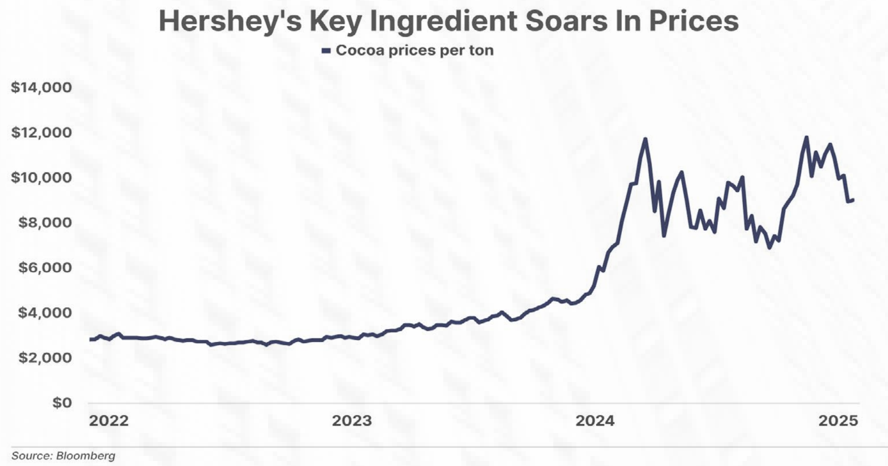
While Hershey's brand power and market share remain as strong as ever, the company is facing the same cyclical challenges many other consumer packaged goods ("CPG") companies face: a limited ability to raise prices to cover higher costs.

Following the inflationary outbreak of the post-COVID environment, CPG companies began raising prices aggressively. This included Hershey, which increased prices by 14% in 2021, 8% in 2022, and another 8.3% in 2023.

Initially, consumers flush with COVID-era stimulus checks paid the higher prices, and Hershey cashed in with record revenue and profits. But by 2024, with stimulus savings running thin and wage growth falling behind the pace of inflation, consumers pulled back on discretionary food purchases. This created a significant slowdown in revenue growth.

In addition to lackluster consumer demand, Hershey also faces another pressure point on its business – the skyrocketing price of cocoa, by far Hershey's single largest expense. Unlike many of its peers that have broadly diversified product lines, cocoa and various derivative products like cocoa liquor and cocoa butter make up the majority ingredient in most Hershey products.

For the last two decades, cocoa prices have traded within a relatively tight range of $1,500 to $3,500 per ton. In 2023, general commodities inflation pushed cocoa prices up to a new high of $4,000 per ton by year end. Then, last year, the world's largest cocoa-producing region of West Africa – responsible for 80% of global supply – was hit by both poor weather and the Cacao Swollen Shoot Virus. The virus decimated the region's cocoa crop, creating a shortage that sent prices up by another 300% last year, from $4,000 per ton to $12,000 by year end. They've since fallen considerably, to about $9,000 per ton – but remain well above historical average levels:



But barring any weather catastrophes, improving crop conditions should bring cocoa supply and prices back to normal in 2026. Between now and then, Hershey investors should brace for a bleak year of operating results.

Over the past year, as cocoa prices have soared, analysts have slashed their expectations for Hershey's 2025 EPS from $11 to around $7.50. This would mark a 27% decline from Hershey's prior all-time high EPS of $10.40 in 2023, reflecting the sharpest earnings decline in the last 25 years – exceeding the 21% drop during the Global Financial Crisis from 2007 to 2008:

With the prospect for improving cocoa crop conditions and therefore lower prices in 2026 and beyond, we believe this year will be the low point in Hershey's business for years to come. And given that there's been no decline in Hershey's market share or overall brand power, we see no reason why the business won't do what it's always done after similar declines throughout its history – recover to create new highs in sales and profitability.

Unlike many businesses – even other great businesses – Hershey does not have to come up with a brilliant business plan to bring about an earnings recovery. It simply needs cocoa prices to normalize, at which point the lower costs will flow straight through to the bottom line via higher profit margins. History shows that the cure for high commodities prices is high commodities prices – high prices reduce demand, which spurs increased production, leading to lower prices.

Once that happens, Hershey should have no problem reclaiming its prior high EPS of $10.40 it last achieved in 2023, with further upside from there as the business continues growing.

At a current share price of $178, investors who believe in this future outlook can purchase Hershey shares at less than 15x its future EPS – reflecting one of its lowest valuations on record. In short, we believe, with *high conviction*, that most (if not all) of the near-term bad news is priced into the shares today, leaving very little downside risk for investors willing to hold for the long run.

Action to Take: Buy The Hershey Company (NYSE: HSY) up to $200 per share