Portfolio Intelligence Report (PIR): 10.08.2022

"Know what you own and why you own it." - Peter Lynch

This weekend, we examine new developments/commentary within our portfolio companies.

We discuss CLPT's lock-in effect with doctors, hospitals, and neuroscience colleges. From there, we dive into SQ's latest Afterpay news, recent bearish sentiment and a CNBC Bear Take that missed the mark. We then discuss our newest addition to the Strategic Basket: Eli Lilly (LLY).

Finally, we unpack two BTU Twitter threads and highlight EGY's recently approved merger with TGA, creating a debt-free cash-returning E&P beast.

Let's get after it.

Strategic Basket Update: CLPT, SQ, & LLY

Total Basket Highlights (including non-updated positions):

- Current Average Return: -25.02%
- Current Notional Exposure: 16.82%

ClearPoint Neuro (CLPT)

CLPT is a neurological platform company that enables neurosurgeons to perform minimally invasive procedures under real-time MRI guidance. The company provides these solutions through its ClearPoint Neuro Navigation System, or CNNS. You can read our write-up here.

Peter Mantas tweeted a snippet from an interview with CLPT CEO Joe Burnett in which Burnett describes CLPT's "lock-in" effect (emphasis added):

> *"So, the fact that our dossier, our portfolio, our bench data, toxicology data, all of that was able to pass the muster as part of a combination device here, I think absolutely says, if its a pharma company in a situation to say, hey,* ***do I use the company and the SmartFlow Cannula that's actually been successful in getting approval?***
>
> *Or do I* ***roll the dice with something that maybe doesn't have that level of data*** *and certainly* ***not that level of clinical experience?*** *So I think that certainly helps."*

CLPT's "lock-in" effect is a critical piece to our bull thesis. It creates a strong moat around CLPT's products, software, and services by skyrocketing switching/agency costs.

No doctor wants to risk their practice using something untested when CLPT's tested products and services exist. And no patient would want to receive treatment from an untested product/device when a tested, reliable alternative already exists.

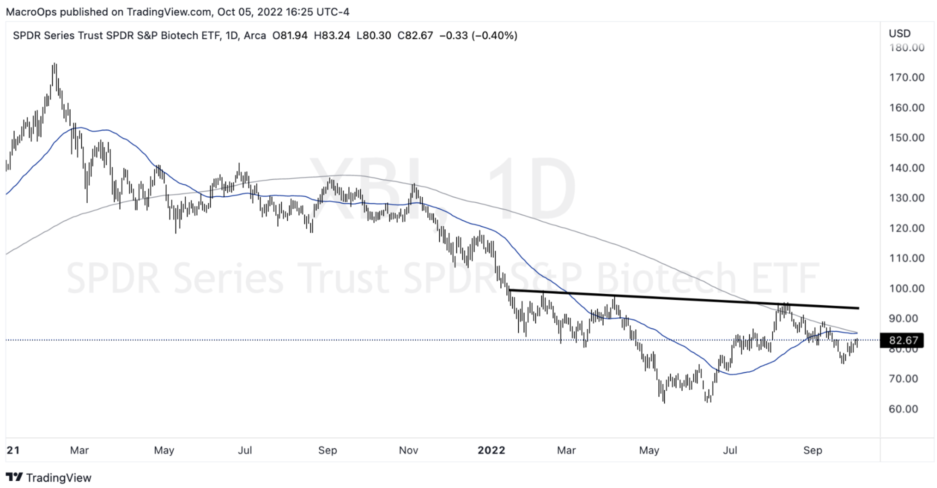
Reinforcing these lock-in effects is CLPT's royalty license agreement with the top neuroscience college UCSF.

CLPT *pays* UCSF to teach its students using CLPT technology (like SmartFlow Cannulas and CLPT software).

So now you've got hundreds of graduates familiar with one technology, one workflow, and one company's products.

Of course, none of this matters as long as biotech remains in a bear market.

XBI is forming a potential inverse H&S bottom. Expect biotech stocks like CLPT to lead the rally once this ship turns.



Management has already stated its goals for its FNN business: 100 cases a year from 100 clinical partners or 10,000 annual cases.

At ~$10,000 per case, that gets us $100M in annual revenue from its FNN segment alone over the next five years.

Then there's the Biologics and Drug Delivery segment. It's impossible to predict how much revenue this business segment will generate over the next few years. However, we can use WST as a proxy. WST generates billions of dollars in revenue from its disposables/delivery mechanism business.

It's not a stretch to think CLPT could create hundreds of millions, if not billions, in revenue should the company become the delivery mechanism of choice for all neurological drug therapies.

We own this business at a ~$200M market cap.

Block, Inc. (SQ)

SQ is a leading provider of merchant point-of-sale hardware, software, and other services, along with its fast-growing financial services app, Cash App. The company supports over 2M merchants through Square POS and software, while Cash App sports 47M+ active monthly users.

You can read my original write-up here, where I outlined SQ's plan to create an "Ecosystem Connection" between its Square Seller business and the Cash App consumer enterprise.

This week, AfterPay introduced new monthly payment options amidst the high inflationary environment (lowkey before the Holiday season). You can read the article here.

This is a big deal because every buy-now-pay-later (BNPL) player makes money on compound interest. Modern MBA did a great video on this industry, which you can watch here. It's very well done and a must-watch as we learn more about SQ and Afterpay.

By removing compound interest, SQ drives consumers' costs to ~$0 for the BNPL option and eliminates the primary revenue driver for every BNPL company.

Everyone in the industry must adjust or face market share deterioration.

SQ can do this because they generate so much GP from Square Merchant and Cash App. They don't *need* BNPL to be a hugely profitable engine.

To SQ, BNPL is another Customer Acquisition Channel to upsell into higher margin products like Cash App.

However, the market doesn't yet care about this positive news. In fact, I found a recent Bear Case from a CNBC Global Interview. I highly recommend watching the full video here.

The analyst who downgraded SQ missed the mark on many points. For example, here are two "issues" mentioned during the interview.

> ***Issue 1:*** *"Jack is absent and spends all his time worrying about bitcoin. Therefore, the company doesn't spend enough time worrying about its core products and services."*
>
> ***Issue 2:*** *"The company spends a disproportionate amount of time working on bitcoin."*

Let's address these issues. Jack is "absent" because he's excellent at building organizations that run themselves and putting people in leadership positions that don't require constant monitoring.

Additionally, while Jack may spend a lot of time on Bitcoin, SQ the *company,* spends very little. Bitcoin is Jack's passion project. Still, SQ and Cash App are run by individuals hyper-focused on those businesses.

I won't go on a limb and say that Bitcoin is the *only* thing keeping SQ's stock price down. We can think of SQ's businesses (Seller Merchant & Cash App) as take rates on consumption. Which, of course, will decline if we enter a recession.

I'm seeing signs of "peak pessimism" surrounding SQ on Twitter (see below).

Consumers are switching to mobile payments (like Cash App) well beyond COVID 2020 trends, despite bearish sentiment suggesting otherwise.

SQ currently trades at ~7x LTM EV/Gross Profit, the cheapest valuation over the past five years. We continue to hold our 5% notional position. SQ should generate over $28B in revenue and $11B in Gross Profits by 2025 (assuming mid-double digit top-line growth and ~40% gross margins).

By that time, the company should trade for ~3x sales or $84B. In other words, that;s 150% upside while assigning 0% probability of EV/GP multiple expansion.

Eli Lilly (LLY)

LLY is the newest member of our Strategic Bucket. The company discovers, develops, and markets human pharmaceuticals worldwide.

Collective member Kulok pitched the idea in #ideas-equities late last week. You can check out his elevator pitch below (emphasis added):

> *"By any measure its expensive relative to its peers ... you can read the financials or go to SA, most analysts bemoan its elevated valuation ... so what gives? while some point to the AD drug as the reason for optimism, I think that's misguided ... imo,* ***its the obesity drug that's generated interest*** *... I read the phase 3 study .,..* ***this drug works AND is very safe*** *(I've linked to the IR release below) ...* ***The obesity market is obviously huge*** *... but if it demonstrates efficacy + no side effects I'm sure that many people who just want to lose a few pounds for whatever reason will take it ... even knowing this, I wasn't ready to commit capital on a long until I read thru* ***Druck's latest filing and he has been buying like crazy*** *...* ***he's allocated ~7% to this name*** *... So, I've put on a starter position and plan to do some more digging."*

Check out the rest of the Slack thread here. We bought a starter position Wednesday (10/05) with a stop at $316. LLY received Fast Track Status from the FDA the following day (link here).

President of LLY Diabetes, Mike Mason, explained the importance of the Fast Track Status (emphasis added):

> *"Obesity is a chronic disease that impacts the health of nearly 100 million Americans and is a significant driver of healthcare costs. While diet and exercise are important steps,* ***most patients don't achieve their desired treatment goals with only diet and exercise.*** *We are dedicated to* ***helping people living with obesity through our research and development of innovative treatments like tirzepatide****, which produced* ***significant weight reductions in patients taking tirzepatide for type 2 diabetes in SURPASS.*** *Tirzepatide also helped nearly two-thirds of participants on the highest dose reduce their body weight by at least 20 percent in SURMOUNT-1."*

Finally, I leveraged my Twitter network and secured a Zoom meeting with a postdoctoral research scientist in LLY's "Discovery Unit." I should have a transcript of our conversation by next week.

Thematic Basket Update: BTU & EGY

Total Basket Highlights (including non-updated positions):

- ➢ Current Average Return: -4.10%
- ➢ Current Notional Exposure: 36.96%

Peabody Energy (BTU)

BTU is involved in mining, preparation, and sale of thermal coal primarily to electric utilities; mining bituminous and sub-bituminous coal deposits; and mining metallurgical coal, such as hard coking coal, semi-hard coking coal, semi-soft coking coal, and pulverized coal injection coal.

The company didn't release any new information or news this week, but @8750Capital did a great job outlining the five potential catalysts for the stock (link to the thread here):

- ➢ **Rapid deleveraging in Q3**
- ➢ **Strong Q3/Q4 FCF** (Seaborne Terminal will generate more FCF than the entire company did in Q2, ~$387M)
- ➢ **Strong Liquidity** ($2.2B in cash, which we outlined last week)
- ➢ **Low hurdle to reduce debt** before returning excess capital to shareholders (~$355M)
- ➢ Wambo mine could produce **$2B of EBIT in 2023** (if Wambo does $1B in EBITDA, it adds ~$50/share to BTU equity value.)

At the current rate, BTU will generate more FCF in the next 12-18 months than its current market cap. This means that the market ascribes ***negative*** terminal value to the company 1-2 years out at today's price.

We like how 8750Capital summarizes its findings (see below).

Summary

1. Only $355M of funded liabilities stand between Peabody and capital returns (i.e., including the $302M LOC, but excluding the '25 bonds and SSTL). Peabody will have more than $2.2B in unrestricted cash at the end of the current quarter.
2. Eliminating the $355M of capital-return-blocking-debt would leave the Company with $1.880 billion in unrestricted liquidity, which is more than enough to launch a buyback and pay special dividend.
3. After untold years of struggling with a high debt-load, Peabody in late 2022 is not the same company it was even six months ago. It's a transformed company in a transformed industry, and it stands to generate billions of cash flow, underpinned by Wambo and other seaborne mines.

There's another good Twitter thread on BTU's negative terminal value, which you can read here. You can read this snippet below.

8750 Capital @8750Capital · Oct 3
To drive this point home, let's go over something really basic: free cash flow is smaller than EBITDA.

To repeat, FCF is calculated as EBITDA less interest expense / taxes / capex / change in networking capital (sorry, this is turning into an interview).

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8750 Capital @8750Capital · Oct 3
So, if they are forecasting that NTM FCF > BTU current market cap, that means BTU's valuation as a multiple EBITDA is pathetically low.

Sorry to be a boring valuation geek, but buying well is 90% of the game and it doesn't get much better than this.

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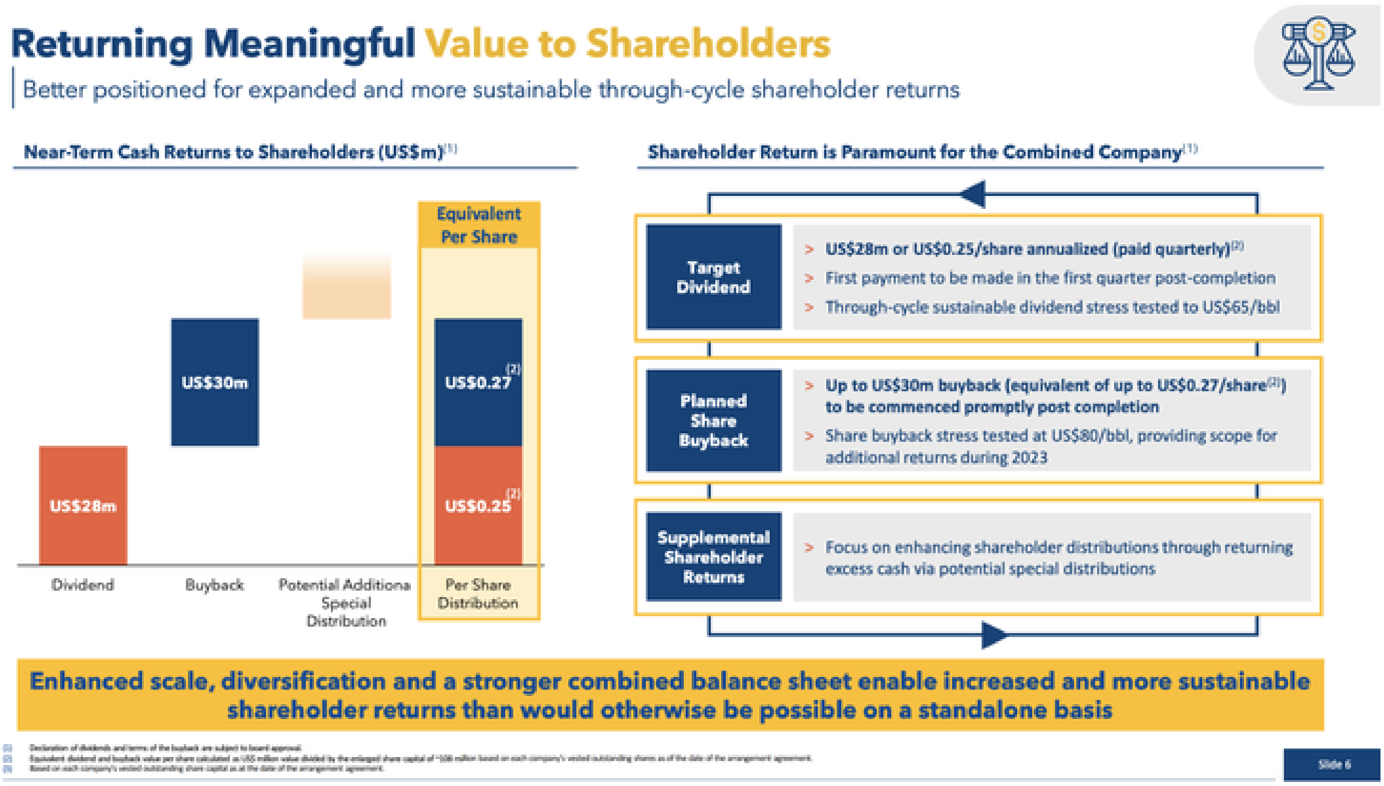
We will add to our core position on pullbacks to the midline or lower Bollinger band and will cap our notional exposure (at cost) to 10%.

VAALCO Energy (EGY)

EGY is an independent energy company that acquires, explores for, develops, and produces crude oil and natural gas in West Africa.

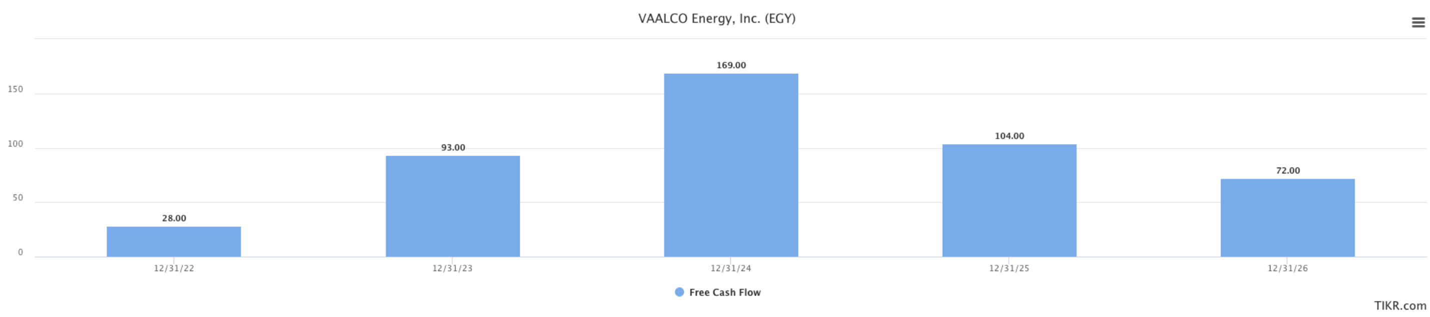
The company and Transglobe Energy (TGA) approved a $307M merger this week. The merger combines two debt-free African E&Ps with big plans for shareholder returns.

Check out the slide below that explains EGY's latest near-term capital return. You can read the merger pitch deck [here](#).



In other words, EGY sees ~$0.52/share in near-term cash returns to shareholders or a 10% yield as of Friday's close.

One analyst has EGY generating ~$466M in cumulative FCF by 2026, or 1.35x its current market cap. So while we'll benefit from short-term capital returns, EGY should generate enough cash to pump out additional buybacks/special dividends.



We currently have a 3% notional position with a stop below the pivot lows ($4.60).

Portfolio Performance Update

- ➢ October (month-to-date): -1.62%
- ➢ Q4 2022 (to-date): -1.62%
- ➢ YTD (as of 10/07): +13.89%