Portfolio Intelligence Report (PIR): 11.05.2022

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

Happy Saturday!

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

First, we highlight a new Cell & Gene Therapy whitepaper from @DeepSailCapital that explains the bull case for companies like CLPT. Next, we unpack earnings reports from Eli Lilly (LLY) and Block, Inc. (SQ).

Both companies crushed earnings, and we remain bullish on their long-term prospects.

We then shift to our Thematic book and discuss EGY's latest capital return announcements (raising dividends and a new $30M buyback program). We also dissect earnings reports from Comstock Resources (CRK) and Tidewater (TDW). Spoiler alert, it was a record-breaking quarter for both companies.

Finally, I discuss CDLX's latest earnings report and explain why we're hesitant to get bullish despite its optically cheap price.

Let's get after it.

Strategic Basket Update: CLPT, SQ, LLY

Total Basket Highlights (including non-updated positions):

- Current Average Return: -22.37%
- Current Notional Exposure: 17.64%

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 on the company here (starts on page 4).

I sound like a broken record, but there's more positive news for the cell and gene therapy industry this week. Charles River (CRL) reported earnings Wednesday (11/02). It offered insights into the CGT space (emphasis added):

> *"Demand for traditional biologics remains strong, but cell and gene therapy clients are driving a disproportionate amount of recent growth."*

CRL beat on earnings and revenues during the quarter, which bodes well for CLPT's upcoming earnings on 11/08.

Additionally, @DeepSailCapital on Twitter released an excellent Cell & Gene Therapy Industry Primer, which you can read here. The fund owns a few CGT picks-and-shovels businesses (MaxCyte, ClearPoint, and Biolife Solutions).

DeepSail also wrote a TL;DR on the primer, which you can read below.

- CGT is in its infancy, but it will see S-curve growth in patient numbers in 2023 and 2024 driven by upcoming CGT treatment approvals.
- CGT requires a different production, treatment, and logistics value chain than traditional small molecules. Traditional providers have been slow to support CGT development, allowing specialty providers like MaxCyte, Clearpoint Neuro, and Biolife Solutions a high growth, high value niche, which is required by drug developers to successfully launch new CGT treatments.
- With COVID-19 largely behind the world, barriers to CGT development including slow FDA approvals and resource constraints are going away allowing CGT to blossom. Timing-wise, everything is lining up extremely well for CGT going forward.
- Since each CGT treatment requires a different production and treatment plan, there is no standard within the industry for commercial scale production, allowing many smaller specialty tools and services companies to thrive.
- CGT will be in high demand for potential patients as it is a curative treatment for genetic disease, unlike all other treatments to date.

The stock remains in a downtrend and is likely headed lower. We continue to hold our shares as the value proposition and growth runway remain strong.

Block, Inc. (SQ)

Block (SQ) provides merchant seller services through its "Square" product to over 2 million businesses. Popular products include Square Invoicing, Payroll, Square for Restaurants, and Square Capital. The company also serves 47M+ consumers through CashApp.

You can read our write-up on SQ here. Here's what you should know this week.

SQ crushed earnings on Thursday (11/03). You can read the Shareholder Letter here. Check out the highlights below (YoY):

- ➢ Revenue increased by 36% to $2.75B
- ➢ Gross profit grew by 38% to $1.57B
- ➢ Cash App increased gross profits by 51% to $774M
- ➢ Cash App Card users increased by 40% to 18M (35% of monthly actives)
- ➢ Square POS solutions (Restaurants, Retail, and Appointments) grew gross profits by 45%

More importantly, the company generated ~$65M in positive adjusted EBITDA ***after*** adding back Stock-Based Compensation (or SBC).

The quarter also showed SQ's operating leverage as Gross Margin exceeded 35% for the first time in ten quarters. Additionally, SG&A expense as a percentage of revenue declined to 19.5%, generating a positive operating cushion of ~15.5%.

Cash App is a growth monster. It's generated a 78% gross profit CAGR over the last three years (excluding BNPL).

We use three levers to track Cash App's progress:

- ➢ Actives
- ➢ Inflows per Active
- ➢ Monetization Rate on Inflows

Cash App increased Actives by 20% YoY to 49M users. 36% of Actives use the Cash App card monthly, an increase from 25% in 2020.

Inflows are also accelerating. For example, Cash App received $2B+ in direct deposit inflows during September. Average inflows reached $1,046/active during the quarter (~ flat YoY) while lapping one of the strongest inflow quarters to date (PPP/COVID and tax season).

Over the last three years, **Cash App inflows have grown at a 17% CAGR.**

SQ's CFO, Amrita Ahuja, might be one of the best in tech. Here are some of my favorite quotes from her during the company's Q&A (emphasis added).

On Cash App's Growth Runway …

> *"Ultimately, we think there's a tremendous opportunity from an actives perspective to continue our growth here. If you think about digital natives, Gen Z, millennial customers, though they make up a significant portion of Cash App customers,* ***we are still only penetrated into 20% of Gen Z, millennial customers as of the U.S. population,*** *as we shared at our Investor Day in March. This is the fastest-growing demographic for us in monthly actives over the past few years,* ***but there's still much more we can do here to bring the other 80% into Cash App over time, too.****"*

On Balancing Growth vs. Profitability …

> *"We are focused on* ***driving long-term profitable growth at scale.*** *And what that means for us is that we're going to* ***balance growth and margins in our investment framework.*** *As you note,*

given the significant growth of our business, we've grown our investments over the past few years to create products and marketing engines that help us drive that top line growth paired with profitable unit economics across both of our ecosystems …

Our ***preliminary 2023 plans really significantly moderate those expenses*** *-- that expense growth as we focus on balancing growth and profitability. Longer term, we do -- we will continue to moderate that expense growth to drive increased operating efficiency, profitability. And* ***specifically for Cash App, we do expect to see operating leverage next year.*** *We'll have more to say in February, of course, as we're still in our planning stages across the business …*

So far this year, we pulled back almost $600 million, about 10% of our planned OpEx space or 25% of the step-up where we haven't seen returns or where the returns are less certain in order to deliver more near-term profitability."

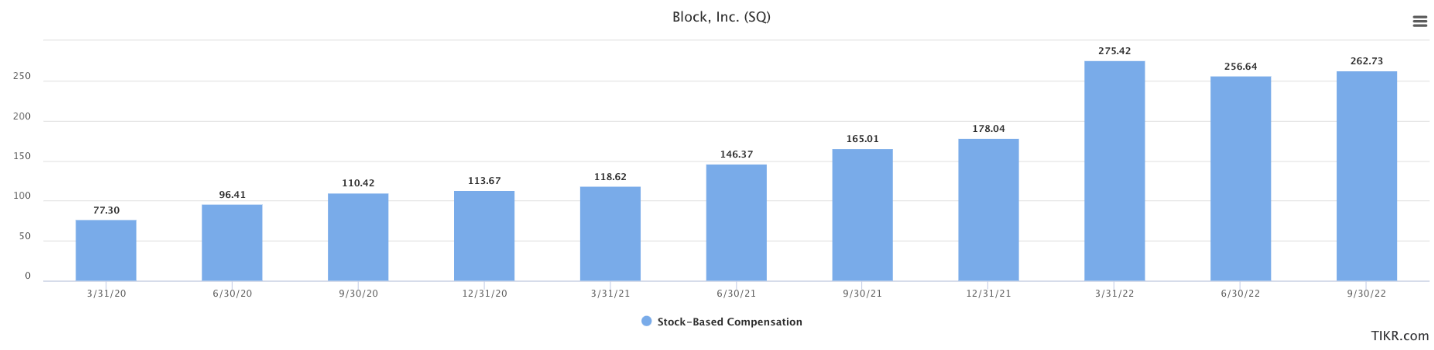
On Cash App ARPU Expansion …

"So from an ARPU perspective, ***gross profit per active, excluding the BNPL platform, was $57 in the third quarter, up from $53 in the second and $50 in the first quarter****. So we are continuing to see growth there, in part driven by our monetization rate, in part driven by the increased utilization of the platform, strong engagement on the Cash App platform.*

If you break that down across our inflows framework, what we look at is active where we've continued to see strong growth; inflows per active, ***which we've seen continued stability despite now lapping some of the significant government disbursements and even some of the seasonal tax benefits from the first half of this year."***

Let's discuss SBC.

SQ spends ***a lot*** on SBC. Specifically, it's spent *at least* $250M/quarter over the last three quarters. It's important to note that SBC is an actual expense that SQ eventually must pay (see the chart below showing SBC over the previous 11 quarters).



Most of the current SBC expense is due to SQ's AfterPay acquisition (which it bought in an all-stock deal).

SBC also increases shares outstanding. For example, SQ has increased its fully-diluted share count from 462M in 12/31 to 592M this quarter.

We'll continue to monitor SBC expenses over the next few quarters and are confident that Amrita (and her team) can leverage SBC over time.

The company currently trades at ~1.65x NTM sales and 6.3x Gross Profits. So far, the stock has held its long-term support around $50/share. We continue to hold our shares.

Eli Lilly (LLY)

LLY discovers, develops, and markets human pharmaceuticals worldwide. If you've heard of Trulicity, you know LLY. The bull thesis is that LLY's tirzepatide drug could more than double its current revenue base over the next 5-10 years while expanding EBIT margins by 1,000bps.

Check out our LLY thread in Slack if you haven't already. It's a great way to get up to speed on the thesis.

Additionally, read last week's *PIR*, where I shared my notes from an interview with an LLY postdoctoral researcher in the company's Discovery Unit.

LLY reported earnings Tuesday (11/01) with solid results. You can listen to the call (here) and read the supplemental slide deck (here). Let's get to the highlights (YoY):

- Revenue grew by 2% (7% on a constant currency basis)
- Worldwide volumes increased by 14%
- $97M in US revenue from Mounjaro (i.e., Tirzepatide)
- $86M in Japan revenue from Mounjaro
- Key growth products (Verzenio, Trulicity, Mounjaro, Jardiance, Taltz, etc.) grew by 19% and represented 70% of Q3 revenues
- EPS increased by 32% to $1.61/share
- FY 2022 EPS guidance between $6.50-$6.65/share

Mounjaro (or Tirzepatide) is all we care about with LLY. The drug has a shot at becoming the most popular drug in human history. One of my favorite biotech investors (and frequent guest on the Value Hive Podcast) Peter Mantas, also agrees.

$100M in Mounjaro revenue for an inaugural quarter is incredible growth, thanks mainly to the FDA's fast-track approval of Tirzepatide for obesity/weight-loss treatment.

The EU and Japan also approved Mounjaro for Type 2 diabetes treatments during the quarter. This should clear a path for user adoption outside diabetes (i.e., weight loss).

We'll have to wait until April 2023 for the FDA's final decision as they wait on SURMOUNT 1 and 2 trial data.

As we mentioned earlier, LLY grew revenues by ~7%. Most of that growth came from volume increases (see below).

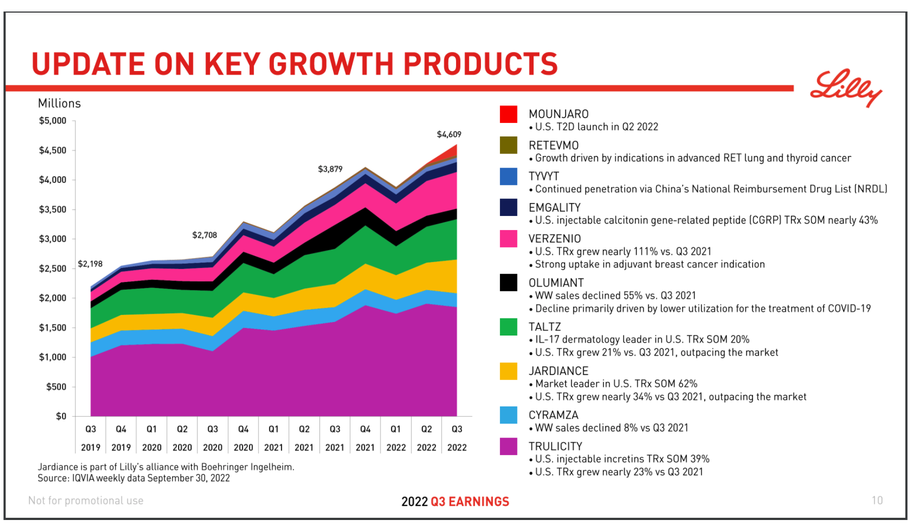
PRICE/RATE/VOLUME EFFECT ON REVENUE

Lilly

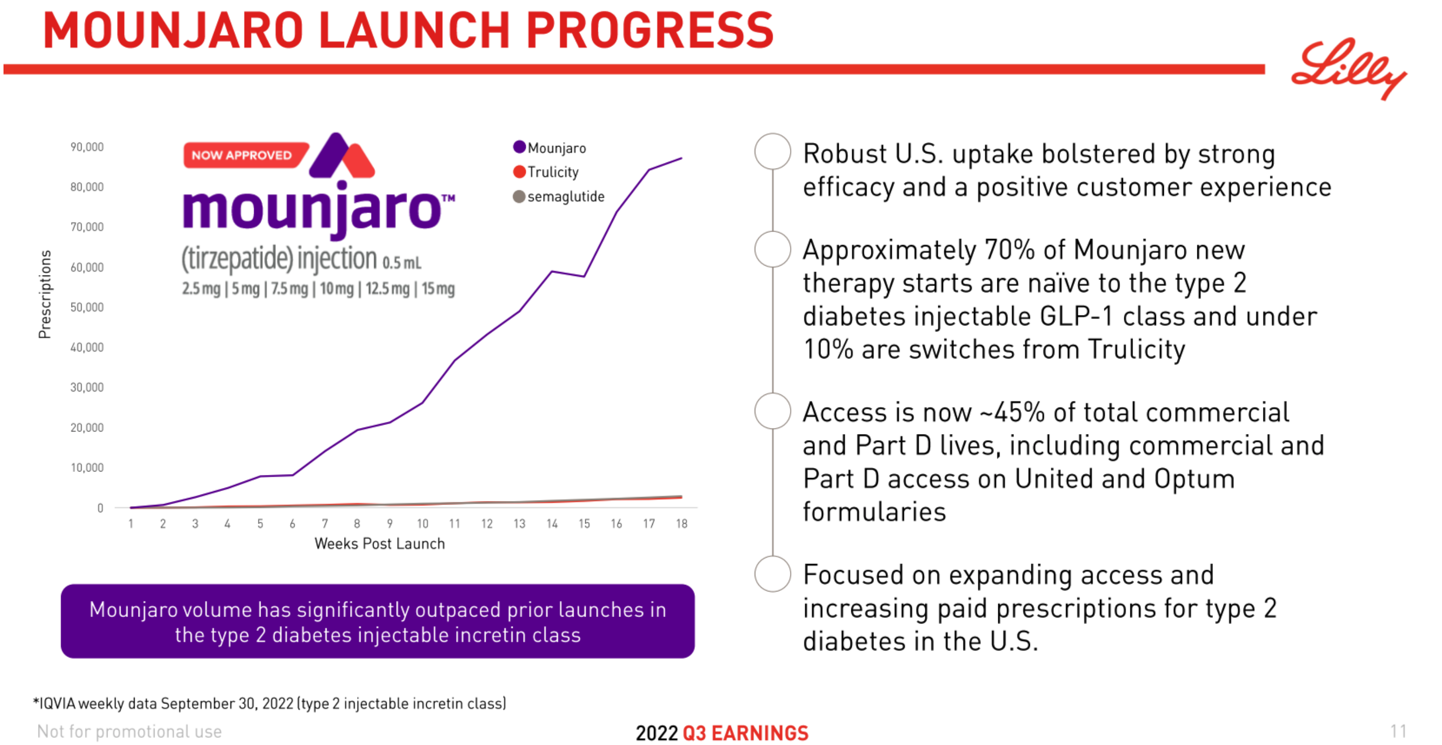
Millions	Q3 2022					
	Amount	Price	FX Rate	Volume	Total	CER
U.S.	$4,422	(4)%	-	15%	11%	11%
EUROPE	1,056	(3)%	(15)%	14%	(4)%	11%
JAPAN	488	(4)%	(16)%	3%	(18)%	(2)%
CHINA	343	(67)%	(4)%	57%	(14)%	(10)%
REST OF WORLD	632	(1)%	(3)%	(4)%	(8)%	(6)%
TOTAL REVENUE	$6,942	(7)%	(4)%	14%	2%	7%

The company made up for its 7% price headwind via a 14% volume increase. Normalize the 4% FX headwind, and LLY generated double-digit revenue growth during the quarter.

Below is one of my favorite slides from the deck. You can see the staying power of LLY's key growth products over the last three years. Each product generates more sales than it did at inception.



Back to Mounjaro. It's hard to overstate the magnitude of Mounjaro's success post-launch. LLY hasn't experienced such rapid success like this in its history. For example, Mounjaro has sold ~18x the number of prescriptions versus Trulicity after 18 weeks post-launch.



One last note on Tirzepatide. Chief Science Officer Daniel Skovronsky outlined LLY's plans for Tirzepatide during the earnings call Q&A. You can read it below (emphasis added):

> *"As you point out, weight loss and restoration of sort of normal metabolism, which we think may be possible with tirzepatide, is going to have benefits in a lot of metabolic- and obesity-related diseases. So how do we pick which ones to pursue and when?*
>
> *I think initially, our thinking has been around generating a body of data that shows that a drug such as* ***tirzepatide when driving weight loss can lead to downstream health benefits****. So that's what drives the MMO study. We have a heart failure study, a sleep apnea study that are all ongoing.*
>
> *When we think about adding more, sort of where can we see improvements in that medical understanding of the dangers of obesity and the benefits of weight loss and restoration of normal metabolism. That's how we think about it rather than how big is this patient segment or how big is the next patient segment, noting that almost all of those patient segments will already have obesity as an underlying disease, which we expect to have indicated next year, as I commented earlier.*

> *Finally, I think one more consideration here, Geoff, for us is **we see fighting obesity as a long-term goal for Eli Lilly and Company.** And so **there'll be multiple generations of drugs here, we hope**. And we'll have lots of opportunities to contribute to our medical understanding of weight loss."*

We're excited about Mounjaro's future. Next week we'll convert half of our common equity position into Deep Out-of-the-Money call options (or DOTMs).

LLY has DOTMs out to 2024.

Thematic Basket Update: EGY, TDW, CRK

Total Basket Highlights (including non-updated positions):

- Current Average Return: +0.96%
- Total Notional Exposure: 32.87%

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 distributed its quarterly dividend this week ($0.13 annualized). Importantly, EGY's CEO George Maxwell plans to **increase EGY's annual dividend to $0.25** (emphasis added):

> *"We closed on our strategic combination with TransGlobe Energy, Inc. on October 13, 2022 and **remain committed to nearly doubling our target annualized dividend to $0.25 per share** beginning in the first quarter of 2023, the first quarter immediately following the closing of the transaction."*

EGY also implemented a new $30M share buyback program, which it can exercise over the next 20 months. More thoughts from Maxwell …

> *"We believe the market has not yet incorporated the value that will be created from the combination of our two companies into a single entity with very strong cash flow generation capacity and a debt-free balance sheet with significant cash on hand.*
>
> *We have a premier portfolio of assets in Gabon, Egypt, Equatorial Guinea and Canada which should allow us to return meaningful cash to our shareholders on a sustainable basis through dividends, share buybacks and potentially through special distributions in the future."*

Dividends and buybacks should support the stock price as it makes its right shoulder in an attempted inverse H&S breakout (see below).

Tidewater (TDW)

TDW provides offshore marine support and transportation services by operating a fleet of marine service vessels worldwide.

The company reported impressive earnings on Thursday (11/03). Check out the highlights:

- ➢ Reported positive quarterly net income for the first time since 2017
- ➢ Revenue increased by 17% to $192M
- ➢ Vessel level cash margin expanded by 200bps to 40.6% (think of this as TDW's unit economic margin)
- ➢ Generated $22M in FCF (versus -$15M in Q2 2022)

TDW sees further vessel rate increases over the next 12-18 months. VP of Marketing/Sales Piers Middleton explains (emphasis added):

> *"**We believe there's a lot more room in rate rises,** frankly, and it's an opportunity for us to continue to push that. And the best way of doing that is to stay as short as possible, keep the contracts as*

much optionality on our side at the moment, which we've not had that opportunity for the last 5 years, really. So that's something which we're going to continue to focus on doing. And it's some initial push back from our customer base. ***But they seem to be coming around to our strategy,*** *whether or not they agree with it is a different matter, but they're certainly accepting it."*

In other words, TDW's customers don't like the price hike, but they're forced to take it.

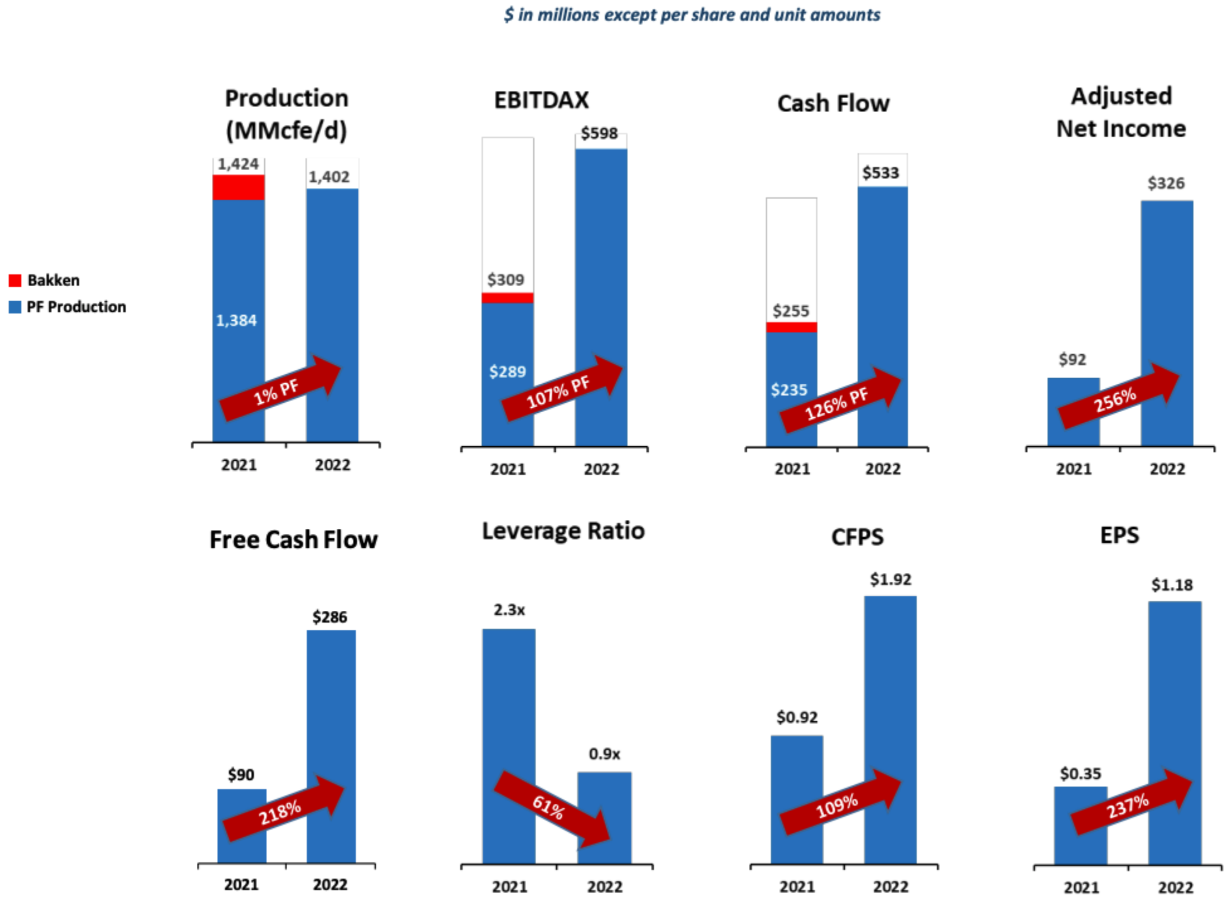
TDW currently trades at ~9x NTM EBITDA and is expected to grow margins from ~22% in FY2022 to 36% by 2024. We hold a ~4% notional position and are up 37% from our cost basis.

Comstock Resources (CRK)

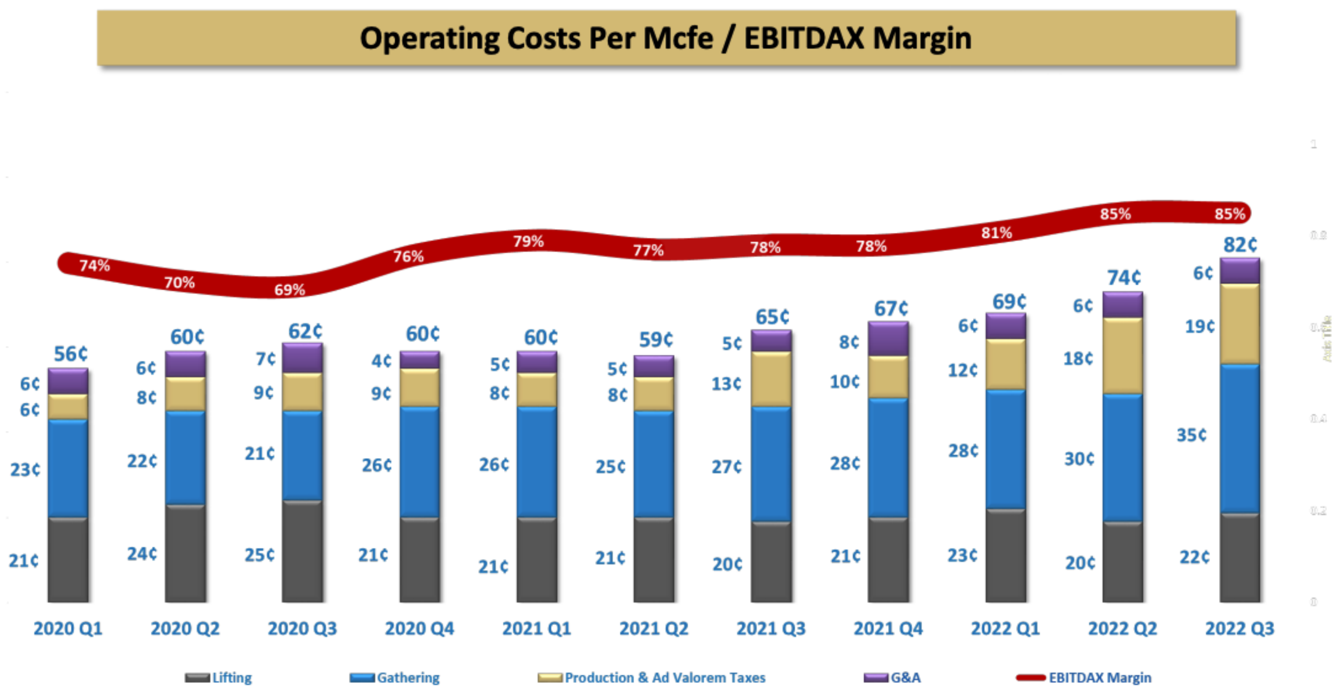
CRK reported historic earnings on Tuesday (11/01). You can read the earnings deck [here](). Here are the highlights:

- ➢ Generated $533M in quarterly operating cash flow (highest ever)
- ➢ Earned $286M in FCF
- ➢ Retired $250M in long-term debt to reduce leverage to <1x
- ➢ Generated $1.18/share in earnings
- ➢ Reinstated quarterly dividend (starts in Q4)

Every metric improved.



CRK's historic cash generation is a byproduct of its low-cost operating model. For example, the company expanded its EBITDAX margin (EBITDA + maintenance capex) from 74% in Q1 2020 to 85% in Q3 2022 (see below).



The company also outlined its capital allocation priorities:

1) Reduce debt by repaying the remaining $100M under a bank revolver
2) Spend $65-$75M on acquisitions
3) Return capital to shareholders via buybacks and dividends

While we prefer buybacks over dividends, we're happy with CRK's dedication to capital returns.

Other Notes: Thoughts on Cardlytics (CDLX)

Cardlytics (CDLX) is down 95% YTD and 83% over the last three years. It's hard to imagine, but CDLX traded at a $3B market cap a year ago.

Today it's a micro-cap stock with a $150M market cap trading at 2x gross profits.

There are many issues with CDLX today. They include:

- Significant advertising spend slowdown (more than management anticipated)
- Expanding EBIT losses (~$40M/quarter burn rate)

➢ Gross Margin compression from increased financial incentives to partners
➢ Expensive migration to new ad server/cloud

CDLX faces going-concern risks. They have ~3.5 quarters left of cash at their current burn rate (~$138M in cash). If they can't reach profitability by then, they'll need to issue equity or debt to survive.

The good news is that CDLX has shown an ability to reduce SG&A expenses to ~30-40% of revenues (which they did in 2019-2020). It would at least buy the company more time to generate profits.

Bulls see the light at the end of the tunnel by claiming:

➢ CDLX hasn't lost a banking partner this year
➢ Four banks + JP Morgan migrated to the new ad server/cloud
➢ Bridg revenues increased by 86% YoY
➢ CDLX connected >50% of MAUs to the new ad server
➢ NEW CEO brings much-needed execution experience

These are valid arguments. And sure, the stock is optically cheap here (<1x sales). But CDLX suffers from the chicken-and-egg problem. Here's what I mean.

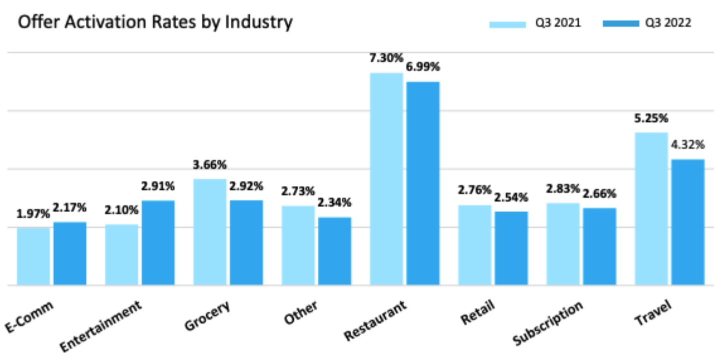
Retailers cut advertising expenses during recessions to save cash. What *type* of advertising do they cut first? **The experimental projects**.

The bad news for CDLX is that they are still an experimental project for many retailers. They're not on the same level as Google or Facebook ads despite the company's reported ROAS.

So when retailers cut advertising spending, CDLX is the first to go.

However, retailers *must* spend on CDLX to see the 5:1 ROAS and view the channel as equal to Google or Facebook. But if they don't spend on CDLX, they can't see the ROAS.

Finally, activation rates remain low for every industry besides Restaurants (see below).



Maybe activation rates expand on the new ad server when advertisers can target SKU-level products and embed images into the advertisement.

Or maybe CDLX's bank partner customers only open their banking apps to pay bills and check balances, and that's it.

To conclude, CDLX is cheap. But we're not rushing to buy.

The company will face significant headwinds over the next few quarters. We'll wait for improved fundamentals (reduced SG&A as a % of revenue, increased activation rates, reduced cash burn, etc.) and technicals before getting excited.

Portfolio Performance Update

- November (month-to-date): -1.20%
- Q4 2022 (to-date): -0.21%
- YTD (as of 11/03): +15.29%