Equity Note: Special Situations Update (FGPR) & Thoughts About 2023 Research

I've gotten a few emails/DMs about my thoughts on FGPR since my June write-up (which you can find here). Since that write-up, we've added many new faces to the Collective (welcome, guys!). So I figured I'd spend some time this weekend updating my priors and recapping the unique situation for newer members.

After that, I discuss my thoughts on approaching investment research in 2023. I had a "research breakthrough" in our weekly MO HQ meetings this week, and I want to share those realizations with you. Maybe it'll help your research journey, too!

But before we dive in, here is a quick update on the portfolio. We added a tactical long gold trade to our core futures holding. That's working well so far. We also took 50% profits in USDCNH short. The currency pair closed weakly into the weekend. We'll likely aggressively move stops to lock in even more profits (keep an eye out for that trade alert).

Alright, let's dive into Ferrellgas Partners (FGPR).

Special Situations Update: Ferrellgas Partners (FGPR)

FGPR is the second-largest propane distribution marketer and the largest propane tank exchange player in the U.S. If you live in the US, you've probably seen a few "Blue Rhino" propane tanks before.

The company generates ~70% of its revenue from its retail business selling to end-users like residential homes and industrial/commercial customers. FGPR's retail propane segment is a good business, generating ~47% gross margins, ~12% EBIT margins, and ~$300M in annual EBITDA.

FGPR's stock has traded down ~35% since my write-up, so it's important to review the main drivers of the special situation and why I still see tremendous upside.

Here's the **TL;DR** version of the situation:

- FGPR is a post-reorganization from Chapter 11 bankruptcy
- The company's equity (Class A Units) were unimpaired during Chapter 11
- FGPR's existing debt converted into Class B Units
- The company ***must pay*** the Class B Unitholders $357M
- Class B Units convert at increasingly higher dilution multiples the longer it takes FGPR to pay the $357M
- Once FGPR pays the Class B Unitholders, it can return all FCF to Class A Unitholders in annual dividends

That's the elevator version, and I encourage you to read my entire write-up for a more comprehensive overview.

There are two options FGPR has to pay off the Unit B holders, of which there are 1.3M "units" (think shares).

First, the company can pay off the Unit B holders within five years post-bankruptcy at a guaranteed 15.85% IRR. Doing this would reduce Class A dilution and allow FGPR to reinstate the Class A dividend with its freely distributable cash flow.

The other option is to wait and *eventually* pay $357M over ten years. However, the longer they choose to extend the pay-off period, the more it dilutes Class A unitholders. Check out the dilution table below:

Year Post–Emergence	Conversion Factor
Y1	1.75x
Y2	2.00x
Y3	3.50x
Y4	4.00x
Y5	5.00x
Y6	6.00x
Y7	7.00x
Y8	10.00x
Y9	12.00x
Y10	25.00x

In other words, Class B converts to 7.3M Class A units if it takes FGPR six years to pay the $357M. Employees own 20% of the company, which they hold in Class A units. The company's founder, Jim Ferrell, owns 5% of the business in Class A units.

There is a strong incentive to pay the $357M without diluting the Class A units.

Which begs the question: *How capable are they of paying off the $357M in time?*

Over the past five years, FGPR has generated between $245-$330M in annual EBITDA. There is little capex needed (especially in their refillable tank business), around 6% of EBITDA.

After subtracting interest payments (debt and preferred stock), **the company is left with ~$150-$160M in free cash flow.**

If the company wanted to, they could pay the remaining $270M (assuming 15.75% IRR for early payment) from **~3 years of FCF generation.**

FGPR has paid $100M towards the Class B Units, leaving $257M to pay within the next few years before further dilution kicks in.

Recent Updates: Step-Up & Litigation

The company has until March 2023 to pay off the Class B units before the dilution factor increases from 2.0 to 3.5x, a substantial step-up.

There are two ways FGPR can achieve this:

1) Refinance and take out the Class B holders
2) Use FCF and existing cash on hand to retire Class B holders

FGPR would need a killer quarter to make it happen. Refinancing would be the surest way of eliminating dilution risk, but more difficult with tightening capital markets.

Then there's the Eddystone Litigation. FGPR's 10-K added detail on the litigation. We'll get the final result around February. If the company loses the litigation, they'll owe ~$140-$180M. This worst-case scenario would guarantee Class A dilution and severely impact free cash flow.

However, if the litigation fails, it would further increase FGPR's odds of paying the Class B units before any severe dilution. At which point, the current $8.40/share equity price is **ridiculously** cheap.

Thinking About Class A Distributions

Suppose it takes six years post-bankruptcy to pay the Class B unit holders. That gives us ~13M Class A units and $150M in free cash flow for dividends.

Next, let's assume the company reinstates its annual dividend of ~50% of available FCF or $75M. That's ~$5.90/share in annual dividends against the current share price of $8.40.

Said differently, if the company paid out half of its FCF in annual dividends at the 6x dilution factor, investors would receive >100% of their cost basis in dividends after two years.

I've been buying at these levels in my retirement account.

Warning: this is a highly illiquid, highly leveraged micro-cap stock. **Position size accordingly.**

Thinking About My 2023 Research Process

A week ago, we held our second Macro Ops Happy Hour (or MOHO). We discussed lessons learned from the worst trades of 2022. Check out the replay [here] if you missed it.

Collective member @Kulok mentioned something during the MOHO that's stuck with me. He said (and I'm paraphrasing) …

> *"When I stick with the Trifecta Setups, the ones where technicals, sentiment, and fundamentals align, I do much better. Whenever I deviate from taking pure Trifecta Setups, I get into trouble."*

Not waiting for Trifecta Setups was the **main driver** behind our poor equity returns. We took a ton of trades that only met one or two parts of the Trifecta Lens criteria. And the common pitfall behind those non-Trifecta Lens trades was **technicals**.

We bought stocks with strong/improving fundamentals, great sentiment, and terrible charts. Take SQ, for example. I love the company, believe the long-term fundamentals are improving in its core businesses, and trust its management team.

When we first started researching SQ, it met two of our Trifecta Lens criteria: **Fundamentals** and **Sentiment.** The stock was cheap while growth was still *slightly* in vogue. Yet the chart was in a clear downtrend no matter what time frame you used.

The red circle below is when we started buying/deeply researching SQ last year.

Tape reading OG Al Brooks preaches, “look to the left” when analyzing price action. Everything to the left of the red circle screamed **DO NOT BUY.**

In other words, SQ’s price action violated our third criterion in the Trifecta Lens approach. Yet we ignored the red light and bought it. And we kept buying under the guise of “this is a long-term holding.”

Traditional value investing says that over the long term (5-10 years), what happens in the next 12-18 months doesn’t matter. While that’s true, **it’s not how we trade at Macro Ops**. That’s not our core competency. More importantly, we don’t have to endure such drawdowns because of our global macro approach. If equities aren’t working, we can switch to currencies, futures, or commodities.

We don’t have to suffer the “inevitable” fate of holding stocks through massive downturns. And the Trifecta Lens helps us avoid that pain **as long as we listen to it.**

Which brings me to my next point: **My 2023 Research Process.**

This year I’m bringing the Trifecta Lens approach to my investment research. Here’s what I mean.

Going forward, I will devote all my research time/focus to industries that meet **every part** of our Trifecta Lens criteria. That means I spend all my time studying the industries, stocks, and sectors that have: **killer fundamentals, strong sentiment,** and **supportive technicals.**

We should only buy stocks that meet every Trifecta Lens criterion. Why should we view investment research any differently?

A few industries that meet our Trifecta Lens criteria include:

- **Oil and gas**
- **Energy equipment services**
- **Precious metals**
- **Agriculture**
- **Fertilizer**
- **Industrials and Chemicals**

Then some industries are on the cusp of hitting our Trifecta Lens, like:

- **Healthcare**
- **Medical Technology Devices**
- **Biotech**
- **Communications**

Another way to think about it is through a **Return on Time** approach.

I can study SQ until I'm blue in the face. But how much value am I creating if technology doesn't meet our Trifecta Lens criteria and we don't think it will for the next 3-5 years?

The Trifecta Lens approach to investment research also allows us to stay in names and spaces longer as the thesis works. We use longer-term technical time frames (weekly and monthly) to judge the **technical** aspect of the Trifecta Lens equation.

Instead of jumping around different industries and names the way a squirrel scrambles to find a buried nut, we can "hibernate" in industries with every tailwind at its back. That means more focused research, more profound insights on companies within those industries, and a greater understanding of what **really matters** in those industries. All of those benefits compound over time, too.

This isn't easy to write because I've spent a lot of time studying, writing, and researching earlier-stage, high-growth technology businesses when I should've spent that time on the things that **were working**. But most "breakthroughs" are uncomfortable in that way.

I'm excited about this new research process. I hope that it provides even more value to the Collective and a few more actionable ideas throughout the year. The more tailwinds we can put at our backs, the better our chances of outperforming in our equity trading.

Here's how it will look. I'll spend a month to a quarter diving into a Trifecta Lens industry (one that hits all three items). Everything I publish (Equity Notes, podcasts, MOHOs, webinars, etc.) will align with the industry. I'll read industry-specific books and write book reviews, interview some of the sharpest traders/investors in each industry, and within a quarter, will have enough information to become an expert. At least, that's the goal.

We're starting this journey in February, so keep your eyes peeled for the first industry selected.

Finally, I want to include the Collective as much as possible in this process. We have tons of intelligent Operators in here. Let's do webinars, MOHOs, and podcasts so we can all learn from each other if you work (or have worked) in one of these Trifecta Lens industries.

Let's make 2023 the year of the Trifecta Lens.

Portfolio Performance Update (as of 01/13)

- January: +7.95%
- Q1 2023: +7.95%
- YTD: +7.95%