February 19, 2025

THE LONG PULL: HODLing Our Winners (RHM and VLE)

We've got a quick Long Pull report this week.

First, we dissect our Rheinmetall (RHM) position and explain why it's time to plug our noses and HODL while our thesis works.

Then, we review Valeura's (VLE) latest earnings report to see why the company is still extremely cheap despite rising 25% this month.

Let's get after it!

Rheinmetall (RHM): Don't Get In Front Of The Train

RHM is our EUR 40B global military/defense manufacturer. We bought the company in November and have enjoyed a ~60% share price increase (see below).

A month ago, I wrote our RHM thesis:

"Trump will demand Germany/EU to spend more on their defense and military (i.e., rely less on the US) and that RHM is the best-positioned company to meet that future demand.

Here's a simple way to frame it: In 2024, Europe spent ~2% of GDP on national defense. Trump wants them to spend at least 3%. A 1% increase would result in an additional EUR 100B in annual spending until 2028 (see the graph below from RHM Investor Day)."

I also noted a few reasons why I preferred RHM as the way to play this thesis:

1) *They're the largest defense company in Germany and the fifth-largest in Europe.*
2) *They're quickly creating one of the largest military vehicle fleets globally.*
3) *They were one of the leading defense partners for Ukraine.*
4) *They have one of the most badass CEOs in the game (Russia/KGB tried to assassinate him at one point)*

So far, the market agrees with that take. But has it run too far too quickly? How much juice is left to squeeze?

RHM's operating profits should reach around EUR 3.6 billion by 2027, with EUR 1.4B in free cash flow. This puts the current valuation around 11x 2027 operating profits and 27x free cash flow.

It's still not expensive, but it's not obviously cheap. That is the sweet spot for some of the best-performing stocks. It's the **Trifecta Lens philosophy** in action.

Take Eli Lilly (LLY), for example.

The stock never looked "cheap" – but it didn't matter. It had (arguably) the strongest secular tailwind you could imagine: Lots of people are fat, LLY makes a drug to make people less fat without any effort, and people will pay whatever price to get less fat without any effort.

I hate to use this word in markets, but LLY was … obvious? Kulok killed it on this tailwind while we exited for a small profit (yay!).

What does LLY have to do with RHM?

The RHM thesis seems equally obvious: The US will stop subsidizing Europe's defense spending, Europe still needs to defend itself, so it will start spending more on local defense to fill the US void.

Here are a few headlines from the past week confirming our thesis.

NEWS > DEFENSE

Poland to Europe: Don’t play games with Trump, spend more on defense

The Polish PM is adamant that Europe must not break ties with the U.S.

Europe talks up more defence spending as Ukraine peacekeeper plan divides

By **John Irish**, **Elizabeth Pineau** and **Humeyra Pamuk**

February 17, 2025 7:19 PM EST · Updated 2 days ago

European Defense Stocks Rise on NATO Remarks on Military Spending Boost

NATO Secretary General Mark Rutte said the alliance’s spending target would be considerably more than 3% of GDP

They’re saying the quiet part out loud … “Increase defense spending now because Uncle Sam won’t be around to bail you out anymore.”

US Defense Secretary Pete Hegseth said as much last week (emphasis mine):

> *“Yesterday, in Brussels, we … **talked a lot about spending and the need for hard power.** Diplomacy is important, talk is important, [and] negotiations are important,"*

> "*But, ultimately,* ***beans and bullets and tanks and helicopters and hard power still [matter].*** *Poland understands that and so do we.*"

He then said:

> *"Our message has been — and, as we discussed, we believe, heard loud and clear — that* ***member countries in NATO need to spend more, need to invest more [and] need to have more skin in the game for their collective defense,***"
>
> *That is not just a suggestion from the United States of America;* ***that is a direct request****, which we will follow up on as a reflection of [the member countries'] desire and commitment to actually defend their own backyard."*

This is where things get tough.

On one hand, the secular tailwinds are obvious and enduring (defense spending a 5-10+ year commitment).

On the other hand, the stock is up 60% on our cost basis in a few months, and odds are we will experience a significant pullback soon.

Here's how I'm managing the trade:

1) Maintain wide stops based on weekly pivot points.
2) Focus on the long-term drivers and avoid intraday price action.
3) Avoid focusing on near-term valuation bear arguments.

I know, that last one feels like what every investor says before they get rug-pulled. But you *need* that mindset if you want to hold long-term winners. LLY *always* looked *expensive*. It *always* looked overextended. There was *always* a reason to exit.

We own a lead dog in an industry with decade-long secular tailwinds. The best thing I can do is nothing.

Valeura Energy (VLE): Exceeding Expectations

Valeura Energy (VLE.TO) is a $630M market cap Canadian oil producer with four producing assets in Thailand.

The company has $259M in cash and no debt. It recently reorganized its operations to unlock $400M in tax losses. At the historic 50% tax rate, the tax losses represent ~$200M in incremental cash flow.

Insiders own ~19% of the company, and VLE recently announced an NCIB to repurchase 7.4M shares (6.5% of the total).

VLE is a testament to the power of a great management team. CEO Dr. Sean Guest turned a $30M company on the verge of bankruptcy into a $630M oil producer, generating nearly $200M in annual free cash flow.

The bear thesis on VLE was that the company had only a few years of production with more decommissioning liabilities (costs incurred to close wells) than its entire market cap.

Since joining the company, Dr. Guest has increased reserves by 200%+ annually while growing production, generating free cash flow, and buying back stock without debt.

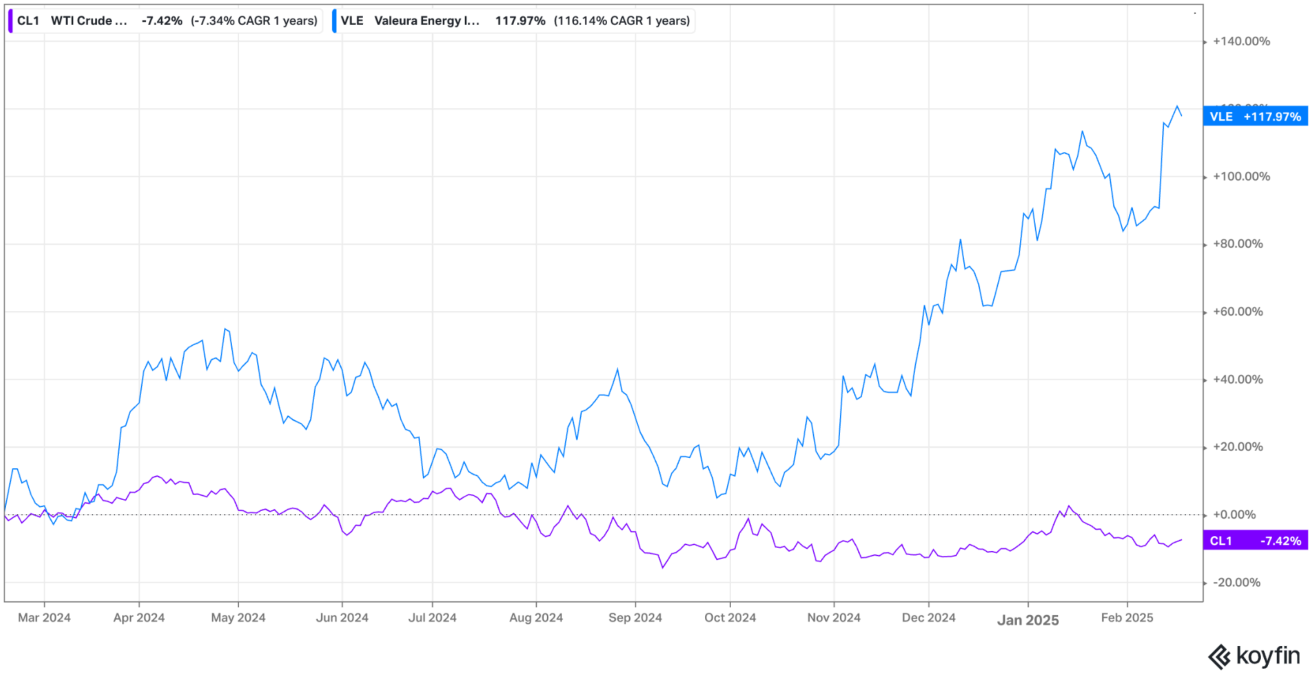
The company released its 2024 year-end Reserves and Resources Assessment. Here are the highlights (emphasis mine):

➢ **Record high year-end reserves:** 32 MMbbl proved (1P), 50 MMbbl proved plus probable (2P), and 60 MMbbl proved plus probable plus possible (3P) reserves;
➢ 2P reserves **replacement ratio of 245%** even **after annual production increase of 12%**
➢ 2P reserves and **end of field life ("EOFL") increased at every field**
➢ 2P reserves net present value before tax of US$934 million and US$752 million after tax
➢ Considering year-end 2024 cash position of US$259 million, **Company net asset value ("NAV") is US$1,012 million**, equating **C$13.6 per common share**
➢ Contingent resources of 48 MMbbl, **more than double the total at end 2023**
➢ **Decommissioning costs significantly reduced** through engineering studies and increased EOFL to beyond 2030.

I like how one Collective member explained VLE's results over DM:

> *"If people think you only have 4 years of reserves and you trade at 2x [cash flow], then replacing 240% of reserves is a pretty good thing."*

VLE continues outperforming every E&P and the underlying commodity over every time frame.



The stock is up 16% YTD and recently passed all-time highs.

We have an 11% notional position with wide stops (a 30% decline from today's price).

Like RHM, the best thing to do with VLE is **nothing**. This is so difficult when you run a finance/investing newsletter. You feel like you have to do something … trade, take profits, find another idea.

But I haven't found a better idea in the E&P space, and that's okay! *Not* doing something is an action.

Why Spend So Much Time On Our Winners?

You're probably thinking, *"why does Brandon spend so much time on what's working in the MO portfolio? Shouldn't he focus on the stuff that's not working?"*

Over the past two years, I've learned that managing our book's "not working" section is easy.

Losers usually reveal themselves within the first week or so of establishing a position. And because we manage risk with stop-losses, we're usually out for a small 50-100bps loss if we're wrong.

The “what’s working” section of our book is much more challenging. Alex will love this part … but I tend to take profits prematurely. I trim my flowers and let my weeds grow.

That habit costs us more money than any “normal” losing trade. It’s much harder to hold VLE with a 6R open profit or RHM at +61% this year.

So that’s why I spend so much time on our winners. Because if I didn’t, I’d get bored, take profits too early, and then complain to Alex that I’m not capturing the bulk of a move I spent so much time researching.

Value investors love the saying, "Focus on the downside because the upside takes care of itself.” On an individual margin-of-safety level, that makes sense.

But you can’t think like that when managing a portfolio. Great investors don’t complain about losing money on positions. They complain about not making enough on the positions they *really* nailed.

I don’t want to make that same mistake.