October 2023

Q3 2023 Right Tail Capital Investor Letter

Can you think of a time when the path to your ultimate destination took a bit of a detour?

The highlight for our family this summer was our trip to Colorado (see picture below). First stop Snowmass where we had a fantastic time with 15 other families that I met at Harvard Business School. We reconnected with long term friends and have enjoyed seeing our kids make long distance friendships. We enjoy these mountain summer vacations. Something about looking at the mountains and the gentle sounds of a nearby creek wash the worries away.

After a wonderful weekend in Snowmass, our family headed to Crested Butte. While only 15 miles from Snowmass as the crow flies, the paths are long and winding (expected travel time: 3 to 4 hours) to this secluded destination. We chose the shorter route heading northwest, then south, then east. The route formed the shape of the letter "C" from top to bottom.

With about one hour left in our drive, we came to a muddy, gravel road on Kebler pass. A sign off to the side suggested a closed road. Ever the optimists, we carried on as the road appeared open. We felt more confident as we saw cars coming in the opposite direction. Only 15 minutes from our destination, we hit another road closed sign – this one accompanied by immovable concrete barriers that would not allow us to continue. We never considered that some roads may not have reopened from the harsh winter weather by late June.

We retraced part of our route, having found a detour further south only to learn that snowmelt had caused a sinkhole on route 133. We then committed to our only option – backtracking all the way to Snowmass/Aspen and taking the other route through Independence Pass. This route came with declining sunlight, navigating the side of a mountain without guardrails, and our youngest child getting car sick. We felt defeated – this drive felt like it would never end.

9 hours after our original departure we finally arrived in Crested Butte. As one of the long-term Crested Butte residents later told us, "No one gets to Crested Butte by accident." Of course, once we got settled in this gem of a town, we had the time of our lives. The beautiful scenery seemed as if we were on the football field of a stadium surrounded by mountains. The most abundant, beautiful wildflowers I'd seen in my life were described by one of the locals as "we're only 10% into wildflower season here…wait 'til they start popping."

Like life and value investing, the road to Crested Butte did not go exactly as planned. We had to make decisions with imperfect information as the trustworthy navigation apps like Waze and Google Maps did not account for the road closures. We could have dug for more information as we later discovered that the local Colorado radio stations often have the best information. Not all roads lead to a fabulous investment opportunity, and there is always uncertainty. Dealing with the unknowns and plodding forward are part of the process. Sometimes unexpected positives come from keeping one's eyes and ears open such as seeing a moose on our detour and spending more time together as a family. Our patience ultimately was rewarded with a fabulous vacation.

After writing about patience last quarter and describing our journey to Crested Butte, I wanted to provide an update on some of our largest investments. Subsequent to investing in these companies, Right Tail has continued to research them while the businesses have gone about their operations and created value for us. As a reminder, Right Tail's goal is to generate excellent, after-tax returns over multiple year time periods through owning a concentrated portfolio of high-quality businesses.

I often get asked for Right Tail's new favorite ideas. Sometimes, I find the question a little confusing because I expect to hold high quality businesses for long periods of time rather than trading in and out of positions. Moreso, the question inspires me because it shows that many are more wired for shorter term thinking. It gives further confidence that a longer time horizon is both a differentiator and challenging to implement – two factors that will continue to help us as we pursue excellent investment returns. Like our odyssey to Crested Butte, one doesn't achieve a long-term, patient investing mindset by accident. It takes discipline, persistence, and consistent reminders of what we're playing for both for our portfolio and at the individual stock level.

Also, excellent research on new companies is a more important indicator than new investments. And on this factor, I have good news to report. Right Tail has done great work on a handful of industries and several additional companies. I'm now more knowledgeable about these industries which may lead to new investment opportunities in the near future.

Portfolio Insight: Ferguson

Ferguson is a leading US-focused distributor ($33B mkt cap) of plumbing and HVAC supplies that is split between non-residential (48%) and residential (52%) as well as repair/remodel (60%) and new construction (40%). Like other high-quality distributors, Ferguson benefits from a prime spot in its value chain. It has many suppliers (over 30,000), customers (~1 million), and small competitors. By providing great service and parts availability, Ferguson guides its customers to the parts they want in a timely fashion.

I think last year the market was worried that Ferguson had over-earned due to rising prices and excess demand during covid. Furthermore, the company had removed its primary listing in the United Kingdom that caused some force selling among European index holders. Right Tail had the key insight that Ferguson should be able to hold onto most of its pricing and margins. I wrote this in our Q2 2022 letter:

> *After a few years of strong fundamentals, investors are questioning Ferguson's near-term fundamentals partially due to increases in interest rates and the impact that may have on construction. I do not know what will happen to business fundamentals though I recognize that this business has historically done a good job of holding onto price after prices have risen. The*

60% of revenues that comes from repair/remodel should provide some protection against any potential cyclical headwinds in new housing starts and commercial construction.

With pricing likely not being the number one concern for contractors and commodity products only accounting for 15% of Ferugson's business, I thought the company's fundamentals would hang in better than others feared. While it's a short period of time to assess performance, Ferguson's stock price has appreciated ~40% since we discussed it in our Q2 2022 investor letter. I would guess that Ferguson's earnings have held up better than investors feared at many points last year.

Whenever I find myself tempted to think too short term, I envision where this company might be in the next five or ten years. This is a subjective exercise based on careful research though the future is uncertain. That said, I believe one can assess the odds of the changes in a company's relevance in a given industry. Ferguson scores quite well on this litmus test. I think they'll continue to gain share in plumbing and HVAC distribution from smaller regional players. I continue to think this investment can compound at a mid-teens rate over the coming years hopefully driven by low to mid-teens growth in earnings per share mixed in with a bit of multiple expansion. Getting added to the S&P 500 index would be a nice sweetener as well.

Portfolio Insight: Constellation Software

Constellation Software buys and builds niche software businesses which provide mission-critical solutions. Current President Mark Leonard has produced a track record of incredible growth and returns on capital and today has an enterprise value of ~$46B.

Constellation has proven itself well over the last almost 30 years. As I wrote in last year's letter, *"Building a business from scratch to $34B over 27 years is an eye-popping result." By retaining most of its customers each year and being incredibly disciplined on the prices it pays for M&A, Constellation has generated fantastic returns on capital. The company has also treated its shareholders fairly, not issuing any shares since its mid-2000s IPO.*

The key question continues to be how much capital the company can deploy and at what rates of return. I've been impressed by the ~$2B of capital the company has invested over the last year – this is one of the rare times the company has found good enough deals to outspend their current free cash flow. While the future returns from these deals are hard to know, the situation surrounding this capital deployment seems ripe for significant value creation. Constellation has continued to do dozens of small deals where they've had tremendous success and there's typically less competition for the assets. Interestingly, Constellation has recently closed on two larger corporate carveouts related to the ICE/Black Knight acquisition. These assets Optimal Blue and Empower were originally highlighted by ICE as 2 of Black Knight's 4 Key Offerings. ICE was likely required to divest some assets by the FTC to close the Black Knight acquisition. Constellation's balance sheet and willingness to act quickly was helpful in closing the deals. And they appear to be getting a fantastic deal - Black Knight appeared to pay ~30x EV/EBITDA for Optimal Blue while Constellation is paying <7x EV/EBITDA!

As the business grows, the 25% CAGR in FCF/share over the last decade will likely decelerate. Interestingly, the total return of our Constellation Software investment has been ~50% since we discussed it in our Q3 2022 letter. At recent prices, I continue to believe Constellation Software can generate north of a 15% IRR for several years (vs ~30% IRR over the past decade). And we won't be upset if management continues to surprise us with better-than-expected capital deployment opportunities.

Best wishes for continued happiness and success as our investment journey continues,

Jeremy Kokemor
Right Tail Capital

DISCLAIMER

This review (the "Review") is being furnished by Right Tail Capital LLC ("Right Tail" or the "Firm") for informational purposes only. This Review does not constitute an offer to sell, or a solicitation, recommendation or offer to buy, any securities, investment products or investment advisory services offered by the Firm (the "Offering"). Any offer or solicitation may only be made to prospective eligible investors by means of an Investment Advisory Agreement and Form ADV, which contain a description of the material terms relating to the Offering, including the numerous risks involved. This Review is being provided for general informational purposes only.

Right Tail Capital ("Right Tail") is registered as an Investment Adviser with the states of Virginia and Louisiana. Interested parties should read Right Tail's Forms ADV I and II, available at adviserinfo.sec.gov.

Certain information set forth in this Review is based upon data, quotations, documentation and/or other information obtained from various sources believed by the Firm to be reliable. No representation or warranty, expressed or implied, is made as to the fairness, accuracy, completeness, or correctness of the information and opinions contained herein. The views and the other information provided are subject to change without notice. This report and others posted on www.RightTailCapital.com are issued without regard to the specific investment objectives, financial situation, or needs of any specific recipient and are not to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments. Company fundamentals and earnings may be mentioned occasionally but should not be construed as a recommendation to buy, sell, or hold a company's stock.

Predictions, forecasts, estimates for markets should not be construed as recommendations to buy, sell, or hold any security -- including common stocks, bonds, mutual funds, futures contracts, and exchange traded funds, or any similar instruments. Investment strategies managed by Right Tail involve a significant degree of risk, and there can be no assurance that the strategy's investment objectives will be achieved or that significant or total losses will not be incurred. Nothing contained herein is or should be relied upon as a promise, representation or guarantee as to the future performance of Right Tail's strategies. Past performance is not indicative of future results.

Images, graphics, logos, and other designs used in the Review are believed to be in the public domain. A reasonable, but not exhaustive, effort has been made to verify that such images, graphics, logos, and designs are not protected under copyright. However, if any party feels that this Review is in breach of copyright law, it should immediately contact the Firm.

Performance data for the Right Tail Portfolio is based on the advisor's brokerage account which was invested beginning on May 16, 2022. This performance figure has not been audited by any third party. Individual account performance will vary depending on a variety of factors, including the initial date of investment, inflows/outflows, account size, fee class, and transaction costs. Please see your individual account statement(s) for actual account balances and performance.

Performance comparisons to benchmarks such as the S&P 500 Index and the SPDR S&P 500 ETF Trust ("SPY Index ETF", "SPY", or "S&P 500 Index ETF") are provided for information purposes only. The SPY is an exchange-traded fund which seeks to provide the investment results that, before expenses, correspond generally to the price and yield performance of the S&P 500 Index. The S&P 500 Index is a diversified large cap U.S. index that holds companies across all 11 GICS sectors, and as such may differ materially from the securities managed by Right Tail in client accounts. Benchmarks such as the S&P 500 Index and the SPY may be of limited use in understanding the risks and uncertainties inherent in the investment strategies managed by Right Tail.

The information in this Review is not intended to provide, and should not be relied upon for, accounting, legal, or tax advice or investment recommendations. The Recipient should consult the Recipient's own tax, legal, accounting, financial, or other advisers about the issues discussed herein. Nothing in this Review regarding tax strategies, tax savings, tax rates, tax efficiency, or any other statements related to taxes should be relied upon as an indication of Right Tail's suitability to give advice or make decisions with respect to taxes in any jurisdiction.