July 2022

Q2 2022 Right Tail Capital Investor Letter

I hope this letter finds each of you doing well and having an amazing summer. Over the past few months of building out the Right Tail investment portfolio, I've been spending time like I always do: trying to find great companies priced at a discount to intrinsic value. At quarter end, Right Tail was ~60% invested across 12 companies that meet our standards - durable competitive advantages, high returns on incremental invested capital, excellent management – and, critically, are currently priced at a discount to intrinsic value.

While Right Tail's long-term returns certainly depend on my ability to find excellent investments, one of our greatest strengths is the patient, long-term mindset of our investors. We will continue to become more fully invested through the balance of the year, with the pace dictated by the availability of investment opportunities that match those criteria, not by the calendar. Your long-term perspective will improve the odds that we are able to look beyond the myopic focus of the market and generate excellent returns over longer investment horizons.

In the meantime, I will continue to show up every day and study businesses. It's a daily habit that leads to significant long-term knowledge and the ability to find great investments when opportunities arise. Today's stock market is offering attractive long-term values for great companies especially relative to the past several years. This investment hygiene applied in the current, highly volatile stock market reminds me of the one type of physical exercise that I suspect I enjoy more than most: running in the rain.

When I'm not searching for those investment opportunities, you will often find me running, usually 3-5 days per week. My exercise routine helps me stay healthy physically and emotionally and to be the kind of person, father, friend, and investor I want to be. Running is a key part of that regimen – not only because it's an efficient exercise that I can do anywhere, without equipment – but because I highly value the other benefits that it offers.

Ted Weschler, the legendary Berkshire Hathaway investment manager, recently described some of these benefits during a rare interview[1] (which I highly recommend), such as the ability to think more clearly and never feeling worse after going for a run. This last sentiment is a bit counter-intuitive in that the act of exercising, both getting started each day and completing the activity, is not easy. But those benefits – that feeling of shedding stress, that sense of accomplishment, those moments of insight – accrue precisely because it is hard, not easy. And perhaps that is why I enjoy running in the rain.

While I admit that my ideal running conditions resemble a clear autumn day, I find pleasure in a good rainy day run. Based on strangers' reactions – which seem to range from pity to questioning my sanity –

[1] https://podcasts.apple.com/us/podcast/lunch-with-warren-buffett-working-for-berkshire/id1502613782?i=1000558829816

not everyone shares my enthusiasm. But I see things differently. I choose to have a positive mindset and embrace this opportunity, even though it might involve getting wet and stepping out of my comfort zone. I often find that the extra difficulty of willing myself through nasty conditions leads to a certain peacefulness, along with increased clarity about what has been on my mind.

Now to be fair, running in the rain requires significant vigilance. I must be extra mindful of my surroundings to not step in a pothole or slip and injure myself. I'll also concede that perhaps part of why I enjoy this activity is that it doesn't happen every day. I would not want to battle the elements during every run. But occasionally, the rain provides a serene setting that will ultimately lead to brighter skies ahead.

Running in the rain has many parallels to investing a volatile stock market such as the one we've experienced this year. Today's stock market is full of the same great companies it was a year ago…several trading at more attractive valuations. Many investors cannot tolerate the uncertainty of a volatile market, and sometimes go so far as to sell their investments at the wrong time, right when better opportunities are starting to present themselves. I often find investors and financial news outlets focusing more on the rain (today's macro environment) than on the running (the process of finding good long-term investments).

Admittedly, what happens from a macro perspective may have a large impact on investment returns in the short term in the same way that a run in treacherous conditions might not yield my personal best 5K time. However, compounding wealth is a marathon not a sprint.

In much the same way that I focus on putting one foot in front of the other and enjoy the peacefulness of a rainy run, I continue to study and value businesses. I enjoy today's current investing environment and thinking through the questions surrounding every company I study. I continue to follow my process and recognize that investing in high quality companies with returns above their costs of capital will lead to significant value creation and likely generate strong returns for investors over time. I am finding good opportunities today and, with the fullness of time, I expect the rain will let up and the superior economics of the businesses we're investing in will lead to sunnier days ahead.

Investment spotlight: Ferguson plc (FERG)

Ferguson is a leading, primarily US-based distributor ($23B mkt cap) of plumbing and HVAC supplies that is split roughly evenly between non-residential (44%) and residential (56%) 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 – fragmented suppliers (over 30,000), many customers (~1 million), and small competitors (75% of revenue comes from #1 or 2 market positions where the primary competitors are mom and pops). By providing great service and parts availability, Ferguson can help guide its customers to the parts they want and supply them in a timely fashion. The contractors who buy from Ferguson certainly care about price, but price is likely not as big of a concern for most of them as getting the correct part on time and on budget. While prices going up too high too fast may lead to demand destruction, Ferguson and contractors can often pass-through increases in prices due to the company's great service, parts availability, and that in many cases the parts are needed.

Until a few months ago, Ferguson was primarily listed in the United Kingdom (and even used the name Wolseley up until a few years ago). When I began studying the business more closely over the last 18 months as Ferguson began moving its primary listing to the US, I noticed a business performing quite admirably. Even if I exclude the recent strong results of the past 2 years, Ferguson's returns on incremental capital have been greater than 30%.

One driver of this performance has been "improving by subtraction". The company's returns have improved partially as the company has sold its lower quality businesses located throughout Europe and focused more on its crown jewel US business. Furthermore, the US business has performed extremely well with high single digit topline organic growth over the prior 10 years with most of the growth coming from volume and mix rather price inflation. A much closer analysis of the financial statements reveals that revenues in the US business have grown nearly 150% over the preceding 10 years – these fantastic results can be obfuscated by a casual look at the reported financial statements that show only a 5% growth in total company revenues before adjusting for the divestitures.

I believe Ferguson can be an excellent investment from today's prices, possibly doubling in the next 3-5 years. Ferguson trades at seemingly attractive headline multiples of ~11x P/E and ~9x EV/EBITDA. The S&P 500 currently trades at ~16x P/E, and in a normal economic environment, Ferguson's valuation would be a compelling setup as I'd expect Ferguson's business fundamentals to perform better than the broader market over time.

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.

If the economy holds up and FERG's earnings are flat to growing over the next several years (Ferguson usually grows earnings at a mid-teens rate), then the stock could potentially double in the next 3-5 years. If there's a more severe pullback in business fundamentals, then Ferguson's earnings could decline further (perhaps 25%) and our potential returns as shareholders may take longer to realize – even in this case, Ferguson's earnings multiple would still be trading at a discount to the broader stock market despite being an above average business. Furthermore, the balance sheet is in good shape (<1x net debt/EBITDA), acquisitions would likely become cheaper in a tougher economic environment, and Ferguson should be able to keep taking market share from weaker, under-resourced competitors.

There are a few other dynamics that are not core to the thesis but may potentially play in our favor. The first is that Ferguson trades at a significant discount to other high quality industrial distributors (for example, FAST, POOL, and WSO trade at 17x P/E or higher) despite having economics that look more similar than different. Lastly, there has likely been some forced selling from European passive investors now that the business is no longer primarily listed in London. Management estimates that as Ferguson gets added to US indices (possibly the S&P 500) over the next year or so, there could be demand for twice as many shares. Ferguson also has some classic spinoff dynamics whereby management is now 100% focused on the North American business, and employees might be more energized by this focus and the corporate name change. Again, these insights are only a piece of the mosaic as to why I find Ferguson to be a compelling investment today.

In closing, thank you for your continued interest in Right Tail. To the extent that you know of someone who would appreciate our long-term approach to investing, I'd greatly appreciate the opportunity to meet him or her.

May you all have a happy and healthy summer.

Jeremy Kokemor
Right Tail Capital

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