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Q1 2024 Right Tail Capital Investor Letter

Do you know the feeling of needing to communicate a difficult message? The type of message that feels mortifying to deliver. A message that may disappoint the person who's receiving the message.

These messages are difficult to communicate, and probably difficult to receive. I recall the times in high school when I'd consumed too much alcohol…I was very good at not getting sick until *seconds* after I arrived home. Then I'd have to tell my hard-working mom what I'd been up to. Not fun.

While the circumstances will be different, there will be times when I'll keep communicating during periods of poor investment performance. Our first two years together have gone well, and we're all grateful. This will not always be the case, especially over shorter time periods. We'll have individual years or longer periods where our performance will look less rosy.

Short term challenging performance could happen for several reasons. Not all our investments will work out as intended. No one has a flawless investing record, and we expect our winners to create enormous value and more than cover for our more challenging investments. I also will continue to practice disciplines that will help me admit when an individual investment thesis has gone awry. Writing investment recommendations with pre-mortems detailing why I might sell are helpful tools to attempt to remove emotions ahead of time.

Another scenario is that we'll go through periods of very challenging broader stock market performance that will impact our investments too. These will likely happen every few years. We know they will happen but we don't know when.

That's to be expected. That's OK. We are not investing to generate strong performance in any given month, quarter, or year. We're investing to compound our wealth over multi-year periods. Our willingness to think longer term enables us to increase our odds of generating excellent investment performance and outperforming over longer periods of time.

Our goal is not to outperform when the market does poorly over a shorter period. This may happen but it's not our goal. Rather, the goal is to have the appropriate long-term mindset to weather the storm and take advantage of the volatility to improve our portfolio and generate better returns over the ensuing years. We endeavor to lay the seeds during challenging times that will bear fruit for many years to come.

When these shorter-term challenges happen, we'll remain steadfast continuing to follow our processes. I'm always studying businesses, searching for the best long term investment opportunities that can create significant wealth for us. During periods of market turmoil, businesses that we've researched in the past may suddenly have a high potential return, showing the value of our years of prior work. These habits will help us dampen any emotional challenges of watching our investments temporarily decline in value.

We'll also remember that many of our investments use these challenging times to get stronger. They'll innovate. They'll earn their customers' respect and gain market share. They'll play offense when their competitors are forced to play defense. They'll likely do it in a way that creates shareholders as well.

Many of the best opportunities present themselves during these times when the market is down considerably. Just in the last 5-6 years, there have been several good buying opportunities. The market sold off ~15% in December 2018. Then COVID-19 happened in early 2020 – fantastic businesses with great balance sheets and cultures were down 50% in some cases. A patient, clear-headed investor could think longer term than the daily news outlets and find great prospective investment opportunities. These opportunities are never guaranteed. However, if a market-leading company can continue to think long term and invest its cash well above its cost of capital over time, the odds are in our favor that value will be created for equity holders over time.

Actually, this may be an extremely positive message. What could be more positive than the freedom of not having to focus too much on short term results? We choose to trust in the value creation of excellent businesses, our analysis and our long-term mindset.

The commitment we make to each other is that we acknowledge that these times will happen. We're prepared for them. We build our library of potential investments and we patiently seek out those opportunities where price disconnects most from a company's intrinsic value. We'll also be prepared to act.

Portfolio Spotlight: Boyd Group Services

On the topic of difficult conversations, let's talk about car accidents. Womp womp. These situations are never fun. I can't recall hearing that someone enjoyed even the most minor fender bender. Possible injuries, property damage, interacting with law enforcement, insurance companies and repair companies are some of the activities that usually don't show up on our wish lists.

One such company that helps with these difficult situations is collision repair company Boyd Group Services. It happens to be Right Tail's newest investment and one that I would not be surprised to see double in value in the next 4-5 years. Like many Right Tail investments, it's a company I've been studying for a long time. I originally invested in the company in 2017 and have researched/invested in several companies which are tangentially related to collision repair.

Boyd owns ~950 collision repair locations across the United States and Canada. The business has produced a track record of incredible growth and returns on capital. Boyd is headquartered in Winnipeg, Manitoba though 90% of its revenue is generated in the US. Its banner in the US is Gerber, which Boyd bought ~20 years ago. The company has an enterprise value of ~$6B.

Like several of our other investments, Boyd does many little things well, which is a great source of competitive advantage. They buy and grow many smaller repair shops. They remain fastidious on what they're willing to pay for acquisitions, despite this becoming an industry that has attracted much private equity capital. In fact, as multi-site operators have become more expensive, Boyd has shifted its focus to buying single locations or building greenfields. They expected to receive 30% returns on capital for the greenfields though the returns take longer to achieve as the new sites mature. They balance growth and profitability rather than solely focusing on growth at any cost like many companies over the past several years. As a result, Boyd's return on invested capital has typically been greater than 25%.

This fragmented industry continues to consolidate with the larger players leading the charge. The top 3 companies (Caliber Collision, Boyd, and Crash Champions/Service King) generate ~20% of industry revenue, a number which has grown significantly over the last 20 years though still leaves much room for further increases.

It's a fun industry to research and develop unique insights with Boyd being the only company that is traded publicly.[1] 60-70% of the locations in the industry are still single store, mom and pops. Often these smaller companies don't have the balance sheets to invest in technology to repair newer cars. I've spoken to a few operators and insurance partners who support our thesis. I have also needed to get some minor collision repair work done twice in the last year. Once I used a direct repair program and the other time I did not. My sense is that there still big improvement that can be made to further optimize these repairs and make them easier on consumers.

Boyd provides significant value to its auto insurance partners and consumers. Consumers want their cars repaired well and quickly. If not, they may decide to change insurance providers. The insurance companies have preferred to establish Direct Repair Programs usually with the larger collision repair companies. The goal is to make the process as easy and simple as possible for the customer. The larger collision repair companies are usually better operators with the latest equipment to repair cars that are becomingly increasingly complex. Often the insurance company pays the collision repair company directly – in fact, 90% of Boyd's revenue involves insurance companies. In inflationary times, collision repair companies need to raise prices to cover their costs and insurance companies need to get prices approved by their state regulators. This process typically works well though time lags are normal.

I expect Boyd to compound at a high teens to low twenties rate of return. This rate of return is achieved by a 2-3% cash yearnings yield + 3-5% growth without reinvestment + 10-15% growth from reinvestment. The most attractive piece here is that Boyd invests nearly all its free cash flow at 25% or higher incremental rates of return. The least attractive part of the equation is the current valuation but I

[1] Auto service company Driven Brands has a franchised collision repair business that is a small % of its revenues and tends to focus more on oil change.

expect the reinvestment opportunity to more than compensate us over a multi-year holding period. I expect Boyd to produce an IRR that I believe ranks near the top of our portfolio. Further opportunities exist if Boyd can get back to pre-COVID levels of profitability which have been impacted by higher labor rates or even higher levels of profitability as calibrating sensors on newer cars is a newer and higher margin opportunity.

I also like that this business is less economically sensitive. People will still drive and maybe even drive more during tougher economic times. Industry specific risks could include a significant, permanent drop in accident frequency possibly driven by collision avoidance technology. Offsetting this risk is population growth, growth in miles driven and continued high levels of distracted driving. Another risk is that more cars are being declared total losses due to increased vehicle complexity and rising repair costs – that said, there continues to be more demand than supply for repair services and backlogs are often several weeks in advance.

Put it all together and I think we have the chance for a five year double or better with a management team that's prudently allocated capital at high incremental rates of return. That it's a less cyclical business is also appealing as we'll encounter a recession at some point in the future. While getting in an accident is never a pleasant experience, I love how this company provides great value to its partners and hopefully will turn into a more than pleasant investment for us.

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

Jeremy Kokemor
Right Tail Capital

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