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Q3 2024 Right Tail Capital Investor Letter

What were you doing in August? Yes, August of this year.

What about August 5th?

If you're anything like me, you have no clue about most specific days in the past.

And yet August 5 was only 70 days ago. Just 10 weeks. That's the way our minds work. We remember the things that really matter to us. We also forget a lot that seems important at the time.

Well on Monday, August 5th, the stock market was down ~3%. The market was also down almost 2% the day (Friday) before. These were reasonably notable days for the markets within the context of the week, the month and possibly the year. It was not really a shocking day though. Many of these days have happened in the past. There will be many more to come.

That day grabbed people's attention. I even heard from a few Right Tail investors. My day was pretty normal. I spent the day doing things you've heard me mention before: reading and thinking long term. I fine-tuned my shopping list of potential investments (existing and new) to add to.

I also considered the context of the situation. Yes, the market had declined ~5% in a short period of time. And yet, part of me thought "so what?" The market was still up ~10% YTD after rising ~25% last year and ending 2022 positively. Suppose we were waking from a lengthy, 22 month nap and someone presented us with stock market returns over that period. We'd likely be pleased with 40%+ returns. From this point of view, the recent 5% drawdown did not seem like that big of a deal. The opportunity set for most individual investments had not materially changed.

The concrete actions of the following days were in the same mindset as achieving our long term goals. Recall that Right Tail's goal is to compound wealth and generate excellent after-tax returns over multi-year periods. We'll do this through owning a concentrated portfolio of undervalued, high-quality businesses and investing with a longer-term mindset. After calmly assessing situation, I added modestly to one of our positions on the following day. I prepared to make more significant changes if the opportunity set materially shifted in our favor.

Morgan Housel has a saying that, "This is the biggest market decline since the last decline you don't remember or care about anymore."

There's a lot of wisdom and humor in those words. I remember several market drawdowns during my career. I can't think of one day that I truly remember. The closest might be when the market was falling early during Covid. Even then, I could not tell you what happened on which day. And still during this period of nearly 20 years that I've been investing, there have always been great opportunities to invest in high quality businesses with a long-term mindset. That's where I'll continue to focus.

Portfolio Spotlight: CDW Corp (CDW) and Insight Enterprises (NSIT)

In the spirit of long-term investing, let's discuss our investment in technology resellers CDW and NSIT. I've been studying CDW for the last 10 years and invested in both companies during 2022. I consider them one position with CDW being the larger position of the two.

CDW is an exceptional IT solutions provider superbly positioned among a fragmented group of customers and vendors. CDW provides IT solutions (hardware, software and services) to more than 250,000 customers primarily in the US and Canada. They help their customers navigate an increasingly complex IT market and maximize returns on their technology investments. CDW's $21B in revenue suggests that the company has less than 10% market share in an estimated addressable market opportunity at ~$440B. The company came public for the second time in 2013 at $17 per share and today has a market cap of ~$30B (~13x higher) and enterprise value of $35B.

I find that several aspects of CDW are under-appreciated at first glance. The company is much more than a B2B distributor of commoditized IT equipment like computers – it creates win-win relationships with its customers and vendor partners. The company is a solutions provider often serving as an outsourced IT teammate for small businesses. CDW has described its sweet spot as customers with less than 5000 employees, those that are big enough to benefit from significant IT expertise but small enough to not have adequate resources internally. Because CDW sells over 100,000 products from over 1000 brands, they act as a neutral third party and recommend the best solutions for each client rather than focusing on one vendor's products. Of their ~15,000 employees, ~2/3 are customer-facing, showing how much the company cares about serving its customers.

Unsurprisingly, vendors also like working with CDW. The company serves as a knowledgeable extension of a vendor's salesforce to many smaller customers. Therefore, CDW sits in the middle of a fragmented base of vendors and a fragmented base of customers serving as a valuable, agnostic partner to both sides. Over the course of my career, I've found that distributors sitting in between fragmented customer and supplier bases can create significant value for all parties involved, including shareholders. Other Right Tail investments such as O'Reilly Auto Parts, Ferguson and Brown & Brown share similar attributes.

These great operational characteristics have led to superior financial results. Over the last 10 years, CDW typically has grown revenues 200-400 bps faster than the overall IT market. The company has produced some operating leverage with EBITDA margins gradually moving up to the 9-10% range. Given the sales compensation structure that is tied to gross profit dollar growth, modest operating leverage makes sense.

I'm amazed by how little incremental capital CDW spends to grow. When the company is not making acquisitions, it needs little fixed capital, and capex has typically been below D&A. As it relates to working capital and P&L investments such as increased sales and marketing, incremental returns on capital have typically been above 30%. Ideally, CDW would be able to grow even faster by reinvesting more capital into the business at these returns; however, the 7% sales CAGR (low double digits EBITDA CAGR) since the company came public in 2013 has been impressive. Interestingly, if I look back to CDW's first time as a public company, the sales CAGR from year end 2000 to today is also high single digits.

In 2022, I noticed that peer company NSIT had been purchased by ValueAct. At the time, NSIT had a much more attractive valuation at 10-12x P/E. The company has a history of success but not nearly as much as CDW. I thought if Value Act could have a slightly positive influence on NSIT, the investment returns could be dramatic. I'd watched Value Act influence other distribution businesses like LKQ and also figured they might know something about NSIT, given its long term partnership with former ValueAct holding Microsoft. Our earliest purchases of NSIT have more than doubled and outperformed CDW.

I find these investments particularly compelling now. The companies have struggled to grow the last 2 years after tech spending significantly ramped during Covid. Fundamentals could worsen in a recession though these businesses do not seem to be over-earning today. In a recession, I would also expect these companies to emerge stronger as they have in the past. Another mitigant is that cash flow is typically counter-cyclical as some working capital would unwind. At some point IT spending should grow faster, and these companies will be there to help their customers navigate complex decisions. I would not be surprised to see these investments double over the next five years driven primarily by earnings growth.

With any of our investments, poor capital allocation is one potential reason we could sell our shares. CDW has allocated capital well through its history and NSIT has become more focused on returns which helps mitigate that risk. I also will monitor the value these companies provide to their customers. They seem to be as, if not more, important to their customers and will be mindful of any changes that simplify IT decision-making.

Many thanks and I hope you have a joyful end of the year,

Jeremy Kokemor
Right Tail Capital

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