October 2022

Q3 2022 Right Tail Capital Investor Letter

I love listening to the old Berkshire Hathaway annual meetings. I joke that I can never identify the year of the annual meeting just by listening to the audio though. It could be 1999 or 2009 or 2019.

Buffett's investing approach is timeless. So is the perpetual amount of noise that exists in the world.

Every year, Berkshire attendees ask about interest rates, headline valuations, geopolitical risks, and inflation. Every year, Buffett's answers stay the same. I would fail miserably trying to guess the year of the annual meeting if a friend played a random clip for me.

Let's examine this excerpt[1] from a Berkshire annual meeting. As you read along, try to guess the year for yourself:

> *Question: "With the historical returns on common stocks, dating back to the 1800s, coming in at about 7%...do you not think that we're in a very dangerous period?"*
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> *Buffett: "The answer is we never know in terms of what markets will do…Whether valuations are too high gets back to the question we talked about earlier, if businesses in aggregate they keep earning very high returns on equity and interest rates stay where they are we are not in an overvalued period. If it turns out these returns are not sustainable or interest rates go higher, we will look back and say it was the high point. At least for a while. We have no notion on that and we really don't think about it. Because we don't know. Our job is to focus on things we can know and that make a difference. And if something can't make a difference or we can't know it, then we write that one off."*

What do you think? I might guess that this is Buffett speaking in October 2022. In fact, it's from the 1997 annual meeting. There are countless examples of these exchanges in the 28 years (1994-2021) of recorded Berkshire annual meetings[2]. I am currently on my 2nd time listening to the ~135 hours of Berkshire annual meetings (1994-2021) and am incredibly thankful for these teachings.

Along with studying businesses and talking to management teams, broad-based learning leads to becoming a better investor over the long term. Like running, another consistent routine that I've discussed, studying Buffett is one of the little things that I do to become a better investor. These podcasts teach me much about business and investing. However, I get as much value from recentering on what's most important to my investment process and long-term success.

Buffett is consistent. He drowns out the noise. He recognizes he cannot predict the macro. Instead, he focuses on finding great investment opportunities. Studying Buffett is one of several little things that I do to become a better investor and increase Right Tail's odds of generating long term excellent returns.

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[1] https://buffett.cnbc.com/video/1997/05/05/slowdown-for-stocks-coming.html
[2] https://podcasts.apple.com/us/podcast/berkshire-hathaway-annual-shareholder-meetings-since/id1445276006

In the same way, we will remain focused on owning wonderful businesses that can produce great long-term results for us. We want to compound our capital at the highest rate that is sustainable over a long period of time. Steady, consistent compounding can produce fantastic long-term investing success. To do this, we will try to find undervalued, high-quality businesses that Right Tail can own for several years.

Right Tail's portfolio is ~74% invested across 13 positions – up from ~60% at last quarter's end – and we will continue to deploy capital over the coming months. These investments are undervalued, high quality companies with durable competitive advantages, excellent management and attractive return potential. I am comfortable owning them at current prices if I could not sell them for multiple years.

Investment spotlight: Constellation Software (CSU.TO or CNSWF)

Constellation Software buys and builds niche software businesses which provide mission-critical solutions. Current President Mark Leonard founded the company in 1995. He has produced a track record of incredible growth and returns on capital. Constellation is headquartered in Toronto and has an enterprise value of ~$34B.

Like the little things I do to become a better investor, Constellation does many little things well, which is a great source of competitive advantage. They buy and grow many "little" businesses. They remain fastidious on price, usually only relying on their own cash flow to buy businesses. 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, Constellation's return on invested capital is exceptional.

Often when I study businesses that consistently acquire, I must strip out intangible assets to calculate a return on capital that might be attractive. Then I ponder the intangible assets. "Are the intangibles worth more or less than what the company suggests?" This is not the case with Constellation. Returns jump off the page at 40% or higher even when including intangible assets. The company also keeps 95%+ of its customers each year. Perhaps Constellation can sell these customers an additional module in the future. Perhaps the intangible assets are worth even more than stated.

Additionally, Constellation has achieved these returns with negligible net debt. Buffett's retained earnings test also confirms the stellar returns – market cap has grown by $33B since 2010 while retained earnings have only grown $1.2B. This indicates that Constellation has created tremendous value. Negative working capital due to customers paying in advance is also a nice feature.

Mark Leonard strikes me as a once-in-a-generation leader. Building a business from scratch to $34B over 27 years is an eye-popping result. It's not like he did it by inventing one product that the world needed and was willing to pay for. Rather he has done it brick by brick with an incredibly disciplined approach to buying software businesses. While he is 65, I would not be surprised if he works for a long time and continues to figure out ways to evolve the business. He's begun to do this by using modest amounts of non-recourse leverage and considering buying software businesses that are mission critical though more horizontal in nature.

Constellation's share count has not grown at all since coming public. This dilution disdain is unheard of. (Usually, companies provide equity compensation to their employees that dilute shareholders by 1-2% per year. It's also not uncommon to see companies use their equity to help pay for acquisitions.) The company also requires employees to use part of their bonus to buy the stock. This alignment is increasingly rare and reminds me of Warren Buffett's approach to Berkshire. I would encourage you to read Mark Leonard's letters[3]. They are insightful, self-deprecating, and have taught me a lot about software and other great businesses.

Growing revenues at a 20% CAGR and free cash flow at a 25% CAGR over the past 10 years while maintaining a flat share count are exceptional results. As the business gets bigger, these growth rates will likely decelerate. However, at recent prices, I believe Constellation Software can generate a 15-25% IRR for several years (vs ~30% IRR over the past decade) even with a slower rate of growth. At a 20% IRR, Constellation Software has the potential to double in share price in the next ~4 years.

If we are in a tougher economic environment, I expect the business to hold up well. Constellation loses fewer than 5% of its customers each year and is diversified across many software businesses and industries that their businesses sell to. Constellation should also fare well in an inflationary environment due to limited capex and the ability to charge higher prices. Additionally, Constellation's acquisition targets could become cheaper if capital becomes more expensive.

The risks here are organic growth declines, poor capital allocation, and a headline valuation (~4-5% earnings yield) that does not scream cheap. Organic growth declines in the more important maintenance and recurring items would be a red flag. This seems unlikely given the company's long history of organic growth and focus on mission critical software.

Other risk mitigants include the company's paranoid discipline regarding returns on incremental capital. In addition, the company primarily acquires smaller businesses, lessening the potential negative impact of one deal. Also, if valuations keep coming down or capital becomes scarcer, Constellation's ability to do new deals may become easier. One other mitigant is that Mark Leonard could begin deploying capital outside of vertical market software at extremely attractive rates. Normally, I'd frown upon this possibility, but I am impressed by Leonard's thoughtfulness and discipline.

Thank you for your continued interest in Right Tail. Your long-term mindset, especially in more volatile stock markets like today, is one of our greatest advantages. Please reach out if you would like to discuss Constellation or Right Tail's other investments in more detail. If you know someone who would appreciate our long-term approach, please put us in touch.

May you all be well,

Jeremy Kokemor
Right Tail Capital

[3] https://www.csisoftware.com/category/pres-letters

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