PALM CAPITAL

Q4 2022

January 2023 | Mahomed Ibrahim

At Palm Capital, we look for businesses with durable competitive advantages run by exceptional managers. We patiently wait to invest when their prices are less than we think they are worth, aiming to benefit as they compound economic value over time. We only sell if fundamentals deteriorate, or we find others offering potentially better after-tax returns.

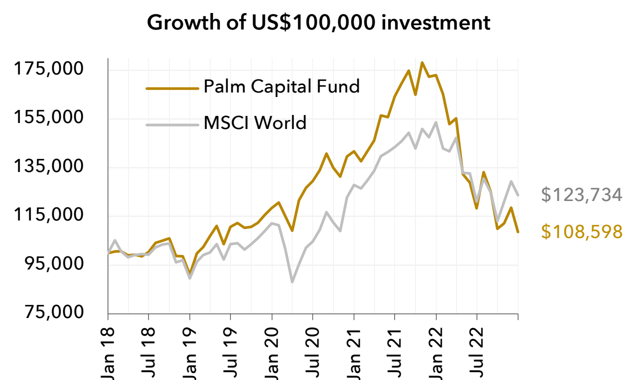
Our performance

Over the three months ending 31 December 2022 our portfolio fell by 1.2% after management fees & trading expenses.

Since we started, five years ago, our portfolio has returned 1.7% per annum after management fees & expenses. We have underperformed the MSCI World Index by 2.6% per annum.

Period ending 31 December 2022	Our Return[λ]	MSCI World	Out-performance
Quarter	-1.2%	+9.4%	-9.7%
1 year	-37.2%	-19.5%	-22.0%
Since inception (annualised)	+1.7%	+4.4%	-2.6%

[λ]after management fees & trading expenses



The thesis underlying our investment approach is that equity prices diverge from their worth in the short term and return to it over longer periods of time. So, we don't typically worry about short-term falls in the prices of equities. However, our terrible performance last year warranted analysis of our actions and a deeper review of our entire portfolio.

We know that, if we follow our disciplined process, our only possible error is from overvaluing shares. And our analysis showed that this was indeed the error we made. It primarily arose because we didn't take the impact of inflation seriously enough. This was because we assumed that the unique advantages of our companies would enable them to increase prices above inflation.

However, we underestimated the impact of the surge in inflation on the operating expenses and revenue growth of our companies. Following boom years during the pandemic, the cost bases of most of the companies we owned had become bloated as many created excess capacity. And with inflation unexpectedly surging, their operating profit margins narrowed quickly. Facing the same challenge, their customers held back spending where they could, resulting in a slowdown in revenue growth.

We can't fault our companies for getting their post-COVID demand projections wrong as there was little precedent for this period. And we know that the only guarantee of forecasting is being wrong. We also can't fault them for underestimating inflation; even the Fed did the same thing!

The overall result was that we overestimated free cashflow in the near term of our forecast period by around 20%. So, our valuations were around 10% higher than they should have been.

While hindsight is 20/20 and we are aware of not trying to fight the last war, we know that we could have been more conservative in our assumptions. And we will use these battle scars to further ingrain this in our process.

On the positive side, our analysis has given us added conviction in our companies and in the fact that the market has thrown the baby out with the bathwater. There are exceptional long-term opportunities abound! We will outline our latest find overleaf.

Perimeter Solutions

Perimeter Solutions was formed in 2018 when SK Capital Partners bought the business from Israel Chemicals for $2bn. It was then bought in 2021 by EverArc, a SPAC co-chaired by Nick Howley, the founder of TransDigm – a company we've long admired – TransDigm, and Will Thorndike – author of "The Outsiders", a book we've learnt a lot from.

Over the past decade, Perimeter has had revenue and EBITDA CAGR of 11% and 17% respectively.

The company has a monopoly in the North American aerial fire-retardant market. This division traces its roots back to a division started within Monsanto in 1963 and makes up two thirds of revenue. The company's customers in this division are The USDA Forest Service and the state of California.

The rest of the company's revenue comes from the production of phosphorus pentasulfide – an engine oil additive that is also being tested in other potential markets.

The company has significant intangible and switching cost advantages:

1. Its 'Phos-chek' product is the only long-term fire retardant that is fully approved by the US Forest Service and the Canadian Interagency Forest Fire Centre giving it patent protection. It also has customer relationships lasting more than 30 years and a track record of 100% reliability. With lives at stake and in emergency situations, this is priceless.

2. Customers tend to choose a sole provider because different chemicals do not mix well. Before switching from one provider to another, a tank rinse is required – impractical during emergency situations. At the same time, the purchase decision is made by government employees who are risk averse. So, they are unlikely to switch providers, especially considering Perimeter's product is proven and is non-toxic. Furthermore, the product only makes up around 3% of total fire control spend. It's critical but low cost, so providers are unlikely to be switched over price.

   At the same time, Perimeter has solidified these advantages by integrating itself with The US Forest Services. The company manages all operations, inventory, storage, mixing and aircraft loading for 150 bases across North America as part of its services. It also owns all the equipment and provides all the personnel for these operations. Forest Service bases carry less than one day of inventory and require frequent replenishment when busy. Perimeter's strategically located supply chain delivers nearly anywhere in North America within hours.

   To quote Perimeter's management: "it becomes a real barrier to entry. It's like, if this dude shows up and he says, 'Look, I've got the best stuff ever to make this thing happen.' They're going to go, 'Okay, fantastic. When can we get it in the bases?' And he's going to say, 'I don't have the capital to do that.'"

To top it off, the company has secular tailwinds driving growth. Between 2009-2020, retardant volume has grown at 10% p.a. due to 3 trends:

1. Increase in acres burnt. Although this is volatile from year to year, the medium to long term trend has been steadily upwards – the average number of acres burnt in the US has increased at every five-year interval between 1995 to 2020 from 2.5m to 7.8m.
2. Increasing urbanisation. As more homes and buildings are built closer to forests, fire services must control more fires than before.
3. Increased firefighting aerial capacity. Modernisation of airtanker capacity is a global trend and this comes with larger tanks and capacity.

In addition to these, the company is pursuing two other avenues for growth – international expansion and acquisitions.

Most countries follow the USDA Forest Service standard, and as the only qualified supplier, Perimeter is in a unique position to expand internationally. It has been doing this by following the same model as in the US. It has entered Canada, France, Spain, Italy, Chile, Australia, Israel, and Greece recently, helping these countries switch from less effective foam to their product.

And the company is well-placed to make acquisitions. The company looks for acquisitions that provide critical products that are part of larger value streams that generate recurring revenue and lots of free cash, have secular growth or the potential for opportunistic consolidation. Their recent acquisition of LaderaTech is a good example. The company struggled to have their Fortify gel approved by US Forest Service and this was approved once owned by Perimeter.

The biggest risk the company faces is from competition. Compass Minerals is launching a Magnesium Chloride product that it argues does not spread invasive vegetation growth as Phos-chek – which is fertiliser-based – does. In our opinion, the high barriers to entry and the secular growth of this space mitigate this risk.

Management are steady hands, with CEO Edward Goldberg being there for five years and Nick Howley acting as Chairman. The one place this company scores poorly is the high fees paid to the SPAC founders. They receive an annual fixed fee paid as a new issuance of 1.5% of all shares outstanding paid until 2027 and an annual variable fee calculated as 18% of the rise in the share price over the previous year paid until 2031.

In spite of this, the share is offering a 15% IRR over the next 10 years. It's a keeper in our portfolios.

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