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"I—I hardly know, Sir, just at present—at least I know who I was when I got up this morning, but I think I must have changed several times since then." -Alice (Alice in Wonderland)

14th of January 2022

Dear Clients & Friends,

Since January 2020, the world has experienced a global pandemic, inaugurated a new U.S. President accompanied by shifting political control of the U.S. Congress, faced unprecedented supply chain bottlenecks, and confronted a U.S. inflation rate of 7%, the highest annual rate of inflation since 1982. In December 2019, few could have predicted what the next two years would look like or how global markets would react to such unexpected and challenging events.

On the back of two years of uncertainty, many investors and market pundits opine for the days of "normalcy"—a set of political, economic, and market conditions that are stable, predictable, and easy-to-navigate. Such conditions are a chimera. The world, and the markets, are perpetually uncertain. The only true constant is change.

We accept that change is a fact-of-life in investing and embrace the opportunities that change offers. We do this by investing in durable companies that have both the business model and the cultural ethos that enable the business to adapt and thrive amidst change. While there is no universal formula that guarantees that a business will be able to navigate and capitalize on change, there are two core characteristics that make it more likely. First, the business delivers an immensely valuable product or service to customers that the customers cannot or do not want to live without. By delivering something essential to customers, these businesses can raise prices to offset higher input costs, grow their customer base, and weather economic downturns.

Second, in a world in which the rate and pace of change is accelerating, we prize management teams that are flexible, bold, inventive and customer-and-employee obsessed. A corporate culture that embodies these traits will embrace change and be made stronger by it.

In the short-term, macroeconomic events, geopolitical turmoil, and shifting political tides will impact market prices and investor psychology. Over the long-term, the quality of the business, the character of the management, and the cultural values of the company will be the key drivers of business performance and stock market value.

LONG-TERM TIME HORIZON

A defining characteristic of our investment philosophy is our long-term time horizon. On each investment, we project our returns over a minimum five-year holding period and identify the core drivers of business value over that time frame. Our long-term investment time horizon allows us to execute a strategy that suits us both analytically and temperamentally.

We have little discernible investing edge forecasting near-term movements in individual stocks, or the market overall. Company specific fundamental research allows us to home in on the core drivers of business and stock market value over the long-term, not what will happen next quarter. Our long-term approach underscores our belief that few great outcomes are achieved quickly, a fact often true in the stock market.

We believe that there are key advantages to a long-term approach, including better compounded returns, less tax leakage, and reduced transaction and trading costs. Many investors, both individual and institutional, recognize the value of patience in investing, but do not have the business structure, or the psychology, to execute a long-term strategy. We are fortunate to have clients that share our long-term orientation, and an investing philosophy anchored in fundamental analysis and long-term results.

We believe this a wonderful time to be a long-term investor in the stock market. In our view, the quality of the public companies in our investable universe has never been higher and the long-term growth prospects of the best businesses has never been brighter. New technologies are enabling bigger market opportunities and more innovative and valuable products and services. It often takes years, not quarters, for companies to fully seize these opportunities and we want to be patient while they do. There are so many forces conspiring against the practice of patience: 24-hour financial news (mostly scary), on-demand access to free trading platforms, and the general human tendency to fear losing money more than enjoy making it. Our investing philosophy, our process, and our day-to-day work is designed to minimize the tendency to overreact to short-term news and events and stay grounded in the long-term performance.

If you have any questions, please don't hesitate to contact us.

Sincerely,

Ben Weiss

Ben Weiss, JD
Chief Investment Officer

Tom Eidelman

Tom Eidelman, CFA
President

CHEWY (CHWY) - $44

Chewy is the leading online pet retailer in the United States. With the broadest selection of pet products, a scaled logistics network, and industry-leading customer service, Chewy has become a trusted and beloved brand for pet owners. For most of 2020 and 2021, Chewy was viewed as a pandemic-winner as many people adopted pets and shifted their pet spending online. However, the stock fell from a 52-week high of $120/share to the current price of ~$44/share after supply chain challenges and difficult year-over-year growth comparisons caused Chewy to post a disappointing quarter, offering a potentially attractive entry point.

Chewy is a beneficiary of strong secular market trends driving pet ownership. Over the last 20 years, pet ownership in the United States has grown substantially. People are staying single longer and getting pets. Married couples are having children later and getting pets. People whose children have moved out of the house are getting pets. As a result of the changing household demographics, pet ownership in the United States has increased to 70% of U.S. households in 2020, up from 56% of U.S. homes in 1988. In 2020, U.S. households spent $103B on their pets. Not only are more households buying pets, but pet owners are spending more on their pets, demanding the highest quality food, toys, treats, medicine, and customer service.

Chewy has been one of the leading beneficiaries of these demographic and psychographic tailwinds. By solely focusing on the pet category, Chewy has built the broadest selection of products across the widest range of categories, creating a one-stop shop for the pet shopper. From 2017-2021, Chewy grew its revenue from $1.4B to $9B, a compound growth rate of ~58%; this growth was enabled by continued investment in quality service and vast product selection.

By investing in industry leading customer service and building a culture that attracts pet-obsessed employees, Chewy has become one the most loved and trusted brands in the industry. Chewy has won this customer love and trust by obsessing over their customers' pets: commemorating a pet birthday by sending a pet portrait, sending condolence cards to owners upon the death of a pet, and guaranteeing customers 24/7 customer support, with all calls answered within fifteen seconds. This attention to detail and commitment to a superior customer experience has allowed Chewy to double its active customer base from 10.5 million in 2018 to 20 million in 2021.

Chewy also benefits from an attractive and defensible business model. Consumer spending on pets is predictable because most pet owners tend to buy the same food, treats and medicine on a regular cadence. Chewy has leveraged the predictability of pet owner purchases by creating a subscription program ("Autoship") that allows pet owners to sign up for regular shipments of pet food. Autoship subscription revenue now accounts for ~70% of Chewy's total revenue, making Chewy's revenue more stable and recession-proof. Chewy is also expanding into higher margin product categories, including private label pet products and pet health. Both represent strong long-term growth opportunities with favorable economics and higher profit margins.

We estimate Chewy will end 2021 with 20 million active customers and $9B in total revenue. A combination of new customer growth, category expansion, and the secular shift of consumer pet spending online could support 25% revenue growth annualized through 2026. In five years, we estimate that Chewy could generate $27.5B in revenue and generate earnings power of $5.50/share. At a 10-year average S&P 500 PE multiple of 22x multiple, CHWY would be valued at $121/share, generating a potential 22% annualized return.

DISCLOSURES

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