

## Select Portfolio Investments: Building Products Companies

*This article<sup>[1]</sup> is excerpted from a letter by MOI Global instructor Phil Ordway, Managing Principal at Anabatic Investment Partners, based in Chicago, Illinois.*

**Building Products - Armstrong (AWI)** remains our largest investment, a position it has occupied for almost four years. We made our initial purchases in late 2015 and early 2016, adding more shares in 2017.

AWI has been the biggest and most profitable investment in our partnership's history. In 2019 our AWI shares returned 63%, more than double the return of the broader U.S. equity market.<sup>[2]</sup> AWI's annual returns compounded over the prior two- and three-year periods were 25.2% and 31.5%, respectively.<sup>[3]</sup>

But those results were not earned in a straight line. For two years after our initial investment we had very little to show for it in the quoted price even though the business made enormous progress during that time. When that progress was recognized the stock price nearly tripled from its 2016 low point. More recently, the share price declined 3.6% in 2018 despite considerable business success and several positive changes. Recession fears were prevalent then, but they should not have been a major concern to a long-term owner. Armstrong has a solid balance sheet, a dominant market position, high margins, good returns on invested capital, and a stream of earnings and cash flow with exceptional durability. In 2019 the business produced solid results with little overall change, and yet the stock soared.

To repeat last year's comments, capital allocation is critical and remains at the top of my list of concerns. Armstrong has ample free cash flow, and the investments made with that cash will determine much of the company's future success.

**Builders FirstSource (BLDR)** - The underlying U.S. housing market has experienced some fluctuations, but BLDR's stock price has gyrated in a wide range and that volatility has given us an investment opportunity twice in the last four years. Most recently, the price of BLDR shares fell 50% in 2018 even though the business was in pretty good shape and the multi-year outlook was promising from almost any perspective.

As noted in last year's letter, "Even a 'bad' year like 2018 wasn't so tough - the company was very profitable, generating copious free cash flow that further deleveraged the balance sheet. The shares could remain volatile, but the business outlook and the value offered by the current market price give us favorable odds." We bought more shares late in 2018, and those odds paid off in 2019 as the stock returned +134%.

Not much has changed in the underlying business over the past year. Builders continues to separate itself from smaller, local distributors with its scale, superior service, and lower prices. Some small acquisitions have expanded capabilities and geographic coverage. The company has used its massive free cash flow to pay down almost 25% of its total debt outstanding since the beginning of 2016 while also refinancing its obligations several times to lower interest costs and term-out maturities. The resulting balance sheet has better resilience to face the next downturn, and operational improvements are also driving a virtuous feedback loop. There is no way to forecast the vagaries of the housing market in

2020 or beyond, but Builders is positioned to benefit from housing demand over time.<sup>[4]</sup>

<sup>[1]</sup> This section is used to discuss investments – both good and bad – that have had a material impact on our recent results or have the potential to do so in the future; it is not meant to be a comprehensive portfolio review. Please note that discussion of any positions currently being bought or sold, or any that may be difficult to buy or sell in the future, will be omitted.

<sup>[2]</sup> It's worth noting that AWI is not a member of most major indexes. (Source: FactSet.)

<sup>[3]</sup> As of 31-December-2019. (Source: FactSet.)

<sup>[4]</sup> As this letter was being finalized Builders announced the retirement of its CEO and longtime executive Chad Crow. A successor has not yet been named and that process will be closely monitored.

*Disclaimer: Gross Long and Gross Short performance attribution for the month and year-to-date periods is based on internal calculations of gross trading profits and losses (net of trading costs), excluding management fees/incentive allocation, borrowing costs or other fund expenses. Net Return for the month is based on the determination of the fund's third-party administrator of month-end net asset value for the referenced time period, and is net of all such management fees/incentive allocation, borrowing costs and other fund expenses. Net Return presented above for periods longer than one month represents the geometric average of the monthly net returns during the applicable period, including the Net Return for the month referenced herein. An investor's individual Net Return for the referenced time period(s) may differ based upon, among other things, date of investment. In the event of any discrepancy between the Net Return contained herein and the information on an investor's monthly account statement, the information contained in such monthly account statement shall govern. All such calculations are unaudited and subject to further review and change. For purposes of the foregoing, the calculation of Exposure Value includes: (i) for equities, market value, and (ii) for equity options, delta-adjusted notional value.*

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*NOTE ON INDEX PERFORMANCE*

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