

PODCAST TRANSCRIPT

Talking Research: Digging Deeper – Understanding Ferguson

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George Dent: At a time when investors are captivated by artificial intelligence and leading-edge technology, it can be easy to overlook the companies doing something rather more mundane. Today's company, Ferguson, is a case in point. Ferguson deals in pipes and pumps, valves and fittings, the unglamorous but essential infrastructure of our built environment. Supplying one million customers with over one million products, it is the largest specialist distributor of its kind in North America.

Ferguson's story began in Virginia in 1953 with a small plumbing supplier and a simple promise: have what the tradesperson needs, when and where they need it. Seventy years on, that promise still holds, whether it's supplying parts for a bathroom renovation or materials for a hyperscaler's data centre. Today, a best-in-class distribution network ensures 95% of customers are within 60 miles of a store.

I'm George Dent, a client investment manager at Walter Scott, and I'm joined today by Alan Edington, the stock champion for Ferguson. Together, we're going to unpick what it is that makes Ferguson a Walter Scott investment, the advantages that set it apart from its peers, why its competitive moat is deeper than many assume, and why modest margins are no barrier to sustained growth.

Before we get started, a reminder that this podcast is intended for investment professionals only and should not be construed as investment advice or a recommendation. Any stock examples discussed are provided in the context of the theme being explored, and the views expressed are those of the presenters at the time of recording.

Alan, welcome.

Alan Edington: Thanks.

GD: Before we get into the joys of Ferguson, perhaps we could have a minute or two on you and your background.

AE: I've been at Walter Scott for 15 years. I've rotated around our geographic regions. For a spell in the middle, I ran the Research team with my colleague Alex Torrens; and for the last four or five years, whilst also being a stock champion, I've overseen our approach to sustainability.

GD: Let's start with a softball question. Ferguson, I've given a little bit of a taster, but what is it, and why do we like it?

AE: What it is not, is mundane. I take issue with your initial premise there, George. But what it is is a US-based distributor across a number of products and end markets that you've already mentioned there in your introduction. The history of it is slightly unusual, so maybe worth just a couple of minutes.

This was a business that was bought by a UK company called Wolseley back in the 80s. It was provided capital in order to grow up to the 1,700 nationwide stores that it has in the United States today. Wolseley hit a challenge during the global financial crisis. It was overleveraged. The business wasn't positioned for a downturn in construction markets and housing markets. And as a result, Wolseley gradually dwindled. Pieces and parts of that were sold off. The CEO of Ferguson today was put in place in 2019 and effectively sold the Wolseley business off in 2021. What had been a division of Wolseley became the dominant feature of Wolseley and then eventually jettisoned Wolseley and redomiciled to the US where the business is largely positioned today, although with a small business in Canada as well.

GD: At a high level, what is it that we like about Ferguson?

AE: I'm sure we'll get into some of this, but it's a growthy business. It has high returns on capital. It's a business that manages its balance sheet quite carefully these days having learned the lesson that Wolseley didn't learn subsequent to the global financial crisis. And, ultimately, this is a business that through lots of additional capabilities compared to the competitive set, will take significant market share over time. It's in growthy areas of the world: waterworks, which is an area that requires infrastructure spending, HVAC, which it's rolling out into its business alongside the plumbing business. It's already got scale in plumbing, and it's going to grow HVAC alongside that.

We've got an aging housing stock in the United States. We've got a lack of house building in the United States, both of which are important drivers that will play into Ferguson. And the final part of the drivers behind why we like it, is large capital projects; whether those be in data centres or somewhere else,

there's a lot of large capital spending going on in the United States that's set to continue, and Ferguson will be really nicely geared into that growth.

GD: Putting some numbers around that; obviously, growth is really at the heart of what we do. What kind of growth has Ferguson delivered in the past? You've touched on what's going to underpin that growth going forward, but what kind of level of growth are we expecting?

AE: If you just looked at the last five years, revenue growth has been 9% compound annual growth rate, nothing to be sniffed at. When we think about future expectations, something very similar is likely for this business. And this is probably slightly unusual, in the way you can think about this, but the market probably grows 2-4%. So, it's not a rapidly growing market, although it is important that it is a growing market. But what you get with Ferguson is 3 or 4 percentage points of additional revenue growth through taking market share and 1-3 percentage points through acquisition.

So, ultimately, in adding up the market growth plus taking some share, plus some acquisitions that they tuck in and bolt on to what they do, you get to something between 6 and 11% in terms of revenue. And there's no rocket science in that. It's consistent, and it's repeatable, and it's what the management team set out as their intention. Then you get a little bit of margin on top of that. This is a business that's highly complex and, therefore, is always looking for little improvements that can drive margin on top. Of course, scale brings some leverage to the business.

There's also some private label within there, which is typically higher margin and is growing from a relatively low base today, that will help drive some margin. So, you get to a faster bottom line typically than top line. You add a couple of points for buybacks that help drive EPS growth upwards, and you get something in the low double digits to the mid-teens level. And on top of that, they pay a decent dividend yield, so you get 1.5% to add to that in terms of your total shareholder return. So, quite a growthy model and a lot coming from taking market share, gaining share within the market that it's in.

GD: And in terms of that market share gain, because I think that's such an exciting part of the story, and and it's something that we've seen previously. Many of our investors will be familiar with Fastenal that we've owned for several decades. In many ways, [Fastenal] is a kind of quintessential Walter Scott story. And, of course, that's another distributor where you've just got this hugely fragmented market, which once you've got your model right and get to a certain scale, you can just keep expanding and expanding and expanding and expanding into. In the case of Ferguson, what is it? And this ties in with barriers to entry as well because they're almost one and the same. But what

is it that allows it to organically grow that market share as opposed to these smaller acquisitions that you touched on as well?

AE: There are a number of things within there. One is that they've gotten to scale quicker than anyone else. So, there are very few competitors, particularly across the breadth of what Ferguson do. There's almost no competitor that competes head-to-head with them. But even within each of the niches that they're in, whether that's water or HVAC, they're typically the number one or the number two player. So, they're very, very scaled compared to many. And what you tend to have in these industries is one or two scaled players and then a very, very fragmented rest of market. So, 10,000 plus small, medium sized enterprises are competing with these guys, and it's often mom-and-pop.

When you think about what the advantage is and why do they take share here? One, they're managing a million SKUs, a million products, as you mentioned in your introduction. That is highly complicated to do, and no one else can match that breadth. So, when you're looking for someone to deliver the thing you need to your construction site, you know for a fact that Ferguson is going to be able to do a better job at it than anybody else in the marketplace.

You also know that they're capable at managing those SKUs. They're capable at managing their inventory. And so, when you need it, on the day you need it, at the hour you need it, in the place you need it, you've got more chance with Ferguson than you do with anyone else. Reliability is incredibly important in what is ultimately a relationship business in distribution. The scale, the reliability, the last thing I'd mention other than the breadth, which I briefly touched on, but if you're running a large capital project, you're going to need plumbing parts, you're going to need HVAC, you're going to need fire and fabrication. Somewhere that can do all of that for you at once in an integrated way can make an awful lot of sense.

But the last thing is capability. This company does a lot more value add than I think people might naturally assume. Whether that is cutting a part to the right size and delivering it to site when others don't have that capacity, they don't have the skills, they don't engage with the measurement, they just supply you the part, drop and run. Something as simple as that; through to something much more complex, like being involved with the design of a project, advising on which parts, which prefab equipment, what can Ferguson provide that can go in to solve whatever the particular problem is. And that can involve helping to manage costs, that can involve helping manage time. And so, delivering a project better, faster, on budget in a way that others just don't have the capacity to compete with.

GD: That's the growth side. That's obviously at the heart of what we look for. There are a number of other characteristics that we're always striving for in investments, and one of those is superior profitability. In the case of Ferguson, as we noted earlier, it's not the most profitable of businesses. In this case, why are we okay with that? And how do you think about that?

AE: When you think about Ferguson's operating margin today, it's about 9%, which sits in line with most of the blue-chip, [large-scale] distributors. If you think about something like Watsco in the HVAC space, Ferguson's in the same ballpark there. There's also capability to raise that margin, and indeed we've seen the margin tick up a bit over time. So that's positive directionally. But when we think about profitability, I don't think we have any hard floors. This is a highly profitable business for the industry that it's in.

But we also think about two sides to what a business can achieve in terms of returns. Margins are one side of that, but the other is what we term asset productivity. So, for every dollar that the business invests, whether that's in working capital or in fixed assets or in goodwill, what do they generate in terms of revenue? So, how efficient is this business with its capital? And Ferguson is a highly efficient business in terms of capital; so, you're generating more dollars on the assets that you're employing in your trade, then you're clipping the ticket on that margin as it falls to the bottom line and you end up with a high returns business. So, returns on invested capital are pretty good here, and that's one of the other key things we think about when we're talking broadly about profitability.

GD: Which is broadly that higher returns on capital is very much a feature of distributors, which is why they've tended to have appeal on a number of occasions in the past.

Just returning to the growth side, when you think about the threats to that growth, there are a couple of areas that I know you will get pressure from within the team. One of those is those large projects, it's been a big part of the story. There is a concern that some of that is being driven by AI data centres. The AI story may continue for a good period to come, but there's always that concern that it does unravel. To what extent do you think we need to be worried about that in the context of Ferguson?

AE: The nice thing about Ferguson, it's a very balanced business across a range of end markets. When we think about the large capital projects, those have been a key driver of the business in the most recent few sets of results, and data centres are no doubt a part of that. Data centres are significantly less than 5% of the revenues today. So, data centre itself is not going to make or break

the Ferguson business. I have asked the question around, what else are you doing that's data centre adjacent? If that data centre isn't built, does the power project happen? Does the water project happen? Does whatever might be around that data centre fail to occur? Even then, we're talking less than 10% of the Ferguson business. So, I think very manageable when you think about the data centre risk, certainly compared to anything that's geared into those things a 100%, which is a lot of what's been going well in the marketplace over the last little while. So, I think manageable in terms of data centre.

The other thing to think about is [that] these large capital projects are broad in terms of their breadth as well. A lot of it is water management today; water infrastructure is getting a refresh, getting some significant spend in there, but also commercial mechanical work. One of the examples that Ferguson gave recently is pharma. There's significant build going on in the pharma space in terms of manufacture in North America, and the US in particular; guys like Eli Lilly building enormous production capacity for GLP-1, the weight loss drugs, for example.

GD: The other area that comes into focus is US residential property. A big part of the business traditionally. As we're moving into an environment of higher rates, there are understandably questions asked around what that means. To what extent do you see that as a risk to growth?

AE: In a business with these end markets, you're always going to see some cycles. The way to manage and mute those cycles and come out on top – point to point – is to take market share during the down cycle. So, actually, US residential has been weak for the last two or three years. Ferguson's managed to achieve flat growth in the [residential] part of its business. The residential is about half of the business today, which is impressive because they're taking points of market share from everybody else, which ultimately puts them in quite a good position to thrive when the upswing does come.

If we go into a higher interest rate environment, I think that does pose a challenge to affordability. It's not the only challenge. Mortgages at 6% is not completely unreasonable in the context of the last 40, 50 years, even if it is in the context of the last 15 years. But that may well not be the key limiting feature. Affordability more broadly matters. If people can't afford to remodel their house, if people can't afford to buy their next house, if people can't afford to buy their new-build house, then that is a challenge. But ultimately, it's a challenge that Ferguson will come out better than anyone else at the other end of it, I think.

But the other thing to think about is there's an aging housing stock in the United States, and the chart is a

one-way ticket at the moment. And there is a lack of build; there's a housing shortage across swathes of the United States. And at some point, those both have to be dealt with; there just reaches a tipping point where you need to build more houses and you need to remodel existing homes. And so, when that eventually comes, when it does come, Ferguson very well positioned having taken market share during this downturn.

GD: To summarise, good levels of growth, and importantly, quite well diversified in terms of the underlying drivers, which ties in very much with what we look for. Another element which is very important is valuation. Most people listening to this podcast will know that quality growth has had a pretty rough ride over the past couple of years. The silver lining of that is that when we look at relative valuations, actually, for global clients, not far off 20-year lows.

When you think about Ferguson and valuation on Ferguson, where is that sitting? I appreciate there's a complexity there given that it used to be part of a bigger Wolseley group. But where does valuation sit? And to what extent do you think that plays into the investment case as we look forward over the next two, three, four years?

AE: I think when we got into this a few years ago, we thought it was a cheap opportunity for the growth that Ferguson can achieve. We actually saw the valuation come back for that first little while. So, what went on was a bit of deflation in commodity products; about 15% of revenues is from pipes, simple plastics, things that are commoditised and that you can't really add any value on. And so, as a result, when there is deflation in the system, prices come down, that has an impact on your revenues.

Coming into the tail end of 2024, the Ferguson valuation weakened quite materially. And then 2025, as that deflation eased, and as a recognition came that the breadth of this business was really positive; despite [residential] being quite a poor place to be, the other side of the business was performing really, really well. I think there was a bit of recognition there; so, the valuation came up quite nicely. It was one of our better performers over the course of last year. Subsequently, it's tailed off a little bit again. Whether there's a bit of interest rate concern in there, honestly, I don't know.

When we think about earnings expectations, they continue to trend upwards; the analyst community is increasingly positive on the future for Ferguson. I think there have just been perhaps more exciting things that people have been chasing, or what others perceive to be more exciting things that people are chasing in the market. But the Ferguson business continues to churn out the sorts of results I would hope for in this environment. And indeed, the most recent results are pretty good, and the stock was up 4% on the day. No real concerns for me from a

fundamentals perspective. And from the starting evaluation, I can get quite excited.

GD: One final question. And it's a little bit more light-hearted, should we say. Is there one thing that you think makes Ferguson special, which the market broadly misses?

AE: I think you could argue this for all good distribution businesses. I think the market fails to understand – and I certainly have historically – what a distribution business really does. There's an assumption that [a] supplier sells you something, you sell it on to end customer, and what you're doing is the delivery or you're housing in a warehouse and the customer's coming to you, which is the case in some instances. But what someone like Ferguson is doing, at the scale they're doing, is so much more complicated. I've mentioned a million different products, a million different SKUs. You're getting them to the customer when they want them, when they need them.

The inventory management required, the complexity required to manage 37,000 different suppliers, that is enormously hard, right down to – and I was given this example by the company themselves, a couple of years ago in discussion – if you have loaded a truck to take to a site that's doing something complex tomorrow and then it rains, what they can do and what they need to do will change, and you have to unpack the truck and repack the truck. And, again, right down to every individual component, you have to have the right stuff in the right place at the right time.

And so, I think there's a real complexity to these things. There's a real value added to these things. There's a real skill in the scale of bringing together and managing that inventory from that huge number of suppliers into that million-plus different customers, that really is the special sauce that's so hard to replicate.

GD: I suppose, in a word, underestimated complexity.

AE: Yes. That's two words.

GD: It is two words. But if I hyphenate it, I'll get away with it.

AE: Let's put a hyphen in it. I like that.

GD: Alan, thank you very much for your time, and thank you to our viewers and listeners. If you found today's session interesting, there are plenty more Digging Deeper on our website. Until next time, thank you, and goodbye.

Important information

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Stock examples

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