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Thompson Research Group

Ferguson (FERG)

Q3'21 (Apr) Earnings Recap

Organic Growth of 20%, May seeing Similar Trends

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Please see pages 7-8 for Important Disclosures

Q3'21 (Apr) Earnings Takeaways

Ferguson (FERG – \$131.07) this morning released Q3'21 (Apr) results that far surpassed estimates and previous expectations laid out last quarter. Q3 started off with high single digit growth (as reposted with previous quarter earnings) and accelerated to **end the quarter with organic growth of 20.1%**. See TRG's flashnote (FERG – Q3'21 (April) Posts Solid Results; Blows Through Previously Outlined Bogie) for detailed segment takeaways. See TRG's recent FERG thought piece post a virtual NDR (published 1/27/21) that contains a deep dive into FERG's longer term outlook and growth prospects across investments in digital/technology/supply chain.

Q3'21 Performance

- U.S. organic growth = +20.1%**, far above the high-single-digits that were seen in the beginning of the quarter. Strong resi trends drove the way with strength seen in new resi from the continued pace of housing starts and RMI activity as tight housing inventory has spurred home remodels post-COVID, including growth in larger scale RMI like kitchen and bath remodels. Commercial markets also improved better than expected, with strength in data centers and distribution helped a recovering hospitality/education sector offset weakness in office and retail. HVAC sales were up 40% and eBusiness sales surged 50%+. Waterworks, a leading indicator of resi activity to come, also saw robust growth across resi build outs, commercial projects, and public work.
- Gross margins** expanded 110 bps to 30.9% on pass through price increases and channel mix. FERG has been able to pass on cost increases to stay ahead of inflation. Blended branch sales were strong in the quarter as COVID restrictions eased, and typically have higher gross margins than the company average. Remember that April last year was largely COVID impacted with branch showrooms limited, while this April likely saw much higher activity and benefitted margins.

US Revenue Growth	Q1'20 Oct	Q2'20 Jan	Q3'20 Apr	Q4'20 July	Q1'21 Oct	Q2'21 Jan	Q3'21 Apr
Organic	3.1%	2.1%	-1.0%	-2.4%	3.3%	3.4%	20.1%

Go Forward Thoughts

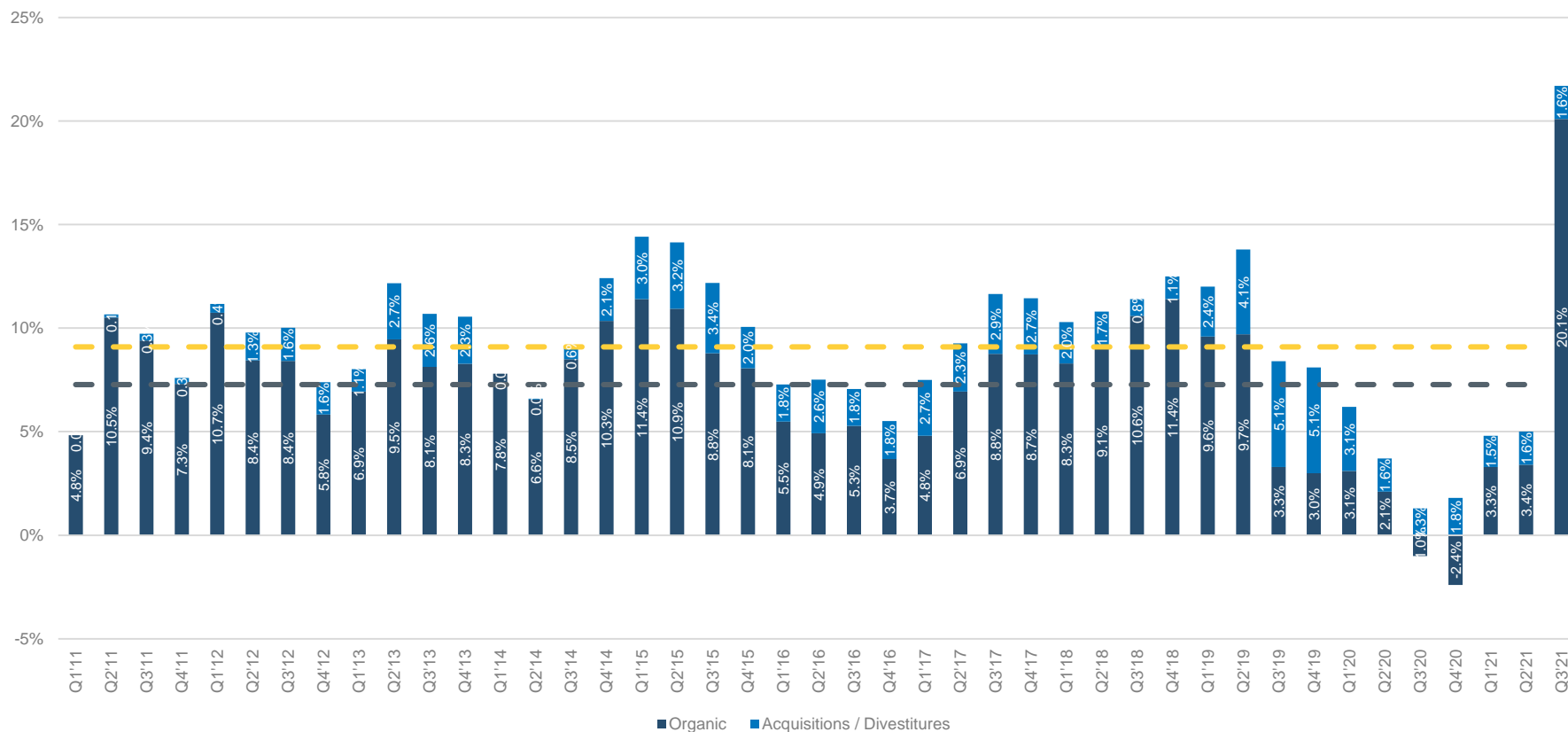
- FY'21 trading profit guidance for \$2.0-2.1B (vs. consensus of \$1.86B)**. Management had not previously provided specific full year guidance. That said, given that Q3 revenues picked up faster than expected and is expected to remain strong into Q4 (May up 20% organic), FERG issued FY trading profit guidance above consensus.
- FERG outperforming historical trend of 200-300 bps growth above market**. FERG outperforms end markets by 200-300 bps in a typical environment. In today's atypical environment FERG is trending above that historical outperformance due to its size, scale, and product availability in a time of supply chain challenges. A focus on product availability and fill rates in store have allowed FERG to gain even more market share than normal. Having product on hand also help with price increases as being the only company availability allows you to effectively pass on price and maintain margins.
- Inflation is running at ~5%** (was flat in 1H'21 ending Jan). FERG has been able to pass on price increases, importantly at almost no lag, as gross margins were up 110 bps in Q3. Inflation in 2021 was a theme in TRG's 2021 Investing Ideas thought piece (published 12/7/20 – [link to report](#)). Last quarter FERG did not anticipate any short-term margin disruptions and uses inflation as a tailwind to drive pricing in the market. Good working relationships with contractors and customers and timely communication would help FERG pass along price increases and maintain margins. Q3 results were proof that FERG's scale and reputation has power as the company was able to deliver above expectations on margins.
- FERG cited improving signs of contractor work in industrial markets as COVID restrictions continue to ease, an encouraging sign for overall non-res activity.
- Labor (wages and hiring) continues to be a challenge, but FERG was able to add 700 associated in the quarter to ramp up with accelerating growth.
- FERG completed \$140MM of the \$400MM buy back program in Q3 and expects to complete this program by the end of FY'21. Leverage ended the quarter at 0.4x (0.8x after dividend payment in May), below the target 1-2x.

TRG Estimates – FY'21 EBITDA = \$2.2B, FY'21 EPS = \$6.32, Trading Profit = \$2.09B (vs. guidance of \$2.0-2.1B)

FERG Valuation – FERG's 12-month fair value range is \$174-\$203, the mid-point being \$188 (implying +41% upside). The mid-point of this range is based off of a 13x EV/EBITDA multiple on our FY'25 EBITDA discounted back.

FERG Historical Growth

Historical Growth, Organic and Acquisitions



Source: Company Filings; TRG Research

FERG Relative Market Share

Category	% of US Sales	FERG Market Position /Market Share	Market Size	% Market by companies with <1%	Comparable Companies
Residential Trade Provides plumbing and sanitary supplies and bathroom fixtures to plumbing contractors serving R&R and new construction	19%	#2 / 18%	\$22B	40%	HD (22% market share), LOW (13% market share), Morsco , Hajoca (5% market share)
Residential Showrooms Serves consumers and trade customers through showrooms displays of bathroom, kitchen and lighting products	15%	#1 / 12%	\$24B	70%	Morsco , Win Wholesale (4% market share), Hajoca (3% market share), PC Richards (3% market share)
Commercial Provides commercial plumbing and mechanical contractors with products and services including bidding and offering support and timeline planning to assist with construction projects	14%	#1 / 21%	\$14B	55%	Win Wholesale (10% market share), Hajoca (8% market share), FW Webb (5% market share)
Waterworks Provides products and solutions to public and private water sewer authorities, utility contractors, public works contractors and heavy highway contractors	18%	#1 / 25%	\$13B	50%	Core & Main (20% market share), Fortline (5% market share), Win Wholesale (4% market share)
HVAC Supplies heating, ventilation, air conditioning and refrigeration equipment, parts, and supplies to contractors serving the resi and commercial R&R market	10%	#3 / 4%	\$50B	65%	WSO (8% market share), Johnstone Supply (6% market share), Lennox (4% market share)
Industrial Supplies PVF and maintenance specialising in delivering automation, instrumentation, engineered products and turn-key solutions to the industrial sector	7%	#3 / 5%	\$29B	60%	MRC (13% market share), Varco (9% market share), Applied Industrial (9% market share)
Fire & Fabrication Provides fire protection products, fire protection systems and bespoke fabrication services to commercial contractors for new construction	4%	#1 / 22%	\$4B	30%	Viking (15% market share), Core & Main (11% market share), Reliable (11% market share)
Facilities Supply Provides products and services to enable reliable maintenance of facilities across several RMI markets including multi-family properties, government agencies, hospitality, education and healthcare	5%	#6 / 1%	\$90B	90%	MSC (3% market share), HDS (3% market share), HD (2% market share)
Ebusiness Sells directly to consumers and trade customers online predominantly using Ferguson's product range and distribution network	8%	#4 / 9%	\$19B	20%	AMZN - including market place sales fulfilled by AMZN (39% market share), HD (12% market share), Wayfair (10% market share)

Source: Company Filings; TRG Research

Company Description:

Ferguson is the largest distributor of residential & non-residential plumbing and heating supplies in the U.S., with additional business in waterworks, fire/fabrication, and other related products. The company is 100% North America based since the divestiture of U.K assets in January 2021 and a dual listing on the NYSE in March 2021.

Investment Thesis:

Dominant U.S. market share, opportunity to consolidate a highly fragmented U.S. market

Double-digit revenue growth fueled by stable organic growth and accretive acquisitions

Clean balance sheet with low leverage and strong FCF

Trading at a deep discount relative to U.S. peers on a EV/EBITDA, P/E, and FCF valuation basis

Potential Catalysts:

- Improvement in residential and non-res construction trends
- Continued strength in repair and remodel trends
- Continued opportunities to consolidate the fragmented industry

Risks to Attaining Fair Value

- Deceleration in residential & non-res construction trends over the next 12-24 months
- Significant downturn in Consumer Confidence
- Rising acquisition multiples that prevent continued meaningful acquisition contribution to revenue growth and market share gains

Fair Value Multiple Justification

- TRG building product & materials price targets are based on historical ranges (i.e., 10 year data, if available) and recent public & private company sale EBITDA multiples. Recent building product distribution acquisitions have ranged from 9x-13x EBITDA over the past 12-18 months.
- Higher relative EV/EBITDA multiples are given to industries and companies with higher barriers to entry, historical and future growth opportunities, and dominant market share positions.

FERG – The Largest Company You’ve Never Heard Of (from 7/26/19 initiation)

TRG is initiating coverage on Ferguson (LSE: FERG). Ferguson is the **largest distributor of residential & non-residential plumbing, waterworks, fire/fabrication supplies in the U.S., and the third largest distributor of industrial and HVAC/R products.** While headquartered in the U.K., the lion’s share of the company’s revenues and essentially all of its operating earnings is U.S.-focused (**80% of revenues and 94% of operating profit coming from the U.S**). Critical to assessing whether Ferguson is a compelling business model with upside to value is answering three critical questions: 1) Do you have scale? 2) Are revenue and earnings growth stable? 3) Are you capable of fending off Amazon? In TRG’s opinion, the answer to all three of these questions is “YES.” We think FERG feels a lot like Pool Corp (POOL) in the late 90s/early 2000s, except Ferguson’s total addressable market is over several multiples the size of POOL’s. Today’s note outlines this thesis.

Investment positives:

- Dominant U.S. market share, opportunity to consolidate a highly fragmented U.S. market
- Double-digit revenue growth fueled by stable organic growth + accretive acquisitions
- Clean balance sheet, strong FCF
- Trading at a deep discount relative to U.S. peers & why cash flows matter for valuation

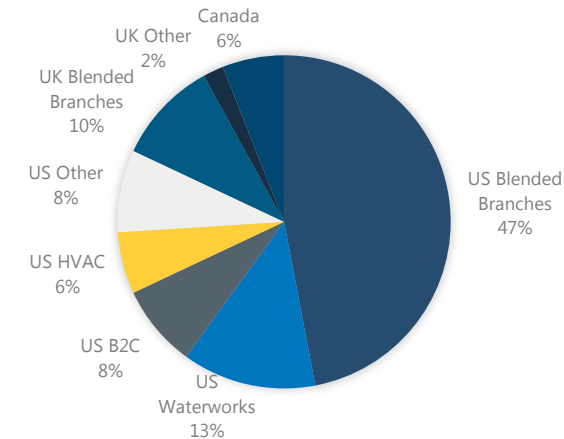
Investment concerns:

- The “cycle” question (**52%** residential & **48%** non-res end market exposure)
- U.K. isn’t necessarily additive to earnings
- London Stock Exchange (LSE) listed (but this could change...)

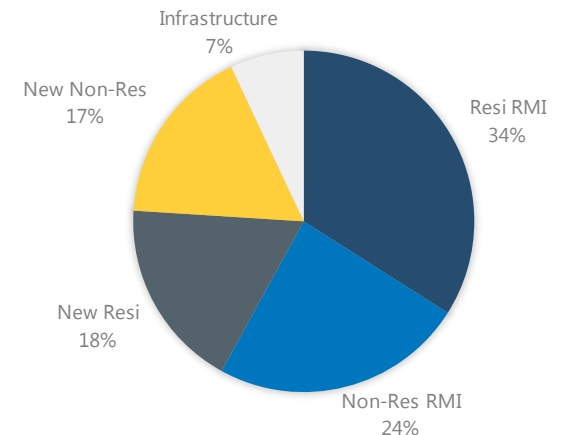
How TRG will add value:

TRG seeks to add value by connecting with the largest relevant peer (particularly private) distributors, in addition to Ferguson’s largest public and private suppliers/manufacturers. TRG’s quarterly *Residential Products Survey* focuses on volume and pricing trends in residential and multi-family construction, focusing on key categories important to Ferguson (plumbing fixtures, cabinets, etc.). This survey addresses **52%** of FERG U.S. sales. New Non-res and Non-res RMI account for a combined **41%** of U.S. sales, and TRG’s quarterly *Bonding & Contractor Survey* tracks trends in the non-res end market. Finally, TRG’s quarterly *Heavy Materials Survey* provides a read through for FERG’s U.S. infrastructure business (**7%** of sales). TRG intends to launch a distributor survey in coming weeks that specifically addresses the FERG business model.

Revenue by Region & Segment



U.S. Revenue by End Market



Source: Company Filings; TRG Research

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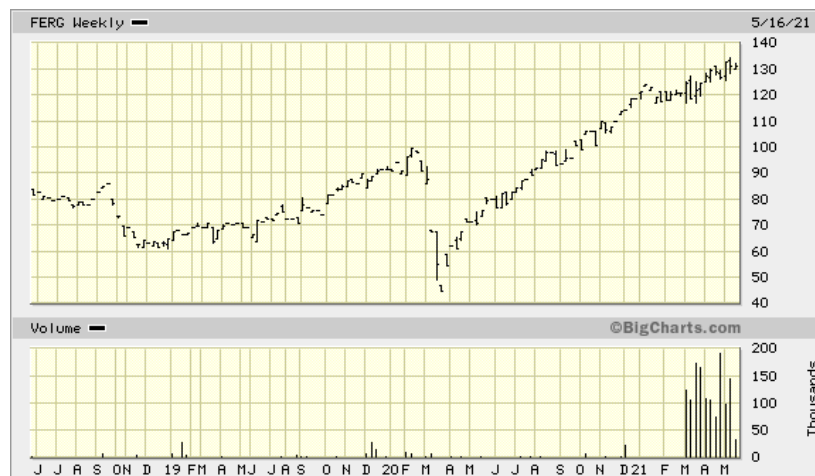
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Source: BigCharts.com

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