
WATSCO – A COOL INVESTMENT

Investment manager Toby Ross discusses recent investment, Watsco.

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Toby Ross: So, imagine if you will, that you are in Miami. You're in your apartment one morning. It's late June, and outside it's nudging 100 degrees (Fahrenheit – because we're in Florida, remember).

And then you hear the air con system splutter and go quiet. It's died. Within about 10 minutes it's unbearably hot inside.

So you call out Tyson, your air con contractor. Tyson runs his own business out the back of his van, driving from condo to condo in this part of Miami. He comes by that lunchtime and finds that the compressor is broken – which isn't surprising given the system is now 10 years old. The new one is going to be a few hundred dollars.

You wipe your brow and tell him that's fine – and can he replace it that afternoon?

This is where Watsco come in. Watsco are the largest distributor of air conditioning, heating and ventilation systems in the United States, and their business is built on these mini “climate emergencies”. They support around 300,000 contractors like Tyson from around 600 locations.

This huge network means that they are able to give contractors exactly the part they need, often immediately. And that helps Tyson who can run his business, without having to drive a van full of spare parts for hundreds of different air con systems all around Miami.

Watsco's business has historically been run around three core principles:

- Firstly, being big means they can get better terms from manufacturers. Watsco are around two and a half times the size of their nearest competitor, but they're still less than 15% of the overall market – so, to us, it looks like there's a lot of room still to grow.
- Secondly, running a decentralised business model. They strongly believe in giving store managers a lot of autonomy. They trust the people they employ to make good decisions about which contractors to support, and how to attract new customers – and that trust has helped them grow faster than the industry.
- Thirdly, being long term in how they run the business. The founder runs the business today, and his son seems likely to take over. They have a quirky pay structure which rewards staff in shares



that only vest when they retire at age 62. So, executives are focused on growing the business over the next 10 or 20 years, rather than trying to massage the numbers for the next two quarters.

Watsco have also been consistent dividend payers for the past 45 years. The business doesn't need much capital to grow, and they believe that dividends are the best way to share the proceeds of growth with shareholders. This is exactly the kind of dividend dependability that we look for in the companies we invest in.

But what really excites us about Watsco is the potential to use technology to help contractors like Tyson run their businesses better.

What does this mean in practice?

Well, Tyson can now check for availability of parts through the Watsco app, while he's standing in your apartment, and order online. And today around a quarter of Watsco's sales are done online. But they've also got tools that will help him monitor the condition of your system so he knows before it breaks.

What's the benefit? Well, the contractors that use all these tools the most do roughly three times as much in sales through Watsco as the average customer. So, this technology should help Watsco out-grow their competitors.

But there's another benefit – investing in all these tools is hard if you're small, so lots of companies in the industry are starting to ask – “wouldn't my business be stronger as part of Watsco?” And we think that a round of consolidation in the industry could really accelerate their growth over the next decade.

Watsco looks to us like a real growth business, that will continue to pay those steady, dependable dividends as it grows.

We took a holding in Watsco in 2019. We think it should be a *cool* investment over the coming years.

Toby Ross is an investment manager for The Scottish American Investment Trust PLC, the Baillie Gifford Global Income Growth Fund and the Baillie Gifford Responsible Global Equity Income Growth Fund.

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