Perimeter Solutions (NYSE: PRM — $598mm)

- Perimeter is the only company in California that provides aerial fire retardants, a key but small part of the cost of fighting wildfires, and unpredictably recurring in nature.
- While there is a clear, secular tailwind in the extent and number of wildfires, caused by the progression of climate change, the past two immensely devastating fire seasons (2022/2023) have showcased just how significant year-over-year variability can be.
- I am an investor, not a gambler. An investment is, essentially, a big gamble on the next fire season being substantial. It is statistically likely, but nonetheless, NOBODY can predict it with certainty.
- The company has a net debt of $725 million and is paying a 5% fixed interest. This arrangement works against a business that is highly unpredictable and cyclical. I believe the management would have no other option than to significantly dilute its shareholders in the event of a low-fire season.

Introduction to the case.

Perimeter Solutions (PRM) went public via SPAC, backed by a team of savvy investors: Nick Howley of Transdigm (who achieved a 3900% return since IPO'ing in 2006), Warren Buffett's mentee, Tracy Britt Cool; author William Thorndike, known for 'The Outsiders'; and Sean Henessey, CFO at the house paint giant, Sherwin Williams, from 2001-2016. He was part of turning a company in the world's slowest industry into a beast compounder that delivered a 17% IRR during his tenure.

But from all of those, let‘s zoom in on Howley, the driving force & initiator behind Perimeter Solutions. In 1992, he launched his holding company TransDigm with an initial equity investment of $10 million, he started building a collection of aerospace monopolies that had outsized pricing power. He noticed a lucrative pattern: many aircraft parts have just one or two makers, some doing it for over 70 years. By acquiring those companies that have a monopoly-like hold on niche aerospace parts and consistently raising prices, Howley built an extremely profitable portfolio of 50 such parts. Take airplane belt buckles, for instance – they bring in a 40% margin, and he owns 95% of that market. By focusing on high-margin products, his company's operating profit margin averaged over 50%; the dwarfing the aerospace parts industry's 15%.

Fast forward over 25 years, and Howley's TransDigm grew to an enterprise value of $70bln, that was thousands of times larger and had rung up a total return of 29% annually for its investors since going public in 2006.

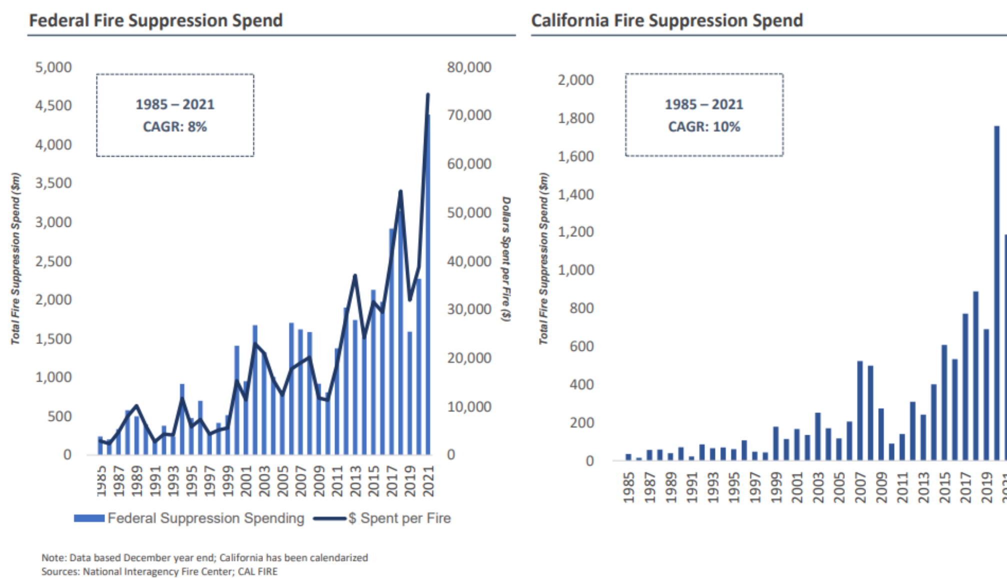
“When a TransDigm investor, in an effort to knock Howley off balance, forcefully asked him why he should believe in the company following Howley's recent sale of millions of dollars of stock. Howley was said to have stunned the room when he sat up in his chair, put his elbows on the boardroom table, looked the guy in the eye, and said: "This may come as a surprise to you, but I'm in this for the money. I haven't had many chances to sell stock under private equity ownership, and now I do. My wife wants a beach house. So we're gonna get a beach house. You can believe what you want, but I'm not going anywhere. I've got more money to make, and if you choose to, you can make it with me."

(Source from Book: Lessons from the Titans)

Tailwinds at a glance (Will Thorndike, on the first earnings call as a public company)

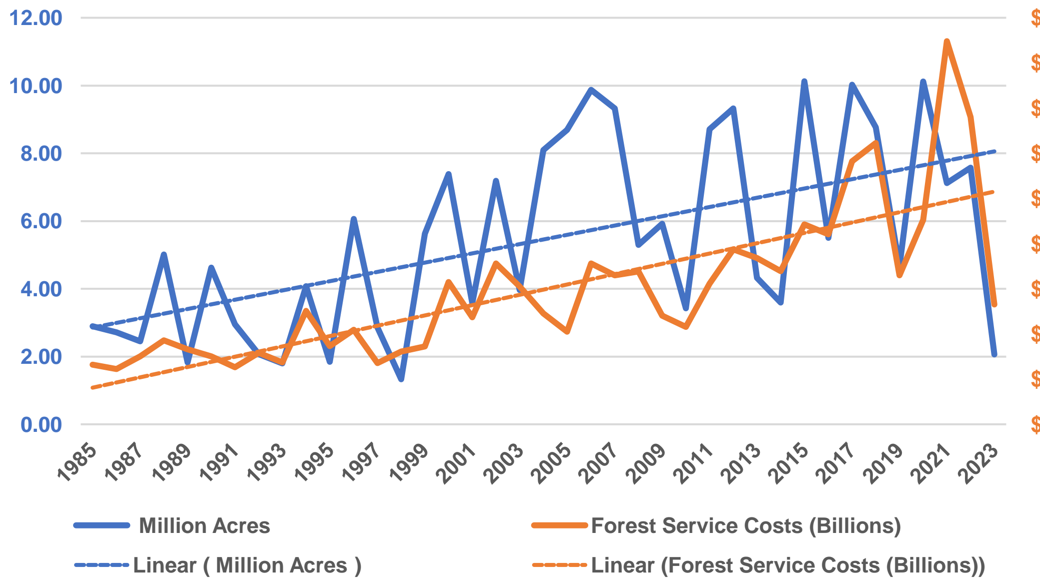
1. Broadly speaking, the US is experiencing longer fire seasons because of climate change.
2. Retardant revenue is extremely sticky. Customers rarely leave and often use more of Perimeter's retardant over time.
3. A growing number of homes are built close to wildlands, which means the 'let it burn' strategy is less of an option for firefighters.
4. Increasing airtanker capacity. The larger the airtanker, the more retardant said airtanker can drop, and the more effectively wildfires can be put out. As fire severity increases, so should usage of the largest airtankers.

Domestic wildfire suppression spend is growing



There are three main reasons the stock trades where it does today.

1) **Devastating Fire Seasons**
Investors in my opinion fail to appreciate just how devastating the past two years of fire seasons were. Management may also have come to learn who significant this year over year variability can be. The 2023 fire season was 54% below the 10-year average, and 71% below what it was in 2020. The 2022 season was also mild, with US acres burned ex-Alaska down 36% YoY (there was a large number of acres burned in Alaska but fire retardants are normally used in locations where the fire is a threat to humans or infrastructure). The business has been expanding internationally, but that was little help in 2022 when Australia experienced such an 'unusually wet' early season that the country literally didn't buy any retardant in Q4. Perimeter has managed this season variability well, with Fire Safety revenue down 1% in 2022 and 8% YoY as of Q32023, but it's much harder to get excited about a business that's so heavily and unpredictably cyclical. In oil and gas investing one can at least come up with some approximation of whether there's a supply shortage/glut; the same approximation can't be made for how severe the wildfire season will be going forward. While there is clear tailwind of more frequent and close-to-urban area wildfires, it still is a highly cyclical industry. Fire seasons are just not perfectly linear.



2) **Competition entering the monopolistic market**
Second, there's a shift in the market perception of Perimeter Solutions as a monopoly in aerial firefighting. This perception is being challenged by the approval of a new competing company, Fortress. I view the risk of them taking substantial market share as unlikely. Perimeter is currently the only supplier with USDA approval on all of the West Coast. While it is likely that, beyond their current test phase, Fortress will be widely approved, Perimeter's infrastructure and integration into the supply chain provides a lasting competitive advantage to help maintain market share. This, combined with the fact that Perimeter's product represents only approximately 3% of customers' suppression spend, makes it challenging and unlikely for Federal and State agencies to switch providers. The fire-retardant business is characterized by its high cost-of-failure, the development and testing of products, and the approval and licensing of such products, is typically a complex and lengthy process, as a result there are only very few providers like Perimeter.

Aerial firefighting started in the 1940s with planes dropping water, which is ineffective for fighting fires because the water would evaporate before it hits the ground. Original retardants were not great for the environment. The early 1960s saw the introduction of ammonium phosphates (Pos-Check started being used in 1963). Today's retardants are much more environmentally friendly and effective. Delivery systems (airplanes) use much better technology today for retardant delivery. They have the same active ingredients as 40 years ago but at much lower volumes (50% of the active ingredients as 40 years ago). Retardants today are safe for animals, people, aquatic life, etc. Color is used so pilots can see where the retardant is on the ground. The color disappears after a few weeks' exposure to the sun. Perimeter has been using phosphate-based retardant for many years and a recent lawsuit against PRM's product amounted to nothing. A Montana district court ruled in PRM's favor as a safe and environmentally friendly product.

Fortress's FR-100 retardant is a Magnesium Chloride-based chemical, corrosive to metals. Fortress obviously says the fear is overblown and that their product does not corrode, but there is a lot of friction in the industry to get over that hump. PRM is not going to let the Fortress product flow through their on-base equipment, so Compass (Fortress' owner-company) will have to make that investment of building bases across the country, which is amazingly capital-intensive. Matching Perimeter's 150 tanker bases in North America is still a long way.
There was a gumming up issue when tanks switched from PRM to Fortress, and they needed to be heavily cleaned in between, which was costly when a fire was raging. Furthermore, aerial tankers need to be convinced to use the product in their planes. Most are hesitant to expose their most important assets to corrosive material or need to be heavily cleaned when switching between the two products. In the 1950s, the USFS studied a total of 12 types of retardants: Ammonium phosphate, magnesium chloride, boric acid, etc. Ammonium phosphate was found to be the best, and magnesium chloride was the worst, even at twice the concentration. Because of that study, ammonium phosphate has been the primary retardant since the 1950s. Recently, the USFS relaxed requirements, and magnesium chloride has come back. Many studies on magnesium chloride suggested toxicity, handling, corrosion, and storage issues.

3) **Record weakness in Specialty Products segment**
To compound misfortune, Perimeter was unsuccessful at predicting demand for its Specialty Products segment. On its first earnings call as a public company in late '21, the outlook for Specialty Products was that revenue would be about flat. Instead, 2022 sales were up 32%, but with a significant slowdown in Q42022 due to inventory destocking. Management expected this destocking to ease in Q1, but it's instead persisted through the most recent quarter, with Specialty Products sales down 35% YTD. Perimeter's CEO, Haitham Khouri, said the following on the company's last earnings call: "We were surprised by the duration and magnitude of the destock…. we've frankly been wrong on magnitude and duration so far, and therefore, I'm hesitant to make a future projection on when it will end."

4) **Egregious Compensation System?**
The fourth factor concerns Perimeter's compensation structure. My view is that if a compensation plan is clearly defined and you can model it out, you can account for it going forward. If management runs the business well and shareholders are rewarded with above average returns, management should be compensated. At Transdigm employees should think, act, and be compensated like owners — Howley is doing something similar here. The compensation structure in the EverArc Founders' agreement (EverArc Entity = the directors that took PRM public as a SPAC) involves both a fixed and a variable component:

1. **Fixed Annual Advisory Amount.** Fixed payout of 1.5% of market cap through 2027, max 50% in cash, which they generally use to pay taxes.
2. **Variable Annual Advisory Amount:** Variable is similar to any fund management fee. The directors earn 18% of stock price appreciation with a high water mark (currently the HWM of 13.69) based off end of year price in 2021. . At this point Perimeter shares need to increase by 250% for them to receive a „variable compensation amount“ again.

The advisory setup should encourage the team to not rush into privatizing the business at today's price. The egregious pay structure makes me wonder if the directors are focused more on having this as their self-enrichment structure. According to people close to the board and my relationship with one of the directors, I believe them to be honorable people, that have accumulated enough wealth throughout their career already, for this not to turn the needle for them.

5) **Highly levered business**

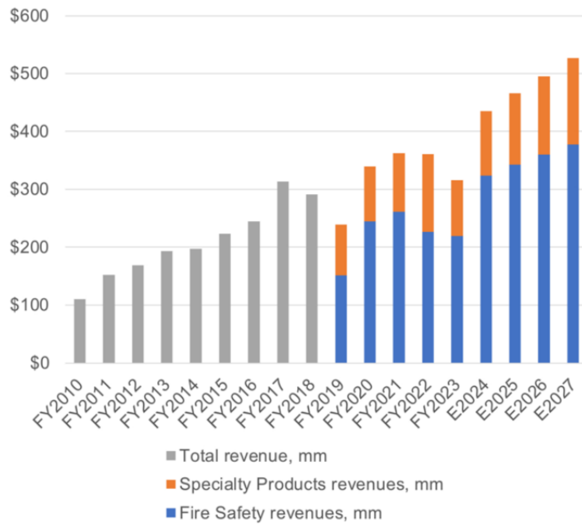
With capital allocation and capital structure in mind, Howley realized that TransDigm, a business built with a high degree of recurring revenue from spare parts, pricing power, low volatility in input costs, and limited capital requirements, could shoulder a higher debt load than an average business. TransDigm has a 6.1x Total Debt/EBITDA.

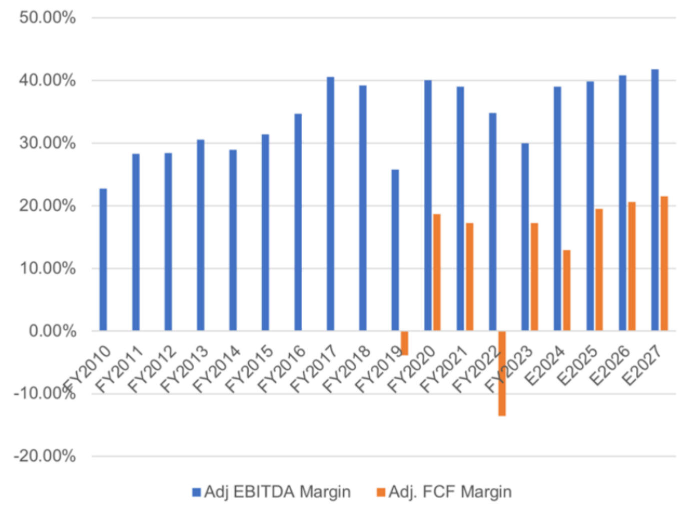
Does the same apply to Perimeter? With a 5.4x Total Debt/EBITDA ratio, it certainly indicates that a similar playbook is in force. However, I am very worried when I look at this. Perimeter's quality of revenue is far from that of Transdigm. While it ticks the box of being recurring, it relies on a very hard-to-predict, cyclical revenue stream. All their debt is fixed 5% through October 30, 2029. Debt service is roughly $40m/year on this debt vs $125m EBITDA in 2022 and ~$110m in 2023. Management has shown a fantastic ability to take price (fire sales down much less than acres burned) as well as protect margins with sales down. Stress testing their business, even if fire sales were down another 25% each year and margins falling, they still make their interest payments. The data shows cyclicality in the acres burned with an upward sloping trend in rolling average. When forest fires do not occur, all that is left is fuel for the next fire, typically making years after "bad fire seasons" major acres burned.

The fixed cost component to pay the cost of debt does restrict their ability to do meaningful share repurchases or M&A that provide catalysts for the stock price. There is a risk of the company being stolen from us at depressed valuations.

Going Forward. Sizing the Opportunity.

Perimeter is a business in an industry with significant tailwind, that with it exceptional leadership, should grow free cashflow per share by over 10% per year for the next decade. Volume growth will continue to be fueled by continued increases in acres burned, larger fires, and further stretched-out fire seasons. Outside of the North American Fire business, additional growth should come from underpenetrated international markets and the Specialty Products segment. International is currently around 20% of revenues and is gaining traction. The second leg of Perimeter, which gets less focus and represents one-third of revenues, is Specialty Products which, as of the third quarter, has grown year-over-year revenues by 40% and has more than doubled EBITDA. While this is a business entirely correlated to unpredictable wildfires, it is mostly uncorrelated to economic cycles, and I believe there is limited downside to normalized earnings. I see a path to nearly $0.75 per share of free cashflow by 2025. Revenue should be able to compound around 10% from a combination of increased volumes and mid-single-digit price increases (like the price increase play book at TransDigm).


Revenue History PRM
$600
$500
$400
$300
$200
$100
$0
FY2010
FY2011
FY2012
FY2013
FY2014
FY2015
FY2016
FY2017
FY2018
FY2019
FY2020
FY2021
FY2022
FY2023
E2024
E2025
E2026
E2027
Total revenue, mm
Specialty Products revenues, mm
Fire Safety revenues, mm


Generally High, But Cyclical Profitability
50.00%
40.00%
30.00%
20.00%
10.00%
0.00%
-10.00%
-20.00%
FY2010
FY2011
FY2012
FY2013
FY2014
FY2015
FY2016
FY2017
FY2018
FY2019
FY2020
FY2021
FY2022
FY2023
E2024
E2025
E2026
E2027
Adj EBITDA Margin
Adj. FCF Margin