

Robotti & Company Annual Meeting Highlights

This article is shared by MOI Global instructor Robert Robotti, the founder, president and chief investment officer of Robotti & Company Advisors, based in New York City. Bob is an instructor at [Best Ideas 2018](#), the fully online conference featuring more than one hundred expert instructors from the MOI Global membership community.

On November 13, 2017 Robotti & Company Advisors, LLC hosted its annual investor meeting at The Yale Club in New York City. The highlights below, delivered by Bob Robotti, have been edited for clarity.

“Thirty four years ago, a handful of us here in the room started a business with the concept that by doing fundamental bottom-up stock research, we could identify companies that would outperform the market. That is what we have done and it has always been the mandate of the business. Now this is a concept that is simple to say, but is not necessarily so easy to achieve. We believe now, as then, opportunities still exist in the marketplace.

By focusing on the longer-term prospects of a business and not just looking at the short-term, immediate outlook, we think we can identify companies that are substantially mispriced and mis-valued by the market. This takes us to places that are not typical, so there is very little-to-no overlap between what we own and what is found in the popular indices.

Of course, we know that over the long-term there will be periods when we will underperform the market. We think an important component of long-term success is the appreciation and realization that during these periods of underperformance you must remain consistent, and stay true to what you understand and the variant view you have developed versus the market.”

Investing in building distribution companies

“One of the things that we do is invest in cyclical businesses. We think that cyclical businesses often provide us with an opportunity to buy when the price per share is significantly less than the normalized earnings power value of the business. Back in 2003-2004, which is where we have to go to understand our housing related investments, we invested in manufactured housing. This was a mistake and didn’t work out in the short-term. Our visits to manufactured housing plants informed us that this is an efficient way to build a home. If you use the same materials that you do on a site built home, the quality ends up better because you have a controlled environment, which includes supervisors making sure the laborers didn’t go out for 3 beers at lunch and forget to install the insulation. Since the quality was better and the cost per square foot was lower we figured manufactured housing was an out of favor industry that would have a revival.

The problem was that in 2005-2006 the federal government stopped buying mortgages for manufactured homes. So a homebuyer could buy a \$200k site built home for less money down, with a reverse amortization mortgage leaving them with a lower monthly payment for that site built home than for an \$80k manufactured home. This meant a recovery would be significantly forestalled. In 2009, Alan Weber, a long-time colleague of ours said, ‘Go visit Builders FirstSource - a distributor to the homebuilders.’ We first invested in Builders FirstSource back in 2009 estimating that we were paying 2x normalized EBITDA for a business that was not a buggy-whip business - so it wasn’t going away. Yes, it did have significant financial headwinds, so from 2009 to 2011 we looked wrong. The

stock traded from \$3.40 down to \$1.70, so we bought more.

As value investors we often purchase too soon but we continued to have conviction in our investment thesis. The industry had gotten closer to a recovery while the valuation had gotten dramatically cheaper. In the meantime, there was a competitor that was coming out of bankruptcy. By 2010 we had accumulated a 15% position in the equity of that post-bankruptcy because its valuation was a fraction of Builders FirstSource's and it also had better cash flow characteristics. In 2012 I joined the board of that company and was a director of BMC over the time that sales grew from \$650 million to \$1.3 billion. The company reverse-merged into a competitor, Stock Building Supply (which interestingly generated roughly the same revenue as BMC but only ½ the EBITDA). That window is an important part of our process - we get involved with our investments, we are shareholders for a long period of time and we become active with the company as friendly, cooperative shareholders which sometimes leads to becoming a director of the company.

The base premise of our investment in this sector is that single family homebuilding is dictated by irrefutable demographic trends. While there are plenty of headwinds that still persist for the business, we think those long-term demographic trends will win out over time. So you have an industry that today will build about 800k single family homes while the 50 year average is between 1.1 - 1.2 million single family homes or 40% - 50% above the current level of activity. For 10 years single family homes built have been significantly below that long-term average. There were definitely too many single family homes built in 2006 and 2007 but those have all been absorbed into the marketplace while inventory continues to come down. So we ask: What is the normalized level of activity in this business? And that is really what we are looking to do - invest in cyclical businesses at low points in the cycle when you can buy the business at a significant discount to its normalized earning power value and then hold the business for a long-period of time.

Of course, what you really have with cyclical businesses is that they often go through a catharsis. The competitive landscape winnows down through industry consolidation. At the same time internal processes improve lowering cost structures. This results in growth of the normalized earning power of the survivors. We believe the long-term mid-cycle earning power of Builders FirstSource, for example, is between \$4 and \$5 while the stock price is currently in the high teens. So it trades at a single digit P/E multiple of our estimate of the normalized earning power of the business. Demographic numbers continue to grow meaning that a reversion to the historical mean is really a modest expectation."

Energy

"You shouldn't believe everything that is written in the newspaper! Articles in the newspaper are written by someone who may have above-average writing skills, but probably doesn't understand the core tenets of a business. So if you are a journalist and you are writing about the energy business, you end up reporting what people tell you and they usually tell you about what is in the news or what might make a good headline. We think there are huge misunderstandings about what the real dynamics are in the energy industry. I'm referring to conventional energy, though we closely follow renewable energy as well.

An important fact is that natural gas accounts for half of the hydrocarbons produced in the world today. And while natural gas doesn't grab headlines, the fact is that natural gas is a growing source of energy, it is a bridge fuel and it is less carbon unfriendly. This means that oil is not necessarily the only driver of energy anymore as natural gas consumption grows.

Natural gas also represents a tremendous opportunity for America. North America has a 10 to 20 year oversupply of natural gas which has caused a disconnection between the price of energy in North America and energy prices worldwide. The price of natural gas is roughly \$3 per MMBtu in the U.S.

and \$2 per MMBtu in Canada. This translates to an energy equivalent price of \$12 – \$18 per barrel of oil. So even at today's oil prices in North America there is a huge arbitrage opportunity. This is a very important driver and is also extremely positive for the U.S. economy given that energy intensive businesses in North America are competitively advantaged against other energy intensive businesses anywhere in the world. We think these dynamics will continue to play out for at least the next decade.

We also think energy markets will continue to come into balance as oil consumption continues to grow – even though we don't know what the longer-term future holds. My nephew recently tried to get me to buy an electric car. In fact, I don't own a car anymore and I primarily use shared vehicles – I am a part of the new millennial economy! These are examples of what is coming and will clearly be an important factor that eventually enter the equation. In the meantime, older wells which represent 1/3 of North American production have been declining at double-digit rates for the past two years. So U.S. onshore shale oil producers are depleting reserves while telling everyone that they are economic at \$50. We believe that this is not only false but is also exacerbating the problem. Instead, our contrarian view is that over the next year or two the risk is that we are actually short oil which would lead to a spike in its price.

In our portfolio we own companies' related to offshore production because the other general perception is that onshore is economic at \$50 and therefore offshore is dead – both of which are false. Offshore is not dead. Just like onshore, offshore economics have dramatically and significantly improved as a result of technological advances and cost reductions. We have already seen signs of increased activity although investors don't seem to be buying into it yet. Over the next year we will see offshore activity continue to pick-up. For now, investors continue paying high prices for uneconomic onshore stocks while shorting the stocks of offshore companies because "offshore is dead." We believe these investors will be wrong on the long and wrong on the short."

Are there any risks that keep us up at night?

"There are two risks that everybody seems to be thinking about. The first is that the markets keep hitting new highs every day. Of course, the other is that we all know that the two of us (Bob referring to himself and Isaac Schwartz) are dinosaurs because we pick stocks in a market where passive investing reigns and active management is dead. Of course we don't believe this and we think this actually creates an opportunity for us. It is true a tremendous amount of capital has flowed out of active strategies and into passive ones where there is no regulator since valuation is irrelevant to this process. As a result, fewer and fewer companies have higher and higher valuations driving higher market levels that are no longer constrained by valuation.

What we do as investors is very different because our philosophy is all based on valuation. Valuation is our real litmus test for whether or not an investment makes sense. Is this a good business? Does it have a good balance sheet? Is there an owner operator? These are all very important questions but only so far as they help determine valuation. We look for companies where the valuation can be understood and appreciated and we can therefore determine whether there is a margin of safety and an opportunity to profit. We believe that the fundamentals of a company is what really drives performance over time which is why it is so important to stick to what you know.

I don't think there is much risk of a 2008 event, which was a worldwide financial crises where there was really no safe haven and everything was at risk of being worth a lot less. I think what we have now is a valuation issue which causes a lot less concern for us. Yes, there could be an event that is perhaps analogous to 1987 where you had portfolio insurance that was touted as a guaranteed way to make sure you don't lose money while you get a great rate of return, similar to the way many perceive passive investing today. We believe the markets are laying the groundwork for future opportunity. As more money goes into things without regard to valuation, active managers will have an easier time

identifying stocks that really are disconnected from their underlying economic opportunities. That is exactly what we look for as an active manager.”

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