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Reiterating Robotti & Company's Value-Based Approach to Investing

This article includes modified excerpts from the 2020 Annual General Meeting of Robotti & Company, based in New York.

Bob Robotti, Founder and CIO, is a featured instructor at Best Ideas 2021.

BOB ROBOTTI: The format is different this year, but our message is exactly the same. There has been a consistent foundation to our investment approach over the 35 years we have been around, and that is we are unabashed value investors. Covid has provided a generational entry point which includes the acceleration of trends we have been noting for years along with consolidation activity among core themes in which we are active investors.

What is value investing? Security Analysis, the seminal work by Ben Graham, introduced that investment approach. And the title is a key indicator of what it is: it is individual stock research and bottom-up investing is a critical element of this investment approach. Now the way it is practiced today is different than when Graham first wrote his text. Back then, he wrote it in the middle of The Great Depression. So, he bought stocks that had low price to book, low PE rations, high dividend yields, and that was the approach. But the intention all along was looking at individual securities, analyzing those companies, making determinations as to what a conservative fair value of that business is, and buying those businesses for less than what that value indicated.

Why is that a potential opportunity? Ben also spent a lot of time talking about investors, the rationality of investors, the emotion of investors, and how that affects security prices. So, another fundamental part of value investing is the disbelief in the idea that there is an efficient market, that every security properly evaluates the future cashflows of that company discounted down to today. An important behavioral bias that Graham often alluded to was the idea of recency bias. What is today and what was yesterday is projected to be what will be tomorrow. Frequently yesterday and today are not the right indicators for the future opportunity. So, it is looking at businesses, understanding the businesses, and making conservative estimates of future values: that is a key determinant. It is individual security analysis and the belief that securities can frequently be mispriced.

The longer a security is mispriced, potentially, the more it is underpriced. That gives you the opportunity for both returns, and, of course, it mitigates risk, the margin of safety that Graham also spoke about. So, those concepts and precepts continue throughout our investment approach today.

THEO VAN DER MEER, SR INVESTMENT ASSOCIATE: I'll start off with a question that is on a lot of people's minds today, which is *when do you think that we'll get back to some semblance of normalcy?*

BOB ROBOTTI: I guess the important thing, in my mind, is to emphasize the last part of your question: "back to some semblance of normalcy." The key, in my mind, is that *the current situation with the pandemic is not the "new norm."* Frequently what we're talking about are behavioral biases. People know the current situation and project it into the future. We think

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this is a transitory issue. We do think– we don't know if it's six months or a year or two, whether it is one of these vaccines or some other solution. But this is not the new norm. So, the importance in thinking about the pandemic or political unrest and social unrest, all of those things, we're looking to invest in businesses and make estimates as to the future cash flows of that business, the present value of those cash flows, and how much will accrue to equity owners. The important question is, okay, so what's the impact on the business? How does it change those future cash flows? How does it potentially reduce some of those cash flows in the short term? How long does that last? How big is that impact? What things are unleashed? What trends that were potentially underway are actually accelerated in the process?

So the important question is not when do we get back to normal. What is important is estimating the impact of the current situation. How much of it is permanent? How much of it is not? And how that affects the valuation of the businesses we're invested in. I'd also highlight that, when the market gets that estimate wrong it creates a really opportune situation for stock pickers like ourselves.

THEO: Bob, do you want to talk about some other ways in which a long-term time horizon has manifested itself in the portfolio?

BOB ROBOTTI: Once again, it's the market looking from the wrong time horizon thinking that today is tomorrow. Our investments in home building are an excellent case study. In 2008, 2009, we were looking at the home building business and thinking, this is an interesting industry. The industry has imploded, worst ever post-World War II, with the lowest amount of new homes being constructed. There was a significant amount of oversupply, too many homes were built, and with the financing on that, foreclosures were rising. With an oversupply that was significant, new home building fell to very low levels, and there was no appreciation, no understanding and no timeline for when that would be corrected.

We started to look for businesses that were well-positioned, differentiated in terms of their business, had financial situations that ensured their ability to withstand the situation, to survive the downturn, and importantly, to thrive in the recovery because clearly those kinds of situations create great dislocations, and for certain well-managed businesses that are well financed, the opportunity is substantial. We believed that the 1 to 1.1 million annual single-family home start number, which had been a 50-year average, would continue to hold, and that's during a period of time when the beginning population was half of what it is today and the beginning number of households was half of what is it today. So, to get back to that modest trendline we thought was almost a surety. The timing of it, however, was uncertain. So, we identified the companies to invest in.

Now, frequently, when we do invest in cyclical businesses like this the recovery often does not happen as quickly as we anticipated. But in the meantime, things are still happening in the industry to those well-managed differentiated companies that are improving their competitive position and improving their earnings power even before the recovery comes. And the extension of a downturn provides even a greater runway of opportunity for a recovery. So, that's, we think, a classic example of something that you've already seen the manifestation of in homebuilding.

Moreover, we think we're still extremely well-positioned today in the homebuilding space interestingly because we still think there was a 10, 11-year period of significant underbuilding. That means you have underbuilt 3 to 5 million homes over that extended period of time. And we've gone from 67% homeownership, an all-time record high, down to

62%, which is a long-time low. And we think there's a lot of underlying trends that already had started to change, that already increased the demand for single-family homes, the interest for people to move out of urban areas, into suburban areas. *We think COVID clearly has been an accelerant to that change and, therefore, the expansion of the earnings power and the timeline and the realization for these investments.*

THEO: Do you want to give a specific example?

BOB ROBOTTI: The best example of what we're talking about are our investments in the distributers to the homebuilders: first, Builders FirstSource in 2009, then BMC in 2010 post its bankruptcy we accumulated equity from a number of the banks who were the lenders. These businesses are better businesses with product and service offerings that are differentiated. The scale and scope of the businesses give them competitive advantages, the geographic spread of the businesses is another positive to the companies. So, the recapitalization of BMC gave it a great financial position for the ability to participate in the recovery.

August of this year was kind of a culminating event when Builders FirstSource and BMC announced they were merging together to form by far the largest building products distribution company. And it's not just this consolidation. In 2015, both companies also participated in a consolidation event. You had a radical change in the structure of the business, the competitive offering of the company, its continued growth and value-added services. So, therefore, it's continued differentiation from its competitors. So, it's, we think, an excellent example of how a patient investor in a cyclical business has an opportunity for an entry point and a long-term runway for opportunity that even today we think is still in middle innings of a very positive trend.

And we also thought that there was a number of suppliers that also were favorably affected by the consolidation trend. So, one of those is Norbord. And, David, you've done a lot of work on it and maybe you'd share with us our investment thesis.

DAVID: Thanks, Bob. Norbord actually is a great case study for how we invest. Norbord is the largest producer of oriented strand board, or OSB, which is a replacement for plywood used in building homes. Now, interestingly, we spend a lot of time speaking about investing in cyclical companies, which is a dominant theme across our portfolio, and I think it's actually one that differentiates us from the majority of investors who list cyclicality at the top of their list of what to avoid.

Of course, or maybe ironically, the reason we often find bargains in cyclical industries is because there's less competition in such a large segment of the market. But that's just one of the tools or frameworks we utilize at Robotti to identify potential value. So, we eventually found Norbord through a company it acquired because that company was raising capital through a rights offering which was backstopped by its largest shareholder. That's another tool we use to identify potential value.

Once identified, we were able to really quickly increase our conviction on the business because, as Bob said, his experience on the BMC board had given him this lens into the industry to help us understand it holistically. Now, Norbord has experienced most of the same dynamics as Builders and BMC that Bob just spoke about. And specifically, it's continued to see the benefit of a more consolidated industry over the past decade.

Now, with what is a somewhat fixed amount of supply currently available in North America, the survivors have become more dedicated than they've ever been in the past to producing

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only what they can sell. And this rational discipline production will eventually result in a more rational and less volatile pricing, which will favor the OSB producers.

Interestingly right now, we're in the midst of what Charlie Munger a lollapalooza effect. Initially when the pandemic hit and we had to lockdown, Norbord's stock was hit especially hard because of its economic sensitivity. And management quickly responded imprudently by enhancing their balance sheet liquidity, but also by curtailing production capacity.

The curtailments that they took were on top of what had already been taken offline in the second half of 2019 as the business focused on matching production with demand. Now, of course, what I don't think anyone predicted is that instead of a pullback in housing demand, the pandemic would actually be the catalyst to unleash this previously dormant demand for new homes, the one we initially identified that Bob just spoke about and that was one of our key investment factors underlying our investments in the home building industry.

When this surge in demand for single-family homes met an even more limited supply of OSB, Economics 101 took over and the price of OSB skyrocketed to all-time highs. And we do expect that prices will moderate from the unusually high level threat. *But we also believe that the dynamics are now in place to sustain a disciplined pricing environment for a considerable period of time allowing Norbord to have an extended runway to produce significant amounts of free cash flow.*

Now, the stock's up an astonishing 330% from its March low. It was currently up just over 45% year to date. But just 12 days ago, West Fraser, which is a Canadian-based producer of lumber and wood panels, made an all-stock offering to acquire Norbord in a transaction that, once it goes through, will value the company at $37.78 a share. And we're still in the process of doing our diligence on West Fraser so we can understand the impact of our unchanged thesis on OSB and Norbord, how that will impact the new business combination. And in fact, we look forward to speaking with West Fraser's CEO later in this week, which is an important part of the diligence we do. As we make sure we're invested in the securities of the business' or businesses' best position to take advantage of what we really believe is a tremendous multi-year opportunity.

BOB ROBOTTI: *We are value investors, we are unabashed value investors in a time where that label has been tarnished.*

It's the confluence of events: macro environment, point in cycle and differentiated individual company (or companies) and our active engagement to maximize the outcome – the right place, the right time, the right company and a compelling, strong opportunity.

Moreover, we are not just doing research; we are active owners of our investee companies, seeking to increase value whether by the size of our holding, by writing letters to the board or joining the board and having a 'seat at the table' and more direct say.

Importantly, while we discussed homebuilding specifically, much of our remaining portfolio consists of businesses in other sectors as well also in various stages of recovery similarly seeing COVID accelerate industry trends which will accelerate recoveries and strengthening economics. The present value of the future cash flow of these businesses are misunderstood due to the view from the rearview mirror market analysis. These investments reflect a decade of very modest economic growth. *Valuation is the ultimate determinant of an investment's merit. In the end, the market is a weighing machine. Cash is what equalizes all* *businesses, not popularity.*

Our goal is always the same, as unabashed value investors, to maximize the valuation and, in doing so, the opportunity. It's fact-based research on individual companies, doing analysis, and that highlights the attractiveness of the investments that we're invested in today. ***Our investment approach should be labeled 'valuation investment.' Valuation matters and is a key differentiator between our investment approach and much of the market.***