Robotti
Value Investors

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Dear Client,

The first nine months of the year have gone well, and compare favorably to the Russell 2500 Value's return of 5.86%, and the S&P 500's 14.24%. As per usual, it's been a bumpy ride to this point, and looking at performance daily would be a nauseating experience. Thankfully we do not do that. We encourage you to also minimize the frequency of contact with 'the latest market developments.' After all, the press' intent is to titillate you to read content, not help you build your net worth. In their process, they exacerbate the most fundamental human emotions known to destroy capital – fear and greed. In contrast, we focus on the long-term prospects of the businesses we invest in. This focus has been a successful course for us to follow and build our clients' net worth.

This year's performance to date has been driven by several different industries and companies. I would like to spend some time highlighting a few, namely homebuilding and RadNet.

RadNet, Inc. (NASDAQ:RDNT) operates medical imaging facilities (e.g. MRIs, CT scans, mammograms, etc.) in a handful of markets around the country. The company has a business model that makes intuitive sense (in an industry not known for efficiency – healthcare). They specialize in a mature part of healthcare (imaging), and in a limited number of geographic markets where they have consolidated the independent (non-hospital based) providers. Their scale provides capital and operating efficiencies which help them provide very cost effective service in all their markets, in turn bringing costs down and helping patients, insurance companies and, importantly for us, shareholders. We have been invested in RadNet for many years, watching them build out this business model. The economic benefits of this model have been slow to manifest in improved economic returns for many reasons (medicare reimbursement rate reductions, consolidating acquisitions, optimizing their locations, service offering, etc.). However, investor apathy and impatience provided us a great opportunity. Earlier this year the shares were particularly weak so we added to our position given the valuation and our belief the business model is proving out.

We think many of the fundamental improvements have yet to play out, and its recent performance has been more of a reevaluation by the market. Often when we talk about an investment, we are asked what the catalyst is. The thinking goes that if something is cheap there has to be an event for the price to catch the value. We've said it before: good things happen to stocks that are cheap. In our view, often just the fact that there is a disparity between price and value can be the catalyst, as over time the weighing machine (economic fundamentals) replaces the voting booth (popular 'investor sentiment'). We are starting to see this happen with RadNet, and are still encouraged by the outlook going forward.

Homebuilding

> *"A business which sells at a premium does so because it earns a large return upon its capital; this large return attracts competition; and generally speaking, it is not likely to continue indefinitely. Conversely in the case of a business selling at a large discount because of abnormally low earnings. The absence of new competition, the withdrawal of old competition from the field, and other natural economic forces should tend eventually to improve the situation and restore normal rate of profit on the investment."* – Security Analysis, Benjamin Graham

Seems fairly logical to us. Why, you may wonder, do so few investors seem to ignore this concept and why aren't there more investors searching for opportunities within this repeating cycle? We have seen many answers to this question but we believe they all boil down to the fact that as long as humans are involved in the markets – even just as beneficiaries – nothing, not even ETFs, quant investing or even AI, can keep us from succumbing to our most basic instincts of fear and greed. Long-term investing in cyclical businesses is difficult. A cyclical investor must be able to act in opposition to the accepted beliefs of most investors, which include people much smarter than ourselves. A cyclical investor must withstand periods where it appears silly to go against the current investment. Most importantly, a cyclical investor must hold an investment long enough to realize an outsized return. We believe that outsized returns are precisely what await those who are able to endure the short term pain of mark-to-market declines.

We have written extensively in past letters about our holdings in Builders FirstSource, Inc. (NASDAQ:BLDR), which has performed well this year and past quarter. As a distributor of many building products, our experience with BLDR provided extra insight into the investment opportunity in Norbord. Norbord, Inc. (NYSE:OSB) is the largest global producer of oriented strand board (or OSB) in the world. OSB is a wood based engineered panel manufactured as a low-cost substitute for plywood and most commonly used in home construction for wall, roof and floor sheathing. After going through the cathartic period of the cycle, the industry has shed unprofitable assets and consolidated, creating a very favorable supply / demand dynamic that will result in a period of time where Norbord should generate cash flows that are above average, and significantly higher than both the market expects and the current valuation implies.

We have found that the companies which emerge from a down-cycle in a dominant position are often led by management teams who have a successful history of counter-cyclical investment in their own company. We believe in contrarian investing and should expect no less from the operating managers who we trust with our capital. Norbord has a history of prudent, often counter-cyclical capital allocation. You can see that in its long term results (return on capital of 22% over 15 years), which has far exceed its competitors. We long ago recognized that cyclical businesses highly reward prudent capital allocators.

So where are we now? Today, roughly 84% of North American capacity is consolidated into the hands of the top 5 companies, the largest share being held by Norbord at 27%. Additionally, the amount of idled capacity is limited, so pricing and cash flow generation is strong and continuing to improve. A more recent dynamic is the rebuilding that the recent hurricanes (Harvey, Irma and Maria) have spurred. We believe this will accelerate an extended period of strong demand, strong pricing and strong free cash flow generation.

Conclusion

We continue to be excited about the prospects of our companies, and believe they will continue to perform well despite dreaded 'market uncertainty.' Our focus on business fundamentals gives us comfort in the true economic value of our investments, which has, and we believe will continue to, provide good returns to our clients. As always, we thank you for your trust and belief in us.

All the Best,

Bob Robotti

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