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Dear Investor,

This year has been full of surprises and while we could have lived without most of them, there have been a few bright spots. Investors have long shied away from investing in businesses subject to the vagaries of a cyclical industry, and this aversion has become even stronger over the past decade as momentum has reigned over the markets and investors continue to favor stocks that have increased in price often without regard for valuations.

We pointed out in our year-end letter how in the last decade, post the world financial crisis, the world's economy experienced an unprecedented period. It was a decade without a recession, yet the slowest recovery ever. There were ever declining interest rates, reaching all time new lows in large part facilitated by central banks' ubiquitous intervention. In this financial world of low growth, anything with growth demanded a premium, and it was no time to be invested in cyclicals. With interest rates at de minimus levels, high multiples are no reason for concern... so long as rates stay at historic lows. So long as they stay at levels not reflective of deteriorating credit quality.

In contrast to the current environment, our success over time has been a result of sifting through areas of the market that are overlooked, ignored or simply out of favor. As we entered 2020, it appeared that the investment seeds we had sown were finally bearing fruit for many of our cyclical investments. For many, the advent of the pandemic has interrupted that recovery. In some cases, it has led to yet a further discounting of these enterprises. The recovery may have been interrupted, but in many cases the pandemic accelerated changes that were already in motion, improving the earnings power of our investments despite the intervening headwinds.

Housing Cyclicality

One perfect example of the merits of our investment approach began just after the 2008 financial crisis when we shifted a considerable amount of our research efforts towards the housing industry which had just undergone the greatest collapse in the history of housing in America. We spent significant time sifting through the rubble, learning about the industry and its businesses to determine whether there was opportunity in the aftermath of the housing bubble. As that recovery was slow to take hold, we have had plenty of time to understand and appreciate the industry dynamics and opportunities. This year has revealed the investment case we believed was manifesting for years. It should lead to very positive earnings growth while also drawing investor attention, and with it a potential investor rerating. This

double benefit of cyclicals recovering is something we have seen multiple times – a strong period of earnings growth and multiple expansion.

Single family home starts continued to rise, albeit slowly. With over a decade of recovery, the current new building rate is still +20% below the 50-year average. Through our research, and industry sources' claims, it is possible that this decade-plus long underbuilding means the country is 3 to 5 million homes below trend lines. It follows then that the annual new home starts should actually be *higher* than the 50 year average to close that gap. Changes in the building products industry were slow and generally went unnoticed, but the transition helped to consolidate the industry with survivors emerging as stronger, better businesses with significant earning potential.

The market payoff for our investment work was put on pause when this year's largest surprise, Covid-19, brought everything to a screeching halt – *or so we thought*. Initially, housing stocks were hit especially hard given the industry's fundamental economic sensitivity. Yet as we spoke to the managers of our investments, we continued to hear similar statements of surprise that they were not seeing any slowdown in building activity. In fact, one of the welcome surprises is that the current situation awoke a dormant demand for a strong housing market.

But That is Only the Start

Our largest investment in the housing industry is leading building products distributor, Builders FirstSource (NasdaqGS:BLDR). It feels like yesterday that we sent a letter supporting our decision to increase our position in Builders after the stock had fallen more than 45% from a high of \$9.40 to \$4.92 but it was actually 6 years ago in the third quarter of 2014.

We awoke on the morning of August 27, 2020 to another pleasant development that Builders FirstSource (the largest distributor) and BMC Stock Holdings (NasdaqGS:BMCH) (the industry's #2 competitor) announced a merger to create the premier distributor of building materials and services to professionals across the United States. Builders FirstSource ended the quarter up 32% for the year, at \$33.42 and providing an average annual return of roughly 38% per year since we wrote our Q3 2014 letter, as noted above.

This merger is yet another milestone highlighting the virtuous cycle with cyclicals in recovery and is only the latest in a series of events that inevitably unfold when recovery comes. In 2015, Builders FirstSource levered up to buy the largest industry competitor, ProBuild, while BMC merged with Stock Building Supply. ***So this merger is the combination of 4 of the industry's top 5 competitors in 2015 and changes the scale, scope and capabilities of the new company, bringing tremendous value-added benefits to both its builder and repair and remodel clients as well as to its supplier.*** With the benefits of prefabricated components reducing costs in a rising cost environment, reduced labor needs in a strained labor market, and shortened cycle times to complete new home sales in a time of high demand, the new Builders FirstSource is uniquely positioned to deliver value for its clients. The combined company will benefit from greater geographic reach and diversity and is expected to generate \$11 billion in revenue with 43% from value-added (higher margin) categories. After factoring in cost synergies alone, management forecasts

EBITDA of ~\$950 million, representing an 8.4% EBITDA margin which is 100bps higher than either company has achieved in the past 12 months.

The company will be poised to benefit from an annual pre-tax savings of approximately \$130 - \$150 million in its first 3 years because of G&A, procurement, and distribution network optimization. The combination will further differentiate the combined entity in what is still a very fragmented and competitive market by enhancing value-added offerings to customers across the country. BMC has a core competency in both its millwork capabilities and its READY-FRAME product offering. This will be a strong complement to Builders FirstSource's core competency in trusses and manufactured components. Further, the ability to cross-sell these products and services should help the new entity continue to grow at a faster pace than its market.

An important aspect of the homebuilding industry is that it is a very local business. The product is generally large and/or heavy, making it expensive to ship. That means a homebuilder in one region does not care about the capabilities of a distributor located in another region. This is a hyper regional business that has national barriers to entry. The complementing competencies of each distributor, when combined with a national footprint (through breadth of product/service offerings and cost), will provide the new entity with a strong advantage in a fragmented market. As incoming CEO, David Flitman, said on the M&A call,

I get really excited about things like penetrating our READY-FRAME offering across the combined companies, the strength that Builders has had for a long time in manufactured components and structural components. And as you've heard us say, there's still a lot of opportunity for penetration in the market for those combined offerings... one of the things I get really excited about is we've had our footprint in our 18 states to this point. But we haven't always had the exact capability we needed to serve, say, large national builders in a consistent fashion across that footprint. This solves that problem for us in a big way.

...part of my excitement here is having the strength of the combined portfolio. And what I've experienced in my couple of years in the industry is these buying decisions tend to be still made on a very local basis. And oftentimes where we don't get business, it's just because we don't have the right offering in that local market. And so I think there's more excitement on the upside of the potential here with the strength of what we'll be able to take to the market on a combined basis.

If we go back and study the period from the end of the financial crisis through today, we can see a number of indications that the building distribution business went through a positive transition during the down-cycle, and an industry emerged with the survivors having better businesses and better prospects. There are only a few true sources of a competitive advantage, and one of the strongest is regional economies of scale. The new entity will be able to leverage its size and scale on a national basis when dealing with suppliers to further strengthen regional economies of scale in most of the country's fastest growing markets. In turn, we believe this will raise barriers to entry and further enhance returns on capital.

In the meantime, the consolidation in the building materials industry over the past decade has led to better pricing discipline among competitors. When combined with the additional reduction of supply due to the pandemic, we are seeing higher materials pricing across the industry. While we do not expect the record high levels in some materials such as OSB to continue, we do believe that the dynamics are in place for pricing to remain strong for some time.

The combined company will still have a healthy balance sheet with ample liquidity to continue its pursuit of attractive acquisitions in the highly fragmented distribution market, which still has a lot of small regional participants. With minimal capex requirements, the company should accelerate its strong free cash flow. We believe this transformative merger has significantly improved the quality of this business and increased the prospects for attractive returns.

A Quick Note on Energy

While our oil and gas investments are significant, and certainly a lightning rod, our largest portfolio allocation is to homebuilding. We would be remiss, however, if we did not provide a quick update on the energy sector. This has been a topic of much conversation throughout the last 9 months and changes are afoot. We have said in the past that energy is an industry of the haves and the have nots. With that being the case, the changes to the industry will accelerate the bifurcation between the two. While I could expound on energy for pages and pages (having done so in the past), I will instead enumerate a few of the changes that we see.

In the immediate, the shelter in place orders and lockdowns have severely curtailed demand. While that demand issue is abating, the overarching change in the energy sector is that the true cost is starting to be reflected in the end-good's price. Whether that comes through government policy (like a carbon tax), investor pressure, or societal pressures, the change is imminent. Due to this, we are seeing European majors actively shifting their capital expenditure programs and investing more heavily in renewables – some as high as 20%. This change also means less investment, especially for onshore U.S., something that we have thought would happen for some time now.

Turning to our specific investments, we are buoyed by the flexibility Subsea 7 (OB:SUBC) has shown with its expansion into offshore wind. Additionally, the prospects for natural gas has improved. Coal generated nearly 40% of the world's electricity last year, and natural gas' supplantation of it as an energy source is a massive boon to reducing CO2 emissions. Many of these changes are novel, but there is also a repeating pattern in the industry. We saw it in our homebuilding investments and are seeing it here as well. The companies we are invested in are differentiated in the new world's economic reality. The fact remains there will be demand of traditional hydrocarbons, albeit it less, and these producers' cost structures have changed. They will need to outsource to service companies more and more, and those services companies are much better equipped to change with the times (as evidenced by Subsea 7). The industry should be managing for its ongoing processes, consolidating on a regular basis and only reinvesting in high return projects. Consolidation should be the industry watchword.

Conclusion

As has been said ad nauseum this year, these are uncertain times. With that uncertainty, comes opportunity. We believe we have a portfolio of companies that are extremely well positioned to take advantage of that opportunity.

We thank you for your continued trust and support and look forward to a brighter time in the world.

All the best,

A handwritten signature in blue ink, appearing to read "Bob" followed by a stylized flourish.

Bob

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