Robotti
Value Investors

Robotti & Company Advisors, LLC
60 East 42nd Street, Suite 3100
New York, NY 10165-0057
www.robotti.com

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Dear Valued Client,

As we enter the third decade of the 2000s, we feel it is a perfect time to reflect upon the decade we leave behind - a decade that has witnessed many firsts. It was the decade the Higgs boson, or 'god particle' was discovered, which purported to explain all the mysteries of the universe (spoiler: while ground-breaking, we still have quite a few questions). Streaming took over our popular culture, providing nearly infinite amounts of media at our fingertips. It also marked the first time a human-made object left our solar system, as the Voyager 1 flew past the 12 billion mile marker in 2013 (35 years after it was launched during Jimmy Carter's presidency). It was also the decade of the acronym, FAANG stocks and unicorns took over business news.

One of the bigger changes was the ubiquity of algorithms. Algorithms have changed the way we all interact with the world. Beyond just our social interactions, algorithms are now responsible for how we see the world around us as Facebook, Twitter and more conventional news sources have all switched to computer generated algorithmic news feeds. (Do you feel better informed today?) Algorithms influence the way we shop, with computers dictating much of what we consume. Does the purchase of an item you were "told" you needed mean you wanted that product in the first place?

Decades in Financial Review

It's good to reflect on history. It takes us out of the immediacy of today to help give us perspective. As Ben Graham warns us in *The Intelligent Investor,* "No statement is more true and better applicable to Wall Street than the famous warning of Santayana: 'Those who do not remember the past are condemned to repeat it.' " A good place to begin this exercise is with a review of the top 10 companies by market value at the end of each of the last 5 decades.

Top 10 Companies by Market-Value

12/31/1979	12/31/1989	12/31/1999	12/31/2009	Today
IBM	NTT	Microsoft	Exxon	Microsoft
AT&T	Bank of Tokyo	GE	PetroChina	Apple
Exxon	Industrial Bank of Japan	NTT Docomo	Apple	Amazon
Standard Oil	Sumitomi Mitsui	Cisco	BHP Billiton	Alphabet
Schlumberger	Toyota	Walmart	Microsoft	Facebook
Shell Oil	Fuji Bank	Intel	ICBC	Alibaba
Mobil	Dai-Ichi Kangyo Bank	NTT	Petrobras	Tencent
Eastman Kodak	IBM	Exxon	China Construction Bank	JPMorgan
Atlantic Richfield	UFJ Bank	Lucent	Royal Dutch Shell	J&J
GE	Exxon	Deutsche Telecom	Nestle	Visa
ENERGY	JAPAN	TECH / TELECOM	CHINA / COMMODITY	INTERNET

Source: Empire Financial Daily

As the investment world turns, major investment trends ebb and flow. Very few companies persist, even decade-to-decade, as investment dynamics change. One of the few predictions I am confident in making is that each subsequent decade will be different from the last. The 1900s saw the Model-T, the 1950s the popularization of air travel, and the 1990s the birth of the internet. All equally, if not more, ground-breaking than the changes of this decade. When I reflect on the investment world this most recent decade I keep coming back to one word to characterize it. Despite the fact that change is the one constant in each decade, the best way I can think of to describe this past decade is, frustratingly, a word that I abhor using:

Unique.

The definition of unique is *being the only one; being without a like or equal*. In the world of investing this word is constantly overused to the point of meaninglessness. Most investors do not have a truly unique style, but rather a slight variation of one of the few main investing dogmas. Some styles of investing may be less popular than others, but they are hardly unique.

There are, however, truly unique attributes to this decade. Since The Great Recession (itself a nearly once in a century event), the economy has displayed many firsts. In 2010 – 2019 investors experienced:

- the first decade without a recession,
- the weakest and slowest recovery of any before it,[1]
- the lowest interest rate environment, not just for a decade, but in the history of lending,
- the dominant influence of algorithms in economic decisions[2]

A Unique Decade

In case you glossed over my comment about interest rates, let me repeat: ***this decade bore witness to the lowest interest rate environment <u>EVER</u>.***

Of course, there was an antecedent event that set up this unique decade: The World Financial Crisis of 2008. The abyss which confronted the world was not unlike the Crash of 1929, but the government response, and outcome, was drastically different. In 1929, Secretary of the Treasury Mellon convinced President Hoover that it would be best to let the crisis run its course to "clean out the system." Recalling the errors of that decision, the world governments stepped in to take action in 2008. That decision did prevent another economic collapse, but it also lead global financial markets to the current unique economic times noted above.

Interest Rates Priced to Deliver Return-Free Risk

Warnings of an overheated fixed income market were so prevalent throughout the past decade that those championing such a view were often cast as the boy who cried wolf. One such warning back in 2012 came from none other than Warren Buffett. In a February 9, 2012 article in Fortune Magazine, Buffett recalled an old quote from Shelby Cullom Davis as being particularly apt to the time, "Bonds promoted as offering risk-free returns

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[1] Since the end of the recession in June 2009, we have had a 4.1% GDP growth rate, the last ten recoveries had an average GDP growth rate of 8.6%. It has also been the longest recovery as we pass the 10th year, and the last ten recoveries averaged a 5 year recovery.

[2] The majority of trades executed are now driven by flows of capital into or between algorithms instead of by informed investors making a decision to buy or sell a specific security based on fundamental research.

are now **priced to deliver return-free risk**." On that date the 1, 10 & 30 year U.S. Treasury were yielding 0.15%, 2.04% & 3.2% respectively. Today those yields are 1.59%, 1.92% and 2.39%.

What do these numbers look like in a real world example? The Austrian government's 100-year issue, initially priced with a 2.1% coupon. In 2017 investors gave the government of Austria €1,000 to get €21 a year for the next 100 years before, if all goes according to plan they get their €1,000 back. Last year it got interesting. The fixed income market exploded with capital inflows, and rates fell. The Austrian 100 year notes were repriced to yield 1.2%. Think through the basic Buffett logic. What is the cash outlay today, and what is the expectation of cash you will receive? The cash outlay is handing over €1,600 today, and the expectation is to get €21 per year and eventually €1,000 in 2117. That's right, you pay a €600 premium, a 60% premium to what you hope to get back 98 years from now! And in return you receive a mere €21 per year for all the risk you are taking on. And, I would argue there is significant risk anytime you are lending money for more than a lifetime. It will take 30 years to recoup just the premium. For what? To receive a mere 2.1% return for another 70 years, all the time running the risk of recovering the €1,000 face value in 2117, and ignoring the time value of money.

So was Buffet wrong, or is there really a wolf out there? His opening premise in the Fortune article was that investing could be simplified as the process of laying out money now in the expectation of receiving more money in the future. That is tough to argue with. So with Buffett's axiom in mind, how should we view the current global fixed income markets where approximately 1/3 of all sovereign debt is priced at a negative yield? Lending money today for the guaranty of being repaid less money in the future is a worse financial proposition than putting your money under the mattress. We see a world that is turned on its head. Of course, when you're dealing with trillions of dollars, it may just be that there aren't enough mattresses.

Because of the ***unique*** time we are in, economists and financial commentators have tried to rationalize the current situation instead of recognizing it for what it is - irrational! This is where we see the power of recency bias, the distorting effect where we overweight the importance of recent events. When the decade started, the commentators were quick to point out the absurdity, even poking fun at the prospect of negative interest rates. As the years rolled by though, the environment of yesterday started to be perceived as "normal."

Speculation is Not Investing

> There is intelligent speculation as there is intelligent investing. But there are many ways in which speculation may be unintelligent. Of these the foremost are: (1) speculating when you think you are investing; (2) speculating seriously instead of as a pastime, when you lack proper knowledge and skill for it; and (3) risking more money in speculation than you can afford to lose. - The Intelligent Investor

It is imperative to understand the difference between speculation and investing. Many investors have made a lot of money this decade buying and selling low-yield fixed income issues, not because they held them to maturity (we should all hope to live that long) but because they were able to find another party equally willing to disregard valuation and pay a higher price based on irrational beliefs and expectations. In economics this is known as the *Greater Fool Theory* – when any price of an asset can be justified based on the belief that another party will eventually pay an even more inflated price. When you confuse speculation with investing you can quickly run afoul.

> An investment operation is one which, upon thorough analysis promises safety of principal and an adequate return. Operations not meeting these requirements are speculative. – Security Analysis, 1934

Valuation largely falls by the wayside for one of two reasons. Either you are persuaded that there is a new normal, or you believe that you are smart enough to time the wave. If one expects an "adequate return" from selling to an even more foolish buyer, and not based on fundamentals and valuation, it is almost certainly based on speculation and not investing. It also means that you may be perpetuating a bubble, and while looking for a greater fool, are likely to become the one left holding the bag.

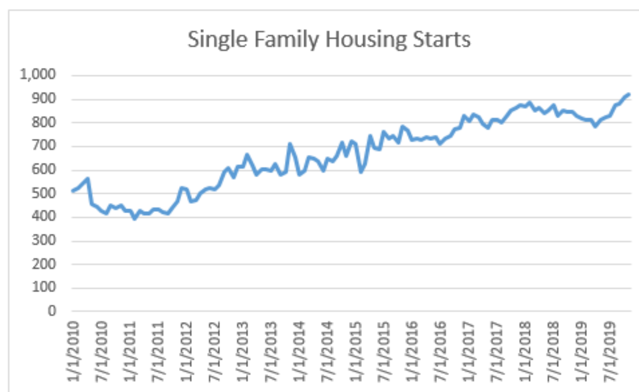
We are reminded of a quote from German born, MIT economist Rudi Dornbusch we think particularly apropos here: "In economics things take longer to happen than you think they will, and then they happen faster than you thought they could."

We believe these facts are a clear indication that what is widely accepted as the boring and safe part of the market (fixed income) actually has some of the riskiest and most unsafe valuations. Instead, the area of the market (equities) generally perceived as riskier actually has valuations that make them a safer bet on a relative basis, and in many cases on an absolute basis.

Knowing What Matters – Seeing Past the Noise

As interesting as it is to discuss these large trends in the market and as important as it is to be aware of the general perceptions of the market, the fact is that we do not invest in "the market." We have compounded capital over decades by keeping our intense focus on identifying situations we understand and working to fully understand the "knowables" that allow us to identify specific companies that are both undervalued and have a long runway of growth ahead of them. We focus on the partial ownership we have in companies. Finding investments which mitigate risk and provide opportunities for returns is where we have proven the ability to add value.

Over the recent decade we have found exactly that in companies associated with homebuilding. When looking at U.S. housing over the decade the pattern of a stable steady recovery seems quite clear. However, those who have invested in the space can attest that the day-to-day was anything but. We first bought shares in one of our largest holdings, Builders FirstSource (Nasdaq:BLDR) in May of 2009 at approximately $3.50 per share. Even as the chart on the right looks steady, on the ground we quickly found our shares trading down to $1.25, at which point we added to our position. Through fits and starts the investment has become a great success for us and our investors, but it is important to remember what was going on at the time, not just in retrospect. There were real data points identifying risks with investing in companies related to single family housing:



Source: U.S. Census Bureau

- Urbanization was becoming more prevalent.
- The sharing economy was taking over.
- Millennials were living at home longer and didn't want to buy a home even when they left.

In short, the mantra was "housing is dead forever." This was largely colored by what the world had just experienced in '08 and '09. The pernicious recency bias monster (more recent information is better remembered and receives greater weight in forming a judgment than earlier-presented information) had reared its head and scared everyone off.

Our analysis incorporated the real facts identified by the naysayers. Urbanization was trending higher and millennials were not yet moving into their own homes, to name just two. However, the population was also growing and people still needed homes to sleep in. Most importantly of all, the market was pricing many homebuilding related securities as if all the doomsday predictions were absolutely true and the new permanency. (This is a refrain we see again and again in cyclical industries). In short, our investments were priced for failure, and so only a few things had to go right for the investment to be a good one. In time many things did go right, and this investment has been a great one for us.

I tell this story of one of our investments in housing not to pat myself on the back, but because that situation strongly resembles the current situation in the energy industry. Here the market is again telling us that traditional energy is in immediate and terminal decline. The prognosticators in energy today are saying:

- Demand is going to stagnate or fall as we become more efficient.
- Electric vehicles (EVs) have already grown over 3,000% this decade, will supplant internal combustion.
- Political acceptance of climate change will lead to regulations that destroy the industry.

There is without a doubt many truths to these concerns, but it is the severity and completeness of the facts that is overstated while other facts compensate for that draconian outlook. Most importantly, it's the companies' valuations that dictate our investments as those valuations mitigate our risks and provide significant return opportunity.

We believe the most significant opportunity is the unheralded growth of natural gas consumption. And with its growth the benefit of it mitigating CO_2 buildup. More on that later.

Electric vehicles are increasingly taking share away from conventional ones, but there are still only 3.3 million EVs on the road, a mere 0.33% of the total cars. Considering that a car's average life is 10 years, the impact is further mitigated. Interestingly, over the last 40 years, average fuel efficiency for a new car has nearly doubled – this has a much larger effect and has been going on in the background during multiple cycles in the energy markets. We have no doubt that the number of EVs on the road will increase drastically in the coming years, but its effect on conventional energy is overstated, including for example, automotive usage is only a portion of demand. Electric vehicles still need energy to run and are simply moving where that energy is produced from under the hood to a power plant.

Climate change is also a very real concern but increased regulation would largely be beneficial to many of our investments. Solar power and wind are becoming larger parts of the energy grid, and there are investments to make in those sectors. (We recently met with the management of a solar power company, who predicted that solar would grow from 2.5% of U.S. power to 10% by 2030.) But one of the greatest, and interestingly least talked about, environmental changes has been the shift from coal to natural gas. Natural gas produces nearly half the CO_2 as coal and 30% less than oil. Not a cure for what ails us to be sure, but an important stopgap in the decades ahead. Much like one of our core theses for housing (people need to live somewhere and there aren't enough houses), people will continue to need to power their lives. This is even truer with the continued development of emerging markets. As we have seen in China over the last 3 decades economic advancement is a powerful force for energy consumption.

So this is the backdrop we have when we look at specific companies in this industry. As when we started investing in housing, today energy companies are priced for failure. This is one of the reasons that we tend to find opportunity among cyclical industries. When a company is priced for failure, an investor gets asymmetric risk reward. Another benefit of investing in cyclical industries is the power of consolidation. We saw this with our investments in homebuilding when Builders FirstSource, acquired the industry's largest competitor in 2016. The

acquisition generated cost savings of roughly $120mm per annum. The announcement of the transaction added $600mm to the company's market capitalization, doubling the stock price almost overnight. While consolidation in housing has happened throughout this past decade, consolidation in energy is only beginning as we enter this new one.

One of our core holdings, Tidewater (NYSE:TDW), provides vessels for the offshore energy industry. Tidewater emerged from bankruptcy in 2017 with the strongest balance sheet in the industry. In 2018, the company smartly and quickly merged with a competitor, Gulfmark, taking significant costs out of the business, resulting in a substantial cash savings and in the process almost doubling Tidewater's gross profit. This is a large reason why Tidewater is currently cash break-even despite a very competitive environment. We believe significant opportunities remain. To help ensure the company capitalized on these opportunities, late last year we filed a Form 13-D, sending an open letter to the board (see attached excerpt). Not even a week later, the company announced significant changes to their board, including appointing a new chairman. Tidewater is now focused on finding a good strategic partner, which will extend its runway for growth, improve the efficiency of the industry as a whole and position Tidewater as a leader in the ongoing recovery. Tidewater is indicative of the kind of opportunities we are seeing across our portfolio – buying a company for a fraction of the asset value with identifiable opportunities to dramatically increase its asset value while preserving a strong financial position and mitigating investment risk.

Conclusion

As long-term investors we often pooh-pooh the idea of arbitrary time frames. Why should the earth's position in relation to the sun dictate that time to evaluate a portfolio? That said, a turn of the decade seems as good a time as any to reflect on time in ways we rarely do. When reflecting back on my nearly four decades in this business, what I most fondly recall is the relationships we have with our clients, which have grown to encompass not just our original investors, but their families and children's families. We recently started to host events with a focus on next generation education. We would love to welcome you and your family to our next such event!

The time really has flown by, as it does when you have a passion for something. Very few firms make it ten years, let alone forty. I sincerely thank you all for your continued confidence, patience and trust, and look forward with excitement.

All the Best,

Bob Robotti

Excerpt from October 27, 2019 letter to the Board of Directors of Tidewater Inc.

Robotti & Company Advisors, LLC
60 East 42nd Street, Suite 3100
New York, NY 10165-0057
www.robotti.com

October 27, 2019

To the Board of Directors of Tidewater Inc.,

Robotti & Company Advisors, LLC's clients and funds it advises have been shareholders of Tidewater Inc. ("Tidewater," the "Company" or "TDW") both pre- and post- Chapter XI reorganization. As we noted in our April 26, 2019 letter (see Exhibit A), we are long-term buy-and-hold investors, with extensive experience investing in the offshore services industry dating back to 1976. As a result, we have seen many cycles, including the more than decade long depression in the industry that started in the early 1980s and persisted through the early-to-mid 1990s. In our role as long-term, active owners, we feel it is vital that we provide our feedback to the management and Board of Directors (the "Board").

Our clients and funds we advise own a substantial amount of equity in Tidewater.

. We urge you to implement the following three step action plan forthwith:

1. **Find a strategic partner with which to consolidate.**
2. **Reduce the size of the Board of Directors from 10 to 7 members, maintaining at least 6 outside directors.**
3. **Act now to do 1 and 2 promptly.**

1. Find a strategic partner with which to consolidate

Prior combinations have proven to be value-creating endeavors, and the potential for further consolidation synergies is dramatic (whether as the acquirer or acquiree), especially given the dearth of capital at this time in the industry cycle. Enabled by its large global fleet and strong balance sheet, it is imperative that Tidewater continues the much needed consolidation. This is the path to positive cash flows.

2. Reduce the size of the Board of Directors

Recent management changes have set the stage for an efficient and responsive Company. The Board needs to take similar actions. Relative to its peers, Tidewater's Board is too large and poorly structured. The resulting inefficiencies, attendant costs and failure to lead by example are direct impediments to the future success of the Company. There have been several examples of missed opportunities, from missed consolidation opportunities to assets that have gone unacquired. We believe this is due, in part, to structural issues. The past year's withhold votes at the Annual Meeting of Shareholders show that we are not alone in our concerns that these issues must be addressed immediately and deplore that such a call to action by shareholders has been "tabled to a later date."

3. Act Now

The industry's prospects in general, and those for Tidewater in particular, appear to be improving, as indicated by FIDs, project awards, commentary and our discussions with numerous management teams. Regardless of whether the recovery will continue to strengthen or be more muted, it is critical that Tidewater not simply wait for industry conditions to improve but rather act aggressively to take advantage of its unique position in the industry and the current position in the industry's business cycle.

To read more, visit our website: advisors.robotti.com/letters

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