Robotti
Value Investors

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Dear Investor,

Once again, we find ourselves living through turbulent times and, as is frequently the case, turbulent times in the markets are exciting times for investing. So far this year we have seen recurring declines in public securities, both in equity markets and fixed-income markets. Equity markets in the U.S. experienced the worst first-half results in over 50 years, while debt markets had the worst performing quarter ever. Wow! Remember, public markets adjust regularly based on two factors: recent economic experience and investors' perceptions of the future. Specifically with our investments, we would argue that the perception of the future is what is driving the market price, as the fundamental performance of our companies has been robust.

So what's different? What's causing this tectonic shift in public markets? In our midyear review (posted to our website) we pointed the finger at inflation. Inflation has gone from nonexistent, even to the point where it was pronounced dead just a few years ago, to its current rampant, and increasingly persistent state. Why this fundamental shift? The risk-free rate of return, the foundation in which all investments are priced, has moved.

In theory, the risk-free rate of return should have, as the name implies, zero risk. In practice, there is no investment that doesn't carry at least a small amount of risk. For the last 12 years we have lived in an anomalistic period of financial history, where interest rates were so low that the real risk-free rate of return even went negative.

Revenge of the Old Economy

Many of our investment companies suffered through a period of stock price underperformance during this anomalistic last decade. Meanwhile, the fundamentals of the businesses were improving and the industries were fundamentally changing. These companies have dramatically reinvented themselves which, in turn, radically changed their respective industries. In many cases this change has taken on the form of reduced supply (even as demand continues to grow, albeit in some cases modestly). We have also seen massive industry consolidation down to a few rational, disciplined companies. A core point we made in our midyear review is our belief in the *revenge of the old economy*, and how one person's pricing power is another's inflation. A key reason we believe in this revenge of the old economy is because these companies are now exercising that pricing power.

So how persistent will inflation be? There is a current debate about what kind of inflation this is. Is it demand-pull inflation, caused by too many dollars chasing the same amount of goods, or is it cost-push inflation, caused by a scarcity of goods and pricing power? Like most other economic phenomena, the answer lies somewhere between the two, although it would appear much more of the latter.

As bottom-up stock pickers, we've always believed that macro-events are not easily predicted. Still, a number of years ago my colleague, Theo van der Meer, noted that our stock research process provides us with *grassroots macroeconomic information*. The research we undertake to understand individual companies gives us insight into the macroeconomic factors affecting that business. What our research shows us is that inflation is currently rooted in the basic building blocks of the economy (e.g. energy, food, chemicals, etc.). The inflation these sectors have seen is orders of magnitude higher than every other contributor. This inflation is largely due to scarcity of resources and pricing power of rightsized companies and industries. While it seems like many of these goods have been repriced already, there is likely still some room for inflation to continue in those areas. Additionally, much of this inflation has not yet trickled down to the industries that *use* these building blocks.

As we noted in our midyear review, "in economics, things take longer to happen than you think they will, and then they happen faster than you thought they could."[1] Well, today we are seeing this happen very quickly. Capital is looking for the best place to be invested.

Energy Inflection

In America, one of the headline economic items has been the higher price of gasoline. We all know that much higher oil prices are the driver here (pun intended.) However, in America, we are isolated from the fact that in the rest of the world all energy prices are substantially higher. We have been largely sheltered as North America has an overabundance of domestic natural gas and coal. This has mitigated higher electricity prices here.

Throughout 2021 power prices in Europe have radically and substantially increased. One aspect of that is strong demand for natural gas, which lead to a price war between Europe and all of Asia to get LNG (liquified natural gas) cargoes. Prices for both natural gas and coal

[1] Rudiger Dornbusch

skyrocketed, surpassing the energy equivalency of even a barrel of oil, which was not cheap. As the year ended and we entered 2022, some of these high prices for hydrocarbons subsided. But then, as we all know, in February Russia invaded Ukraine. While this exacerbated the energy problem worldwide, it *has not* been the main driver.

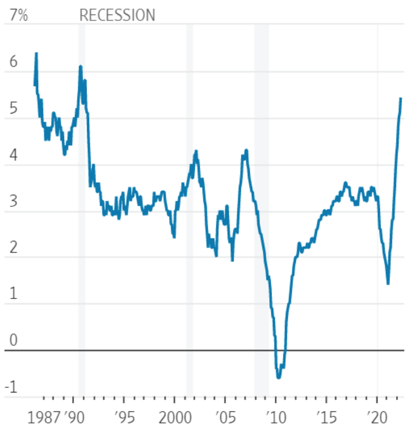
Part of the issue has been getting ahead of ourselves in understanding the pace of energy transition. In Europe, the decommissioning of low carbon nuclear power, the shutdown of coal power plants and the growth in demand for power, especially in the form of electricity have misaligned the supply/demand situation.

Now, with the fault line recognized between suppliers and consumers (most dramatically Russian suppliers and European consumers) we have highlighted the current energy trilemma the world finds itself in; we recognize concerns for the availability and security of energy as well as its affordability alongside the need to lower carbon production. You can see radical changes in the most environmentally sensitive European countries. In Europe, they are restarting coal power plants. The speed at which they can ween off this most pernicious carbon producer looks daunting, delayed, and likely to create strong demand for old economy building blocks. The EU has acknowledged that natural gas and nuclear are part of the interim green solution.

Not Just Energy

Another sector where inflation has been pronounced is the building products sector. The price of lumber and other wood products has been especially volatile. This was not unexpected.

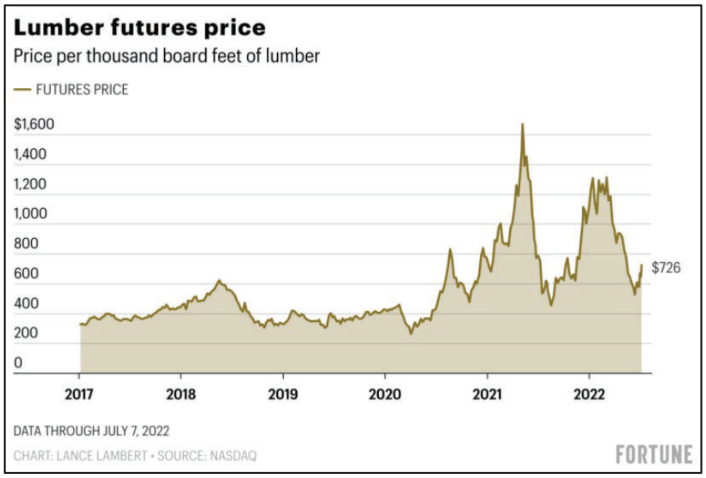
Housing inflation, 12-month change in the consumer-price index



Source: Labor Department

We had long surmised that the building products industry in general and the oriented strand board (OSB) and lumber industry in particular would face material shortages as the number of single-family homes built in America recovered to its 50-year average. Even that is a conservative estimate in our view since it did not account for population and household growth or for growing new end markets (for OSB in particular). Furthermore, with utilization already running high and few, if any, viable shuttered facilities remaining in the U.S., prices were likely to rise dramatically if/when the recovery occurred. In the case of both lumber and OSB, prices initially rose even higher than we had imagined. Over the last two years the price of lumber has gone up by 450% and down by 70%, ending up 50-65%. That's a lot of volatility noise, even for us! What is important and fundamental to our thesis for West Fraser (WFG: NYSE) is that we expect it will take a meaningful period of time (at least 3 – 5 years) before incumbent manufacturers or new entrants can bring new capacity to market. During this time, we think that lumber and OSB will continue to sell for at least twice the average price it historically sold for, as these consolidated companies will no longer sell below cost.

Higher prices and higher margins have led to the generation of a significant amount of free cash which, in the case of WFG, has been used to pay a quarterly dividend and repurchase and cancel more than 12% of its shares. Shares currently trade at just 3.6x this year's consensus earnings estimate. Analysts are expecting earnings to decline by more than 50% in 2023. Yet shares still trade at just 7.4x this bearish estimate, a double-digit earnings yield should this happen. In other words, we still believe our investment in West Frasier represents a company with an attractive valuation and a margin of safety.



Interest Rates

This decade will not be like the last one was. What we saw in the 2010's was the lowest interest rate in the history of the U.S. and it is to be expected that it will eventually have to change. We are seeing that change now. In general we view this as a return to sanity, and it is making it clearer just how unusual the interest rates we were seeing in debt for the last decade really was.

There are growing concerns about the ongoing housing recovery, as higher interest rates increase the cost of buying a home. We have expected interest rates to go up for a long time now, even if it did take longer than expected.

So how does a higher interest rate affect our investments in homebuilding? Well, there are two types of companies we invest in that I would like to highlight. First, we have the building products suppliers. Our largest investment is Builder's FirstSource (BLDR: NYSE), which is still trading at less than 4.5x EV/EBITDA. As interest rates rise, homes do get more expensive, but the industry has underbuilt for so long and the distributors have consolidated down to such a point that even in a rising cost environment they are still well positioned.

Another lesser-mentioned area of homebuilding we are invested in is manufactured housing (MH). Historically, higher interest rates have helped the MH industry, as it reduces the spread between traditional mortgages and the type of loans some areas require for manufactured houses. Additionally, as housing gets more expensive, the cost savings of a factory built home become more attractive. MH is an industry that had been in the trough of its cycle for longer than the housing industry as a whole, and what emerged from that is a consolidated group of incredibly disciplined survivors. Over the last two years, the manufactured housing industry has seen huge growth in demand and expanding margins, leading to large amounts of cash being generated. The discipline the companies have shown is impressive, as they have only grown capacity on the edges and instead used excess cash to further consolidate and streamline production. What we have today is a group of companies with truly robust balance sheets, experienced managements teams, wider margins and continued high demand for a product short of supply.

Conclusion

As self-labeled classic "value investors" we think that the price you pay is the most critical element in all investing. No matter what is happening in the world, no matter how crazy it is, the price you pay is the one lever you can always control. We cannot dismiss the fears of a recession, as they are a necessary and common part of the economic cycle. While we cannot control whether a recession happens, we can control what companies we own and how much we pay for them. Even if we are wrong and housing does slow down more than expected, energy prices come down and demand diminishes across the board, we have a margin of safety with the companies we own. This comes in two forms. The first we touched on already: the companies we own have exceptionally strong balance sheets, fewer competitors and have been acting more rationally going into any potential downturn. The second comes down to valuation: many of the companies we own are priced cheap even *assuming* trough earnings. Whether it is Olin Corporation (OLN: NYSE), West Fraser or LSB Industries (LXU: NYSE), each of them is trading at ~7.5x trough earnings. Our investments are incredibly cheap even assuming the worst. What if events unfold and are not as bad as currently feared? As we said, the price you can pay is the only lever you can control, and right now the price we are paying for these companies is extraordinarily compelling.

As always thank you for your continued trust and confidence in us, as what we do is only possible with clients such as yourself.

All the best,

Bob

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