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Dear Client,

On October 1st, I spoke at Grant's Fall Annual Conference in New York City. I want to share with you two topics we highlighted. The first topic we discussed was the universe of public companies we regularly cull through – the Zombie 1000. The second was the idea of slow capital. These are both critical concepts of our investment approach.

The Zombie 1000

When I say Zombie 1000, I refer to that fact that roughly half of the companies in the Russell 2000 (the small-cap index) are considered ***zombies,*** shuffling about without making any progress or money. This has become such a common phenomenon that market prognosticators often classify the Russell 2000 as un-investable. However, we have found some of our best investments by digging through the garbage heap of these zombies - finding those that still have plenty of life in them. Frequently these businesses operate in industries that have radically transformed in response to extremely difficult economic conditions. We find value in the Zombie 1000 because these companies are often going through a cathartic process that begins with an outflow of capital, leading to consolidation, liquidation, and the culling of weaker competitors, while the remaining few fortify their positions. The longer they remain zombies, the more cathartic the rehabilitation and the cheaper valuations can get.

Our investment experience has shown us time and again - nobody is interested in these zombies. "What value? Without a catalyst? Are you crazy man?", is a refrain we have heard throughout my investment career. We have found that as investors flee, we can engage with management teams to learn about the business *slowly*, discuss their outlook, build relationships with the critical people, and gain critical insights into an investment opportunity. All of this allows us to create an informational advantage over transitory owners, many of whom come into an investment without even a pretext of having researched the companies or understanding their business. When other investors are focused on market indicators, fund flows, and market timing, an investor with a patient, bottom-up research approach is advantaged.

These discussions with companies that nobody else wants to talk to further help inform our grassroots macroeconomic view. As a refresher, when we use that term, we mean that by talking

to management, industry competitors, suppliers and customers, we are able to develop macroeconomic views from the bottom up on portions of the economy we invest in. We are getting our information from those that know these businesses better than anyone. Information that is not only backward looking, which can be found by anyone with the internet, but also has predictive value.

Our extensive and decades long investing experience provides us with insights that allow us to discern when market forces, which dictate the flow of funds, are actually setting the stage for small-cap value stocks to outperform. The logical pushback is "So why does this set up future outperformance?" BECAUSE VALUATION MATTERS! The price you pay for an investment has a critical influence on your return. Yet those prices, especially today, are broadly determined by fund flows with increasing irrelevance to security analysis. Our analytical process enables us to identify businesses that have demonstrable asset values, earnings potential and in many cases even the current earnings themselves are ignored in public security valuations. This valuation disconnect provides the margin of safety described by Ben Graham in *Security Analysis*, as we are identifying companies that are frequently trading for 2x their normalized earnings. That means we don't need to be exactly right, because there is a cushion baked into public market valuations.

Slow Capital

The second topic is the idea of *slow capital*. Slow…patient…willing to defer gratification. You can't be quick to "cut your losses" when an investment that is already beaten up and out of favor suffers additional outflows, becoming even more discounted. An investment that requires patience on the way in frequently requires patience afterwards as well. Once an interesting business experiencing a difficult environment has been identified, diligence and patience is required. (Once a recovery manifests, diligence and patience are also required to reap the benefit of your work.)

To illustrate, I'll use an example where we learned a powerful, painful lesson about the advantages of slow capital. In the late 1990's one of our analysts became interested in NewMarket (which at the time was known as Ethyl Corp). What caught our interest was the fact that the company had bought back ~30% of their stock at roughly $46 per share. More interesting was the fact that the family that controlled the company and had a long, successful history of being both shrewd and thoughtful investors, did not tender any of their shares. Instead, they increased their stake in the business. A year later, the stock fell to $35 per share, which is when we began buying. NewMarket produced petroleum additives, including an additive for leaded gasoline which was obviously a declining business. Although the industry had consolidated down to four competitors, competition became fierce when supply was increased by a new capacity addition while customers consolidated and demand was hurt by the Asian financial crisis, all leading to margins compressing significantly. By 2002, the stock sold down to less than $4 per share. It generated $650-$700 million of revenue but had a market capitalization of less than $70 million with $300 million of

debt (although down from over $700mm on the completion of the repurchase). By the spring of 2005 shares had recovered to $15, which is when the market leader, Lubrizol, acquired a company that made chemical additives for hair care products that was growing at 6% - 7% per year and decided to run its competitive petroleum additives business for cash. They shut down a plant, expanded margins, began to turn down unprofitable business, and increased prices. Initially, lock-step earnings improvement was illusive, as oil prices, a primary raw material, chose that moment to rise dramatically. That set off several rounds of price increases, but margins quickly evaporated with repeated cost increases. These successive rounds of price increases convinced us that industry consolidation had facilitated rational, disciplined pricing. We realized oil prices would eventually exhaust this leap-frog progression and when it did, margins would expand, and earnings would rise. Our slow capital investing process was about to be rewarded. We aggressively invested, substantially increasing our position, filed a 13D in the process, and even encouraged the company to buy back more shares.

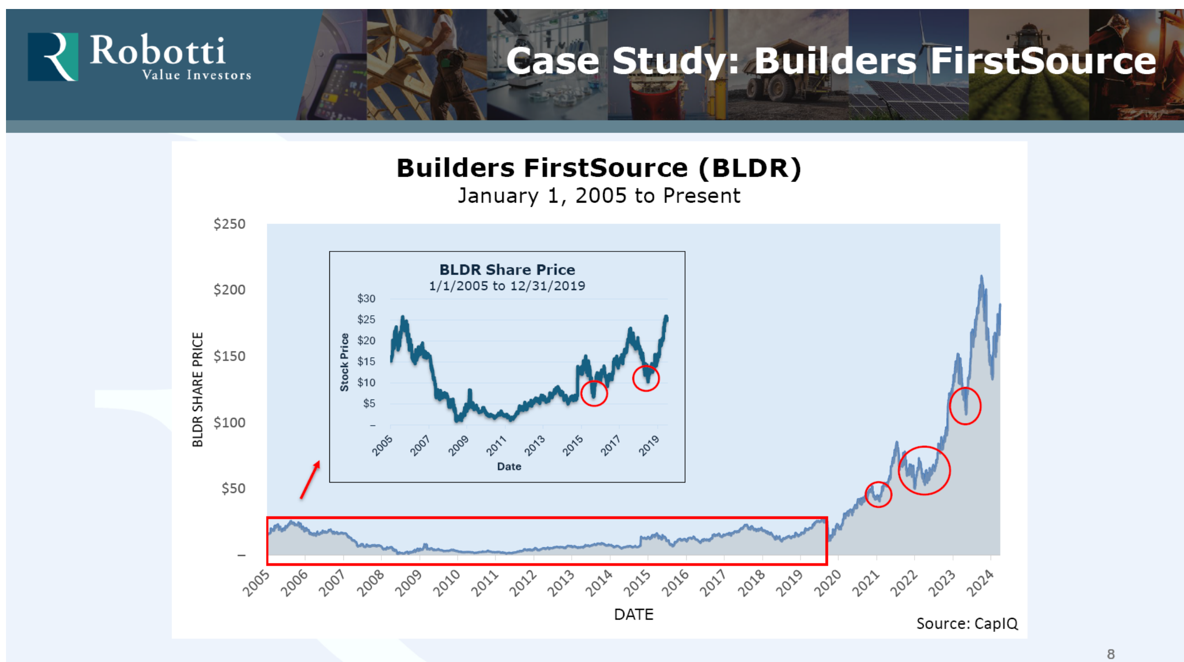
I will always remember my conversation then with the CFO, noting that I believed the company would earn $4 of cash per share imminently. Not bad compared to its $15 share price, but the market didn't care. Since the company had been facing headwinds for so long, the CFO's response to me was, "from your lips to God's ears." Our patience paid off as oil prices weakened, competitors remained disciplined, and margins widened. When the stock reached roughly $40 or 10x our estimate of free cash flow in the next year or so, we thought shares traded much closer to fair value and began selling our position. The result of our patient capital philosophy yielded a return of over 170% from when we showed the CFO our estimate. Still, there were more lessons to be learned. Since we sold much of our investment in March 2006 the stock has continued to rise. Today, shares trade for $535, or 1,275% higher, illustrating the value of having the patience required to invest with "slow capital." An 8 year downturn most likely sets up more than a I year recovery. We did not fully appreciate the advantages of *slow capital* and did not repeat that mistake in our investment with Builders FirstSource.

I have discussed the history of our investment in Builders FirstSource many times in these letters as well as in interviews and other presentations. In fact, we touched on this aspect in our Second Quarter 2014 Letter where we described one of Benjamin Graham's fundamental principles – Mr. Market.

> Price fluctuations have only one significant meaning for the true investor. They provide him with an opportunity to buy wisely when prices fall sharply and to sell wisely when they advance a great deal. At other times he will do better if he forgets about the stock market and pays attention to… the operating results of his companies.
>
> - Benjamin Graham, The Intelligent Investor

The recovery in the housing market and for Builders FirstSource took longer than we anticipated. Recall, as we noted earlier, the longer it takes for recovery, the more cathartic the rebuilding and

the more discounted the valuation. The recovery was not only long but was also volatile. Volatility has gotten a bad rap in investing because it is often used as a synonym for risk. Maybe, but maybe not. Our experience highlights the value of understanding the company and the business through our bottom-up research. As we said back in 2014, "when stock prices fall sharply, we often find opportunity - so long as our conviction in our long-term view remains solid."



We know that recoveries are frequently not linear. From the time that we first invested in Builders FirstSource, the stock fell by more than 40% on several occasions. The Second Quarter 2014 Letter marked one of those when BLDR fell from a high of $9.40 in early 2014 to $5.10 over just six months. Each time we experienced one of these unpleasant mark-to-market adjustments, we reviewed our thesis and each time nothing had changed other than the timing of our expected outcome. In fact, that slowdown in the recovery and the resulting market losses played a critical role in motivating the owners of 2 competitors to capitulate and actively pursue their exits. Longer recoveries and periods of setback regularly accelerate cathartic responses. While the time it takes for an investment thesis to manifest is an important variable, in the case of BLDR, it didn't change the direction of travel, but it did magnify the outcome, which further amplified the ultimate return. The important ingredient was patience. I can't tell you how often I read about an investor who boasts that they will immediately sell any holding that falls by 20% or 30%. Those are investors at risk of letting Mr. Market control their decisions instead of the other way around. As for the outcome? Builders FirstSource is still one of our top investments and the stock was at $171.40 at the end of Q3 2024 consistently generating profits through a downturn in its business, generating excess free cash flow and thoughtfully deploying that capital including substantially reducing the share count opportunistically. This exemplifies the essence of slow capital. By having the patience to endure volatility and setbacks while remaining focused on the long-term potential, not selling

right as things were getting better, but continuing to be invested as it improved, and the thesis fully unfolded.

Although we had planned to discuss the idea of slow capital at Grant's conference for quite some time, it turns out that the lessons are very much applicable today. Tidewater, another of our top positions, has now fallen close to 50% from its May 2024 high. While the experience is still never fun, the lessons we have learned do make it easier to know what to do. Reflecting upon the reasons we own Tidewater, the fundamentals of both the business and Tidewater's position within the industry, our understanding of the company and the business strongly support our view that the direction of travel has not changed while the market overreaction provides an environment to be opportunistic.

Conclusion

Our research continues to unearth highly discounted public companies struggling or having struggled through difficult situations. Those difficult situations lead to cathartic reconstitutions of the business with consistent and prolonged price discounting. The investment community broadly and uniformly characterizes this universe as zombie companies and deems them uninvestable. We know there is gold in them thar hills for those willing to do the bottom-up research to identify the jewels, patiently investing, patiently waiting and patiently letting the phoenix fly.

All the best,

Bob

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