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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Lifestyle Changes Set to Spur Increase in Homebuilding

ROBERT ROBOTTI is the Founder and Chief Investment Officer of Robotti & Company Advisors and has been since inception in 1983. Previously, he was VP and a shareholder of Gabelli & Company. Mr. Robotti received a bachelor's degree from Bucknell University and an MBA in accounting from Pace University. Mr. Robotti also is a board member of PrairieSky, AMREP and board Chair of Pulse Seismic. Previously, he was a board member of BMC and also chaired the finance committee prior to its acquisition of Stock Building Supply. Mr. Robotti is also active in not-for-profit volunteerism, including service on the board of Pace University where he is Chair of the investment and pension committee.

SECTOR — GENERAL INVESTING

TWST: Could you tell me about the firm?

Mr. Robotti: Sure. We've been in business for 35 years. We're investors, and we're investors in cheap cyclicals. The question is: When do cheap stocks go from being cheap stocks? When do they become good investments? And for those looking for cyclicals — we do think it's actually interesting about recent events. And we do think that COVID-19 actually has turned out to be an unexpected catalyst to a lot of our cyclical businesses, most specifically, you see it very clearly in the homebuilding investments that we've had.

TWST: And maybe you could explain about your approach to investments.

Mr. Robotti: We're looking for businesses that are undergoing periods of difficulty, and therein, the companies become cyclical. The valuations become depressed. But at the same time, we identify those companies that are well-positioned with differentiated businesses that have strong financials and good management, and frequently, that means insider ownership. That means those companies survive and improve their competitive situation in downturns, right?

Two things happen. One is the individual company continues to improve its position. And again, if well-managed and well-capitalized, it is opportunistic to invest and increase the earnings power of the business at extremely modest entry points. At the same time, the valuation is at a significant discount to what the potential earnings power of that business is. So that cyclical framework is a key and recurring theme across pretty much our entire portfolio.

TWST: And you mention cyclical. Obviously, the market took an impact from COVID-19, and if the vaccine turns out to be more than just promising, but actually works, might a lot of investments improve?

Mr. Robotti: The way we look at it is, two things happen. The advent of the pandemic, first off, it decreased the valuations of pretty much everything, and in which case, companies that we know well, we think went far beyond. We think they were cheap to begin with and became extremely discounted.

The other point is, we do think that there's, in many cases, the recovery in those businesses and in those companies, a compounding in the future earnings power of those businesses. So we actually think there is an unintended consequence, which is extremely positive for many of the portfolio companies we have today.

TWST: If the COVID vaccine does become widely available and works, the impact on the market might not be all immediate. It might extend out over a period of time. Is that your feeling? Or is it going to be more of an immediate impact?

Mr. Robotti: The timing will change based on whether the vaccine works or not. It seems as if there's a strong likelihood that three years out from now that we'll be past COVID and it won't have the impact that it's had. So the timing of the pandemic's cure is here at some point. And therefore, that's what we're focusing on: What does that mean for the company in two, three years' time? Where does the earnings power of the business stand? What's the valuation today?

And whether it's in six months' time that we have a vaccine or whether that's in two years' time, that has some impact on the short-term cash flows, but we don't think that has a significant differential on what the valuation of that business is. And we do think recent events kind of highlight the idea that at some point the market will look beyond what is most likely, or what is clearly, a temporary event, and just uncertain when it dissipates.

TWST: And with some stocks, is it possible that because of the pandemic, consumer and business approaches to purchases have changed — maybe indefinitely — in terms of air travel or people using a lot more online orders or things like that?

Mr. Robotti: Yes. As I said, homebuilding we think is exactly an example of that. There are two things. One is that we've been investors in this industry for over 10 years, and we've extensively looked at the companies, identifying well-positioned business models, good managements, with differentiated financials, which have been improving their situations over what has been an extended period of difficulty for the homebuilding business.

Historically, going back to 1968, we've built on average 1.1 million single-family homes to meet new home formation. Yet in the 11 years post the financial crisis, we have built only 7 million homes versus an estimated 12 million homes. Cumulatively, that means there are 3 million to 5 million homes under-built over a decade.

And why that happened is due to a multitude of events. Mainly, Millennial lifestyle decisions, a clear preference for urban, multifamily living, etc. So that trend has had an impact on single-family home demand and, therefore, has moderated it. But it hasn't eliminated it. The population has grown, the demand is there, and people had that interest that therefore dissipated that demand for a while.

Highlights

Robert Robotti discusses investing in cyclical businesses, especially homebuilding. Robotti seeks to identify companies that are undergoing periods of difficulty, yet are well positioned with strong financials and good management. He notes that since the financial crisis, only 7 million homes have been built versus an estimated 12 million; however, he believes the onset of COVID has changed home-buying trends as buyers want their own single-family home and work-from-home options make larger homes outside of urban areas more attractive. He also cites single-family home rentals and manufactured homes as areas of interest.

Companies discussed: Builders FirstSource (NASDAQ:BLDR); BMC Stock Holdings (NASDAQ:BMCH) and AerCap Holdings N.V. (NYSE:AER).

TWST: And did you want to highlight a company in the homebuilding sector?

Mr. Robotti: Yes. We've got extensive experience in the industry, but not only as investors in many of these companies. We made very significant investments in certain companies. So I also serve on the boards of two companies related to the homebuilding business. That rounds out and extends the knowledge base of information we have about the businesses and the intricacies and nuances of these businesses. That, we think, is an extremely important differentiator between us and other investors.

The other thing we would identify is when we're looking for businesses, we're looking for companies that have business models that we think are extremely strong ones, which means the ability to generate free cash flow. So what we didn't do in homebuilding is, we did not invest in the actual homebuilders that in the short term probably have been the biggest market beneficiaries because everybody sees that one. But that business requires recurring the deployment of capital and recycles of its capital, and then you need to go out and build new homes, get new communities and, therefore, requires significant cash reinvestment.

Instead, we've invested in distributors, and we've invested in a number of suppliers that we think are effectively the picks and shovels to the business as opposed to the gold miners. You're always going to need picks; you're always going to need shovels. And so not only do those businesses have more consistency to them, they also are businesses that require much less capital and, therefore, generate free cash flows and so, therefore, are a much better business to be invested in.

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The onset of COVID has radically changed that. Suddenly, the idea of having your own home, your own backyard, having a study, having to work from home — all of those things — the ability to work from home, therefore, the ability to live further outside of an urban area at lower cost. There are all these trends that are unleashed by events. We think if — we clearly already see a significant impact in the business, and we think that there's an extended period of recovery, which is just manifesting something that we think has been an underlying opportunity for a decade.

TWST: And did you want to give an example?

Mr. Robotti: Sure. The best example we have is actually on the distribution side of the business. Starting in 2009, we invested in **Builders FirstSource** (NASDAQ:BLDR), and we bought that business at $3.40. That investment led us to another company that had gone through bankruptcy and came out of bankruptcy. We bought out a number of the debt holders in **BMC** (NASDAQ:BMCH). **BMC** became a very large investment; we actually became a 15% shareholder.

As a result of the size of our position, we approached the company and became a director in the company. So ourselves and, actually, Davidson Kempner Capital Management appointed someone to the board. So two very large shareholders had board representation to make sure the business was run and optimized for the shareholders and increasing shareholder value.

1-Year Daily Chart of Builders FirstSource

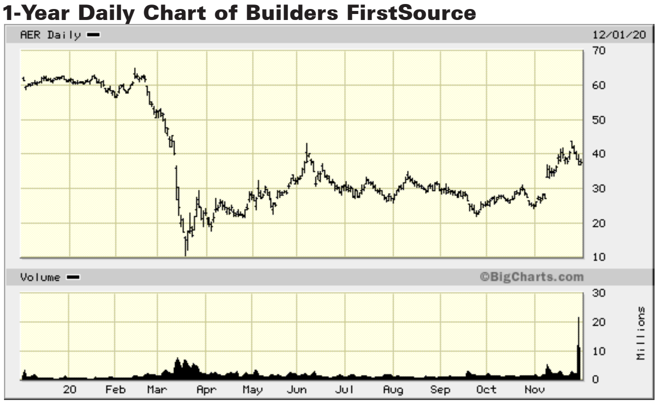

Chart provided by www.BigCharts.com

Eventually, that company was reverse merged into Stock Building Supply. And again, experience and perspective that we had, I was one of the key persons who negotiated that transaction in that merger. We were invested in what became the second-largest distributor to the homebuilders. The combination of **BMC** and Stock Building Supply made it the number two, while **Builders FirstSource** acquired a private company, making it number one. So those two distribution businesses are key investments that we've had over time.

TWST: Is there anything on the horizon for either of those companies that you think might be of interest to investors?

Mr. Robotti: In August of this year, those two companies agreed to merge. So the number-one distributor and the number-two distributor became by far the largest distributor. And looking back, starting in 2015, the combination that **BMC** did with Stock Building Supply and when **Builders FirstSource** bought the largest company, **Pro Build**, four of the five largest distributors will now be amalgamated.

When this deal closes sometime the end of this year, the beginning of next, it will be by far the largest distributor to homebuilders and have a scale and have a breadth of value-added products they sell that make them totally different from anybody else in the industry — and make them key and integral partners to every homebuilder probably across America. In 75 of the major 100 metropolitan markets and 400 locations throughout the country, the combination of these two businesses clearly accelerates the opportunity and grows the opportunity.

TWST: And are they being forward-thinking in terms of what supplies they're offering with changes in technology?

Mr. Robotti: Yes, that's right. First off, the homebuilding industry still is a relatively similar business to what it was 50 years ago — how you cut a piece of wood and you put it together and assemble a home. Of course, one of the key value-added components in the business is component manufacturing. So either building a roof truss, a wall panel, a floor truss, and then in a factory setting, you do that through models that you have. Therefore, you have the schematics for every piece of wood and where it goes and how it is put together. You put it together off-site, you ship that pre-built component to the location, and then it makes it much easier for the homebuilder to install.

Therefore, he needs less labor, he needs less skilled labor, and he does it in less time. So therefore, the cycle time for building that home is much shorter. And therefore, the builder loves that because it's sooner from the time he sells the home on contract to the time he closes the sale and gets his money. So the homebuilder is facilitated in terms of his return on capital because he has less capital employed because you shorten the cycle time.

And not only do they do components today, **BMC** has what's called a Ready-Frame product. And the Ready-Frame product ships you every piece of wood and lumber — presorted by installation and application — and therefore makes the construction process so much easier, simpler and in the process also is environmentally friendlier because you're not cutting wood on location. Therefore, you don't have resources that are going to waste. Instead, you're doing it in this factory setting with less wood in a more efficient way. So therefore, not only is that a cost, an economic benefit, it's also environmentally friendly.

1-Year Daily Chart of BMC Stock Holdings

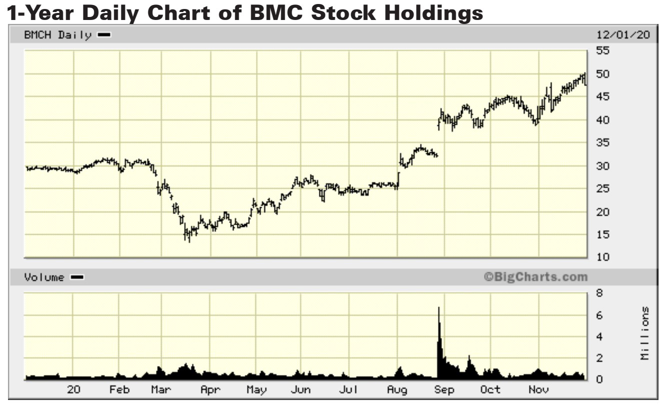

Chart provided by www.BigCharts.com

TWST: Are there certain policies the federal government under a new presidential administration might want to follow to increase the number of homes being constructed in America?

Mr. Robotti: We think there's a very large likelihood that any government will be understanding that this is an industry that is critical and key. Two reasons: One, it's been missing from the economy in the last 10 years. Part of the problem with the fundamental and the slowness of the recovery is you haven't had homebuilding. So the homebuilding industry has huge benefits in and of itself, implications across the economy, and it creates jobs. So therefore, those are critical elements that I think anybody in the government wants to endorse and support.

Not only is that the case, but two-thirds of Americans own a home. As opposed to owning financial assets — which we know the top-one-percenters do — this is 65% of the American population that owns a home. The idea of facilitating and enabling more people to own homes — to increase homeownership — is a policy where you're spreading the wealth out across the population.

So the idea that you want to be supportive to the homebuilding business, it seems as if that's a no-brainer in terms of government policy and reasons for them to be supportive of homebuilding in any way and every way they can.

TWST: Looking back, after a major challenge in American history, you sometimes do see people purchasing homes and maybe having children, like after World War II. Do you see something similar that could happen after COVID — that people's priorities change and they want to get on with their lives?

Mr. Robotti: First off, we would emphasize that a lot of those trends actually had been unfolding. For the last 10 years, Millennials weren't getting married, weren't having children, weren't thinking about living in a home, and if they did, they were happy living in the city. We think that Millennial trend is changing. We think the idea of urban living is clearly changing. And those things were underway before the pandemic.

We thought, coming into this year, you had already seen a 10-year period of preference for one style of living in housing changing. Therefore, the aging of the population, Millennials getting married, having kids, changing their view point, is now dramatically accelerated to not just them, to everybody who wants to consider the option of living not in an urban area, to live outside, to live in an individual home. We think that that trend has already been underway and that latent demand is clearly then unleashed by events that have unfolded in COVID.

And that's what you've seen recently with first-time homebuyers. It is one of the huge things that really has finally come back. Not long after the financial crisis, larger homes came back and activity grew there, and therefore, the average size of the home grew only because the mix changed, because high-end buyers had financial access and could buy homes and had an interest in doing that. The starter home segment of the population had more financial issues.

So there's a number of things that we think are really positive there, and one of them is a trend that came up as a response to the financial crisis: single-family home rentals. There were large companies that were formed that bought homes that were in foreclosure and have accumulated single-family homes that are in the rental pool today. That group has had an extremely successful re-experience and has now generated low cost of funds. They actually are building communities specifically to rent out. We don't have the money for the down payment but still want to live in a single-family home, and it would give me one option to do that. So that's a growing component of the market.

A second component that we're invested in: the manufactured home companies. And a manufactured home is built in a factory setting per square foot at much lower cost than for what you can build a site-built home. And so that component of the homebuilding business has really grown, and we think that they're extremely well-positioned. Manufactured homes are also part of what we're invested in and we think have already experienced strong recovery in the last number of years, and we think COVID further accelerates and expands the opportunity for growth in those businesses.

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So suddenly, "Yes, I want to do that. I want to do that now." We think the thought process and the time to do it goes from, "Yeah, I'll do that next year," to "I want to do it now." And so you've seen that. Homebuilding activity across the country has significantly improved, and it's setting new records, new decade-long records from what it has done.

TWST: And with some of these homes that people are looking for, especially after COVID, do you think more people might choose to work from home at least part of the week, if not all week, especially if they have been working remotely during the pandemic?

Mr. Robotti: We definitely think that that's a contributory benefit to demand. And that is people working from home, working remotely and working further outside the city bounds. And living in a new home — one that's the way exactly you want it with the study the way you want. So you can close the door, and if the kids are in the other room and they're studying from home, they can do that.

So we're reminded of the benefits of having maybe a little bit more square footage in the home you buy in the suburbs for the same dollars that you could buy in an urban area. Generally, you get much more square footage, and more square footage is something that people understand the value of today and are very interested in getting. So yes, they're all these positive trends that have been unleashed by COVID.

In addition, we would point out that one of the hurdles to the business has been that the first-time homebuyers have had issues in terms of finances, and a lot of that is, do you have a recent college graduate who is post financial crisis, and how much money they made, how much money they saved. And so therefore, the affordability of buying a home became somewhat problematic.

I would just add that with homebuilding, there's still obviously a long runway ahead. And there was that decade-long supply/demand imbalance — COVID kind of was the catalyst to unleash that. And that was all a fundamental economic reality that was revealed. It's just beginning because, for 10 years, when you do that, you want to build 3 million to 5 million homes, there's a lot of catch up that you still need to do. And so we're very early on in that process.

It's a great confluence of events. You've got a macro environment that has very significant growth opportunities, and you've got an individual company that has a very differentiated business model and offering, and therefore can bring solutions to a business that needs solutions. So it's a wonderful combination: the right time, the right place, the right company and an excellent opportunity.

TWST: And looking at the broader picture, what advice would you give to investors as we start a new year with maybe a new president and, hopefully soon, a vaccine against COVID?

Mr. Robotti: Well, we spent a lot of time talking about this one specific industry: homebuilding. But we have actually invested in other areas. We invested in a company, **AerCap** (NYSE:AER), which is a leasing company to the airline business. So,at the beginning of the advent of COVID, people thought that business was gone and out of the way — no one's ever going to fly again. And we thought, no, eventually — whether it's six months or a year, or two years or three — that's a business that is coming back, and we'll be there. And so we got to buy that stock at a significant discount to what we think the intrinsic value of the business is.

And clearly, the idea of a recovery or a cure has had the market start to have a more realistic expectation of what the value of that business is. But in addition, that's an example of something we got into given the opportunity that COVID brought and, therefore, the market's overreaction and misallocation of capital.

But there's a number of other industries we're invested in, including conventional oil and gas. A lot of the things we experienced over that extended time period with homebuilding, identified, sifted through opportunities and identified when the business was tough, identifying the survivors, thrivers in the business. We see that same thing in many situations today in the oil and gas business. We also see it in other industrial businesses.

Again, cyclical businesses, we think, are out of favor in the market and extremely well-positioned today. Those investors just aren't looking, and the opportunities in those companies continue to improve and individual companies have — as in the ones we've done at homebuilding — differentiated business models with strong balance sheets, with good managements that understand the opportunity and are increasing by reinvesting at opportune prices the market's given them today.

TWST: So what is some of the advice you'd give investors who are looking for cyclical companies?

Mr. Robotti: First off, we'd suggest people look at cyclicals. Some investors say they never want to invest in a cyclical business, with the mindset, "Don't tell me it's cheap. I don't know the 'W' situation today." We actually think that the environment is extremely right for us today.

TWST: Do you think that there are definitely opportunities if people find the right stocks starting next year?

Mr. Robotti: At the end of 2019, we wrote in our letter to clients that as the decade ended, it really was a strange decade. It was the one decade without a recession the entire time, but it was the slowest recovery ever. The recovery was extremely anemic. And you've had this trend with interest rates going down and down and down. And so we think that isn't the future, that's not the next decade.

And we actually do think, therefore, COVID also is accelerating trends, and things are going to change radically. And the next decade will look very different than the last decade. And this is the example analogy we use: There's no three-second rule in investing. You could stand in the lane, you can stand under the basket, and there are all these basketballs there that nobody cares for because they were missed shots. People are inclined to say, "I don't want to invest in that company. That's a missed shot," when you could pick it up and get an easy basket today.

So there are many companies, we think — because our portfolio is just replete with them — that are absolutely misvalued based on the fundamentals of the business today and, therefore, reduced risk and excellent opportunities for upside and recovery.

TWST: Is there anything we haven't talked about that you care to bring up?

Mr. Robotti: We've been doing it for over 35 years. We're consistent. We stick to our knitting. We know what we do. It's something in recent times that nobody cares about anymore. That's perfectly fine. That means the competition looking at these companies is much less. And it's not just doing the research; it's becoming active owners of the business, whether that's pushing management and boards to do the right thing, to position the business properly to maximize the opportunity. That can mean stepping onto the board, which gives us a seat at the table in the selection of the CEO.

One of the things we haven't mentioned is how we have a new president in the United States. What impact does that have on your portfolio? Our view is, the president of the United States is the most important person in the world, but that person is not the most important person in our companies. That's the CEO of that company.

So we've got good businesses that are well-financed, managed by smart managers, government policies inevitably change, and every company has to be responsive to that. If we've got the right company and the right CEO, you can easily respond to that. And that's the person we're focused on. And that's something we can know about the business and we can know something about the CEO. We know a lot about those things. And therefore, that's what's going to drive the results in our portfolio, not who the president of the United States is, not government policies. They will react; they need to. But of course, that's all manageable with a well-run, well-managed business.

TWST: Thank you. (ES)

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