Robotti
Value Investors

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Dear Investor,

Returns have been strong for the first half of 2021, for us as well as the overall market. This has occurred as equity market indices are hitting new highs. In that context, it is only logical to have concerns about the market generally. We believe that many asset classes are pricing in very positive outcomes, but in many cases have attendant valuations. This means it is all the more important to understand what you own, its valuation versus underlying fundamentals based on estimated future free cash flows, and the margin of safety an investment provides most noticeably through its valuation.

When we look at our portfolio investments, we see the earnings of many of our investments have improved even more than their market prices reflect. Based on the current economic environment, an important question is whether these improved earnings are sustainable, for how long and can they position the company to improve even further. Based on our analysis, we have strong conviction that conditions exist to sustain the current level of free cash flow and, in many cases, have created opportunities for continued improvements. The supply/demand fundamentals for our heaviest weighted industries such as homebuilding, energy and chemicals are strong and sustainable. The bottom line is that many of our investments are valued even more modestly today than they were at the start of the year before appreciating more than 20%.

We thought it would be helpful to highlight three core holdings that have each recently gone through some corporate actions, being opportunistic. These investments demonstrate the ways in which management has positioned these companies to take advantage of a robust environment.

Westlake Chemical

Westlake Chemical, a leading global manufacturer of chemicals, vinyls, polymers and building products, has done a tremendous job of navigating a difficult period over the last few years, despite the many challenges brought on from the pandemic. In the last two years, the company has grown its EBITDA by ~30%, while the enterprise value has only gone up ~19%. Through smart, disciplined capital allocation, the company has continued to grow, but valuations have not kept up. Today, they once again are actively capturing reinvestment opportunities to further grow future free cash flows.

In June of this year, Westlake announced it was acquiring Boral Limited's North America building products business. This addition expanded Westlake's exposure to the home building industry while providing the company with significant cost synergies. Westlake already had a leading position in many vinyl trim, roofing and PVC products for homebuilding, and this announced acquisition will add even more product diversification.

The Chao family, who have run Westlake for decades, have an extremely impressive track record when it comes to capital allocation. As a result, the company has $1 billion in cash that they can use towards the acquisition, making the additional debt very manageable. Boral's homebuilding offerings are mostly in concentrated competitive markets, with the top 3 players in each making up 55-80% of the market – often Boral is the #1 in each of those sectors. This is a recurring theme across many of our investments. A competitive industry experiencing years of weak demand responding with capacity right-sizing to lower activity levels and substantially consolidating into the hands of the well-managed. With an inevitable recovery in demand, the well-managed consolidated companies have been able to move prices up to absorb cost inflation and even expand margins. This recurring dynamic indicates, especially for the consolidated industry structures, that higher prices are more sustainable versus transitory.

With this acquisition, Westlake will be able to take advantage of secular trends in the homebuilding and repair/remodel markets. The combined revenues of the existing PVC business, and the newly expanded building products business, will represent over half of the revenue for the company. To be clear, this is not an overnight shift for the company. Westlake has been in the PVC business since the early 90's, and more recently in 2015-16 made acquisitions to substantially grow the business. We should note, that at the same time their paired caustic soda business seems well positioned. This latest transaction is just the next step in Westlake's strategy of continually growing its future cash flows, with largely self-funded, well timed acquisitions, to take advantage of opportunities that the market gives it.

West Fraser

Shares of Canadian-headquartered (although production is mainly from plants located in the US) wood products producer West Fraser ended the second quarter roughly flat. No American has missed the news that throughout the first quarter lumber prices experienced a meteoric rise peaking in early May at more than 4x the price just a year earlier. The price of Oriented Strand Board (OSB), a critical building material (but not the headline grabber lumber is), rose by roughly 100% in just the first six months of 2021 and were approximately 6x higher than they were one year ago. As could be expected, an asset price increase of that magnitude in such a short period of time caught the attention of both traders and speculators alike. In fact, with soaring commodity prices adding roughly $36,000 to the cost of a home, lumber found itself fashionable joining the ranks of crypto-currency and *meme-stocks* as a hot topic for discussion. With headlines focused on price volatility in the first half of 2021 declaring *lumber mania* and *skyrocketing prices* followed by *the bursting lumber bubble* and a *lumber wipe out* it was easy to miss the important news that lumber prices are still roughly 2x – 3x higher than the 10-year average and up significantly over the past twelve months.

As we have pointed out before, we believe a structural shift that played out over two decades has altered the supply/demand equation in favor of lumber and particularly OSB producers. That advantage should have much greater sustainability than ever given the consolidated industry dynamics of today. Still, as the market is often prone to do, momentum was driven by momentum, and prices were pushed to excess - even in an environment where the producers have pricing power.

Today, shares of West Fraser trade at less than ***2x consensus free cash flow estimates for this year and less than 5.5x analyst estimates of free cash flow for 2022*** which we believe could prove to be modest given the current industry dynamics. This means that between the remainder of this year and next year the company will generate well over 50% of its current valuation in free cash flow. This reinforces our view – VALUATION MATTERS! In a world of sub 1.5% 10year treasuries and 16x PE for the S&P 500, our portfolio is littered with discounted investments on both an absolute and a relative basis.

We have also discussed the importance of capital allocation in a situation where we expect above average free cash flow for a period of time. On July 7th we received further evidence supporting our view that West Fraser's leadership has been and will continue to be prudent capital allocators when the company announced a substantial issuer bid to repurchase $1 billion (Canadian $) shares of its own stock using excess balance sheet cash. This is just another example of how opportunistic value creating capital allocation further compounds the value of our investments.

Subsea 7

As you know, the portfolio has a significant energy allocation to what has historically been conventional oil and gas. There is no doubt that the world of energy is experiencing significant changes. Over the last few years this has been a drag on our aggregate performance. Today our specific investments in this area are extremely well positioned, not only from their traditional business, but in many cases as important participants in renewable energy solutions while reforming and reducing the carbon footprints of their historical business.

We have noted in the past that Subsea 7, a global leader in offshore engineering and installation, has built out its business installing new offshore wind farms. Already, over 25% of their backlog comes from businesses that use Subsea 7's historic equipment and engineering expertise to install platforms for offshore wind versus platforms for oil and gas production. Recently, Subsea 7 announced the combination of its offshore fixed platform wind renewables business with another company, OHT. The combination with OHT rounds out the current business by adding the full complement of services required for the installation of new offshore fixed platform windfarms: the installation of ocean bottom affixed foundations, cable lay, substation installation, turbine installation and heavy transport needed to move fabricated components from Far East shipyards to offshore wind locations worldwide. We believe this positions Subsea 7 as a critical EPIC contractor in the burgeoning offshore wind industry.

Subsea 7 has also been awarded a $150mm carbon sequestration project off the coast of Norway capturing CO_2 from an onshore cement plant (cement plants worldwide produce over 5% of the world's CO_2). It is also developing floating offshore wind EPIC technologies. These new energy technologies and businesses remain wholly owned by Subsea 7.

As for the core historical business, the company has been awarded a growing number of contracts. The pipeline continues to build, supported by dramatically higher oil prices. This improving outlook continues to gain momentum as historical oil demand continues to recover as societal mobility comes back, even if on a somewhat seesaw basis. A year ago, we spoke about this trend in a video we posted on our website and on YouTube. (https://www.youtube.com/watch?v=O1ePjP96vK4)

World consumption of oil has dramatically increased since April 2020. It is apparent to us that this will continue. Air travel has improved some, and the outlook for continued flight activity seems inevitable. The current price levels for oil supports the economics of an additional ramp up in activity. Worldwide demand for natural gas as a bridge fossil fuel continues to grow. In the interim, traditional fossil fuels continue to play a key role in economic activity and world prosperity that comes with it, which are critical elements to the UN's first Sustainability Goal of eliminating world poverty.

Conclusion

We once again thank you all for your trust in us. We take our responsibilities as stewards of your capital extremely seriously and are delighted when we can execute on our mission of providing you good returns on that capital.

As always, feel free to reach out to us with any questions or concerns. We are always happy to speak with you all.

All the best,

Bob

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