Robotti
Value Investors

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

September 30, 2021

Dear Investor,

Many years ago, my wife Suzanne and I were walking home from work when I spotted a $100 bill in clear view laying in the gutter outside a fancy midtown restaurant. This wasn't just the proverbial quandary of when you see a penny on the street do you pick it up? This was $100! My wife said, it can't be real or someone would have picked it up. I did. It was real.

Today, many of the companies we own and research are extremely undervalued on an absolute basis. Many trade at a single digit multiple to earnings. Strong returns have continued through the first three quarters of 2021. We are encouraged by the progress our companies have made and how these businesses are positioned today. As a result, we continue to believe that the future is bright for our investments. Just like that $100 bill, these stocks have been ignored and are waiting to be picked up.

What is in a number?

Statistics in a vacuum can be easily misleading. In WWII, the U.S. wanted to know how to better armor combat planes. A group of statisticians concluded that damage on returning planes was concentrated on the edges of the wings, the fuselage, and the tail of the plane. Naturally the response was to armor those sections where the most hits had been recorded. It was not until a statistician, Abraham Wald, pointed out that the planes that were returning with this damage were those that were still able to fly. He concluded planes that had been hit in the other areas were too damaged to return to base. The extra armor should go where the bullet holes weren't on the returning planes. Good data initially led to poor analysis, but many thanks go to Mr. Wald for his courage to go against his profession's consensus view and analyze the same data more effectively.

One statistic that is potentially misleading people today is the interest rate. The return offered by the 10-year US Treasury, (in classic finance it is known as "the risk-free rate of return") is 1.6% per year annually with a return of the principal in 10 years.

If we consider that the current rate of inflation is 3-4% or more, the 10-year Treasury should NOT yield 1.6%. ***A rational investor should require a much higher rate to provide a likelihood of earning a real, positive return on their investment.*** Even if the inflation rate is transitory (we will see), a 10-year treasury buyer is accepting a calculable loss on their investment in year one. This is the result of linear thinking. The 10-year treasury has been a very good investment for decades, but the past is NOT the future.

A logical question then is, why is anyone buying these U.S. treasuries? One simple answer is because it is a staple of financial advisors' allocations, and since it always has been, it always will be. Another reason is that interest rates have fallen over the last 10 years, and when that happens the price of existing treasury notes go up. So, two reasons people continue to buy them is because (1) they always have, and (2) they are hoping rates will continue to fall. Given how low they are already, that is a very risky proposition in our minds.

Since financial markets are priced off this standard "risk-free" rate of return, it follows that assets across the financial markets are mispriced. If the foundation of a model is faulty, everything built on it is at risk. Think about the high yield market, which has a yield slightly above 4% (based on the SPDR® Portfolio High Yield Bond ETF). At that rate you will break even given the current inflation rate, but you will get no real return for accepting the credit risk of these issues with terms and conditions (including covenants) which are historically the least favorable to the holder of that debt in the history of higher risk or high yield bonds.

Revenge of the Old Economy

Bloomberg TV recently interviewed Jeff Currie, Global Head of Commodities Research at Goldman Sachs, about his views on the recent energy crisis facing Europe, the UK and China that has sent natural gas and power prices to record highs. His views echo many of same ideas we have communicated in the past with regards to both the *capital cycle* in general and energy specifically.

Currie terms the current situation facing many countries around the world as the *Revenge of the Old Economy*. It isn't just the energy sector but is in fact happening across the entire *old economy.* "Poor returns saw capital redirected away from the old economy to the new economy." Would you rather own an energy company or a new economy company such as one of the FAANG (Facebook, Amazon, Apple, Netflix, and Google) stocks? With the returns FAANG stocks have realized, it is no surprise that capital has shifted to the new economy and, in the process, drawn capital away from the old. The surge in demand that accompanied the easing of the global pandemic just exposed this underlying problem of underinvestment. As a result, many of these businesses and industries have undergone significant change. Profitability has dramatically improved, but investors have yet to adjust to this new paradigm and/or don't believe these economic benefits are sustainable.

The Old Economy is Back with a Vengeance

These problems are not unique to any company or geography. Looking as far back as 2008-2009 we can see investors shunning long-cycle capex in favor of short-cycle capex. People are justifying very high valuations for the comfort of hopping on the winning bandwagon. Conversely, we are invested where it has NOT been comfortable because that is where the valuations are extremely modest.

According to Currie, renewable energy is one sector that did experience significant investment over the last 5 – 10 years - an investment that needs to be continued. However, investment in renewables such as solar and wind was so heavy that it actually drove power prices negative in some parts of Europe. That economic structure pushed the shutdown of what was perceived to be surplus, or at-risk power generation (like nuclear in Japan and Germany). Clearly that power generation is still needed as part of the supply to provide dependable power availability (as seen by the energy crises ongoing today in Europe and China). So, while the new economy is growing and attracting capital, it has a long way to go to displace critical power generation sources. This is especially true as the demand for electric power continues to grow as we electrify.

Currie points to natural gas as one example. As the world shifts from hydrocarbons to renewable energy, there needs to be a *bridge fuel* to handle "… the intermittency problem from when the wind isn't blowing, and the sun isn't shining." Supply also needs to be multiples of its current size to meet the growing power demand worldwide. That will come but it will take time. The obvious problem with natural gas is that it is still an "…old economy hydrocarbon-based fuel." That fuel needs to be developed through new drilling and new production to meet power supply demands until then, which requires investments in E&P companies and the broader old economy.

While many attribute the lack of sufficient investments in E&P companies to ESG concerns, that's a recent phenomenon. The fact is that these companies have experienced poor returns over the past 5 to 10 years causing capital to be redirected into areas that have recently experienced high returns. It is easy to withdraw investment capital from an industry that has generated dismal returns.

It is not just fossil fuels. West Fraser's oriented strand board (OSB) business provides another excellent example of this revenge of the old economy. As the price of OSB struggled for over a decade and as the housing recovery muddled along, capital was shifted to industries promising eternal growth. This pushed valuations of these "eternal growers" increasingly higher while producers of OSB and other building materials companies, including lumber, watched their valuations sink. With capital flowing out of the industry, older mills were shuttered, companies with weak balance sheets were acquired by stronger competitors and no new incremental capacity was built. The result is that North America barely has enough OSB to satisfy the current housing demand. The price of OSB has surged and producers such as West Fraser continue to generate significant free cash flow. While 2 new mills were just announced, the additional capacity is not yet significant and, importantly, it will take 3 to 5 years minimum for these mills to reach full scale. These mills will only net add less than 5% to the industry's capacity. In the meantime, producers such as West Fraser will remain competitively advantaged and use their cash balances to repurchase stock or pay special dividends. Despite these strong fundamentals, the stock is still cheap. It is trading at less than 4x 2021 consensus free cash flow and roughly 8x 2022 estimates, which have price moderation priced in.

Currie concluded, "The only way you are going to see capital (redirected) to these sectors is you have to get the returns up and you need to get the prices of these commodities much higher to get the returns sufficient enough to start attracting capital." Strong returns will drive inflows of capital.

Energy
It's amazing how the world can be turned on its head in such a short period of time.

A year ago, I proclaimed the fallacy of the argument that the US was energy independent. There was the claim that the US oil shale drilling had brought about a change to America that would make it oil independent. The fact is that we continue to import that incremental barrel. My belief was that the production level was not sustainable, especially given the unsustainable cash flow of capital that facilitated uneconomic drilling. That would be corrected and go away, and we would once again continue to import larger amounts of oil.

I missed the point. I too like the rest of the world focused on the high-profile commodity - Oil. What I should have said is that we would not be oil independent. My comment failed to appropriately focus on natural gas which was becoming a much more significant component of energy consumption. It failed to recognize the fundamental changes in the world energy supply and demand***. When it comes to natural gas, America is indeed energy independent and has a long runway of opportunity to extend that advantage.*** It's not just that we are energy independent, but we are producing excess supply which we can and do export to the rest of the world. The world is in short supply of this key industrial commodity. If you're a European or Asian buyer, who would you prefer as your provider, the U.S. or Russia? In practice, there really isn't much choice. You need them both and others too!

The natural gas industry is still the largest supplier of electricity generation to North America. Industries in which electricity is critical such as steel, aluminum, etc. have cost advantages if they are "Made in America." In addition to powering the economy, many industrial companies in America use natural gas as a key raw material including chemicals and all the downstream products, fertilizers, methanol, ammonia production, and many others.

It's even better yet for America!

As bright as the prospects are for natural gas exports to capture this world demand, the ability to grow exports is constrained by physical limitations. It takes years to build the infrastructure necessary to export enough natural gas to tie the U.S. into the world's pricing. What that means is prices of natural gas in North America remain significantly discounted to the world price and will continue to be so for years to come. U.S. industrials are competitively advantaged.

Conclusion
In our 2019 year-end letter we postulated that the decade of 2010-2019 was a unique period in American economic history. Yet investors had come to accept many things as the way it is and forever will be.

And why not? 10 years is a long time.

We postulated that the 20's will be a very different decade. Why? Because as we always say, valuation does matter. Past success does not dictate future performance. Valuation and business fundamentals do. The past economic events have positioned certain historically underperforming segments of the economy well due to the response to that underperformance. This comes in the form of consolidation and critical economic re-creation. Coming out of the pandemic freeze isn't causing temporary issues as much as it has revealed structural imbalances which industrial America is well positioned to profit from.

The pandemic showed us the importance of the tangible world – critical even in a digital age: How to get products from point A to point B, and the equipment, materials and work power required to create it. A critical element is the adequate availability of low cost, predictable electricity. In this respect America is advantaged versus all other developed economies. A plethora of U.S. industrial companies with consolidated end markets, barriers to entry, pricing power and very strong free cash flows are in positions of great financial strength, and most excitedly, at valuations disconnected from those economic realities. The persistency of this economic result will attract investment capital back.

We look forward to the next few years, and once again thank you for your trust in us. We are extremely proud to have such strong returns this year, but regardless of the recent performance, we remain focused on our mission: Providing good **long-term** returns on your capital.

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

All the best,

Bob

The above letter, dated September 30, 2021, is an update letter of Robotti & Company Advisors, LLC ("Robotti Advisors"). This letter should be read in conjunction with the following disclosure information:

This information is for illustration and discussion purposes only and is not intended to be a recommendation, or an offer to sell, or a solicitation of any offer to open a separate account or become an investor in a private fund managed by Robotti & Company Advisors, LLC, as the case may be, nor should it be construed or used as investment, tax, ERISA or legal advice. Any such offer or solicitation will be made only by means of delivery of a presentation, prospectus, account agreement, or other information relating to such investment and only to suitable investors in those jurisdictions where permitted by law.

Further, the contents of this letter should not be relied upon in substitution of the exercise of independent judgment. The information is furnished as of the date shown, and is subject to change and to updating without notice; no representation is made with respect to its accuracy, completeness or timeliness and may not be relied upon for the purposes of entering into any transaction. The information herein is not intended to be a complete performance presentation or analysis and is subject to change. None of Robotti & Company Advisors, LLC, as investment adviser to the accounts, private funds, or products referred to herein, or any affiliate, manager, member, officer, employee or agent or representative thereof makes any representation or warranty with respect to the information provided herein.

In addition, certain information has been obtained from third party sources and, although believed to be reliable, the information has not been independently verified and its accuracy or completeness cannot be guaranteed. Any investment is subject to risks that include, among others, the risk of adverse or unanticipated market developments, issuer default, and risk of illiquidity. Past performance is not indicative of future results. If interested, please contact us for additional information about our performance related data.

The attached material was provided to investors in a specific Robotti Advisors vehicle at a specific past point of time, advice that may no longer be current or timely. References to past specific holdings of that specific vehicle and matters of related historic fact must be seen in context (as would have been apparent to investors in that vehicle) and are not intended to refer directly or indirectly to specific past recommendations of Robotti Advisors (other than as an indication of language sometimes found in the newsletters). Any reference to a past specific holding or outcome is not intended as representative. None the less, for individuals actively interested in investing in such vehicle, a list of recommendations made by Robotti Advisors with regard to the vehicle in question will be made available on request.

Note: certain statements in the attached material, including but not limited to (a) statements of things that "are well known" to be the case (other examples include: "In hindsight people often say, "I should have known better," and more often than not, they did."), (b) statements with the phrase "always", and (c) certain similar statements, are not intended to represent absolute literal fact, but rather represent certain colloquialisms/mannerisms expressed by select market participants (but not necessarily individuals associated with Robotti Advisors).

Opinions contained in this letter reflect the judgment as of the day and time of the publication and are subject to change without notice and may no longer represent its current opinion or advice due to market change or for any other reason. Robotti & Company Advisors, LLC may provide investment advisory services to clients other than its separately managed accounts and private fund clients, and results between clients may differ materially. Robotti & Company Advisors, LLC believes that such differences are attributable to different investment objectives and strategies between clients.

The information provided herein is confidential and proprietary and is, and will remain at all times, the property of Robotti & Company Advisors, LLC, as investment manager, and/or its affiliates. The information is being provided for informational purposes only. A copy of Robotti & Company Advisors, LLC's Form ADV, Part 2 is available upon request. Additional information about the Advisor is also available on the SEC's website at www.adviserinfo.sec.gov