

## “Small-Caps, Big Winners” - Robert Robotti

Robert Robotti is the president of Robotti & Company. He began his career in public accounting. Prior to founding Robotti & Company, Bob was a vice president and shareholder of Gabelli & Company, Inc.

Mr. Robotti holds a B.S. from Bucknell University and an MBA in Accounting from Pace University. He is a certified public accountant.

**G&D:** Mr. Robotti, you graduated from Bucknell University before getting your CPA and an MBA from Pace University. How did you first become interested or involved with investing?

Robert (Bob) Robotti: It was actually happenstance - good fortune. The accounting firm I worked for was the auditor for Tweedy, Browne Company. The very first thing I did, while I was still in college, was to work on the audit of Tweedy, Browne and TBK Partners, which was a great entrée to value investing. At the time, Ed Anderson managed the firm and Howard Browne was still very active. Tom Knapp was a fixture in the office; Chris Browne and John Spears were young analysts and Walter Schloss and Eddie Schloss sat in the offices searching through annual reports. The firm was originally called Tweedy, Browne and Reilly. Joe Reilly was a retired partner, but would come in every day, and I'd sit in the office with him and chat about investing. His insight and encouragement were invaluable. Shortly thereafter, I left that accounting firm and was hired by one of their other clients, Mario Gabelli (MBA '67). I worked directly for Mario as his CFO for three years when he was only a twelve-person firm. Although I had no role in stock picking, I knew everything about what stocks Mario liked, why he liked them, and what he was buying for clients. I became totally enamored with value investing. No one could ask for a better education in value investing. Of course, both Tweedy and Gabelli's original core were small-cap value, and I decided I wanted to emulate



Robert Robotti - President and CEO of Robotti & Co.

these greats.

**G&D:** What pushed you to take the initiative and start your own firm?

BR: I went to Pace for my MBA. I didn't go to Columbia, so nobody was going to hire me. The only person foolish enough to hire me to pick stocks was me, so I had to strike out on my own.

In addition, Gabelli sure didn't need me to help him pick stocks. He has a phenomenal mind and is a phenomenal investor.

**G&D:** What was the most difficult aspect of starting a firm?

BR: It's a unique thing that people can do in this business.

From 1983 to 1991, the firm didn't have enough critical mass to grow. The business just broke even, mainly due to a modest payroll. Our investments did well, but the firm wasn't profitable. I was already married, but I didn't have children or a mortgage or any of those significant financial obligations for the first eight years until the firm gained critical mass and started to grow. That personal financial staying power is a luxury that a lot of people don't have.

**G&D: What do you think is the biggest advantage that has allowed your firm to grow, especially over the last 20 years?**

BR: I think it is as simple as providing good returns for our clients. It sure has not been due to any marketing prowess on our part. For example, our primary separate accounts composite has compounded annually at 13.02% net of fees over the last decade versus 6.33% for the Russell 2000 and 1.41% for the S&P 500. This is fairly representative of our performance over time. On an absolute basis, we have not experienced a down 5 year period and on a relative basis we have outperformed both indices in most periods. Our returns are driven by our ability to identify mispriced securities and have the conviction to invest based on our research. We accumulate securities that are mispriced by the market. It sounds simple, but at the same time it is frequently quite difficult. If you follow this type of process, it is important to act independently based only on the conclusion of your work. You can be wrong sometimes, but you must rely on your own work and your own judgment.

We are also extremely fortunate to have the right clients. They are patient investors that are willing to stick with us even through the trying times, which are inevitable if you are an investor. It is not so much the quantity, but the quality of the clients that enables a manager to maintain the long-term view that is so vital for successful investing.

**G&D: Have you found it any more difficult as your capital has increased?**

BR: No. We still manage a modest amount of capital. In aggregate, it is just over \$500 million.

**G&D: Do you look to grow your assets further?**

BR: Growing the firm is really as much an obligation to the people who work here as it is to me. My lifestyle isn't really going to change if our assets under management continue to grow. I like what I do, so I'm going to continue to do it. However, there are people who are coming to work here like David Kessler who graduated from the Columbia Value Investing Program in 2008. They are looking to work in a

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place where they can grow over time and that will provide them with opportunities. It's an obligation to my team to make sure that the firm continues to grow so there's economics for them to continue to work here, and there's a future for them.

**G&D: Can you talk about how your accounting roots have helped you as an investor?**

BR: We tend to invest in smaller cap companies where the accounting is going to be a lot less complicated. GE is a company I've thought about a lot over time. I wouldn't want to be the auditor of GE because whatever numbers GE wants to put out, they can put out. You can spend 365 days a year with a big accounting team, and you still won't be able to understand all the numbers that GE wants to put together. With smaller companies, the auditors have a much easier time auditing the numbers, so the reliability can be greater. Additionally, understanding accounting and financial statement construction helps an investor gain an even deeper understanding of the business itself. It enables you to ask the right questions and have the right concerns. I think my knowledge of accounting is an extremely important part of the success I have had as an investor. An accounting background has also given me an increased understanding of whether or not the numbers on a company's financial statement truly reflect the economic reality.

**G&D: The focus of your investing has been to find undervalued, out-of-favor, micro, small, and mid-cap value stocks. How would you describe your strategy?**

BR: Our strategy is to find securities, that when looked at with a long-term horizon, are significantly mispriced by the market. We tend to find these opportunities in companies that are misunderstood or out-of-favor. The 'out-of-favor' category frequently means companies in operating or financial distress. Of course, this strategy comes with its own risks. Like many value investors, we are sometimes 'too early'. Over the years though, some of our most successful investments were the result of finding undervalued companies and accumulating a position, only to see them get cheaper – occasionally a whole lot cheaper. That happens more frequently than I would prefer, but we invest in a company when we believe its share price has become attractive

relative to its valuation. We accept that the stock may continue to trade lower. This can happen for a multitude of reasons. Sometimes fundamentals deteriorate, in which case we need to reassess our view of the business value. At other times, the markets overreact, providing a dramatic investment opportunity.

**G&D: Do you have any examples?**

BR: One business that we think meets those parameters today is Builders FirstSource. It is a supplier / distributor to the homebuilding industry. As you might imagine, the company has been losing money consistently since 2007. In 2005-2006 it generated \$2.3 billion in revenue; last year sales fell below \$700 million. It has lost money over the last couple of years, but that's been mitigated somewhat because working capital has come down dramatically, since they need to hold a whole lot less inventory as they sell to homebuilders. In addition, they received a sizeable tax refund last year which was the result of being able to carry back losses for 5 years.

**G&D: How about valuation?**

BR: The stock trades at about \$2.00 per share and there are 96 million shares outstanding. It's got \$100 million in cash, and \$160 million in debt, so plenty of cash on the balance sheet. That being said, they burned through another \$35 million in cash over the past twelve months, net of a tax refund, which is concerning. Still, I think the company as it exists today can generate \$1.5-\$2.3 billion in revenues, when you build 1 million to 1.5 million homes in America. In that case it can generate \$100-200 million in EBITDA compared to an enterprise value today of roughly \$250 million.

Of course we don't know when homebuilding is going to go back to 1 million to 1.5 million homes, but at some point it will do that on a normalized basis. In the meantime, there is enough cash to get the company through these tough times. In addition, the long-term trend in the industry is for continued consolidation. Builders FirstSource has grown through acquisition, and the industry is still very fragmented, which shows that when things eventually stabilize, they have the ability to go out and make more acquisitions to augment the cyclical rebound we would anticipate in this business. As I mentioned, with its current footprint, the business can probably generate \$2.3 billion in revenues, when homebuilding gets back to 1.5 million new homes, but the footprint is probably going to become larger. We think that the earnings potential of the business should imply a stock price that is significantly higher than it is today.

**G&D: Do you think that a company in this situation should be making acquisitions with its excess cash flow?**

BR: It's difficult to execute an acquisition strategy today. This is a very regional business and there can be multiple competitors in each region. If a certain region has only a few competitors, then they are probably operating at just over break-even. In these markets it might make sense. But if there are multiple competitors in the same regional market, then they are all probably losing money. In this environment, it would be difficult to create enough synergies through acquisition to turn operations profitable. You can't just take two players in a region that are losing money and combine them to make a profitable business.

Instead, management should try to winnow down the business to lose as little money as possible, while exiting as few markets as possible, because once you leave a market it is very difficult to get back in. It's a difficult process, and that's why they're still burning cash today. A year ago, Builders could have decided to exit certain regions. They wouldn't have lost as much money, but they would be permanently out of those markets. At the end of the day, we have to believe that management will make some adjustments to continue to minimize cash losses so that the cash they have available will give them the ability to weather the storm.

**G&D: Who does Builders FirstSource compete against? Is it Lowe's and Home Depot, or is it the wholesaler?**

BR: Builders sells directly to homebuilders themselves, not to the do-it-yourselfers, home remodelers, or small contractors that Lowe's and Home Depot focus on. There is one national firm, ProBuild, which is much larger than Builders and at least 3 other super-regional firms including BMC Select, Stock Building Supply, and Lumber 84. There are also many small regional competitors. None of these competitors are public companies. Two of the super regional competitors, BMC Select and Stock Building Supply, went through bankruptcy reorganizations in 2009. Stock Building Supply was a wholly-owned subsidiary of Wolseley, the British company. Gores Capital helped to recapitalize the company in 2009 and now controls it. ProBuild is a private company controlled by the Johnson Family of Fidelity.

Longer-term, the larger players will continue to grow their share as the larger homebuilders have become an even bigger percentage of overall homebuilding. To a certain extent, the national build-

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ers will prefer suppliers who can handle their business on a national level. Larger distributors also have volume-buying advantages. Even if this is all passed on to their customers, which is the case in today's competitive landscape, it will still make them more attractive to do business with as they will be able to sell at lower costs. In better times, these larger distributors will have opportunities to keep some of these volume pricing advantages as incremental margin.

Another valuable service these suppliers provide to homebuilders is component assemblies, such as roof trusses, floor trusses, wall panels, etc. Homebuilders continue to outsource component assembly as there are clear advantages over doing it themselves. We think that Builders FirstSource performs a very important service to the homebuilder for which they will be profitably paid in a normal homebuilding environment. It's just that the entire industry has been decimated over the last few years, and no one knows exactly when it will recover.

**G&D: Are you concerned with timing and catalysts? Is that part of your process?**

BR: In many situations, including turnarounds such as these, the timing is inevitably a significant unknown. However, I think we can all agree that when a catalyst manifests itself, that uncertainty dissipates, which will lead to a repricing of the security. For example, a pickup in homebuilding will undoubtedly lead to a repricing of Builders shares. However, we don't require that a catalyst be known before we begin investing as long as we believe that the conditions are right for stabilization, that the financial condition of the company provides it with staying power, and that the valuation is extremely discounted.

I have always believed that the existence of a catalyst creates its own risks. Unless you are the first one to identify the catalyst, you are probably paying some premium for the probability that catalyst will occur. You are paying a reduced discount. As with most situations, there are trade-offs. If a catalyst doesn't work out, you pay the price for that. That means there's additional risk in the stock price.

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**G&D: You have been successful with investing in special situations. Are there any situations that attract you in general?**

BR: Our strategy is to buy undervalued securities that are mispriced by the market. So, we are generally attracted to the classic special situations like significant share repurchases, spin-offs, and rights offerings. We are particularly fond of rights offerings, especially when one of the companies we know well is involved. The externalities of a rights offering, overlaid on a company that you know well creates a powerful combination.

Our largest holding is Subsea 7 (formerly Acergy, formerly Stolt Offshore). I'm going to refer to the company as Acergy to differentiate from Subsea 7, which is historically a separate company that merged with Acergy just this year. We have been shareholders since the mid-1990's. As such, we have a deep knowledge of the company and its business. In 2004, the company ended a period of operational and financial restructuring with a rights offering. We used that opportunity to significantly add to our holding.

**G&D: What does the company do?**

BR: They do deepwater installation of sub-sea equipment for the oil and gas industry. Acergy's specialty is installing equipment 3,000-5,000 feet underwater. As you might imagine, there is a technological complexity to the business. In addition to specialized equipment and process experience that is necessary, the engineering skill required is dramatic. We believe the combination of technology, equipment, and experience provides Acergy with a competitive advantage and forms high barriers to entry. We think this is an aspect that investors don't necessarily appreciate. Historically, four companies have done the vast majority of deepwater installations, and then on January 7, 2011, Acergy merged with Subsea 7. Today, Acergy has the largest fleet and in many markets is the top competitor.

**G&D: How did the merger affect market share within the industry?**

BR: I think it was positive for everyone, especially Subsea 7 / Acergy. The combination of fleets provides opportunities for efficiencies on contract executions. This is very promising for margin improvement. Each geography around the world is its own market, and prior to the merger, Acergy and Subsea 7 were top competitors in different markets. Of course, we think the Macondo disaster in the U.S. Gulf of Mexico will complicate matters for new entrants into the business. Any major oil company will only want to work

with a company that has significant experience with installations in 5,000 feet of water. At that depth, if you have a leak, you have a problem. Experience and safety records will strengthen the incumbent's competitive advantage.

**G&D: Why do you like the business?**

BR: The addressable market is growing significantly. Deep water finds are not only the largest, but also the most economic. The size of the average field is 2 billion barrels. You end up with a fully-developed cost of \$5-6 a barrel. Today, there are four deep-water provinces in the world: West Africa, Brazil, Gulf of Mexico, and the North Sea. I think in 10 years, there could be 15 deep-water provinces in the world. For example, today there is significant activity off the east coast of Africa, including discoveries off Mozambique. Activity off the West Coast of Africa continues to expand beyond the primary market of Nigeria and Angola to Ghana, Sierra Leone, and Mauritania. It looks as if the entire West Coast of Africa may be prospective. There has also been development off the coast of Australia, Malaysia, China, and India.

As with the activity off Mozambique, natural gas discoveries have now become economically viable in deep water too. The viability of natural gas as an economic hydrocarbon is a dramatic development for deepwater activity. Seismic and other exploration tools can identify structures that are hydrocarbon-prone, but you still need to drill a well into the structure to find out if it fact actually contains hydrocarbons. Until recently, the only economic hydrocarbon in deepwater was oil. Now natural gas discoveries can also be economic which will only encourage future explorations. The additional exploration should inevitably lead to discoveries that will need to be developed. We think the growth of deep water development will be dramatic, and this company is extremely well positioned to benefit from that trend.

In 2001, Acergy acquired a competitor operating in West Africa. That acquisition proved to be life-threatening as some of the contracts this company had were bid at very aggressive rates. Those contracts were further complicated by problems associated with supply procurement executed by their international oil company customer, Shell, in Nigeria. As if not challenged enough, Acergy experienced technical difficulties that can be associated with such deepwater projects. So, in 2002 – 2003, the company ran into financial trouble that required a comprehensive restructuring.

**G&D: How did the company get back on their feet? What did you see that made you believe the reward for participating in the rights offering was worth the risk?**

BR: During the period of financial trouble, a new management team was brought in including a new CEO, Tom Ehret, who had been the CEO at industry leader Technip. They raised institutional capital a couple of times. They also went back to Shell to negotiate compensation for the issues with Shell's procurement. I believe Shell appreciated the need to ensure that viable, competent contractors were a necessary component of their deepwater installations.

Keep in mind that Shell had its own issues. Around the same time, Shell had announced that it was eliminating 30% of its worldwide reserves! It acknowledged that almost 1/3 of its total reserves were not economically viable. I believe then, as now, the major oil companies are in denial. Replacing their reserve base is extremely problematic. They didn't want to acknowledge that they are (slowly) liquidating. Instead, the major oil companies are determined to show that they were growing their reserves and deepwater development is critical to any hope of success.

This is an important backdrop to Acergy's industry – the major oil producers, like Shell, needed Acergy and its competitors to execute deepwater projects. At the same time, the industry was consolidating. The confluence of events led to fundamental changes in contract terms. Conditions shifted from favoring the operator of the field to favoring the contractors that installed the subsea equipment. This marked a period of continual margin improvement now clearly visible, even if it was temporarily moderated by the 2008-2009 world financial crises.

One impact of these changes is that today this is a negative working capital business. The business is almost entirely funded from operations, because of the prepayment terms of their contracts from the likes of Shell, Exxon Mobil and Total to do the work. That was another signal of the strengthening position these contractors had with their customers. We don't envision that changing, given the dramatic increase in development contracts we expect to be awarded.

Getting back to the rights offering - in May 2004, the company was in the late stages of a financial turnaround when the company did a public rights offering. As a result of their listing on the Oslo exchange, Acergy was required to offer shareholders same financing terms that they had offered to institutions in previous financings.

The rights offering was priced at \$2.20 per share. Pro forma for

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the rights offering, Acergy would have no net debt. So this company, that just a year ago was teetering financially, had now restructured and paid off all of their debt through capital raising activities.

With this one last financing activity, public investors could get a free ride after the majority of capital had already been raised. So after the offering, an investor was getting a chance to invest in a \$440 million market-cap company with no net debt, \$1.2 billion in revenue, and which two years prior was generating a 15% EBITDA margin. The replacement value of the equipment was in excess of \$400 million. We thought that the industry could get back to where it was in terms of margins. We believed this company could do even more than \$1.2 billion in revenues. Even with \$1.2 billion in revenues, and 15% EBITDA margins, the company could generate \$180 million in EBITDA, while it was being valued at only \$440 million.

So to go back to the question about what why we thought the risk/reward equation was asymmetrical: the answer is that participating in the rights offering had been largely ‘de-risked’. By the time of the offering, the balance sheet had been repaired and the management strengthened. Even more important, the valuation was predicated on the price level the prior year, when the company’s position was precarious. This is one of the positives of a rights offering – they are determined based on the market price of a company’s stock, not on an estimate of its intrinsic value. A rights offering can also provide an opportunity to invest substantial capital both through the offering and in the open market. Specifically, in the case of Acergy, we fully subscribed, oversubscribed 100% and bought heavily in the open market. All in, we quintupled our position.

**G&D: Do you frequently look for rights offerings?**

BR: Rights offerings are definitely one of the things that we look for. As I mentioned, the price is set by the offering price level, not a company’s intrinsic value. Occasionally, as

was the case with Acergy, the disparity is great. One factor we look to see is if there are insiders who participate in the rights offering. Insiders probably know more about the long-term prospects of the company than the market does. In addition, the capital a company raises will often fundamentally change the financial viability of the business itself. There are all these fundamentally positive things about rights offerings, and the value you get compared to price can be much higher than the price because of the dynamics of the rights offerings.

**G&D: The most grueling part of investing is often just generating the idea – how do you go about it?**

BR: There are eight of us here who generate ideas. There’s a plethora of names that are always coming to us, and a number the analysts have been doing this as long as I have. Each analyst has refined their own process. The process of stock selection is an art. The most important thing for people is to be motivated and passionate about what they do. I give broad discretion to the analysts to go out and find what they want to find, develop an idea, and tell me why their ideas make sense. I also want them to share it with not just me, but with the other analysts here as well, to leverage each other’s thinking and experience. The combination of passion, talent, and experience allows us to keep the ideas flowing. We have an open door policy, no formal investment committee process.

**G&D: Could you walk us through another investment you have made?**

BR: Another great company case study from a valuation standpoint is NewMarket. Today it is down to less than 3% of our portfolio. One of our analysts found the name because the company had bought back 30% of their stock in 1997 at roughly \$46 per share (after adjusting for a 1-for-5 split). What was even more interesting was that the Gottwald family, who controlled the company, did not tender their family shares. The Gottwalds had a long successful history of making money. A year later, the stock was at \$35 per share, which is when we began buying.

NewMarket at the time was Ethyl Corporation. The Gottwald family controls NewMarket and I think their history of capital allocation is important. In 1962, the Gottwalds controlled Albermarle Paper Manufacturing Co., which borrowed \$200 million to purchase Ethyl Corp. Ethyl was a 50/50 JV between GM and ESSO and was 13x the size of Albermarle. “Jonah Swallows the Whale,” the headline read. Ethyl made petroleum additives, including an additive for leaded gasoline which was in decline, because leaded gasoline was on its way out. They paid a modest price to

buy a business from two institutions that did not want to own a sunset product and leveraged up to do that. Over the years, Ethyl generated huge amount of cash to pay down debt and diversified into many other business. Then starting in 1989 they began restructuring, and spun off Tredegar, then First Colony and finally in 1999 its non-petroleum additive chemical business into Albermarle.

These spin-offs were another thing that attracted our interest. We figured, if someone is spinning off pieces like that, it is a clear indicator that they are concerned about shareholder value. Two or three years after spinning off First Colony, they sold it to GE, which was a very tax-efficient thing to do. Shareholders paid capital gains tax on the sale to GE but avoided the double taxation had Ethyl sold directly to GE. This increased our conviction that the Gottwalds really thought about shareholder value. By the time of our first purchase, the stock was trading at a discount to where the company repurchased their own shares.

The additives business for fuel, oil, and lubricants was a consolidating, mature business. From 1992 – 1996, NewMarket bought out Texaco's and Amaco's additives businesses, helping consolidate the industry down to just 4 players. Then they looked around and didn't see any other acquisition opportunities, so they leveraged up.

#### G&D: How levered was it?

BR: At peak, they had \$650 million in debt or well above 3x trailing debt-to-EBITDA. They figured that they would continue to generate a lot of cash.

Unfortunately, the U.S. economy weakened, Asia had troubles, and the phase out of leaded gasoline accelerated. One of NewMarket's competitors Oronite, a division of Chevron, built a new facility, because it was growing in Asia. That brought on more capacity and the supply and demand equation fell out of balance.

The largest company in the business was Lubrizol, which is a publicly traded company with 35% market share. Lubrizol was telling its investors that it was going to be able to grow its top line organically. Well, in a mature business where there was no growth, especially one that was going through such a consolidation phase, you could not execute a growth plan successfully. It became much more competitive and the margins were really compressed. At the same time, their customers, such as Quaker State and Pennzoil merged. Now, the customer was coming back saying that whoever had the lowest price would get the business.

#### G&D: What happened with the business?

BR: We were convinced that the Gottwald family would not let this business go. After all of the spinoffs, different family members were each running different businesses. Part of that decision was probably for family unity purposes. What often happens when you have a third-generation family business is that all the members end up fighting over control. The family tears itself apart and the company usually ends up getting sold. The Gottwalds said, instead, we'll split the company and different people will run different pieces.

I had this vision that every time they got together for Thanksgiving, all the family members would tell Bruce Gottwald, one of the family patriarchs who was running Ethyl, "Bruce, look at all the money we're losing in Ethyl." Bruce was not going to let this thing go under, because Bruce's personal reputation was tied to this company, and he did not want to come to Thanksgiving dinner saying that he had filed for bankruptcy.

They did things to make sure the Company would survive. In 2002, the stock got down to less than \$4. At the time it had 17 million shares outstanding. That was less than a \$70 million dollar market cap for a company that was generating \$650 - \$700 million in revenues. Debt had been paid down to \$300 million and the stock was trading for roughly 1.5x trailing free cash flow. There were only four competitors in the industry. You weren't paying anything for the business at what was a low-point of a cycle.

#### G&D: What made you think the industry would figure out a way to generate a rate of return that was worth the cost of capital?

BR: Well, there sure was no catalyst in place, but we thought the valuation was extremely cheap. Although EBITDA was less than half of where it was in 1997 at \$90 million, debt had been paid down to \$300 million, which we thought was manageable. We also had faith in the Gottwalds when we bought more, based on their level of high insider ownership (close to a third of the company). They weren't going to let this thing go. It was a core supplier in the business. We also believed that as a result of the industry consolidation to just 4 players, the business would be able to generate returns that were much higher than the level at that time. Three years later, in the spring of 2005, the stock had rebounded to \$15 per share.

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But that's when the best risk/reward appeared. Lubrizol, their main competitor, went out and bought a company that made chemical additives for hair care products. That business was growing 6-7% a year.

With that, Lubrizol decided to run the petroleum additives business for cash as it acknowledged this was a mature business. They shut down a plant, raised prices, decided to get a return on the assets, expanded margins and turned away business if they could not make money. You had the pricing leader in the business suddenly saying that they were going to be running things differently. But what proceeded to happen was that the earnings did not go anywhere, because oil prices went up significantly, and oil and derivative petrochemicals are the raw materials that go to make NewMarket's product. The costs kept going up, but so did the industry's selling prices - just not soon enough. You would see the margins contract due to rising costs, but then turn around and expand due to the pricing discipline within the industry. Eventually, you know that the reason margins expand is because the supply/demand fundamentals are allowing that to happen. The industry had gotten pricing discipline. At some point, the raw materials are going to stop going up and the margins are going to expand. You could see that the earnings were going to go up.

I did a model on the company and gave it to the CFO, saying that they should generate \$4 a share in annual cash. Now, some of it was because of the excess depreciation from buying and consolidating all those companies, and because they don't need to put anywhere near the amount of money back into the business. He said "from your lips to God's ears." The stock was trading at \$15, less than 4x that free cash flow estimate, with margins likely to expand significantly. We bought more and also encouraged the company to repurchase shares. Since then, the Company has bought back stock, which I also think has been a positive. Companies can often be stubborn about buying back their own shares. Luckily that wasn't the case with NewMarket.

**G&D:** It is interesting though, how often companies don't buy back their own stock when the stock is undervalued.

**BR:** There are many different reasons. One reason is that boards and management are afraid that a buyback will result in less available float which might prevent institutions from buying the stock. In the meantime, the important metrics are the earnings per share and the value per share, and clearly buying back shares for less than what they are worth increases the earnings potential and value of the business. Over time, the market will inevitably recognize that economic reality. If the right conditions exist, this is

how you create value with a really low risk basis.

**G&D:** Getting back to NewMarket, how did the story end?

**BR:** It was a great buy back then, yet nobody wanted to own it. The only people that wanted to own it were people like me who had owned it for five years, and had probably lost money in the interim. It turns out that I was wrong about the earnings estimate of this company. I thought it could generate \$4 in cash annually. Today, the company earns roughly \$3 per share quarterly, or \$12 per share annually. It's a \$120 stock.

Now, you have this industry, with four competitors who are competing in an intelligent way, making very high returns. Lubrizol has no interest in changing that dynamic. There's some growth in the business. It looks like a fundamentally different business today, yet it is the same business that it was in 1998, same business as in 2003, with vastly different valuations, and vastly different financials.

**G&D:** What kind of returns are they reaping at \$12 of earnings per year? Is it attractive for other people to enter?

**BR:** The business is a low growth / no growth, mature business. Four companies dominate the business. There are barriers to entry and there is still some opportunity. The real opportunity for NewMarket is still a consolidation play, because Lubrizol is the biggest player with 35% market share. NewMarket has less than 20% market share. One of the companies in the middle is Infineum, which is a joint venture between Shell and Exxon, and from time to time, each probably thinks maybe they should get out of the joint venture. The fourth competitor is Oronite, which is a wholly-owned subsidiary of Chevron. Six years ago or so, Chevron took the rest of their chemical businesses and merged them with Conoco Phillips because there were some efficiencies that could be realized. With this additives business, there were no efficiencies, so it stands on its own.

The logical thing for one of these guys is to say, why am I in

***"Our buy decisions are always predicated on valuation more than anything else. The sell decisions are a little bit different, though, because we do have more history and knowledge of the company, so there are more qualitative factors that come into play."***

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this business? Should I get out of it? I can't sell it to Lubrizol because of anti-trust issues, and Infinium may also be too big. The only buyer in town is NewMarket because it is the smallest. And if they sell to NewMarket, and take back part cash, part stock, the synergies of putting these two companies together could be really dramatic. The opportunity to execute that last piece of the consolidation is a real opportunity that sits out there and makes us labor to make a decision about what to do with the stock. Today, it trades at a reasonable multiple of earnings, close to 10x, and the prospects are reasonable. The family is out there thinking about how to create value, but it's not cheap anymore. The business is clearly firing on all cylinders today, and we don't see that that is necessarily going to change, but things happen and people did not anticipate what would happen to the business in 1998.

**G&D:** How do you think about selling or trimming down a position like that in the context of your portfolio?

BR: Our buy decisions are always predicated on valuation more than anything else. The sell decisions are a little bit different, though, because we do have more history and knowledge of the company, so there are more qualitative factors that come into play. Who are the people running the business? What do we think of them? We realize that is clearly one of the more important components of valuing businesses. What is the value of the management and their capability to reinvest capital? What are the opportunities to reinvest in the business? Those are important things to assess in addition to the valuation. The longer you own the company, the better sense you have about management's thinking process and capabilities.

Going back to Subsea 7, although it is the biggest position we currently hold, it clearly does not have a discounted valuation today. The stock today is trading at \$25 per share, and the company will earn somewhere between a \$1.00 - 1.20 a share, so it is trading clearly at a high multiple of earnings. It has a relatively modest book value, so from all of the standard Ben Graham valuation methodologies, it's a pretty rich price. But one of the most important things that happened with the merger is that Kristian Siem, who used to own 40% of Subsea 7, now owns 20% of the combined company. The concern we always had about Acergy was

that the board did not own any stock. We had gone public with that concern, among others by writing a letter to the board and sharing our view with all owners of the business. We had complained about some of the decisions they have made which we believe might have been different had they thought like owners. We think the best way to think like an owner, is to be an owner. We have been activists with Acergy, pushing them to do things including implementing a mandatory board director share ownership policy for the company.

In 2008, when the world was at peril, this company had \$300 million in net cash on the balance sheet and it got down to an \$800 million market cap. We thought that the peripheral assets alone were worth \$800 million, including the \$300 million net cash, so we thought buying stock made all the sense in the world. The customers of the company were major international oil companies. Even if the world went into a financial collapse, which I think it was at risk of doing then, those customers would still be in business. Clearly, the market's valuation was very wrong and the balance sheet gave the company the flexibility of doing repurchases. There was an opportunity to significantly increase shareholder value.

**G&D:** What about today?

BR: Today, I don't have that concern, because suddenly you have this guy, Kristian Siem, thinking about shareholder value and how to create it. Based on my understanding and conviction about the business, I think the top line of this business will more than double over the next five years, and the margins will expand. There are only three major companies in the space and there are huge barriers to entry. They have land-based engineers in addition to equipment, who are working on extremely complicated projects that get even more complicated over time, so all of those things have created barriers to entry in a business that is not overly capital intensive. For example, from 2004-2008 revenues more than doubled, the number of shares came down a little bit, maybe 10 million shares. The company went from having zero net debt to having \$400 net cash on the balance sheet by the end of 2009. They doubled the size of the business, financed it internally, and did not issue shares or take on debt in the process. I think these are attractive attributes, and now you also have the efficiencies from having two different fleets and not having to move equipment nearly as much, getting higher utilizations which will

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also benefit margins. We own a stock today that is not a Ben Graham value stock, but our conviction level about what the earnings look like and what the growth of those earnings are lead us to conclude that it is still an attractively valued investment.

Needless to say, we own shares in all of the companies I mentioned and over 1% of the outstanding shares of each one.

**G&D:** Can you discuss what prompted you to start investing abroad after spending over two decades investing primarily in the U.S.?

**BR:** Historically, we have primarily invested in the U.S. and Canada. Five years ago, one of my analysts, Isaac Schwartz, came to me and insisted we should be investing in Asia. His argument was simple. Today, there are a lot more people practicing value investing in the U.S. than when I started, so there is less inefficiency in the market, and finding undervalued securities can be more difficult. Value investing isn't something that is practiced in much of the developing world, and in Asia it clearly makes sense to pursue our approach. Isaac traveled to Asia for an extended period of time and returned convinced that the opportunities were significant. So, in 2006, I went with him to Bangkok. I was thinking to myself, I can't even speak English very well, let alone speak or read a foreign language. But I just couldn't ignore Isaac's enthusiasm and conviction.

I didn't think this was something we would have the capability of doing. As it turns out, Thailand was a great place to go to, because the management teams of even the small-cap companies are conversant in English. The financials are all translated into English. There is frequently additional information that is not available in the U.S. For example, companies with multiple businesses often provide both consolidated financials as well as operating company financials. You can then disaggregate the companies, look at the individual accounts, and manipulate the data to get a lot more information and a better understanding of the different businesses. At the time of our visit, in Thailand, many stocks traded for high single-digit P/E ratios and 8-10% yields while the government bond was yielding 6% - 7%, so it was a pretty straightforward opportunity. Gee, the company has no debt, there is cash on the balance sheet, and earnings are positive. Some of these companies have been public for 20 years. It's not like they have been public for 3 years, which makes it easier for management to manipulate the earnings. I said to myself, "I get it. It is easier to find bargains in Thailand than it is in the U.S."

Now Isaac lives in Hong Kong and manages our Asian investments with me. He spends all his time visiting with companies and doing primary research on current and potential investments throughout Asia. I join him several times a year, meeting with the managers of our current holdings, as well as candidates for investment.

**G&D:** Is there a particular country you are focused on?

**BR:** Our focus is entirely on bottom-up research, so the short answer is 'no'. Instead, we search for undervalued investment opportunities wherever we can find them. Isaac and I have visited companies in 11 different countries around Asia since the beginning of 2006. Isaac has actually been to even more countries in search of opportunities. Today, the majority of the capital is invested in Southeast Asian countries, with less than 10% invested in Thailand. More recently we have visited a number of Central Asian countries, and investments in Kazakhstan and Mongolia are now 2 of our top 10 holdings.

We believe there are two key advantages to investing in Asia. First, the Asian markets are fundamentally different than the U.S. markets. We think those differences result in Mr. Market being much more manic-depressive. There is a lot of money in U.S. markets from endowments, pensions, and individuals that will always be invested in equities. This permanent capital leads to less volatility. Wealth overseas is still not invested in equities, or if it is, it's invested in speculative capital, not investment capital. The institutional capital invested in equities in these markets is most frequently from foreign investors. As a result, the capital flows in and out depending on whether or not foreigners want to be in that country. All of that capital movement translates into higher volatility in prices. If you are a disciplined investor

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who understands the difference between the price of a security and its intrinsic value, you can often find a large disparity between what these companies are trading at and what they are really worth. In addition, the multiples at which the premier companies trade is very pronounced from the valuations at which the vast majority of the public companies trade at.

The other advantage to investing in Asia is the obvious one: that over the next 10 years, most emerging markets will grow and likely grow faster than the U.S. markets. The world is flattening and the relative growth in Asian economies should be measurably greater than the growth of the U.S. economy, even if the U.S. is due for some catch-up at this stage of the world recovery.

**G&D: How do you handle currency risk?**

BR: As a matter of policy, we generally don't hedge on any of the currencies. Hedging is a process in itself that requires time and attention. We prefer to focus our time on company specific research. That decision is made much simpler since we also believe that the long-term outlook for most emerging market currencies is positive vs. the U.S. dollar. We think the axiom noted by much smarter investors tends to apply here as well. We would much rather end up with a bumpy 15% return instead of a smooth 10% return. We're going to be in these markets ten-plus years from now. Not hedging should add extra return over time, and it makes all the sense in the world.

**G&D: What reservations do you have about investing in these countries?**

BR: One issue that comes up regularly is whether foreign markets have weaker corporate governance and a litany of related issues. Having been an investor in the U.S. for 30 years, we have often invested in companies that are undervalued because there may be a controlling shareholder, and maybe that controlling shareholder 'forgets' that there are other shareholders. We've been involved in well over 20 class-action lawsuits in the US where we've been the main plaintiff because we believe that the company effectively disadvantaged its outside shareholders. The particulars of such a situation are frequently difficult to get a judge to understand.

We have had some success in litigation, but there are other situations where someone has done something clearly egregious and wrong, and we haven't been successful in court. Management and/or boards can and do destroy shareholder value, whether it is intentional or whether it's a misunderstanding of what shareholder value is. In America, it happens all the time, so it's not like it's something new to us just because we are investing in Asia. There are valid concerns about corporate governance. You just have to be on the lookout for the same warning signs that you have to look for in the U.S.

**G&D: Some investors won't get involved with corporate governance issues because they believe it is not worth their time. How do you justify the effort it takes to pursue governance issues, and do you think it is a good return on that time?**

BR: Like I said, there are times that we've been extremely successful, and it has been a good use of our time and capital, but there are many cases where it does not create a productive end result. Even when the facts are on our side, we are often unsuccessful, which is all the more frustrating. The fact of the matter is, we are long-term shareholders, and as such, we believe it is our obligation to advocate what we believe is right.

**G&D: Thank you very much, Mr. Robotti.**

*The commentary represents the opinion of Robert E. Robotti as of 2/4/2011 and is subject to change based on market and other conditions. The opinions expressed are not necessarily those of the firm. These materials are provided for informational purpose only. These opinions are not intended to be a forecast of future events, a guarantee of future results, or investment advice. Any statistics contained here have been obtained from sources believed to be reliable, but the accuracy of this information cannot be guaranteed. The views expressed herein may change at any time subsequent to the date of issue hereof. The information provided is not to be construed as a recommendation or an offer to buy or sell or the solicitation of an offer to buy or sell any fund or security.*

