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Takeaways from Best Ideas Omaha 2018

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Bob Robotti at Best Ideas Omaha 2018

Bob Robotti serves as President of Robotti & Company Advisors, LLC. The following is an edited transcript of Bob's remarks at Best Ideas Omaha 2018. The transcript may contain errors.

First of all, I want to say it's great to be able to co-host this event with MOI Global. We have great respect for MOI Global. We think it's a great network. Its community is composed of thoughtful investors, value-oriented investors who view investments through a different lens from each other and therefore often totally disagree on what things they want to own in their portfolios ensuring a critical and thoughtful debate on this art.

Robotti & Company has much in common. It's a nurturing environment. Derived by our focus on the client's success, including investments in funds or separate accounts or whether that's our broker-dealer clients which many of you in the audience are today. Something we are trying to do across the firm is providing great ideas that help clients produce outsized returns.

Forty-four years ago, I fell into value investing. I was auditing Tweedy Browne and Gabelli & Company. Today of course both icons in value investing but back then they were just budding asset managers who had great processes that of course ensured their eventual success. It was love at first sight for me, so I started our flagship fund while I was at Gabelli almost 35 years ago which I still manage today.

The key tenets of the business are: First, markets are inefficient. They have an inefficiency called humans, and stock picking is the tool we apply to provide out performance for clients. At least that's true for the time being; computers haven't displaced us yet.

The structure of the firm: I did what most people do when they're starting a business. I copied the successful people I knew and that is Tweedy and Gabelli. Both of those have two parts of their business; the broker-dealer business that eventually morphed into an asset management business.

We mainly look in places that are going through difficulty and that therefore have an increased likelihood of being misunderstood and potentially, mispriced securities. The focus of the firm is a three-to-five year time horizon. We're not deterred by the ways of the market, but rather do our own work to meet our own conclusions. The important component of the firm I believe is its culture - it's a very collaborative place and it's really an important differentiator.

At Robotti Securities, LLC (our broker-dealer entity) if you talk to the people there, they really define the smart and thoughtful investor, not a broker. There's a strong track record that demonstrates that trend for people who work for us over the years. Many of them today are successful managers who were part of the process and were helpful in the two-way mutually beneficial evolution. They are pushing me to think about things and do things that I wouldn't otherwise have thought about. That collaborative process is really important across the firm.

Assessing the report card of the firm, I think we've done reasonably well. In the last 30 years, our flagship fund has compounded at 14.3% net. So, 400 basis points per year better than the Russell 2000 and the S&P 500. That's in spite of the fact that in the last five years I've underperformed the Russell by 200 basis points and the S&P by 500 basis points.

But as I said, much broader than that, there are six successful asset management businesses that started within the firm and the environment of the firm who are truly successful today. One of them is our global fund which also has a track record of outperformance. How many 34-year-olds can say they started the fund at the beginning of the financial crisis and 11 years later have a record of outperformance?

In addition, another aspect of the firm is the collaborative process in both parts of the businesses and the relationship we have with Curtis Jensen who is a nineteen year veteran of Third Avenue; its Chief Investment Officer for many years. He was looking for a place to be in the future and decided to join us two years ago and is running his own fund. We think just being part of the firm is hugely positive for both of us. That exchange of information and ideas is the key tenant of the Manual of Ideas and Robotti & Company. So, we thank those of you who are part of our client network already and we welcome those of you who are not to join us soon.

I'll start off with the first idea. The stock I'm going to talk about is consistent with our firm's investment approach. What we do is we look for securities that we think are significantly undervalued. So, the way we look, and especially in today's world, we think cyclicality is a great place to look for discounted investments. People say you want to stay away from cyclical businesses, they want to stay away from commodities and think there's a lot of investment in better businesses. Well, we think there are a lot of opportunities in cyclical businesses, which is really the focus of what we found through the years. One of the things in cyclical businesses, there's an opportunity with the cycle of the business and capital allocation at good, opportune points in the cycle. Capital comes in, competitors come in the marketplace, margins decline, times are difficult, companies have leveraged balance sheets, go through a hard process with the wrong business, the competitive landscape changes and then the process starts all over again. Well, in cyclical commodity business, we think that timeline, that process, of course is accelerated and accentuated. So, therefore, can create great opportunity.

So, we're not just looking to invest in cyclical business at the bottom of the cycle, we are looking to identify better businesses in that process. Therefore, if a company has a combination of things in terms of differentiation in technology of the business and also capital allocators (because capital allocation in the cyclical business is extremely important), and is accentuated in a business that has good growth to it, it could make for a very worthwhile investment. Capital allocation is potentially as incrementally an advantage if you can deploy capital to the business at the bottom of the cycle that's hugely effective in increasing the earnings power of the business.

So, the stock I'm going to talk about today is Subsea 7. So, we've been invested in the predecessor companies for 25 years. Subsea 7 trades around $14 per share. On the Oslo Stock Exchange that's equivalent to NOK 113. It has a market capital of $4.8 billion. Today, it probably has almost $1 billion in cash and, while having gone through a really difficult period, the oil service businesses of course had been declining since oil prices broke in 2014.

So, we have a company with an enterprise value of $4 billion which has tangible assets of $3.2 billion. Last year, it generated, I think about $800 million in free past cash flow for that business. So, this business generates 20% of return on capital at a low point in the cycle.

So, that's an indication of a business with a barrier to entry. People don't think of it that way but even in cyclical businesses there are companies and managements running those businesses that will differentiate themselves from their competitors. If you can identify a differentiated business that often becomes apparent in the dynamic of the competitive landscape during the downturn. Subsea 7 has gotten much bigger and increased its footprint to capture future increased earnings when activity levels return, while many of its competitors fell by the wayside. A handful of competitors have gone away. That includes Oak Tree's backed company… which went to zero and got wiped out. Another one is a Goldman Sachs backed company called Ceona which tried to compete with Subsea 7 and its experience and track record and was wiped out also. So, smart people got into the business five years ago thinking this business has interesting dynamics to it. It didn't have the ability because they don't have the engineering and project/risk management capabilities nor the track record to operate these inherently technically complex projects.

It has also happened in the downturn. In spite of what people tell you, about a year and a half ago onshore oil shale was the incremental low-cost provider, which we think is not the case. For example, lots of invested capital flowed into onshore. We've seen cases where you could buy an asset for a third of replacement value and a year and a half later sold it for two times of replacement value. So, craziness happened onshore and if people wanted to go long, they would pick one of the onshore energy players. On the flipside the sentiment has been to shorting all the offshore companies, offshore is dead, not economic, and not part of the value equation. We take a fundamentally very different view through the lens of understanding Subsea 7 very deeply. We're studying all its dynamics of understanding that business with its footprint all around the world and we come to the conclusion that many of the offshore projects are economic closer to $35 or $40, in Norway even as low as the 20s.

So, offshore is definitely part of the equation, and of course we feel that you can also produce for a 20-year period with a tremendously lower decline rate vastly different from onshore where within a year you're at production levels significantly less than it was. So, we think the offshore thesis really makes huge amount of sense. So, we have other investments in that area, but Subsea 7 is one that is emerging. Consider for a moment what they've done in the last year. In 2015, they smartly eliminated the dividend. The stock went down when they eliminated the dividend. People concluded they are in a difficult financial situation. Instead they said no, you have about 1.2% of the company directed to capital allocation. I'm going to reinvest this capital opportunistically in businesses. So, they saved $400 million in dividends last year. They used $100 million to buy one of its competitors EMAS which put them in a new market in the Middle East where they weren't before. They also bought an asset in Mexico they didn't have and they bought out the rest of an installation businesses for offshore windmills.

So, a shrewd management team on top, barriers to entry into the business (visible through its reducing competitive landscape), and extremely low valuation in terms of the future earnings power of the business. During the downturn, the company also took the employee count down from 14,000 to 8,000, and they took the vessel fleet and rationalized it. So, they did a number of great things in terms of operating the business with better control which we think actually will have long-term sustainability even beyond the point of recovery and we think it has probably significantly changed and improved the earnings power of the business. So, that's what we think about the business.

In the meantime, the other thing is there's one other hugely positive asset that's an affirmation of the differentiation of barrier to entry. Three years ago, in 2015, they entered into an alliance with Schlumberger. Technip FMC is the other main competitor in the space. They merged the two companies together while Schlumberger partnered with Subsea 7. More importantly, a few months ago they announced a 50:50 joint venture in the life-of-field business. The life-of-field business is interesting because it's the early intervention, identification, and design of the project, but it's also the 20-year life of production in the field. So, what they really do is they're growing the business that is a recurring revenue stream that has higher margins and predictability to it and they're doing it with the Schlumberger who is the preeminent player in the offshore services business. We actually think this is kind of the engagement process. We wouldn't be surprised at the end of the day, it ends up in a marriage. You did see about six months ago reports in the paper that Subsea had been approached by Baker Hughes GE. I don't think Subsea 7 chairman Christian Siem showed any interest in being part of that organization. That said, being part of Schlumberger is something that would probably interest him if you have a company (Schlumberger) trading at around 15x EBITDA while the other is trading at around 4x EBITDA. We think this cooperation is truly accretive with all of those entities. We also think this is an engagement process and there's a reasonably good chance within the next year that we'll have a really fancy wedding service.

Excerpts of the Q&A session with Bob Robotti:

Q: What's the reason for them going after McDermott?

A: It made all the sense in the world. I'm distressed that the company didn't do that two and a half months ago, when they first announced the potential transaction with Chicago Bridge & Iron. McDermott's probably a Tier-2 competitor, so they are a good competitor, but from a technology point of view, it doesn't have anywhere near the capabilities of both TechnipFMC or Subsea 7. The fact of the matter is they are an aggressive, decently well-run company. Its CEO, Dickson, ran Technip's business. He's done a commendable job for making a reasonable competitor. They've also gone through a couple of alliances that has made them more competitive. There was a contract that they recently won in Mauritania which was a contract Subsea thought they would win.

So, our point of view in favor of: To consolidate in the only remaining Tier-2 competitor would have been hugely positive for the entire industry. To own the Tier-2 competitor in that space and to subsequently therefore be competing with three players for projects as opposed to four. And from McDermott's perspective, they could have been part of the clear #1, there was stock offered out of the box, half cash, half stock. So, the idea that the board didn't engage with Subsea 7 and see what they would get in the process with the prospect of easy integration and the elimination of a competitor in a field where there aren't that many competitors. So, that's huge positive of economics. So, in fact, why they didn't do it is disappointing.

That said, I don't want to complain too much because I used to complain about the people at Atwood Oceanics (now Ensco) which had no core ability to hold any stock. So I met with them, wrote letters to them, pushed them and trying to get a mandatory stock ownership program on the board of directors. I was told by the chairman of the company, if I have stock or not, I will think about the company the exact same way. I said, why don't you buy stock and find out, and maybe look at it differently (for context: the chairman of Subsea 7 Kristian Siem owns near 16% of the company). In the meantime, I called him and said I'm trying to do you a favor, this is 2009, I'm trying get you to buy the stock at a critical low price and you could make a lot of money if you'd listen to me and buy the stock. He did not buy the stock.

Q: I remember looking at the presentation you did on MOI that John sent across. One of the projections that was mentioned there was the earnings or the EBIT or EBITDA will go down over the next few years. Can you talk a little bit about that?

A: I can't tell you anything about that other than I don't know the answer to that. So, the one thing I will say is you cannot figure out the EBITDA of this company because each of these contracts has a lot of different aspects that is further complicated by the fact that when you bid a contract and you get a $400 million reward but a lot of it comes from variation orders beyond the original terms, and it's not a competitive process when you are dealing with variation orders. The variation orders always have some kind of compensation about what gets charged and what doesn't get charged. The expenses all come through the Income Statement. So, at the end of the time, frequently half of the revenues that they get are from the variation orders on contracts.

So even when they bid the contract, they have the stances that they can make money at it, we think we have reasonable margin, we don't know what the variation orders are going to be and a variation was intended to flow based on capital environment outside in a field situation. So, it's really difficult to know. I always laugh when people come up with estimates. So, it's like wild guessing because I don't know what the numbers are, and I think the company probably has a problem in projecting in the beginning of the year. They have senses on where they're going to be or where those contracts will come in. In the meantime, recently, I saw Jefferies (who covers the stock) reduced its price target down dramatically. They said there is lack of visibility on the business. In the meantime, the company is saying two things. They say the backlog has gone up and the revenues in the last quarter have a significant amount of variation orders. So, what they say is these variation orders are not going to the backlog and that revenue all has really high margins in it. So, what they're saying is there's a pickup in variation orders in an environment where the clients' positions also improve. Companies have cash flows, they re-evaluate what they decide to do in the field and then realizing, "If I do spend an extra $100 million at this point, I think I can get 5% of my recovery at the left field for example." That's hugely economic. Therefore, I think there's more and more stuff that continues to happen that translates to more activity in the short-term. So, they're giving some indications. So, I don't think those values, because that's what people said one year and a half ago they said it was only going to be 8% EBITDA, it was in fact 22%. The Street has no ability to estimate the numbers and the numbers generally come much better and the company's very conservative in terms of what they expect numbers to be because it's very difficult for the company to foresee variation orders activity.