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# 8TH ANNUAL NEW YORK VALUE INVESTING CONGRESS

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## BUILDING AN INVESTMENT THESIS

BOB ROBOTTI, ROBOTTI & COMPANY ADVISORS

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# Building an Investment Thesis: A Review of the F(r)acts

VALUE INVESTING CONGRESS  
OCTOBER 2, 2012

**Robert Robotti**

**President & CEO**



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# About Robotti & Company

## History

- Established in 1983 by Robert Robotti.
- Our niche is small-to-mid capitalization equities of misunderstood, neglected, or out-of-favor companies.
- Until 2004, our primary focus was on North American investments.
- In 2005, Isaac Schwartz launched Robotti & Company's international investing initiative, initially focusing on Asia.
- Putting his “boots on the ground,” Isaac moved to Singapore in 2007. He currently resides in Hong Kong.

# About Robotti & Company

## Approach

- The classic value investing tenets, as pioneered by Benjamin Graham, form the foundation of our investment approach.
- We believe that market prices of securities do not necessarily indicate their true economic worth.
- Guided by this philosophy, our analysts research and identify equities selling at significant discounts to their "intrinsic value" and have positively skewed risk-to-reward ratios.

# Three Investment Edges

## Analytical

- Superior/unique analysis of information leads to a different conclusion than the market.

## Behavioral

- The ability to overcome inherent behavioral biases and make rational investment decisions.
- Temperament, Process, Instestinal Fortitude.

## Informational

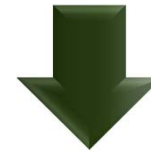
- Superior information not readily understood by the market.
- Multiple data points help to create a mosaic.

# Two Edges Too Many ?

## Professor Bruce Greenwald on Porter's Five Forces – Four Forces Too Many

“We agree with Porter’s view that five forces – Substitutes, Suppliers, Potential Entrants, Buyers, and Competitors within the Industry – can affect the competitive environment. But, unlike Porter and many of his followers, we do not think that those forces are of equal importance. One of them is clearly much more important than the others. It is so dominant that leaders seeking to develop and pursue winning strategies should begin by ignoring the others and focus only on it. That force is *barriers to entry* – the force that underlies Porter’s ‘Potential Entrants’.”

*Competition Demystified*, Bruce Greenwald and Judd Kahn



- We believe that a similar concept applies to investment edges.
- Analytical or informational edges *can* lead to superior investment results, but we believe that a behavioral edge – maintaining the proper temperament – is much more important in the context of long-term investment performance. It is also the most difficult edge to explain, teach, or learn.

# Investment Edge

## Behavioral Edge

We take a longer-term view and have the ability to tolerate losing money before we make it.

*Leads Us To*

## Analytical Edge

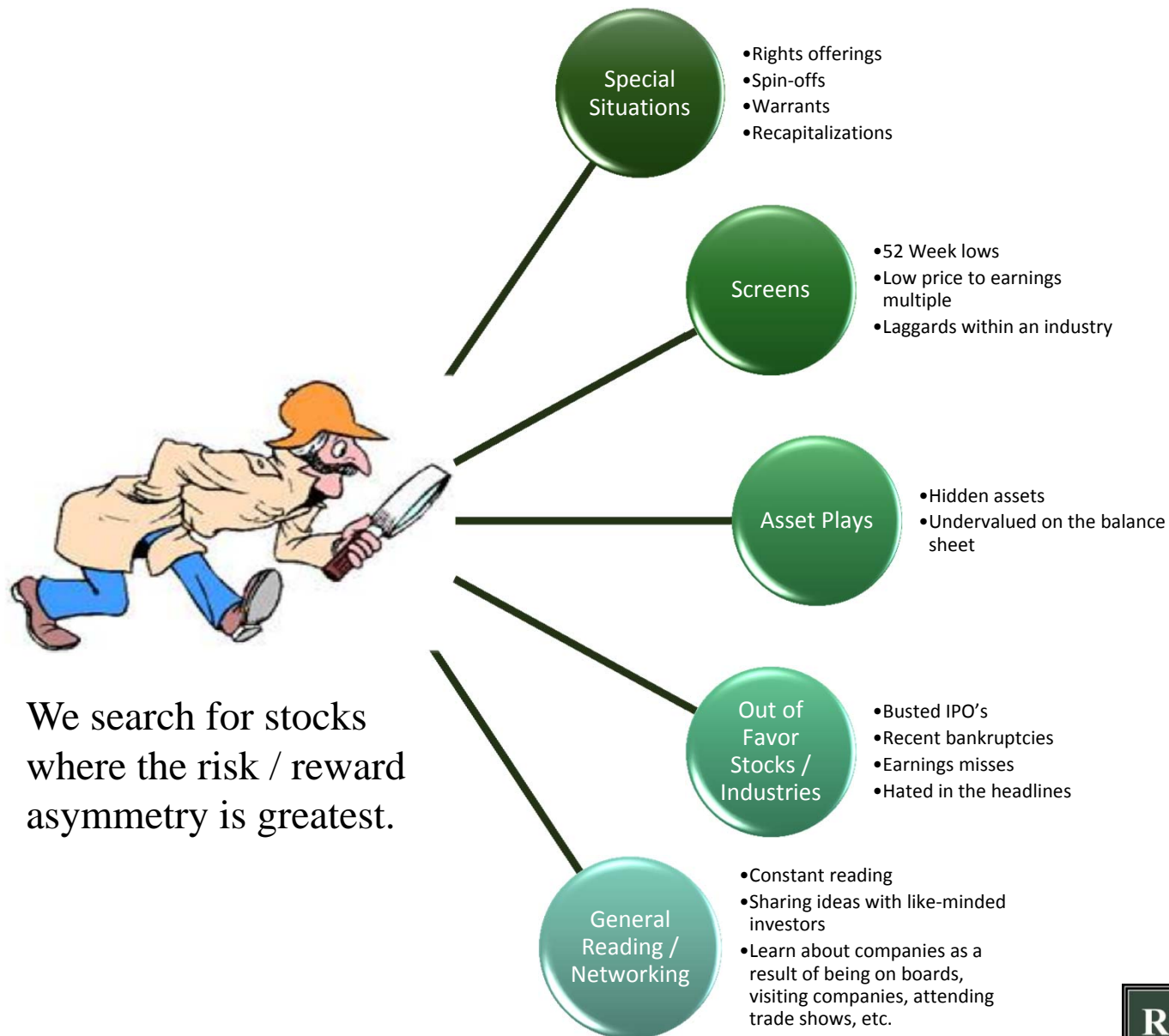
Within the context of a longer-term perspective and 30+ years of experience, we have the ability to develop a different conclusion than that of the market.

## Informational Edge

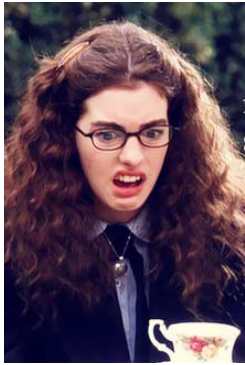
Our network of industry relationships, focus on deep primary research, and experience serving on company boards, provides us with more pieces for building our information mosaic.



# Idea Generation: What's the Secret?



# Secret #1: Ugly Ducklings



- Many value investors say they look for companies or industries that are beaten-up, out of favor, or out of fashion - ugly ducklings.
- However, we find it most common for investors to avoid near-term uncertainty at all cost and only invest once the dust has settled.
- Our ability to tolerate losing money before we make it allows us to concentrate on understanding the long-term normalized earning power of a business well before it turns into a swan.

# Our Job as Contrarians

“...most people say, ‘We’re not going to try to catch a falling knife; it’s too dangerous.’ They usually add, ‘We’re going to wait until the dust settles and uncertainty is resolved.’



**The one thing I’m sure of is that by the time the knife has stopped falling, the dust has settled and the uncertainty has been resolved, there’ll be no great bargains left...**

Thus a hugely profitable investment that doesn’t begin with discomfort is usually an oxymoron.”

Howard Marks, Oaktree Capital

# Ideas That Make Most People Cringe

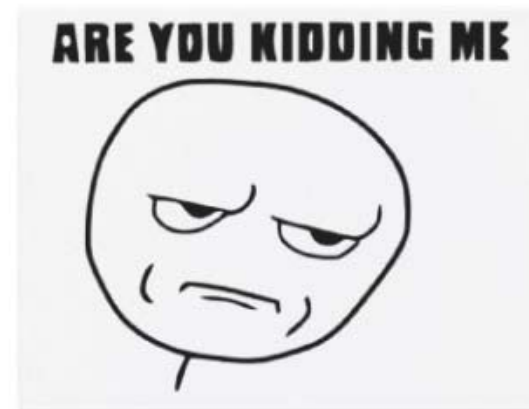


- Mentioned Builders FirstSource (BLDR) in February 2011 interview with Columbia Business School's *Graham and Doddsville*.
  - The stock was trading at \$2.00 with an enterprise value of ~\$250 million.
  - We suggested that normalized earning power, based on building ~1 mm homes in the U.S., was \$100 - \$200 mm of EBITDA or approximately \$1.00 - \$2.00 per share.
  - *However, there was no end in sight to the housing crisis.*
- Mentioned BLDR again in August 2011 interview with *Value Investor Insight* when the stock traded at \$2.09.
- ❖ (BLDR closed at low of \$1.03 in October 2011.)

\*\*See disclosure on slide 52 for all stocks mentioned in both interviews\*\*



# General Reaction to BLDR idea in 2011



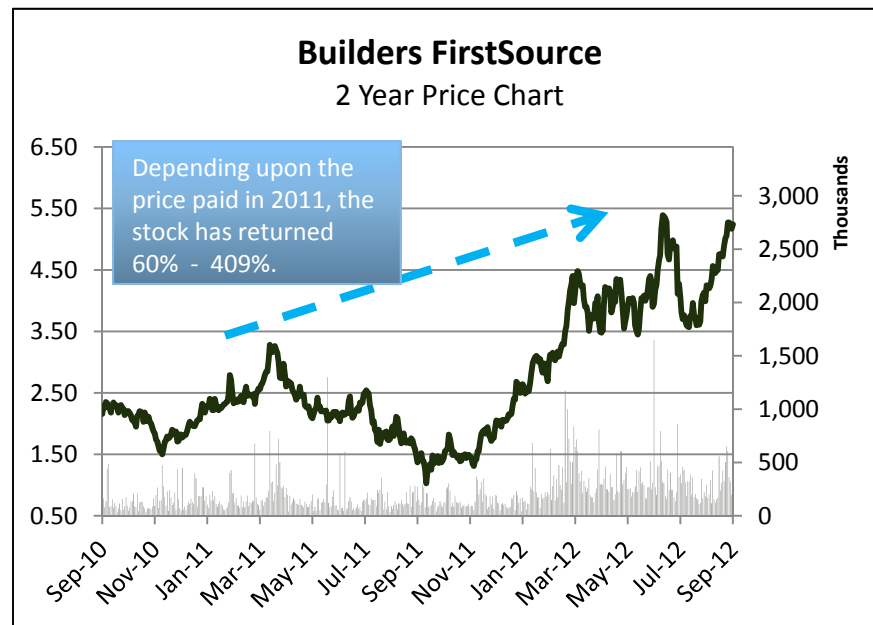


# Investor Interest Rises as Uncertainty Falls

- While the housing market is certainly not out of the woods, headlines and rhetoric have changed tone.
- We argue that the dust is just beginning to settle and people are just beginning to accept that the uncertainty will somehow be resolved.
- Over the long-term, we still believe that Builders FirstSource is undervalued.
  - However, the argument that the stock is near-term fairly valued is more credible at the current valuation.



Source: CNBC.com



Source: Capital IQ



## Secret #2: Identify Long Runways

- ✓ Industries facing significant short-term headwinds / “unknowns.”
- ✓ Individual companies that are certainly not immune to the industry-wide issues and may even have more serious complications.
- ✓ **The dynamics are in place for very long runways of growth once headwinds dissipate.**



Behavioral Edge: Patience and discipline are essential, since a catalyst may not be readily identifiable and the timeline generally unpredictable.

# Calfrac Well Services, Ltd.

## TSX:CFW

\$23.95 (as of 9/27/12)

### INVESTMENT IDEA

*The following case study is presented strictly for informational purposes as an illustration of the investment process and approaches of Robotti & Company Advisors, LLC. This information should not be interpreted as a performance record or as an indication of future performance results.*

(All figures from this point forward, except per share data, are in million Canadian Dollars unless otherwise noted.)





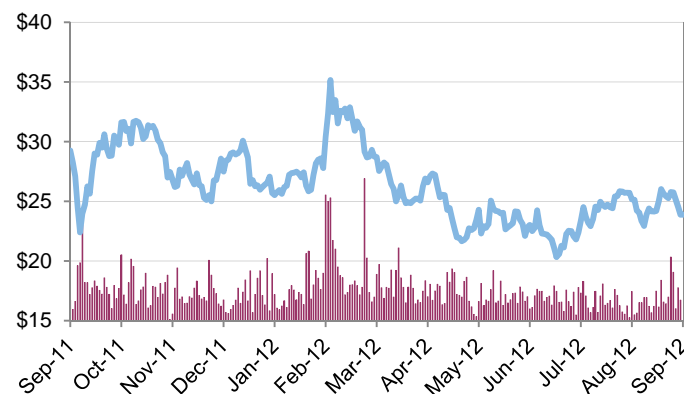
# Calfrac Well Services, Ltd. (TSX:CFW)

- Canadian based independent provider of specialized oilfield services with operations in Canada, the United States, Russia, Mexico, Argentina, and Columbia.
- Majority of revenue (92%) is generated by hydraulic well fracturing.
- Other services include coiled tubing, cementing and other well stimulation services.

## Data as of 09/27/2012

Price	\$23.95
<u>Diluted Shares</u>	<u>44.7</u>
<b>Market Cap</b>	<b>\$1,067</b>
Long-Term Debt	458
Non-Control Interest	0.4
<u>Cash</u>	<u>167</u>
<b>Enterprise Value</b>	<b>\$1,362</b>

## Calfrac Price Chart (9/27/2012 to present)



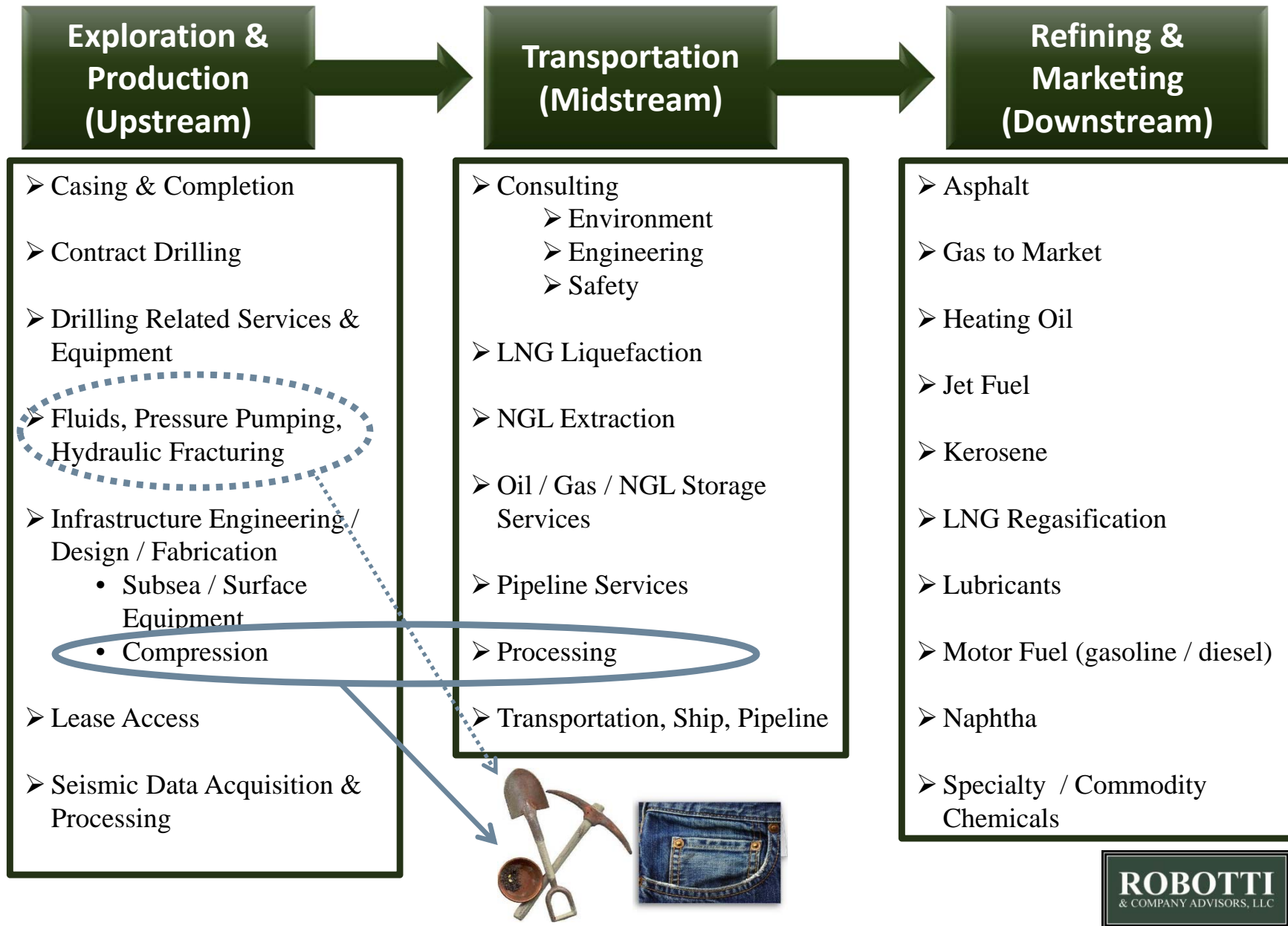
Source: Capital IQ

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# Investment Highlights

- ✓ Canadian leader and #6 in the world – with ability to compete internationally.
- ✓ Very long runway for growth of hydrocarbon production in both North America and also around the world.
- ✓ Trend towards longer, more complex, multi-stage fractures.
- ✓ Solid balance sheet and ample liquidity provides Calfrac with the ability to pursue opportunistic acquisitions.
- ✓ High returns on capital, high inside ownership and 4.2% dividend yield.
- ✓ Potential upside of 80% - 100% assuming a normal scenario where natural gas demand remains flat.
- ✓ Potential upside of >100% assuming a scenario where increased global demand for natural gas provides a long runway for growth.

# Industry Map: Oil & Gas



# Services: Hydraulic Fracturing

- Leading provider of hydraulic fracturing services across all of North America, parts of Mexico, South America and Russia.
- Revenue generated from hydraulic fracturing accounts for roughly 92% of global revenue.
- The objective of hydraulic fracturing is to increase the amount of oil & natural gas extraction by increasing the conductivity of an oil or natural gas zone within a reservoir to the wellbore.



**Opportunity:** Increased demand and intensity of hydraulic fracturing in both North America and abroad should drive growth.

# Services: Coiled Tubing and Cementing

- Coiled tubing accounts for ~6% of global revenue, while cementing accounts for ~2%.
- Calfrac added 10 deep coiled units with the 2009 acquisition of Century.
- The company currently has 30 coiled tubing units and 22 cementing crews worldwide.



**Opportunity:** Coiled tubing and cementing services allow for entry into new geographic areas with promising potential for increased hydraulic fracturing needs.

# Calfrac Background

## Worldwide Operations – June 30, 2012



### Calfrac Worldwide Capacity

Region	6/30/2012
Canada	302,000
United States	456,000
Russia	45,000
Latin America	27,000
Total HP Capacity	830,000
2012 Year End Projection	990,000

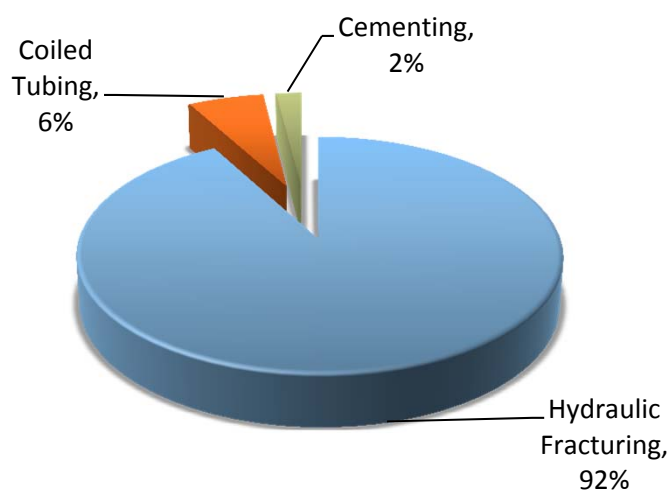
- Calfrac was founded in 1999 by Ronald Mathison (Chairman), Doug Ramsay (CEO), Robbie Roberts and Gordon Dibb with 2 fracture fleets and one coiled tubing unit in Canada.
- Currently operates 35 fracturing spreads worldwide.



# Revenue Mix

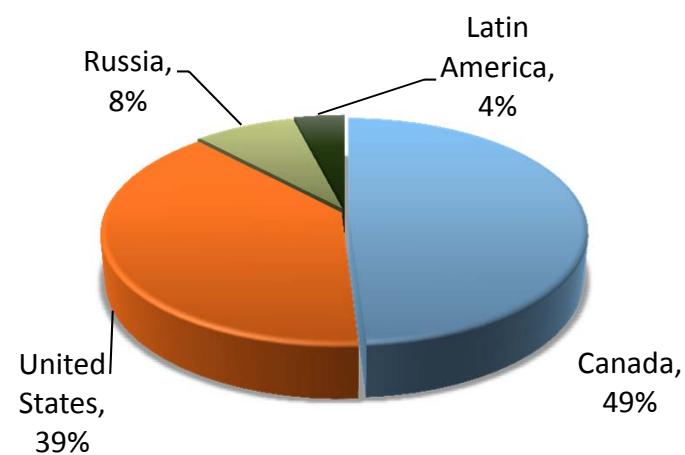
## Revenue by Service Segment

Hydraulic Fracturing	92%
Coiled Tubing	6%
Cementing	2%



## Revenue by Geographic Segment

Canada	49%
United States	39%
Russia	8%
Latin America	4%



Source: Calfrac SEDAR Filings

# The Bear Case – A Falling Knife?

- Overcapacity of hydraulic fracturing equipment in North America continues for an extended period weighing on both revenue and margins. Flat rig counts support this belief.
- There is no relief in sight for low natural gas prices. Prolonged low natural gas prices will curb the ramp up of demand in North America.
- High returns on capital will attract competition – exasperated by relatively low barriers to entry.
- As a result, Calfrac will face lower market share with lower margins and higher competition.



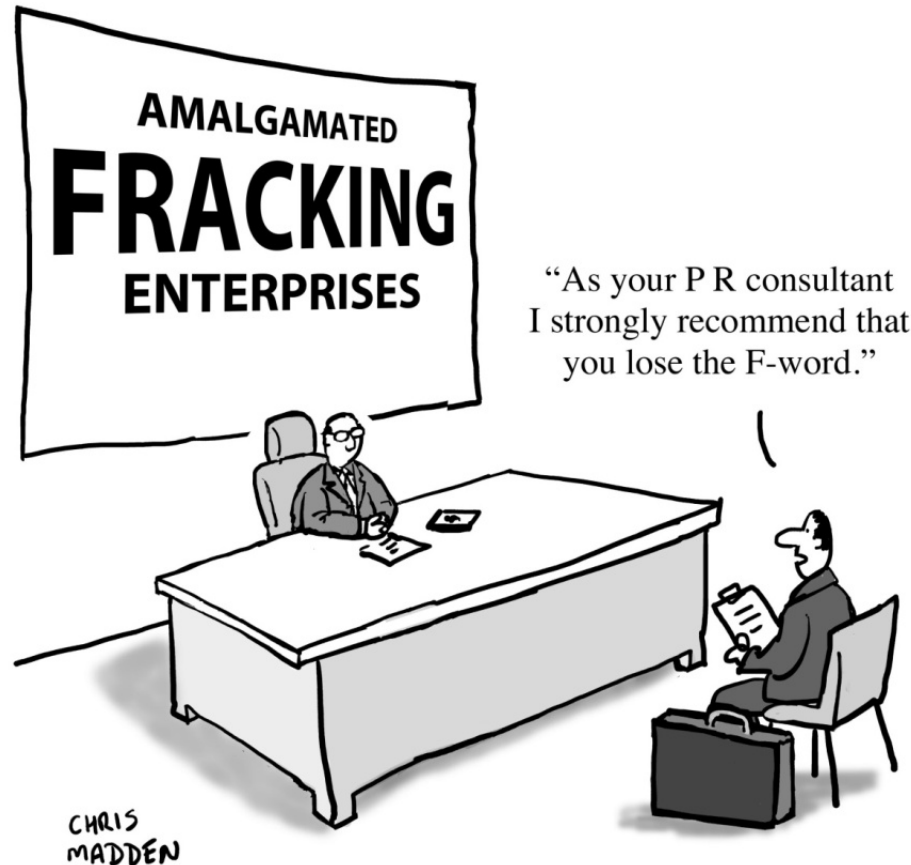


# Our Variant View

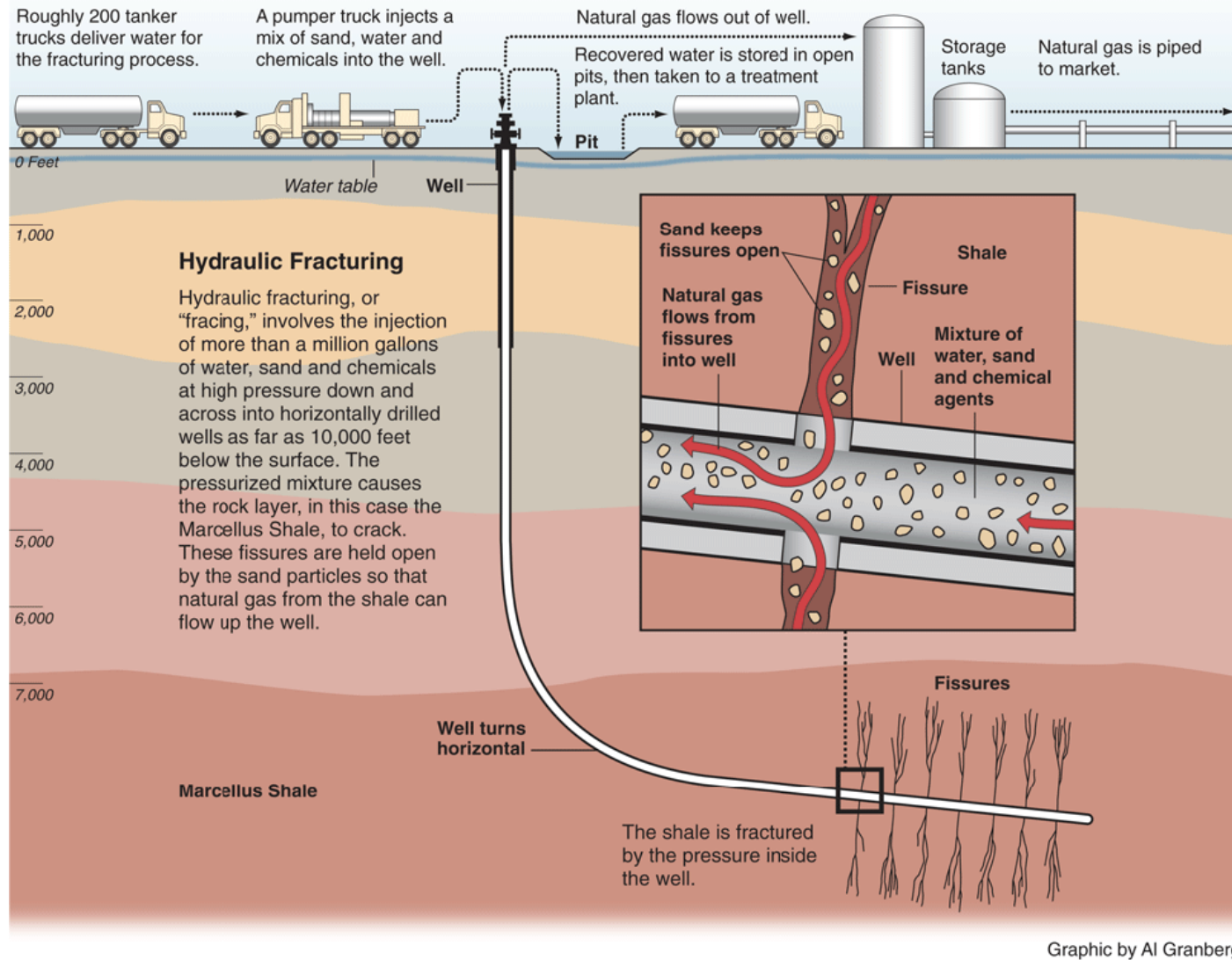
- The current disparity in energy prices sets the backdrop for an industrial resurgence in North America. This is not a short-term phenomenon; it is a very long-term opportunity.
- Energy intensive businesses will have a long-term economic advantage in North America. The size and scope of the resource will enable significant amounts of capital to be invested.
- This will become a reinforcing opportunity as the acceleration of industrial development will require an increase in production of natural gas in North America.
- While rig counts have been flat – meters drilled is increasing due to longer horizontal laterals. Total well depth, or ‘meterage’, has become a much more important indicator as a result of the increase in horizontal rigs. A greater number of fracturing stages and higher fracturing intensity along the laterals should lead to continued demand for pressure pumping even in a flat rig count environment.

# Long-Term Opportunity

## Advances in Horizontal Drilling Technology Combined with Hydraulic Fracturing



# Hydraulic Fracturing

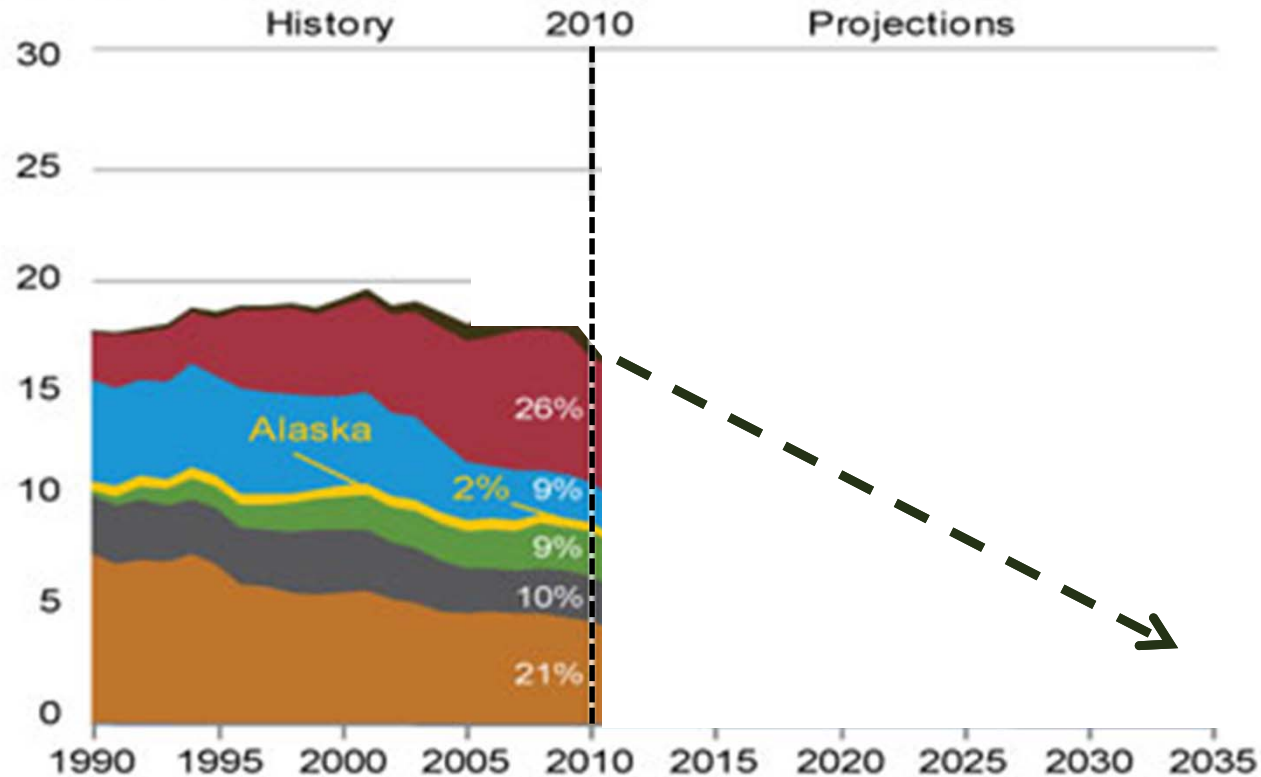


Source: <http://stateimpact.npr.org/texas/tag/fracking/>

# Projected Natural Gas Production

## U.S. Natural Gas Production, 1990-2035

trillion cubic feet



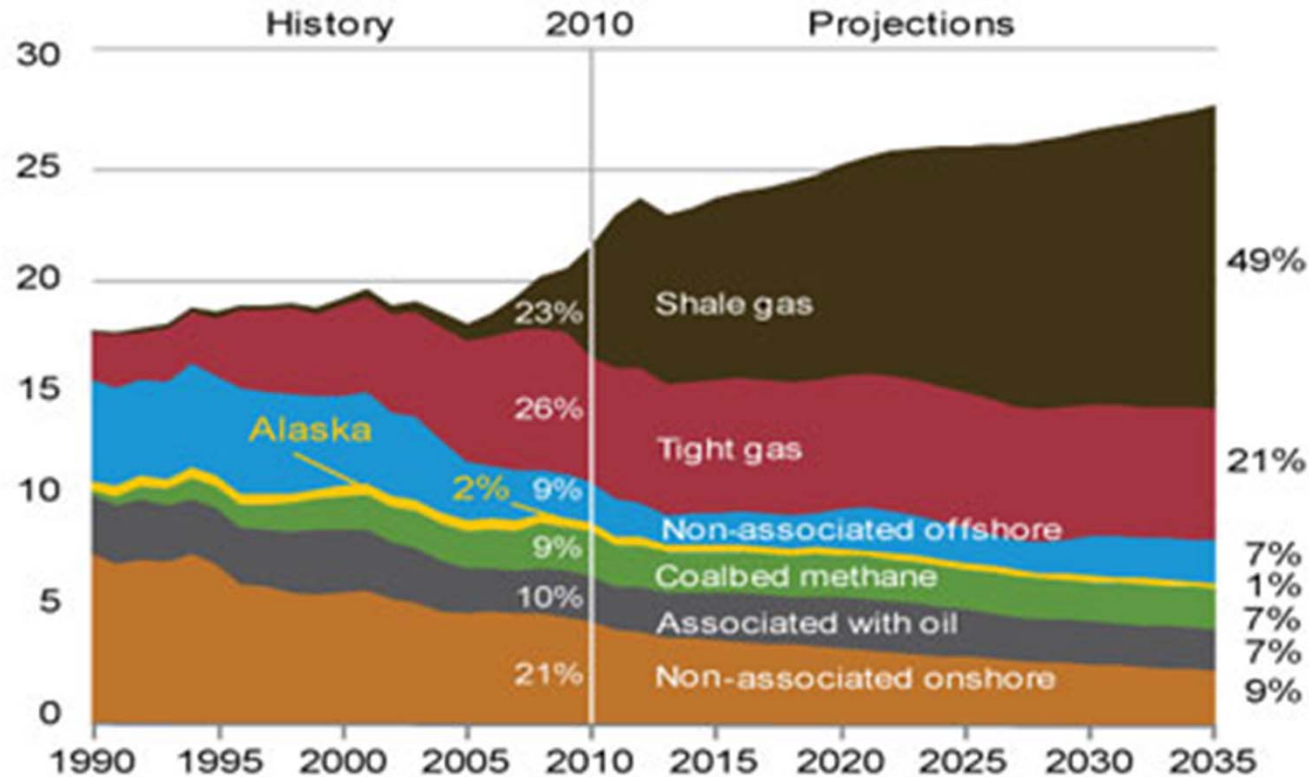
Source: U.S. Energy Information Administration, AEO2012  
Early Release Overview, January 23, 2012.

Source: U.S. Energy Information Administration

# Projected Natural Gas Production

## U.S. Natural Gas Production, 1990-2035

trillion cubic feet

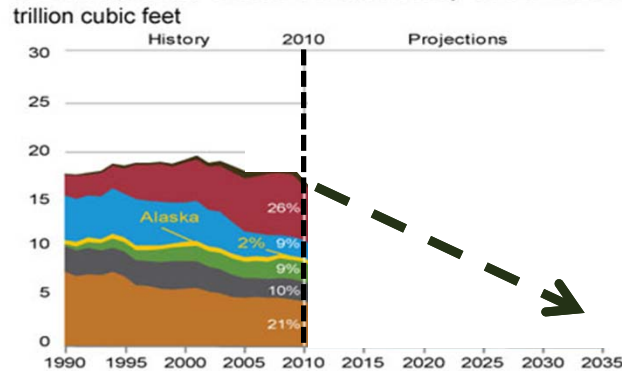


Source: U.S. Energy Information Administration, AEO2012  
Early Release Overview, January 23, 2012.

Source: U.S. Energy Information Administration

# Long-Term Opportunity for Natural Gas Production

**U.S. Natural Gas Production, 1990-2035**

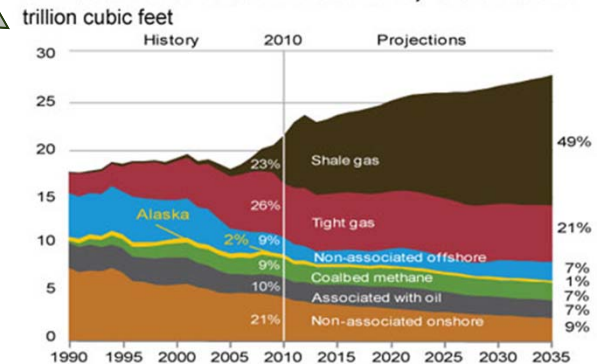


Source: U.S. Energy Information Administration, AEO2012 Early Release Overview, January 23, 2012.

- The ability to extract natural gas from shale has turned the United States from a country with declining gas production to one with future growth.
- Over 90% of new oil and gas wells in North America now require the use of hydraulic fracturing.

- The ability to recover hydrocarbons from low-permeability rock will increase the recoverable resource base in the continental U.S. by 86% to ~650 tcf from ~350 tcf.

**U.S. Natural Gas Production, 1990-2035**



Source: U.S. Energy Information Administration, AEO2012 Early Release Overview, January 23, 2012.

Source: U.S. Energy Information Administration and Tudor Pickering Holt & Co.



# North American Shale Gas Plays



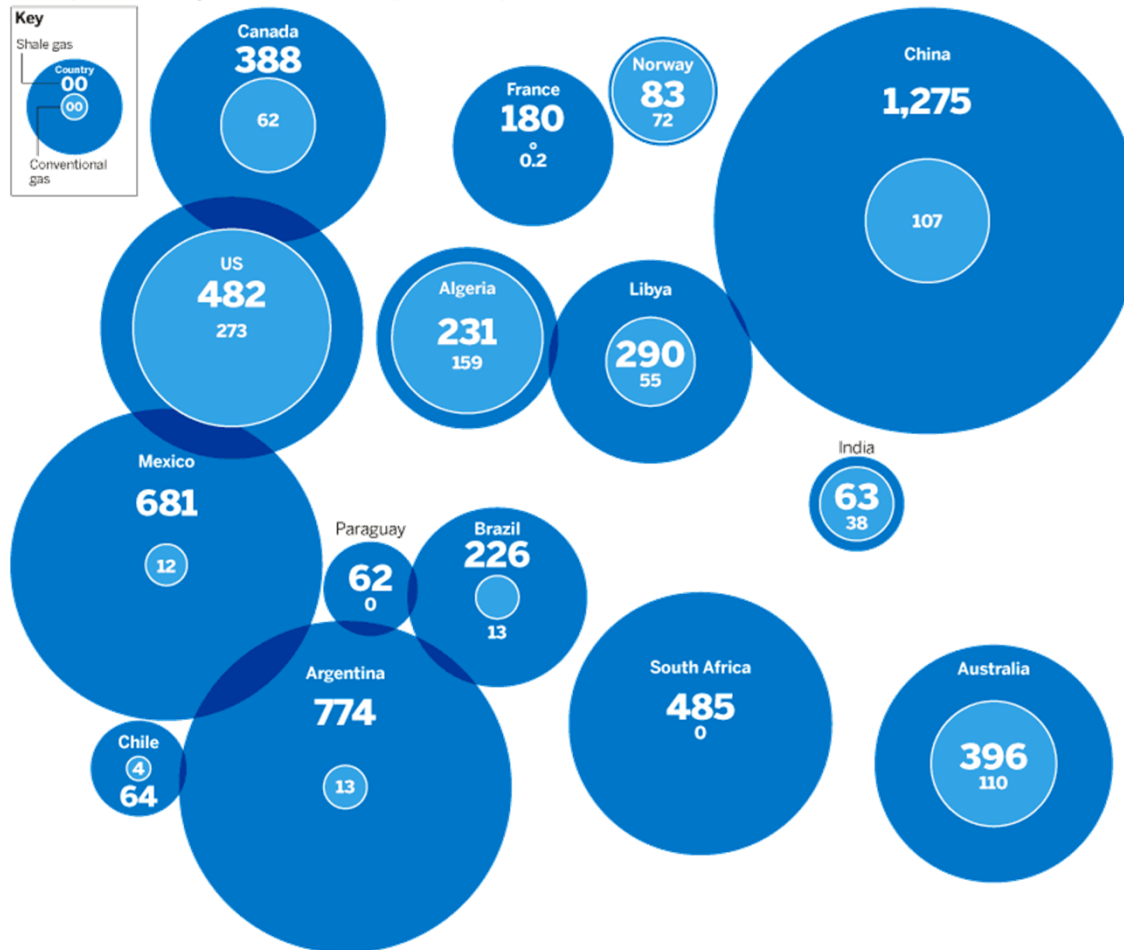
Source: U.S. Energy Information Administration based on data from various published studies. Canada and Mexico plays from ARI.  
Updated: May 9, 2011

# Worldwide Supply: Conventional vs. Unconventional Sources

## Big supplement to supply

### Estimated shale gas in relation to conventional gas reserves

Technically recoverable shale gas resources, top 15 countries (trillion cubic feet)



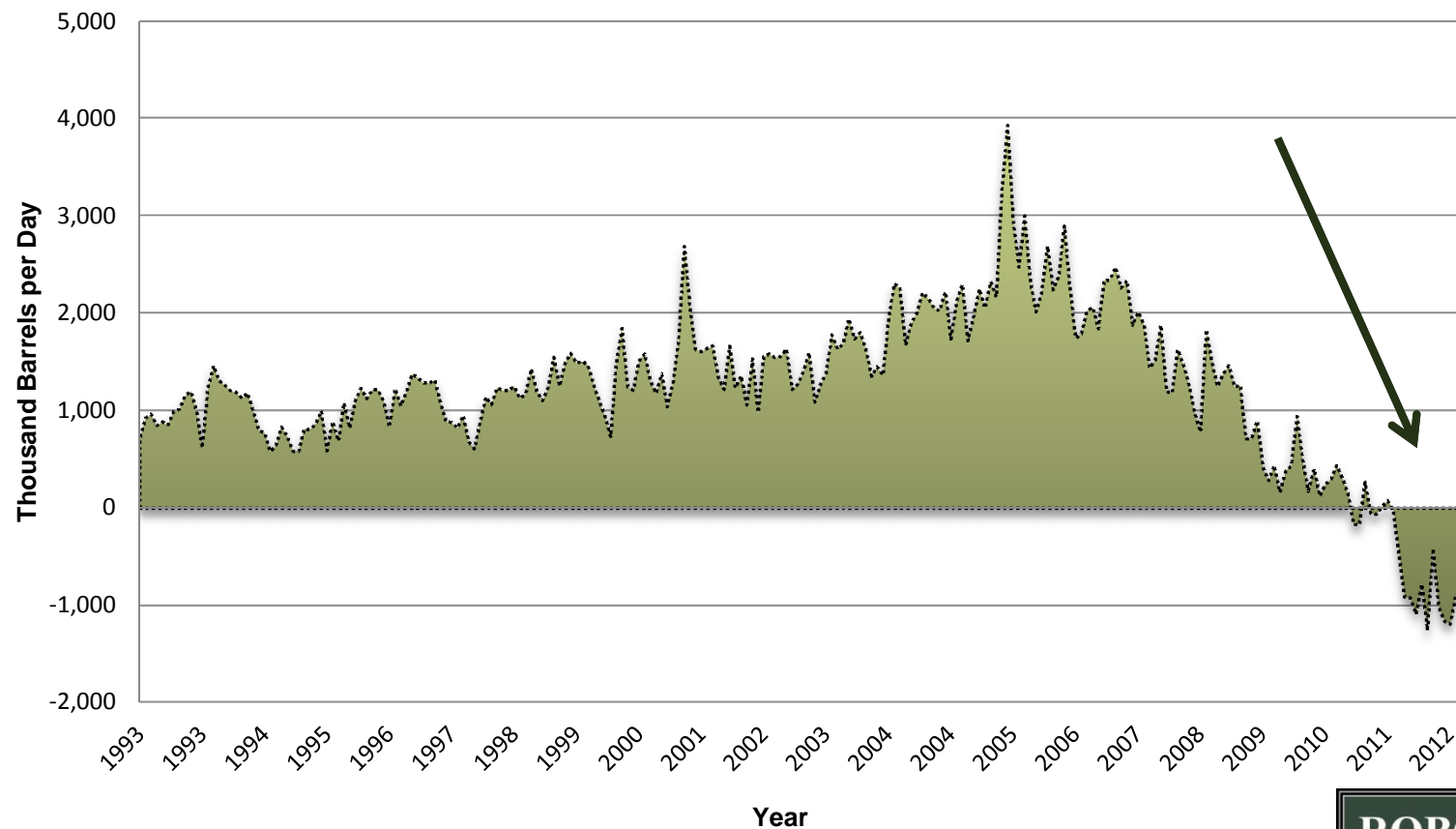
Source: Financial Times 4/23/2012



# U.S. Oil Production: Same Technology

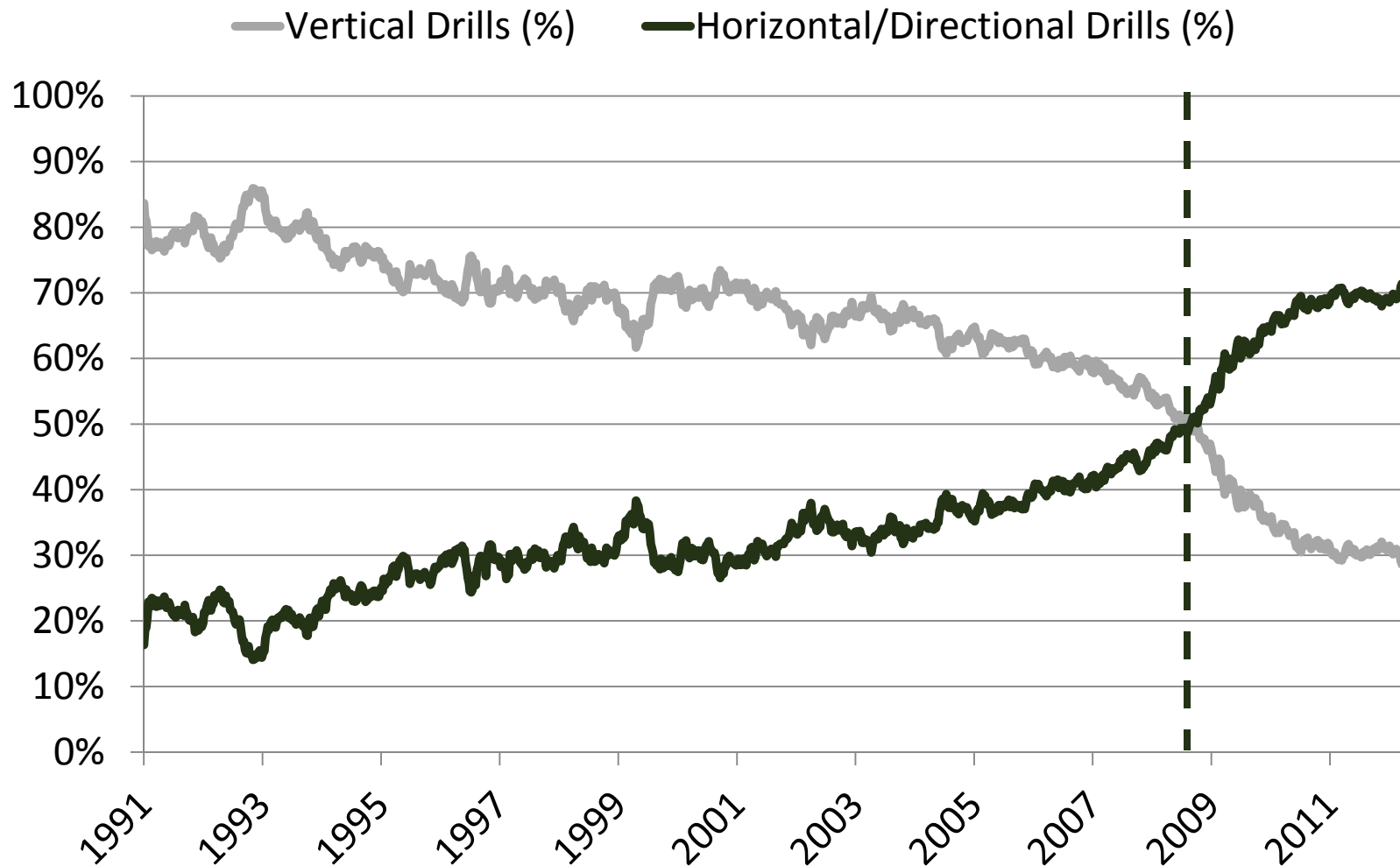
## United States Became a Net Exporter of Petroleum-Based Refined Products for the First Time in 62 Years

U.S. Net Imports of Total Petroleum Products  
(Thousand Barrels per Day)



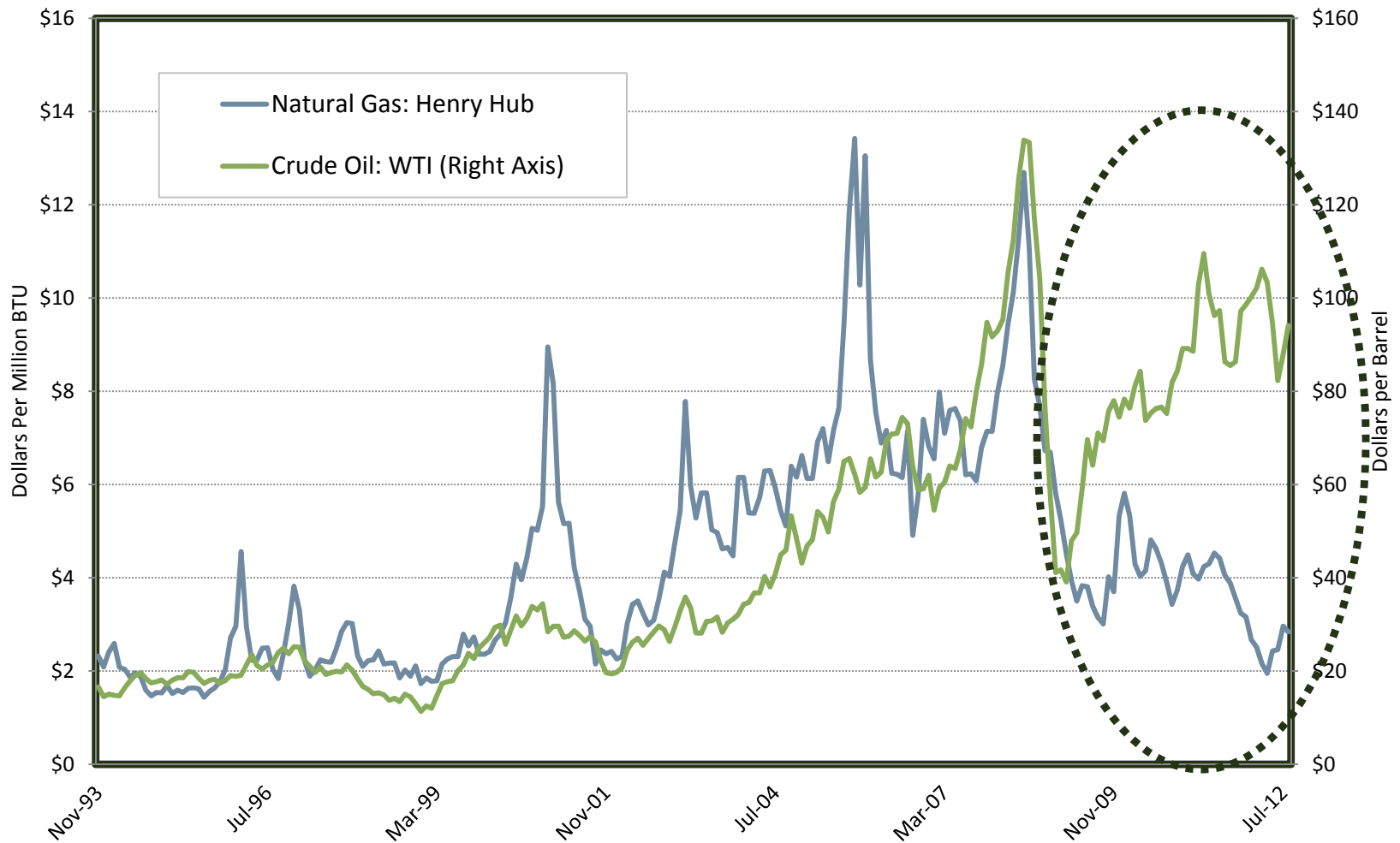
Data Source: EIA

# North American Rigs: Horizontal Drilling



Source: Baker Hughes Rig Count

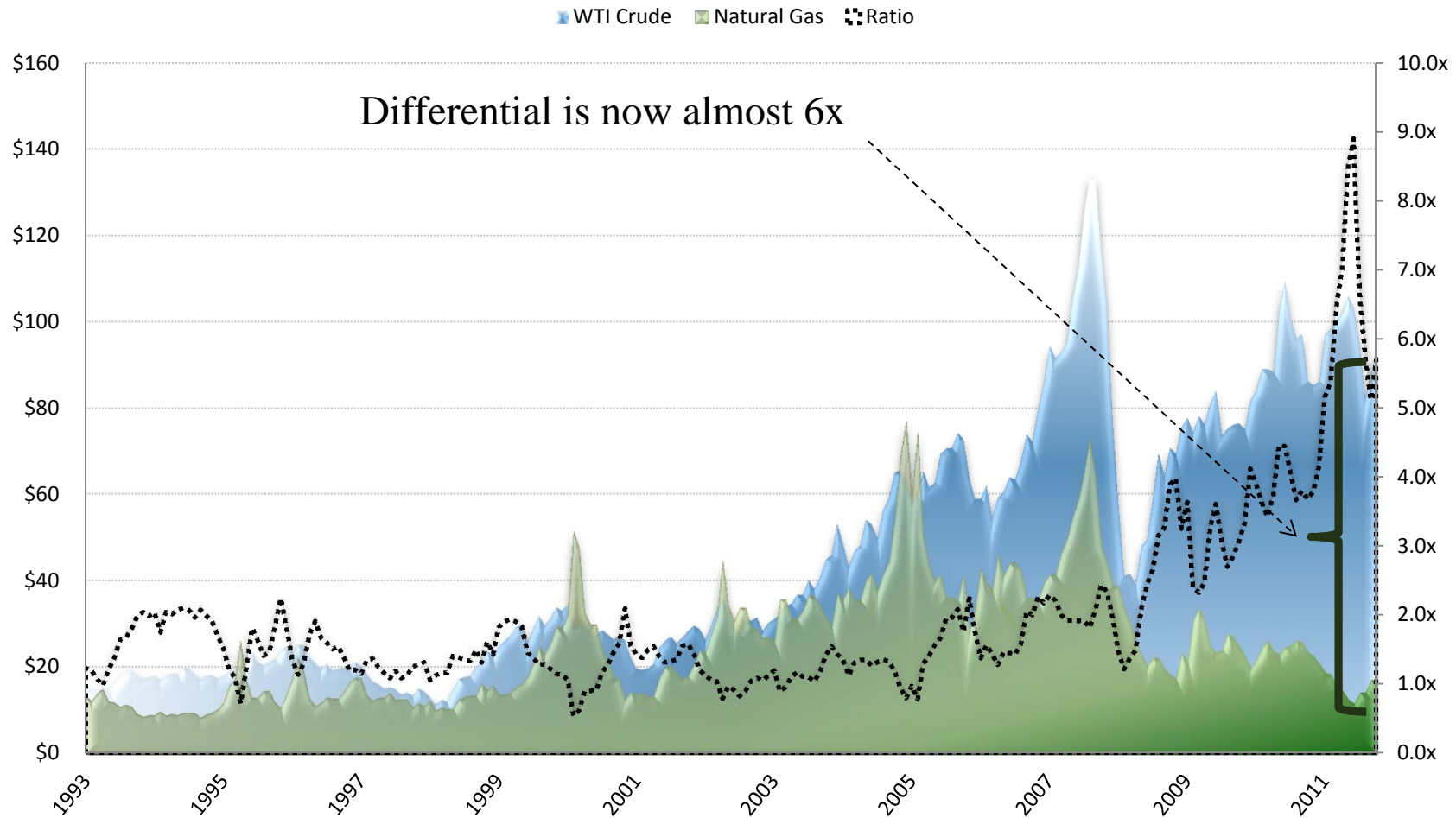
# Oil & Natural Gas Prices in the U.S.



Source: Dow Jones & Company/U.S. Department of Energy: Energy Information Administration/FRED

# Energy Equivalent Price Differential

**Differential Between Oil and Natural Gas**  
Energy Equivalent Price per Barrel of Oil

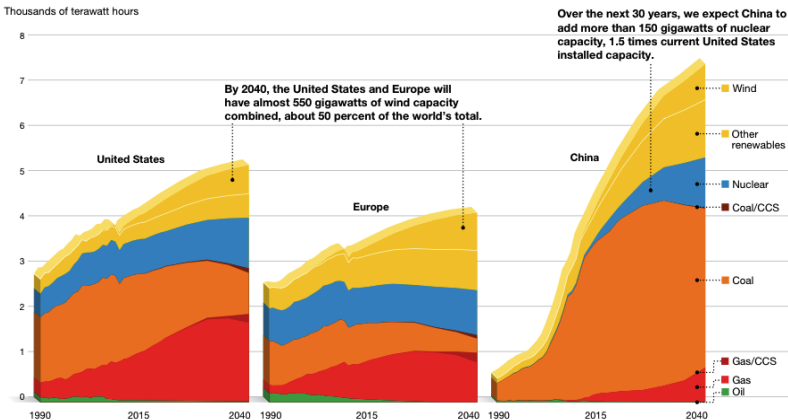


Data Source: U.S. Energy Information Administration

# Potential Sources of Demand

## Natural Gas Replacing Coal

Electricity generation by fuel  
Thousands of terawatt hours

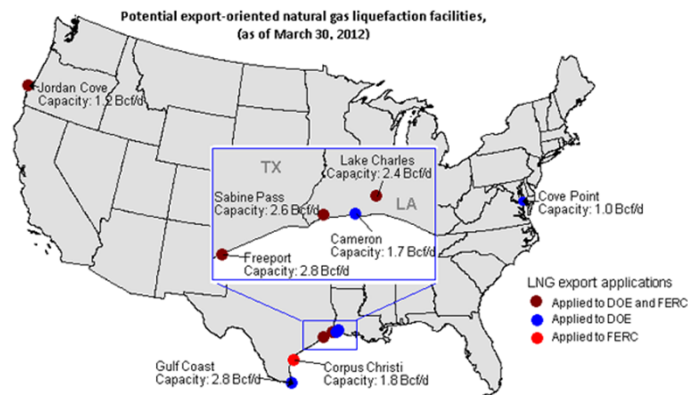


(Source: Exxon Mobile Outlook for Energy: A View to 2040)

## Other Potential Sources of Demand

- Refining
- Manufacturing
- Chemical Production
- Major IOC's returning to the U.S.

## LNG



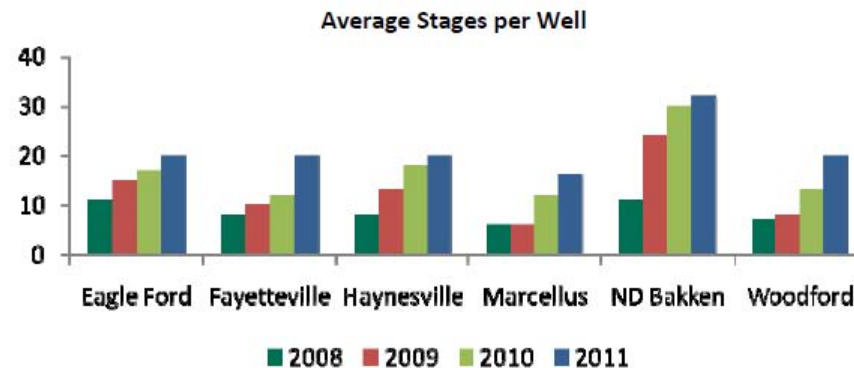
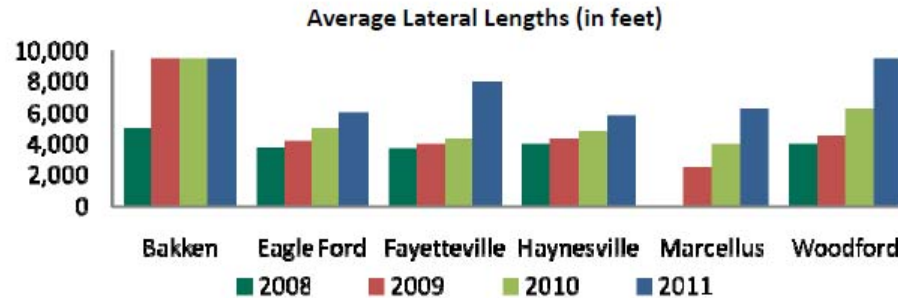
Source: U.S. Energy Information Administration, based on U.S. Department of Energy (DOE), Office of Fossil Energy, Applications Received, and Federal Energy Regulatory Commission (FERC).

## CNG



# Increase in Lateral Length / Fracturing Stages

- Increasing lateral lengths leading to more fracturing stages and therefore greater revenue per well.
- Focus is on creating maximum efficiency and contacting as much of the reservoir as possible.
- Expect increasing adoption of 24-hour operations.
- Commodities and logistics are critical to job execution.



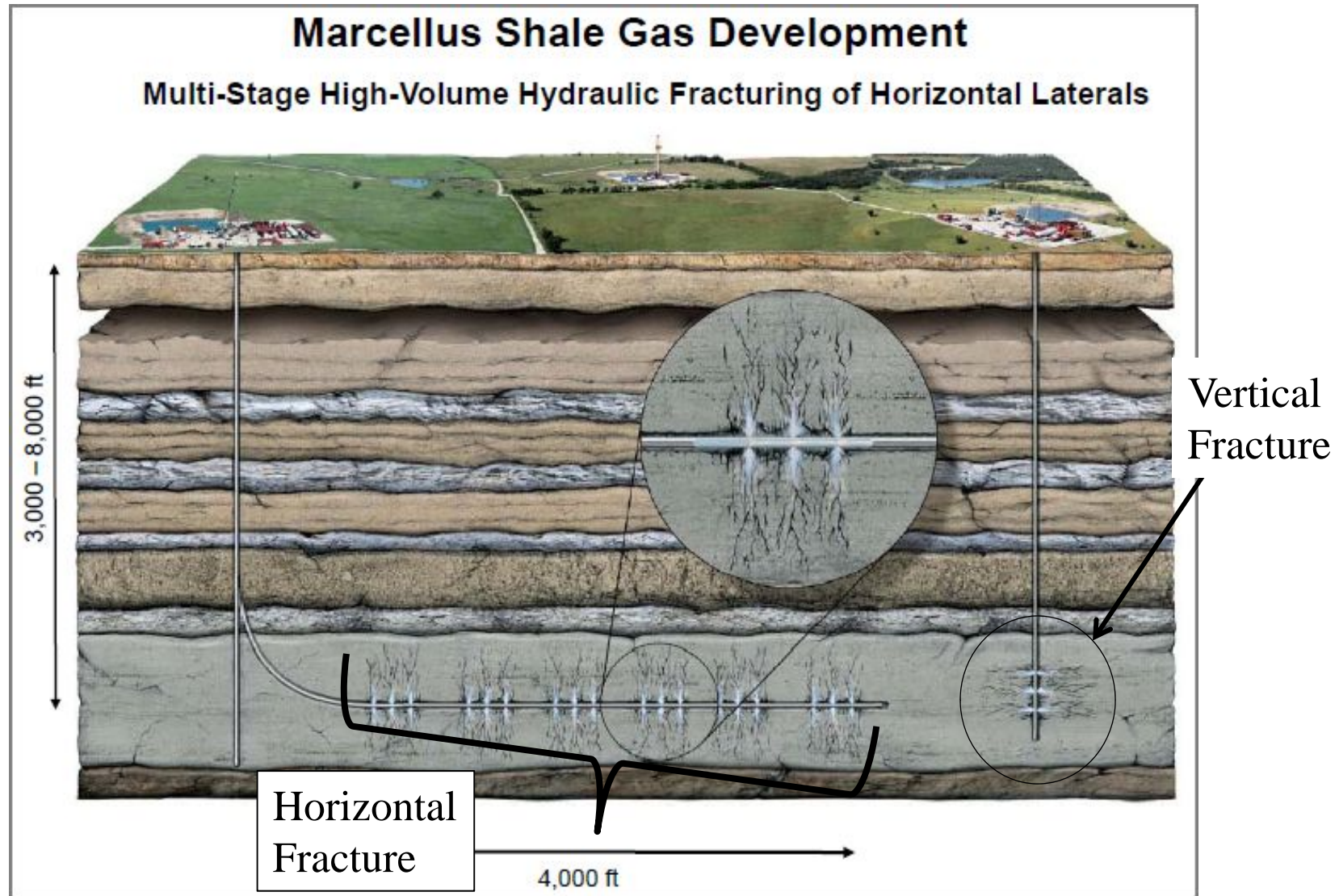
Source: Morgan Stanley Research estimates



- Hydraulic fracturing costs make up 30% - 60% of the total well cost up from ~10% just 5 years ago.



# Increase in Lateral Length / Fracturing Stages



Source: <http://stevemaley.files.wordpress.com/2012/06/marcellus-xsection.jpg>

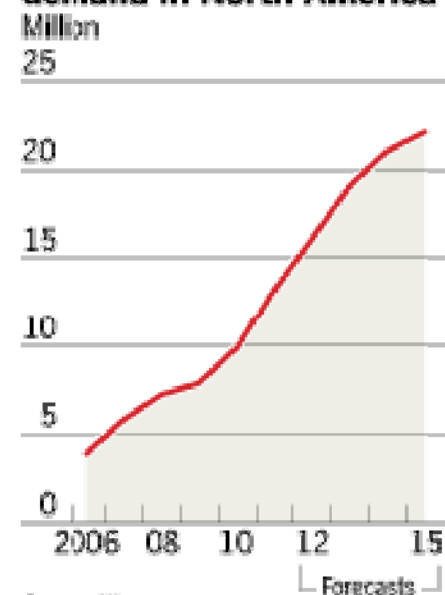
# Industry Landscape

## North American Fracturing Equipment Fleet

Canada	2011	2012E
Baker / BJ	185,000	200,000
Calfrac	285,000	400,000
Canyon	175,000	225,000
GasFrac	100,000	100,000
Haliburton	95,000	145,000
Nabors	—	40,000
Sanjel	220,000	250,000
Schlumberger	240,000	265,000
Trican	321,000	414,000
Other	—	30,000
<b>Canadian Supply Estimate</b>	<b>1,621,000</b>	<b>2,069,000</b>
	y/y change:	27.6%
United Staes	2011	2012
Baker / BJ	1,400,000	1,550,000
Basic	271,000	277,000
Bayou	150,000	200,000
C&J	242,000	306,000
Calfrac	364,000	447,000
FTS International	1,416,550	1,473,250
GasFrac	50,000	50,000
Green Field	30,000	208,300
Haliburton	2,000,000	2,250,000
Naboprs	733,000	765,000
Patterson-UTI	631,000	660,000
Performance Technologies	140,000	365,000
Pioneer	150,000	300,000
Platinum	149,500	229,500
RPC	600,000	683,000
Sanjel	160,000	260,000
Schlumberger	1,800,000	2,000,000
Superior	429,750	659,000
Trican	570,000	670,000
Weatherford	650,000	1,000,000
Other	1,073,000	1,386,700
<b>U.S. Supply Estimate</b>	<b>13,009,800</b>	<b>15,739,750</b>
	y/y change:	21.0%
<b>North American Supply Estimate</b>	<b>14,630,800</b>	<b>17,808,750</b>
	y/y change:	21.7%

Source: Peters & Co., Robotti & Company Estimates

## Fracking horsepower demand in North America



Source: Weir

Source: Weir / FT.com

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# Calfrac: Geographic Footprint

**Calfrac has operations in the 4 largest pressure pumping markets:**

## **Canada**

- Complex geology allows Calfrac to differentiate itself from the competition.
- Centralized location of unconventional basins allows Calfrac to leverage relationships with operators.

## **United States**

- Large unconventional resources would allow for a significant increase in production if/when U.S. natural gas prices rise.

## **Russia**

- With a 5 year lag in technology, and easy oil slowly dissipating, there is potential for a significant increase of horizontal and multi-stage hydraulic fracturing jobs.
- Calfrac has used its cementing business to make inroads into Russia

## **Latin America**

- There are many unconventional plays spread across Latin America.
- Calfrac's deal with Pemex provided an entry into Latin America.
- A recent cementing job in Columbia will also help increase their presence.

# Calfrac: Why Canadian Pressure Pumpers?

- Investor bias against investing in companies outside of the United States creates the opportunity for even greater mispricing.
- Canada's complex and diverse geology, especially in the Western Canada Sedimentary Basin, give Canadian pressure pumpers a greater ability to differentiate themselves.
- It is likely that Canada has a shorter timeline for the completion of LNG export terminals which will help increase demand.
- Oil shale exploration is at an earlier stage than in the U.S. leading to higher growth potential.
- Because the Canadian basins are more centrally located, service companies often gravitate towards expansion outside of North America. There are countries where not being an American based company could give Canadian counterparts an advantage.

# Calfrac: Additional Investment Factors

## **High Quality Management – High Insider Ownership**

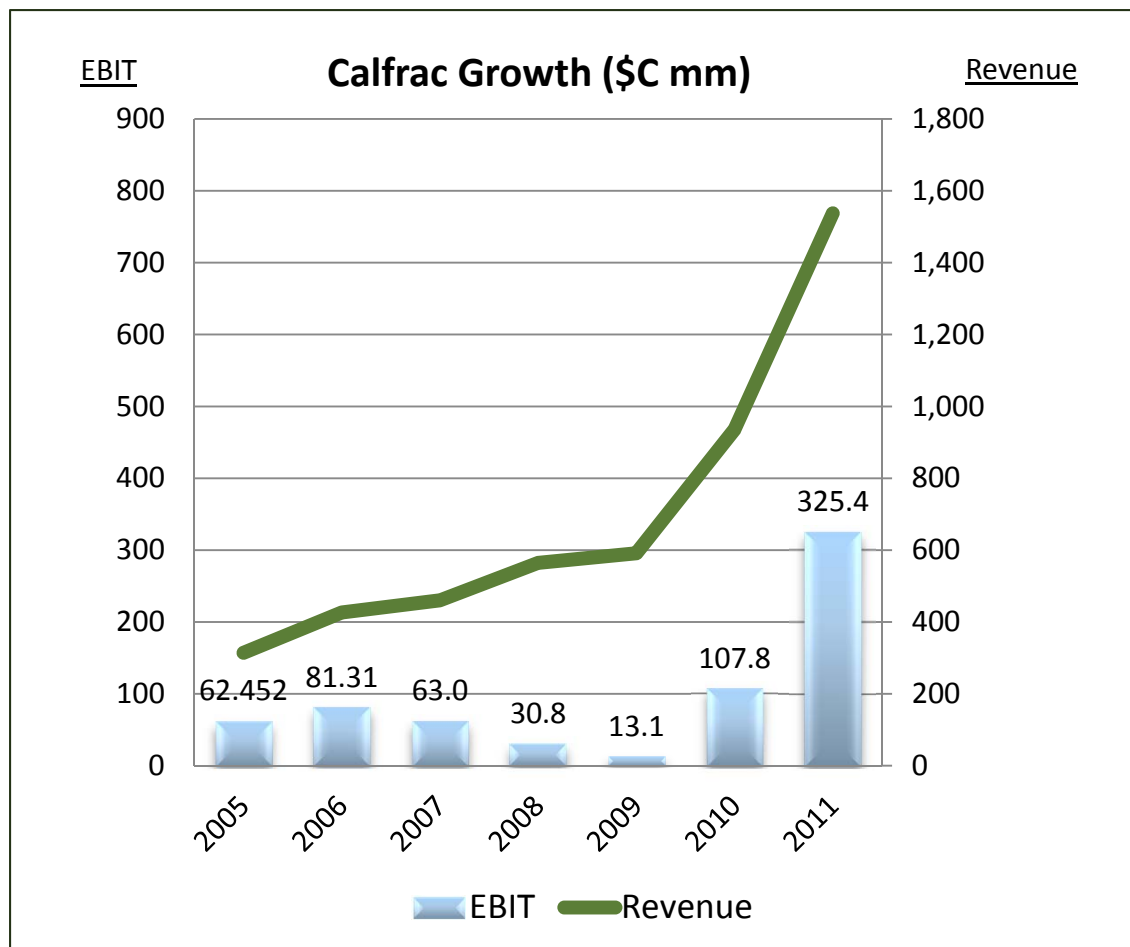
- Experienced, shareholder friendly management team led by CEO Doug Ramsay and Chairman Ron Mathison.
  - Ramsay has over 25 years of industry experience.
  - Mathison is a former investment banker.
  - Origins of company, formerly Denison Energy, indicate capital allocation / financial prowess.
  - Directors and Management own 26% of the company's outstanding shares.

## **Dividend**

- Calfrac pays a semi-annual dividend of \$0.50 and has a current dividend yield of 4.2%.

# Revenue and EBIT Growth

- Revenue CAGR of 30% from 2005 – 2011.
- Canada and the U.S. have led growth.
- Acquisitions, improved utilizations and pricing have driven growth.
- Oil-focused activity becoming a larger portion of activity base.
- Increase driven by changes in service intensity.



Source: Calfrac Presentation – Peters & Co. Limited 2012 Energy Conference

# Earnings Summary

<b>(Fiscal Year End 12/31)</b>	<b>2010</b>	<b>2011</b>	<b>TTM</b>
Total Revenue	935.9	1,537.4	1,690.4
Gross Profit	167.6	402.5	416.8
<i>Gross Margin</i>	<i>17.9%</i>	<i>26.2%</i>	<i>24.7%</i>
EBITDA	185.2	412.8	420.1
<i>EBITDA Margin</i>	<i>19.8%</i>	<i>26.9%</i>	<i>24.9%</i>
Operating Income	107.8	325.4	330.8
<i>Operating Margin</i>	<i>11.5%</i>	<i>21.2%</i>	<i>19.6%</i>
Cash Flow from Operations	128.3	244.2	292.6
Capital Expenditures	118.9	324.0	345.4
Free Cash Flow	9.4	(79.8)	(52.8)

Source: Calfrac SEDAR Filings

# Balance Sheet and Liquidity

(Fiscal Year End 12/31)	2010	2011	TTM
Working Capital	341.7	398.5	357.1
Total Assets	1,095.6	1,405.1	1,478.7
Long-Term Debt	443.3	451.0	451.5
Total Equity	502.1	700.8	748.0
Total Cash	216.6	133.1	166.6
Available Credit			247.4

- Calfrac has available liquidity of \$414 million and does not have any long-term debt maturities until December 2020.

Source: Calfrac SEDAR Filings, Robotti & Company calculations



# Return on Invested Capital

(Fiscal Year End 12/31)	2010	2011	TTM
Net Working Capital	125.1	265.4	357.1
Net Fixed Assets	588.8	825.5	939.0
<b>Invested Capital</b>	<b>713.8</b>	<b>1,090.9</b>	<b>1,296.1</b>
Operating Income	107.8	325.4	332.7
<b>Pre-Tax ROIC</b>	<b>15.1%</b>	<b>29.8%</b>	<b>25.7%</b>
NOPAT	70.1	211.5	216.2
<b>After-Tax ROIC</b>	<b>9.8%</b>	<b>19.4%</b>	<b>16.7%</b>

<sup>1</sup>Assumes 35% tax rate

Source: Calfrac SEDAR Filings, Robotti & Company calculations

# Risks to Our Thesis

- Drastic regulatory intervention.

## **Primary Objections:**

Contamination of drinking water  
aquifers;

N.I.M.B.Y.;

Chemical handling / surface spills;

Waste disposal



Photo credit: Adam Welz for CREDO Action.

**Question:** If hydraulic fracturing has been around for more than 50 years, why haven't we heard much about it before?

While hydraulic fracturing has been around for over 50 years, the volume, intensity, and complexity have all grown significantly over the past decade.

- Declining oil prices would negatively affect demand for Calfrac services.

## Margin of Safety

- Assuming there is no value on the technology, market position or goodwill, we project that a reasonable estimate of reproduction value is \$23 - \$24 per share
- We believe that reproduction cost provides for a sufficient margin of safety when compared to the current market price of \$23.95.

# Valuation

Year End December 31	2011	Normal Estimte
<u>Average Fleet (000s HHP)</u>		
Canada	248	400
U.S.	284	490
Russia	45	45
Latin America	24	25
<b>Total</b>	<b>601</b>	<b>960</b>
<i>y/y change</i>		59.7%
Revenue	1,537.4	2,358.0
<i>y/y change</i>		53.4%
EBITDA	412.8	557.0
<i>margin</i>	26.9%	23.6%
Interest	35.5	35.5
D&A	87.5	130.0
Taxes	88.579	127.2
<b>Normalized Net Income</b>	<b>201.2</b>	<b>264.3</b>
Shares		44.7
<b>EPS</b>		<b>\$5.91</b>
P/E Multiple		8.0x
<b>EPV Estimate</b>		<b>\$47.30</b>
Current Share Price		\$23.95
<b>Upside</b>		<b>97.5%</b>

Source: Company Financials, Robotti & Company estimates



# Disclosure: Ownership Information

<b><u>Disclosures</u></b>	<b>Calfrac Well Services (TSX:CFW)</b>	<b>Builders FirstSource (NASDAQ:BLDR)</b>
Robert Robotti and/or members of his household have a financial interest in the following securities	Yes	Yes
Robotti or its affiliates beneficially own common equity of the following securities	Yes	Yes
Robotti or its affiliates beneficially own 1% or more of any class of common equity of the following securities	No	Yes
Robert Robotti serves as a Director or Officer or Advisory Board Member of the following securities	No	No

As of the date of this presentation, Robotti & Company Advisors, LLC and/or its affiliates owns shares of Calfrac Well Services, Ltd. and Builders FirstSource and does not have any current intention to exit the position.

Companies have been chosen solely as a case study to illustrate the investment process and approach of Robotti & Company Advisors, LLC. This information should not be interpreted as a performance record or as an indication of future performance results.



# Disclosure to Slide 11

Below are all of the stocks mentioned in the February 2011 interview with *Graham and Doddsville* and the August 2011 interview with *Value Investor Insight*.

Graham and Doddsville Interview	Ticker	2/4/2011	9/27/2012	% Change
Builders First Source	BLDR	\$2.22	\$5.25	136.3%
Subsea 7	OB:SUBC	\$142.10	\$132.80	(6.5%)
NewMarket	NEU	\$130.45	\$244.08	87.1%
Value Investor Insight Interview	Ticker	8/31/2011	9/27/2012	% Change
Cavco	CVCO	\$36.37	\$46.03	26.6%
Sawada Holdings	JASDAQ:8699	\$746.00	\$320.00	(57.1%)
Panin Insurance	JKSE:PNIN	\$560.00	\$495.00	(11.6%)
KazMuniGas	LSE:KMG	\$16.95	\$18.10	6.8%
Enerflex	TSX:EFX	\$10.70	\$12.60	17.8%
Panhandle	PHX	\$28.39	\$31.24	10.0%
Builders First Source	BLDR	\$1.93	\$5.25	171.8%
Pricesmart	PSMT	\$65.46	\$76.29	16.5%

(Prices from CapitalIQ)



# Questions

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