

## Fundamental Truths

*Recent market turbulence has turned his idea flow from “good to great,” says Ricky Sandler, whose record would indicate he can well make the distinction.*

While his focus on “quality value” hasn’t been in the market’s sweet spot in recent years – as classically strong companies have by and large become greater relative values – Ricky Sandler has no intention of switching gears. “There’s never been a better time than right now to be long quality,” he says.

Sandler’s champagne taste has served his investors exceedingly well. His Eminence Capital, founded in 1998, now manages around \$3.6 billion and has delivered net annualized returns of 13.2%, vs. 2.2% for the S&P 500.

Arguing that investors should be fleeing to stocks rather than from them, he’s finding opportunity in such areas as financial exchanges, insurance brokerage, software and industrial distribution. [See page 2](#)

### INVESTOR INSIGHT



**Ricky Sandler**  
Eminence Capital

**Investment Focus:** Seeks growing, high-return companies when their shares are out-of-favor due to transitory company-specific or industry-wide challenges.

## Uncommonly Good

*His portfolio companies certainly lack name recognition and sex appeal, but Bob Robotti’s record in finding undervalued stocks is downright glamorous.*

### INVESTOR INSIGHT



**Robert Robotti**  
Robotti & Co.

**Investment Focus:** Seeks off-the-beaten-track companies when their recent performance and the health of their industries cause most investors to look elsewhere.

Many investors go to great lengths in trying to articulate their investment “edge,” but Bob Robotti’s description is short and sweet. “Our advantage is a longer-term view and an ability to tolerate losing money before we make it,” he says.

Focused on small-cap companies others largely ignore, Robotti’s formula for success has proven winning. Since establishing Robotti & Co. Advisors as an independent firm in 1993, it has earned a net annualized 14.1%, vs. 8.7% for the Russell 2000.

Looking toward trouble when others look away, he’s finding opportunity today in such industries as energy infrastructure, natural gas and building-products distribution – and in such countries as Kazakhstan and Mongolia. [See page 11](#)

### Inside this Issue

#### FEATURES

**Investor Insight: Ricky Sandler**

Prospecting for “quality value” and finding it in CME Group, Aon, Oracle and Wolseley, while seeing its clear absence in Verizon. [PAGE 1 »](#)

**Investor Insight: Robert Robotti**

Searching for value where others fear to tread and finding it in Enerflex, Panhandle, Builders FirstSource, Cavco and KazMunaiGas. [PAGE 1 »](#)

**Uncovering Value: SuperInvestors**

We hesitate to call it lucky, but many stocks popular with SuperInvestors have gotten much cheaper. [PAGE 18 »](#)

**Uncovering Value: Alamo Group**

Betting that the market eventually recognizes the good news at this far-off-the-radar company. [PAGE 19 »](#)

**Editors’ Letter**

Advice from an investing master on catching falling knives, “hopefully with care and skill.” [PAGE 20 »](#)

#### INVESTMENT HIGHLIGHTS

INVESTMENT SNAPSHOTS	PAGE
<a href="#">Alamo Group</a>	<a href="#">19</a>
<a href="#">Aon</a>	<a href="#">6</a>
<a href="#">Builders FirstSource</a>	<a href="#">15</a>
<a href="#">CME Group</a>	<a href="#">5</a>
<a href="#">Enerflex</a>	<a href="#">13</a>
<a href="#">KazMunaiGas</a>	<a href="#">16</a>
<a href="#">Oracle</a>	<a href="#">7</a>
<a href="#">Panhandle Oil and Gas</a>	<a href="#">14</a>
<a href="#">Verizon</a>	<a href="#">9</a>
<a href="#">Wolseley</a>	<a href="#">8</a>

**Other companies in this issue:**

[Advance Auto Parts](#), [BP](#), [Cavco](#), [General Motors](#), [Goldman Sachs](#), [Lowe’s](#), [LyondellBasell](#), [Marathon Oil](#), [Marriott](#), [MetLife](#), [Panin](#), [PriceSmart](#), [Research in Motion](#), [Sawada](#), [Seagate](#), [Sherwin-Williams](#), [Teva](#), [Wells Fargo](#)

# Investor Insight: Robert Robotti

Robert Robotti and Isaac Schwartz of Robotti & Company describe the cyclically challenged industries that most interest them today, on what they focus when markets go haywire, what overturned their skepticism about investing outside the U.S., and why they think Enerflex, Panhandle Oil and Gas, Builders FirstSource and KazMunaiGas are mispriced.

The past three years on Wall Street – not to mention the past three weeks – have rattled even the steadiest investing hand. Have you rethought any aspects of your strategy over that time?

**Robert Robotti:** We focus on smaller-cap companies that are largely ignored by Wall Street and face some sort of distress, of their own making or due to an industry cycle. These companies are more likely to be inefficiently priced and if you have conviction and a long-term view they can produce not 20-30% returns, but multiples of that. All of that has served us well for nearly 30 years and is as true today as it was three years ago, so it would be foolish to change what we're doing based on some bad experiences that I believe are way out of the norm.

Many of your current holdings are bets on out-of-favor industry cycles turning. Why does that particularly attract you?

**RR:** It's a consistent reason why things get cheap. We'll put a reasonable multiple on the normalized earnings power of the business over three to four years – knowing it can take five or six – and given the types of things we look at often come up with intrinsic values that are three to five times where the stock is trading today.

Which is not to say the wait can't sometimes be painful. Five or six years ago we thought the manufactured-housing business looked interesting. You had homes built in a factory-controlled environment that delivered more-consistent quality at a lower price, particularly relevant as the prices of site-built homes were going through the roof. Industry sales in the U.S. had gone from 370,000 per year down to less than 150,000. Industry competition had also gotten far more reasonable as the biggest player in the business,

Clayton Homes, was now owned by Berkshire Hathaway.

Very little has gone right for the industry since. First, the financing of site-built homes entered its craziest phase, where you could actually pay less per month for a site-built home because you didn't have to put any money down and could get all the mortgage you wanted. This at a time when buying a manufactured home actually required a down payment and a credit check. Then the housing market collapsed and new-home building of all kinds fell off a cliff. In 2010 the manufactured-housing industry delivered 50,000 new homes – a higher percentage of total new home starts than a few years earlier, but still the lowest number on record since the industry began tracking it in 1959.

We still believe the industry is well positioned when there's a rebound in home building. The financing playing field has been leveled and manufactured housing, with its significantly lower per-square-foot costs, should compete very well for the first-time homebuyer. There aren't that many publicly traded players left, but our primary holding is Cavco Industries [CVCO], which has been a consolidator in the industry and has net cash on its balance sheet.

Is your affinity for energy-related stocks similarly tied to playing the cycles?

**RR:** Because there are commodities behind it, there is certainly plenty of volatility to the business and share prices, which we try to take advantage of. But more generally it's an industry I've invested in since 1976, so I'd like to believe I have somewhat deeper knowledge than others that gives me a better sense of when companies are attractively valued relative to their assets and the outlooks for their specific businesses.



**Robert Robotti**

## New School

Bob Robotti's introduction to investing as an independent auditor for client Tweedy, Browne in the 1970s was decidedly old school. He'd spend hours talking stocks with Joe Reilly, a firm partner since 1945. Legendary investor Walter Schloss would drop in at times when not poring over annual reports in his nearby office.

Thirty years later when one of Robotti & Co.'s analysts, Isaac Schwartz, suggested the firm make a commitment to investing outside the U.S., Robotti's initial response was pure old-school. "My English isn't that great," he says, "how would we add value when even the language was different?"

Spending time in Asia, at Schwartz's behest, changed Robotti's mind. Financial statements were cleaner and more accessible than expected, competition from other value investors was sparse, and the valuations uncovered from time to time were shockingly low. Schwartz jumped at the chance to move to Hong Kong, where he spearheads the firm's investments in the region, now 10% of total assets. "It's easy to get stuck in your ways and ignore someone else's enthusiasm for something new," says Robotti. "Over time you learn that sometimes it pays to listen."

**Describe the macro overlay behind your current interest in several North American natural-gas-related companies.**

**RR:** Natural gas is a commodity that's not easily transportable, so market prices are dictated far more by local supply and demand than is the case for oil. For some time now, the significant increase in gas supply in North America from shale discoveries coupled with weak demand in the aftermath of the recession have pushed gas prices extremely low on an absolute and relative basis versus oil. At around \$4 per thousand cubic feet [Mcf], North American natural gas is priced at less than one-third the price of oil on an energy-equivalency basis.

While we don't expect that discount for North American gas to go away for the foreseeable future, we believe the discrepancy will definitely shrink. U.S. natural gas has many competitive advantages versus oil – lower cost, plentiful domestic supply and far less impact on pollution – which we expect to result in incrementally higher demand. At the same time, today's gas prices provide no return on natural gas drilling, which will keep production supply in check. We think that a \$6 per Mcf price – 50% above today's level – will be needed to sustain drilling that will be necessary to meet even current production levels.

With \$6 natural gas the business environment for related companies should be highly attractive relative to what's expected. The changes necessary to get there may take time – bus fleets don't switch to compressed natural gas or coal-fired electricity capacity isn't shifted to gas-powered plants overnight, for example – but we consider North American natural gas an interesting decade-long play.

**More on that later, but still speaking generally about the types of situations that attract you, how often are you betting on potential operating turnarounds?**

**RR:** We've been successful in the past with a variety of special situations, including companies in bankruptcy or having to raise capital through rights offerings. The challenges facing the com-

pany may be industry-related or a result of its own mistakes. One of our best investments over the past several years has been PriceSmart [PSMT], which runs Costco-like warehouse stores in Latin America. It overextended itself and in 2005 went through a restructuring, which included a rights offering and bringing in new management. One appealing aspect of the offering was that the founder and largest shareholder, Sol Price, backstopped the deal and instead of taking warrants or special pricing in return,

---

**ON ASIA:**

**We're focused there because our investing style isn't in common practice and the markets are more manic-depressive.**

---

actually offered public shareholders a better deal on the offering than he and his family got. We unfortunately owned the stock before, but bought a lot more in the rights offering at \$7 per share – it's now closer to \$65.

**Do you still own it?**

**RR:** We've reduced our position as the stock has done extremely well over the past couple of years, but we still own it. The company has compounded same-store sales in the mid-teens through the recession and now has 28 stores, mostly in Central America and the Caribbean, but it still has considerable opportunity for growth. They're opening their first store in Colombia, for example, which has a population equal to the current population base served by the rest of the company today.

**You've made a concerted effort to expand your international investing [see box, p. 11]. Describe how that's going so far?**

**RR:** We've focused almost exclusively on Asia, where our style of value investing isn't in common practice and where, because the markets are even more

manic-depressive, you can find dramatic disparities between public and private market values. It's been a wild ride, with those markets going down more and faster into the financial crisis and then up more and faster coming out of it. Our knowledge base and contacts throughout the region are significantly better and we continue to find plenty of ideas that should do very well as these economies continue to emerge over the next ten years.

**Give some examples of the quirky types of things you're finding in Asia that fit your strategy?**

**Isaac Schwartz:** We see considerable potential in Mongolia, whose economy is being fundamentally transformed by demand for its natural resources. Roads, railways and processing facilities are being built in the country to facilitate the shipping of coal, copper and iron ore to China and elsewhere. One way we've found to play that is through a Japanese company called Sawada Holdings [8699:JP], which owns a majority stake in Khan Bank, the dominant bank in Mongolia. Khan's asset base has grown a hundred-fold in the last decade and it now controls roughly 30% of the country's total banking assets.

Khan in the first half of 2011 had net earnings of \$24 million, a 49% return on equity. Put a 15-20x multiple on that on an annualized basis and the bank overall would be worth \$700 to \$950 million, making Sawada's stake worth maybe \$400-500 million. But if we value the rest of Sawada's holdings, primarily a Japanese broker-dealer, at book value, its current market value [at a share price of around ¥740] implies a value for Khan of only \$130 million at current exchange rates. That's a pretty nice discount for a company with dominant market share, great returns on capital and extraordinary growth upside.

Another bank bet we're making is through Indonesia's Panin Insurance [PNIN:IJ], the control shareholder of Bank Panin, a leading commercial bank serving the country's affluent ethnic Chinese minority. There's actually a bank

museum in Jakarta that focuses on the Asian financial crisis of 1997-98, which is indicative of the influence that crisis had, resulting in a conservatively capitalized and risk-averse banking industry in Indonesia. Bank Panin trades independently at a much higher valuation, but on our look-through numbers we're able to buy it through the insurance holding company at an implied P/E closer to 5x and at only 50% of book value. That for a bank in a growing economy that has increased its book value per share by 16% annually over the last five years.

**Coming back to natural gas, describe why Enerflex [EFX:CN] is one of your favorite bets on the sector.**

**RR:** The company engineers and manufactures equipment used to modulate the natural gas pressure out of the wellhead. In general, the gas comes out at a different pressure than is necessary for it to enter the pipeline, and Enerflex's compression equipment steps it up or down to pipeline pressure. They also sell equipment that separates other elements like carbon dioxide and sulfur from the gas, and there's a nice, growing service business given the heavy wear and tear on the equipment.

The company in its current form is the result of a 2010 merger of Enerflex, which was a stand-alone company, and the competitor division of Toromont, a large Canadian industrial company. Earlier this year Toromont decided to spin off the merged company under the Enerflex name. It's now one of two leading companies in the business – the other is U.S.-listed Exterran – with most of its revenues coming from Canada, the U.S. and Australia.

The driver of the business is the level of drilling and production of natural gas, which as we've discussed, we believe will eventually accelerate rapidly as gas takes global market share from oil. Not only should the level of drilling increase, but more of it will come from unconventional sources like shale, where the need to step up gas pressure before it hits the pipeline requires more compression

equipment. Unconventional sources also require more separation processing of the gas at the wellhead, which also bodes well for that side of Enerflex's business.

There's also an operational piece to the story as management continues to realize a variety of cost savings from last year's merger. They continue to rationalize manufacturing and shipping capacity to take advantage of scale economies and where they can do things for lower cost. On top of the ongoing savings, they've also done things like sell a manufacturing facility in Canada for more than \$40 million Canadian, which for a company with an \$820 million market cap is a nice cash recovery on an excess asset.

**With the shares at a recent C\$10.65, how are you looking at valuation?**

**RR:** In 2008, when the two companies were separate, they had C\$1.8 billion in revenue and a pro-forma C\$218 million in EBITDA. There's at least C\$30 million of cost savings associated with the merger, so C\$248 million is the most the combined companies have made. As revenues grow and margins expand, we expect EBITDA within the next few years to be higher than that pro-forma peak.

Against that you have an enterprise value on the company today of C\$920 million, after adding back roughly C\$100 million in net debt. That's only 3.7x the pro-forma 2008 EBITDA level that we expect the company to eventually surpass. Were that to happen, we believe a business like this would more reasonably trade at closer to 8x EV/EBITDA. As is always the case, we're uncertain when

**INVESTMENT SNAPSHOT**

**Enerflex**  
(Toronto: EFX:CN)

**Business:** Design, manufacture, sale and maintenance of compression equipment used primarily to transfer natural gas from the wellhead to the distribution pipeline.

**Share Information**  
(@8/30/11, Exchange Rate: \$1 = C\$0.979):

<b>Price</b>	<b>C\$10.64</b>
52-Week Range	C\$9.53 - C\$14.99
Dividend Yield	0.6%
Market Cap	C\$821.5 million

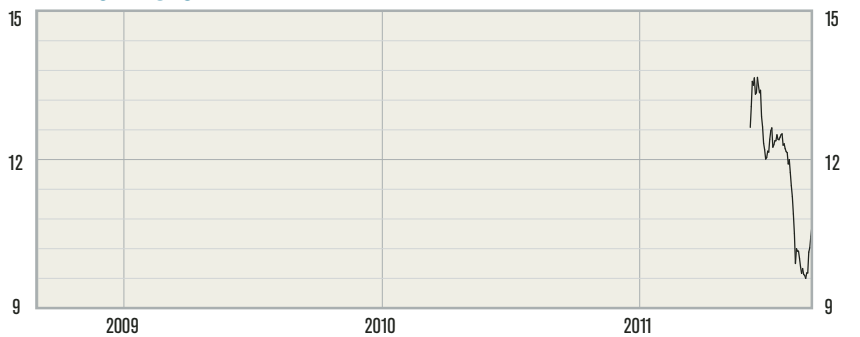
**Financials** (Six mo. ended 6/30/11, annualized)

Revenue	C\$1.16 billion
Operating Profit Margin	4.7%
Net Profit Margin	3.3%

**Valuation Metrics**  
(Current Price vs. TTM):

	<b>EFX</b>	<b>Russell 2000</b>
P/E	n/a	32.5

**EFX PRICE HISTORY**



**THE BOTTOM LINE**

Operating improvements, a mix change in natural gas production, and an eventual normalization of natural gas prices should allow the company at least to return to its 2008 pro-forma EBITDA level, says Bob Robotti. If that happens, he'd expect the shares to trade at closer to 8x that EBITDA level on an EV basis, he says, from 3.7x today.

Sources: Company reports, other publicly available information

that happens, but our conviction that it eventually will is quite strong.

**Describe why Panhandle Oil and Gas [PHX] is your natural-gas resource play of choice.**

**RR:** This is something we've owned for 30 years – we now own more than 9% of the company and I've been on the board since 2004. What's particularly appealing about it is that rather than take out long-term leases on minerals in the ground – which most oil and gas companies do – it actually owns the mineral rights in perpetuity on 255,000 net acres located in

some large and proven shale natural-gas deposits, mostly in Oklahoma, Texas and Arkansas. They don't operate any wells themselves, but only through partnering with large operators like Devon Energy and Chesapeake.

Perpetual mineral ownership is somewhat unique among public independent oil and gas companies and offers many advantages. Panhandle has tremendous flexibility to pick and choose the drilling projects it wants to participate in after others have made the upfront investment to identify the best prospects. The end result is that Panhandle's finding and lifting costs are among the lowest in the

industry and its margins for every cubic foot of gas produced are among the highest.

This is a case where we basically believe the company's size and its makeup have made it largely uninteresting or misunderstood by most investors – on top of the general lack of interest in anything to do with natural gas. Our experience is that that indifference won't last forever and the wait can be well worth it.

**What upside do you see in the shares, now at \$29?**

**RR:** As of its mid-year report, Panhandle has 64 billion cubic feet of proved developed reserves of natural gas. The resource base on top of that – on roughly 20,000 of its net acres – has been identified as potentially another roughly 330 billion cubic feet. So while its production has been growing at double-digit rates, it has considerable growth opportunities that it is able to finance internally, including investing excess capital in acquiring new properties.

Say the sustainable long-term price of natural gas is \$6 per Mcf. Assume also that Panhandle's lifting cost – consistent with historical experience but assuming economies as volume increases – is \$1.50 per Mcf. Using back-of-the-envelope math, that 330 Bcf of undeveloped natural gas reserves could then be worth roughly \$1.5 billion, undiscounted. That asset base alone provides significant upside to today's enterprise value of around \$230 million.

With net cash, the company is well-financed to weather a continued depressed market for natural gas, and we just think it's uniquely positioned to deliver excellent returns when the environment turns – which we believe is certain, even if the timing is not.

**Turning to another less-than-vibrant industry, describe your investment case for building-products distributor Builders FirstSource [BLDR]?**

**RR:** This is a value-added distributor to the homebuilding industry. We first

**INVESTMENT SNAPSHOT**

**Panhandle Oil and Gas**  
(NYSE: PHX)

**Business:** Ownership of primarily natural gas mineral rights in properties located in Arkansas, Kansas, Oklahoma, New Mexico and Texas.

**Share Information**  
(@8/30/11):

<b>Price</b>	<b>28.90</b>
52-Week Range	21.00 – 36.25
Dividend Yield	1.0%
Market Cap	\$238.3 million

**Financials (TTM):**

Revenue	\$43.2 million
Operating Profit Margin	28.4%
Net Profit Margin	20.6%

**Valuation Metrics**

(@8/30/11):

	<u>PHX</u>	<u>Russell 2000</u>
Trailing P/E	27.3	32.5
Forward P/E Est.	n/a	19.4

**Largest Institutional Owners**

(@6/30/11):

<u>Company</u>	<u>% Owned</u>
Robotti & Co	9.3%
Amica Mutual Insurance	5.9%
BlackRock	5.3%
Dimensional Fund Adv	1.9%
Vanguard Group	1.7%

**Short Interest** (as of 8/15/11):

Shares Short/Float	4.0%
--------------------	------

**PHX PRICE HISTORY**



**THE BOTTOM LINE**

By owning rather than leasing its mineral rights, the company has excellent flexibility to pick and choose drilling projects and benefits from low finding and lifting costs for its natural gas, says Bob Robotti. Using back-of-the-envelope math, he figures its identified but undeveloped reserves alone are worth multiples of the current market value.

Sources: Company reports, other publicly available information

bought into it in May 2009 and now own more than 5% of the outstanding shares.

The company has gone from \$2.3 billion in annual revenues to around \$700 million, a direct function of new housing starts falling from their highs to around 450,000 last year. Our premise is that on a longer-term basis new housing starts will normalize somewhere between 1 and 1.5 million, and that Builders FirstSource will be a prime beneficiary when that happens.

The competitive environment on the supply and manufacturing sides of the business continues to go through radical changes. The four largest players in the

U.S. – ProBuild, Stock Building Supply, Building Materials Holdings and Builders FirstSource – continue to go through varying levels of distress, but have also been consolidating the many smaller local and regional competitors in the industry. While these companies haven't been spared in the current environment, the consolidation that is ongoing should make for greater economies of scale for the major players and more rational competition when the business finally improves.

Another trend that should benefit Builders FirstSource is that national homebuilders are narrowing their focus to acquiring land, sighting communities,

identifying the types of homes people want to buy and then marketing the end product. The actual building of the homes is less of a focus, which has resulted in suppliers like BFS moving aggressively beyond just supplying lumber and supplies to sub-assembling at lower cost things like wall panels and roof and floor trusses. That's become a very important service to the homebuilder, for which BFS should be profitably paid in a normal homebuilding environment.

**How good is the company's financial staying power?**

RR: It currently has \$60-70 million in cash and is probably burning \$40 million a year at current rates. The numbers improved in the second quarter, with EBITDA close to breakeven, so the cash burn now is down to required debt payments. In any event, they've got another 12 to 18 months before they would need to raise capital if things don't improve.

While that's clearly a risk, we believe it's a dilution risk, not a viability risk. The lead shareholders here are private-equity firms JLL Partners and Warburg Pincus, who we're confident would participate in and help lead any financial restructuring necessary. That means we don't know whether the ultimate value we see here will be divided by the current 95 million shares or something higher. Given the upside value we can imagine, that's a risk we're willing to take – especially since we are willing and able to participate should incremental capital be required.

**Describe the potential upside you see from today's share price of \$2.10.**

RR: With 1 million homes being built in the U.S., we'd expect BFS to generate roughly \$1.5 billion in revenues. At 1.5 million homes – a number frequently cited as the sustainable annual demand – revenues would be closer to \$2.5 billion.

Given ongoing efforts to expand its footprint and cut costs, we believe the company in a normal environment should be able to sustain an EBITDA margin of around 10%. So that translates into

**INVESTMENT SNAPSHOT**

**Builders FirstSource**

(Nasdaq: BLDR)

**Business:** Manufacture and distribution of structural and other related building products for residential new construction, primarily in the southern and eastern U.S.

**Share Information**

(@8/30/11):

<b>Price</b>	<b>2.09</b>
52-Week Range	1.43 – 3.39
Dividend Yield	0.0%
Market Cap	\$198.3 million

**Financials (TTM):**

Revenue	\$696.7 million
Operating Profit Margin	(-7.5%)
Net Profit Margin	(-11.7%)

**Valuation Metrics**

(@8/30/11):

	<u>BLDR</u>	<u>Russell 2000</u>
Trailing P/E	n/a	32.5
Forward P/E Est.	n/a	19.4

**Largest Institutional Owners**

(@6/30/11):

<u>Company</u>	<u>% Owned</u>
Warburg Pincus	25.3%
Stadium Capital	15.3%
Robotti & Co	5.3%
Prescott Group Capital	3.5%
Coliseum Capital	2.8%

**Short Interest** (as of 8/15/11):

Shares Short/Float	9.0%
--------------------	------

**BLDR PRICE HISTORY**



**THE BOTTOM LINE**

It's on its heels due to the depressed U.S. housing market, but few companies have as much leverage to the upside in an eventual rebound, says Bob Robotti. If U.S. housing starts return even to a less-than-normalized 1 million level, he says, the impact on BFS's earnings and the warranted multiple could result in a share price of \$11.

Sources: Company reports, other publicly available information

\$1.60 per share in EBITDA at 1 million housing starts and \$2.60 per share at 1.5 million starts.

This is largely a distribution business, which isn't capital intensive, so we could imagine it in normal times earning a 7-8x EBITDA multiple on an enterprise value basis. Assuming net debt stays constant, that would result in a share price at the low-end housing-start number of around \$11, and at the higher-end level, a share price closer to \$18. If we get anywhere near that, even with additional potential dilution, we should do extremely well.

**What attracted your attention in KazMunaiGas [KMG:LI]?**

**IS:** We started looking at Kazakhstan because we were interested in all coun-

tries close to China and within its sphere of economic influence. Kazakhstan certainly qualifies, sharing a 1,000-mile border with China and blessed with plentiful natural resources that that country needs.

KazMunaiGas is the second-largest oil producer in Kazakhstan, 63%-owned by the state, 11%-owned by China's sovereign wealth fund and the rest traded publicly both in Kazakhstan and on the London international exchange.

**We'll profess to knowing little about Kazakhstan. Please give us a brief lesson.**

**IS:** Kazakhstan is Central Asia's largest economy, with 16 million people and per-capita GDP comparable to middle-income countries like Malaysia and Turkey. It was the last former Soviet

republic to declare independence in 1991, and it shares a 4,000-mile border with Russia. Although the Kazakh people are Turkic Muslims, Russian is as widely spoken as Kazakh, and social mores have evolved more in a Russian than strictly Islamic way.

The economy is primarily natural-resources based and the government recently announced plans to increase per-capita GDP by 50% over the next four years. That's obviously a bold thing to say, but there appears to be a legitimate plan behind it, focused on expansion of the production of oil, zinc, iron ore, copper and other resources. Liquid investment opportunities for foreigners are limited to a dozen or so companies traded on overseas exchanges, mostly in London.

Our thesis for KazMunaiGas is pretty straightforward. Its earnings derive from mature oil fields with decades of remaining life. In addition to that, it has excellent growth opportunities, most of which are tied to the fact that the government of Kazakhstan has the right of first refusal on secondary-market transactions in oil-fields within the country. Since the government conducts its onshore upstream activities through KMG, it cedes this right to KMG, which has used it to expand its asset base at attractive prices.

Even with what we consider a solid business profile, interest in KMG's shares is minimal. Kazakhstan was a popular emerging market until its asset bubble popped in 2007, a year before the global crisis took hold. Foreign investors still haven't regained interest, resulting in apathetic trading in KMG shares – its public float is nearly \$2 billion, but it trades less than \$5 million per day.

**How cheap has that made the shares, currently trading at \$16.20?**

**IS:** The current market cap of the company is \$6.8 billion, of which \$3.9 billion is in net cash. Against that you have a company that in 2010 earned \$1.7 billion. So on last year's earnings, net of cash, the P/E is less than 2x.

It almost doesn't make sense to try to specify an intrinsic value for something

**INVESTMENT SNAPSHOT**

**KazMunaiGas**

(London Int'l: KMG:LI)

**Business:** Exploration, development and production of oil and natural gas. Resource base located in Kazakhstan, the last Soviet republic to declare independence, in 1991.

**Share Information**

(@8/30/11):

<b>Price</b>	<b>16.20</b>
52-Week Range	14.55 - 24.93
Dividend Yield	5.6%
Market Cap	\$6.83 billion

**Financials (2010):**

Revenue	KZT 609.24 billion
Operating Profit Margin	30.6%
Net Profit Margin	38.5%

**Valuation Metrics**

(Current Price vs. TTM):

	<b>KMG</b>	<b>S&amp;P 500</b>
P/E	n/a	13.9

**KMG PRICE HISTORY**



**THE BOTTOM LINE**

Isaac Schwartz believes the company's earnings power and its home country's political and economic modernization are being almost entirely ignored by the market, which prices its stock at less than 2x earnings, net of cash. Without citing a specific intrinsic value, he says that's "a fraction" of where companies with similar assets are valued.

Sources: Company reports, other publicly available information

this cheap. Our simple premise is that the stock trades at a fraction of where companies with comparable assets are valued. Exactly when and how that discount shrinks we can't say, but we're confident that it eventually will.

Political risk has to be a key issue here. How do you reconcile that?

IS: We think the current ownership structure of the company provides some protection against misdealing, at least for the time being. KMG is the first of many government-controlled companies in Kazakhstan to sell pieces to the public via initial public offering. Next year, the government plans to list the national airline, the electricity distributor, and some energy-related transportation-infrastructure businesses. The more they attempt to turn the country into a destination for foreign investment, the more likely they are to try to treat investors fairly. We also think the large stake held by China helps – you don't want to alienate your best customer.

One key concern in all Central Asian countries is what might happen upon a change in regime. Kazakhstanis have done well under current leadership – the country has the best infrastructure and educational systems among Central Asian states

**ON KEEPING COOL:**

**With 30 years' experience reinforcing the importance of focusing on the long term, it's easier to stay patient.**

– so we think the risk something bad happens on this front is lower for Kazakhstan than for neighboring countries.

Bob, you've been at this a long time. Any advice for keeping your cool when emotion is running high in the markets?

RR: Temperament is a function of your personality, but can also be developed

with experience. It's always been fairly easy for me to stay focused on the long term, but with 30 years' experience reinforcing the importance of that, it's easier to stay patient.

In 2008 that patience didn't serve me so well. When the problems started to get attention, conviction that things would be fine in the medium to long term kept me from trying to time the cycle. In the short term, a lot more selling would have been a good idea. Hopefully that was a one-in-50-year event.

In general, the non-discriminating volatility that we've had lately creates opportunity, and we're finding a lot of places to deploy capital. It hasn't changed what I've done, but I will say I've questioned myself more than usual this time around. If I'm doing that after 30 years in the business, I can imagine what's going through a lot of investors' minds these days. VII

*Disclosure: Robotti & Company Advisors owns more the 1% each of the outstanding shares in CVCO, PSMT, EFX and Savada. Robert Robotti individually owns EFX, BLDR and PHX.*

# Investment Ideas That Stand Out



Subscribe now and receive a full year of **Value Investor Insight** – including weekly e-mail bonus content and access to all back issues – for only \$349. **That's less than \$30 per month!**

- [Subscribe Online >>](#)
- [Mail-in Form >>](#)
- [Fax-in Form >>](#)

Want to learn more? Please visit [www.valueinvestorinsight.com](http://www.valueinvestorinsight.com)