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VALUE INVESTING | Q&A

Coal, Copper, Contrarian Picks Power Third Avenue Value's Turnaround

By Lauren Foster

Matthew Fine was just out of college when he got the best advice of his life: If you want to be an investor, go work for Marty Whitman, the legendary value investor who founded Third Avenue Management in 1986.

And so he did, starting "about one step above the mailroom" in 2000 and climbing the ladder to portfolio manager of the firm's flagship strategy, the $900 million Third Avenue ValueTAVFX –0.40% fund, which he has overseen since late 2017.

Last year, the fund returned 17.5%, including reinvested dividends, while the S&P 500 index returned a negative 18.1%. That performance placed Third Avenue Value in the first percentile of its category, according to Morningstar, meaning that it delivered better returns than 99% of its peers. The fund is in the top quartile over three and five years, with annualized total returns of 37.5% and 7.9%, respectively. That's quite a comeback, considering that Third Avenue struggled when growth took off and value fell out of favor, leading to management turnover and poor performance.

Whitman, who died in 2018, stepped back from managing the value fund in 2012. In 2017, the firm made a series of changes that set it on the course it's on today. "We made a commitment to reinvigorating the investment culture of this firm, and that meant, ironically, turning back the clock on Third Avenue to its earliest and most successful days," says Fine. "We were eager to take it back to this traditional, fundamental, deep-value, contrarian approach that Marty built."

Matthew Fine, portfolio manager of the Third Avenue Value fund.

Photograph by Cole Wilson

Fine spoke with Barron's on April 24 about Third Avenue's transformation, his investment style, and stocks he's excited about. An edited version of the conversation follows.

***Barron's:* The Third Avenue Value fund was in the bottom quartile in 2017-19 and top quartile in 2020-22. What changed?**

Matthew Fine: When the portfolio-management team changed in 2017, statistically speaking, the portfolio

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became much cheaper, much more global in orientation, less U.S.-focused, smaller in market capitalization, and more contrarian and opportunistic.

How do you choose investments?

We are looking for businesses that have fallen on some sort of difficult, but resolvable, set of circumstances. The circumstances could be macroeconomic, or at an industry level where the industry is going through a cycle or a depression, or it could be at the company level, where a company has tripped up in some way. We're trying to find areas where the pessimism has become excessive or irrational, and buy securities at a substantial discount to what we believe to be conservative estimates of a company's net asset value.

What does the portfolio look like overall?

We tend to hold about 30 positions. The largest 10 typically constitute about 50% of the portfolio. By U.S. mutual fund standards, that's a highly concentrated portfolio. We do that across market capitalizations, geographies, and industries. And we are benchmark-agnostic, which means I don't know what the composition of the benchmark is, and I don't structure a portfolio based on the benchmark.

Which stocks stand out?

Our biggest holding is Tidewater, which operates a fleet of platform supply vessels supplying oil and gas platforms. An important part of our investment process is searching for companies emerging from the bankruptcy process, as Tidewater did.

The beauty of that is twofold: One is that companies coming out of bankruptcy have usually cleaned up their balance sheets. Tidewater exited bankruptcy with essentially a net-cash balance sheet. And two, we got an incredible bargain. In the bankruptcy, Tidewater had written down the carrying value of its assets by about 75%, meaning that it was carrying its fleet at about 25 cents on the dollar postbankruptcy. We bought it at a substantial discount to that restated book value. That felt like a bargain in an industry that we were confident was going through a cyclical, not a secular, decline. We bought the stock in 2017 in the mid $20s per share, and today it is about $45 per share.

Does Tidewater have more upside?

I see a lot of upside. The dearth of investment in maintaining existing oil production globally is going to result in shortfalls of oil production. And the roughly 25%-plus of global oil production that takes place offshore is essential. There is an accelerating mismatch between the demand for supply vessels and the supply. The fleets today are far smaller than a decade ago, so if demand continues to increase, that could be a powerful recipe for upside.

What is another stock you like?

Bank of Ireland is one of my highest-conviction investments. When we bought the stock in 2019, we took the view that the unprecedented interest-rate environment—in Europe, that meant negative interest rates from a policy perspective—created about the worst banking environment from a rate perspective that has ever existed. It put pressure on the interest income and interest margin earned by banks, and thus, return on equity.

However, price is what matters. Bank of Ireland got down to 40% of book value, even though it was earning only about a 5% return on equity in 2019, which is terrible from a banking perspective. But if you're paying only 40% of book value, you're getting a double-digit earnings yield. We thought that when the pendulum had swung so far from an interest-rate perspective, the probabilities were in favor of improvement. That played out to our benefit.

In Ireland, the regulatory environment is extremely strict, and the banking industry has consolidated in the past 24 months from five banks to three banks, of which Bank of Ireland is one of the two largest. The increased scale, improved competitive environment, and improved interest-rate environment are all working in favor of far better returns.

Today, Bank of Ireland is valued at about 90% of stated book value. It just reported 2022 return on equity north of 10%, so it is still valued at a single-digit multiple of earnings and double-digit earnings yield. However, the consolidation of the Irish banking market has only happened recently and Bank of Ireland management is credibly forecasting that the bank can reach a 15% return on equity by 2025. On that basis, the earnings multiple would shrink to a mid-single digit multiple.

The fund has owned Warrior Met Coal since 2017. Why did you buy the stock—and hold on?

This is another position we bought postbankruptcy. Warrior's two mines were part of the former Walter Energy. The company had a terrible balance sheet and was controlled by private equity and its creditors. After the bankruptcy process, it came out with a net-cash balance sheet and the two crown-jewel assets of Walter—two metallurgical coal mines in Alabama. The company is developing a third mine, Blue Creek.

The company has about $200 million worth of excess coal inventories on its balance sheet. It also has $500 million of net cash, so that's $700 million. And the Blue Creek project has a net present value—at long-term normal coal prices—of about $1 billion. So, you have $1.7 billion of value on a $1.9 billion market cap. There is only $200 million left attributed to the two operating mines, which generated close to a $1 billion of Ebitda [earnings before interest, taxes, depreciation, and amortization] in 2022.

Coal is reviled because of its carbon content. But you can't make steel without iron ore and metallurgical coal. Warrior is trading today at less than three times trailing earnings per share.

I suppose it could stay incredibly cheap at a low-single digit multiple of operating cash flows. But the one

thing that really attracts us to Warrior is that the company has been distributing, in large special dividends, all of its excess unencumbered cash flow. Another bit of icing on the cake from the bankruptcy process was that Warrior came out with a huge net-operating-loss carryforward, so it wouldn't pay material taxes for a long time. That is still the case. It isn't paying any cash taxes on all of this cash flow. Cash will pile up and eventually be distributed to shareholders again. Since emerging from bankruptcy, Warrior has distributed almost the equivalent of its market capitalization today in special dividends.

One of your largest investments is Capstone Copper. Why?

We have gone through a period where all kinds of natural-resource production has been viewed as antiquated. It isn't reviled to the extent that coal is, but mining in general has been frowned on from a capital-markets and an environmental perspective.

There is no metal or natural resource more critical to renewable energy than copper. It is critical to the basic functioning of modern society but also incredibly scarce. We've done a terrible job of finding more copper resources. Part of the reason is because capital markets have frowned on mining, and capital has been expensive and hard to come by. Copper demand is increasing, and there will be a shortage because it is hard to find more at a reasonable cost.

Renewable energy will also drive demand, whether it is electric vehicles, wind energy, or solar. Those technologies, and facilitating their connection to the grid, have the potential to be a demand accelerant for copper.

Capstone is copper-focused and a mid-cap company—far cheaper than the mining majors. Its assets are in politically safe mining jurisdictions, and it has one of the best production-growth profiles in the industry. By the end of 2023, we expect the company to be producing at a rate that would translate to roughly $1.1 billion of annual Ebitda at today's copper prices. With an enterprise value of $4.1 billion, that would translate to a multiple of about four times. However, copper prices are far more likely to rise than fall over the medium term, and Capstone's cash flows are leveraged to copper prices.

Do you have a favorite Marty story?

Possibly my favorite Marty quote is, "The next time someone walks into this room with a perfect investment will be the first time." He said it a number of times while presiding over investment-team meetings. He would go on to explain that there was something wrong with every investment, and if you don't know what was wrong with an investment, you didn't fully understand it.

Thanks, Matt.