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Case Study – Cleveland-Cliffs

In this piece, we discuss some of the lessons we have learned from Warren Buffett over the years and how we have applied them to our investment philosophy at 2XL Capital.

Warren Buffett is arguably the most famous investor of our lifetime with hundreds of books written about him. He has not only succeeded as an investor, but most importantly has influenced so many generations of new investors who learnt from him and applied his philosophy to their investment business. These people include Mohnish Pabrai, Nick Sleep and Bill Miller, among many others. It is difficult to condense everything that we have learned from Buffett in this article, but four lessons stand out:

- **You're neither right nor wrong because other people agree with you.** Other people's opinions shouldn't be a factor in your decision-making process.

  "You're neither right nor wrong because other people agree with you. You're right because your facts are right and your reasoning is right – that's the only thing that makes you right. And if your facts and reasoning are right, you don't have to worry about anybody else."

- **Define your circle of competence.** Your odds of success improve when you are forced to direct all of your energy and attention to fewer stocks that are within your circle of competence and bet big on them. ''It's not a competency if you don't know the edge of it.'' – Charlie Munger.

  ''I could improve your ultimate financial welfare by giving you a ticket with only 20 slots in it so that you had 20 punches—representing all the investments that you got to make in a lifetime. And once you'd punched through the card, you couldn't make any more investments at all. Under those rules, you'd really think carefully about what you did and you'd be forced to load up on what you'd really thought about. So you'd do so much better."

- **Capital allocation, the most important job of a CEO.** Capital allocation is arguably the most important job of a CEO. It is a skill that many CEOs lack.

  ''Over time, the skill with which a company's managers allocate capital has an enormous impact on the enterprise value.''

- **Temperament beats intelligence.** Success in investing doesn't correlate with IQ.

  ''If you've got 160 IQ, sell 30 points to somebody else because you won't need it in investing. What you do need is the right temperament. You need to be able to detach yourself from the views of others or the opinions of others.''

Below is a case study on an investment idea that we owned for the last 2 years that clearly illustrates the points that we made above.

Cleveland-Cliffs is a 175-year old company that was the largest iron ore miner in America. We started buying it between October 2019 and July 2020 at prices ranging between $10 and $6. Three things got us interested in the stock:

- Distressed valuation
- Infrastructure program in the US which we thought was bound to happen
- Superstar CEO

<u>Lesson 1: You're neither right nor wrong because other people agree with you.</u>

When we first started buying Cleveland-Cliffs, the stock was totally unloved by Wall Street. The market back then was focused on FAANGs and some high-flying growth companies, whereas dull mining companies like Cleveland-Cliffs were deeply out-of-favor and traded at significantly depressed valuations. This is one of the factors that got us interested. But more importantly, we saw a business run by a phenomenal shareholder-friendly CEO with talent for capital allocation. Furthermore, we identified a catalyst; a major infrastructure plan bound to happen in the US given the poor state of roads, bridges, etc… As the oldest and largest independent iron ore miner in the US and a major supplier to the American steel industry, we believed Cleveland-Cliffs would be a major beneficiary of the country's much needed infrastructure spend. We also concluded from our analysis that the stock offered a margin of safety.

<u>Lesson 2: Define your circle of competence.</u>

We spent two months understanding Cleveland-Cliffs' iron ore business, the competitive dynamics, the drivers and all other aspects of the business. We felt we had an edge and/or a competitive advantage over others looking at the same stock. Our analysis determined that the stock had an asymmetric risk/reward profile, and that gave us the confidence to build a 10% position in the name.

Lesson 3: Capital allocation, the most important job of a CEO.

Lourenco Gonzalez, the CEO, reminds us of Tom Murphy, who Buffett regarded as one of the best CEOs and capital allocators ever. In fact, Buffett said about Murphy: *''most of what I learned about management, I learned from Murph''.* We regard Lourenco as a master capital allocator. When he took over in 2014, the company was nearly bankrupt. In his first six months, he repurchased the company's public debt at steep discounts and extended maturities, effectively strengthening the balance sheet. He also eliminated dividends to accelerate debt reduction and got rid of the Bloom Lake mine which was draining the company's capital resources. In 2015, total capital expenditures dropped to a mere $80m, compared with $862m in 2013 and $1.1Bn in 2012. But that's not all Lourenco achieved. A few years later he saw an opportunity to consolidated the steel market in the US just at a time when steel prices were near their bottom and were to embark on an upturn. He then bought AK Steel in March 2020 and ArcelorMittal USA in December 2020. The timing of both acquisitions could not have been better. These acquisitions transformed Cleveland-Cliffs into the largest vertically integrated producer of flat-rolled steel in North America with $20Bn in annual revenues (vs. only $2Bn pre-acquisitions). He also recently acquired the largest processor of prime scrap in the US, which is a key raw material in steel production that is in increasingly high demand and short supply. But more importantly, he is shareholder oriented and owns $100m worth of stock. He is on the record saying he will favor profitability over increasing capacity. He has also used free cash flow to fully redeem preferred shares and is committed to eliminating net debt with future free cash generation. Without the amazing capital allocation decisions that Lourenco took, we would not have been able to achieve these returns.

Lesson 4: Temperament beats intelligence.

In December 2019, Cleveland-Cliffs announced the acquisition of AK Steel. The acquisition was not well received by the market, evidenced by the stock falling almost 20% in the subsequent weeks. The reason investors did not like the acquisition is that they were diversifying out of being a pure-play iron ore company to buying a steel company. We felt that this was a good acquisition because of the CEO's capital allocation skills as well as our view that steel prices were at an inflection point to turn higher. Then in February 2020, when the pandemic broke out, this exacerbated the downturn and sent the stock even lower. Having the right temperament, and not letting the market influence our judgement enabled us to double down on our position, buying more at around $5.65 (our cost on the initial position was $10.50). That move was instrumental in helping us generate superior returns; a year and a half later, the stock hit $26.50. Our returns would have been different had we not had the temperament to step up and buy more shares at lower prices.

In summary, Cleveland-Cliffs has been one of our big winners this year and last year and has been a huge contributor to overall performance.

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