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ELM RIDGE

“Cash or Cachet”

First Quarter Report • March 31, 2025

“Graham and Dodd investors are people who place a very high value on having the last laugh. In exchange for the privilege, they have missed out on a lot of laughs in between.”

– Michael Lewis

ELM RIDGE	1ST QUARTER 2025	2024	2023	2022	INCEPTION-TO-DATE ANNUALIZED
NET PERFORMANCE	1.6%	-5.6%	-15.4%	48.6%	5.6%
GROSS LONG CONTRIBUTION	-3%	1%	7%	15%	11%
GROSS SHORT CONTRIBUTION	5%	-6%	-21%	25%	-5%
S&P 500	-4.3%	25.0%	26.3%	-18.1%	7.4%

The quarter started somewhat miserably for us, as the market reacted to tariff threats by inflicting further damage on those most exposed (even if the stocks had already priced some of them in). But, as we have seen before, our holdings reached the point where they were just too cheap and stopped going down, while heretofore more optimistic investors began to recognize that valuations and profit outlooks for their own faves were also vulnerable. And so what might have been some very minor reallocations helped our longs bounce two percent in the last four weeks of the quarter while the S&P dropped another four. While they are once again getting shellacked as we write mid-day April 3rd, the day after “Liberation Day,” our longs are still holding their early March lows, despite the S&P dropping another 7%

Although I wrote my doctoral dissertation on trade protection (predicting a continued rise in US protection, if that’s what domestic producers wanted, just a few years before GM and President Clinton sent the country in a different direction¹), I’d say my two cents on the topic probably isn’t worth much more. We’ve been talking in broad terms about the extreme valuation disparities as investors have divided the market into their CBGBs (Certified Bonafide Good Businesses, e.g. what their friends and cronies like) and dreck. So now we’ll put some meat on the bone and give some examples of why we are so willing to stay off the beaten path.

As we turn to our long positions, we recognize that some of you will decide to buy these on your own and come back to us if they don’t work out within your investing timeframes. But so be it. First, we need to explain a few basic metrics that many of you can skip. You will often hear Price/Earnings (PE for short) bandied about. In essence this reflects the multiple of expected earnings (measured many different ways, usually dictated by the company being

¹ No. I will not cite myself here.

measured²) one is paying for a stock. It might be easier to think about the inverse, or the current earnings yield. While the S&P was just trading at nearly a 25 PE at the end of February, a level only seen at the end of the 1999-2000 tech bubble, one could justify this 4% earnings yield against that of the “risk-free” US treasury (at about 4.3% then). After all, if earnings continued to grow, and you were willing to accept some added volatility, you would earn a higher return holding the S&P versus Treasuries. A related measure is free-cash flow (FCF) yield (or cash from operations less capex), which can also be compared to the risk-free treasury. Here we note that this measure, often trotted out by acquisitive companies, can be rendered meaningless, as the growth they speak of is usually funded through continued spending on acquisitions, which are not considered expenses according to this metric. Finally, you’ll hear EV/EBITDA, which measures close-to-cash returns on invested capital (market cap plus debt), dividing that figure by pre-tax earnings before interest, depreciation and amortization.

One Person’s Trash is Another’s Treasure

*I'll wear your granddad's clothes
I look incredible
I'm in this big-ass coat
From that thrift shop down the road*
—Macklemore & Ryan Lewis, *Thrift Shop*, 2012³

Fresh out of college, you might have seen me rocking some bowling shirts, a uniform from the Arkansas Game & Fish Commission or my light blue leisure suit that I copped at the Salvation Army. While that era is long past, I still get hand-me-ups from my son and tend to fill our long portfolio with other folks’ refuse.

Most of the stocks we’re writing about are cyclical, in that their earnings do not grow in a straight line but fluctuate according to changing supply and demand. Since the demand side for these companies is usually tied to the general strength of the economy, that makes them fat targets for some factor-based quant trading where they tend to get really spanked (the stocks that is, not necessarily their businesses) whenever fears of an economic slowdown resurface. But since the Street has avoided them like the plague, they now sell at such ridiculous valuations – even in a market as highly valued as this one – that we are willing to grin (not really) and bear it.

Although General Motors (GM) usually trades like the next downturn is imminent, the typical concerns about the auto cycle rolling over have now been amplified by tariff threats. The company originally guided to \$10-\$12 per share of real free cash flow this year back in January. There is no doubt that tariffs will take a toll. At this point, with the details still unclear, our latest estimates are based on unit sales falling in line with the tariff hit. Under this scenario, FCF would fall to around \$9/share this year and \$7-\$8 in 2026. And with the stock trading at \$47 (all prices here are as of midday 4/3, as noted above), we think a lot of those downward revisions are already priced in. Over the past two years, GM has bought back 25% of its shares (increasing the ownership of each by 33%), with the board recently authorizing another \$6b against a less than \$50b market cap (about 1/20 that of TSLA, a company with about half GM’s sales, even after that stock was cut in half). If it sold at an 8% FCF yield, twice that of treasuries, we’d get a double.

Next, we’ll turn to an even sexier story: LyondellBasell (LYB), a commodity chemical company that turns oil and natural gas into a variety of plastics, with large operations in both the US and Europe. While polyethylene and polypropylene markets are indeed cyclical, as capacity tends to come on in waves, they do grow faster than the overall economy over time, so more investment, and the profits to fund it, are necessary. LYB does have a cost advantage in its US operations, as its Texas refineries have access to stranded low-cost gas and a nearby port. The

² The headline “adjusted” numbers can often add back stock comp, ongoing investments in the future and amortization stemming from growing a business through acquisition.

³ <https://www.youtube.com/watch?v=QK8mJJvaes>.

company knows it will never get the multiples of a less cyclical, easier to forecast company. So, it rewards us by paying a high dividend, currently an 8.3% yield, that has grown at an 8% annual rate over the last dozen years, while cutting the number of shares at a 5% clip. While we are currently at a cycle bottom, LYB has still managed to pay down debt while funding the dividend, and we would expect the company to boost it once again in May. At a 4% dividend yield, the stock would more than double (and would still be selling at a mid-cycle FCF yield of 8%).

We also own Mittal Steel (MT), the world's second largest steel producer (behind China's Baowu). The company has been penalized for its large European presence (including a large steel and iron operation in Ukraine, running at a 30% operating rate and losing cash) and earnings have been hit by weak steel markets that have solidified of late. While it pays just a 2% dividend, it has cut its share count by 35% over the last 4 years (increasing their ownership stakes by more than 50%). After cutting our numbers to reflect a possible recession, thus pushing out the return to mid-cycle earnings, the stock still trades at less than 7x earnings and only 2.2x EBITDA vs its US competitors at 15x and 7.5x respectively. Just moving back to the 5x (now depressed) EBITDA it traded at in 2019, would get us more than 150%.

Next, we turn to one of the biggest flops of the last 20 years, Citigroup, a stock (we were short in 2007-08) that has fallen more than 80% over that time, just slightly lagging the 5x move for the S&P. With new capital rules, the company's strong local presence in many geographies turned into a liability. It is now selling off these local franchises to focus on a collection of disjointed strengths (treasury services for cross-border trade, credit cards and wealth management for the international elite) while they integrate hundreds of old IT systems at the same time. This is a big and complicated project, and there will be some hiccups (e.g. recent regulatory reporting issues) along the way.

We recognize the high levels of underpriced risk in commercial real estate markets, exacerbated by private credit funds and less-regulated entities looking to deploy capital. But the large banks are much less exposed than in the past, as the \$1.6T private credit market is now up to 60% of the value of bank commercial and industrial lending and the big four banks default rates are running less than 1/3 those of the private credit industry.⁴ Furthermore, we have more than hedged this risk on the short side, as we will discuss later. If Citi does pull it off and sells at the multiples of book (net asset) value and earnings of the other universal banks, these shares (that had outperformed by 30% in the year leading up to mid-February when we trimmed our holding by a similar amount) could also double.

Let's turn to a much simpler financial, OneMain Holdings (OMF), providing relatively small loans to near prime customers (average 630 FICO, \$65-70k annual income, ~10 years in the same residence), mainly through its 1400 branches where it both originates and help collect loans. While well-heeled investors seem unable to grasp this "alien" market, the small loan sizes, lack of unused credit lines and personal interaction staff (average tenure of a branch manager is 14 years) have allowed them to generate consistent 20% returns on book value while treating shareholders to a sizable (currently 9.1%) dividend – set at a level they can cover during a recession, including a bump in losses equivalent to what they saw in 2006-2009 – that has been growing at a regular rate for the past several years. (In fact, I started covering its predecessors when I entered the business more than 35 years ago and remember the difficulty of explaining to my colleagues why anyone would borrow and pay off a loan at a mid-20s APR, which I too was doing at that time.) It has done this without cutting corners, willing to incur the added interest expense from terming out funding so that it can survive two years, if necessary, without returning to the capital markets. It can thus take advantage of any opportunities that arise when competitors run into trouble. If the stock just traded to a 5% dividend yield (and we would expect it to get a boost when it reports its next quarter), it would mean more than an 80% gain, and still leave it with 10% FCF yield as well.

⁴ Empirical Research, "Private Equity and Debt: Game Changers?" 10/25/24.

For our oil-related stocks, macro sentiment and factor-based trading continues to push them around much more than the reported results. Fears have rotated between surging supply and the potential for recession-driven decline in demand. As the commodity has mostly stayed in \$70-\$80 range for the past couple of years, the US drilling rig count has fallen from over 600 to 485 with the US management teams focusing on maintaining production and returning excess capital to shareholders. The initial post-Covid production boom has come and gone, and we now see the industry adding 200-300k barrels per day versus the one million plus in 2023. Devon Energy (DVN), for example, can generate a nearly 15% FCF return at \$70 oil, which in addition to its 3% fixed dividend, it is using to buy back shares. At \$75 oil, we think they can generate FCF of \$5.30/share which could give us a double at an 8% yield.

Valaris (VAL), an offshore oil driller, has been one of our worst performing stocks since the middle of last year. While 95% of offshore projects are profitable at \$75 oil, rig rates have been very volatile over time, peaking in 2014 at close to \$600k/day before plummeting to below \$200k during the downturn. Until this most recent run, each spike in rates led to a surge in ship orders. Since Covid, however, we've seen rates rise to over \$500k/d on new contracts while the supply of new ships has remained limited. And even with recent delays on new projects (good for our E&P's), rig rates have held steady in the high \$400k/day range, with VAL signing a new two-year contract at \$475k/day in late March. At today's rates, the company should be able to eventually earn \$17/share in free cash flow as their contracts reset to current prices while the stock trades at \$35. If it maintains its current 6x cash flow (EV/EBITDA) multiple, the stock would be more than a triple from here.

The natural gas producers have been the only bright spot in our energy book lately. We were adding here, as the US gas rig count fell from 160 to 100. For much of 2024 natural gas prices hovered around \$2/mcf and management teams focused on cleaning up their balance sheets and maximizing cash flow to weather the storm. Recently, however, prices moved back up as investors began to focus on the potential for rising demand due to LNG exports and Data Center power consumption related to the AI buildout. Gas contracted for delivery in 2025 is now over \$4.65/mcf vs. around \$3.50 a year ago. Some management teams suggest they could add production when prices got to \$4.50-\$5mcf but we still haven't seen it. In the meantime, EQT, the largest producer in the US, can generate \$4.30/share in free cash flow at around \$4 gas with each \$50c move adding \$1/share. Although we trimmed all of our natural gas holdings, including Antero Resources and Range Resources, during the recent run, we still see some upside in the group. With EQT's stock trading at a recent \$52, going back to the 6% yield the stock traded at in the middle of 2024 would get you another 40% upside.

Success Breeds Excess

"Fortune makes a fool of those she favors too much."

—Horace

"Popularity is a bubble. It's a mountain: you can go up really hard but walk down really fast."

—RM

"Listen, if you don't talk big game, you never get anywhere. If you don't think big, you don't get big. Some people call it egotistical, some people call it high hopes, some people call it confidence. It's all in how you want to dissect it."

—Vanilla Ice

Shorting scares us much more than what we do on the long side. While we strive to profit in an absolute sense from the endeavor, it is very difficult to do so when the market is going up 10%/year. As opposed to the longs we just touted, where upside could be measured in "x's" rather than "%s," shorts have limited upside and unlimited downside. But shorting can allow us to dampen volatility and trim unwanted factor risks (this is considered a good thing when markets decline) and keeps us in the game during scary periods – allowing us to capitalize on

opportunities during these episodes and reap the benefits when markets bounce back. But we need to be much more careful here to keep from getting run over and forced to cover. Thus, we are quicker to both trade around positions and take them off the table when markets are tumbling. All of this makes us quite hesitant to talk about them in much detail, preferring to discuss our broader themes.

We have, however, already discussed Boeing (BA), the poster child from last year's letter on how agency capitalism was moving in a direction that would lose popular support. We watched, at first from afar, as management responded to shareholder pressure to goose short-term returns, leading to a kluge-y fix for the 37 MAX (stretching the fuselage and using heavier more powerful engines to avoid the cost of designing a new wing) that may have produced the instability behind a couple of high-profile crashes. Our initial position was premised on the belief that these pressures had produced more business shortcuts than were currently visible and would come back to haunt the company for a very long time. And since that time, we've seen them take almost \$10b of charges on the defense side (tanker, trainer, drone, space), \$4b more on the 777x development while 37 and 87 reliability and production issues continue to crop up as well. The hope for \$15.00/share of free cash flow starting in 2017 has now pushed out and dropped to about \$10 in 2027 (a 7% FCF yield if it does come to pass), which we would expect to be soon wiped away as management eventually bites the bullet and begins development of a new 737.

Now let's address the elephant in the room. We do have some shorts betting on the collapse of what we see as the current tech bubble although we're not as big here as you might think. Note that much of our short profit in 2000-02 did not stem from the internet collapse itself but came a few months later after growth investors flocked back to what they thought were the safer, profitable companies geared to the soaring spending of those given free capital. As that dried up, so too did demand and the big boys' earnings.

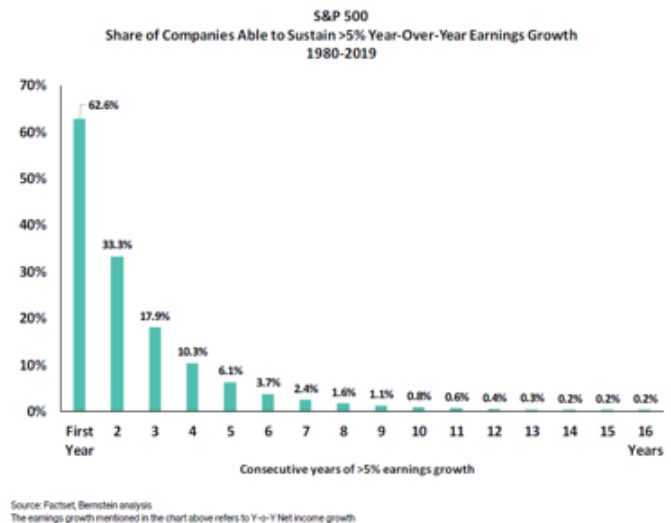
We've maintained short positions in some of the bubble (e.g. 20x sales) stocks but kept them small because, at times, there seems to be no limit to how they might climb. Recently, however, we might be seeing the start of the unwind. Over the past few months, investors have taken a more skeptical view of the billions of dollars companies plan to spend on building out AI products and capabilities. There still seems to be no clear way to recoup that investment, let alone make a good return on it, with the only counter point being that the products *will* be amazing and *will eventually* change the world. That makes it tough to figure out exactly how much companies should spend on infrastructure, not to mention how much investors should pay for businesses on the hope of AI products boosting revenues at some undetermined point down the road. Any tightening of the purse strings could lead to a big impact on the "arms dealers", who, while they don't trade at crazy multiples, could see big drops in earnings and growth expectations.

In a related note, we think that we're going to need to see evidence that AI can be monetized before we get the kind of datacenter build that those pumping the previously (they have been hit of late, leading us to book profits, while waiting for them to levitate once more) highflying equipment manufacturers and utilities were counting on (akin to the expected fiber build out, see Global Crossing, during the last tech craze). They don't worry that Microsoft's CEO thinks we'll already see excess capacity in just a couple of years (i.e. with the funds that have already been committed) and has already halted new projects. They also seem to have no concerns that in a heavily regulated market, public officials will allow utilities to leave retail customers in the lurch while they meet the needs of tech execs used to operating in a more unfettered world.

On a larger scale for us, are levered serial acquirer "compounders," who avoid the accounting treatment of in-house capex (which counts against reported free cash flow) by purchasing the same kind of assets from other companies (which doesn't). Here, we are looking for those companies that require further acquisitions to meet investor expectations: as they jack-up prices and cut off investment to boost reported current profits at the expense of longer-term health. The Street used to look warily at these, after seeing the rather abrupt downfall of their predecessors (again look up Jack Welch, Dennis Koslowski, Bernie Ebbers, Maurice Greenberg, etc.), but twenty

years of low interest rates and easy credit seems to have removed all vigilance as a new group of sycophants fearlessly cheers them on – so long as they deliver the reported results that their acolytes expect.

Valuation is often irrelevant to their holders. Despite the empirical evidence (see table at right⁵), They believe (we've heard them speak) that these companies can maintain double-digit earnings growth for such a sufficiently long period of time (say until the Jets win the Super Bowl), that they can grow into whatever multiple they sell at. That is why we see price targets bumped from 69.7 to 76.5x (pick some year toward the end of the decade) earnings/EBITDA/FCF if the stocks deliver. The problem here is that the real world is not as predictable as their overly confident supporters believe, and any stumbles (and the usual accounting shortcuts taken to tide them over) in one, in combination with their onerous debt loads can produce some dramatic tumbles and a hunt for others with the same issues. This is why these stocks tend to fail in waves and we would expect to reap percentage returns (these stocks could fall in half or lower in a heartbeat) on the order of price/concept (bubble) tech.



Finally, turning to our largest exposure, while we do have a decent sized long position in low-priced financials, we noted above that we are even more exposed to a credit event on the other side, through two different groups. On the one hand, C, OMF and Aercap trade at about 8x earnings, while popular concerns about credit don't seem to extend to more highly valued (PE's here average some 80% higher) mid-American regional banks with the same kinds of exposure (with a lower capital cushion to boot). Yes, the Texas economy is doing well and there is strong demand for investment dollars. But boomtimes sow the seeds for future busts and we are already seeing some cracks with potentially problematic and delinquent loans.

For the second prong here, as we've noted earlier, we want to be on the other side of the Private Equity, Credit and Real Estate craze, where investors, supporting what we think is a charade, are assuming well above market returns – with the added cherry that they do not need to show any losses as they wait⁶. In commercial real estate, for instance, we are now dealing with a glut of multi-family and commercial mortgages written during a period of lower interest and cap rates that developers can no longer flip and refinance, as originally expected, under current ones. We are currently witnessing a massive game of "extend and pretend"⁷ with few arms-length transactions⁸ to allow us a better window into the problem, as the major players hope that they get rates low enough to bail them out. Private equity is having the same kind of problem as they struggle to find buyers for their portfolio companies (other than trading among each other), holding them for a record length of time, while seeing a record number of bankruptcies in their holdings in the past year

Although we can't short the university endowments, state pension funds and the investment portfolios of the typical high net worth investors, we can take aim at those who resorted to riskier investments to insure corporate pension

⁵ From *AllianceBernstein*, "Looking back at the Nifty Fifty... What does it tell us about the tech sector today?" 10/5/20.

⁶ Cliff Asness' recent tweet puts it best. "S&P pre market is now -3.6%. But this is your reminder that thoughtful private equity investors are flat and private credit investors are actually up by their daily coupon. Genius! Bringing this kind of diversification to retail is a holy mission and not at all a cash grab or even an exit strategy." https://x.com/cliffordasness/status/1907776974334079137?s=51&t=ju_be7W5bDm4RjgBXZR21g
⁷ https://www.newyorkfed.org/research/staff_reports/sr1130.html

⁸ For instance, read this https://www.ft.com/content/6e070b14-74cc-4ade-bd80-7bd3900c6a82?FTCamp=engage/CAP/desktopapp/Channel_Bloomberg//B2B

risk and maintain higher rates on guaranteed investment products. While a few blow-ups back in 2023 did prod analysts to spend a few months worrying about some bank exposures here, they seem to be more accepting of management defenses (we haven't lost money in 20 years, etc.) in those life insurance companies whose commercial real estate and alternative investments are much higher multiples of book capital. Indeed, I just read that the life insurance industry's "balance sheet strength has been validated in the face of commercial real estate/credit fears." As we noted before, these firms have no problem showing a de-volitized EPS number pointing to what they would earn on their assumed 10+% return assumptions. In fact, Street models tend to incorporate these going forward – completely ignoring what might happen if they paid the piper for all the previously reported excess returns. These companies do return their excess cash to shareholders and current multiples are not demanding. But if we're right, they would be capital constrained in a heartbeat.

Cash or Cachet

"Show me the money!"
–Jerry Maguire, 1996⁹

I hope we were able to give you an inkling of why we think the opportunity set is so provocative. Our holdings are showing us the money while investors on the other side are finding comfort in cachet. But that's been the case for a while. We can't predict the timing of these reversals. But we do know that just a little reallocation from what has worked to what has been overlooked can be fast and furious, allowing us to make money on both sides of the ledger (e.g. 58% net to -13 for the S&P, +16% long/+35% short in the last four months of 2000, well after the internet busted that spring, or 52% to -13 in the first five months of 2022 with a 27/21 split). As you have read above, we own some big companies and yet if you total up all their market caps, they reach just 1/8th that of AAPL, and about 1/5 those of the rest of the Big 6 (now excluding TSLA). Just small reallocations from the megacaps can send ours flying. It may be happening as we speak.

DISCLOSURES AND NOTES TO PERFORMANCE

Past performance should not be construed as an indicator of future performance. Inception is January 2000.

(a) The performance figures are estimates and unaudited. (b) All returns presented are calculated on a time weighted, total return basis (include all dividends, interest, accrued income, realized and unrealized gains and losses and commissions). Gross Returns do not reflect the deduction of a 1.5% management fee, applicable fund expenses, or a 20% performance allocation. Net Returns include dividends, net interest, and reflect the deduction of a 1.5% management fee plus applicable fund expenses; they are also net of a 20% performance allocation, if applicable; (c) These returns are not GIPS compliant. These returns are not AIMR compliant as they represent only the performance of the Series A, Class 1 shares. Individual investor returns may vary due to several factors, which include but are not limited to: the timing of subscriptions and redemptions; differences in fee structures; individual investor account high water marks, and differences in tax treatment. Because of certain governmental regulations, not all accounts are New Issue eligible. New Issues contributed approximately 9.6% gross to the performance figures presented for the year 2000, 0.6% gross for the year 2001, 0.09% gross for the year 2002, 0.48% gross for the year 2003, 0.47% gross for the year 2004, 0.30% gross for the year 2005, 0.17% gross for the year 2006, 0.24% gross for the year 2007, 0.03% gross for the year 2008, 0.01% gross for the year 2009, 0.03% gross for the year 2010, 0.05% gross for the year 2011, 0.00% gross for the year 2012; 0.05% gross for the year 2013; 0.05% gross for 2014; 0.01% gross for 2015 and 0.00% thereafter; (e) All performance figures are before-tax returns. Actual after-tax returns depend on an investor's individual tax situation and may differ from those above. (f) All historical performance and exposure statistics reported in this letter prior to October 1, 2001 refer to Elm Ridge Value Partners, L.P., a 3(c)1 limited partnership. (g) All S&P 500 performance percentages are shown with dividends reinvested. The S&P 500 has not been selected to represent an

⁹ <https://www.youtube.com/watch?v=lpwSXWq1wwU>

appropriate benchmark to compare Elm Ridge Management's performance, but rather is disclosed to allow for comparison of Elm Ridge Management's performance to that of a well-known and widely recognized index and is not intended to imply that the fund's portfolio is comparable to this index either in composition or elementary risk. The S&P 500 Index is a market-capitalization weighted index containing the 500 most widely held companies chosen with respect to market size, liquidity, and industry. The index is calculated on a total return basis with dividends reinvested. (h) The Form 13F that is filed on a quarterly basis by Elm Ridge contains the required details concerning our portfolio.

Where indicated, select performance results included in this document are hypothetical returns which have been compiled by Elm Ridge Management. Hypothetical performance results may have inherent limitations, some of which are described below. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. One of the limitations of hypothetical performance results is that they are prepared with the benefit of hindsight. There are numerous other factors related to the markets in general or to the implementation of any specific trading strategy which cannot be fully accounted for in the preparation of hypothetical performance results and all of which can adversely affect actual trading results.

Any hypothetical performance results do not include the reinvestment of dividends, interest, and capital gains, and do not reflect the deduction of Elm Ridge Management's investment advisory fees. Thus, actual return will be reduced by the advisory fees and any other expenses which may be incurred in the management of the fund. All investments involve risk including the loss of principal. Cumulative and annualized returns are shown. Cumulative returns represent the amount, including all interest or dividends and capital gains received on an investment over a period, usually expressed as a percentage of the amount invested. Annualized returns represent the increase in value of an investment, expressed as a percentage per year.

Contribution figures are estimated and may not sum due to rounding and compounding effects. Estimated Gross Long and Short Contributions are calculated independently by compounding the respective monthly returns.

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