SeaBridge Investment Advisors, LLC

SeaBridge Asia Strategy

First Quarter 2015
Commentary

Among all macro themes affecting our Asia strategy portfolios, central bank adventurism leads front and center. The Federal Reserve's zero interest rate policy and its quantitative easing program following the financial crisis of 2008 and 2009 have had a profound effect on interest rates, and market psychology, since that time. More recently, the Bank of Japan embarked on its own massive bond buying program, sending long bond yields in Japan to microscopic levels. The European Central dutifully followed suit, making its first bond purchases in the month of March on its way to realizing a goal of buying €60 billion of government debt and other assets per month. The Fed is now pondering "normalizing" monetary policy, i.e., raising the fed funds rate and perhaps reducing its balance sheet, in the face of steady if unspectacular growth in the U.S. All this monetary maneuvering has conspired to send the dollar sharply higher and commodities lower. Anyone involved in financial forecasting has had to go back to the drawing board and substantially recalibrate the future.

The strong dollar is being reflected in the behavior of the portfolios although perhaps not in a way that has historically been the case. Generalizations about Asia, while tempting to a portfolio manager, are now elusive. One such sweeping observation is that historically weak currency countries with U.S. external debt, like Indonesia, must fare poorly while traditional bastions of economic strength, like Singapore, will do well. Portfolios could be managed accordingly. Sell some Indonesia and buy more Singapore. However, the overarching trend of globalization of commerce and finance negates this simplification. Our individual companies, though predominantly focused on Asia, are more likely than not to have very diverse geographic reach and thus have complex responses to macro conditions, including extraordinary interest rate and currency moves. Company hedging strategies further complicate the earnings picture.

This diversity is evident in portfolio company performance in the first quarter. Eight of the top ten best performing companies are domiciled in different countries and represent a variety of industries including but not limited to real estate, factory automation, electronics, luxury goods and engineering and industrial services. The robotics company, **Fanuc**, headquartered in Japan, is the world's foremost robotics manufacturer. It sells its sophisticated automation equipment to the rest of the world with large concentrations of sales in China and the rest of Asia. If there is any question that the world is going robotic, the answer may lie in the company's latest quarterly results: revenue up 65%, year on year; robots up 34%; robo drills up 284%, benefitting from investment in smartphone-related cap ex. **SM Prime Holdings** (the Philippines; mall operator; real estate developer) benefitted from the influx of dollars from overseas workers into the Philippines leading to increased spend in the malls and ultimately working through to higher rents for the company. Shareholders of **CK Hutchison Holdings**, formerly Cheung Kong Holdings, are already benefitting from a restructuring that should see the company acquire that portion of Hutchison Whampoa it does not own so that the holding company could then be split into two separate companies, one focused on property and the other on everything else including ports, telecom and retail with a view toward eliminating the conglomerate discount now being applied to Cheung Kong by the market. **Coach** (US: leather goods, **Kepco Engineering Services** (South Korea : power plant engineering services), **Cleanaway** (Taiwan; waste removal services), **L'Occitane** (France; cosmetics), and **Delta Electronics** (Thailand; power supply equipment) are our other motley winners in the quarter.

Our laggards during the quarter, like Tolstoy's unhappy families, also underperformed in their own way:

- cyclical earnings trough: **Pacific Basin Shipping** (bulk shipping);
- lumpiness of earnings: **Hollysys** (rail system control and industrial automation equipment) and **Lung Yen** (cemeteries, funeral services);
- stifling government policy and regulation: **HSBC** (banking) and **Midland Holdings** (Hong Kong real estate broking).

We expect these companies eventually to perform. Of course, we will not be uniformly right, but we believe there is enough franchise value in these firms, all of whom have leading positions in their markets and the financial wherewithal to withstand the occasional rough period that affects every company. It is our belief that if we are to outperform , it will be on the basis of companies having a tough go now but with a game plan and the resources to make it through to better times. All of these companies fit the bill.

Among the positions initiated in the quarter is **Fanuc**, the world leader in robotics. We had looked at it in the past but passed on it because of its notoriously poor corporate transparency. However, given available information and the enormous opportunity in the accelerating worldwide proliferation of robotics in assembly and processing, we added it to the portfolio. The weak yen should only provide a tailwind for this company whose reach extends globally. Our timing was fortunate in that it was disclosed a short time after our purchase that Dan Loeb, the well known activist investor, had taken a relatively large position in the company. Uncharacteristically, the company seemed receptive to Loeb's suggestion that it become more shareholder friendly with buybacks and dividend policy. The shares traded up sharply on this development.

We also started a position in **Cleanaway**, a Taiwanese waste removal firm specializing in the highly regulated removal and disposal of hazardous material. The company can only be categorized as a modest grower, but has been a reliable earner and currently yields 6%.

We added to certain companies on pullbacks. **Navitas** is a world leader in the recruitment and pathway programs for Asia students seeking matriculation at Western Universities. The firm lost a major partner in Macquarie University in Australia who decided to institute their own recruitment program, calling into question the viability of the Navitas business model. Since Macquarie's departure, Navitas has managed to extend contracts with major universities and sign up new ones. Northern Hemisphere enrollment jumped nicely in the first quarter, signaling to the market that company's business model remains relevant. It is our belief that there will be continuing strong interest in a foreign university experience among Asian secondary school students matched by an interest in foreign universities in providing it to a cohort that is motivated, contributes to a school's diversity and perhaps most importantly are not reliant on grants or loans.

We increased our weighting in **Teco Electric and Machinery**, a Taiwanese manufacturer of medium to large size motors. While Teco does sell to the currently depressed oil and gas industry the likely explanation for its underperformance during the quarter, it is largely diversified across a variety of industries. We count Teco among our industrial companies that are stealth environmental plays. From batteries, to motors, to power management to equipment testing, low emissions and power use, Teco and our other companies have consistently demonstrated the ability to introduce products that can stand out in an environmentally conscious world.

SM Prime is our diversified Philippines property company develops residential property, leases commercial space and, most significantly, operates malls. As we indicated above, we view SM Prime and its malls as a way to play the phenomenon of remittances of U.S. dollars from overseas workers. Malls in the Philippines, unlike those in the U.S., are still a primary entertainment destination and are less affected by the disintermediation of bricks and mortar retailing engendered by e-commerce.

As we close the first quarter of a new year, there is much to worry about:

1. We are living in an extraordinary period of quantitative easing of monetary conditions that is being relied on as a cure all for all economic malaise. Despite its promise, QE's efficacy and ultimately the consequences of its removal are still uncharted. QE has undoubtedly boosted financial assets but the outsized currency responses to the program have created challenges in the global economy. Companies are scrambling to rethink their strategic plans, budgets and hedging programs. This maneuvering is often opaque to the fund manager.
2. Rising income inequality and aging demographics mean that we can expect more, not less, government interventions which can wreak havoc on a company's business model. We have numerous examples in the portfolios of companies that have been blindsided by government action.
3. Pricing pressure is endemic.

Some of this deflation pressure is the residual effect of over-investment that led us into the financial crisis and great recession of 2008 and 2009. But there is something else going on here. David Hokey, Australia's Treasury secretary, framed the issue succinctly in a recent speech on tax reform:

"…the rapid emergence of new global intermediaries has threatened traditional companies and economic structures and, of course, the traditional tax base. Facebook is now the biggest media company in the world and doesn't employ a journalist. Uber is the biggest taxi company in the world and doesn't own one car. Airbnb is the largest hotel chain in the world and doesn't own one hotel room. And Alibaba is the most diverse retailer in the world and doesn't have one traditional shopfront. Globally, consumer sovereignty is marching at a pace that is transforming the global economy and it's transforming our economy."

Consumer sovereignty is the correct phrase. The internet has long been a platform for price discovery; now increased mobility makes it an electronic exchange medium that can bring buyers and sellers together in both traditional and unconventional ways in both primary and secondary markets. It democratizes business opportunities enabling the entrepreneur, threatening the incumbent and benefitting the consumer. Commerce is no longer just about capacity utilization but about spare asset deployment. It encourages an asset light model putting at a disadvantage those firms that are heavily invested in the old way of doing business. And it all puts downward pressure on the pricing of goods and services. This is perhaps our biggest worry.

Ironically, we now worry less about China. In fact, China's self-confidence in its destiny as an economic power with global influence is growing. China is clearly working toward the full convertibility of the yuan, its home currency. Twenty five percent of its external trade is already denominated in yuan. The yuan may become an IMF reserve currency as soon as this year. China has opened its stock market to foreign investors through a program known as the Hong Kong/Shanghai Connect. Foreigners now have the ability to invest in more than 600 companies listed in Shanghai through a Hong Kong exchange portal. Additionally, China has proposed a new regional infrastructure bank to be capitalized at US$100 billion with leveraged investment capacity of perhaps US1.2 trillion. Finally and most importantly, China is contemplating a massive, nationwide refinancing of the bad loan portfolio of its total social financing book, i.e., including non performing private loans. Details are sketchy, but the scheme would likely involve some write-offs, lower interest rates on new paper, extended maturities and certain guarantees. The refinancing would be done with local governments as obligors on the new debt. This would do two things – introduce financial discipline into the system to lessen the risk of a repeat of the non-bank loan fiasco and give the local governments time to come up with alternative funding sources like a property tax to fund the debt service payments that result under the new scheme. Stepping back on what is happening in China we can only conclude that it is getting its financial house in order. This provides decent backdrop for investing in Asia.

Finally, we continue to believe that investing in Asia offers as good a risk reward as there is anywhere in the world. Asian equity valuations are decidedly cheaper than those available in the U.S. at a time when, because of currency moves, earnings in Asia may improve on better margins while those in the U.S. will likely be weighed down by the strength of the dollar. Dividend yields are higher. Although imperfect on the political front, Asia does not have the political strife so evident in other parts of the world. As an emerging market, there is simply no comparison between relative safety of Asia and that of the other major emerging countries of Russia, Brazil and Turkey. There are signs that the Asian equity are now beginning to move upward. We see reasons why this momentum can be sustained.

David Descalzi
April 6, 2015

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