SeaBridge Investment Advisors, LLC

SeaBridge Longview Strategy

First Quarter 2017
Commentary

The portfolios generated a mid single digit return during a somewhat euphoric quarter for global asset markets. As we entered the period, we considered our portfolios undervalued and are happy to see some of the value being recognized by the market. The price appreciation during the quarter likely exceeded the growth in intrinsic value for most of our investments, so we enter the second quarter with slightly less "unrecognized value" in our holdings, narrowing the margin of safety on our capital.

We continue to work to fully deploy our capital, but we think the markets are fully priced and our caution results in cash balances higher than we would like. As of quarter end, we held approximately 20% of portfolio assets in cash & short term investments. Even "bad news," like the failure of ACA reform legislation, seems to make the market go up. This leaves one with the feeling that we are in a liquidity-driven "equity euphoria".

Our best performing holdings were **HRG Group** (HRG), **Liberty Ventures** (LVNTA), **Liberty Global** (LBTYK), and **Liberty Expedia** (LEXEA). All rose between 15%-20% during the period. Our worst performing positions were **Now, Inc** (DNOW) and **Cimpress** (CMPR) that fell about -19% and -7%, respectively.

DNOW was our smallest position for most of the quarter. Its hyper-cyclicality makes its intrinsic value harder to approximate, but with the dramatic period weakness, we are fairly confident it is now trading well below its fair value; we added to our position near its lows. As for CMPR, we had a timely (lucky) reduction in our position size just ahead of a poorly received earnings report - this limited its drag on overall portfolio performance. The catalyst for our action was valuation and a large position size (>7% of assets) as a strong rally into earnings drove the stock price to near 12 month highs and approached our estimate of fair value. The swing in price during the quarter from its highs to its recent lows was over 20% so we took the opportunity to partially rebuild our position later in the quarter.

During the quarter, we added 3 new positions including **Twenty-First Century Fox** (FOX), **Berkshire Hathaway** (BRK.B), and **Dollar General** (DG) and eliminated 2 positions: **Express Scripts** (ESRX) and **Liberty Broadband** (LBRDK).

FOX is a diversified media company operating production & distribution assets globally. Sky is one of Europe's largest media production and distribution companies with operations focused in the U.K. The recent Sky acquisition looks like it could be a major coup for the company which is not reflected in the current valuation. The company knows the Sky asset well as it has held a minority stake in Sky for 25 years. The current CEO of Fox, James Murdoch, ran Sky for many years in the early 2000's. Pro-forma the total revenue mix shifts to >60% recurring revenue from businesses like cable & internet subscriptions, while the more volatile transactional type of revenues like advertising drops significantly. Further, we consider FOX's legacy core assets to be franchise brands with dominant market positions in key markets (e.g. Fox News in U.S.). Lastly, the Murdoch family owns large interests in the company, aligning management's interest with minority shareholders. Bottom-line, we think Fox is a higher quality company post Sky merger and is in an advantaged position to benefit from media consumption trends globally.

Berkshire Hathaway (**BRK**) really needs no introduction as it represents the diversified holding company managed by the legendary investor Warren Buffett. We consider it a defensive investment trading at a discount to its intrinsic value, with a long history of investing well on a counter-cyclical basis. We estimate about 50% of the value is tied to wholly owned operating businesses (e.g. Burlington Northern Railroad) and remaining 50% of value is tied to passive investments sourced from the insurance business float, including its large stake in Kraft-Heinz (KHC) and Bank of America (BAC) equity warrants. Finally, with over $80 billion in cash, Berkshire offers an opportunity to partner with an excellent capital allocator at a time when we consider value to be scare in public equity markets. At this point in the market cycle, we view BRK as an anchor of value in our portfolio and will likely increase our position as the year progresses.

We initiated a small position in Dollar General (**DG**) towards the end of the quarter following a soft earnings report. DG is the second largest discount retailer in the US with over 12,500 stores but still only controls a small fraction of the overall market. We believe the business has a long runway for reinvestment at attractive rates of return, compounded by their proven ability to drive productivity from the existing store base. DG has delivered 26 consecutive years of "same-store" sales growth demonstrating its stable business model. Even though DG sells to a disadvantaged customer base, we consider the company to be a quality business with defensive, almost subscription-like, demand characteristics. DG is run by shareholder friendly management and a skilled Board. The weakness in DG's stock price over the past 12 month appears to be driven by concerns we consider transitory, like food price deflation. At 2.25% of portfolio assets, DG represents our smallest investment as of quarter end. We likely will increase the position as we gain more confidence in management's ability to navigate the current retailing challenges while benefiting from a stabilizing food pricing environment.

Even though we had only initiated our position in Express Scripts (**ESRX**) in 4Q16, we sold our entire position in 1Q17. This was not an easy decision because ESRX "checks the box" on almost everything we look for in an investment: favorable demand outlook, leading market position in consolidated industry, owner operated/experienced management, and highly compelling valuation. Unfortunately, we view the political dimension surrounding the pharmaceutical drug supply chain as inherently unpredictable and opaque. Our specific concern arose after further digging into litigation claims. Plaintiffs argue that pharmacy benefit managers like ESRX have been working with insurance companies in a way that lays off costs on both the retail consumer and the Medicare system. This could be politically explosive, if true, and we decided it was best to stand aside and placed it in the "too hard" pile as the healthcare debate rages.

Finally, we exited our position in Liberty Broadband (**LBRDK**), which is essentially a holding company with a 17% economic stake in the U.S. cable operator, Charter Communications (CHTR). LBRDK's price has been very strong as CHTR continues exceeding operational and synergy expectations from its merger with Time Warner Cable. (This created the 3rd largest cable/broadband provider in the country.) Our estimate of the discount to net asset value (NAV) at LBRDK narrowed to about -10% reducing our risk / reward equation. We opted to partially redeploy the sales proceeds to increase our position in Liberty Ventures (**LVNTA**). LVNTA is another holding company with a 24% stake in LBRDK, which comprises >80% of LVNTA's NAV. We estimated the discount to NAV at LVNTA to be closer to -30% and believe its performance will largely be tied to CHTR's performance. Essentially, we view Liberty Ventures as the cheapest way to gain exposure to the economics of Charter's very attractive business. All the Liberty companies are controlled by John Malone who we consider one of the best cable investors in history and proven great partner for shareholders.

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