SeaBridge Investment Advisors, LLC

SeaBridge Asia Strategy
First Quarter 2018
Commentary

The pattern of trading in Asia markets followed that of world bourses in the first quarter. It was a tale of two tapes with most world market indices soaring in January before swooning in February and then struggling to regain momentum as the quarter closed out.

Despite the choppy trading in the period, our optimistic outlook for Asia equities for the year remains intact. There were early signs in the quarter that the strong earnings momentum of 2017 has continued into the new year, providing the strongest evidence that markets there can continue to advance. Consumption, led by China, drives the continuing transformation of the region from one based on a mercantilist economic model to something that is broader based and looks like that of the developed world. Middle class consumers are emerging from underclass status at the highest rate of any global region. Macro conditions external to the region including synchronized global economic growth, low interest rates despite the prospect of some tightening during the year, and the resurgence of earnings growth outside the region are tailwinds for the markets this year.

So, with all the positives, why did Asian markets sputter during the course of the quarter? The answer to this question may be found in a very brief historical review of the factors that have moved markets in the region since the Asia Crisis of 1997. That tumultuous period was characterized by excessive leverage, massive credit account deficits and the classic dilemma that is faced by central banks particularly in the emerging world of setting a target for interest rates that can either protect currencies or spur economic growth but cannot do both. In the end, currencies had to be let go, asset values collapsed in U.S. dollar terms, and a deep pan-regional recession set in. The carnage and lessons learned were such that since that unhappy time, Asia, collectively, has arguably been the most responsible global region in terms of disciplined economic stewardship. Current account balances, for the most part, have reversed, currencies stabilized, and while debt levels have increased, the portion of that debt denominated in U.S. dollars declined. More recently, Asian central banks did not board the quantitative easing train like those in the U.S., Europe and Japan. Since the banks in the region did not participate in the grand experiment that exploded balance sheets of their global counterparts, there will be no market angst attached to an unwinding exercise.

In the intervening post-Asia-crisis period, there have been a number of events that have precipitated significant pullbacks in the region's markets. The top three in our view were the Nasdaq collapse and ensuing U.S. recession in the early part of the first decade of the new milennium, the bursting of the U.S. housing bubble and the global financial tsunami that followed, and the first signals of tapering of quantitative easing and general withdrawal of accommodation put forward by the Fed, the ECB. and the BOJ in the middle part of the current decade. Notably, all were exogenous shocks to the region. One could argue that China and its debt problem weighed on the region's markets at the beginning of this decade such that the "calamity import" theory is flawed. But even if China were a culprit, its profligacy could be rationalized in the context of the U.S. crisis of 2008. At that time, China sought to combat the deflationary effects of the housing collapse in the U.S. with its own massive fiscal stimulus program funded by debt. It was right to be worried and react with an infrastructure investment program. It was wrong to keep credit spigot wide open for so long after the crisis receded. (As a side note, there are recent signs that China recognizes the error of its ways and is set to rein in credit and invite foreigners into a domestic debt market with a view toward spreading investment risks.) Based on the evidence, it is our contention that Asia is more sinned against than sinning in the creation of conditions that lead to the market and economic turmoil that occasionally roils the region.

This historical review tells us some things about the maturation of the region since the Asia Crisis. If it is not quite yet fully developed, Asia, led by China, can now be considered a fast maturing strapping adolescent. Relative economic stability, the burgeoning middle class, the proliferation of world class companies by size and sophistication of goods and services rendered, and the leadership position in a connected, digital world are all signs that the region's reliance on external markets is no longer as crucial to its economic wellbeing as has previously been the case. Asia is increasingly able to stand on its own.

The outside world continues to matter, however. External factors that impinge on conditions in Asia now, as they have been in the past, mainly emanate from the U.S. The outcomes of some currently large, unresolved issues, including but not limited to, a possible trade war (obviously involving Asia but instigated by the U.S.), the line in the sand on a nuclear-armed North Korea, the Mueller investigation and the 2018 Mid Term elections, which could see a flip of one or both of the currently pro-business legislative branches of the US government, may have a profound effect on the way markets behave in Asia and elsewhere. We cannot say how these issues will resolve. We can only say that as news-flow on these issues veer between hope and despair, volatility will likely increase perhaps dramatically.

We will end on positive note. The region and its companies are basically healthy. Earnings are strong, despite some expected softness in the first quarter that has more to do with seasonality than anything else. Valuations are attractive on an absolute basis and stunningly so on a relative basis to other parts of the world. As we always keep some cash in the portfolio, we would not hesitate to use that cash to buy stock on pullbacks. We will not shy away from exporters as we are of the mind that the current trade dispute will resolve favorably for all parties. We like industrials as we believe they are in the sweet spot of the current economic cycle. We are still attracted to high yield equities because their combination of dividends and growth is attractive even in a rising interest rate environment. In short, we believe the region's markets will continue to advance, but with more volatility.

David Descalzi

April 3, 2018

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Transaction Summary

Note: some accounts did not participate in some of the trades mentioned in this summary due to client-specific factors.

Purchases

We took a 1% position in **Boral**, an Australian-based manufacturer and supplier of construction material. The company's two end markets (Australia and the U.S.) could each be entering into a substantial infrastructure buildout period, a development which would obviously benefit the company. The residential part of the business should be strong in the U.S., although we have greater concerns that the residential side in Australia could be vulnerable to the interest rate increases we expect there. It is notable that household debt in Australia as a percent of GDP is significantly higher than it is here. A reversal of the recent weakness of the dollar would be beneficial to the company.

Although the stock is trading at the upper end of its 5 year PE bands, with the company poised to take advantage of growing demand from public and private investment for infrastructure and property, we suspect that, with its operational leverage, the P/E ratio will contract making the stock appear attractively valued.

We initiated a position in **General Electric**, a company much in the news of late. The bear case for the stock has been amply laid out by the analyst community. Lingering insurance and pension liabilities make it difficult to value the shares. Additionally, GE's accounting practices are now being questioned by the regulators. This could result in either a restatement of past earnings or a fine or both. It is our view that, even if the company is obliged to rectify past wrongs with outsized provisioning, the current stock price compensates investors for such an eventuality. The company has slimmed down, having exited credit cards, leasing, appliances, electrical equipment and water. They are a much more focused company concentrating on gas turbines, airplane engines, locomotives and medical imaging, where a growth case for each product can be made in an expansionary economic environment. New management seems capable. Seventeen percent of the business is in Asia, a bit less than the 20% we look for in companies that are domiciled outside the region. However, Asia will likely be among the fastest growing regions for the company. We think the upside downside probabilities favor the upside. We will monitor developments closely and either increase our position over time or exit entirely.

We initiated a position in **HI-P International**, a company discovered on a trip to Singapore. HI-P is an integrated contract manufacturer with capabilities in both component manufacturing and product assembly. HI-P had its IPO in 2003. It is a fully fledged ODM and EMS service provider with competencies in both plastics and metals, which allows the company to fabricate products in their entirety from the design stage. This broadens the company's reach and the value-added proposition for customers. We expect continuing margin improvement. Notable clients include: Apple (sim tray, buttons, iPen, phone charger, internal metal structures), Amazon (Echo and Kindle), Keurig (coffee machines), Colgate (toothbrushes), Braun and Gillette (shavers), Fitbit (consumer wearables), Ofo (bicycle lock), Motorola (walkie-talkie) The company has 13 manufacturing plants worldwide and a workforce of 15,000 employees globally. Most plants are in China (Tianjin, Chengdu, Shanghai, Nantong, Suzhou and Xiamen) as this is where their main clients' supply chains are based. The company also has operations in Thailand, Singapore and Poland. Revenue by category: Wireless (~20%), Computing & Peripherals (~20%), Consumer Electronics, (~40%), Medical & Industrial (<5%), IoT and Accessories (15%-20%).

The company has capabilities in both plastics and metals, making it a useful partner to OEM's whose end products combine both materials. Clients are sticky as HI-P can be involved from the inception stage of a product. HI-P can still offer the same services as the big contract manufacturers albeit as a smaller scale. This should enable the group to service clients who have been rejected by the larger EMS players (the Taiwanese) who only accept large volume orders. As a result, HI-P has crafted a niche characterized by smaller volumes but better margins.

The first two quarters may disappoint again because of a subdued iPhone cycle. We expect to add to the position opportunistically over time.

We initiated a 1% position in **India Fund, Inc**. a closed-end fund that is listed in the US. The India market has lagged other markets in the region over growing concerns that growth is slowing, inflation is rising and the Central Bank is turning more hawkish. Growth may slow, but inflation seems under control and the Reserve Bank of India may demonstrate more dovishness than the market is currently anticipating.

Our research on the ground also supports initiating an India position. We found the atmosphere and sentiment there more buoyant than was the case on previous trips to India when the country seemed preoccupied with demonetization and the election of Donald Trump. We believe that reforms targeted toward the agricultural sector and FDI and the benefits that should accrue with the implementation of a national service tax supplanting a hodgepodge of provincial taxes will be tailwinds for the market. Despite unmet earnings expectations for the last few years, the consensus among companies at the conference was that earnings growth should finally come through and that markets will respond positively.

Sales

We sold out of our entire position in **Bank of the Philippine Islands** after a strong one day rise. The bank announced that it would raise up to 50B Pesos in a rights offering. The market perceives this as a removal of a capital raise overhang. We see it as dilutive of existing shareholders in a bank that has gotten expensive relative to its regional peers.

We again trimmed **China Lodging,** our China based hotel operator. Although we like the company and believe it will be a winner in the low-to-mid-priced hotel industry in China, the rapid advance of the stock price makes us nervous. We are taking down our large position.

We eliminated our position in **RHT Health Trust (Religare)**, our Singapore-listed trust of medical facilities, primarily India-based. Religare received a proposed offer from Fortis Healthcare to buy out all RHT's assets at INR46,500mn or INR34,980mn net of debt which translates to ~S$0.90 per share at 14% premium to the March 31 share price. However, at the time of sale, we note that the 1H18 distribution had not been declared, reducing the value of the takeout price. We have been concerned that the acquisition of the trust by Fortis Health Care will not close, thus eliminating the price support for the stock. Our suspicions surrounding the transactions have increased given the lack of progress on the sale to Fortis, announced in October of last year, of a convertible, subordinated instrument issued by Fortis and held by RHT. Something doesn't feel right here.

Religare has never met expectations as a hospital landlord in what one would think is a fast-growing sector of a buoyant emerging economy. Occupancy rates at the trust's hospitals seem to always disappoint. The distribution yield, while adequate at 4.5%, should be higher given the relatively high rate environment in India. We think it prudent to exit.

We trimmed **Tencent**, the Chinese gaming and social media giant and **Venture Corporation**, our Singapore based contract manufacturer on price strength. We are looking to reduce further our position in Tencent at the appropriate time as we believe that it will be difficult for the company to meet very lofty expectations

David Descalzi
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