SeaBridge Investment Advisors, LLC

SeaBridge Global Growth Strategy

First Quarter 2018

Commentary

Market Review & Outlook

Volatility appears to have returned to global financial markets. Using the VIX index[1] as a proxy, we saw volatility spike to its highest level in more than two years and end the quarter 81% higher than 2017 year-end. We think this is evidence that correlation across financial assets may begin to decline after years of elevated levels. From a macro-economic perspective, we are maintaining most of our views expressed in our Q4 commentary with the exception of developments relating to U.S. trade policy discussed below. We continue to see accelerating economic growth accompanied by rising consumer confidence which is underpinned by stable advances in employment and income levels, moderate inflation, and low long-term interest rates which remain <3.0% (based on 10-year Treasury Bond).

During Q1, a stronger than expected wage growth number sparked concerns that inflation may be running higher than anticipated. However, subsequent wage data failed to support the thesis while other inflation measures like the CPI or the PCE deflator index continue to register below or just above the key 2.0% level. Anecdotally, our companies are beginning to experience increasing input cost inflation on rising commodity prices while higher wages are being offered to drive retention. We expect the labor market to become increasingly competitive but, as we have written in prior commentaries, this can be a healthy outcome if the advance in wages is measured and labor productivity keeps pace with income growth. This should result in lower overall inflation which should allow monetary policy to remain accommodative for longer and support the expansionary period.

In the 2H of Q1, there was an increasing level of rhetoric out of Washington on U.S. trade policy which added to the financial volatility. President Trump began promoting an agenda which penalized our trading partners, specifically China, for our structural employment problems. He cited illegal "dumping" practices as a major contributing factor to U.S. job losses in manufacturing. This controversial view was followed by a presidential order placing import tariffs on some key commodities like aluminum and steel. Investors have viewed this increasingly protectionist posturing as a threat to economic stability, fearing tariffs could spark a trade war. A trade war would reduce earnings visibility for the vast majority of companies and is likely to result in lower stock prices as investors demand higher risk premiums to compensate for the rising uncertainty. The latest development out of the White House is a seemingly "softening" stance which includes concessions for many trade partners, reducing the likelihood of a messy trade war erupting. Fortunately, the president has proven to be "more bark than bite" over the past 15 months. He has seemingly adopted a fire and brimstone approach when initiating negotiations in a given area, so we see a tenable outcome as more likely than a trade war erupting.

[1] The CBOE VIX index is a measure of the stock market's expectation of short-term volatility implied by S&P 500 index options.

Portfolio Results & Activity

The portfolio was flat during Q1 while the MSCI World Index which was down -0.91%. As active managers, we favor the recent period of volatility as it is in this type of environment that we should be able to add value as we take advantage of what we believe to be short term mispricings. We viewed the period's volatility as an opportunity and deployed our cash reserves into new opportunities and reinforced existing positions.

During the quarter, our best performing holdings were **Cimpress NV** (CMPR), **Redhat** (RHT) and **Amazon** (AMZN). Our worst performing positions were **Deutsche Bank** (DB) and **Colfax Corp** (CFX).

Cimpress NV (CMPR) has been a long-term winner for us as it continues to defy conventional wisdom. Cimpress, better known as "Vistaprint", is a traditional print media company supplying customized printing services. This "business card" company has positioned itself as the low-cost producer in a largely commoditized industry that has been in secular decline for years due to the proliferation of digital content. In this environment, CMPR has delivered double digit organic revenue growth as it steadily captures market share from its competitors. We believe the secret sauce lies in its customer acquisition or marketing spend which benefits from scale. CMPR spends more on marketing ($600M in FY 2017 or ~25% of sales) but a lower amount on a per customer basis compared to competitors. In addition to the scale benefits, the customers tend to be sticky. Customer retention further enhances the return on investment. For example, 75% of orders in the Vistaprint segment are from repeat customers, with the most recent quarterly period seeing the highest customer retention rate since 2007.

The competitive position and reinvestment runway combined with owner operated leadership creates an ideal opportunity for us. We think the company can reinvest 100% of its FCF organically at >20% return on invested capital for many years by increasing marketing spend. This should support a low double digit organic sales growth rate over the next 5 years and a higher level of steady state FCF growth as it benefits from operating leverage. However, at >20x FY 2018E FCF the stock appears expensive and offers less margin of safety if we are incorrect on the size of the reinvestment opportunity. This has led us to trim into price strength which has proven to be too conservative in the past 2 years but allows us to rest easier at night considering that our "risk is controlled with position size."

Colfax Corp (CFX) is a global industrial company we added in Q4 2017 following a weak earnings report. CFX has leading market positions supplying products like pumps and welding equipment to customers mainly in the power generation, oil & gas, and industrial end markets. CFX's products generally represent a small % of overall project costs but are mission critical to proper functioning (e.g. gas compressor to $1B refining renovation project). Company customers tend to prioritize reliability, quality, and performance over price. We believe this supports pricing power and improves the overall quality of the business. Despite further weakness in the quarter, we were reluctant to add to our small position because of our inability to assess whether the power segment is facing a structural headwind. New build activity for gas and coal electricity plants is near all-time lows as alternative energy, specifically, solar becomes an increasingly competitive clean energy substitute. We do have a high degree of confidence in company leadership which includes the Rales brothers, Mitchell & Steven, who each own nearly $400M worth of company stock. They have a good record of creating value for shareholders as they are responsible for much of the multi-decade success at **Danaher** (DHR). Further, the company is actively repositioning its portfolio through asset sales and is currently searching for another "platform" asset to incorporate into the company. Given management's record for creating value and current valuation, we are satisfied with our current allocation until we learn more about the company's prospects in this tough operating environment.

Our turnover during the period continued to consist of repositioning the portfolio away from technology into seemingly more attractively valued areas like financial services and commodities. We initiated three new positions including **Cal-Maine** (CALM), **Leucadia National Corp** (LUK), and **HRG Group** (HRG). We eliminated three positions entirely from the portfolio, including **Digital Realty Trust** (DLR), **Facebook** (FB), and **General Electric** (GE). We increased allocations to a number of positions on weakness including **International Business Systems** (IBM), **Liberty Expedia** (LEXEA), **Fairfax Financial** (FRFHF), **Post Holdings** (POST), **Allergan Plc** (AGN), and **DNOW** (DNOW). We also reduced our allocation to three positions including **RedHat** (RHT), **Tencent Holdings** (700-HK), and **Cimpress NV** (CMPR) following strong quarterly results and substantially higher valuation levels.

General Electric (GE) was a tough experience for us as we only initiated a position in December 2017 then proceeded to eliminate it from the portfolio in March after it had fallen more than 20%. We wrote about GE in the Q4 commentary maintaining optimism for GE's prospects and the company's new leadership team. However, we underestimated the encumbrances on its assets, specifically, reserves related to the insurance segment and the growing unfunded pension obligations. In January, the company announced a major insurance reserve deficiency related to their Long-Term care business of $15B which prompted an SEC investigation focused on accounting irregularities. After reviewing the company's assumptions in estimating the insurance reserve charge in their annual report, we concluded it may prove insufficient over time. Without being comfortable with the absolute levels of the company's liabilities, we think it is nearly impossible to estimate the normalized free cash flow to equity for shareholders. In the words of the former U.S. Secretary of Defense Donald Rumsfeld "we don't know what we don't know" so we sold our position believing there are easier opportunities to earn return on our capital.

<u>Investment Process</u>

We search for businesses with strong fundamentals and bright long-term prospects that are operated by trustworthy and skilled leadership being offered at a reasonable valuation. The importance of the diligence we perform on company leadership cannot be understated. In many cases, it is critical to our analysis. We are especially interested in the analysis for businesses that are reinvesting a large percentage of their cash flows for future growth or considering a repositioning of their asset base. Essentially, we are searching for strong capital allocators.

During this process, we aim to understand how rational the company's leadership is and their capacity or ability to make tough business decisions. These tough business decisions could include exiting certain segments to protect equity value, rather than choosing to further entrench themselves through misguided acquisition activity. We consider the more obvious endorsements including management incentives (compensation & equity ownership level) while also considering other more abstract elements. For instance, we evaluate the level of promotion or conservatism in investor communications and search out challenging periods for the business to evaluate transparency levels and rationale shared with investors. This process usually leaves us with a good idea on whether we are dealing with trustworthy and competent partners.

We are optimistic about our current allocation as many our holdings undergo a portfolio restructuring. We consider all of these efforts to be aimed at unlocking or creating value for our underlying equity. We are seeing a number of our holdings selling some level of their assets ranging from the vast majority of the asset base (e.g. **21st Century Fox** (FOXA)) to a small portion of it that has been deemed "non-core" by management (e.g. **Post Holdings** (POST)). Further, many of our companies are currently engaged or have recently completed (in past 3 months) some addition to the asset base. For example, **Liberty Latin America** (LILAK) is in the process of completing the acquisition of an 80% interest in Cabletica, a Costa Rican cable operator, at an attractive valuation which promises to deliver accretive value for the combined operations. In our prior commentary, we cited the pending acquisition of our FOXA holding as a good example of why we value this emphasis on management quality in our process. FOX leadership moved to preserve value rather than try to create value as an independent company in an increasingly uncertain environment. At some level, "A bird in the hand is worth two in the bush", so against this context the offer by **The Walt Disney Company** (DIS) remains attractive in our eyes.

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