



SeaBridge Longview Strategy
First Quarter 2018
Commentary

Market Review & Outlook

Volatility appears to have returned to global financial markets. Using the VIX index¹ 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 declined modestly during the volatile quarter. 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. Longview's lower cash balance reflects this as we deployed around half of our beginning period cash reserves and ended the quarter with approximately an 8% cash level.

During the quarter, our best performing holdings were **Cimpress NV** (CMPR) and **Advance Auto Parts** (AAP). Our worst performing positions were **Colfax** (CFX) and **Leucadia National Corp** (LUK).

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 two years but allows us to rest easier at night considering that our "risk is controlled with position size."

Advance Auto Parts (AAP) benefited from a relief rally as negative sentiment drastically overshot the fundamentals of the business in the face of a stabilizing operating environment. As noted in the Q3 commentary, AAP is undergoing a substantial restructuring led by an entirely new management team. In the eyes of many investors, management's credibility was damaged in 2017 due to some poorly communicated performance results which led to a sharp decline in the stock price in 2H 2017. While the fundamentals remain soft, we saw positive momentum in the most recent earnings. We have held the position for less than one year and continue to look for assurance the turnaround is moving in the right direction. Late in Q1 2018, our confidence was reinforced by insider activity with the CEO, Thomas Greco, purchasing \$1M of stock on the open market. At current levels, we think the valuation remains attractive as we are paying little to no premium for the business's recovery and anticipated profit growth especially with the latest development of a lower U.S. corporate tax rate.

Colfax Corp (CFX) is a global industrial company and has been a long-term holding in the portfolio. We recently increased our allocation in Q4 2017 following a poor 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 percentage 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 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 was low which is consistent with our long-term expectations for the strategy. Most of our turnover resulted from position size management rather than initiating new positions or eliminating existing holdings. We initiated one new position in **Cal-Maine (CALM)** and increased our weighting in a number of positions on weakness including **Liberty Expedia (LEXEA)**, **Fairfax Financial (FRFHF)**, **Leucadia National Corp (LUK)**, **Post Holdings (POST)**, and **DNOW (DNOW)**. We reduced our allocation to **Liberty Sirius (LSXMK)**, which now represents our smallest position.

Now Inc. (DNOW) is an oil & gas parts distributor servicing mainly onshore upstream Exploration and Production clients across the world. We expressed our thesis and concerns in the Q4 commentary following a period of weakness in the stock price. Following the Q4 earnings results, we increased our allocation as fundamentals continued to improve against an increasingly conservative outlook from management while valuation remains compelling and balance sheet remains essentially debt free. Our confidence was further reinforced by the \$300k open market purchase by the company's CEO, Robert Workman, in March 2018 which represents approximately 50% of his 2017 estimated cash income.

Investment Process

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 half our holdings undergo some level of portfolio restructuring. We consider all of these efforts to be aimed at unlocking or creating value for our underlying equity. Six of our companies are in the process of 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 that has been deemed "non-core" by management (e.g. **Post Holdings** (POST)). Five of our companies are currently engaged or have recently completed (in past 3 months) some addition to the asset base, ranging from a tuck-in acquisition (e.g. **Liberty Latin America** (LILAK)) to a transformative merger transaction that may deliver long-term value through the combined operations (e.g. **Qurate Retail Group** (QRTEA) formerly named **Liberty Interactive** (QVCA)). 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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