SeaBridge Longview Strategy

Second Quarter 2017
Commentary

The portfolios were slightly positive for the quarter as we benefited from our allocations to U.S. media assets and financials. We had above average turnover in the style due to high levels of price volatility in some of our holdings, which we used as opportunities to rebalance our positions. We continue to work to fully deploy our capital, but the markets appear fully priced and our caution results in higher cash balances than we would normally like.

At a high level, the most notable event was the flattening yield curve in the U.S. (i.e. short rates rising and long term rates falling). At one point, the spread between the 10Y and 2Y Treasury yields narrowed sharply and we saw complete retracement of the steepening in the curve that occurred following the presidential election in Q4 2016. This proved to be a negative development for most stocks as it is sign that investors believe economic growth may be stalling. With inflation data also giving back some of the gains it reported earlier in the year and GDP growth remaining stuck at ~2%, who can blame them? The "Trump" growth premium baked into valuations following the election in many of the cyclical stocks, like banks, has proven tenuous.

Our best performing holdings were **Liberty Interactive** (QVCA), **Liberty Ventures** (LVNTA), and Liberty Expedia (LEXEA). All rose between 17%-23% during the quarter. Our lowest performing positions were **Liberty Global** (LBTYK), **Twenty First Century Fox** (FOX), and **Post Holdings** (POST) with each falling between (10%)-(12%).

LBTYK is the largest European cable operator with assets across Europe including the UK, Germany, and Switzerland. It has the leading position in many of its markets for broadband and video services. Fortunately, LBTYK was trimmed late in Q1 on strength as valuation no longer warranted a full-size position. Unfortunately, we did not trim enough as it turned out to be very weak during Q2 largely driven by a soft earnings report that saw management reduce the guidance issued in January. We think the growth concerns weighing on the stock should prove transitory as management increases cash flows in the UK, its largest market, on the back of a new build capital expenditure program. At one point in June, the price was down (24%) relative to the price at which we trimmed in March, and we think the long-term value is unchanged – so we added again to our position. It now again stands as one of our largest holdings and we continue to consider it a core position.

POST is a diversified food staples company largely focused on serving the U.S. market. During the quarter, POST announced its first international acquisition buying Wheetabix, UK's #1 cereal brand. Investor response was negative with the consensus viewing the acquisition as expensive and a shift in strategy away from the US. Investors were also concerned about the debt and foreign exchange risks involved in the transaction. We disagree with this view and place our confidence with management given their demonstrated track record of completing value-accretive acquisitions. On the conference call, the CEO explained the company's rationale for the transaction, citing factors including distribution synergies and the conservative estimates applied to achieve the company's hurdle rates. This includes an assumption that top-line growth for Wheetabix will be zero. Management also noted company's ability to finance the transaction mostly with existing cash balances and requiring no equity financing.

During the quarter, we added two new positions including **Advance Auto Parts** (AAP) and **Fairfax Financial** (FRFHF) and did not eliminate any positions though we did trim a number of positions on strength.

AAP is a North American auto parts retailer operating in an industry with attractive characteristics including defensive demand profile, consolidating industry structure, and scale advantages accruing to the largest operators. Under prior management, AAP stumbled in recent years on the back of an M&A strategy that failed to integrate operating three separate brands. They also failed to gain the synergies from increased scale. In Q3 2015, Starboard Value, an activist

hedge fund, launched a campaign calling for the incumbent leadership to resign citing poor management execution. Eventually, they won board representation and installed a new CEO, Thomas Greco, in Q2 2016. In the ensuing 12 months, nearly the entire C-Suite and half the Board of Directors either resigned and/or retired while the new CEO handpicked an entirely new management team.

We watched all this unfold with excitement as we got to know the new leadership from ensuing earnings releases and the "investor day" held in October 2016. This event served as the debut for management's new strategy to improve the company's profitability. The examples provided as "low hanging fruit" increased our confidence in the new leadership. However, valuation tempered our enthusiasm as we believed we would be paying a premium for all this "management talk" with little yet to show for it in terms of fundamentals. This changed during the quarter as the sector came under heavy selling pressure from a confluence of factors including weak earnings, general negative sentiment toward bricks & mortar retail, and investor shift towards higher growth areas like technology. We took this as our cue and established a 3% position on May 1st and added to the position two more times during the quarter on continued weakness, eventually reaching an allocation of about 4.75%. Finally, we are reassured by recent heavy insider purchase activity as we saw management and Starboard Value make significant additional purchases at prices comparable to ours.

We initiated a 3% position in Fairfax Financial (**FRFHF**) during the quarter. FRFHF is a Canadian Property & Casualty (P&C) insurance operator with a long history of delivering attractive returns to shareholders. It is led by Prim Watsa who is the founder and principal capital allocator for the organization. He is a Warren Buffett disciple and operates the company in much the same way as Berkshire Hathaway (BRK.B) by embracing its de-centralized structure and "hands off" approach when dealing with its business subsidiaries. We have followed this company for years considering it a potential hedge to other cyclical risks in the portfolio but always deemed it to be expensive. During the past 5 years, FRFHF's investment performance had been poor as a result of equity shorts and total return swaps linked to global inflation indices. Obviously, this proved costly in a rising market and flat price environment but we were encouraged when Mr. Watsa lifted all "hedges" immediately following the Trump victory in Q4 2016. We continued to follow the story as sentiment worsened, watching the price fall. We acquired our position at about 1.1x book value for an asset we think will earn a normalized high teens return on equity driven by its superior insurance businesses and a normalization in its investment performance.

Lastly, you will note that we have a substantial allocation to "Liberty" assets, which represent assets either directly or indirectly controlled by John Malone, a long-time cable and media investor. Mr. Malone favors assets that generate subscription-like cash flows with defensive characteristics, insulated from competition by some type of competitive advantage. For example, he has been successful in managing cable assets around the world which exhibit monopoly-like market positions protected by strong barriers to entry and high returns to scale that tend to generate predictable cash flows.

We consider our Liberty holdings diversified as they represent interests in a wide number of businesses including the online travel agency Expedia.com (LEXEA), the Formula One racing franchise (FWONK), the television retailer QVC (QVCA), SiriusXM satellite radio (LSXMK), and cable assets spread across the world (LVNTA, LBTYK, & LILAK). Each asset's operations are managed independently while the capital allocation function is largely centralized by Mr. Malone and his long-time lieutenants, Gregg Maffei and Michael Fries. We have confidence in Mr. Malone's 40+ year record of creating value, heavy insider-ownership, and his record of fairly treating minority shareholders.

Adrian Morffi
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