SEABRIDGE
INVESTMENT ADVISORS, LLC

SeaBridge Global Growth Strategy

Second Quarter 2018
Commentary

Market Review & Outlook

We would characterize Q2 markets as choppy with an increasing sensitivity to daily headlines surrounding U.S. and European political developments. Year over year U.S. GDP growth has averaged 2.5% over the past four quarters supported by private investment demand, which averaged above 4%. Inflation has firmed but remains within the Fed's target level of around 2.0%. Our base assumption expects U.S. growth to accelerate, driven by the household sector with support from a continued rise in business investment demand. We expect more of the same headline-driven volatility in 2H 2018 as U.S. foreign policy and international developments likely continue to influence U.S. markets.

As we wrote in our Q1 commentary, we believed the hard line taken by President Trump is merely posturing with intent to draw concessions. Thus far, it appears we were wrong. Under the mandate of reaching what he believes to be a fair deal for Americans, Mr. Trump has imposed tariffs on a limited array of goods resulting in proportionate responses by our trading partners. The "tit-for-tat" volleying appears to be intensifying with Trump recently threatening to tax what amounts to the entire supply of Chinese imports into the U.S., which is about $450B per year. Given the huge trade deficits which it runs with its major trading partners, the U.S. may "win" the explicit trade wars, but there are many other ways that China or our partners can retaliate against U.S. interests. For example, they could impose sanctions or additional taxes on U.S. companies operating within their territories. We have no special insight to share on the eventual outcome but recognize the structural impact it can have on an individual company's profitability. Based on available disclosures, we believe our overall portfolio has limited direct exposure and look to the upcoming earnings releases to better understand management's perspective regarding any long-term impacts.

Across the pond, Europe's outlook, while not terrible, is far from robust as it continues to struggle with generating positive economic growth while inflation remains weak despite extremely accommodative monetary policy. The ECB, albeit at a slower pace, continues to expand its balance sheet by buying government and corporate European bonds at a rate of 30B euro per month. The official ECB overnight deposit rate remains negative with the futures market[1] implying it may not turn positive until Q2 2020. Further, the "safe-haven" government bonds in places like Germany have negative yields out to almost seven years. The markets appear to be telling us that European inflation and economic growth are expected to remain very low for some time to come.

Against this backdrop, many member nations are facing political upheaval as citizens lose faith in their leadership. In Italy, the third largest economy in the union, fringe parties have gained a foothold in the national government on an anti-EU platform. An exit from the EU would undoubtedly threaten global financial stability. While many question marks still surround Brexit, the UK's exit is more manageable since,

[1] Based on the Euro Interbank Offered Rate (EURIBOR) futures curve which represents a close proxy for the expected ECB overnight deposit rate.

unlike Italy, it is a non-currency member of the EU. The situation would be complicated by Italy's high level of external indebtedness and uncertainty around the impact on the debt's value for creditors, which are often leveraged themselves (e.g. banks). Italy's government debt stands at 2.3T euros, or 132% of GDP, which is many times the size of Greece's debt level at its peak of ~370B euros. We have limited direct exposure to Italy through our Jefferies (JEF) investment. We have one direct European holding, Liberty Global (LBTYK), with operations across Central Europe and the UK but none in Italy.

Portfolio Results & Activity

The portfolio appreciated modestly during the volatile quarter as we benefited from a largely strong earnings season across sectors. We continue to view volatility as an opportunity which is reflected by our portfolio activity and lower overall cash balances.

During the quarter, some of our better performing holdings were **Now Inc.** (DNOW), **21st Century Fox** (FOXA), and **Advance Auto Parts** (AAP). Our weaker performing positions included our international holdings like **Deutsche Post** (DPW GR), **CP ALL** (CPALL RTB), and **Fairfax Africa** (FFXXF).

Our patience with **Now Inc.** (DNOW) appears to have paid off as Q1 results exceeded expectations, driving a strong reaction in the stock. DNOW is an oil & gas parts distributor serving mostly customers in drilling oil wells. We expect drilling activity to accelerate in North America, benefiting DNOW as operating leverage drives profitability. Due to the heavy fixed costs embedded in its operating model, income levels remain sensitive to revenue growth. We consider management to be conservative and appreciate their habit of under-promising and over-delivering while tending to avoid debt financing. This insulated the business throughout the downturn and it remains essentially debt free. For these cyclical businesses with large operating leverage, we use a balance sheet approach to valuation relying on a multiple to tangible assets and an estimate for the businesses' normalized returns on capital. We trimmed our position late in the quarter as the price appreciation began to stretch valuation, no longer warranting an oversized position in our opinion.

21st Century Fox (FOXA) benefited from an official bid from Comcast (CMCSA) that was 19% higher than Disney's (DIS) outstanding bid. CMCSA's bid was also an all cash offer versus DIS's offer which, at the time, was 100% stock. DIS responded by raising its own bid to $38.00/share comprised of 50% stock consideration and 50% cash consideration. This represents a 9% premium to CMCSA's all-cash bid and leaves CMCSA faced with a decision to make before the scheduled July 27th shareholder meeting where FOXA shareholders will vote on the DIS offer. With the DIS's new bid, valuing the FOX assets up for sale at $70B or 15x EBITDA, it is unlikely that CMCSA could justify paying a much higher premium. With the share price above $45/share, we reduced our allocation as the price began to reflect much of the potential upside that would be realized from a higher CMCSA bid. We still see long-term value in the FOX assets if the share price were to return to the latest DIS offer of $38.00/share. This implies a double digit FCF yield for the assets that will remain in the FOX holding company called "New Fox" comprised mostly of U.S. television broadcast stations.

Advance Auto Parts (AAP) delivered a good earnings report, easing investor fears that the productivity initiatives were not working. Margins exceeded expectations and working capital efficiency continued to improve, generating solid free cash flow growth. Many of previously discussed initiatives are finally beginning to deliver. Savings are offsetting the operating expense investments as the company enters the third year of a five-year plan. As it relates to the restructuring, the business still has a lot of execution risk while absolute same store sales continue to be negative. We used the strength in the stock as an opportunity to reduce our allocation concluding the risk / reward was more balanced, no longer warranting an oversized allocation.

Some of our new positions include **Qurate Retail** (QRTEA) and **Frank's International** (FI).

Qurate Retail (QRTEA) represents the QVC retail business that was renamed following the merger with Home Shopping Network (HSN). QVC is known as a global "television retailer" but its business also represents the 3rd largest multi-category e-commerce business in the U.S. behind Amazon and Walmart. QVC's strategy is to keep the customer engaged with its content as viewing time is highly correlated with purchase activity. QVC's customers have consistently demonstrated solid loyalty and engagement levels as evidenced by stable retention rates, spending levels, and purchase frequency. We initiated a position prior to Q1 earnings and, despite overall positive sales growth during the period, the stock performed poorly because of disappointing profitability trends in Q1. Average selling prices (ASP) were lower than expected due to mix issues impacting cost absorption from some expenses like shipping costs. Management expects the ASP headwind to continue into Q2 but expects relief in the 2H as shifts in mix begin to benefit margins. As underlying trends in customer performance metrics appear to be firm, we chose to increase our allocation at the lower levels at what we consider to be a highly attractive valuation providing a 12% FCF yield implying limited growth premium at current prices.

Franks International (FI) is an offshore O&G services firm. Company provides offshore well casing services, which is a mission critical service, but represents a low percentage of overall well costs (~2.5%). Given total well costs can be >$100M, customers tend to prioritize proficiency and productivity over pricing, benefiting FI's margins. Company has a solid reputation for its technology advantage allowing it to handle the most technically complex wells (e.g. deep /high pressure wells). This technology advantage is insulated from competition by a wide patent portfolio providing pricing power and hopefully leading to excess returns on capital over the full cycle. It has the largest global market share at 30% followed by **Weatherford** (WFT) at 25% with remaining 45% of the market highly fragmented. It is a family controlled business with the founding family owning 70% of the shares outstanding providing effective control of the board. Currently, Enterprise Value/Net tangible assets is less than 2.0x for a business with estimated normalized pre-tax ROIC of >30%, implying a substantial discount to intrinsic value. The balance sheet has zero debt and $275M in cash or (15% of market cap) and the company is generating positive cash flows. We consider the primary risk to be permanent reduction in offshore drilling activity. At current oil prices, we are beginning to see a recovery in offshore activity.

Investment Process

World markets have been tumultuous because of developments around denuclearization of North Korea, trade wars, the integrity of the European Union, and Brexit, to name a few. Depending on news flow, the markets will trade on great enthusiasm or be weighed down by an abject sense of despair. Our largest obstacle to success is allowing these market emotions to influence our decisions. Employing a framework designed to limit the market's influence should help us make more rational decisions. Thinking long-term is a cornerstone of this framework.

A story from Amazon's Jeff Bezos provides powerful context on how we view the stock market as he was once asked the best advice Warren Buffett ever gave him and he responded with following:

> Bezos: [I asked Warren] your investment thesis is so simple… you're the second richest guy in the world, and it's so simple. Why doesn't everyone just copy you?
>
> Buffett: <u>Because no one wants to get rich slowly</u>

We believe having a long-time horizon when most others have a short one creates opportunities. When we buy a stock, we think of ourselves as owners acquiring the entire company at the current market capitalization placing trust in long-term fundamentals. When faced with new information, this mindset also places questions in a more meaningful context, shifting focus away factors weighing on short term performance.

When assessing long-term prospects, we like to imagine the market being closed for 10 years such that it would not be possible to sell until the market reopens. Can the company, as it is currently organized, managed, and armed to compete, thrive over the long term? If the company is in the process of transitioning, will its transformation allow it to do the same? Even though we are unlikely to hold many of our positions for 10 years, the exercise helps us focus on company attributes that are key to a company's long-term success. It can also reveal whether our interest is being disproportionately influenced by a low valuation at the expense of quality.

Finally, we consider that the market's role is to serve us, not instruct us, and, importantly, it can be ignored. Mr. Market provides daily offers on existing and prospective investments which at times appear irrational. As any enterprising business owner would understand, we are willing to consider all proposals. From this perspective, we consider the stock market to offer us a big advantage over the private markets while complementing our long-term investment style. This context is also helpful in understanding the portfolio's turnover during this volatile period.

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07/09/18