SeaBridge Investment Advisors, LLC

SeaBridge Longview 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 no operations in Italy.

Portfolio Results & Activity

The portfolio appreciated modestly during the volatile quarter as we benefited from a largely strong earnings season across sectors, partially offset by a few weaker-than-expected earnings reports. 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) and **Advance Auto Parts** (AAP) and our weaker performing positions included **Qurate Retail** (QRTEA) and **GCI Liberty** (GLIBA).

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 overdelivering 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.

Advance Auto Parts (AAP) also 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.

Qurate Retail (QRTEA) represents our QVC holding 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. Despite overall positive sales growth during the period, the stock has 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.

Our turnover during the period was above average as we actively managed positions responding to weakness and strength across the holdings. We initiated a new position in **Tencent** (TCEHY) at 2.5% allocation and increased our allocation in **GCI Liberty** (GLIBA), which now represents one of our largest holdings.

GCI Liberty (GLIBA) represents one of largest allocations as we increased our position following a poor earnings report by **Charter Communications** (CHTR), which represents GLIBA's largest investment. GLIBA is a holding company comprised of a wholly owned Alaskan cable business and a 6% economic ownership interest in CHTR. We consider the CHTR cable asset to be highly compelling at these levels with free cash flow growth expected to accelerate as we head into 2019 following the full integration of its Time Warner Cable acquisition purchased in 2016. Given the large valuation discount to its net asset value, we favor holding GLIBA rather than CHTR. On a look-through basis, our proportionate free cash flows from CHTR provide a higher yield than would be provided through direct ownership in CHTR. GLIBA is managed by the John Malone complex which we think provides assurance on rational capital allocation including the eventual collapse of the discount through an asset merger with the underlying investment holdings which has tended to be Malone's hallmark.

Tencent (TCEHY) operates in the world's largest internet market by user count, with a rare dominance across its vast lines of business. Our confidence is enhanced by owner operator CEO & Founder, Pony Ma's 9% stake in the company. Tencent is the ultimate franchise asset with dominant market positions in each of its end markets, benefiting from strong competitive advantages and protected by a powerful network effect. Imagine a company that offers services like Facebook, Amazon, Youtube, WhatsApp, Visa, Paypal, Netflix, EA Sports, and Pandora all within the same company. This begins to illustrate the breadth of Tencent's business in China. The centerpiece of the asset base is the "WeChat" social media platform with more than 900 million active users which allows members to do mostly everything noted above including talk/text, shop online, watch videos, play games, and send online payments all from this single platform. Taking a longer-term view, we consider Tencent to be at the crossroads of one of the better secular growth stories in the world: the Chinese internet armed with an unrivaled asset base should drive double digit growth in the company's intrinsic value for years to come.

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.

Adrian Morffi
Matt Falkowski
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