SeaBridge Global Growth Strategy

Third Quarter 2017
Commentary

The portfolios delivered solid returns with our technology allocation remaining the primary driver but with the vast majority of our holdings showing positive returns for the quarter. This was against a market that was broadly higher and marked by an historically low level of volatility. Cash levels remained relatively constant at approximately 8%. We continue to gradually reduce our technology allocation using proceeds to fund purchases in areas like Energy, Retail, and Financials. Given the level of the markets, we are comfortable with our cash levels at this time.

Global macroeconomic factors remained largely unchanged. U.S. monetary tightening has placed upward pressure on short term rates but has had little impact on long term rates. Many point to weak or stalled economic data from broad measures (e.g. Consumer Price Index) as culprits. Anecdotally, we are seeing evidence that inflation is accelerating as commodity prices seem to have bottomed and many of the companies we follow are discussing higher wage pressures as a near-term headwind. We think steady measured inflation generally leads to increased investment, higher employment, and more income, thereby creating more demand.

Importantly, beginning in October, we have another major factor to consider that is not well understood by the market. The Fed will begin to reverse its QE program by limiting its reinvestment of principal payments from its maturing assets, effectively removing a source of demand for financial assets. So far in this tightening cycle, the Fed has only used interest rates to target the money supply.

It is unclear what impact this will have on rates, but many believe it could lead to a rise in volatility. As rates and/or volatility increase, higher discount rates may be applied to growth assets making us increasingly cautious in this environment. Our effort is to ensure that the quality of growth in our portfolio is reliable and driven by durable advantages such as scale, brand, or network effects allowing short term pressures to be more than offset by the long term growth in the business's intrinsic value.

Some of our best performing holdings included Fairfax Africa (FFXXF), PayPal Holdings (PYPL), and TencentHoldings (700.HK). All rose between 19%-35% during the quarter. Some of our weaker positions were Allergan (AGN), Advance Auto Parts (AAP), and Now Inc. (DNOW) with each falling between (14%)-(16%).

Our best performing position was Fairfax Africa (FFXXF). Similar to Fairfax India investment, we view this as an interesting way to gain access to a scarce and attractive resource base (i.e. Africa) with trustworthy management. This is an investment vehicle sponsored by Fairfax Financial (FRFHF), a Property & Casualty (P&C) insurance company managed by Prem Watsa, with an explicit mandate to invest in public & private African assets. To date, the fund has raised $500 million USD including $275 million from the sponsor, FRFHF. The company has deployed or committed to deploy all of the funds raised primarily into two assets focusing on the financial and the cement production sectors. We consider the transactions to be highly accretive on a look-through basis to our initial purchase price, but now our focus shifts to the opportunity remaining at the current share price. As the transactions close and we learn more about the assets, we will decide on the appropriate allocation.

Allergan (AGN) is a diversified pharmaceutical drug company led by management with a record of successful capital allocation. Its products have a wide range of uses ranging from eye care to plastic surgery supported by a robust R&D pipeline. Approximately one third of existing sales relate to its "durable" brand products (e.g. Botox) that are largely funded outside the traditional healthcare payor system or are "cash pay". The sector has suffered negative investor sentiment for much of the past two years as investors feared lower profits as the issue of drug pricing has become increasingly politicized in the U.S. Recently, further weakness in the holding was driven by what we consider to be an over-reaction to the possibility of generic competition for one of the company's largest drugs, Restatsis, a treatment for chronic dry eye.

Our thesis is that the "durable" drug portfolio's more attractive cash flow profile and growth outlook should earn a premium valuation. We also consider the drug pipeline to be a source of substantial optionality being offered for a limited implied premium. The company has several drugs in late stage clinical trials that could be $1B+ opportunities. Following the earnings release, we thought the valuation at an estimated 13x earnings to more than fully reflect the risks when considering the potential value of the entire company, leading us to increase our position.

During the quarter, we added four new positions including Deutsche Bank (DB), International Business Machines (IBM), Fairfax Financial (FRFHF), and iStar Financial (STAR) and eliminated two positions including Masco (MAS) and Naspers (NPN-JSE).

We initiated a position in Deutsche Bank at the beginning of the quarter and increased our position following their earnings release as the stock reaction was unfavorable. Deutsche Bank is one of the largest investment banks in the world with assets over $1.7 trillion. It has spent the past 5 years restructuring its business and deleveraging its assets as bad debts and legal issues consumed its capital. We viewed the April 2017 rights offering as the final stage for the company's deleveraging, which has seen its assets contract 40% since 2011. At 0.6x tangible book value, we are paying a fair price for the company's currently poor capital returns while paying no premium for the likely improvements in profitability driven by internal and external factors. Internally, we find integrity in management and appreciate the rationalized approach being applied to improve business operations and the transparency shared with inventors. We believe the opportunities to improve profitability are substantial just on the cost side. Further, if European monetary policy normalizes, DB should be a natural beneficiary of a more normalized interest rate environment providing support to a recovering P&L.

We initiated a position in iStar Financial (STAR), a U.S. REIT that has been in a state of restructuring for nearly 10 years. The company is led by long time CEO and large shareholder, Jay Sugarman. We consider his actions to preserve the equity value of his company during and since the crisis as extraordinary and consistently rational. The company recently completed a recapitalization we view as dramatically changing the value of the equity as it pushes out the nearest debt maturity to 18 months. STAR was able to secure low cost financing to retire near term maturities, high cost preferred stock, and used additional proceeds to retire 4% of its shares. Its asset base is a mix of steady cash flow generating assets (e.g. loans) and development assets that produce no current cash flows. At current levels, we believe we are receiving the development assets at cost. We expect them to deliver a greater than 10% return on the asset value driving significant value for the (leveraged) equity. Further, we anticipate cash flows from its income producing assets to fund its development needs, limiting our expectation of equity dilution. We are likely to increase our position as we learn more about the timing and level of asset sales.

We exited our position in Naspers (NPN-JSE) with the intention of reducing our allocation to the Tencent (700-HK) investment. Naspers owns a 33% stake in Tencent worth $130B at current prices versus their 2001 investment cost of $34M. We estimate >90% of NPN's net asset value is tied to the value of the Tencent stake.

We decided to exit the NPN position in spite of the implied discount to net asset value relative to our direct holding in Tencent. Unfortunately, the discount has only widened in recent years as the South Africa based company exposes the asset base to an added layer of macroeconomic risk, which has been deteriorating in recent years, driving the widening discount.

Adrian Morffi
Matt Falkowski
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