SeaBridge Longview Strategy

Third Quarter 2017
Commentary

The portfolios delivered a positive return during a period of broad market strength amidst steady, if unspectacular, economic growth marked by continued low levels of volatility. Now entering its ninth year, the U.S. recovery has likely been enabled by ultra low interest rates targeted by the Federal Reserve in response to the Great Recession of 2008.

Since the Fed began to tighten policy in December 2015, there have been steady increases in short term (ST) rates but a limited response from long term (LT) rates. We are now entering a period of increasingly tighter Fed policy that may have a lasting impact on long term rates. Beginning in October, 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.

We believe LT rate levels have been a source of discomfort for investors despite the impressive advance of the stock market. Taken together, higher ST & LT rates could contribute to dispelling deflationary fears that have been a source of investor discomfort. We are seeing evidence that inflation is firming 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 view these first signs of inflation as a positive for the market as it signals strong underlying demand in the economy and pricing power for companies leading to increased investment, higher employment, and more income.

The direction of asset prices is likely to be influenced on how skillfully the Fed and other Central Banks around the world pull back on their accommodative policy. With the ultimate impact of tighter policy remaining unclear, many believe it could lead to a rise in volatility. With volatility at historically low levels, increases would be welcomed as higher volatility is usually accompanied by pricing inefficiencies, advantaging managers with active mandates, and cash reserves

Our best performing holdings in the quarter were Fairfax Financial (FRFHF), Post Holdings (POST), and Dollar General (DG). They each rose 12%-20% during the quarter. Our worst performing positions were Advance Auto Parts (AAP), Now Inc. (DNOW), and HRG Group Inc. (HRG) with each falling between (12%) and (15%).

Fairfax Financial (FRFHF) is a newer position we initiated at the end of Q2 and discussed in the prior commentary. It is a Canadian Property & Casualty (P&C) insurance operator led by Prem Watsa, who is the founder and principal capital allocator for the organization. As we entered Q3, the company announced significant asset sales reinforcing our thesis that the reported book value was understated due to conventional accounting rules. Between the two sales announced, we expect approximately $100/share accretion to equity or the equivalent of 20% of its market capitalization. Further, Mr. Watsa recently justified share repurchases as the best use of capital given the stock's current valuation. Following the closing of the transactions, a repurchase program was announced representing 10% of the common stock outstanding. This gave us the confidence to increase our position despite the strong rise from our original purchase price. We feel this continues to represent a compelling opportunity and now represents an average sized allocation.

Advance Auto Parts (AAP) is a newer position initiated during Q2 and discussed in the prior commentary. We have been disappointed in its performance as both sector sentiment and idiosyncratic issues have contributed to the weakness. As a reminder, AAP is the nation's largest auto parts retailer undergoing a business restructuring under new company leadership.

The sector is experiencing a period of weakness mainly due to a temporary contraction in their customer base or "sweet spot". The size of this key addressable market is at the lowest level since 2013. The "sweet spot" represents cars in the U.S. fleet aged 6-12 years old, i.e. vehicles produced during 2006-2012, which coincided with a period of very low auto sales. We expect the target customer base to return to growth in 2H 2017, becoming a tailwind for the business.

Further weighing on the stock was an earnings report that missed guidance while lowering full year estimates. Given heavy operating leverage embedded in the retail model, management expected SG&A investments related to the restructuring to be more than "funded" by anticipated sales growth. However, sales turned out to be flat (consistent with peers) leaving those investments "unfunded", leading to a magnified and unexpected impact on operating income. There was no margin for error in management's optimistic guidance, which we missed in our analysis.

The investments being made are intended to lower employee churn and improve customer service levels. We consider these to be critical elements of the turnaround strategy to improve profitability and asset productivity. We concede our original thesis is being tested by concern about management's ability to restructure the business effectively. Many company insiders were buying stock in Q2 (including the CEO) but since the poor quarterly results there has been no activity, which we consider unusual. It remains an average sized position as we continue to assess management and outlook.

Lastly, one of our largest positions, Liberty Global (LILAK), saw a volatile quarter driven by a positive reaction to Chairman John Malone's $36M open market purchase in early July, which was his first open market purchase in any company in at least 4 years. The company then reported a stronger than anticipated quarter, demonstrating its ability to grow profitability in many of its key markets, further buoying the share price. Unfortunately, late in the quarter, Hurricane Marie devastated one of its main and most profitable markets, Puerto Rico, driving a negative reaction in the stock and partially offsetting the period's price appreciation.

It is difficult to estimate the level of impairment to the company's intrinsic value at this stage but we do know that the Puerto Rico segment represents approximately 11% of the company's (proportionate) cash flow. We know the company carries loss of business insurance that should offset some income losses and fund some of the capital expenditure related to repair. However, it is too soon to assess much else as it relates to duration of its income losses or the cost to rebuild, net of insurance recoveries. We continue to assess our position and wait to hear from management on what the true impact may be before making any decisions.

As of quarter end, we held approximately 16% of portfolio assets in cash and short-term investments, slightly lower than prior period end, but well above what we would consider an optimal level. Given the limited value we see in the market, we consider the security and optionality that cash reserves add to the portfolio as increasingly attractive.

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10/10/17

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