SeaBridge Global Growth Strategy

Third Quarter 2018
Commentary

Market Review & Outlook

The backbone of the U.S. economy and often of the global economy, the U.S. household sector, is in an increasingly strengthening position. We see most of the sector's relevant credit metrics below their long-term averages which is highly favorable. This is in stark contrast to the period leading into the last recession that saw the household sector aggressively use credit to finance consumption. For reference, total household debt grew 3.5% year over year in Q2 versus disposable personal income (DPI) growth of 5.1%, whereas in 2006, household credit growth peaked at 13.5% or about twice the level of 2006 DPI growth. This positive outlook is further aided by a nearly record low rate of unemployment, accelerating wage growth, and historically low interest rates. Despite record low unemployment rates, we believe low inflation rates could continue as productivity improves due to businesses accelerating investment spend.

As labor resources become increasingly scarce, an increase in productivity becomes vital to offset inflationary pressures thereby preserving the incentives for further reinvestment. With price stability and favorable business conditions, a virtuous cycle is triggered in the sense that attractive returns on capital incentivize owners to reinvest profits into additional capacity. This leads to improving productivity and higher incomes, which can support higher levels of demand, thus sparking further reinvestment.

We view growth in real GDP per capita as a proxy for the nation's gains in productivity as it adjusts for the effects from changes in population. As of Q2, real GDP per capita was $56,455[1] which is 48% higher than the level 25 years ago and even 9% higher than the level 10 years ago. Despite the challenges the U.S. is facing around wealth inequity, increasing productivity is a positive force as it contributes to lower real prices, improving affordability and driving real consumption per capita higher. People respond to incentives, and the U.S. system is designed to reward productivity, greatly benefiting society in the long run through higher living standards for everyone.

Portfolio Results & Activity

Despite all the negative macro-economic headlines, Q3 was a period of strength for the portfolio due to accelerating momentum in company fundamentals. The earnings season was one of strongest we have seen in years with many of our holdings reporting better than expected results on accelerating organic demand growth. Our large U.S. allocation benefited performance particularly with our technology and retail holdings. Our emerging market holdings continued to struggle with weakness in our China-related positions (e.g. **Tencent** (700 HK)). We regularly assess overall exposure to different sectors or markets to ensure overall exposure remains appropriate. As valuations have contracted across the emerging market world, we have begun to revisit names from our watchlist. Currently, our direct exposure to emerging markets remains <15% of the allocation.

[1] Per the Bureau of Economic Analysis (BEA) using 2012 Constant Prices

During the quarter, some of our better performing holdings were **Now Inc.** (DNOW), **Apple** (AAPL), and **Advance Auto Parts** (AAP). Our weaker performing positions included our emerging market holdings, **Tencent** (700 HK), **HDFC Bank Limited** (HDB), and **Fairfax India Holdings** (FFXDF).

We continue to benefit from our patience with **Now Inc.** (DNOW) which reported another strong earnings report leading to a ~25% gain as recent earnings results delivered strong operating leverage. During recent years, fixed costs have often consumed the company's entire gross margin, often leading to negative EBITDA margins. As customer demand has recovered, the market has underestimated the "incremental margins" the company could earn on additional demand. Profitability has also benefited from the inflationary pricing environment leading to an unexpected expansion in gross margins as replacement-cost based market pricing runs ahead of inventory costs. The shares are now 81.5% above the 12-month low and near the levels we last added to the position paying slightly above 1.0x net tangible assets or 0.8x P/B. At the current level of 2.0x net tangible assets, the risk reward is much more balanced for this highly cyclical business leading us to continue to reduce the allocation in the portfolios.

Advance Auto Parts (AAP) returned another 21% during the quarter and is up 69% YTD reaching $168 per share. More interestingly, it is now >115% above the lows reached less than 10 months ago in November. In 2017, AAP fluctuated between $177/share and $78/share representing a 225% variation in price per share or $7.3B swing in its market value. Less than a year later, the operating environment has completely changed as the industry has returned to growth and prior period investments begin to generate margin rather than consume it. Recently, the company reported the highest sales growth rate since 2016. More importantly, the operating income growth rate was 2.5x above the sales growth rate leading to higher margins. AAP has now managed its second sequential quarter of year over year margin expansion after more than a year of declining margins. The company also raised full year 2018 sales guidance and announced a new share repurchase program. AAP illustrates the extreme reactions the stock market can experience within a short period of time affecting even seemingly mundane businesses.

We remain constructive as margins remain >1,000 bps lower than peers, O'Reilly (ORLY) and Autozone (AZO), and net working capital represents ~15% of the company's sales relative to negative working capital positions at peers. There are some structural impediments that will likely limit AAP's ability to fully close the gap but even crediting a 25% improvement results in a dramatically undervalued company. We see many pundits argue that AAP is over-valued citing a current forward P/E ratio relative to peers. We caution using a P/E approach to valuation but especially when the numerator (or the earnings portion) is not at a steady-state operating level. AAP was trading at a premium to AZO and a slight discount to ORLY when it was offered at 40% of the current price levels in Q4 2017. The P/E ratio is sensitive to changes in investor expectations, which are influenced by sentiment.

We have held **Tencent** (700 HK) for more than 5 years in the portfolio and have seen it create significant value for shareholders. As of January 2018, the position represented >4.0% of the portfolio. Due to risk management concerns, we reduced our position by a total of 40% targeting a 3.0% allocation in 1H 2018 securing average prices well above current levels. Currently, the position represents a 2.5% allocation following a period of substantial weakness for the shares. The weakness has been driven by recent general negative sentiment around Chinese equities but primarily due to surprising recent company developments. As Q2 earnings were released, we learned the company is seeing increasing regulatory risks potentially threatening the company's highly profitable operating model. Experience has shown us real regulatory risk is impossible to discount and should be avoided. However, we have spoken with other Chinese investment professionals and they have explained that this activity is cyclical and a compromise should be reached. The two distinct developments of increased regulatory risk are impacting the company's cash cow, the gaming business, and one of the company's fastest growing segments, mobile payments business.

The company has been unable to monetize in China the most popular game in the world, i.e. Fortnite, because of increasing red tape around the approval process by regulators. During the Q2 conference call, management could not provide investors a timeline for resolution or many details on the updated process. Some speculate this marks a change in policy for online gaming as the central government becomes increasingly concerned on how much time children are spending playing these games. As it relates to the mobile payments business, WeChat Pay, there was a further reduction in in the level of interest income that can be earned by Tencent on customer deposits. In 2017, this represented about 2% of revenues and grew 50% year over year, representing a source of income with very high returns on capital not requiring incremental capital to support growth. The revised rules completely eliminate the company's ability to earn interest income on customer deposits by January 2019, as they require customer deposits to be held in bank custodian accounts, which coincidentally are run by the nation's government-controlled banks.

On the one gaming side, our looming question is whether this is just a response to the new world of mobile gaming versus the old world of desktop gaming or the first step aimed at controlling gaming content in the world's largest gaming market. Banking has less concern for us as it is a fraction of the company's revenue base and the money market mutual fund dimension of the WeChat service offering is not included in the new rules. We already knew that the Chinese government considers banks a national security interest, as they deal with the flows of capital that fund the government. Therefore, we are less surprised by their actions to limit encroachment into this area. With the stock 19% lower than our purchase price, these changes appear to be discounted by investors as we continue to weigh their implications.

<u>Portfolio Turnover</u>

We initiated two new positions, **Zooplus** (ZO1-ETR) and **Comcast** (CMCSA), and eliminated three non-core positions, **Nestle** (NSRGY), **Williams Partners** (WMB), and **iStar Financial** (STAR). We added to a few of our core positions on weakness while reducing our allocations to others on strength. We believed the market provided us an opportunity to build exposure to some attractive assets at deep discounts to their estimated intrinsic value during the quarter.

Liberty Latin America (LILAK) currently represents one of our largest positions as we increased our position twice in the quarter. We consider this to be a highly defensive business with strong competitive barriers, operating within a secular growth market. At the time of our last purchase, we estimated the asset was valued to deliver <3% growth. Against a favorable industry backdrop, this seemed unreasonably low and is more than 50% below our growth expectations. This implies a highly undervalued asset which offers us the opportunity to partner with leadership that include one of the best cable operators in history, John Malone.

Over the past 2 years LILAK has underperformed dramatically due to a confluence of factors including seeing 15% of its attributed EBITDA wiped out overnight due to Hurricane Maria's destruction in Puerto Rico. Over the summer as investors shunned emerging market stocks, we saw the market increasingly ignoring the accelerating fundamentals and improved visibility. Our additions also followed a period of significant insider purchases totaling $5M by the CEO, CFO, and a key board member we highly regard, reinforcing our confidence.

We see the business rapidly nearing an inflection point in FCF generation as headwinds reverse. Most importantly, Puerto Rico is cash flow positive and nearly fully rebuilt, already recovering 90% of its pre-storm customers. Management expects to return to steady state cash flow generation by Q4 2018 implying a fully normalized contribution from Puerto Rico in 2019. The company's acquisition of Cable & Wireless in 2016 (CWC), which more than doubled the size of the company, led to confusion around the normalized profitability for LILAK due to the shifting mix, a multi-year investment period, and sizable integration/restructuring efforts. These factors, along with damages in two key markets from last summer's hurricanes, completely consumed FCF over the past 4 quarters, leaving investors frustrated with another year of zero FCF generation. CWC is now nearly fully integrated, nearing completion of a large investment cycle, and beginning to accelerate growth. The company also is beginning to move past the heavy organic and hurricane related investments completed in 2H 2017.

We initiated a small position in **Comcast** (CMCSA) following the announcement that CMCSA had won the bid for Sky against 21st Century Fox and Disney. The stock fell about 7% on the news as investors were concerned that they overpaid for the Sky asset at 15x EBITDA. We think the core U.S. cable business has real pricing power due to limited viable substitutes for its broadband services as telecom operated copper networks and mobile wireless cellular networks struggle to compete economically against CMCSA's fiber network. This position is complemented by a vertically integrated operating model and the nation's largest fixed line network spanning more than 55 million homes. This transaction represents about 25% of the company's enterprise value so, while it is material, it is not a "bet the company moment", adding just ~10% growth to the company's EBITDA base. Further, the 100% debt-financed transaction re-leverages the company's equity to benefit from its strong mid-single digit growth rate underpinned by the subscription like nature of its revenue profile. At 3.3x Net debt/EBITDA leverage ratio versus 2.1x prior to the acquisition, the company remains reasonably capitalized and still well below leverage levels of its peers. Brian Roberts, the long-time CEO and largest shareholder with a $1.5B stake, has a good track record of M&A that has created value for investors, with some pointing to the 2002 acquisition of the old AT&T's broadband business as one of the better acquisitions of all time. We are excited to finally own a piece of this company at what we consider to be an attractive valuation as the strategic vision for CMCSA's global ambitions unfold.

We eliminated iStar, a real estate investment trust, or REIT, at a small gain following a period of strength resulting from its addition to S&P Small Cap 600 index. Following a successful 2017 refinancing, we established a small position considering the near-term liquidity overhang removed, allowing management to focus on accelerating the monetization of its non-income producing asset base. Representing 40% of total assets, and with REIT investors ascribing little value to assets generating no current yield, we believed a renewed focus monetization provided a clear path to collapsing the >30% discount to NAV embedded in the stock price. Despite hiring investment bankers to broker transactions and an asset spinoff to shareholders, we never added to our position as monetization activity failed to meet our expectations. This, coupled with some unexpected turnover in key leadership roles, were enough for us to look elsewhere for opportunities.

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10/1/18

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