# SeaBridge Longview Strategy

Fourth Quarter 2016
Commentary

**Introduction**

As explained in our November communication, there has been a change in how the Longview style is being managed. Dan Micit, Managing Member of CKM Research LLC ("CKM"), has an opportunity to launch a hedge fund and so has decided to terminate the CKM research agreement with SeaBridge Investment Advisors LLC as of November 30, 2016. I will continue the research process to find and analyze securities that fit the Longview strategy. I have had the pleasure of working closely with Dan as we both share similar investment philosophies and have spent hours discussing the positions in the Longview portfolio.

As a brief background on my own experience, I began my career working as a CPA spending 5 years with the accounting firm Ernst & Young. I attended Emory University for business school. During my MBA, I began as an intern at SeaBridge Investment Advisors and after graduation I transitioned into a full time analyst role. I have been working with the firm for nearly 6 years and recently became a minority owner in the firm. I have spent my time supporting Garnett Keith and John Conti in the portfolio management process.

**Investment Process**

Our biggest concern is losing money over the long term on an investment by funding low quality or permanently impaired assets. Generally speaking, we expect to avoid losses by limiting investments to simple businesses that exhibit attractive qualities run by trustworthy management being offered at reasonable valuations. *Of course, there are no guarantees that we will be able to achieve this. Our conclusions about the quality of the company may be incorrect and/or the markets may bring the price down despite the quality of the company*. A significant dimension to the Longview strategy is that it employs a "Guru" screen to narrow its universe of investable ideas. We track the quarterly reported portfolios of leading investors with long records of success.

In evaluating the quality of a business, we consider a number of factors including the demand profile for its output and its ability to increase prices. We assess levels of competition by analyzing current industry structure and understanding how it has changed over time. Finally, we consider any existing or developing competitive barriers that would protect the business from existing or new competition.

When assessing a business's leadership, we favor managers with a record of rational capital allocation and an aligned incentive structure among the CEO, Board, and shareholders. We consider significant levels of insider ownership to be a major positive. We also favor a management compensation structure tied to long term performance, reassuring us of management's time horizon.

We believe no two businesses can be valued the same, with each new valuation exercise requiring special considerations. We favor qualitative assessments of the business and management team over any supposedly "precise" expected return generated by a financial model. Lastly, we aim to make investments at discounts to our estimates of intrinsic value providing a margin of safety for our capital.

**Portfolio Management Process**

We target a 15 stock portfolio and, when markets seem fully valued, we tend to hold a structural cash allocation of between 10%-20%. We think of this cash allocation as a strategic asset to be leveraged during times of market dislocations. Initial allocations to an investment generally range from 3%-10% of net assets while we will generally trim positions that grow larger than 15% of assets respecting the benefits from diversification. We expect the portfolio to experience low turnover given our expected holding periods for investments.

We consider ourselves bottom-up investors managing a portfolio that reflects ownership interests in quality growing businesses. There will be periods our portfolio suffers losses as prices decline while our conclusion about intrinsic value remains unchanged. Our intent is to view these periods as opportunities rather than challenges by staying focused on changes in a business' value *relative* to prices.

**Performance Review & Outlook**

The Longview style had positive returns on capital for the year and the Q4 period. During the year we raised cash levels as we struggled to find opportunities to fully deploy the capital raised from asset sales as some investments reached our estimates of fair value.

We are satisfied with our portfolio as many of our investments continued to meet or exceed expectations. Despite some challenges, all of our managers actively worked towards increasing intrinsic value of their underlying businesses or delivered on promises of narrowing the discount between net asset value and market prices on certain of the investments.

Our best performing holdings were Liberty Media Group (LMCK), Bank of America (BAC), Colfax Corporation (CFX), and Liberty Broadband (LBRK). We were fortunate to have substantially increased our positions in LMCK, BAC, and CFX at times of market dislocations driving stronger returns and evidencing the benefit of holding a cash reserve providing flexibility to act opportunistically.

The biggest surprise in Q4 was BAC's performance as the stock rallied 41% during the period, climbing about 100% off its February 2016 lows. This was driven by a Trump victory that has raised inflation expectations on promises of fiscal stimulus, tax cuts, and regulatory reform. This drove a sharp rise in long term rates and steepening of the yield curve benefitting the commercial banks with a widening spread between long and short term interest rates. We built our position at a substantial discount to book value considering this discount a margin of safety for our capital while we waited for the under-earning business to normalize its earning power. At current prices we are no longer being compensated to own this capital intensive and largely commoditized business given the rosy outlook largely reflected in its current price. We will likely trim our position in 2017 as gains go long term.

We discussed the events driving the LMCK stock price in our Q3 letter and are pleased to report the price has continued to move higher following the December announcement that the deal financing for the Formula One transaction has been fully secured. The stock is now up over 75% from the levels at which we acquired most of our stake in April 2016. Despite the rally, we continue to evaluate our position to ensure our capital is still being offered a fair forward return given the operational risks embedded in this transformative acquisition.

The final winner is CFX which returned 54% during the year, increasing approximately 100% off its January 2016 lows. CFX is an industrial parts manufacturer with significant exposure to the energy and power generation industries.  The collapse in Oil & Gas capital spending led to a decline in CFX's operations which we believe was discounted excessively by the market, providing us an opportunity to increase our position.  While the business quality is not as attractive as some other holdings, given its cyclical nature, we consider management to be excellent partners and valuation to be undemanding relative to the reinvestment runway for our earnings which we think should drive attractive growth in intrinsic value for years to come.

Our largest detractors from performance were our holdings in Liberty Global Plc (LBTYK), LILAC Group (LILAK) and Liberty Interactive (QVCA).

LILAK operates cable assets in Latin America which we consider to be a region that is ripe for consolidation due to the fragmented and under-penetrated markets.  Despite the business's prospects, LILAK fell (-51%) in 2016 and (-25%) during the Q4 period.  We believe the poor performance has been caused by technical and fundamental factors that we consider to be transitory and have taken the recent weakness as an opportunity to increase our position.

Earlier in the year, the company closed on a large acquisition that was viewed as expensive and had a complicated structure.  Subsequently, the company reported decelerating fundamentals in many of the key markets that were acquired, further decreasing investor sentiment and the stock price.  Our view is the acquisition will be value accretive as the benefits from increased scale are realized and competitive forces diminish as its main competitor struggles with an overly indebted balance sheet.  Our conviction is supported by the accomplished management team in place combined with an appealing business and industry structure underpinned by a compelling valuation.

QVCA is a television retailer that has demonstrated a long record of steady growth while many retailers have struggled.  The company's success has been driven by a loyal customer base in the U.S. that purchases an average of 26 times per year and spends a total of about $1,300.  The stock fell (-27%) in 2016 as the company reported the first period of negative year over year growth since 2009 in its key US segment (60% of sales).  We consider the weakness to be related to temporary merchandising issues and trust management is responding accordingly.  The stock decline followed a fall in the average spend per customer while their number of transactions per customer held firm, reassuring us that customer engagement remains intact.  Given our faith in management, their leading industry position/profitability, and current valuation levels, we consider the current price to be attractive.

Adrian Morffi
1/4/17

*There are differences among portfolios managed by SeaBridge in each strategy based on client-specific factors. Not all portfolios hold the same securities. Not all stocks held in the portfolio perform similarly. Some client accounts may not have as much cash reserved as other accounts managed in the strategy due to client withdrawals or other issues. SeaBridge manages portfolios in several styles.*