SeaBridge Global Growth Strategy

Fourth Quarter 2017
Commentary

Market Review & Outlook

Financial markets were strong in 2017 as global fundamentals improved and investors viewed challenges as increasingly manageable. Concerns around excess capacity, over indebtedness, and deflation appear to be moving further from investors' minds. The majority of asset classes saw a positive return for the period including equities, bonds, and most commodities. Risk assets outperformed led by technology and emerging market equities returning around 38% and credit spreads narrowed to near record lows.

We believe the U.S. economic growth is accelerating, aided by a robust labor market, healthy consumer balance sheets, and a well-capitalized banking system. The U.S. has registered two consecutive quarters of greater than 3.0% GDP growth (Q2 & Q3) and is expected to register a third consecutive 3.0%+ growth period in Q4. It would be the first time this has happened since 2004. Further, the Q4 tax cut is likely to be stimulative to growth with consumption benefiting from a near-term rise in disposable incomes. With U.S. long term rates still pinned at around 3.0% and inflation below its target level of 2.0%, financial conditions seem supportive for the critical housing sector and more broadly for a continued expansionary period.

Outside the U.S., the Eurozone crisis is widely viewed as contained with firmly positive economic growth returning to the region (>2.0%) setting the stage for the ECB to end its QE program in 2018. China is managing its economy well as it continues to avoid the oft predicted looming debt crisis while still generating some of the highest GDP growth in the world of nearly 7.0%. This growth is led by its under-represented household sector that is seeing income levels rise greater than 8.0%. Lastly, other emerging markets such as India appear well positioned for continued strong growth on the back of manageable current account and fiscal deficits, low inflation rates, and stable political and monetary regimes.

We contemplate this positive outlook with the Fed raising rates, the yield curve flattening, and credit spreads seemingly priced for perfection while investor fear is becoming increasing scarce, evidenced by the record low levels of volatility. These are usually the hallmarks of an aging economic cycle so signals are mixed. The S&P 500 at 18.4x earnings leaves little margin for error if earnings growth fails to accelerate. Surely, tax reform supports a structurally higher multiple. However, we expect higher interest rates on rising inflation to pressure equity multiples as the relative attractiveness of bonds improves. This leaves us with limited visibility on the medium term net impact on equity prices from these factors.

Portfolio Results

Returns for the portfolios were generally above the MSCI World Index return of 25%. The good performance was primarily driven by our sector concentrations in technology and emerging markets, which benefited from a positive shift in investor sentiment. The performance in many of our holdings likely exceeded their growth in intrinsic value as investors were willing to pay increasingly higher multiples for these investments. For example, our five largest holdings saw P/E multiples expand by an average of 24% in 2017 with Tencent's (HK0700) multiple increasing from 28x to 39x or 34% during the year. We continue to use strength in many of our names as opportunities to raise cash to redeploy into more attractively valued opportunities.

During the year, our best performing holdings included **Tencent** (HK0700), **Misumi Group** (JP9962), **Canfor Corp.** (CFPZF), and **RedHat** (RHT). Our worst performing positions were **Now Inc.** (DNOW), **Advance Auto Parts** (AAP), and **Kennedy Wilson** (KW).

Tencent (HK0700) remains our largest holding though we have reduced the position by about 33% from its peak weighting due to risk management targets. Operating in the world's largest internet market by user count, we view Tencent as one of our strongest companies. 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 power 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 >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. As to valuation, the stock returned >110% in 2017 and now trades at 39x 2018 earnings leaving us vulnerable to short term shifts in sentiment. 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 which should drive double digit growth in the company's intrinsic value for years to come.

We hold the three largest lumber producers in the North America: **Canfor Corp.** (CFPZF), **West Fraser Timber** (WFTBF), and **Weyerhaeuser Company** (WY) with the intention of benefiting from an acceleration in lumber demand as residential housing construction in the U.S. accelerates. WY also earns most of its profit from farming timber, which is produced and harvested on company owned land located across North America. We value these cyclical commodity businesses applying a net tangible asset approach targeting to buy them near tangible asset (NTA) value, which only includes net working capital and fixed assets, and selling them at a premium to NTA. During 2017, our holdings benefited from the more than 40% appreciation in lumber prices, which mostly drops to the bottom line due to the heavy fixed costs nature of the lumber mill business. At current premiums to NTA, we are likely to view our timber allocation as a source of cash in 2018.

<u>Portfolio Activity</u>

Much of our portfolio turnover resulted from our positioning away from technology and biotechnology holdings and into more attractive sectors. We trimmed a number of positions on strength as their valuation no longer provided adequate safety margin to justify an overweight allocation. We acquired a number of new positions in areas like financials, including **Deutsche Bank** (DB) and **iStar** (STAR), emerging markets, including **Fairfax Africa** (FFXXF) and **Grupo Financiero Santender Mexico** (BSMX), and industrials, including **Colfax** (CFX) and **General Electric** (GE).

During the Q4 period, we initiated three new positions: **Kroger** (KR), **Colfax** (CFX), and **General Electric**. We also eliminated four positions from the portfolio: **Shire** (SHPG), **NXPI Semiconductor** (NXPI), **Cyrus One** (CONE), and **QTS Realty Trust** (QTS).

We initiated a starter position in **GE** late in the fourth quarter following a dismal quarter and year for the stock with it falling (28%) and (45%), respectively. The weakness has likely been driven by a confluence of factors including leadership transition, end market deterioration, and liquidity challenges that ended in a dividend cut. GE has an attractive asset portfolio largely comprised of products with dominant market positions operating in stable and consolidated industry structures where GE splits the market share with 1-3 other competitors. These franchise assets include gas turbines, airplane engines, medical imaging technology (e.g. MRI machines), and locomotive manufacturing.

We consider the new CEO and company veteran, John Flannery, to be honest and transparent with the company's challenges. We also view positively the restructuring of the GE board with 9 existing members likely to resign as the board size is reduced from 18 to 12 and 3 new directors expected to be added. We were encouraged by the heavy insider buying during Q4, which included the CEO and key directors including admired investor James Tisch, CEO of Loews (L) and GE Director, who purchased $53M of stock on the open market. Lastly, Nelson Peltz from Trian Partners, an activist hedge fund with a good long term record, has joined the board after taking a large stake in the company, promising to bring accountability to the company leadership with profitability targets that we can measure as investors. We consider the risk/reward attractive. We believe that the new leadership will either create value in each segment or preserve value by exiting underperforming segments. We view the breakup value of the company as much higher than the valuation providing a margin of safety for our capital given our confidence in the new leadership and our aligned incentives.

After finding success in our datacenter REIT holdings, we reduced our allocation to concentrate positions in higher quality assets with more reasonable growth plans and lower leverage levels. We view datacenter development as a capital intensive, low capital return business characterized by long payback periods and a high need for external financing (debt & equity). Many are structured as REITs, requiring them to payout the majority of their annual income to investors increasing the reliance on external financing to fund growth. As growth plans for our holdings became only increasingly more aggressive requiring even more funding we opted to reduce our allocation to more conservative operators despite the secular demand outlook for their services.

We now have about a 3.5% position concentrated in three holdings, **Digital Realty Trust** (DLR), **CoreSite Realty** (COR), and **Interxion** (INXN). We view each of our remaining positions as adding a different dimension to the thematic bet. To highlight one of the positions, INXN is a European datacenter operator heavily focused on serving its customer base as an interconnection point. Interconnection services are critical because the internet is a combination of countless networks, and in order to transfer data between these independent networks, there must be a physical point where they are connected to each other so data can pass from one to the other, which is usually a specialized datacenter. Interconnection benefits from a powerful network effect as it becomes increasingly valuable with each major customer increasing the barrier to entry for new entrants. We view datacenter assets with a high mix of interconnection services as the highest quality type of datacenter assets due to their strong network effects, which should support pricing power relative to the their more commoditized counterparts.

<u>Conclusion</u>

We have seen a rise in investor euphoria while fear appears to have been dispelled from the collective psyche of investors. We are natural skeptics and are wary of the lack of volatility and increasing investor accord at these prices. Perhaps Buffett said it best with the quote: "You pay a high price for a **cheery consensus**".

Our approach in this environment is to remain disciplined in our positioning and to increase our diversification. We are becoming increasingly selective in the more volatile allocations like technology and emerging markets as risk premiums continue to narrow. As we reduce our allocation to these areas, we are likely to continue to deploy proceeds in areas where valuation levels appear relatively more attractive.

Adrian Morffi
Matt Falkowski
1/3/18