SeaBridge Investment Advisors, LLC

SeaBridge Longview Strategy

Fourth Quarter 2017
Commentary

Market Review & Outlook

Equity markets were strong in 2017 with global fundamentals improving as investors viewed challenges as increasingly manageable. In the face of Federal Reserve monetary tightening, many see economic strength as evidence that the threat from overcapacity and deflation is waning and growth shouldcontinue to accelerate. Risk assets outperformed led by technology and emerging market equities returning around 38% and credit spreads narrowed to near record lows.

The U.S. has registered two consecutive quarters of more 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. As consumer confidence reaches pre-recession levels, consumers may be feeling more optimistic about the future due to record low unemployment, rising real income growth, and healthy balance sheets. This is driving an acceleration in consumer spending with retail sales measuring more than 6% growth in the November period, which is the highest level since Q1 2012. Further, the Q4 tax cut is likely to be stimulative to growth with consumption benefiting from a near-term rise in disposable incomes. With long term rates still pinned at less than 3.0% and inflation below its target level of 2.0%, financial conditions seems supportive of the critical housing sector and a continued expansionary period.

The S&P 500 at 18.4x 2018 earnings leaves a narrow margin for error if earnings growth fails to accelerate above the 5.0% annual earnings growth rate registered over the past 5 years. Surely, tax reform supports a structurally higher multiple; however, we expect higher interest rates on rising inflation to pressure equity multiples as bonds' relative attractiveness improves. This leaves us with limited visibility on the medium term net impact for equity prices.

Portfolio Results

The portfolios lagged the S&P 500 which returned 22% in 2017 largely due to our large cash position and our limited allocation to the technology sector, which was the strongest performing sector in 2017 returning almost twice the level of the general market. We remain committed to our process which focuses on finding securities which we think are cheaper and growing faster than the broader U.S. equity market and should be recognized by the market over time.

During the year, our best performing holdings were **Liberty Ventures** (LVNTA), **Bank of America** (BAC), and **Liberty Interactive** (QVCA). Our worst performing positions were **Now Inc.** (DNOW) and **Advance Auto Parts** (AAP).

BAC remains our largest holding as we aim to capture the benefits from an improving operating environment. This franchise asset offers us ownership in the largest commercial bank in the U.S. benefiting from economies of scale driving a low cost position and high customer switching costs supporting pricing power. For example, BAC pays only 0.15% on its interest-bearing deposits despite the fact the Federal Reserve began raising short term interest rates over 24 months ago and now stands at 1.50%. This reflects the stickiness of customer deposits despite competitors offering much more attractive rates. It also supports lending margins as loans are regularly repriced at market rates while funding costs remain much more stable. This is what pundits are referring to when they say the bank is "asset sensitive".

Given recently tepid loan demand, continued solid credit quality, and high levels of excess capital, we are less concerned with asset quality at this point. Also with the bank finally moving past the legal issues related to the crisis, we think the company is well positioned to fund growth while returning excess capital to shareholders as regulators increasingly allow more flexibility. In December, BAC raised its buyback program 40% or $5B to $17B, which represents >5.0% of shares outstanding and is set to be completed by June 2018. When combining the buyback amount and the cash flows tied to the dividend, the bank is set to return to shareholders 100% of its net income. At 1.25x book value or 13.5x earnings, the current valuation remains attractive for an asset that should see its normalized ROE improve to low teens in the near term.

The poor performance of **DNOW** has caused us to reassess our conclusions on its prospects. **DNOW** is an oil & gas parts distributor operating within a favorable industry structure where the company splits 50% of the market with their largest competitor and the remaining 50% is highly fragmented. We think the company has a unique market position and benefits from experienced leadership focused on leveraging its size to consolidate smaller competitors while capturing scale benefits. However, given the unprecedented operating environment in the oil and gas sector, it has been difficult to evaluate structural improvements or measure returns on acquisitions. We were satisfied with the Q2 and Q3 earnings results, noting steady operational improvement. The market, however, heavily discounted the results with many analysts concluding the recovery is taking longer than expected. At current levels, we are paying a small premium (20%) to net tangible assets for a company with low debt and a history of generating free cash flow. Given the company's market position, we think it can earn higher normalized capital returns supporting a larger premium to its tangible asset base. We are unlikely to change the position until we hear the Q1 results, as we look for a high level of operating leverage (high incremental margins) to drive an acceleration in cash flow generation supporting our view the fundamental weakness is more cyclical than structural.

We hold a sizable position in **21st Century** (FOX), which we acquired in Q1 in two stages, eventually reaching a full-sized position. During Q4, Fox received a merger offer from Disney (DIS), which, if approved, should see much of the company folded into the Disney complex. Rupert Murdoch, Executive Chairman of Fox, is the company's largest shareholder and its founder. No one knows this company better or has more to lose than he if the right choices are not made. Given the media sector's increasingly fluid state since our purchase, we are satisfied with this outcome providing us an attractive return on an asset with increasingly uncertain growth prospects.

We mention FOX to highlight the importance of investing with leadership that has incentives that are aligned with our own. This helps ensure that our interests will be in sync when tough decisions are required to preserve value, like whether or not to sell the company. Given their interest in job security, management teams with little to no stock ownership are more likely to be in conflict with shareholders. Such misaligned interest often weighs on equity values. As asset managers, we rely on company management to not only create but to preserve value. We often pass on investments in good companies where we feel management and shareholder interests are misaligned.

<u>Portfolio Activity</u>

Most of our turnover resulted from position size management rather than initiating new positions or eliminating existing holdings. We trimmed a number of positions on strength as their valuation no longer provided adequate safety margin to justify an overweight allocation. For the full year, we acquired 7 new positions in areas many would consider "out of favor" like the retail sector (**Kroger**(KR) and **Dollar General**

(DG)), media sector (**21st Century Fox** (FOX)), the Property & Casualty insurance sector (**Berkshire Hathaway** (BRK.B) and **Fairfax Financial** (FRFHF)), concluding the low valuations on offer more than compensated us for the risks.

Kroger (KR) is the second largest U.S. grocery retailer that has seen its equity value suffer as sector sentiment turned increasingly negative. We admire KR's industry position (#2) in the largest consumer category, the $700B+ food at home segment. This is a highly competitive industry where barriers to entry and customer switching costs are low, products are commoditized, and operating expenses are high which all weigh on long term capital returns. We tend to avoid this type of investment but thought the risk / reward proposition had shifted heavily in our favor. Investors remain focused on the Amazon/Whole Foods risk which we view as significant, but given relative market positions and different targeted customers, we do not consider Amazon's entry into bricks and mortar food to be an existential threat for KR. Investors also remain focused on continued price competition as recent trends have wreaked havoc on the sector. Recently, with input costs rising, companies have been unwilling to entirely pass through rising costs to customers, thus defending their market share but hurting margins. We think the stock price largely reflects this reality making the shares an attractive option for investors that should benefit from a more normalized pricing environment, which early signs indicate may be returning.

We acquired our initial position in this defensive and mature business with industry veteran leadership at a 10x earnings multiple after the stock fell more than 40% in 2017. Following the company's annual investor day and Q3 earnings report, we increased our allocation despite the strong price appreciation since our original purchase. Management comments regarding the near-term business outlook and medium-term free cash flow generation estimates convinced us there was still a high level of value in the holding. The company has just completed a major cap-ex cycle and now has in place the operational leverage that shouldbe accretive to margins over time. Lastly, KR should benefit significantly from a lower corporate tax rate as it has historically paid a high cash tax rate.

Fairfax India (FFXDF) is an investment vehicle formed and sponsored by Fairfax Financial (FRFHF), another Longview holding, with an explicit mandate to invest in public and private Indian assets. Launched in Q1 2015, the fund has raised $1.5 billion USD to date including $450 million from the sponsor, Fairfax Financial (FRFHF). The company has deployed >85% of its funds into 7 assets ranging from an agricultural commodity trader to leading diversified investment banking company. All but two investments represent minority stakes in companies whose backing managements have long term records and heavy insider ownership.

We initiated a small position at a mid-single-digit premium to net asset value, which we consider reasonable given the scarcity value of the asset base. The fund charges 1.5% management fee and a 20% performance fee payable in shares (subject to a 5% hurdle), which we think is reasonable as we estimate management can deploy capital at the minimum of 20% ROE in order to meet our return objectives of a 15% annual return.

<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 likely to continue to deploy capital in smaller slices, focusing on areas where we think valuation levels more than offset the risks prevailing in investor minds. Lastly, our cash allocation is viewed as a strategic asset to be leveraged during times of market dislocations in individual holdings. We recognize that cash reduces to a degree the return profile of our strategy. Still, it is a safeguard against the downdrafts in the market which we will inevitably encounter. That said, we are still cautiously optimistic in our outlook.

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1/2/18

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