SeaBridge Investment Advisors, LLC

SeaBridge Core Strategy

First Quarter 2017
Commentary

As we have noted in several past commentaries, emotions can prove to be the Achilles' heel of portfolio management. Our goal has always been to remove as much emotion as possible from the investment process by employing a set of decision-rules that we have developed through experience and applying those rules in a disciplined manner. As a result of invoking three of our decision-rules, our cash reserves increased during the first quarter of 2017 and are now above normal. Two of these decision-rules pertain to our sell discipline and one applies to new investments.

Our portfolio management process employs several sell disciplines. The four most common sell disciplines that we embrace are: 1) accounting issues, 2) broken investment thesis, 3) adverse change in corporate governance, and 4) management vacuum. During March, **Caterpillar** (CAT) and **American International Group** (AIG) triggered sell discipline #1 and #2, respectively. Both investments performed well over the past year and we were of the opinion that they had plenty of room to run further. That is, until March.

CAT is the largest heavy equipment company in the world. The company has a global manufacturing footprint, the broadest product line in its industry and the largest installed base. (The large installed base is particularly important because it provides a steady demand for spare parts). All of these attributes plus a premium brand and a management team that likes to return ample free cash flow to shareholders prompted our decision to invest in Caterpillar. In its Form 10 K, CAT has a rather benign footnote that describes a dispute with the Internal Revenue Service (IRS) regarding intra-company sales from a Swiss subsidiary. Although the footnote indicates management's opinion that the dispute is not material, the IRS is seeking $2 billion in back taxes. In March, several U.S. Government agencies, including the IRS, raided CAT's headquarters with a subpoena for undisclosed documents. The following week, a report was leaked to the press. It was authored by a professor from Dartmouth's Tuck School of Business, and alleges that Caterpillar's intra-company accounting practices could rise to the level of criminal fraud. We have no way to evaluate the veracity of the accusation based on the publicly available financial statements. We rely on external auditors to render opinions affirming the accounting practices and financial statements of the companies in which we invest. When we obtain information that has the potential to challenge the integrity of the financial statements or accounting practices of any company in which we are invested, we sell first and ask questions later. Importantly, we do not guess. When, as, or if the information proves to be incorrect, we can always reinstate the investment.

AIG is a very large multi-line insurance company with global scale. We initiated an investment in the company in 2016 after we evaluated the CEO's plan to cut costs, reduce the scope of the business and return $25 billion to shareholders through share repurchase over two years. Since, at the time, AIG was trading at a large discount to book value, a $25 billion share repurchase would have substantially increased book value per share. After reporting earnings for the fourth quarter of 2016, AIG was running well ahead of its plan to cut costs and repurchase shares. Management also booked a large reserve for adverse claims experience. Although CEO Peter Hancock should have been lauded for his conservatism in booking the reserve for adverse claims experience, the Board of Directors was being pressured by shareholder Carl Icahn to oust the CEO. Since Peter Hancock and his plan to reduce costs and return capital to shareholders were the cornerstone of our investment thesis, we had no choice but to sell the shares when he announced his decision to resign. As with CAT, we can always reinstate the investment at some point in the future after we have had the chance to evaluate the business plan of the new CEO. We will do so, however, as a dispassionate observer rather than as a shareholder. Sell disciplines such as we invoked with CAT and AIG help us keep our emotions in check and avoid big losses.

In addition to the sale of CAT and AIG, we also sold **Harman International** (HAR). While we were content to hold HAR for the long-term, Samsung made a cash tender for the company. We had no choice but to tender our shares even though we were of the opinion that the price was insufficient. Despite the disappointing price of the tender we, nonetheless, made a very attractive return on our investment in the short period in which we had an investment in Harman.

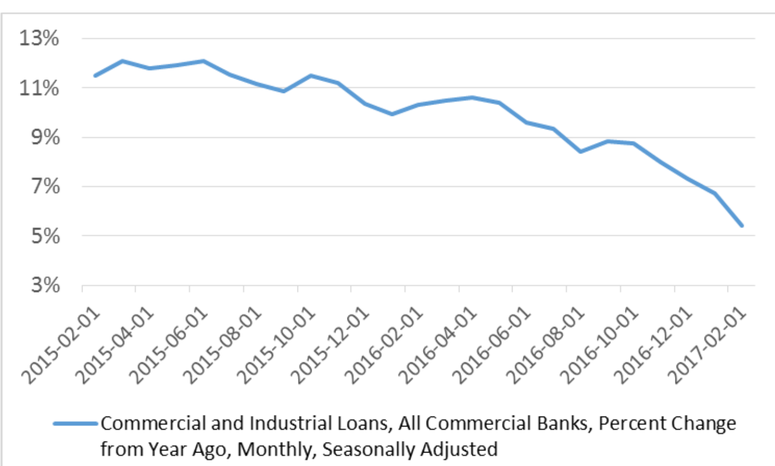
The third discipline that we exhibited in the first quarter of 2017 was valuation discipline. The proceeds from the sale of CAT, AIG and HAR, combined with other positions that we trimmed due to position size or valuation, created a bit of reinvestment challenge in the current market which, as we noted in our January commentary, seems to be in a fair value range. Nonetheless, despite the overall full valuation of U.S. equities, we believe we found one interesting investment opportunity in **NCI Industries** (NCS).

NCS is one of the primary manufacturers of mid-rise, engineered steel buildings and insulated metal panels (IMP). The industry structure for both of their market segments is very concentrated. In the steel building market, NCS has a 22% share of the market for engineered steel structures, which is close to market leader Nucor (NUC) with 27% of the market. A third participant is Australia's Bluescope (BSL AU), which has a market share similar to NCS. These three companies have a combined market share of more than 70% of the market for engineered building systems. In the IMP market, NCS and Ireland's Kingspan (KSP ID) split the market with a combined share greater than 90%. The market for mid-rise steel structures and components in the U.S. seems to be poised to accelerate as the economic recovery continues to gain traction. In addition, if President Trump is successful in stimulating the manufacturing sector of the economy, or in increasing capital investment, the demand for steel structures should trend towards a level more consistent with its historical average, which is 50% higher than the present level of construction in the low rise commercial market segment. The IMP market is being driven by environmentally motivated building codes at the state level. According to NCS, 27 states have adopted building codes that favor insulated metal panels for use in metal structures. The penetration of IMPs in the U.S. is a mere 3% compared with 15% in Europe (source: NCS management). As the remaining states adopt more energy efficient building codes for commercial structures, insulated metal panel demand should experience a substantial growth spurt.

Given the overall full valuation of U.S. equities, we have also begun to take advantage of investment opportunities outside of the U.S. During the first quarter of 2017, we initiated a position **in Venture Corporation** (VMS SP) and **Ascott Residence Trust** (ART SP), both of which are based in Singapore. Venture is a contract manufacturing company that has a cash rich balance sheet, a 4.4% dividend yield and trades at 14X earnings. After stagnating for several years, Venture's earnings growth appears poised to accelerate as the company has migrated its business away from the mature PC market to higher growth markets, such as medical devices. Ascott Residence Trust is in the business of managing fully serviced residences for short-term occupants around the globe. It trades at a discount to net asset value and offers a dividend yield of more than 7%.

Despite the relatively full valuation of U.S. equities, we are still looking for investment opportunities in the U.S. market as well. As noted in our January commentary, the U.S. economy seems to be getting a boost from "animal spirits" unleashed by the election of Donald Trump. In fact, many of the economic indicators that we follow have turned sharply higher in the wake of Mr. Trump's election. In particular, measures of consumer sentiment, business sentiment, and home builder sentiment have all become remarkably strong. In addition, the Institute of Supply Management's manufacturing and non-manufacturing indices also jumped. Moreover, our favorite harbinger of business conditions, the Conference Board's Index of Leading Economic Indicators, suggests that U.S. economic activity is poised to accelerate. If Mr. Trump can deliver on his promise to reduce corporate taxes, we believe the economy may be able to grow fast enough to produce an increase in the rate of corporate earnings growth. If this were to occur, a stock market that presently looks fairly valued could quickly appear cheap and cause a sharp, upward revaluation of equities.

Chart 1:



Source: St. Louis Federal Reserve

We are also mindful that there are risks that could cause the economy to slow, earnings growth to decelerate, and equities to decline. Chief among these risks is the possibility that Mr. Trump will fail to effect any change due to lack of consensus within the Republican Party. We are also keeping a close eye on Commercial & Industrial Loan (C&I) growth, which has surprisingly slowed in recent months (Chart #1). With all of the economic indicators turning up as previously noted, it is odd for C&I loans to be moderating. Our elevated level of cash reserves gives us a fair degree of flexibility to invest into a potentially volatile stock market as the disquieting legislative process plays-out before our eyes and on Twitter and, at the same time, protect our downside exposure in the event that Mr. Trump fails in his effort to stimulate the economy.

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