SeaBridge Investment Advisors, LLC

SeaBridge Core Strategy

First Quarter 2020

Commentary

In a span of merely two months, the stock market has nearly collapsed. The debacle occurred in two steps. The first downdraft in the stock market happened in February and was in anticipation of the challenge that the U.S. economy would confront as a result of the coronavirus. The second leg down was in March as many parts of the nation officially went into quarantine. Subsequently, the retail, travel and hospitality industries shut down almost entirely, and commerce has ground to a halt. Although we were reasonably well prepared for the market down-turn with cash reserves considerably above our normal level of reserves, the cash was simply not enough to cushion the Core Global portfolios from substantial losses. The losses are attributable to the shares of many companies that were reduced to price levels that imply some doubt about their ability to weather the economic maelstrom.

During the market melt-down, you should have received two interim commentaries regarding the SeaBridge Core Global strategy. The first was distributed at the end of February before many parts of the nation went into quarantine. The second was distributed in mid-March after the quarantine began, thus forcing the U.S. economy abruptly into recession. Looking back on March, the U.S. economy started the month from a position of strength. Unemployment was at a historically low level, worker incomes were rising at the best rate in many years, and the stock market was priced at such a high level that we were having serious difficulty investing our cash reserves at reasonable valuations. By the end of March, however, initial unemployment claims were at an unprecedentedly high level, the U.S. Government passed a rescue package that was twice the size of the package provided in 2009, the Federal Reserve spent $1 trillion in the course of one week to stabilize asset funding markets, and the stock market erased the majority of the gains achieved over the last four years. Moreover, many stocks are now at prices last seen in 2008, the beginning of the Great Recession.

In our two interim notes, our goal was to accomplish two objectives. First, we wanted to keep you informed of our specific actions as soon after the decisions were made as practicable. Second, we wanted to articulate the abstract tenets of the Core Global investment strategy so you would understand the rationale behind our decisions. In the February interim note, we identified **discipline** as an important tenet of our strategy. We define discipline as the inclination to buy stocks when they're cheap and to resist buying them when they're not cheap. We entered the recent period of market panic with elevated cash reserves precisely because we refrained from making investments when the market was stretching to new highs earlier this year and late last year. A corollary to resisting the impulse to buy when the stock market party is roaring is the discipline to invest reserves when stocks are cheap. The second tenet of our strategy is that **the only time stocks are truly cheap is in the midst of panic**.

As a result of our commitment to discipline and belief that stocks are cheap when everyone else is running for the door, we began investing reserves into the market's sharp decline. In our first interim commentary, we noted that we added to Iron Mountain (IRM), Tapestry (TPR), Newell Brands (NWL), and Citigroup (C) during the first down-leg of the market. The decision to buy these companies was based on the small size of these positions relative to other investments in the portfolio, but also because of their relatively low valuation and high dividend yield. After the nation went into quarantine, however, our criteria changed. With the airlines not flying, and restaurants, malls and public events shut-down, revenue for many companies evaporated.

Suddenly, valuations based on earnings or cash flow were moot and dividends would likely be reduced or eliminated by some companies. In phase two of the market debacle we, therefore, added more stringent criteria for future purchases. Specifically, we wanted to either see a press release regarding current business conditions and plans for managing the crisis, or investments by insiders, such as CEOs, CFOs or board members. Based on these criteria, we added to our position in Newell (NWL) and Alexander & Baldwin (ALEX), and initiated a new position in ViacomCBS (VIAC) as insiders at each of these companies bought shares. Adding these new criteria also slowed our pace of investment. Now that March has ended, we won't see many insider purchases as they must refrain from buying shares in their own company until quarterly results are reported. We also expect to see many earnings pre-announcements informing investors that previous forecasts are withdrawn and providing updates on actions each company is taking to weather the storm. It is our expectation that we will continue to invest reserves as we receive those updates.

In the last week of March, we received updates and action plans from three companies in our portfolio: Steelcase (SCS), Tapestry (TPR) and The Howard Hughes Corporation (HHC). Each action plan was different from the others.

Steelcase has a February year-end rather than December as is the case for most companies. Companies with fiscal years ending on months other than the normal calendar quarter are of great value during times of economic distress because they provide information regarding current business conditions before the majority of companies report at the end of the calendar quarter. Steelcase is the world's largest manufacturer of office furniture. The Company reported outstanding results for the quarter and year ending February 2020. In addition, SCS indicated that their order backlog was robust coming into March and that very few customers either cancelled their orders or asked for deliveries to be stretched-out. We find this surprising given the effects of the global quarantine on business conditions.

Despite having a very strong balance sheet and ample lines of credit to tide the Company over until better times, Steelcase management wisely expects business conditions to get materially worse before they get better and decided to take draconian measures to ensure the Company's survival through the economic storm. First, they eliminated cash compensation for Board members and reduced CEO compensation to $1. Second, Steelcase also cut salaries for members of the executive team by 60%. Third, salaried employees based in the U.S. had 50% reductions in their salaries. Fourth, manufacturing was slowed or halted in many of their factories. Fifth, the dividend was cut in half for the time being. Finally, Steelcase also drew-down $250 million of its credit line despite having $700 million of cash on hand, which marks the most liquid position the Company has had in the past 10 years. Clearly, Steelcase is preparing for Armageddon!

Tapestry is the parent company of luxury leather brands, Coach, Kate Spade New York and Stuart Weitzman. They are the market share leader in women's handbags and have broad distribution in the U.S. and Asia. The domestic quarantine comes closely on the heels of a similar quarantine in China, during which Tapestry's stores in China were closed. Although the Asian stores are now open for business, all of their U.S. stores are now closed. Thankfully, Tapestry has a well-developed e-commerce presence, so they are receiving some revenue from their U.S. business as well as Asia. Nonetheless, closing the U.S. stores will result in a sharp reduction in revenue. Tapestry entered the coronavirus crisis with $1.2 billion in the bank. Despite this impressive cash balance Tapestry management, nonetheless, chose to draw $700 million of their $900 million credit facility because the duration of the disruption to their business is unknown. The Tapestry Board also eliminated the dividend for the time being. Like Steelcase, Tapestry is preparing for the worst.

The Howard Hughes Corporation is in the real estate development business. Their major properties are their Master Planned Communities (MPCs) in Summerlin, Nevada; The Woodlands, Texas; Bridgeland, Texas; Ward

Village, Oahu; and two commercial real estate developments in Columbia, Maryland and the South Street Seaport, Manhattan. The MPCs, in particular, are unique in that HHC creates cities out of large tracts of land by building the infrastructure for the community, and then selling parcels of land to residential home builders. As the MPC matures, Howard Hughes then takes the proceeds from land sales to fund the development of the office buildings, neighborhood shopping centers, hotels, and other commercial properties, and holds them for their own account. By controlling all of the commercial real estate in a particular MPC, HHC has the ability to manage the supply of commercial properties, thereby controlling commercial rents. Clearly, The Howard Hughes Company will suffer a substantial loss of revenue during the current national quarantine. Although HHC went into the economic challenge with $400 million cash on the balance sheet and $1 billion available on their credit lines, they chose to raise equity capital at a very depressed share price to prepare for the unknown effects of a sustained quarantine. Under normal circumstances, we would have been very disappointed if any company raised equity capital at a depressed share price because it is very dilutive to current shareholders. In the case of HHC, however, the circumstances are significantly different than normal.

Bill Ackman is the Chairman of the Howard Hughes Board. Through his hedge fund, Pershing Square, Mr. Ackman owned 5.2% of HHC pre-crisis. Howard Hughes had 42.7 million shares outstanding pre-offering. The public bought 2 million shares through the recent share offering. This established an arm's-length price for HHC to then issue 10 million shares of Howard Hughes to Ackman's Pershing Square. Post offering, Pershing Square now owns 22% of The Howard Hughes Corporation. As previously noted, the best indicator of confidence in a company's ability to survive and thrive in a difficult economic environment is insider buying. Pershing Square's $500 million incremental investment in HHC sends a loud vote of confidence in The Howard Hughes Corporation.

The three case studies above describe how three different management teams have prepared their companies for the unknown economic environment that lies ahead. While all three approaches are dilutive to the value of the investment going into the crisis, in all three cases the initial reaction by the share price of each company was to go higher. We take this price action to mean that short-sellers are wagering that many companies will not survive the air pocket in the U.S. economy. By taking decisive action to increase the probability that each company will survive, the extinction probability got factored-out of the share price, thus resulting in an increase in price.

Although depleting cash on hand and drawing-down credit lines, as did Tapestry and Steelcase, is dilutive to equity value, increasing the number of shares outstanding at a depressed price is substantially more dilutive to shareholder value. We have written about The Howard Hughes Corporation many times over the years. In those notes, we've referred to HHC as a cornucopia of value. While we have always been able to identify enough value within the HHC property portfolio to justify our substantial investment in the shares, we have also thought that there may be substantially more opportunity in their real estate portfolio than investors can see from the outside. By increasing Pershing Square's investment in HHC from 5.2% of the shares outstanding to 22% post offering, it seems as though Chairman Bill Ackman shares our belief. In fact, we believe the substantial increase in ownership of The Howard Hughes Corporation will someday be seen to have turned HHC into Bill Ackman's version of Berkshire Hathaway. The story of Warren Buffet's Berkshire Hathaway is now, of course, legend in the annals of the investment world. Many years from now, we hope to be able to say the same about The Howard Hughes Corporation.

Everything we've discussed in this note thus far describes what we have done. The more important question, given the uncertainty of the economy post COVID-19, is what do we plan to do? This brings us to the third key tenet of our investment approach**: separate all information into that which is knowable with certainty from**

that which is not knowable. We strive to base our decisions on facts, rather than opinions, and understand the difference between the two types of information.

What are some facts?

- Iron Mountain is the leader in the business of records management. They have 225,000 customers. Their service is essential for their customers.

- Tapestry is the market share leader in women's handbags. Their business model is highly cash generative and the balance sheet is strong. They have broad distribution and a strong e-commerce capability.

- Newell Brands markets a broad range of global, consumer branded goods that includes Paper Mate, Sharpie, Elmer's, Sunbeam, Graco, First Alert, NUK, Baby Jogger and many others. Newell is the market leader in product categories that account for 79% of their sales. During the recent market panic, Carl Icahn increased his investment in Newell from 9.7% to 10.7% of the shares outstanding. Icahn's son, Brett, sits on Newell's Board. Brett Icahn also increased his investment in Newell by 111,000 shares in recent weeks.

- Citigroup is an extremely well capitalized bank with an impressive common equity Tier 1 capital ratio of 11.81. Its revenue is diversified both geographically and by product. The shares trade for ½ of book value.

- Alexander & Baldwin owns substantial real estate assets in Hawaii. The core asset is a commercial leasing portfolio comprised of 22 neighborhood shopping centers that are all anchored by food and/or drug stores. The CEO bought shares in 6 increments during the depths of the market panic. The CFO also bought shares.

- ViacomCBS is the recently-formed media giant that has a substantial library of 140,000 TV shows and 3,600 movies, and participates in all dimensions of entertainment distribution: TV broadcast, cable TV, pay TV, over-the-top TV, and phone and computer apps. ViacomCBS is currently number 1 in all key viewer demographics. Chairperson Shari Redstone controls the voting stock through her family's investment vehicle National Amusements. Despite already controlling the voting shares, Ms. Redstone increased her investment in ViacomCBS by $1 million during the market panic.

- The Howard Hughes Corporation has a unique collection of commercial real estate assets with an exceptional ability to control rents within its leasing portfolio. Chairman Bill Ackman owns 22% of the shares outstanding after having substantially increased his investment in the Company during the crisis through his investment vehicle, Pershing Square.

Those are some of the facts regarding a few of the investments in our portfolio. IRM, NWL, C, and ALEX were highlighted because we added to those existing positions during the market swoon. VIAC was included because we both initiated a new position in the shares and brought the investment up to a full position within a just one month because of the significant opportunity presented by a market that was under tremendous pressure in March. HHC is highlighted because of the enormous investment in the company by Chairman Bill Ackman's Pershing Square.

The information we have presented for each of the above companies falls into the category of things that we believe are knowable with certainty. Below, we highlight some things that we consider to be not knowable with certainty:

- How long will the quarantine last?
- How much value dilution will each company suffer as they dig-in for survival?
- What will the economic environment look like when the coronavirus moves on?
- How will consumer and corporate behavior change?
- How will Federal, state and local tax policy change?
- And, of course, the $64,000 question: When will the stock market find a bottom?

While we strive to make most of our investment decisions based on that which is knowable, these non-knowable facts are, clearly, very important. As we have noted in previous commentaries, we don't make forecasts; we can't predict the future. Nonetheless, we have to make assumptions regarding the questions noted above, as well as other key assumptions. We then test our assumptions as information develops and refine our assumptions and decisions accordingly.

As we sit here writing this note at the end of March, the two key assumptions that we have made are:

1) COVID-19 will pass through the U.S. economy in a manageable period of time.
2) The combined response of the Federal Reserve, Congress and the United States Treasury to the economic disruption caused by the quarantine was both swifter and more powerful than any public policy action we've ever seen before. We believe these public policy initiatives provide most of the support needed to sustain the U.S. economy on life support for at least two months.

After reviewing the cash reserves and credit lines of our portfolio companies, we have concluded that two months should be manageable for most of the companies in our portfolio, albeit noting that there will be some dilution of value due to taking-on additional debt or issuing shares. If this coronavirus beast were to linger beyond two months, our conclusions and actions are likely to change.

John Conti
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