SeaBridge Core Strategy

Second Quarter 2018

Commentary

The message from our April commentary was that wage growth is a latent inflationary force, which should become apparent as the peak of the baby boom generation approaches retirement age over the next five years. (See the April Core Global Commentary for the full analysis). We suggested that rising wage inflation could be offset by an increase in productivity that may occur if corporations increase the pace of capital investment on the back of incentives provided by The Tax Act of 2017. First quarter corporate earnings reports, however, revealed two other drivers of inflation, raw material and transportation costs, which are not latent forces but, rather, actual inflationary forces that are currently impeding gross profit margins, and are likely to drive consumer price increases in the coming months.

Although gross margins were broadly lower than expected in the first quarter earnings reports, most companies were able to generate earnings above expectations because revenue growth was typically better than expected. Despite strong earnings growth, businesses are likely to attempt to restore gross margins by raising prices. Typically, price increases lag input cost increases by 3 to 6 months as producers need time to sensitize their customers to the need for price increases. However, the comments from the companies we monitor was consistent: Customers were aware that raw material and transportation costs were up sharply and there was a broad consensus that price increases would stick. This is a big change in the pricing environment from the experience of the past ten years!

In its May statement on monetary policy, The Federal Open Market Committee (FOMC) noted “Inflation on a twelve month basis is expected to run near the Committee’s symmetric 2 percent objective over the medium term.” The key word in their statement is “symmetric.” This is Fed-speak acknowledging that inflation is likely to be higher than the FOMC’s target rate of 2% along with a palliative for stock and bond markets. Essentially, the FOMC is saying that inflation was below their target for a very long period of time, therefore, they will tolerate inflation above their target for a while. The FOMC has left it up to markets to guess how high and for how long they will tolerate inflation above their target by characterizing their inflation objective as “symmetrical.” For now, we will assume that the FOMC will keep monetary policy accommodative despite the near-term inflation that will likely appear as companies pass along raw material and transportation cost increases. From our perspective as investors, this line of reasoning begs the question: What sorts of investments will flourish in an environment of modestly rising inflation?

In our judgment, equities and some types of real estate can perform reasonably well in an environment characterized by modestly accelerating inflation. Conversely, longer-dated debt instruments should perform poorly as rising inflation will drive interest rates higher, thus eroding the value of bonds. Short-term debt instruments, such as 3-month Treasury Bills may preserve capital in a modestly rising inflation environment but, at present, the after tax/after inflation return on Treasury Bills is still negative.

As previously stated, the theme of first quarter corporate earnings reports was a propensity to raise prices. This sentiment stands in sharp contrast to the 8-year post-recession environment during which many corporations generated earnings growth through managing expenses, mergers and repurchasing shares. Price increases, along with the improvement in demand resulting from an accelerating economy, should drive better top line growth for most corporations than they have been able to generate since the powerful deflationary force of the great Recession of 2008/09.

Within the broad equity asset class, some corporations will have a better ability to maintain profitability than others. Industrial enterprises, for example, tend to have a lot of operating leverage based on both unit growth and price increases that come from an accelerating economic environment with moderately rising inflation, which we believe best characterizes the current environment. Our Core Global portfolios are well populated with industrial investments, such as **Pentair (PNR), ITT (ITT), Hubbell (HUBB), nVent (NVT), Simpson Manufacturing (SSD), RPM International (RPM), SPX Corp (SPXC), and Deere (DE)**. We believe all of these companies have a better than average ability to maintain or improve operating margins in a modestly rising inflation environment, albeit with a lag as raw material cost increases initially squeeze gross margins as we witnessed in Q1 2018 earnings reports. The margin squeeze then serves as the means for negotiating price increases with customers.

In some cases, commodities and companies that produce commodities may also provide some inflation protection in a modestly rising inflation environment. In general, however, we do not believe commodities are a good inflation hedge. Over a very short period of time, commodities such as oil, copper, gold and most crops can experience sharp increases in price, such as has been the case for many commodities recently. Although these price increases are coincident with an increase in inflation, high prices induce a supply response that, ultimately, puts downward pressure on prices. Some commodities, however, have attributes that limit the supply response to increased prices. Two that have had a presence in our Core Global portfolios for quite some time are road salt and timber. We also have a newer investment in a company that produces fly ash, which we believe may also have some of the qualities that limit the supply response to rising prices.

Road salt is a unique commodity in many ways. First, demand for road salt is completely economically insensitive. Even during the Great Recession of 2008/09, amidst an environment of tremendous cost cutting, municipalities had to pay the going rate for salt to keep their roads safe. The price for road salt moves up and down from year to year in response to changing winter weather conditions but, in the long run, the price of road salt is a function of growth in the amount of roads which, in turn, is a function of population growth. Another favorable quality of road salt is its resistance to competition. Salt is a bulk commodity that sells for a price that is low relative to its volume. This means that the cost to transport salt by truck or rail is a large component of its selling price. Therefore, producers that control salt deposits near their service territory and are located away from the coasts have a land-mote around their business. **Compass Minerals (CMP)** is the only public company that fits that description. CMP controls the world’s largest salt mine, which is near the Great Lakes in Ontario, Canada. Given the mine’s location, it is well positioned to ship economically by water to the high-volume markets in Southern Canada and the upper Mid-West of the United States.

Compass Minerals has made great strides in recent years to balance its business mix and alleviate the volatility in earnings that comes from its weather-dependent salt business. At present, nearly half of CMPs earnings come from specialty fertilizers, such as sulfate of potash (SOP) and micro nutrients. Compass minerals is the only U.S. producer of SOP and holds most of the market share for this specialty fertilizer, which has unique benefits for high value specialty crops such as fruits and nuts. In a moderately rising inflationary environment, we believe the entire product line at Compass Minerals has above average pricing power.

Fly ash is another commodity that we believe is likely to offer above average pricing power. Fly ash is the particulate matter that tries to escape from the smoke stacks of power plants that burn coal. Of course, the fly ash is captured by scrubbers before it pollutes the atmosphere. Historically, fly ash was dumped in land-fills as solid waste. Increasingly, however, fly ash is being recycled as an ad mixture in concrete. The benefits of using fly ash in concrete are many. Since fly ash is typically 30% cheaper than Portland cement, substituting some fly ash for cement reduces the cost of concrete. In addition, fly ash is less permeable than Portland cement. Therefore, concrete that uses some portion of fly ash is more weather resistant and more durable. Moreover, the environmental benefits of recycling fly ash are compelling.

In 2017, an Australian company called **Boral Limited (BLD-AU)** purchased a U.S. company called Headwaters. The combination created a company that controls more than 50% of the U.S. fly ash market. The business model incorporates an exclusive network that gathers fly ash from coal fired electric utility plants, and also recovers fly ash from land fills that were created in the past when fly ash had less of a market in concrete. Overall, given the price differential between fly ash and Portland cement, combined with Boral's gathering network and commanding market share, Boral should enjoy an above average ability to raise prices in a rising inflation environment.

In addition to the U.S. fly ash business, Boral is also benefiting from a favorable demand environment for their other products in the U.S., which include metal and ceramic roofing materials, cultured stone for finish work on the inside and outside of structures, as well as landscaping. Boral also owns 50% of a recently formed joint a venture in a brick company that holds a 30% share of the U.S. brick market and hopes to improve pricing by rationalizing capacity in a market that has experienced low prices due to excess capacity. In Australia, Boral produces cement, aggregates, concrete and asphalt. The market for these building materials is likely to be strong for several years based on a large backlog of infrastructure projects that have already begun or will get underway in the coming years. Given the substantial backlog, the Australian business should also have above average pricing power for several years. Longer-term, the sweetener in the Boral story is their 50/50 joint venture with U.S .Gypsum. USG Boral produces wall board in Asia. Although wall board is not yet as prevalent in Asia as it is in the U.S., USG Boral has a very large share of the market, which appears to offer above average growth potential as the economics of using wall board in construction become more apparent to developers in Asia.

Along with road salt and fly ash, we believe timber is another commodity that offers an above average ability to maintain its value in a moderately rising inflation environment. Just as road salt demand grows over time as a function of road growth driven by population growth, timber demand grows as a function of housing demand, which is driven by population growth. Moreover, just as salt has a natural barrier to entry in its price relative to shipping cost, timber has a quality that is somewhat unique: during periods of slack demand, such as would occur in a housing recession, timber harvesting declines, but the standing trees continue to grow. Depending on the local climate, growth in the girth of a tree will vary. In the U.S. as a whole, we believe trees grow at a rate of about 2% to 3% per year. In the South, the growth rate is closer to 7% per year. As a tree grows large enough to be used as a pole or dimensional lumber, the value of the tree has the potential to increase at a faster rate than the underlying rate of growth in the tree volume. Just as it is not possible to produce 25 year-old whiskey in fewer than 25 years, a tree that will be used to create dimensional lumber or a pole needs 25 years to mature. Consequently, although timber prices vary with the business cycle, over time, timber has great pricing power.

With 12.4 million acres of land, **Weyerhaeuser (WY)** is the largest owner of timber land in the U.S. other than the Federal Government. Weyerhaeuser's earnings are approximately evenly split between the sale of timber and wood products, such as lumber and engineered wood products. Earnings growth in recent years has come from the wood products side of the business as single-family housing starts have grown at a slow, but persistent, rate since the last recession. Although unit growth in lumber has been slow owing to the moderate pace of recovery in housing, prices have been strong as saw mill capacity was greatly reduced in the 2008/09 recession and it has yet to be restored to the pre-recession level. Moreover, lumber lead the way in our trade dispute with Canada and, as a consequence, lumber prices have doubled over the past two years. The timber side of the business has experienced relatively flat pricing since the recession due to the slow recovery in single family housing and abnormally low inflation. As inflation accelerates, we expect the price of timber to increase to reflect the growth in the girth of tree stands during the lengthy period of reduced timber harvesting since the recession.

Real estate is yet another asset class that has demonstrated exceptional pricing power in a moderately rising inflationary environment. Within the broad asset class, however, different sub-categories of real estate will behave quite differently. Commercial real estate, for example, trades as a function of differential interest rate capitalization (cap rates). In recent years, commercial real estate transactions frequently occurred at a cap rate around 4%. In some exceptional markets, transactions at 3.0% to 3.5% were common. In weaker markets, the cap rates were much higher. Given the increase in Treasury rates experienced since the FOMC has begun to reverse the extraordinarily easy monetary policy in place since the Great Recession, commercial real estate cap rates should rise proportionally. As a consequence, commercial real estate properties now trade at slightly lower valuations than they would have only one year ago. After a knee-jerk valuation adjustment, however, commercial real estate assets should grow in value based on their ability to raise rents. This, of course, is a function of the location and quality of the property, the lease structure, and the ability of the property manager to develop or re-develop the asset.

Our Core Global portfolios hold three pure play investments in real estate: **The Howard Hughes Corporation (HHC), Alexander & Baldwin (ALEX), and Senior Housing REIT (SNH)**. Indeed, as interest rates have increased over the past year, all of these investments have languished as commercial properties have been marked down in the manner previously described. Over time, however, we believe the assets owned by these three companies offer tremendous value and a well above average ability to keep pace with inflation.

Senior Housing REIT derives roughly 60% of its cash flow from assisted or independent living properties for elderly residents, and 40% from medical office buildings (MOB). In anticipation of the baby boom generation reaching retirement age, a lot of senior housing properties have been developed in recent years. SNH believes that roughly 1/3 of its properties have experienced pricing pressure from new development. With prices now soft in many regions, development has slowed and we appear to be at the beginning of an extended period in which demand will grow more rapidly than supply and lead to rental income growth. Moreover, a lot of the development has been done by small independent owners who are struggling to reach critical mass in the temporarily glutted markets. This represents a great opportunity for SNH as it is well capitalized and, therefore, well positioned to acquire properties at distressed prices. In fact, in just the past six months, SNH has sold some of its properties at cap rates of 4% to 4.5% and reinvested the proceeds in properties yielding 8% to 8.5%.

On the MOB side of the business, SNH has a large office property in Boston Harbor that has a long-term lease that had been at a fixed rate for the first five years but is now poised to garner a 10% rent increase that goes into effect in 2019. As noted earlier, although commercial properties initially experience a decline in value as interest rates rise, rent increases that accrue to well located property act as an inflation hedge over time.

The Howard Hughes Corporation is a cornucopia of value. It was spun-out of General Growth properties (GGP) in 2010 and represented all of the land and properties in need of redevelopment that were not being properly valued by the market when buried within GGP. Initially, most of the value was in the land held in the master planned communities (MPC) under development by HHC. The two biggest MPCs are Summerlin, Nevada and The Woodlands, Texas. The business model for these MPCs started with a very large tract of land within which future cities would be built. HHC defines the community, procures the permits, develops the roads and utility infrastructure, and then sells tracts of land to builders who construct single family homes. Over time, as the community develops, land sales to builders rise in price to reflect the increasing attractiveness of the community. More importantly, once population density reaches a critical mass, HHC begins development of the choice land for retail, office and multi-family income producing assets which are retained by Howard Hughes. By developing the commercial property in this manner, HHC retains control of the supply, which ensures that the commercial properties are not over-developed. This is the essence of HHCs ability to maintain pricing power to keep pace with inflation over time. In addition, as the commercial property improves the appeal of the community, the remaining land earmarked for residential development rises in value also providing an inflation hedge.

At present, the land available for sale in Summerlin, Nevada plus The Woodlands and Bridgeland in Texas, combined with the value of the income producing properties which are mostly located in Summerlin and The Woodlands, account for most of the value of HHC's shares price. This means that future commercial development in their MPCs as well as re-development projects outside of the MPCs can be considered as upside potential. The two most significant re-development projects that are currently well under way are Ward Village in Hawaii and The South Street Seaport in Manhattan. The ultimate value for these projects will depend on execution and market acceptance. We believe both assets have the potential to be extremely valuable and should drive share price appreciation for years to come. A unique incentive structure for the CEO supports our expectations for these projects.

David Weinreb joined HHC as CEO in 2010. At the time, he purchased warrants for $17 million that gave him the right to buy 2,367,985 shares at a price of $42.23, which was the price of the shares at the time the warrants were purchased. When the warrants expired in 2017, Mr. Weinreb exercised the warrants, paid the tax on his substantial gain and was granted the right to purchase warrants to buy 1,965, 409 shares at $117.01 until June of 2022. Weinreb paid $50 million for the new warrants. The key point in this incentive system is that the CEO purchased the warrants, they were not given to him. If the price of HHC does not rise in value, Mr. Weinreb stands to lose his entire investment. Perhaps other companies have instituted incentive structures similar to this, but we are not aware of any such cases. We also believe Weinreb's desire to take such a personal financial risk suggests that the ultimate value of The South Street Seaport and Ward Village has the potential to be substantial.

Alexander & Baldwin is a baby HHC. It is comprised of both income producing commercial properties as well as raw land held for development. ALEX also has a quarry and paving business, but the value of that business is small in comparison with the real estate assets. All of ALEX's real estate is located in Hawaii. Hawaii has many attributes that have made it an above average real estate market for many years and we expect Hawaiian real estate to have a well above average ability to maintain its value in a moderately inflationary environment. As an example, commercial real estate leases that have expired in 2017 have been rolled into new leases at rates that are 10% higher than expiring leases, thus providing inflation protection.

The income producing properties owned by ALEX combined with the quarry and asphalt business explain most of the current equity value of the shares. Their vast land holdings represent upside potential.

Recently, the CEO of Alexander & Baldwin indicated that they are exploring several development partnerships that should enable the Company to move faster in the development of their land holdings and, hopefully, close the gap between the current value of the shares and their intrinsic value.

Despite the recent under performance of our real estate investments that is likely the result of an increase in interest rates, we are content to hold these investments until their value is realized. With respect to all three companies, we believe that the management teams are taking the right actions to unlock the hidden value over time. Moreover, the quality of the assets and dynamics of their markets give us confidence that the intrinsic value of these companies will keep pace with inflation as the U.S. economy enters a normal phase for the first time since the recovery began in 2010.

Throughout this note, we have characterized the economic environment as one of moderately rising inflation. We have argued that road salt, timber, fly ash and well-located real estate offer some pricing power in the presence of inflation. Many readers are likely now wondering why we have not included gold and oil as inflation hedges. Ironically, the answer is because they are not inflation hedges. In a regression between the Personal Consumption Expenditures Deflator (PCE) and gold, we calculate an R^2 of 0.68. This means that inflation explains only 68% of the price variability in gold. Oil has an R^2 of 0.60, or 60% explained by inflation. Essentially, both oil and gold have a low correlation to inflation. Road salt, on the other hand, has an R^2 of 0.90, which we see as a fairly high correlation. Timber leads the pack with an R^2 of 0.96 and is the most highly correlated asset to inflation that we can find.

The correlation between fly ash and inflation cannot be calculated because, historically, fly ash has been mostly dumped in land-fills. In the future, however, we believe fly ash has the attributes of a commodity that has the potential to keep pace with inflation for the reasons previously cited. Similarly, real estate is all about location. Therefore, it is not practical to produce a single figure for the correlation between inflation and real estate. As with fly ash, however, we believe the real estate assets represented in our Core Global portfolios have the attributes that can keep pace with inflation.

Inflation throughout this note has been characterized as rising at a moderate pace. Of course, if inflation were to rise too rapidly and the FOMC were to unleash the sledge hammer to keep inflation under control, all assets are likely to decline in value. The only safe harbor for investors in such an environment would be short-term, U.S. Treasury securities.

6/12/18
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