SeaBridge Investment Advisors, LLC

SeaBridge Core Strategy

Second Quarter 2020

Commentary

The stock market was a bit of a roller coaster during the second quarter of 2020. After finding a bottom in late March, stock prices rebounded slowly until late May and then recovered sharply as the end of the COVID-19 quarantine seemed to be in sight. Let's remember, we know the stock market is a discounting mechanism; it adjusts current prices based on some understanding of the future. Unfortunately, the market frequently jumps the gun one or more times before it, ultimately, tells us what the future may hold. In the first week of June, the market seemed to have declared an end to the economic impact of the virus as the broad market indices temporarily recouped 2020's losses. We wish the story ended there but, unfortunately, the COVID beast reared its ugly head in states that had missed the initial onslaught in March. As we write this note in late June, the COVID case count is surging back to the peak level and, for now, stocks seem to be stabilizing at a level below where they started the year. Investors are left to ponder whether the maximum economic impact from the virus is behind us or if more pain lies ahead. Our inclination is to proceed as though the economic trough will have been the second quarter and the economy is now rebounding, but not likely in a straight line.

Before economic activity came to an abrupt halt in the middle of March, the U.S. economy was strong and chugging along at full employment. After blending-in the economic contraction that occurred in the last two weeks of March, first quarter GDP contracted by 5% on an annualized basis from the annual rate of growth in the 4th quarter of 2019. This led us to conclude that the economy might contract by as much as 40% in the second quarter if the quarantine were to remain in effect for the entire quarter. Thankfully, the economic picture now looks a bit better, although still horrible. Based on comments from companies in our portfolio, as well as economic data from May, it appears as though the economy began to rebound from the March low, with growth likely accelerating into June. A GDP contraction of 25% to 30% now seems more likely for the second quarter. If the COVID resurgence in some of the more populated states, such as California, Texas and Florida, does not cause those states to go back into full quarantine, the U.S. economy has a chance of returning to growth in the third quarter. Although the jury is still out, we remain hopeful that the economy can return to growth in 2020.

To be clear, while we are hopeful, we are not oblivious to the damage that the virus has caused. It will be several years at best before the U.S. economy recovers to a level that could support the low rate of unemployment that we experienced before COVID gave us a severe blow to the gut. Recessions have a tendency to accelerate trends in society that are already under way. The major trend that almost certainly accelerated in the past few months is the digitization of business processes. Working from remote locations and shopping on-line are two major trends that likely got a permanent boost from our quarantine experience, but there are others, to be sure. While changes such as these yield greater productivity, they also displace workers. In the wake of COVID, it may be quite a challenge to get the unemployment rate back down to a socially acceptable level for a generation, if not longer. We can also imagine many other disruptions to the economic and social order that may result from the sudden collapse of the U.S. economy.

Despite the immense changes that have occurred in recent months, the U.S. economy seems to be showing some very encouraging signs that growth is, once again, at hand. In particular, retail sales have rebounded sharply off of a very depressed level and housing activity seems to be hot, hot, hot! A rebound in retail sales and housing are the two classic signs that a recession is over and a new growth phase has begun. While these indicators bode well for future corporate earnings, second quarter earnings will likely be horrendous. In evaluating our investment options, we will look through the trough in earnings and focus, instead, on management comments about current business trends. We will also evaluate the balance sheet and cash flow implications of the trough in earnings and focus on companies that we think can make it through the COVID induced business disruption with as little dilution of value as possible. Of course, valuation is always paramount in our investment decision process.

These are the same criteria that we discussed in our first quarter commentary. Based on these criteria, we made many adjustments to our Core Global portfolios in the past three months. Thankfully, the management teams of many of our portfolio companies were very communicative throughout the economic maelstrom. Some provided press releases with updates regarding current business conditions and others presented at virtual conferences. Based on these business updates, we added to several of the existing positions in our portfolios. Specifically, we added to the following investments: **nVent (NVT), Newell Brands (NWL), Alexander & Baldwin (ALEX), American International Group (AIG), CF Industries (CF), Iron Mountain, (IRM), ITT, Inc (ITT), Hanesbrands (HBI), Citigroup (C)), and Steelcase (SCS)**. We also added one new position in **Sysco (SYY).** In the interest of brevity, we won't discuss the specific details behind all of these purchases. Rather, we'll highlight Steelcase and Sysco.

Steelcase is the world's largest manufacturer of office furniture. Right about now you are likely wondering why we are adding to our investment in office furniture while everyone is working from home. Good question. Our answer is that while the pandemic has made it more likely that many people will spend more time working from home, business surveys suggest the office will still play a major role in the corporate workday. Before workers return to their offices, their employers will have to make a sincere effort to reduce office density in order to avoid liability for COVID. Reducing office density would reverse a major trend to densify the office that has been in place ever since the millennial generation entered the workforce. According to Steelcase management, they have now been working with many of their customers to outfit the new office floorplan that will be necessary to practice safe social distancing. Based on Steelcase's order backlog, the near-term future seems bright.

Sysco is the largest food distributor in the U.S. In fact, SYY is larger than the next two competitors combined. Beyond the top three market participants, the food service industry is extremely fragmented. With many restaurants and office cafeterias closed or operating in a restricted manner, it is likely that smaller food service distributors will go out of business leaving SYY to gain market share. Beyond the opportunity to replace bankrupt competitors, Sysco is also going on the offensive with many new services designed to help their restaurant clients survive in this strange new COVID world. Some of the services they have provided to help their customers through a period of maximum stress are as follows: helping restaurants apply for government loans; working with restaurants to improve web sites to facilitate e-commerce; consulting on streamlining menus to make the kitchen more efficient; and, providing cleaning supplies and personal protection gear, just to name a few. These added services have enabled Sysco to gain mindshare and market share as competitors struggle to survive.

Despite the many investments that we made in the second quarter our cash reserves remain very high as we were also active on the sell side of the ledger. We trimmed **Simpson Manufacturing (SSD)** because the valuation is getting a bit stretched. We also eliminated our position in **AJ Gallagher (AJG)** due to valuation. In taxable portfolios, we cut our investment in **Harley-Davidson (HOG)** in half to book a loss for tax purposes. In the coming months, we will look for more opportunities to reduce the tax burden for our taxable portfolios.

For reasons other than valuation, we also eliminated three positions from the portfolios: Diversified Healthcare Trust (DHC), Cornerstone Building Brands (CNR) and Corelogic (CLGX). **Diversified Healthcare Trust** was formerly known as Senior Housing Trust. They are a real estate investment trust that owns medical office properties and senior living facilities. We had held these shares because we believe their real estate is worth substantially more than the current share price. We sold the shares, nonetheless, because DHC's senior housing business has the potential to become substantially impaired if the virus were to linger for an extended period of time.

Cornerstone Building Brands has an interesting strategy of rolling-up manufacturers of building products, such as metal and tile roofing, siding and windows, just to name a few. The building products industry is extremely fragmented, which gives CNR enormous potential to grow by acquisition over time. Nonetheless, we sold the shares because their strategy has resulted in a debt burden that would be difficult to manage if the economy does not continue to recover. Overall, our transactions during the past quarter were intended to reduce the risk in our portfolios if the COVID calamity were to continue while maintaining upside potential if the virus were to dissipate, or if we were to develop effective treatments or vaccines.

Corelogic is in the business of providing data to banks and insurance companies that enables them to underwrite mortgages and property insurance. Given the extremely low mortgage rates that are the result of the Federal Reserve's unprecedented flood of liquidity, Corelogic has benefited from an unusual volume of mortgages being re-financed. We sold the stock because we thought the current level of earnings may be unsustainable after all of the outstanding mortgages are refinanced. Unfortunately, within two months of selling CLGX, the company became the target of a take-over bid, which sent the share price substantially higher. This makes us wonder if we are, perhaps, being a bit too conservative, and need to get more aggressive in putting our cash reserves to work. More likely, however, we believe the extremely low interest rate environment is fostering pockets of speculation in the securities markets. We'll monitor the case curve of the virus over the next few months within the context of business updates that will be provided in the upcoming quarterly earnings calls and recalibrate our thought process accordingly.

John Conti
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