SeaBridge Core Global Strategy

November 2014 Commentary

The lackluster economic recovery following the Great Recession could have been partly attributable to the slow return of investment in commercial structures. Generally, the commercial construction sector has highly pronounced business cycles because businesses tend to delay major investment decisions as confidence wanes, and only commence investment when the outlook for demand improves. In our prior commentaries, we have noted that the residential construction sector turned up in 2012 and contributed 0.3 percentage points to GDP each year in 2012 and 2013. Total private and public non-residential structure investment also added 0.2 percentage points to GDP in 2012 with the private sector adding 0.3 percentage points and the public sector subtracting 0.1 percentage points. However, the initial rebound in non-residential construction did not sustain into 2013 when private sector growth flattened, thus resulting in a net 0.1 percentage point subtraction to GDP. As the residential sector continues to move forward at a slowly accelerating pace, the long-awaited non-residential construction recovery may now be on the horizon. Chart 1 depicts year-over-year real growth of structure investment from 1971 to 2013. (Chart 1.1 shows private, non-residential investment in structures and the chart 1.2 shows public, non-residential investment in structures). Although the charts are very busy, careful inspection should reveal that, post each recession, the residential sector typically leads the recovery of the non-residential sector by 2 to 3 years. Hence, the non-residential sector may be poised to catch-up with the improvement we've experienced in the residential sector.

Chart 1.1:

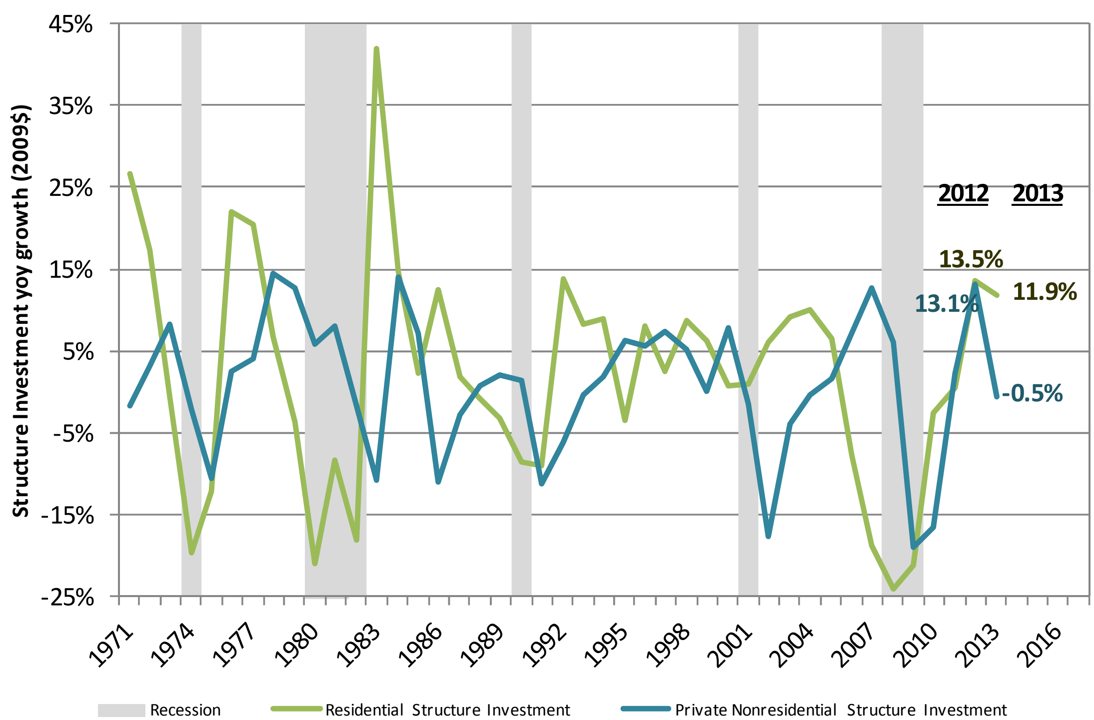
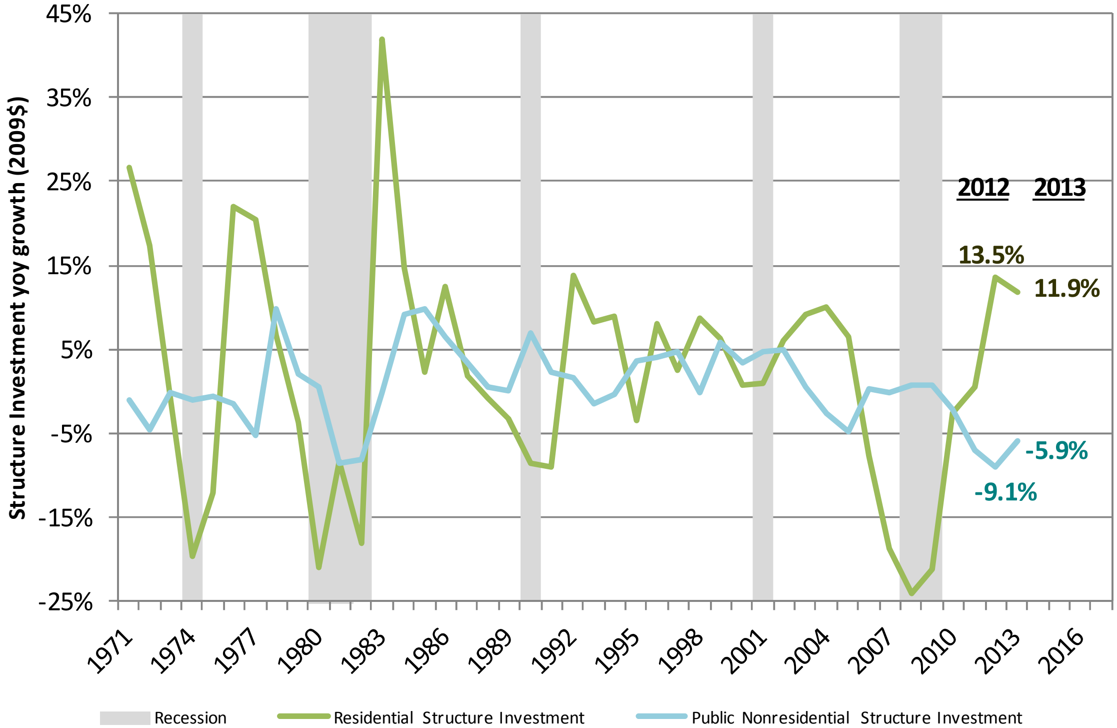


Chart 1.2:



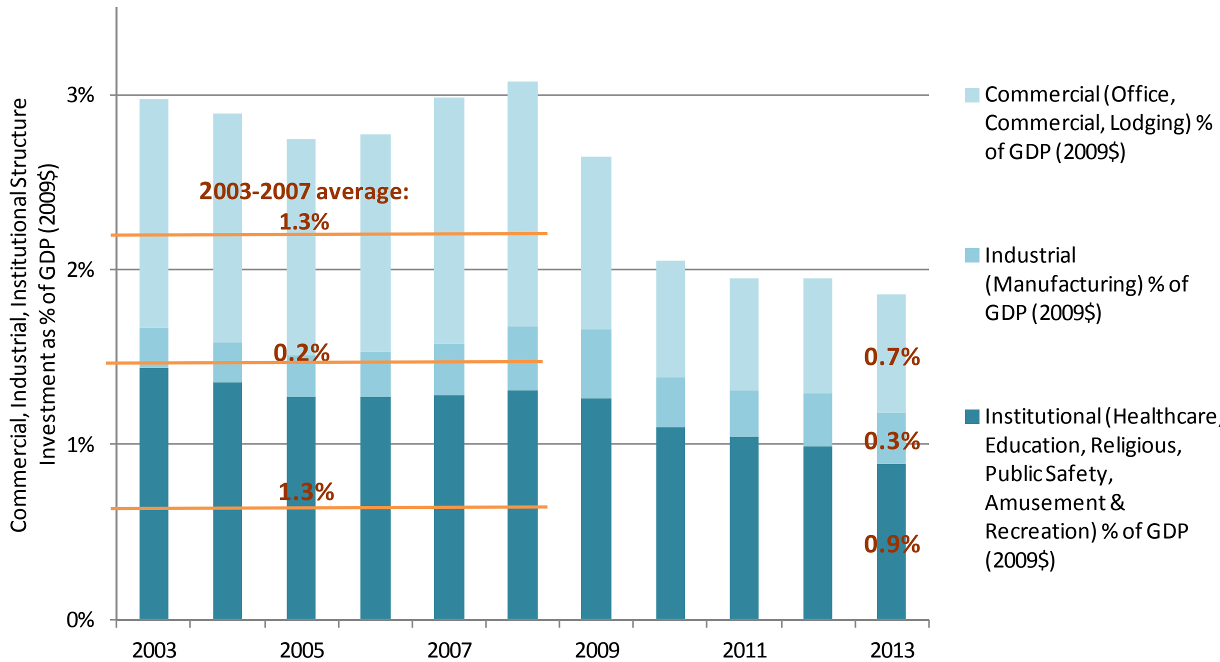
Source: Bureau of Economic Analysis

Unlike residential investment, which could be well explained by housing starts, non-residential structure investment cannot be tracked by a single metric due to its diverse nature. Non-residential structure investment spans multiple sub-segments including commercial, industrial, institutional, mining, power, and infrastructure. Mining, power, and infrastructure represent 19%, 12%, and 24% of total non-residential structure investment, respectively. The focus of this commentary is on the remaining 45% of the non-residential sector which includes commercial, industrial, and institutional construction where signs of growth are beginning to emerge. However, given their large shares of total non-residential investment, the roles of mining, power, and infrastructure should not be diminished. To briefly summarize their contribution, we have seen mining and power gain significant share of total non-residential investment in structures from 2003 to 2013 increasing +8% and +4%, respectively. These increases were primarily due to the shale-driven energy boom while other non-residential segments faltered because of the recession. On balance, as a percentage of real GDP, increases in mining and power were offset by declines in highways and streets, communication, and transportation, resulting in a 0.2 percentage point decrease to 2.3% from 2.5%. Continued shale development as well as a recovery in municipal government spending should support growth in this component of the non-residential sector.

Turning to the commercial, industrial, and institutional segments of non-residential construction, private investment represents about 65% of segment total. The commercial structure sub-segment includes offices, shopping centers, food and beverage establishments, warehouses, and other structures used for commercial purposes. The industrial sub-segment consists primarily of private manufacturing. The institutional sub-segment includes healthcare, education, religious, public safety, amusement & recreation. The public sector contributed more than 50% in this segment. Chart 2 depicts the 10-year trend of commercial, industrial, and institutional structure investment as a percent of real GDP. Compared with the

2003-2007 (pre-recession) average, commercial and institutional structure investment as a percentage of GDP in 2013 were lower by 0.6% and 0.4%, respectively. A recovery of commercial and institutional structure investment to the pre-recession average could potentially add 1.0% to GDP, or 0.2%-0.3% per year if spread over 3 to 4 years. Although the direct contribution of construction appears modest, research from the Commercial Real Estate Development Association (NAIOP) suggests that each $1 of direct construction spending generates an additional $2 of value to the economy. This output multiplier reflects the cumulative effects of the initial construction expenditures as they are re-spent throughout the economy (http://www.naiop.org/en/Research/Our-Research/Reports/Economic-Impacts-of-Commercial-Real-Estate.aspx)

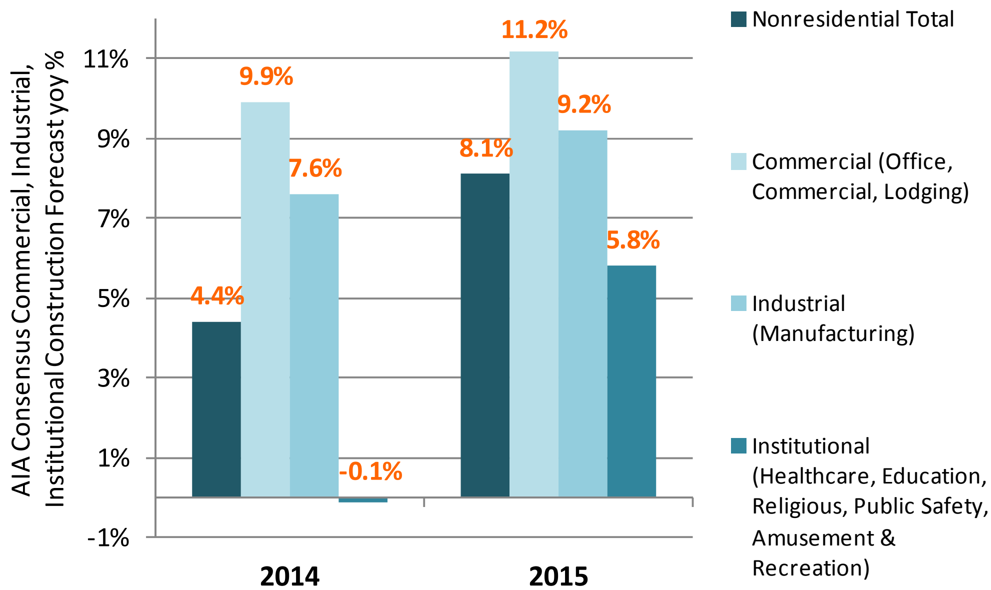
Chart 2:



Source: Bureau of Economic Analysis

Though imperfect, the Architecture Billing Index (ABI) from the American Institute of Architects (AIA) is perhaps the closest leading indicator of national trends in commercial, industrial, and institutional building construction activity. Like the Institute for Supply Management (ISM), the ABI is a diffusion index based on surveys of U.S. architecture firms where readings above 50 generally are indicative of growth. Research from the AIA suggests that that the ABI leads U.S. Census reported construction spending (which directly feeds into GDP) by 11 months with a correlation of 0.85 since index inception in 1996 to 2013. The ABI started to enter the expansion territory in late 2012, but fell to below 50 during November 2013 to April 2014 primarily attributable to the severe winter. From May 2014 to September 2014, the index averaged 54.0. Should the trend continue, we could begin to see solid gains in construction spending in the near future.

Chart 3:



Source: The American Institute of Architects

Further, construction industry participants seem relatively optimistic for 2015 growth. AIA's compiled consensus forecast indicates growth of 4.4% for 2014 and accelerating to 8.1% for 2015 (see Chart 3). Growth is projected to accelerate for all three segments, commercial, industrial, and institutional with institutional gaining the most. We estimate that this potential growth acceleration to 8.1% from 4.4% could add 0.2 percentage points to GDP. As explained above, the total effect of direct and indirect construction spending could mount to 0.6 percentage points through the multiplier effect. In summary, strong growth reported by architecture firms, the early-cycle players, should feed through related sectors such as building material producers, engineering companies, and installation firms and more broadly in the economy as wages are spent.

We are encouraged by emerging signs of confirmation at the company level that the non-residential construction cycle has begun in earnest. United Technologies (UTX), a recent addition to portfolios, is a leading product and service provider to the building systems and aerospace industries. The company's Building and Industrial Systems represent about half of its overall business and is comprised of two major segments: Otis elevators and escalators, and UTC Climate, Controls and Security. In a recent conference, management commented, "Otis North America last year grew 24% on the order rate, year-to-date we're up over 50% in orders in North America. So the recovery in commercial construction is indeed happening. We're seeing it at the Otis business, not surprisingly it's at the frontend of the recovery cycle as the elevators are typically the first ones spec-ed." During the third quarter earnings conference, the company reported further acceleration of Otis North America orders to 60% from 44% in the second quarter.

Another portfolio holding, RPM International, Inc (RPM) which is a specialty chemical products manufacturer serving the consumer and industrial end markets commented in their earnings release "We continue to see improvement in the U.S. commercial construction market, which is reflected in solid sales growth in concrete admixtures, commercial sealants and industrial and commercial polymer flooring". Further, at a recent conference management supported its positive outlook through the following statement "In the U.S., there is – signs of optimism… the Portland Cement Association has indicated this summer shipments in the U.S. were up 8% which is way above any numbers that I've seen from them for the last few years, and it was across a number of sectors very broad-based, across retail construction, office construction, manufacturing. So I think it's real, and the architectural billings index was up double digits as well this summer. So I think there is some good signs in the U.S."

Lastly, another portfolio holding company, Airgas Inc. (ARG) which is a leading industrial gas distributor 98% leveraged to the US economy reported in their recent earnings call "that the non-residential construction recovery that we've been waiting patiently for is beginning to take hold." We believe this anecdotal evidence supports our thesis of a meaningful recovery in non-residential construction as we head into 2015 which should positively contribute to GDP growth and an overall more robust economic recovery.

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