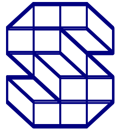


Steinberg Asset Management, LLC

First Quarter 2017 Commentary and Outlook

Markets Sustain Advance as Investors Weigh Potential for Stimulus

Major stock market indices delivered solid gains in the period, marking a sixth straight quarter of advance. Virtually all of the upward movement came in the first two months of the year. Stocks were largely unchanged in March as the "Trump Trade" (shorthand for the price appreciation in equities viewed as beneficiaries of the Trump agenda) waned after the administration's initial efforts to restructure the national health care law failed on launch. This contributed to investors' growing concerns that the rest of the administration's pro-growth agenda could similarly derail.

The market's ability to hold on to its gains in spite of growing uncertainties about the administration's pro-growth agenda suggests investor belief that the pillars of tax relief, regulatory reform and infrastructure spending will eventually be put in place and lead to an acceleration of economic growth. At the same time the investment climate has been bolstered by continued improvement in global growth along with the revival of domestic earnings.

Pro-Growth Policies May Contribute to Overheating of the Economy

If the Trump Administration is successful in implementing major fiscal stimulus (lower corporate and individual tax rates coupled with a major multi-year infrastructure program) then the biggest challenge might be preventing the economy from overheating.

The U.S. economy already is operating at close to full capacity and it would not take much to create a classic late-cycle build up of inflationary pressures. That would set the scene for enough Fed tightening in 2018 to give high odds of a recession in 2019. Any delays in the implementation of the administration's fiscal program would be helpful in stretching this timeline and thus reducing the potential for overheating. Programs which grow the work force, from legal immigration to technical training, would also be helpful in reducing inflationary pressures and enabling a higher rate of economic growth.

Non Traditional Monetary Policies Could Help Mitigate Inflationary Pressure

Growing uncertainties surrounding the scope and timing of the administration's fiscal program may weigh on economic growth in the near term. However, should the principal elements of tax reform and infrastructure spending be approved by congress a continued rise in the Fed's target for the fed-funds rate, which was recently lifted, would likely follow. This policy would likely exacerbate the frailties of the financial system, reflected in record consumer borrowing from auto loans to credit cards, possibly limiting how far the central bank can raise rates without creating undesirable financial and economic consequences both at home and abroad. Therefore, over the next few years, should inflation heat up and the interest rate on the 10 year government bond rise above 4%, the Fed may be forced to consider non-interest rate tools to meet its objectives.

A shift away from quantitative tools to more subjective measures such as requiring greater scrutiny and restraint on lending practices could be used so that interest rates needn't rise to levels that could cause financial accidents. If this shift in monetary policy were to develop, the risk of a serious financial accident to a highly-leveraged domestic and interconnected global system may be reduced but the consequences for inflation, the availability of capital for various sectors of the economy and the political fallout would inject new uncertainties into the decision-making process of business and investors.

Political and Geopolitical Risks Remain

While the fate of Trump's pro-growth agenda has received most of the attention, it is not the only risk keeping investors up at night. Others include: slowing commercial and industrial U.S. credit growth; the rising trend of interest rates; the path of the dollar; the potential for a slowdown in China once the new five-year leadership team is in place this October; upcoming elections in Europe that may influence the future of the European Union; and geopolitical events from North Korea to China, Russia and the Middle East that continue to simmer and could come to a boil with any unexpected event. All of this is occurring at a time when stocks and bonds are not cheap by standard measures of valuation. On the other side of the coin, domestic and global economic growth continue to move forward, corporate profits are rising and fiscal policy may translate into more robust growth and an acceleration of earnings gains.

In the near term the market is likely to be particularly sensitive to both political and geopolitical developments. Events that create downdrafts should present excellent opportunities to add to existing holdings and to initiate new positions in several businesses we deem as having exceptional long-term risk reward profiles. While equities are not statistically cheap we believe there is substantial value embedded in your portfolio, and that this will continue to become evident with the passage of time.

Portfolio Update

Because the macro environment is replete with uncertainty we look for investment opportunities where your capital can grow under virtually any reasonable scenario and where, if the worst does transpire, your capital is well protected. While investors can be certain of very little, we do have near perfect visibility into the aging of America. Between 2015 and 2020 the senior population aged 75+ with incomes over $50,000 per year is expected to grow 40% (by 2030 it is estimated there will be 34 million seniors, up from 20 million today). As a consequence we believe demand growth for senior living facilities will be in excess of 5% per annum. We believe one of our portfolio companies is uniquely positioned to capitalize on this immutable demographic trend.

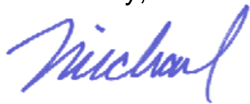
The business is at an inflection point. Units should grow on average 8% per annum through 2020 primarily through acquisitions but also through the conversion of nearly 800 units (on a base of around 12,000) to higher levels of care and therefore higher rents. Rent increases should conservatively approximate 4% per annum, driven by an improved mix of units and annual rent increases. As a result, cash flow from operations (CFFO), the metric most frequently used in the industry for valuation, is likely to increase by around 2x in 2020 from 2016 levels. Shares could conservatively be expected to trade at around 10x forward CFFO which compares favorably to the current share price. The company could also be valued on its high quality owned real estate portfolio. Today we estimate the value of the company's real estate to be in the area of $20 per share. We expect this value will grow to over $40 by 2020 as revenues grow meaningfully faster than expenses, expanding the company's net operating income (NOI).

Unlike competitors this business has not faced an increase in supply of senior housing, because the company operates at a more affordable price point in secondary markets where it is uneconomic to build. In fact the company has only a single property out of its portfolio in the ten geographic areas that have been most impacted by new supply, and most of its properties are in areas with benign supply growth.

Firm Update

We are encouraged by the development of the businesses in your portfolio over the first quarter and similarly encouraged by our progress as an investment team and firm. While there were no events of note within the four walls of Steinberg Asset Management, I would be remiss if I did not mention that we added to the "Steinberg family" with the birth of Vivian Steinberg to parents Justin and Shirley. Needless to say we are very happy with this development and wish them the very best.

Sincerely,



Michael A. Steinberg
Managing Partner

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