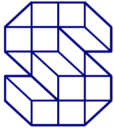

Steinberg Asset Management, LLC

Second Quarter 2014 Commentary and Outlook

Despite continued subpar economic growth and plodding gains in corporate profits, major stock indices reached record highs in the period. It was the sixth straight quarter of equity gains and the longest such run in more than 14 years. The primary driver behind the advance continues to be the ultra-easy money policies of the world's leading central banks in their dogged efforts to keep a sluggish and fragile global economic recovery alive.

Expect Monetary Policy to Remain Steady

While a pre-mature tightening of monetary policy could end the recovery, investor fears on the issue are unlikely to be realized. Even as the U.S. Federal Reserve has been reducing bond purchases, investors have begun to recognize that the monetary tightening cycle that they had feared is likely to be modest and gradual. This view was affirmed in a recent speech by Federal Reserve Board Chair Janet Yellen, who pushed back strongly against the notion that central banks should consider raising interest rates simply because some segments of the market may look "stretched". Hers is the dominant perspective among Fed officials which is important because a pre-mature tightening of monetary policy remains one of the major risks to sustained recovery.

Pre-mature tightening is also unlikely because important measures of economic growth remain well off the peak that preceded the bursting of the housing bubble and the recession that began in late 2007. While ebbing fiscal drag, a pickup in capital spending and improvement in employment will provide a lift, headwinds to growth remain in the form of slower export growth, a stabilizing household savings rate and diminishing wealth effects tied to a slower rate of increase in the prices of assets like equities and homes. On balance, with the economy operating well below its potential, and absent any meaningful wage pressures that would translate into higher CPI inflation, the Fed is unlikely to raise rates.

Oil Supply and Demand Color the Outlook

The global outlook for oil currently triggers intense debate and discussion due to its importance to economic and financial markets' performance. Some believe future oil supply will exceed demand, leading to lower prices for this important commodity. Proponents of this position point to a range of factors including:

- **Shale oil growth −** Since the shale oil revolution took hold in 2010, U.S. shale oil production has risen by 3+ million barrels per day (MBD) to over 8 MBD and healthy growth is projected for years ahead.

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- **LNG substitution −** A projected increase in LNG supply could result in the displacement of more than 3 MBD of oil demand by 2020.
- **Libya −** When political stability returns, renewed production activities will result in a recovery in oil exports from the North African producer adding more than 1 MBD to world supply.
- **Iran −** If economic sanctions are lifted, the Persian Gulf state could provide more than 2 MBD of increased supply.
- **Iraq −** With large reserves and great ambition to raise production, the beleaguered Middle East country hopes to add more than 5 MBD to world supply by the beginning of the next decade.
- **China demand −** A shifting of economic priorities from investment to consumption in coming years is projected to reduce global demand by around 2 MBD. This is forecasted to occur largely as a result of a decline in the industrial production of China's trading partners as China's demand for imports declines.

Sustained Lowering of Oil Prices Unlikely

Were all of these events to transpire, they would produce a shift in the supply-demand balance for oil of more than 10 MBD. With global demand at about 93 MBD and climbing by close to 2 MBD per annum, a shift of this magnitude over the next few years could result in sharply lower oil prices that would benefit global growth, reduce inflation and buoy financial markets. However, even if these events were to transpire, they would be most likely to converge closer to the end of the decade than in the immediate future. Moreover, if a meaningful decline in the price of oil were to be sustained over the next five years, then OPEC would have had to abdicate its role as swing producer and allowed prices to fall. Given the budgetary pressures OPEC member governments face, foremost their ever-growing social programs, this scenario is unlikely. Therefore, in the immediate future any meaningful decline in the price of oil would likely be short lived.

Important Oil Supply Dynamics

On the other side of the oil debate are those who see prices advancing in both the short and longer terms. Some of the factors supporting this position include:

- **Accelerating decline rates −** Global production from established oilfields is declining with some industry analysts estimating the falloff may have recently increased by around 2% - 3% per annum. This works out to an incremental reduction of about 2.5 MBD of supply, based on current global production of about 93MBD. This incremental production decline has been masked by rapid increases in production from U.S. shale oil and increased Saudi production of nearly 3 MBD. Going forward, the rate of growth in U.S. shale oil production is likely to slow while OPEC's capacity to increase production appears limited.
- **Reduced deep-water drilling −** Major oil companies have curtailed exploration and production in ultra-deep environments because recent results haven't provided returns sufficient to justify the investment. Ultra-deep drilling is particularly important for future global production. From 2000 – 2012 land-based drilling operations served to replace only about 90% of production while offshore drilling replaced production by 350%.
- **Iraq −** With around 2.5 MBD of current production for export along with large reserves and ambitions to increase production to as much as 9 MBD in years ahead, Iraq holds great potential to bolster world supply. There are expectations for Iraq to provide 60% of OPEC's incremental production over the next five years. However, the political and operational realities of Iraq, including the current fighting and political upheaval, suggest

that anyone relying on these forecasts will be disappointed. To date, the oil market's response to events in Iraq has been muted. The bulk of Iraqi oil production lies in the south of the country, an area investors are currently assuming will remain secure from the advance of the ISIS army. However, once a revolution is underway, the course it will follow and its ultimate outcome are unknowable. Uncertainty over output is not confined to Iraq. Production in Nigeria and Libya is similarly restricted by operational issues, which will not be easily resolved.

- **Russia −** The current geopolitical climate is particularly cold toward Russia in light of its ventures into Ukraine and Crimea and that affects the global outlook for oil. Russian President Vladimir Putin wants to see increased production and higher oil prices in order to meet his country's social, economic and geopolitical objectives. In order for Russia to slow its decline rate in oil production, additional flows of capital are essential. However, in light of Russia's conduct on the global stage, capital flows to Russia are now much more uncertain.

Financial markets have not accounted for the significant tail risk arising from the prospects of meaningfully lower oil production in the short or long term. With global supply and demand for oil currently well balanced, a significant shortfall in production would seriously undermine global economic growth and elevate inflation at a time when central banks have limited flexibility to respond because interest rates are already near rock-bottom levels.

Discrete Investments Present Compelling Opportunities

U.S. stocks have been supported by expectations that the economy, while sluggish, will continue to grow and support corporate profits expansion. Absent any shocks such as rising interest rates or oil prices, investors should continue to enjoy the benefits of rising asset prices. Still, either the pace of returns will need to moderate or earnings growth will need to significantly accelerate if stocks are to advance without their valuations (price earnings ratios) reaching unusually high and unsustainable levels.

With the tailwind of rising valuations likely to moderate or end, the investment environment should favor investors who can identify opportunities that offer unique, value-creating drivers. These are investments in companies that are truly differentiated and where returns are unlikely to be highly correlated with the performance of the market or economy. This developing environment plays to the strength of our investment philosophy and opportunistic investment approach. Further, it is worth remembering that given our concentrated portfolios and long investment horizon we can be disciplined and selective in adding new investments to the portfolio. While valuations generally may not be exceptionally compelling today, we continue to find a handful of investments which we believe offer extraordinary risk/reward profiles.

One such position we have recently begun to add to your portfolio is an industrial "platform company" (in the model of Danaher). The company has two segments, the first is a manufacturer of small, highly engineered parts for large industrial equipment and accounts for around 80% of EBTIDA. Because of the critical nature of the parts it manufactures and their low cost relative to the total end product, the company competes on quality and reliability, not price. Moreover, customers face high risk were they to switch products, creating a very sticky customer base. As a consequence, over 50% of revenues come from annuity-like after-market sales with the remainder coming from sales to OEMs. The second segment is a fast growing water management business that is gaining share in a $3-4 billion addressable market. As the business gains scale and contributes a more meaningful portion of EBITDA, we believe this segment will be well received by investors who appreciate that it is well positioned to help address the long-term global need to access ever larger sources of water.

The company generates free cash flow in excess of earnings, which management plans to deploy to fund high quality, niche acquisitions. Between free cash flow generation and incremental debt capacity, the company will have a significant amount of capital that they can deploy for acquisitions over the next four years. The company has excellent leadership at the management and board level, which is critical given the central importance of using acquisitions to generate outsized rates of returns. The board is led by a very experienced and admired executive who helped assemble the management team, which is similarly well regarded and is compensated to generate returns for shareholders. Currently investors are not giving the company credit for the value creation that we believe this management team can achieve through the existing businesses and accretive acquisitions. As a result, valuation is reasonable if not cheap. Should earnings develop as we expect over the next several years, these shares could reasonably be expected to trade as much as two times higher than today's share price. Moreover, should the company find acquisitions at more attractive prices than we currently anticipate and should the economic environment, particularly non-residential construction, accelerate, we could see earnings per share accelerate at a more rapid pace leading to much higher values.

This business is well positioned to capitalize on two secular trends: the reinvigoration of the U.S. manufacturing base -- in large part due to its newfound position as a low cost producer of energy -- and the need for solutions to what is in many parts of the world a water crisis. While the business certainly has exposure to the broader economy, we believe its performance will be driven mostly by discrete events, namely its ability to successfully use its free cash flow and debt capacity to enhance its competitive position. For that reason, we highlight this new investment as being indicative of the type of investment opportunity we are looking for and which over time we expect to drive exceptional risk adjusted returns in your portfolio.

Firm Update

We had a number of noteworthy occasions at the firm this quarter and thought it worthwhile to share some of them with you. In May we held a celebration for members of our firm who were marking their 10 year (or in some cases longer) anniversary at SAM, including members of our investment team, Lisa Shaplen and Richard Lee. In addition, Alex Reventlow our Director of IT (and a member of the 10 year anniversary club) and his wife Geneva welcomed their first child, Owen. We are very happy for them and glad to see the SAM family growing. Megan Kulick, a member of our investment team, has left the firm. We wish her well in her future endeavors.

As always we appreciate your questions and feedback and hope you will not hesitate to reach out to our team should you have thoughts or questions.

Sincerely,

Michael A. Steinberg
Managing Partner

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