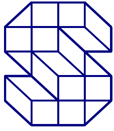

Steinberg Asset Management, LLC

First Quarter 2014 Commentary and Outlook

In contrast to their strong early performance in recent years, equities struggled in the first quarter, with major market indices up modestly for the period. Concerns over economic slowing in China, Russia's aggressive stance in Ukraine and the debilitating effects of extreme weather on the domestic economy, all contributed to a difficult environment for equities.

Economic Growth Should Drive Earnings

In prior letters, we have discussed our expectations for accelerating domestic growth contributing to rising corporate profits and gains for equities in 2014. Growth was anemic in the first quarter but largely as a result of temporary factors, including exceedingly cold winter weather that depressed spending and production, and the expiration of emergency unemployment benefits, which reduced household disposable income. In addition, the pace of inventory accumulation was sluggish. As these temporary impediments subside, we expect economic growth will accelerate.

As we have previously discussed, economic growth in 2014 won't be stifled by some of the structural challenges of 2013. The fiscal drag that resulted from statutory restrictions on federal and local government spending has been worked through and earners won't face tax hikes such as were experienced last year. As a result, both government spending and personal consumption expenditures should present normal growth characteristics. Business investment should also increase as corporate confidence continues to improve. It remains unclear whether exports will improve since the growth trajectory for China is declining and European markets remain in the throes of deflationary forces. The success of Chinese and European monetary authorities in combating slower growth will strongly influence the pace of global growth and the strength of US exports.

On balance, as long as economic growth and corporate profits continue to advance, equities should provide reasonable returns. It is doubtful that a market advance would be as robust as last year's when rising liquidity contributed to higher stock price multiples resulting in outsized equity returns. With the Fed committed to a withdrawal of liquidity in the event of robust and sustainable economic growth, a second consecutive year of meaningful multiple expansion is unlikely.

Ukraine Crisis: Near-term Challenges

While the domestic backdrop should remain supportive of equities, the crisis in Ukraine presages increased near-term volatility, important long-term geopolitical shifts and some compelling investment opportunities.

In our view, Moscow precipitated this crisis as a defensive action to protect its sphere of influence amid eroding relevance and geopolitical power. Russian President Vladimir Putin recognizes his country's growing weakness in economic, demographic, and military terms. The country has little to offer to members of its sphere in either economic or social development terms. In contrast, today's West and tomorrow's China hold far greater appeal for the Eastern European and Asian economies that have traditionally aligned with Russia. As such, Russia felt forced to act in Crimea this year, as it did in Georgia in 2008, to prevent economic and social alignment of a former Soviet republic with Europe. Further, Russia's actions are an attempt to dissuade other countries from leaving its sphere in the future.

If, as we believe, Moscow is simply acting to protect its sphere of influence, then there is little reason to expect Russia to act aggressively beyond Ukraine, Moldova and Transnistria. A wider conflict that leads to a direct confrontation with the West seems highly unlikely.

While events in Ukraine have had little impact on global economic activity, that situation could change depending on the path to resolution of the crisis. Ukraine is central to Russia's strategic goal of developing a Eurasian Federation that can compete economically and geopolitically over the long term and counterbalance the European Union. Russia can be expected to keep up military and political pressure in Ukraine until it feels confident that the republic is on a track that conforms with Russian interests. With Ukraine now in social, political, and economic chaos, and with antipathy towards Russia having grown with the annexation of Crimea, it may be difficult for the West to achieve a diplomatic resolution before Russia feels compelled to use military force. If this were to occur, the economic repercussions could be significant and financial markets would not likely respond well over the short term.

Long-Term Opportunity

Regardless of the final outcome, the events in Ukraine will create new investment opportunities and enhance existing areas where we have made investments. For example, European efforts to reduce reliance on Russian natural gas imports should benefit companies with demonstrable shale gas expertise, ranging from drilling to infrastructure to transportation. In the US, liquefied natural gas export approvals can be expected to gather momentum and companies with LNG-related expertise will be long-term beneficiaries.

When we originally invested in a leading, independent LNG shipping company, our thesis was predicated on the view that the new extraction technology of hydraulic fracturing, or fracking, would open up vast new sources of natural gas, a highly desirable fuel source due to its relatively low cost and more environmentally sensitive properties compared to other fossil fuels. Natural gas is also attractive for many countries from a national security perspective in that it enables diversification of supply away from Middle East and Russian sources.

The crisis in Ukraine serves to highlight how national security will help drive long-term demand for LNG. The LNG shipping company in which we have invested, as the world's largest independent LNG shipping company with a burgeoning liquefaction business, will be a prime beneficiary of the rapid growth in global demand for LNG. The global LNG market is in the incipient stages of development, and the industry is dependent on the construction of large, complex, long lead time infrastructure projects. The implication for an investment in a company such as this, which is actively participating in the development of the industry, is that its investment return profile will not be smooth. However, in the long term, we believe the returns in this LNG shipping company will be well above our normal target return for a single portfolio position. This investment illustrates why we expect that the portfolio's stream of returns may be

irregular and not necessarily in synch with broad equity market returns. We believe, however, that the cumulative long-term returns will be well above average.

New Investment Opportunities

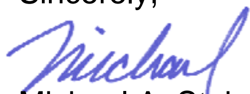
We continue to identify new investment opportunities that should further enhance long-term returns. For example, we have recently initiated a position in a high value-added producer of specialized metal and metal alloys primarily for the packaging, automotive and aerospace industries. We regard the company as very high quality and the risk/reward profile as very favorable. Around 70% of its current sales are under long-term contracts, a number we expect to trend upwards, and its products are largely patent protected or high value and proprietary. As auto emissions and fuel efficiency continue to grow in importance, lightweight, high value alloys will win an increasingly large share of content on planes and autos. This is a long-term secular trend that we expect to persist for at least the next decade given the long tail design cycles in the auto and aerospace industries. This will result in significant profitability growth as these specialized products have much higher margins than the attractive but more commodity-like packaging businesses in which the company participates. We note that the company earns a conversion spread on its products and, therefore, has limited exposure to input cost volatility. The business has a strong financial position and is currently under-levered with debt on the balance sheet materially below management's target. Given its attractive business characteristics, strong returns on invested capital and expected rapid earnings growth through at least 2017, and we suspect well beyond, we regard the shares as currently mispriced. We would expect the shares to more than double from the current price. It is not unreasonable to think that as investors begin to appreciate the company's rapid growth, attractive competitive position, and secular tailwinds, the shares could command a premium multiple. Were that to occur, shares could trade appreciably higher. It is worth noting that the company has not enjoyed significant exposure in the U.S. investing community and, as a result, we believe that investors have not fully grasped the story.

We believe our capital is well protected for a number of reasons not least of which is the company's disclosure that the replacement value of its assets is over two times its enterprise value. Finally, management owns over 3% of the company's equity and their compensation and incentives are tied to EBITDA and EBITDA/ton targets thereby aligning their interests with shareholders.

While much has been made of the historic rise of the US market over the past year we are pleased that we can continue to find discrete investments that we believe represent very attractive risk/reward profiles and will help ensure that our portfolios can generate attractive returns in the years ahead.

As always, if you have any questions please don't hesitate to reach out to us.

Sincerely,



Michael A. Steinberg
Managing Partner

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