News Highlights

Owners. Operators. And Insightful Investors.

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Established in 2007

PORTLAND INVESTMENT COUNSEL®

Our views on economic and other events and their expected impact on investments. November 4, 2019

Owner Operated Companies

Berkshire Hathaway Inc.'s Q3 2019 operating earnings of $4,812 per A Share ($3.21 per B share, up 15% year/year) exceeded estimates of $4,127 per A share ($2.75 per B share). The most recent quarter's result benefited from a foreign exchange gain (15 cents per B share) and a lower-than-expected tax rate (9 cents per B share). Overall, operating segment earnings grew 4% year/year. Net Q3 2019 EPS of $6.75 per B share including net unrealized investment gains from equity investments declined 10% year/year due to outsized unrealized investment gains a year ago. Book value per share increased 4.1% quarter/quarter to $243,675 per A share ($162.45 per B share). This increase includes a pre-tax non-cash mark-to-market net unrealized equity investment gain of $10 billion in Q3 2019. In Q3 2019, pre-tax Insurance earnings increased 15% year/year to $2.4 billion including stronger-than-anticipated Berkshire Reinsurance underwriting income. BNSF Railway Company earnings increased 3% year/year despite a slight decline in revenues which reflects an industry slowdown. Earnings declined 9% year/year in the Energy unit (worse than our estimate), and increased 2% in the Manufacturing, Service and Retail segment. It is estimated Berkshire now has over $100 billion of immediately deployable cash for accretive acquisitions to supplement organic growth as well as for investments and share buybacks. Warren Buffett (age 89) intends to remain at the helm for the foreseeable future, and his succession plan is in place. Berkshire repurchased $695 million of its shares in Q3 2019.

Energy Sector

Baytex Energy Corporation reported Q3 2019 results which were in line with expectations on production. Variances to estimates stem primarily from higher-than-expected realized pricing and lower-than-expected royalties and transportation costs. Highlights from the quarter include the redemption of $150 million of senior unsecured notes, the revision of 2019 full-year guidance to 97,000 boed (upper end of the previously announced range), and a reiteration of 11,500 bbl/d of crude-by-rail exposure the company has (around 40% of heavy oil volumes) for Q4 2019. Production of 94,927 boed (82% liquids) was in line with consensus of 94,504 boed (83% liquids). In the U.S., production was 36,793 boed, down 8% from Q2 2019 production of 39,822 boed reflecting the timing of completion activity. In Canada, Viking production was 22,198 boed, flat from Q2 2019 production of 22,565 boed as the company maintained an active pace of development. The company currently has three drilling rigs and two frac crew executing its program and remains on track to deliver 245 net wells this year. Baytex's heavy oil assets produced 28,483 boed, down 5% from Q2 2019 production of 29,983 boed. In the East Shale Duvernay, the company drilled and completed four wells in the first half of 2019 and has drilled seven wells to date. Two wells that were brought on-stream this year have showed an IP30 (Initial Production – 30 days) of 1,050 boed (75% liquids). These results are encouraging in our view as they de-risk a significant component of the company's land at Pembina.

Royal Dutch Shell PLC - Adjusted EBIT of $5,734 million was 18% ahead of consensus, with beats in integrated gas and oil products more than offsetting the upstream miss. Adjusted current cost of supply (CCS) earnings of $4,767 million were 22% ahead of Vara-compiled consensus. Upstream production of 3,563,000 boed was in-line with forecast and down 1% year/year. It is estimated upstream net income per barrel of $11/boe, down $1.7/boe year/year and compares to the $13.4/bl fall in the Brent oil price. Reported cash flow from operations of $12.3 billion was flat year/year, with a release of working capital of $0.2 billion. With cash capex of $6.1 billion and dividends payments of $3.9 billion, there was a positive FCF post capex and dividends of $1.4 billion. Net debt of $59.1 billion was up 1% quarter/quarter, with gearing (net debt to capital) of 23.5% up 0.5 percentage points quarter/quarter. Shell will continue the next tranche of share buyback for up to $2.75 billion and still intends to buy back over $25 billion buyback but noted "the prevailing weak macroeconomic conditions and challenging outlook inevitably create uncertainty about the pace of reducing gearing to 25% and completing the share buyback programme within the 2020 timeframe." Fiscal year 2019 capex expected to be at the lower end of the $24-29 billion range. Integrated gas production expected to be 920,000-970,000 boed in Q4 2019, with LNG expected to be 8.8-9.4 metric tonnes. Upstream production expected to be 2,650,000-2,800,000 boed in Q4 2019.

Financial Sector

Ares Capital Corporation Q3 2019 core net investment income per share of $0.48 was above the consensus of $0.46/share, with the beat driven primarily by higher capital structuring fees. Book value per share was roughly flat quarter/quarter at $17.26. This was another solid quarter in our view with most items coming in better than expectations, while asset growth was strong with around $1 billion of net originations. Ares had $2.4 billion of new commitments during Q3 2019, of which 90% were in first lien securities, 7% were in second lien securities, 1% in subordinate certificates, with the remainder in other equity securities. Against that, Ares had around $1.4 billion of exits. The portfolio mix at quarter end was 45% first lien (vs. 41% previously), 32% second lien (vs. 33%), and 6% in certificates of the Senior Direct Lending Program (vs. 7% previously). Overall yield on debt and income producing securities at amortized cost was approximately down 60bps quarter/quarter at 9.8%. Leverage was around 0.86x debt to equity, roughly flat from 0.82x the prior quarter.

BCE Inc. - Q3 2019 results -- Wireless service revenue grew 2.5% as strong subscriber loading of 127,000 postpaid and 77,000 prepaid offset any pressure from the migration to unlimited. EPS was $0.91 vs. consensus of $0.91. EBITDA was $2.59 billion vs. consensus of $2.58 billion. Revenue was $5.98 billion vs. consensus of $5.98 billion. **Wireless**: 2.5% service revenue growth driven by subscriber loading -- Postpaid net additions were 127,000 vs. consensus of 110,000. Service revenue was $1.67 billion (+2.5% year/year) vs. consensus of $1.66 billion (+2.0% year/year). EBITDA was $1.01 billion vs. consensus of $1.02 billion. **Wireline**: Overall in line quarter -- Internet subscriber adds were 58,000 vs. consensus of 51,000 -- TV subscriber adds were 5,000 vs. consensus of 9,000 -- Revenue was $3.06 billion (+0.2% year/year) vs. consensus of $3.08 billion (+0.6% year/year) -- EBITDA was $1.36 billion vs. consensus of $1.36 billion (+1.5% year/year). **Media**: Revenue growth driven by increased Crave subscribers -- Revenue was $751 million (+2.7% year/year) vs. consensus of $748 million (+2.3%) -- EBITDA was $226 million vs consensus of $209 million.

BNP Paribas SA reported net income of €1.94 billion, beating consensus by 7%. Clean profit before tax (excluding Corp. Centre) of €3.10 billion was around 5% above consensus. **Revenues**: €10.90 billion (reported), around 2% ahead of consensus. Much of the delta came from Corporate & Investment Bank (CIB) , which beat by 8% (both Global Markets - notably very strong Fixed Income Currency & Commodities (+39% year/year, better than peers), but weaker Equities, down 15% year/year on weaker flows) and Corporate Banking beat consensus. Asset gathering businesses (especially Insurance) were also a bit better. Most retail divisions in Europe did slightly miss consensus, and French Retail revenues of €1.49 billion missed by 1% (but broadly in-line). Clean costs come in marginally worse than consensus. Provisions at €847 million, surprisingly worse than consensus of €799 million (albeit still at a low level). Personal Finance, the U.S. and EuropeMed were key drivers of the miss, while CIB provisioning was worse too. BNP describe the 41bps as still a low level reflecting low rates and improvement in Italy and compared to a low base last year due to CIB write-backs. There was a significant file in CIB this quarter. CET- 1 ratio increased 10bps quarter/quarter to 12.0% (in line with consensus of 12.0%), with Risk Weighted Assets a little higher than expected.

Standard Chartered PLC - Q3 2019 underlying Profit before Tax of $1.24 billion beat consensus by 18%, on better revenues and costs. The pre-provision profit beat is a very impressive 22%, but impairments are worse. Revenues of $3.98 billion are 4% above consensus. Net Interest Income ticked up marginally quarter/quarter, despite a -6bps Net Interest Margin compression (ended Q3 2019 at 1.56%), while loan balances grew 2% quarter/quarter (broadly as consensus had expected). Costs of $2.50 billion are 4% better than consensus. Fiscal year 2019 cost guidance (excluding UK bank levy) "to grow below the rate of inflation" compares to fiscal year 2019 consensus of 0.2% increase, perhaps implying some back-end loaded nature of investment spend in Q4 2019. Impairments (total) of $284 million are around 37% worse than consensus, driven by a big miss in credit impairments. The bank blames this in IFRS 9 expected credit losses, including some "unconnected corporate exposures". On asset quality, there was no quarter/quarter improvement in 'Stage 3' loans, but there was a modest build in Coverage. Against that, 'Credit grade' 12 accounts (nearly non-performing loans) did worsen by 10% quarter/quarter. The bank says that asset quality overall was broadly stable quarter/quarter, "with no new areas of stress identified". CET-1 ratio rose 6bps quarter/quarter to 13.5% (missing consensus by around 20bps). This echoed the pattern at Q2 2019 results. Risk Weighted Assets were modestly below consensus. **Outlook**: sticking to its 10% ROTE target in 2021, but admits to the "growing headwinds".

Activist Influenced Companies

Nothing significant to report.

Dividend Payers

Dufry AG - Hudson (24% of Dufry revenues) has acquired OHM Concessions. The OHM Concession Group (founded in 1998) has 60 restaurants (brands: &pizza, the Kitchen by Wolfgang Puck, Chick-fil-A, Currito, Dunkin Donuts etc.) in 13 airports and has seen strong growth in recent years (2013: 10 units in 2 airports). It has revenues of $62 million in fiscal year 2018 and therefore adds 3% to Hudson's sales. Hudson is the clear market leader in the North America travel retail market and is present in 89 airports with 1,028 stores, compared to 13 airports for OHM. Hudson already has around 50 food and beverage locations and therefore the 60 units from OHM more than doubles Hudson's position in this segment. In North America, HMSHost (owned by Autogrill, present in 87 airports) is the clear market leader (24% market share), followed by SSP Group (present in 30 airports). With the acquisition of OHM Concessions, Hudson / Dufry enters into the food and beverage market in airports in North America, which was awaited since the IPO (Q1 2018). It brings Hudson the knowhow and brands to operate more restaurants in U.S. airports, which is considered to be a growth segment. The impact for Dufry is rather small (adds 0.7% to sales).

Mondelez International Inc. adjusted Q3 2019 EPS of $0.64 beat estimates with organic growth of 4.2%, whereas Operating Profit missed consensus by 1.5%. Gross margin of 39.7% missed estimates by 90 bps. Management attributed the lack of flow-through to its ongoing problems in Brazil, which now include significant sales declines in its over $300 million powdered beverage business in addition to the supply chain realignment challenges previously known. The 4.2% organic growth in Q3 2019 included about 0.6% from hyperinflation in Argentina. Management raised organic growth guidance to 3.5% from 3% which implies that Q4 2019 will be lower than the year-to-date trend of 4.2%. The EPS guidance increase to 5-7% (from 5% previously) is more-than accounted for by a lower tax rate and interest expense, thus implying a 1% reduction to our expectations for operating income growth for the year. Just about every market except for Brazil and Argentina is very much on track. Global category growth for snacking is now up 4.0% year-to-date compared to 3.4% last quarter and Mondelez is gaining or holding share in 65% of its categories. Europe grew 5% with some help from an easy comparison to last year's hot summer. North America grew 2.5% with selective pricing. China grew 9%, India grew double-digit, and Russia grew double-digit. Operating profit, excluding foreign exchange, grew 4% in the quarter and year-to-date, with Brazil posing a 2.5% drag, similar to Q2 2019.

Newell Brands, Inc. reported Q3 2019 Core EPS of $0.73, which compares to consensus of $0.55. Home & Outdoor Living was up 1.3% driven by Home Fragrances and Home & Security. Food & Commercial was down 11.3%. **Raised 2019 guidance**: Normalized EPS at $1.63-$1.68 (vs. $1.50-1.65); Net Sales at $9.6-$9.7 billion (vs. $9.1-9.3 billion); Cash Flow from Operations: $700-$850 million (vs. $600-800 million); no change in Core Sales guidance.

Economic Conditions

U.S. Nonfarm payrolls rose 128,000, well above market expectations, and the prior two months were revised up by a total of 95,000. The three- and 12-month trends are now both over 170,000, which is quite strong for the 11th year of an expansion in our view. Private-sector payrolls rose 131,000, and likely would have been closer to 190,000 if not for the GM strike (now ended). Accounting for this temporary hit, the 3-month trend would be above the past year mean. Despite another big increase in household survey jobs (for a third straight month), the unemployment rate edged off its 50-year low to 3.6%, as the participation rate ticked higher again. Wage growth remained subdued, with average hourly earnings up 0.2%, holding the yearly rate at a revised 3.0% pace. That's not nearly strong enough in our view to threaten the Fed's inflation target, though rising incomes will continue to support consumers.

U.S. economy slowed a bit further in Q3 2019, as the trade war and weaker global demand hammered investment, while consumers stepped back amid ebbing job growth. Real GDP rose 1.9% annualized, versus 2.0% in Q2 2019 and 3.1% in Q1 2019, the second weakest quarter in over three years. This trimmed the yearly rate to 2.0%, just below the post-recession mean. The economy's big engine, consumers, moderated to 2.9%, though that's still decent in the eleventh year of an expansion in our view. Durables and nondurables posted big gains, while services spending faded to 1.7%. Exports bounced only a little (0.7%) after getting crunched in the prior quarter, while government spending moderated to a 2.0% rate. The only sector showing some momentum was residential construction, which advanced for the first time in seven quarters due to the earlier plunge in mortgage rates. But this sector is too small to drive the expansion. Non-residential investment contracted for a second straight quarter (-3.0%), and by more than the previous period. Investment in structures plunged at another double-digit rate (-15.3%), while spending on equipment fell nearly 4%. Uncertainty about the trade war and a slowing global economy didn't help, and the GM strike provided a small dent, too. Still, despite the sharp retreat in investment, final domestic demand grew 2.0%, close to the economy's long-run potential rate.

U.S. personal incomes rose 0.3% in September, following an upwardly 0.5% gain in August. Unfortunately, wages & salaries were flat, though that follows a big 0.6% jump in the prior month. The savings rate rose for the second month in a row, up 0.2 percentage points to 8.3%, highest since March. **Personal consumption** rose an as-expected 0.2%, the second consecutive increase in a row of that size. In real-terms, spending advance for the seventh month in a row, or 0.2% in September but it was a low 0.2% (+0.171%), while July and August were revised higher.

'Brexit' - EU member states have agreed to grant Britain a three-month flexible delay on its departure from the European Union, European Council President Donald Tusk has tweeted. Envoys representing the 27 remaining European Union members states agreed to the request, which will see the UK leave on January 31, 2020, EU Council President Tusk said on Twitter. The bloc's decision will be formalized "through a written procedure," Tusk said, meaning that there will be no leaders' summit. The extension gives the British parliament plenty of time to debate Prime Minister Boris Johnson's Brexit deal. Mr. Johnson will also continue try to push for an early election having pledged to take Britain out of the EU on October 31, 2019.

Australia's Consumer Price Index came in at 0.5% quarter/quarter for Q3 2019, lower than the 0.6% quarter/quarter in the previous three months, but in line with expectations. On a yearly basis, inflation advanced 1.7% year/year, slightly higher than 1.6% year/year in the previous three months, also in line with expectations. Of more importance to interest rates, the Reserve Bank of Australia (RBA)'s trimmed mean was up 0.4% quarter/quarter and 1.6% year/year, similar to the readings in Q2 2019. The RBA's weighted median was up 0.3% quarter/quarter, down from 0.4% quarter/quarter in Q2 2019. For the year, it was 1.2% year/year, slightly lower than the revised 1.3% year/year reading in Q2 2019. Underlying inflation has been anchored under the RBA's 2% to 3% target band since early 2016.

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Financial Conditions

Bank of Canada - No change in rates. The Bank shaved 0.1 percentage points from its global growth forecast for 2020, bringing it to 3.1%. Inflation projections were revised higher for 2019. The Bank attributed some of this outperformance to transitory factors, such as airfares and vegetables, and repeated that a modest drag from the output gap will be largely offset by carbon taxes. The Bank continues to see two-sided risks from trade policy but notes that this risk is now tilted to the downside. The Bank's global outlook now incorporates a 1.3% drag from global trade conflicts (through the end of 2021) which is 0.5 percentage points larger than July 2019. Stronger residential investment was flagged as a risk. If residential investment continues to outperform it would have negative implications for financial stability. The Bank noted that Chinese growth has continued to slow. The Bank continues to monitor the housing market for signs of pronounced weakness.

The U.S. Federal Reserve cut official interest rates for the third time but indicated it has finished for now what chairman Jerome Powell previously called a "mid-cycle adjustment". Board members lowered the target range for the federal funds rate by 25 basis points to 1.5% to 1.75%. Two of the 10-member committee dissented. Coming hours after official preliminary figures showed economic growth cooled to 1.9% last quarter from 2.1%, the cut last Wednesday was made in response to the weaker global outlook and weak inflation, the policy committee said.

The Bank of Japan (BOJ) kept its monetary policy stance and policy rate unchanged in the October Monetary Policy Meeting (MPM) decision on October 31, 2019. However, it "dovishly" enhanced its forward guidance to suggest possible rate cuts in future policy meetings (without making any immediate changes). The BOJ's new forward guidance states: "As for the policy rates, the Bank expects short- and long-term interest rates to remain at their present or lower levels as long as it is necessary to pay close attention to the possibility that the momentum toward achieving the price stability will be lost." The BOJ's projected GDP growth and CPI inflation estimates and the forecast ranges were broadly adjusted lower across the forecast period. The effects of the consumption tax hike are still assumed to be "flushed out" by fiscal 2021 with CPI inflation projected now at 1.5% in fiscal 2021 (from 1.6% previously), well below the 2% target.

The U.S. 2 year/10 year treasury spread is now 0.185% and the U.K.'s 2 year/10 year treasury spread is 0.161% - meaning investment banks remain constrained from profiting from a steep yield curve and instead are seeking operational efficiencies, including job cuts and lower compensation, to maintain acceptable levels of profit, i.e. above costs of capital. Also, the narrowing gap between yields on the 2 year and 10 year Treasuries is of concern given its historical track record that when shorter term rates exceed longer dated ones, such inversion is usually an early warning of an economic slowdown.

Influenced by the withdrawal of quantitative easing, the U.S. 30 year mortgage market rate has increased to 3.78% (was 3.31% end of November 2012, the lowest rate since the Federal Reserve began tracking rates in 1971). Existing U.S. housing inventory is at 6.4 months supply of existing houses. So the combined effects of low mortgage rates, near record high affordability, economic recovery, job creation, and low prices are still supporting the housing market with housing inventory well off its peak of 9.4 months and we believe now at the low end of a more normal range of 4-7 months.

The VIX (volatility index) is 12.64 (compares to a post-recession low of 18.00 achieved in early November) and while, by its characteristics, the VIX will remain volatile, we believe a VIX level below 25 bodes well for quality equities.

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Glossary of Terms: 'boe' barrel of oil equivalent, a measurement of a unit of energy, 'boed' refers to barrel of oil equivalent per day, 'CET' core equity tier, 'EBITDA' earnings before interest, taxes, depreciation and amortization, 'EPS' earnings per share, 'FCF' free cash flow, 'GDP' gross domestic product, 'netback' is a measure of oil and gas sales revenues net of royalties, production and transportation expenses and is used to compare performance in the oil and gas industry, 'ROE' return on equity, 'ROTE' return on tangible equity, 'ROTCE' return on tangible common equity.

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