News Highlights

Owners. Operators. And Insightful Investors.

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PORTLAND INVESTMENT COUNSEL®

Established in 2007

Our views on economic and other events and their expected impact on investments. February 24, 2020

Owner Operated Companies

Berkshire Hathaway Inc. – Warren Buffett's Berkshire Hathaway Inc. posted a 23% decrease in quarterly operating profit, while soaring prices in stock holdings such as Apple Inc. enabled the conglomerate to smash its old record for full-year earnings. In his annual letter to Berkshire shareholders, Buffett defended Berkshire's foray into stocks, which comes amid a four-year drought since its last major acquisition that has left Berkshire sitting on $128 billion of cash. Berkshire did step up repurchases of its own stock, buying back roughly $2.2 billion in the quarter. Repurchases totalled $5 billion for the full year. Nonetheless, while The BNSF Railway Company's and Berkshire Hathaway Energy's units showed improvement, reinsurance operations weighed on operating results, and the GEICO car insurer posted loss claims which eclipsed premium growth. Fourth-quarter operating profit fell to $4.42 billion, or approximately $2,720 per Class A share, from $5.72 billion, or about $3,484 per share. Berkshire did not write down its 26.6% stake in The Kraft Heinz Company, which is struggling to rebound from years of cost-cutting amid changing consumer tastes, though its market value is well below the $13.8 billion carrying cost on Berkshire's balance sheet. Net income, reflecting stock gains, totalled $29.16 billion, compared with a net loss of $25.39 billion a year earlier. For all of 2019, net income totalled $81.42 billion, topping the record $44.94 billion for 2017, when Berkshire benefited from a lower U.S. corporate tax rate. Buffett wrote that companies whose stocks Berkshire owns are generating returns that are "remarkable under any circumstances," especially compared with returns on bonds. Apple soared 86% in 2019 and 31% in the fourth quarter alone, leaving Berkshire with a $73.7 billion year-end stake.

Fortis Inc., a leader in the North American regulated electric and gas utility industry, released its 2019 fourth-quarter and annual financial results, which included strong annual net earnings of $1,655 million, or $3.79 per common share in 2019, up from $2.59 per common share in 2018, adjusted net earnings of $1,115 million, or $2.55 per common share in 2019, up from $2.51 per common share in 2018 and deployed capital expenditures of $3.8 billion at its utilities in 2019. During the fourth quarter of 2019, Fortis issued approximately 22.8 million common shares representing gross proceeds of $1.2 billion at a price of $52.15 per share. The issuance accelerated the equity funding needed to support the corporation's five-year capital plan as well as strengthened the corporation's balance sheet and credit metrics. The net proceeds were used to redeem US$500 million of outstanding 2.10% unsecured senior notes due October 4, 2021, to repay credit facility borrowings and for general corporate purposes. Capital expenditures in 2019 were $3.8 billion, $0.6 billion higher than in 2018, driven by higher spending at the U.S. regulated utilities. Fortis' five-year capital plan for 2020 through 2024 is targeted at $18.8 billion, $0.5 billion higher than the $18.3 billion capital plan reported in November 2019. The company's $18.8 billion five-year capital plan is expected to increase rate base from $28.0 billion in 2019 to $34.5 billion by 2022 and $38.4 billion by 2024, translating into three- and five-year compound average growth rates of 7.2% and 6.5%, respectively. Beyond the base capital plan, Fortis continues to pursue additional energy infrastructure opportunities. Fortis expects long-term growth in rate base to support continuing growth in earnings and dividends. Fortis is targeting average annual dividend growth of approximately 6% through 2024.

Energy Sector

Nothing significant to report.

Financial Sector

HSBC Holdings PLC has unveiled its much-anticipated strategic update, to cut US$100 billion ($150 billion) in assets, slash its investment bank and restructure in the United States and Europe, as it launched its biggest overhaul in years in a bid to improve returns. HSBC's main target include: Return on Tangible Equity of 10-12% by end-2022 (consensus has estimated 9.6% for Fiscal Year (FY) 2021,); Risk Weighted Assets (gross) to be reduced by $100 billion by end of 2022. But, HSBC says that these will be reinvested, so expects net Risk Weighted Assets (RWAs) to be broadly flat between 2019 and 2022. Ultimately, RWAs will be reduced in the U.S. and (non-UK) Europe, with Global Banking & Markets the main drivers. These will then be reinvested in higher return areas, which is consistent with the framework previously mentioned. FY2022 adjusted costs of less than $31 billion - that looks a positive evolution vs what consensus is tracking towards (FY2021 consensus is about $33 billion), and includes $4.5 billion of cost saves over 2020-2022 (with $1 billion coming in 2020). CET1 ratio in 14-15% range, and at top-end of that by FY2022 (consensus FY2021 is 14.6%). Revenues: guided down modestly year/year in FY2020 with low single digit growth guided for FY2021 and FY2022 (looks inline consensus for FY2021). Global Banking Markets restructuring: HSBC announces various initiatives to reposition Global Banking and Markets, across different geographies. Europe and the U.S. in particular will be downsized, with the focus more on "strengths in Asia and the Middle East". Buybacks suspended for FY2020 and FY2021. Restructuring costs: Guides to $6 billion out to 2022 (of which 40% in FY2020 and 50% in FY2021).

HSBC – Q4 2019 results in isolation, these look healthy enough overall (adjusted basis) in our view. Q4 2019 adjusted Profit Before Tax (including UK bank levy) of $4.35 billion was 11% above consensus, on higher revenues and lower provisions. These offset a cost miss. Revenues (adjusted) of $13.65 billion beat consensus by 5%. Adjusted Net Interest Income of $7.69 billion was stable quarter/quarter, and looks about 2% above consensus, despite no Net Interest Margin expansion quarter/quarter. The bulk of the revenue beat comes from Non-Interest Income. Costs (adjusted, excluding levy) of $8.10 billion were about 3% worse than consensus. Provisions: of $733 million were much more benign than consensus, and more reassuring after the big miss in Q3 2019. This benefited from a UK release (on more economic certainty). CET1 ratio rose +40 bps quarter/quarter to 14.7%, clearly above consensus 14.2% (on sharply lower Risk Weighted Assets, which fell -2.5% quarter/quarter, mainly in Global Banking & Markets). Tangible NAV per share of $7.13 rose +2% quarter/quarter and beat consensus $7.04. Dividend Per Share of $0.21 as expected, so the FY2019 Dividend Per Share of $0.51 equates to a 6.7% yield.

Morgan Stanley (MS) announced the acquisition of E-Trade Financial Corporation (ETFC) in an all-stock transaction valued at $13 billion. ETFC stockholders will receive 1.0432 MS shares for each ETFC share, or $58.74/share, a 31% premium to closing price before the announcement. This equates to 2.2x book, 3.9x tangible book, 15x 2020 estimated EPS and 16x 2021 estimated EPS. MS trades closer to 1.4x book. ETFC will add 5.2 million client accounts with over $360 billion of retail client assets. MS has 3 million client relationships and $2.7 trillion of client assets. Still, MS's model is full-service, advisor-driven, while ETFC is more direct-to-consumer. Both offer workplace solutions. We expect MS to retain the 'E*TRADE' brand. Pro forma, MS's combined Wealth and Investment Management businesses will contribute 57% of MS's pre-tax profits, up from 51% in 2019. MS expects the acquisition to be accretive once fully phased-in estimated cost and funding synergies are realized. The transaction is expected to increase its ROTCE by more than 100bps with fully phased-in cost and funding synergies and improve Wealth Management's pre-tax profit margin to over 30% (its 2-year objective was 28-30%; aspirational target was over 30%). MS expects its CET1 ratio to increase by over 30bps at closing. MS expects to maintain its current share repurchase program. Cost savings are estimated at $400 million (25% of ETFC's expense base; phased-in over 3 years) from maximizing efficiencies of technology infrastructure, optimizing shared corporate services and combining the bank entities, while funding synergies are estimated at $150 million (phased-in over 2-years). The transaction adds $56 billion of low-cost deposits, providing a funding benefits to MS. MS can replace its wholesale bank funding with ETFC's off-balance sheet customer cash holding. Post-closing restructuring/integration costs are expected to total $800 million over 3 years. ETFC CEO Mike Pizzi is expected to join MS and run the ETFC business within the MS and lead the integration. ETFC will get one board seat. The transaction is expected to close in Q4 2020.

Royal Bank of Canada (RBC) reported adjusted cash EPS of $2.44 (+11% year/year), well above consensus of $2.30. The earnings beat primarily was driven by Capital Markets and credit. Canadian banking fundamentals remain strong (market share gains), while market sensitive businesses rebounded particularly with Capital markets (Net Income (NI) +35% year/year) and Investor & Treasury Services stabilized, while adjusted ROE in the quarter improved to 17.8%. Total bank Provisions for Credit Losses of $419 million (26 bps; -6 bps quarter/quarter) was lower than consensus of $493 million. Capita; CET1 ratio of 12.0% (-10 bps quarter/quarter) was in line with the consensus. Solid internal capital generation (38 bps) was more than offset by Risk Weighted Asset growth (-15 bps), share repurchases (-14 bps; 7 million shares for $727 million in Fiscal Q1), pension and post-employment benefit obligations (-10 bps), and regulatory (-9 bps; including IFRS 16). As expected, RBC announced a dividend increase of 3% (pattern of raising dividends every other quarter). Key segment highlights: Canadian banking. The Property & Casualty division reported strong Net Income, up 5% year/year (vs. 6% in Fiscal Q4). **Canadian banking** was driven by solid loan growth at +7% year/year (e.g. residential mortgages +8.6% year/year, commercial +7.9%, credit cards +4.2%) and deposit growth (+9% year/year). Mortgages incrementally benefited from home equity line of credit (HELOCs) (-3.5% year/year), but overall growth still should remain peer leading at 7.0%. Net Interest Margin was down 4 bps quarter/quarter mainly related to competition and product mix. Expenses were up 4% year/year implying modest positive operating leverage of 0.7%. Wealth management NI increased 4% year/year as strong revenue growth (7% year/year) was more than offset by higher expenses (+10% year/year). Larger costs related to higher variable compensation, larger staff-related and technology costs. City National Bank (CNB) adj. earnings were flat year/year (vs. -8% year/year last quarter). Loan growth remained solid (+19% year/year), but U.S. Net Interest Margin declined 17 bps quarter/quarter to 2.97% due to rates and higher funding costs. Assets Under Management rose 22% year/year complemented by higher equity markets and net sales. Record quarter in Capital markets. NI of $882 million increased 35% year/year driven by Mergers & Acquisitions (North American advisory and debt origination in the U.S.), trading of $1.1 billion (e.g. corporate bond and interest rate), and lower provisions (-44% year/year).

Activist Influenced Companies

Nothing significant to report.

Dividend Payers

Nestlé S.A. has reported FY2019 organic sales growth of 3.5% (of which price was 0.6%); 3.0% in Q4 (lapping a tougher comparative). Consensus was expecting FY growth of 3.6%. The star performer was Pet Care (7.0% organic sales growth) with more subdued performances from Waters (0.7%) and Confectionery (1.9%). The underlying margin increased by 60bps to 17.6% (consensus 17.7%), reflecting: an unchanged gross margin, a 10bps reduction in distribution costs and a 50bp reduction in operating expenses. Helped by a lower tax charge (down 220bps to 21.6%), this translated to a 10% increase in adjusted EPS to SFr 4.41 (11% in constant currency). Consensus is SFr 4.41. Free cash flow increased by 11% to SFr 11.9 billion helped by a further benefit from working capital. "Cash flow is expected to remain at around 12% of sales with working capital trending to zero". CEO Schneider had a long-standing target of achieving mid-single digit organic growth in 2020, which appears to have been pushed out. The 2020 outlook is for "continued increase in organic sales growth expecting further acceleration in 2021/22 towards sustainable mid-single-digit growth". Consensus expects 3.9%, which now looks stretching, particularly given the potential impact from coronavirus (China is 8% of group sales) which Nestle say it is too early to quantify. The guidance is for an improvement in margin. Consensus expects 18.3%.

RioCan Real Estate Investment Trust reported funds from operations (FFO) per diluted unit of $0.46, up 2.6% year/year and just above consensus of $0.45. The key positive drivers in the quarter were residential inventory gains and same-property net operating income (NOI) growth, partially offset by reduced non-recurring income. For the full-year 2019, FFO per diluted unit was $1.87, up from $1.85 in 2019, equating to growth of 1.2%. The largest factors supporting the growth were $36.3 million ($0.12 per unit) of residential inventory gains as well as a $12.3 million ($0.04) increase in same-property NOI. These positive factors were largely offset by a $35.6 million ($0.11) decrease in gains on marketable securities and the dilutive impact of $1.5 billion in asset dispositions since the beginning of 2018. Overall, same-property NOI was up 2.3% in the quarter, with strong internal growth of 2.8% in the core portfolio (Canada's six largest markets), while same-property NOI declined 2.3% in secondary markets. RioCan defines its core markets as Canada's six largest markets and the GTA, and this portfolio now represents 90.1% of rental revenue. Management guided to same-property NOI growth in excess of 3.0% in 2020. RioCan completed approximately 789,000 square feet of lease renewals during Q4 2019 (retention of 90%), with leasing spreads of 10.2% ($2.12 per square foot). Additionally, during the quarter, RioCan completed 485,000 sf of new leasing at average rents of $29.03 per sf, 47% higher than the portfolio average net rental rate of $19.75 per square foot.

Walmart Inc. reported comparable adjusted EPS of $1.43, in-line with consensus of $1.44 and when adjusting for a $0.05 headwind from disruption in Chile and a legal matter. Revenue came in better than expected driven by continued strength in U.S. e-commerce (grew 35%) and U.S. adjusted compensation of 2.4% (when adjusted for the extra week). Grocery and consumables were particularly strong as Walmart continues to improve quality in fresh and private brands and invest in price. Operating profit came in slightly worse than expected with U.S. adjusted operating profit of $4,928 million missing consensus of $5,269 million. Therefore, the top line appears to have come at a cost, a trend that will likely continue to next year in our view. Walmart also provided FY 2021 guidance which was better than expected but again comes with a cost when considering the implied operating profit guidance for 2021. Assuming 4.5% growth, U.S. operating profit for FY2021 is about $18,632 million from $17,830 million in 2020, below consensus expectations of $19,042 million (11 cents on EPS). Consolidated operating profit for FY2021 assuming 4.5% growth implies $21,493 million from $20,568 million in 2020 vs. consensus of $22,652 million.

Economic Conditions

Coronavirus: there is no letup in **COVID-19 news**. In **Italy**, for example, more cases and deaths prompted the cancellation of many public events in Venice and Milan, including the Venice Carnival, although the Armani and Dolce & Gabbana fashion shows were still on. In fact, **Italy has the fourth highest number of cases** (most recently 152), outside of China, Japan and South Korea. So the coronavirus news continued to dominate the headlines…..along with the Nevada caucus.) As of Monday morning (Feb. 24th), there are now a total of 2,625 deaths, 79,434 confirmed cases, and 23,944 recoveries. And COVID-19 consumed those gathered at the **G20 Finance Ministers and Central Bankers** meeting in Saudi Arabia over the weekend. According to the International Monetary Fund, the base case scenario expects that "China's economy would return to normal in the second quarter". But the host country confirmed that everyone is ready to step up when needed. According to **Saudi Finance Minister Mohammed al-Jadaan**, "We have discussed the outbreak of coronavirus in China and other countries and all the G20 countries agreed collectively on being ready to intervene with necessary policies."

Canada Relaxes Mortgage Qualification Rules as Rates Fall – Bloomberg reported that Canada's Finance Minister Bill Morneau is relaxing mortgage qualification rules to make it easier for home buyers to secure financing, a move that could give Canada's real-estate market another boost. The finance department announced it will set up a new benchmark interest rate used to determine whether people will qualify for an insured mortgage that will be based on actual borrowing costs, rather than advertised rates. The article notes that the existing qualification rule, which was introduced in 2016, wasn't responsive enough to a recent drop in lending interest rates -- effectively making the stress test too tight. Mr. Morneau has been under pressure to ease up on stress tests that require home buyers to prove they can handle payments at about two percentage points above the contracted rate. The government's qualification rules were matched by the country's banking regulator on non-insured mortgages in 2018, prompting realtors to warn the measures were too heavy-handed, and disproportionately hurt young home buyers. Further, the article adds that leaving the stress test as is may have had unintended consequences, particularly a rapid rise in alternative lending activity as more borrowers moved into the less-regulated private market, including provincial credit unions, mortgage investment companies and mortgage finance corporations.

U.S. housing starts, after surging 17.7% in December to a 13-year high of 1.626 million units annualized rate (upwardly revised), dropped by only 3.6% in January to 1.567 million units, the 2nd highest level in 13 years (taking a backseat to the prior month). **Singles** fell 5.9% but that can be shrugged off as they had jumped over 14% in December. The more affordable **multi-unit** category climbed for the fourth month in a row. There is also a good indication of more starts in the pipeline, as **building permits** (need to ask permission before breaking ground) surged 9.2% to 1.551 million units, the highest since March 2007, with higher permits for singles and multis, and across all regions of the country. In summary, it seems still-decent affordability continues to support housing demand. As long as rates stay relatively low and jobs and wage growth are respectable, the U.S. economy can count on the housing market for support.

U.S. existing home sales fell 1.3% in January, which wasn't as much as expected, to a 2-month low of 5.46 million units. All of the decline was notably in the **West; everywhere else**, sales were either flat or higher. They've been on this up one month, down the next pattern for much of the past six months and, as of now, are still up 9.6% from a year ago. That is pretty good in our view. This is a supply issue in our view. Just like the job market. Still plenty of demand, just not enough homes to go around. Although the number of homes available to be bought rose for the first time since June, **inventories** of these homes are still near record lows (and are down 10.7% year/year). The **months' supply** was at a low 3.1, which is about half of normal. **First-time homebuyers'** saw their share inch up to 32%, which is far from 40%-to-45% seen during normal, healthy times. Even with prices up nearly 7% year/year. **Repeat homebuyers** came in at 47%, the lowest since 2012.

Financial Conditions

The U.S. 2 year/10 year treasury spread is now 0.11% and the U.K.'s 2 year/10 year treasury spread is 0.12% - 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 3.49% (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 3.1 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 22.76 (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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