News Highlights

Owners. Operators. And Insightful Investors.

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PORTLAND INVESTMENT COUNSEL®

Our views on economic and other events and their expected impact on investments. October 28, 2019

Owner Operated Companies

Danaher Corporation reported third quarter results, which included net earnings of $648.4 million, or $0.89 per diluted share which represents a 4.5% year/year decrease from the comparable 2018 period. Non-GAAP adjusted diluted net earnings per share for the third quarter 2019 were $1.16 which represents a 5.5% increase over the comparable 2018 period. Revenues increased 4.0% year/year to $5.0 billion, with non-GAAP core revenue growth of 5.0%. Excluding its dental segment, now named Envista Holdings Corporation, non-GAAP core revenue growth for the third quarter 2019 was 6.0%. For the fourth quarter 2019, the company anticipates that diluted net earnings per share will be in the range of $1.06 to $1.09 and non-GAAP adjusted diluted net earnings per share will be in the range of $1.32 to $1.35. Thomas P. Joyce, Jr., President and Chief Executive Officer, stated, 'We are pleased by our strong third quarter performance as we delivered another quarter of 5% core revenue growth and solid margin expansion. We believe our ongoing investments in innovation and commercial initiatives helped to continue building sustainable competitive advantages across a number of our businesses.'

Fortive Corporation reported quarterly adjusted earnings of 87 cents per share for the quarter ended in September. The mean expectation of 16 analysts for the quarter that ended in September was for earnings of 87 cents per share. Revenues from continuing operations increased 16.2% year/year to $1.9 billion, with core revenue growth of 2.1%. James A. Lico, President and Chief Executive Officer, stated, "Today we reported an 18% year/year increase in our adjusted diluted earnings per share for the third quarter. While the more challenging macroeconomic conditions impacted growth in our Professional Instrumentation segment, we generated a double-digit increase in earnings and strong free cash flow driven by the contributions from recent acquisitions and the resilience of our portfolio. With the support of the Fortive Business System, and the compounding of the higher growth and higher recurring revenue elements of the portfolio that we have added over the past few years, we are well positioned to generate long-term value for all of our stakeholders."

Walgreens Boots Alliance, Inc. said it does not expect adjusted earnings to grow in fiscal 2020 and warned that prescriptions it fills at its pharmacies may fetch lower reimbursements. Walgreens has been benefiting from the process of procuring generic drugs to offset growing pressure from insurers and pharmacy benefit managers on reimbursements for filling prescriptions. However, as of late, that came under pressure as prices of such drugs stabilized in the U.S. Same-store sales at the retail pharmacy division in the U.S. rose 3.4% from a year earlier and the company said higher prices for patented drugs and prescription volumes helped its profit beat Wall Street estimates. Walgreens said it now expects annual savings of $1.8 billion by fiscal 2022 from its cost-cut plan that was announced late last year, up from $1.5 billion. As part of the plan, it had decided in August 2019 to close 200 U.S. stores. Excluding extraordinary items, Walgreens earned $1.43 per share, beating analysts' expectations of $1.41 per share. Revenue rose 1.53% from a year earlier to $33.95 billion.

Energy Sector

Crescent Point Energy Corp. completed the sale of oil and gas assets located in Uinta Basin, for a cash consideration of approximately $700 million. The assets are forecasted to have an approximately 20,000 boe/d (75% crude oil and 85% total liquids) of production in 2020. BMO Capital Markets and CIBC Capital Markets acted as financial advisors and Tudor, Pickering, Holt & Co. acted as a strategic advisor to Crescent Point on this transaction. The transaction enables Crescent Point to exit Uinta Basin and is in line with its key criteria for its asset portfolio. Craig Bryksa, president and CEO of Crescent Point, commented, "The sale of the Uinta Basin and certain conventional assets is accretive for our shareholders and aligned with the key criteria we established for our asset portfolio. These transactions are a considerable step forward in our ongoing plan to focus our asset base."

Financial Sector

Barclays PLC produced a strong set of Q3 2019 numbers. PBT Q3 2019 was £246 million. Excluding litigation, PBT Q3 2019 was £1,814 million or +18% (+£271 million) ahead. Pre-provision £2,248 million was +10% (+£208 million) with revenue the key area of outperformance. Year/year income was +7% and costs were -1%. Litigation costs included £1.4 billion (range £1.2 billion - £1.6 billion). Overall, a much better set of numbers from Barclays. Much of the outperformance was in the Investment Banking Division, but the performance of the UK Retail stood out (revenue +4%; costs -7% on a quarter/quarter basis). CET- 1 was at 13.4%, beating consensus of 13.0% but was driven by change in treatment of operational risk standing at +0.6% even as the regulatory minimum increased only +0.3% to 12.0%. Management increased target by +0.5% to 13.5%. Q3 2019 Tangible NAV was at 274 pence per share up 7 pence per share (+3%) ahead of consensus of 267 pence per share. The shares are not expensive relative to a 2021 forward price-to-earnings ratio estimate of 7.6x. Price /Tangible Book Value ratio was estimated at 0.6x in 2019. Whilst immaterial for profits, Barclays has faced a backlash recently in the media and amongst clients and politicians after its abrupt decision to stop customers withdrawing money from Post Office branches as of January 2020. Last night, Barclays changed its mind, and will continue to allow withdrawals for the next 3 years.

HSBC Holdings PLC – Q3 2019 adjusted profit before tax (PBT) of $5.35 billion was 6% below consensus, weaker on revenues and provisions (which more than offset a better cost performance). Revenues (adjusted) of $13.27 billion missed consensus by 4%. Adjusted Net Interest Income of $7.69 billion was flat quarter/quarter, but missed consensus by 1%, with -6bps quarter/quarter. Net Interest Margin contracted to 1.56% (versus consensus of 1.61%). Costs (adjusted) of $7.55 billion were around 7% better than consensus. Note though that headline / reported costs were a lower beat versus consensus, as Q3 2019 also included $488 million of customer redress (of which $388 million for Principal Protected Insurance), and $140 million of restructuring charges. Provisions of $883 million were surprisingly 31% worse than consensus. This included higher provisions in Hong Kong, partly to reflect the worse economic outlook. Beyond that, unsecured lending in the US, as well as the Mexican and UK businesses saw higher charges. CET- 1 ratio was flat quarter/quarter at 14.3%, matching consensus (despite lower Risk Weighted Assets quarter/quarter). Tangible NAV per share fell 2% quarter/quarter to $7.02, missing consensus by 1.5%.HSBC have officially dropped their ROTE target in 2020, after admitting in the first half of 2019 that the outlook had changed. Also, no mention now of "positive adjusted jaws" as a financial target. HSBC mention in its slide-deck of various "business update" plans, to "improve returns, rebalance capital allocation away from low-return businesses" and "redeploy capital to faster growth and higher return markets". Continental Europe and geographies within Global Banking & Markets are cited as examples of failing to produce acceptable returns. The cost base will be adjusted for this. Further citing that "significant charges", including goodwill impairments, could be booked in Q4 2019 or beyond from these initiatives (or if the revenue environment keeps worsening). Moreover, the slide-deck seems to drop references to future share buybacks, but the dividend and CET-1 commentary is broadly the same.

Royal Bank of Canada - Bloomberg reported today that Royal Bank of Canada set a goal nine years ago to become a Top 10 investment bank in the U.S. -- but cracking Wall Street's upper echelons for advising on takeovers had proved elusive. Until now. RBC Capital Markets has risen to the No.10 ranking for advising on announced U.S. mergers and acquisitions this year, its highest standing ever, according to data compiled by Bloomberg. The firm has 9.9% market share, with 72 deals valued at about $179 billion as of October 21, 2019.

Activist Influenced Companies

AT&T Inc. – unveiled a three-year strategic plan that included adding two new board members, selling off up to $10 billion worth of non-core businesses next year and paying off all its debt from the purchase of Time Warner Inc., bowing to pressure from activist investor Elliott Capital Management LLC. Elliott Management revealed a $3.2-billion stake in AT&T in September 2019. In a letter to shareholders supporting the plan, Elliott Management said AT&T would evaluate all potential CEO candidates and separate the role of Chairman and CEO. The company expects to generate $14 billion through asset sales and other initiatives by the end of this year. It reduced its net debt by $12.7 billion so far this year. Total operating revenue in Q3 2019 fell to $44.59 billion from $45.74 billion, a year earlier, missing analyst expectations of $45 billion. Excluding extraordinary items, AT&T earned 94 cents per share, above analysts' estimates of 93 cents.

Brookfield Business Partners L.P. – Canada's regulators are scrutinizing the Genworth Financial, Inc. deal, which would have allowed Genworth to sell its majority stake in the Canadian unit to asset manager Brookfield Business Partners. Regulators are focusing on national security matters, including safeguarding customer data after the deal closes. Genworth, which was spun out of General Electric Company in 2004, announced the $1.81 billion deal with Brookfield in August 2019. The deal is part of a move by Genworth to close its own pending merger with Beijing-based investment firm China Oceanwide Holdings Group Co., announced in 2016.

Pershing Square Holdings Ltd. – The Howard Hughes Corporation, which counts activist investor William Ackman as chairman, said it would sell about $2 billion of non-core assets following a strategic review and announced a management reshuffle. Ackman, said in a conference call with analysts that the company would only consider selling itself if a substantial premium was offered. The company is currently valued at over $5 billion. The company named Paul Layne as CEO, effective immediately. He will replace David Weinreb who, along with the president Grant Herlitz, will step down from the company. Layne was most recently the president of the company's Central Region, which include properties in The Woodlands, The Woodlands Hills and Bridgeland in Texas. Ackman said Layne's appointment, along with the company's headquarter move from Dallas to Houston, will enable Howard Hughes to be more profitable and free-cash-flow-generative. Howard Hughes was formed in 2010 as a tax-free spinoff from General Growth Properties.

Dividend Payers

Bunzl PLC - Organic sales growth was close to flat in Q2 2019 and has fallen to a decline of 1% in Q3 2019. The main factor in the reduction was due to Walmart's negotiated price cuts with its manufacturers. This alone is around a 0.8% drag. The other factor is more sluggish GDP growth across the regions in which the company operates. Organic growth of -1% is slightly weaker than estimates. Management guidance of unchanged full year expectations therefore requires margins to make up for modestly lower organic growth. Recent FX moves and the strength of the pound knocks off around 1.5% from fiscal year 2019 operating profit. No new acquisitions are announced, which is a bit disappointing. This leaves spend for the year at £100 million compared to the £300 million average in recent years. The pipeline continues to be described as active with discussions ongoing.

GEA Group AG reported Q3 2019 order intake of €1,255 million with sales of €1,235 million (+2% versus consensus). Adjusted EBITDA came in at €143 million (+3% versus consensus), including €3 million of "special effects" of -€3 million (legal settlement costs). 2019 revenue guidance nudged up to "on par with 2018" from earlier "moderately lower" whilst adjusted EBITDA guidance remains unchanged at €450-490 million (consensus: €474 million) and ROCE guidance also unchanged at 8.5-10.5%. Net working capital of €941 million or 19.2% of last twelve month sales (Q3 2018: 18.9%) – still higher year/year, but sequential momentum is slowing.

WPP PLC Q3 2019 net sales grew 3.7% (excluding Kantar, the new basis for reporting) to €2,725 million, up 0.5% on an organic basis (110bps higher than company-compiled consensus). By geography, the UK grew 3.1% organically to €334 million (240bps ahead of ZoneFinance consensus), Western Continental Europe grew 1.7% organically (50bps ahead of consensus), and RoW grew 4.0% organically (250bps ahead of consensus). In North America (WPP's largest market) net sales declined -3.5% on an organic basis, 50bps ahead of consensus forecasts, an improvement on first half 2019 organic decline of -6.9%. This is all unexpected and we believe is positive. Management is not changing 2019 targets of -1.5% to 2.0% organic decline and -100bp operating margin decline ("Our growth in Q3 2019 is encouraging but we are focused on delivering these longer-term goals and know there will be twists and turns along the way. Our guidance for 2019 remains unchanged"). The Q4 2019 implied growth however becomes easier (-2.3% to achieve -1.5%; -4.0% to achieve -2.0%). Consensus is already at -1.4% therefore organic upgrades are not necessarily forthcoming but confidence should increase. There is also a significant catalyst remaining, namely how WPP will return the Kantar proceeds to shareholders - a buyback or a special dividend with share consolidation. A buyback would create buying pressure but also offers downside protection in case of a recession.

Economic Conditions

Canada - minority rules… Canadians voted in the 43rd federal election and results show that the incumbent **Liberal government has secured a minority mandate** after holding majority status for the past four years. The Liberals took 157 seats, down from 177 at dissolution (and 184 in the 2015 election), leaving them shy of the 170 needed to govern freely. So, they will need to lean on support from another party. The Conservatives won 121 seats, while the Bloc Québécois and NDP took 32 and 24, respectively. The Greens took 3 seats, and Jody Wilson-Raybould won her seat as an independent. The Conservatives actually won the popular vote with 34.4% support, ahead of 33.1% for the Liberals—the latter was down from 39.5% in the prior election.

U.S. durable goods orders fell a larger-than-expected 1.1% in September (most since May), dragged down by the transportation sector (in part due to the GM strike), while orders excluding transportation fell 0.3%. Granted there were plenty of special factors, aside from the GM strike and Dorian—during the month that likely influenced business sentiment just a little. On September 1st, 2019 the 15% tariff on over $100 billion worth of Chinese imports took effect, as did the 5%-10% tariffs on American goods imposed by China. The U.S./China trade war had its ups and downs, but the U.S. agreed to hold off on raising tariffs on October 1st, 2019; instead, would do so October 15, 2019 (and subsequently held off on the October 15, 2019 move). The U.S. and Japan signed Phase 1 of their trade deal, but the U.S. /EU trade dispute began to take form.

Financial Conditions

European Central Bank President Mario Draghi's final press conference seemed to be more relaxed than usual, with the questions not only forward-looking but reflective in nature, on the last eight years at the helm. Of no surprise, there were **no changes** made to policy. The key rates remained as is with the **Refi rate** at 0.00%, **Marginal lending facility** at 0.25% and the **Deposit rate** at -0.50%. And, that is where it is believed they will stay, or lower, until inflation "robustly converges" around the 2%-or-below target. As announced last month, net asset purchases of €20 billion/month will start on November 1st, 2019, and will continue for as long as necessary. The purchases will end "shortly before it starts raising the key ECB interest rates".

The U.S. 2 year/10 year treasury spread is now 0.19% and the U.K.'s 2 year/10 year treasury spread is 0.17% - 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 3.75% (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 12.89 (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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