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. February 3, 2020

Owner Operated Companies

Berkshire Hathaway Inc. agreed to sell its newspaper business to Lee Enterprises Inc. for $140 million in cash, abandoning an industry the billionaire investor, Warren Buffett, had long defended even as its financial prospects deteriorated. The transaction includes 31 daily newspapers and 49 weeklies including the daily Omaha World-Herald in Berkshire's hometown in Nebraska, Buffalo News in New York, Richmond Times-Dispatch in Virginia and Tulsa World in Oklahoma. Lee owns 50 daily newspapers including the St. Louis Post-Dispatch, and has since July 2018 managed Berkshire's papers other than the Buffalo News, which Berkshire bought in 1977. As part of the transaction, Berkshire will also become Lee's sole lender, refinancing the Davenport, Iowa-based company's existing debt and lending $576 million at a 9% interest rate. A closing is expected in mid-March 2020.

Brookfield Asset Management Inc. received the go-ahead from Brazilian antitrust regulator, the Administrative Council for Economic Defense (CADE), for certain solar energy projects in the country's northeast. The solar power plants, to be built in the state of Ceará, will have total capacity to produce 278 megawatts (MW) of electricity, according to a description of the projects in CADE's decision. The move underscores Brookfield's drive to expand its presence in Brazil's electricity sector, where it operates hydropower dams, wind farms and electricity transmission assets. Construction of the projects will begin in the first half of 2020 and be completed by the end of 2021. After the work is finished, Brookfield will have its generation capacity in Brazil expanded to 1.9 gigawatts (GW). The company has 66 assets in the South American country, including 43 hydroelectric plants, 19 wind farms and 4 biofuel co-generation plants.

Danaher Corporation announced results for Q4 2019 and FY2019, which included net earnings of $792.9 million, or $1.07 per diluted share which represents an 11.5% year/year increase from the comparable 2018 period. Non-GAAP adjusted diluted net earnings per share for the Q4 2019 were $1.28, which represents a 12.5% increase over the comparable 2018 period. For Q4 2019, revenues increased 5.5% year/year to $4.9 billion, with non-GAAP core revenue growth of 6.0%. For FY2019, net earnings were $2.4 billion, or $3.26 per diluted share which represents a 4.0% year/year decrease. Non-GAAP adjusted diluted net earnings per share for 2019 were $4.42 per share, which represents a 9.0% increase over the comparable 2018 amount. Revenues for FY2019 increased 5.0% to $17.9 billion, with non-GAAP core revenue growth of 6.0%. For FY2020, Danaher anticipates that diluted net earnings per share will be in the range of $3.96 to $4.06 and non-GAAP adjusted diluted net earnings per share will be $4.80 to $4.90, which assumes non-GAAP core revenue growth of approximately 5.0%. These estimated results do not include the impact of earnings from the pending General Electric (GE) Biopharma acquisition, which is expected to close in Q1 2020.Thomas P. Joyce, Jr., President and Chief Executive Officer, stated, 'Through a combination of organic and inorganic initiatives, we have transformed Danaher into a higher growth, higher margin and higher recurring revenue company with leading positions in attractive end-markets. Our portfolio today -combined with the power of the Danaher Business System - positions us well to continue to deliver long-term shareholder value.'

Facebook, Inc. reported Q4 2019 results, which included revenue growth of 25%, beating analysts' expectations of a slowdown to 23%. But the company reported total costs and expenses increased 34% to $12.22 billion in Q4 2019, more than double the 14% that analysts had forecast and impacting the operating margins, which were at 42% in Q4 2019 down from 46% a year earlier. It also announced it had reached a $550 million settlement in principle of an Illinois lawsuit that claimed it illegally collected and stored biometric data for millions of users without their consent. Facebook, the world's second-biggest seller of online ads, has been under scrutiny worldwide in recent years over its privacy practices. The company addressed those issues starting in mid-2018 following repeated scandals, causing growth in expenses to surge by more than 100% for several quarters as it hired privacy staff and invested in content moderation. That investment began declining last year, signalling Facebook could be largely finished building out its new systems and beginning to find efficiencies that could reduce costs further. Monthly users of Facebook's core social network climbed 8% to 2.5 billion, while 2.9 billion people used one of its apps - Facebook, WhatsApp, Instagram or Messenger - each month.

Energy Sector

Saudi Arabia is reportedly, considering deeper crude oil production cuts to address the temporary dip in demand due to the coronavirus outbreak in China and related suppressed travel. A technical meeting is set up this week with representatives of OPEC nations and non-OPEC participants in the current production cuts with the purpose of producing recommendations to members. A decision is likely to be taken mid-February 2020.

Royal Dutch Shell PLC reported Q4 2019 results with a -9% miss at the net income line ($2.93 billion vs. the consensus of $3.2 billion) driven by weak Integrated Gas and Downstream segment performance. Cash flow from operations excluding working capital actually looked ok vs. expectations, coming in at $11.2 billion vs. Barclays' estimate of $10.9 billion. The main focus however is going to be this upcoming quarter's buyback tranche which has been announced at $1 billion. As a reminder, to hit the $25 billion buyback promised by the end of this year approximately $10 billion of shares need to be bought. Most investors I had spoken with expected some form of buyback slowdown, where a $1 billion buyback looks to be below even the most bearish of estimates.

Financial Sector

The Goldman Sachs Group, Inc. released new financial targets for higher returns at its first-ever investor day. The company said that ROTCE will exceed 14% within three years. Last year, the firm posted ROTCE of 10.6%, brought down in part by $1.24 billion in legal costs. Goldman said that in the longer term, returns would be in the "mid-teens or higher" as its nascent businesses, including in retail banking, mature. Those return targets are similar to those given this month by its rival Morgan Stanley.

Activist Influenced Companies

Nothing significant to report.

Dividend Payers

GEA Group AG – The 2019 adjusted EBITDA guidance has been narrowed to €470-480 million (earlier €450-490 million). On the company's recent conference call, management said it expects that to come in at the high end of the range, i.e. closer to €480 million. Nothing was learnt on the conference call about the charges taken "above the line" in Q4 2019, i.e. included in the €470-480 million FY 2019 range, but, it's possible the company will be burdened by further charges (as management looks to clear the decks ahead of 2020 and the implementation of the new organizational structure as of January 1, 2020. Barclays continues to forecast adjusted EBITDA of €561 million for FY 2020 versus consensus at €537 million (up from €506 million in April 2019). In addition to this, the company has taken a €248 million non-cash impairment charge in relation to the goodwill of the Pavan Group, which was acquired in November 2017 (under prior management). The company says it anticipates Pavan's development will continue to be "significantly below the business plan assumed at the time of the acquisition", and this has led to the complete impairment of the goodwill of the Pavan Group.

Mondelez International Inc.'s long term goal is to deliver attractive dollar profit increases, driven by solid top-line growth, as well as FCF expansion, by focusing its business on three clear priorities: 1) accelerate top line growth with more consumer centric marketing and sales, creating more demand for the company's brands and products; 2) an obsession with operational excellence to optimize demand fulfillment and drive efficiency and lower costs, translating that extra demand into sales and profit; and 3) change in corporate culture from short-term cost focus to a purpose-driven, long-term growth focus, creating more opportunities to grow the business. Mondelez's overall thinking is that, as it invested more in 2019, it will get higher top-line growth (volume growth together with pricing), which will lead to solid gross profit growth and then moving forward about half of gross profit and overhead savings will flow to the bottom line and the other half will be reinvested, resulting in increased investment every year.

Economic Conditions

Global Economy - Housing markets across the world, from the U.K. to China, are losing steam, holding back prospects for the global economy that last year grew at its slowest rate since the financial crisis. Across 23 countries, an index of inflation-adjusted home prices compiled by the Federal Reserve Bank of Dallas grew 1.8 per cent in the third quarter of 2019 from a year earlier, down from a recent peak of 4.3 per cent in 2016, according to an Oxford Economics analysis. In 18 large economies, worldwide residential investment dropped on a year/year basis for four consecutive quarters through September 2019, the longest stretch of declines since the 2008-09 crisis, according to the Oxford Economics' analysis of national accounts.

U.S. Interest Rates - Policymakers at the Federal Reserve voted, as expected, to keep the key U.S. interest rate unchanged. Markets were little changed as investors awaited comments from Fed chairman Jerome Powell. In a statement, the policy committee said: "Job gains have been solid, on average, in recent months, and the unemployment rate has remained low. Although household spending has been rising at a moderate pace, business fixed investment and exports remain weak." As expected, the economic assessment applied a less robust description of household spending… now "moderate" versus "strong" before. And, interestingly, in the discussion on why the current stance of monetary policy was appropriate, the Federal Open Market Committee (FOMC) said it was because it would lead to inflation "returning to" as opposed to remaining "near" its symmetric 2% target. When asked about this in the presser, Chair Powell said it was to avoid any misinterpretation that the FOMC was somehow comfortable with a slight undershoot of 2%.

U.S. New Home Sales - New single-family home sales slipped 0.4% in December 2019 to 694,000 units (annualized). This marked the third consecutive monthly drop since hitting near-cycle highs in September 2019. The 725,000 reading at the time was the second highest level (the highest was 729,000 in June) in almost a dozen years, so some spillage isn't surprising - particularly for this notoriously volatile series.

With record-low, existing single-family homes available for sale (the record dates back in 1982), some would-be resale buyers are turning to the new home segment. It's one reason why homebuilders saw cycle-high sales activity in December 2019; the 76 reading for the NAHB's Housing Activity Index was also the third highest result in its 34-year history. The index reflects not only in-month unit sales, but also sales expected over the next six months and the traffic of prospective buyers. With the January reading at a still-lofty 75, new home sales are destined to rebound. The bottom line is that the demand for homes (both new and existing) remains sturdy given improved affordability, solid job and income growth, relatively low interest rates, strong household balance sheets and decent consumer confidence.

U.S. Durable Goods - The headline U.S. durable goods orders jumped 2.4% in December 2019, which was above-expected and the biggest increase in 1.5 years. It was all due to defense capital goods (+90.2%), and besides, November was revised down to -3.1% from -2.1%, previously. The sectors were mixed where the gains were in communications, computers/electronics and transportation equipment were offset by losses in machinery, computer/related, and electrical appliances. Non-defense aircraft and parts were due to Boeing where it was down 74.7%. However, inventories of non-defense capital goods excluding aircraft rose for the first time in a few months (+0.4%).

United Kingdom – The Bank of England left interest rates unchanged at 0.75%. The vote wasn't even close, as the usual doves—Jonathan Haskel and Michael Saunders—dissented for the third meeting in a row, voting for a 25 basis point rate cut (citing the usual factors) but the rest opted to stay the course. Even Silvana Tenreyo, who mentioned three weeks ago of a possible rate cut in "coming months" and Gertjan Vlieghe, who sounded impatient a few weeks ago when he declared that "I really need to see an imminent and significant improvement in the U.K. data to justify waiting a little bit longer", decided to go with the flow. These particular policymakers are important because it was their comments, along with Governor Mark Carney who mentioned "if evidence builds that the weakness in activity could persist, risk management considerations would favour a relatively prompt response", that prompted many to expect a rate cut. It was only those words that prompted this expectation and not the data (there's been a post-election bounce), and not the timing (there's fiscal stimulus on the way so no rush).

Financial Conditions

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 0.04% - 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 3.51% (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 3.9 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 17.94 (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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