News Highlights

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PORTLAND INVESTMENT COUNSEL®

Our views on economic and other events and their expected impact on investments. March 2, 2020

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Owner Operated Companies

Brookfield Asset Management – Cincinnati Bell Inc. announced that it has amended its definitive merger agreement with Brookfield Infrastructure and its institutional partners (collectively referred to as "Brookfield") to increase the consideration payable to holders of outstanding shares of Cincinnati Bell common stock to $12.50 per share in cash from $10.50 per share in cash, which values the transaction at approximately $2.745 billion, including debt. The revised transaction price represents a 62% premium to the closing per share price of $7.72 on December 20, 2019, the last trading day prior to the date when the merger agreement was entered into. The Transaction is subject to certain customary closing conditions, including the approval by Cincinnati Bell's shareholders, expiration or termination of the waiting period under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 and certain regulatory approvals, and is expected to close by the end of 2020.

Energy Sector

Whitecap Resources Inc. reported its operating and audited financial results for the quarter and year ended December 31, 2019. Results included average production of 71,050 boed on capital expenditures of $404 million compared to 70,000 - 72,000 boed on capital expenditures of $425 - $475 million as press released on December 18, 2018. Whitecap subsequently reduced its capital budget on August 26, 2019 to $400 million with no change to 2019 average production. The company reduced its net debt by $103.1 million. The company's commitment to returning capital to shareholders in 2019 resulted in $19.6 million spent on share repurchases and a 5.6% increase to the annual dividend with total dividends paid in 2019 of $138.3 million. The company remained focused on profitably converting undeveloped reserves to proved developed reserves (PDP) and funds flow and, at the same time, growing total proved (TP) and total proved plus probable (TPP) reserves to support future funds flow growth. Undeveloped reserves were converted to PDP reserves and funds flow at a low cost of $14.33/boe, resulting in a very profitable recycle ratio of 2.1 times. PDP, TP and TPP reserves increased per debt adjusted share by 7%, 9% and 11%, respectively. As part of its commitment to responsible development, Whitecap operates one of the largest carbon capture, utilization and storage (CCUS) projects in the world. At Weyburn, it stores 1.8 million tonnes of CO_2 annually which is more CO_2 than it emits corporately on an annual basis. Funds flow was $184.5 million ($0.45 per share) compared to $138.8 million ($0.33 per share) in the prior year quarter, an increase of 33%. Operating netbacks improved to $30.34/boe compared to $24.03/boe in the prior year quarter primarily due to higher realized crude oil prices.

Financial Sector

The Bank of Montreal (BMO) reported adjusted cash EPS of $2.41 in the quarter, which was above consensus of $2.37. The quarterly dividend was unchanged at $1.06/share, as expected, while the bank's adjusted ROE was unchanged sequentially at 13.5%. Capital Markets had a very strong quarter, beating consensus estimate by a sizable $0.15/share. That was consistent with the other large Canadian banks that have reported Q1 results so far. Canadian Personal & Commercial (P&C) Banking was also ahead of expectations (+$0.05/share) as net interest margins held up well (down only 1 basis point quarter/quarter), while Wealth Management was in-line. Partly offsetting was a weak result in U.S. P&C Banking (-$0.07/share), which was adversely impacted by elevated loan loss provisions (in the commercial portfolio), although that was partly offset by a relatively flat net interest margin that was much better than management's guidance last quarter for a 10 basis points (bps) sequential decline. The Corporate segment had an abnormally high loss in Q1, resulting in a $0.06/share drag vs. expectations. Loan losses were higher than expected ($349 million), which showed up largely in the U.S. P&C segment (PCLs overall were a $0.10/share drag). Within the commercial portfolio, losses were particularly elevated in the Oil & Gas book, which remains a lingering concern in our view.

The Bank of Nova Scotia (BNS) reported Q1 Fiscal Year 2020 adjusted cash EPS of $1.83, which was above consensus of $1.75. The quarterly dividend was unchanged at $0.90, while adjusted ROE in the quarter was 13.9%. Capital Markets was the big positive outlier in the quarter as adjusted earnings of $451 million comfortably beat both our expectations and consensus estimates. Canadian Banking was also slightly better than expected, while International Banking was a sizable drag, and Global Wealth missed modestly (the 'Other' segment was a positive in the quarter). Adjusted earnings for International Banking (according to management's definition) were down 15% sequentially and 17% year/year, which was not a surprise given the bank's numerous dispositions. What was surprising was the fact that earnings fell modestly (down 4% quarter/quarter and 1% year/year) even when excluding divested operations. That weak result was largely related to a decline in Mexico, which continued to face macroeconomic headwinds in the quarter. Overall, the Provisions for Credit losses ratio of 60 bps, including the IFRS-9 related addition to allowance for credit losses, or 51 bps excluding this item, was up from 47 bps last year (prior period benefited from recoveries). Notably, gross impaired loan balances were down 10% year/year or 13 bps to 77 bps, helped by divestitures in International Banking. The capital CET 1 ratio is 11.4%, which we believe positions the bank favorably for continued share buybacks (repurchased 3.6 million in Q1 2020).

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The Canadian Imperial Bank of Commerce (CIBC) delivered adjusted cash EPS of $3.24 (+8% year/year), significantly beating consensus of $3.00. Reported EPS was $2.62 and impacted by two items: (1) $250 million after-tax (-$0.56 EPS) restructuring charge mainly related to employee severance; and (2) $21 million after-tax impact (-$0.05) related to amortization of acquisition-related intangible assets. Adjusted EPS mainly benefited from better credit and Net Interest Margin (NIM) (on both sides of the border) and a rebound in Capital markets (adjusted Net Income +63% year/year). We believe the restructuring charge is not too surprising (based on a media report prior to the quarter). CET ratio of 11.3% (-28 bps quarter/quarter) was below consensus at 11.6%. Strong earnings, net of dividends (+33 bps), were more than offset by the restructuring charge (-10 bps), Risk Weighted Assets increase (-36 bps), regulatory changes (e.g. IFRS 16) and share repurchases (-7 bps; about 1.5 million shares in fiscal Q1). If we include the expected sale of its controlling interest in CIBC FirstCaribbean (FCIB), CIBC's pro-forma CET 1 ratio would be 11.7%. The bank announced a dividend increase of 1.4% (in line) with the pattern of raising its dividend every other quarter. Total bank Provisions for Credit Losses were $261million (26 bps; -23% year/year), well below consensus of $328 million. Key segment highlights: **Canadian Personal and Small Business Banking**. Adjusted Net Income declined 2% year/year (fiscal Q4: -10%). Revenue growth was up 2% year/year as loans were flat (compared to deposits +6%), while NIM came in stable (+9 bps year/year). Adjusted expenses increased 5% year/year. Residential mortgages were flat year/year (still well behind peer growth). **Canadian Commercial Banking and Wealth Management**. Adj. earnings increased 7% year/year (fiscal Q4: -8%) mainly driven by lower credit provisions (-19% year/year). Commercial volume growth (+9% year/year) and NIM of 3.22% (+14 bps quarter/quarter) contributed towards revenue growth of 7% year/year. Expenses rose 9%. **US Commercial and Wealth Management**. Adjusted Net Income was up 6% year/year (fiscal Q4: 37%) driven by double-digit loan growth (+18% year/year) and better margin expectations (NIM of 3.02% up 3 bps quarter/quarter vs. prior guidance of few bps sequential decline). Total credit provisions (PCL ratio of 15 bps) decreased 6% year/year. **Capital Markets**. Adj. earnings rose 63% year/year (fiscal Q4: -3%) benefiting from higher trading & financing activities and reversal of credit. Revenue increased 22% year/year.

Prudential PLC - last week Reuters reported that U.S. activist hedge fund Third Point has built up a stake worth more than $2 billion in Prudential and is calling for changes in the group structure, including for the firm to:

a) split its Asian business (PCA) from its U.S. life insurance operations (Jackson National [JNL]) into 2 standalone, publicly-listed companies (with primary headquarters in Hong Kong and Michigan respectively, and local management / boards);

b) allocate capital in distinct ways at each - in Asia, more reinvestment of cash and potentially increasing its Chinese exposure, while a different approach in JNL to strengthen its balance sheet;

c) eliminate central / Head Office costs (notably those in the UK), to boost earnings.

A $2 billion stake equates to just below 5% of Prudential's share capital, making Third Point the #2 shareholder (behind BlackRock). There has long been speculation over Prudential's group structure. This intensified into and after the M&G demerger which was executed last year, and which left the residual Prudential with the Asian and U.S. businesses – optically not natural companions (with Asia faster growth, and JNL throwing off cash but with U.S. life insurers' valuations fairly subdued at present. Clearly the intervention of Third Point may well accelerate Prudential's thinking, and lead to a greater need for management to articulate its strategic thinking with fiscal year 2019 results on March 11th (as the company alluded to in its brief response).....although we strongly doubt that the reality of a further Prudential break-up will be as simple as perhaps it may read on paper.

Activist Influenced Companies

Nomad Foods Limited posted its quarterly earnings results, which included reported $0.32 earnings per share for the quarter. The business had revenue of $628.00 million during the quarter, compared to the consensus estimate of $626.95 million. Nomad Foods had a net margin of 6.59% and a return on equity of 9.58%. Nomad Foods' revenue for the quarter was up 2.1% compared to the same quarter last year. During the same period in the previous year, the firm posted $0.29 earnings per share. Nomad Foods updated its Fiscal Year (FY) 2020 Pre-Market guidance to 1.32-1.34 EPS and its FY 2020 guidance to 1.19-1.21 EPS. Stéfan Descheemaeker, Nomad Foods' Chief Executive Officer, stated, 'We are pleased to report another year of solid growth. In 2019, we achieved a third consecutive year of organic revenue growth and exceeded our guidance despite certain external challenges, namely raw material inflation and Brexit uncertainty. We enter 2020 well positioned to deliver another year of profitable growth. Our expansion into Green Cuisine presents an attractive incremental growth opportunity within the fast growing meat-free segment. We also expect our supply chain productivity program to begin to drive meaningful cost savings and fuel growth. Finally, our strong balance sheet and cash flow provide us with the resources and flexibility to execute on our M&A strategy.' Noam Gottesman, Nomad Foods' Co-Chairman and Founder, commented, 'Fourth quarter and full year results reflect the strength and durability of our business model. We have an exciting year ahead and remain well positioned to sustain our growth and continue to meet the needs of our consumers and our retail partners. We look forward to achieving another year of organic revenue growth and remain actively focused on acquisitions which, based on our balance sheet, have the potential to translate into significant earnings power.'

Dividend Payers

Bunzl PLC - A good finish to the year in our view with EBITA 4% better than expected in the second half and free cash flow 10% above forecast. Full year constant currency revenue growth of 1%, FY 2019 Organic growth: -0.2% vs. -1% in Q3/Q4. FY 2019 EBITA: £653 million is 4% ahead in the second half of 2019. In the region of £2-3 million was a gain on property and won't repeat in 2020. FY 2019 EBITA margin: 7.0%. EPS came in 3% ahead, mainly due to lower interest costs, while Net debt: £1,727 million, 7% better than expectations. Two new acquisitions were announced with annualized revenue of approximately £60 million (0.6% of group sales). Medcorp, a healthcare products distributor in Brazil (approx. £11 million of revenue) and ICM A/S, a personal protection equipment distributor in Denmark with revenue of approx. £48 million. Management says the acquisition pipeline is promising with a number of discussions taking place. The outlook statement is cautious, understandably, but there are no new notable negatives other than potential disruption from Coronavirus. North America is expected to remain weak in the first half of 2020 due to lower sales to the group's largest grocery customer, although management will continue to focus on operating costs in the region. In Continental Europe and Rest of the World, trading is expected to improve, supported by a mix of organic and acquisition growth. Growth in the UK is expected to be limited given uncertain economic and market conditions. Regionally, at the revenue level UK and Rest of World came in ahead of our expectations while North America and Europe were slightly weaker. At the EBITA level, all regions other than Europe came in ahead of expectations. The shares are trading on approx. 16x 2020 Price/Earnings, with about 3% dividend yield and about 7% free cash flow yield.

Mondelez International, Inc. (MDLZ) announced an agreement to acquire a significant majority interest in Give & Go, a manufacturer of fully-finished sweet baked goods, with significant exposure to the in-store bakery space. The deal value is reported at $1.2 billion. MDLZ expects to close the deal in Q2 2020. MDLZ categorizes this acquisition as "bolt-on" in nature and the company has recently spoken about entering into faster-growing snacking adjacencies. From a strategic standpoint, we believe that in-store bakery is growing more quickly and is becoming increasingly important for retailers as it is viewed as a low-labour play which drives traffic and net sales. We would expect MDLZ to be able to help continue to grow the business by providing access to its distribution platforms, whether at retail or foodservice, and we also see an opportunity for cross branding given MDLZ's recent push into chocobakery. MDLZ notes that the company generated net revenues of approximately $500 million in 2019. While MDLZ does have some room on its balance sheet as it stands now and has the ability to flex commercial paper to finance this deal, we would not be surprised if the company ultimately ended up using a portion of its coffee investment to help fund the deal, which MDLZ has previously discussed as a lever to finance future snacking acquisitions.

ThyssenKrupp AG (TK) announced it will sell its Elevator unit to a consortium led by Advent International, Cinven, RAG Foundation for €16.9 billion. Selling was not only the best outcome for investors in our view, with a transaction price of approximately €1.4 billion above market expectations (or €2.25/share), but also avoided paying approx. €150-350 million in taxes (necessary in case of an IPO). With the transaction, TK will reach net cash for the first time since 2006. Gross debt-to-equity ratio will improve to 49% (from about 650% pre-transaction) for FY 2019/20 on a pro forma basis. Cash proceeds will be used to pay down debt, fund pensions, and for restructuring with more details to be given in May 2020, with the group's presentation of the new strategy.

Economic Conditions

Coronavirus fears continue to dominate headlines but the markets have shifted to focus on what the response will be from central banks globally. Despite cases in China subsiding the new hotbed of breakouts are continuing to see climbing cases. Italy recorded a 50% jump in one day and South Korea reported hundreds of more cases. New York reported its first case (a woman in her 30s who caught the virus during a recent trip to Iran) as the U.S. confirmed the latest two casualties to the virus in Washington (both deaths at the same hospital and residents of the same nursing home). Delta Airlines and American Airlines have suspended flights to Northern Italy. The White House Administration has ordered an extra 35 million masks a month but urged Americans to not buy the masks as they are needed by healthcare workers. Currently the death toll exceeds 3,000 with 87,000 confirmed cases and 2,000 cases in Europe. Expectations of central bank response is now high. The markets see the central bank cutting 25 bps Tuesday and have priced in 32 bps of cuts from the Bank of Canada on Wednesday. Fed Chair Powell said on Friday that the coronavirus is posing evolving risks to the U.S. economy and that the Fed are monitoring the implications on the economic outlook. Powell says that the Fed will "act as appropriate" to support the economy. Fed Futures have now fully priced in a cut for the March meeting and 75 bps of cuts by the June meeting. 10 Year Treasuries are trading at 1.06% and the 2 year is trading at 0.78% this morning. With that, equities looks to have stabilized a little.

Canada - The Globe & Mail reported on Friday that the Canadian economy nearly ground to a halt in the final quarter of 2019, and the few flickers of momentum could be short-lived as the world contends with the coronavirus outbreak. Real gross domestic product inched up by an annualized 0.3% in the quarter, Statistics Canada reported, matching what the Bank of Canada and private-sector economists had expected. For the year, real GDP rose by 1.6%, marking a slowdown from 2018's 2% pace. But while output perked up in December, the Canadian economy is now grappling with fresh disruptions –including rail blockades and COVID-19 fears – that could hinder any swift recovery to start 2020. As such, an increasing number of market watchers are betting the Bank of Canada will cut interest rates, with traders pricing in an 80-per-cent chance that happens this week. A weak quarter was hardly surprising given a number of temporary disruptions, including the week-long Canadian National Railway Co. strike in November, poor weather in parts of the country and the partial shutdown of the Keystone pipeline in late October and early November after a leak in the United States. The 0.3% gain was the weakest quarterly result since 2016. In particular, business investment and trade activity were notable drags on the economy, with exports falling by an annualized 5.1%. Consumer spending expanded at an annualized 2% rate, or strong enough to ensure that overall growth was positive.

Financial Conditions

The U.S. 2-year/10-year treasury spread is now 0.28% and the U.K.'s 2-year/10-year treasury spread is 0.15% - 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 3.45% (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 41.47 (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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