PORTLAND INVESTMENT COUNSEL®

NEWS HIGHLIGHTS

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OUR VIEWS ON ECONOMIC AND OTHER EVENTS AND THEIR EXPECTED IMPACT ON INVESTMENTS

AUGUST 17, 2020

OWNER OPERATED COMPANIES

GO TO PORTLAND 15 OF 15 ALTERNATIVE FUND

Softbank Group Corp. - Talks between SoftBank chip designer Arm Limited and Nvidia Corporation are accelerating, with a deal expected to be reached by the end of the month according to media reports. Negotiations between the companies have been exclusive for the past two weeks, with exclusivity period expected to last 30 to 45 days. The deal has resurfaced an agreement made between the UK's Takeover Panel and SoftBank that said Arm's headquarters would remain at its base in Cambridge and double UK staff numbers by 2021. It is understood that the UK Government is monitoring the progress of the deal, although since Arm would be being sold to a US company it would almost certainly not raise national security concerns, despite its highly strategic technology.

Softbank Group Corp. – SoftBank Group reported a 12% rise in Q1 net profit at 1.3 trillion yen and announced that the value of the assets has risen since March. For April-June gains, it pointed out to portfolio businesses in e-commerce, food delivery and healthcare growing during the COVID-19 outbreak. Softbank has benefited from a global rally in technology stocks and strong performance of the new public listings like Lemonade Inc. and BigComerce Holdings Inc. At the end of June, Vision Fund's US$ 75.2 billion investment in 86 startups was worth US$ 71.5 billion. SoftBank also recorded gains on the sell-down of assets such as wireless carrier T-Mobile US Inc. following its merger with peer Sprint Corporation. The firm has raised 4.3 trillion yen through asset sales, meeting 95% of its target. It has been using the proceeds for a share buy-back plan which has helped its share price rise 140% from its March lows. Softbank reiterated its commitment to complete the rest of the buyback of approximately 1.5 trillion yen by July 2021.

Reliance Industries Ltd. – Reliance Industries is in talks to acquire online furniture brand Urban Ladder Home Decor Solutions Pvt. Ltd. (Urban Ladder) and milk delivery platform Milkbasket as it looks to strengthen its e-commerce play, according to multiple media reports. The Mukesh Ambani led conglomerate is also said to be in talks to acquire players like e-pharmacy startup NetMed Inc. and lingerie retailer Zivame. The discussions with Urban Ladder have been going on for the last few months and are now at an advanced stage, said four sources briefed on the matter. A deal with Urban Ladder could be pegged at around $30 million, including further infusion in the business and earn-out for the management team, said one of the sources. Milkbasket's previous talks with firms like Bigbasket and Amazon India haven't fructified due to valuation mismatch, according to one of the sources. Milkbasket are negotiating for a better valuation than previous suitors and are thus in discussions with Reliance Industries. The recent capital infusion of $5 million has bought them extra time, according to people familiar with the situation. Since the pandemic started, grocery orders online have increased, including daily essentials like milk, bread and eggs. But for players like Milkbasket, which focus on daily essentials, margins are thin as milk is the core product of delivery even though companies have been trying to bundle non-milk products to increase their revenue per order. Improving unit economics has so far been a challenge in this space, triggering consolidation.

DIVIDEND PAYERS

GO TO PORTLAND GLOBAL ALTERNATIVE FUND

GO TO PORTLAND GLOBAL ARISTOCRATS PLUS FUND

Metro Inc. - Q3 results did not deviate much from relatively high expectations with earnings up 15.6%. Additionally, gross margin expansion of 60 basis points (ex International Financial Reporting Standards) was also strong, driven by COVID-19 mix shift to the higher margin conventional banners. Notably, Metro incurred $107 million of COVID-19 costs, of which half related to premium wages and bonuses. Clearly, the impact from COVID-19 is driving significant strength as Q3 was the best quarterly earnings performance on record. That said, with trends starting to normalize, food comparisons slowed to approximately 10% in the first 4 weeks of Q4. Management noted that traffic declines have improved, implying that basket growth has decelerated more than the traffic improvement. While management would not provide e-commerce penetration (despite online food sales almost quadrupling), Metro noted that it is equipped to fulfill delivery orders from 9 Quebec stores and will add a third hub store in Ontario in October, while also adding click and collect to 30 stores in fiscal year 2021. Nonetheless, a concern remains that Metro will not be equipped to serve customers' increasingly omni-channel needs to the same degree as competitors. Further, risk of margin compression is elevated given the need to invest/grow e-commerce while sales are set to slow next year.

GO TO PORTLAND GLOBAL BALANCED FUND

Prudential PLC is to split off its US business, Jackson National Life Insurance Company entirely and reduce its dividend as it prepares to complete the long awaited break-up of the UK's largest insurance company, a move that will leave it focused on its fast-growing operations in Asia and Africa. The company plans to float Jackson in the first half of 2021 before selling its stake down to zero. If market conditions don't facilitate an initial public offering, it will demerge the business directly to shareholders. Until last year, Prudential was spread across three markets but it demerged M&G PLC, it's UK unit, and in June of this year sold 11% of its stake in Jackson to Athene Holding Ltd. for US$ 500 million, so valuing Jackson at US$ 4.5 billion. Prudential reported half year adjusted operating profits down 3% to US$ 2.5 billion although net income fell 54% to US$ 534 million reflecting the impact of volatile financial markets. It intends to pay US$ 0.161 in dividends this year compared to earlier analysts forecasts of around US$ 0.40 (Source: Financial Times).

LIFE SCIENCES

Roche Holding AG announced that Enspryng (satralizumab) received FDA approval for Neuromyelitis Optica Spectrum Disorder (NMOSD). NMOSD, also known as Devic disease, is a rare chronic autoimmune disorder that affects the central nervous system. The timing is in line with expectations (submission accepted October 2019) and Roche expects to launch in two weeks' time. Approval was granted on the positive P3 SAkuraStar and SAkuraSky studies which assessed Enspryng as a monotherapy and in combination with baseline immunosuppressant therapy. This follows the first regulatory approval in Japan, granted on June 29th 2020 and in Canada. European approval is anticipated imminently (Roche filed with EMA August 2019) and submission in China took place in April 2020. Satralizumab is an anti-IL-6 receptor monoclonal antibody which was discovered by Chugai. NMOSD primarily causes damage to the optic nerve and spinal cord, which leads to blindness, muscle weakness and paralysis. NMOSD can be diagnosed through a diagnostic test, however some patients are misdiagnosed with multiple sclerosis (MS) due to similar symptoms. Like MS, there is a higher prevalence of NMOSD in women and both are relapse-based conditions. According to Roche, there are approximately 66,000 patients in the US, EU5 and China combined, of which approximately 47,000 are treated. The majority (approximately 50%) of these patients are in China. This is the third drug approved in NMOSD, following Alexion's Soliris (CD5 inhibitor) and AstraZeneca's spin out Viela Bio's Uplizna (anti-CD19). A key difference is that Roche allowed two populations of NMOSD to enroll into their study (those with NMOSD and a subgroup of aquaporin-4 antibody, AQP4), whereas Alexion/ Viela Bio looked at only patients with AQP4 present. However, Enspryng was only approved to treat AQP4 antibody-positive NMOSD. Analysts note that in clinical studies, those with AQP4 antibody present saw greater efficacy (74% reduction in relapse vs 55% in the monotherapy Enspryng study and 79% reduction in relapse vs 62% in the combination study). Enspryng list price is $190,000 for 13 doses ($14,615 per dose). The first year of treatment requires 15 doses, so costs approximately $220,000. The drug is a subcutaneous injection which patients can administer themselves, unlike Soliris and Uplizna which are both infusions. Dosing of Enspryng is every four weeks following the initial loading dose. This compares with Soliris which is priced at greater-than $500,000 per year. Uplizna has not yet set a price. It's estimated that global peak sales may be up to $950 million, with $500 million of that in the US. NPV CHF 2.28 pershare (less-than 1% of Roche group).

ENERGY SECTOR

Nothing significant to report.

ECONOMIC CONDITIONS

Canada - Ontario's deficit will increase to a record $38.5 billion in 2021, almost double the size predicted in March, and Finance Minister Rod Phillips declared that the province is in a recession as a result of the COVID-19 pandemic. The Progressive Conservative government released its first-quarter financial report which revealed it will now spend $30 billion on its economic recovery plan, up from $17 billion announced in March. The document says the province's gross domestic product declined by 2% in the first quarter, with economists predicting it will fall by 6.6% by the end of the year. "We are in a recession today in Ontario and I would argue across Canada," the Finance Minister said. "We are in for a difficult economic time." The province shed nearly 1.2 million jobs between February and May, "significantly larger than the declines recorded in past recessions," the report said. Mr. Phillips warned that some economic downturns in the province have lasted more than seven years. Further, while Mr. Phillips said the current level of government spending and deficits are not sustainable over the long term, he expressed "cautious optimism" as Ontario gradually reopens its economy. While jobs numbers fell in the early part of the year, the province gained 528,600 in June and July combined, pushing the unemployment rate down to 11.3% at the end of July.

US filings for unemployment insurance fell further in early August. Initial claims were down 228,000 in the week to August 8 (or 156,400 on a not seasonally adjusted basis (NSA)) to 963,000 (or 831,900 on a NSA basis) … that's the first reading below the one million level since March. Continuing claims, which measure those who remain on unemployment insurance and are behind a week, also fell further in the last week of July but the decline has been slower. They were down 604,000 to 15,486,000, the lowest since early April. Yes the levels are still too high (initial claims started 2020 at 212,000) but the direction is critical.

US Consumer Price Index (CPI) - The CPI increased a larger-than-expected 0.6% in July, lifting the annual change 4/10s to 1.0% year/year. This reflected higher gasoline prices (energy prices were broadly up 2.5% month/month) and food prices slipping 0.4% after a three-month surge (not surprisingly, the latter move was led my lower beef prices as previous supply chain disruptions were remedied). Excluding food and energy prices, the core CPI also increased 0.6%, which lifted the annual change 4/10s to 1.6% year/year. The core increase was much larger than expected (the consensus call was 0.2%) reflecting several factors. New and used vehicles prices rose the most in more than a decade, driven more by the latter. Sluggish new sales (despite a strong July rebound) have resulted is relatively lean inventories of used cars and trucks. Motor vehicle insurance premiums posted a record increase for the second consecutive month. Discounts applied during the lockdowns because of reduced driving are being removed. Also, video and audio services along with wireless telephone services both posted record monthly increases. The latter also reflects the removal of pandemic-related concessions. There were broad gains across the prices of both core goods (0.7%) and core services (0.6%), as consumer spending continued to recovery from the recession, and retailers and service-providers realized they don't have to entice as much through price.

US retail sales disappointed with a 1.2% increase in July but there were upward revisions to the prior two month's record gains (combined). And the disappointing headline was due to a 1.2% fall in auto sales, the first in three months. Most of the other major components fared much better. Sales at stores that specialize in electronics & appliances racked up over 20% gains for the third month in a row. There were more sales for health & personal care, as well as clothing and accessories. And, bars and restaurants saw a 5.9% increase but the pace slowed dramatically (May and June were each up approximately30%) as a number of states dialled back their openings. Remember … early in this eventful month, Miami started to change course on its reopenings, bars in Vegas were shut down again, and California shut down indoor dining, theaters, and zoos. Offsetting these gains were declines in sales of building materials & garden equipment (-2.9%), but they are still up 14.8% from a year ago. And, sporting goods, book stores & other hobby stores, saw a 5% drop in sales but they're still up 17.8% year/year.

US industrial production rose 3.0% in July, matching expectations and on the heels of an upwardly revised June increase (+5.7%… initially estimated at +5.4%), but downwardly revised April and May figures. The headline is positive but it is always skewed by the volatile component – utilities – which rose 3.3%, the second monthly increase in a row. Excluding utilities, industrial production gained ground for the third consecutive month, up 2.7% in July. Mining activity rose for the first time since January, but by a soft 0.8%. The biggest and most important component, manufacturing, jumped 3.4% last month, thanks to a 28.3% advance in the auto sector. Without motor vehicles & parts, production still rose, but by a more subdued 1.6%.

Chinese Industrial Production for July rose 4.8% year/year versus the 5.2% expected. Retail sales in China fell 1.1% year/year versus expectation of an increase of +0.1% year/year in July. Data shows fresh evidence that domestic consumption has not materially recovered with consumer habits changing post-pandemic.

The UK economy suffered its biggest slump on record between April and June as COVID-19 lockdown measures pushed the country officially into recession. The economy shrank 20.4% compared with the first three months of the year. Household spending plunged as shops were ordered to close, while factory and construction output also fell. This pushed the UK into its first technical recession - defined as two consecutive quarters of economic decline - since 2009. Chancellor Rishi Sunak told the BBC that the government was "grappling with something that is unprecedented" and that it was "a very difficult and uncertain time". (Source: BBC)

UK Jobs data says the unemployment rate stayed at a surprising 3.9% but the Office for National Statistics says it was because 300,000 left the workforce and were not considered unemployed. The number of employed fell by 220,000 in the three months leading to June. A Chartered Institute of Personnel and Development survey showed 1 in 3 UK employers is expecting to reduce staff in Q3.

The Australian jobs report exceeded expectations. Although the unemployment rate ticked higher, it was only up 0.1% to 7.5% with the participation rate at 64.7%. The underutilization rate also dropped 0.4% to 18.7%, a sign that spare capacity while elevated continues to be slowly absorbed. The 114,700 jobs added in July were mostly in part time, +71,200 with full time +43,500 and hours worked in July increased 1.3%. Given this survey was conducted before the lockdown hit in Victoria, the August report will be more revealing.

FINANCIAL CONDITIONS

New Zealand's central bank surprised markets last week by expanding its bond-buying programme and held out the prospect of negative interest rates in a bid to revive the COVID-19-battered economy as the country was plunged back into lockdown. The Reserve Bank of New Zealand (RBNZ) left interest rates at an all-time low of 0.25% in a widely expected decision, but expanded its large scale asset purchase (LSAP) programme to as much as NZ$100 billion (US$ 65.39 billion), from NZ$ 60 billion. Flagging policymakers' readiness to step-up support, the RBNZ said it is also actively considering a package of additional monetary tools, including negative interest rates and low-cost funding to banks. The purchase of foreign assets also remain an option. (Source: Reuters)

The US 2 year/10 year treasury spread is now 0.54% and the UK's 2 year/10 year treasury spread is 0.27%. A 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.

The US 30 year mortgage market rate has increased to 2.96. Existing US housing inventory is at 3.1 months supply of existing houses - well off its peak during the Great Recession of 9.4 months and we consider a more normal range of 4-7 months.

The VIX (volatility index) is 22.32 and while, by its characteristics, the VIX will remain volatile, we believe a VIX level below 25 bodes well for quality equities.

And Finally …..

"First come the innovators, then come the imitators, then come the idiots" Warren Buffet

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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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