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. March 16, 2020

Owner Operated Companies

Alphabet Inc. – Corporate America joined the fight against the spread of coronavirus as executives announced that Google would offer a website to help people determine whether they needed tests and retailers would set up drive-through testing in parking lots. A U.S. administration presentation showed a potential user would be asked several questions on the website and then given a recommendation as to whether they should get a coronavirus test. Those requiring a test would be referred to a store that can provide assistance, potentially including a drive-through test, according to the administration's presentation. Results would be available online in 24 to 36 hours. Verily, a healthcare tech company also owned by Alphabet, said it was leading the effort to develop the web tool, with the help of an undisclosed number of Google employees. Leading U.S. retailers will work with the government to assist with drive-through coronavirus testing, the Retail Industry Leaders Association said. Senior leaders of Walmart Inc., Target Corporation, Walgreens Boots Alliance, Inc. and CVS Pharmacy stood with President Trump at the announcement. The tests will be conducted in retail store parking lots and sent to labs to complete testing in partnership with local health departments and diagnostic labs. The testing sites will not be run by the companies.

Berkshire Hathaway Inc. – Warren Buffett's Berkshire Hathaway Inc. announced that former American Express Company Chief Executive Officer Kenneth Chenault has been nominated to the conglomerate's board of directors, replacing Microsoft Corporation co-founder Bill Gates. The change was disclosed in Berkshire's annual proxy filing, ahead of its scheduled May 2 annual meeting. Chenault, 68, led New York-based American Express from January 2001 to February 2018, and became one of the most prominent black CEOs in corporate America. Berkshire knows Chenault well, having long been American Express' largest shareholder, and ending 2019 with an 18.7% stake in the travel and financial services company. Gates, 64, has known Buffett since 1991 and been a Berkshire director since 2004, but now devotes most of his attention to philanthropy, including the Bill & Melinda Gates Foundation. He is also the world's second-richest person, worth $103.6 billion according to Forbes magazine. Buffett ranks fourth, at $76 billion. "I have made the decision to step down from both of the public boards on which I serve – Microsoft and Berkshire Hathaway – to dedicate more time to philanthropic priorities including global health and development, education, and my increasing engagement in tackling climate change," Gates said in a LinkedIn blog. Microsoft announced separately that Gates stepped down from its board.

Brookfield Asset Management Inc. has put the $2 billion sale or potential listing of its coal export terminal in Australia on hold due to travel restrictions amid the spread of coronavirus. Running a sale and listing process had become impossible given travel bans due to the global outbreak. The decision makes the Dalrymple Bay Coal Terminal (DBCT) the largest and most high profile corporate transaction in Australia to fall victim to the volatile financial market conditions sparked by the epidemic. The dual track process, which also includes the prospect of an initial public offering (IPO), could be restarted in the middle of the year with the aim of a transaction in the third quarter.

Linamar Corporation reported strong FCF of $380 milllion, beating analysts' expectations for the full year 2019. FCF was also well ahead of expectations in the fourth quarter, with the 2020 outlook calling for another year of robust cash generation (i.e., $500 million-$700 milllion). The management continues to see several drivers of earnings growth for company, including global auto industry growth and expanding presence in international markets. Linamar has been executing well, but uncertainty weighed on results and sentiment.

Oracle Corporation – Growth in cloud business helped Oracle top quarterly profit and revenue and Oracle said the coronavirus will have "minimal impact" on the fiscal fourth-quarter revenue, which is usually skewed toward software licenses rather than hardware. "We expect minimal impact from the virus in the quarter, given that much of the subscription revenue is already contracted," Chief Executive Officer Safra Catz said on an earnings call with investors. The business software maker's cloud services and license support unit, which accounts for more than half of its revenue, grew 4% to $6.93 billion in the third quarter. Oracle has been trying catch up with rivals such as Amazon.com, Inc. and Microsoft Corporation in cloud business that helps companies save cost by renting data centres rather than owning them. Oracle said last month it added new data centres in five countries and plans to add 36 locations by the end of the year. Total revenue rose nearly 2% to $9.8 billion, beating analysts' average estimate of $9.75 billion. Net income fell to $2.57 billion in the quarter ended Feb. 29, from $2.75 billion. But on a per share basis, it rose to 79 cents per share from 76 cents a year earlier.

Nomad Foods Ltd. announced a new share repurchase authorization of up to $300 million, which represents about 9% of the company's market cap. While aware of the optics of selling stock to investors at $20 a year ago and buying it back at closer to $15, analysts believe this is the right financial decision for investors. It's no secret that it has taken longer for Nomad to complete an acquisition, the potential for which it had raised $400 million in equity last March. Importantly, in analysts' view, given the solid trajectory of the business over the past year, Nomad's underlying business has generated an incremental $250 million in cash, which can be used to buy back stock at today's discounted price. In addition, given the admittedly slower start to the year (particularly due to weakness in January) and the company's expectation of a significant sequential acceleration, as we are nearing the end of the company's quarter, analysts think Nomad has incremental confidence around fundamental trends. Lastly, while the company's buyback does not preclude the pursuit of its Mergers & Acquisitions (M&A) agenda, some may see this announcement as suggestive that no deal is imminent. On this, analysts believe private market valuations have not yet collapsed the way public market ones have and expect Nomad to be thoughtful and prudent around its timing of any M&A activity. In other words, analysts don't think the market would take too kindly to a deal at say ~12x EBITDA while the company currently trades at roughly 8.5x.

Energy Sector

U.S. Petroleum Reserves – The United States could begin purchasing U.S. produced crude oil for the Strategic Petroleum Reserve as soon as two weeks from now, and fill it in several months, as disclosed by the Energy Department. President Donald Trump said that he has ordered the Energy Department to fill the reserve "to the top." The move was aimed at helping domestic energy producers suffering from the plunge in oil prices brought about by the spread of coronavirus and a price war between Saudi Arabia and Russia. The Energy Department has said the reserve, which has a capacity of 713 million barrels, can take an additional 77 million barrels of crude.

Financial Sector

The Bank of America Corporation is asking clients about their coronavirus exposure and preparations as part of its evaluation process of which deals to underwrite, according to sources. The additional layer of risk assessment is aimed at helping prevent the bank from losses on deals, like bond issuances, the sources said. It comes as coronavirus spreads quickly around the world and is forecast to dent global economic growth.

Goldman Sachs Group,Inc. Chief Financial Officer Stephen Scherr said the bank is "very open" to acquisitions, especially those that would speed the growth of its existing businesses. "We're ... very open to the proposition of acquisitions that fill gaps or accelerate elements of our growth plan," Scherr said at a conference convened via conference call and webcast, rather than in-person, due to concerns about the coronavirus outbreak.

Leading U.S. bank executives in a meeting with President Donald Trump at the White House said banks are strongly capitalized and prepared to help small businesses and American consumers weather the coronavirus outbreak. The chief executives of Bank of America, Goldman Sachs, Citigroup Inc., JPMorgan Chase & Co. and others said banks are in good shape, there is no financial crisis and bankers want to provide liquidity.

Global banks are pushing for guidance from regulators over the exemptions and temporary permissions they will need to keep their trading businesses open if the coronavirus outbreak forces staff to work from home or triggers a mass quarantine. Trading room compliance is the biggest logistical concern for financial groups as they plan for scenarios such as evacuating offices, moving staff to back-up sites and the shutdown of infrastructure such as postal services.

New Zealand's banks are ready to respond to the impact of a coronavirus outbreak which has the potential to hit banking operations, staff and funding, the country's central bank said on Monday. The Reserve Bank of New Zealand (RBNZ) has asked all banks about their risk management approaches and preparedness for COVID-19. Governor Adrian Orr said the responses showed the banks were prepared.

Italy's banking lobby is asking European authorities to ease rules on problem loans for at least six months, as a coronavirus outbreak hits the economy and throws the fragile sector's recovery off course. Europe's worst flare-up of coronavirus is expected to have pushed Italy into a new recession as measures to prevent the spread of the virus cripple economic activity, threatening an increase in the number of bad loans that Italian banks have worked hard to reduce in recent years.

India's central bank has seized control of the country's fourth-largest private lender, enlisting the top state bank to lead a rescue designed to prevent a loss of confidence in the financial system. The government's emergency takeover of heavily indebted Yes Bank Limited, announced close to midnight on March 12, 2020, prompted its shares to close down 56%. The Reserve Bank of India said "it had no alternative" but to take control of the bank, replace its board and temporarily restrict withdrawals.

Activist Influenced Companies

Nothing significant to report.

Dividend Payers

Dufry AG – Fiscal Year 2019 results : organic growth was with +3.0% (like-for-like (lfl) +0.6%, new concessions +2.4%) fully in line with expectations with Q4 seeing an acceleration in lfl (+2.2%). Also gross profit margin was with +40bp to 60.2% in line and FCF reached CHF 383 million, reaching the target of CHF 350-400 million. Net debt/ adjusted fee cash was 3.52x compared to 4.5x threshold. Dividend will be CHF 4.00/share (yield 8.6%!). For 2020, January continued with a growth acceleration, but February was in organic growth -7.3% (year to date -2.3%) with Asia/Middle East (14% of sales) being double-digit down. EU (44% of sales) was just slightly down in February but closure of Italy (approximately 4% of sales), new rules in the U.S. (23% of sales in duty free) etc. we expect more to come. Dufry has started with an action plan and expect savings of CHF 60 million but also lower capex will be targeted. With the expectation that second half 2020 sees an improvement (Q3 is the most important one), Dufry expects in Fiscal Year 2020 a negative single-digit organic growth. Whereas Fiscal Year 2019 was in line with expectation, the focus in on the current situation which saw the first impact in February, which will even accelerate in March/April. Dufry expect a negative single-digit organic decline for Fiscal Year 2020, which we consider to be an optimistic scenario. Covenants could be reached but assume that it will be increased temporarily. We consider the share price collapse reflecting the current situation but also believe 2021 will see a strong rebound.

Economic Conditions

Canada - The Financial Post reported last week that Canadian financial regulators and trading authorities are taking steps to prevent a major disruption if the novel coronavirus outbreak develops into a pandemic. The Investment Industry Regulatory Organization of Canada (IIROC), which regulates investment dealers on matters such as registration, trading compliance and maintaining adequate capital, told member firms it would make some allowances in how they went about meeting their regulatory obligations, as a result of COVID-19. "IIROC recognizes that some level of regulatory flexibility may be required to enable Members (investment dealers) to best serve investors and maintain market stability," the guidance said. "If Members (firms) are able to meet the requirements from backup sites or with staff working from home, IIROC has no objection as long as appropriate measures are in place for supervisory, confidentiality and other regulatory requirements." As part of the guidance, IIROC also suggested that firms consider obtaining "dedicated or premium broadband service for the homes of critically important employees" in order to navigate potential work-at-home scenarios. In an earlier message on its website, IIROC had said that to protect its employees it would conduct examinations of its members remotely, where possible. It would also allow certain committee meetings to be conducted by video or teleconference instead of in person. "In the event of a major disruption, IIROC has detailed business continuity plans (BCPs) in place for each regulatory area of the organization, to preserve critical functions and activities," the regulator said, noting that while it had already invoked elements of that plan, "we continue to carry out all our market oversight responsibilities."

U.S. Core consumer prices rose 0.2% for a second straight month in February, lifting the yearly rate slightly to 2.4%, the high side of a four-year range. But this is all water under the bridge, as price pressures will ebb in response to the recent oil-price shock and COVID-19's impact on the economy. The shorter-term (3- and 6-month) core rates are tracking at or a little below the yearly rate. Clothing prices jumped for a second straight month, possibly due to some tariff pass-through, but remain below year-ago levels. The headline CPI rose 0.1%, as gas prices fell, cutting the yearly rate to 2.3% from 2.5%. It will, we believe, move lower in coming months due to the sharp drop in oil prices and an expected contraction in Q2 GDP.

British Chancellor Rishi Sunak has unleashed a torrent of emergency spending measures and infrastructure investment worth at least £30 billion ($58.4 billion), in a budget he touted as the most far-reaching anti-coronavirus package anywhere in the world. His spending blitz came hot on the heels of a surprise interest rate cut of 50 basis points from the Bank of England, taking the benchmark back to the record low, last touched in 2016, of 0.25%.

Financial Conditions

The Bank of Canada announced at an emergency press conference with Finance Minister Bill Morneau and Office of the Superintendent of Financial Institutions (OSFI) Superintendent Jeremy Rudin, that the Bank of Canada lowered its target for the overnight rate by 50 bps to 0.75%. This unscheduled rate decision was classified as "a proactive measure taken in light of the negative shocks to Canada's economy arising from the COVID-19 pandemic and the recent sharp drop in oil prices". The Bank noted that "the coronavirus is having serious consequences for Canadian families, and for Canada's economy" and that "lower prices for oil, even since our last scheduled rate decision on March 4, will weigh heavily on the economy, particularly in energy intensive regions". The Bank added that they would provide a full update on the outlook for the Canadian and global economy on April 15 and still stands ready to adjust policy further if required, including coordinating with other G7 central banks and fiscal authorities. These actions are in addition to the liquidity measures implemented by the Bank of Canada last week where they increased the scope of repo operations to 6 and 12 months and introduced bond buybacks for all benchmark maturities across the curve. While an imminent interest rate cut was largely expected, many thought it would come after the Federal Reserve's meeting this Wednesday so the timing of this stimulus is somewhat surprising. Moreover, this adjustment marks 100 bps of easing provided by the Bank of Canada in less than 10 days—a record for the central bank. Given the rapidly evolving nature of this virus, we believe this will not be the last we hear from policymakers in the coming days. We will see a substantial fiscal stimulus package from the federal government next week as confirmed by Finance Minister Morneau today. Collectively, these actions (in Canada and increasingly across the globe) show a growing sense of urgency while virus-related disruptions/shutdowns will lead to an exceptional, perhaps unprecedented Q2 contraction. It is hoped that proactive policy measures will put in place conditions for a return to growth later in 2020.

U.S. Federal Open Markets Committee (FOMC) on Sunday cut policy rates by 100 bps. The target range for the fed funds rate is now 0%-to-0.25%, back at the zero lower bound (ZLB), where it stood

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for seven years from December 2008 until December 2015. And, to ease further, the FOMC announced large-scale asset purchases (quantitative easing totaling $500 billion Treasuries and $200 billion Mortgage-Backed Securities (MBS))… "Q4" has officially begun (MBS redemptions will also now be reinvested back in MBS instead of Treasuries). The Fed said "the effects of the coronavirus will weigh on economic activity in the near term and pose risks to the economic outlook." And, that it "will continue to monitor the implications of incoming information for the economic outlook, including information related to public health, as well as global developments and muted inflation pressures, and will use its tools and act as appropriate to support the economy." Formal forward guidance and more quantitative easing remain on the policy table.

Also, the Fed, along with the Bank of Canada, the Bank of England, the Bank of Japan, the European Central Bank, and the Swiss National Bank announced a coordinated action to **beef up U.S. dollar swap lines** (lower pricing Overnight Index Swap (OIS)+25 bps, offering 84-day along with 1 week swaps).

Bottom line: As evidenced by Friday's surprise moves by the Bank of Canada and OSFI (the Canadian bank regulator) - the BoC cut policy rates by 50 bps and OSFI encouraged banks to tap their buffers—central banks and regulators are acting quickly and forcefully to mitigate the impact of COVID-19 on economies.

The increasing cancellation and curtailment of activities involving gatherings of people are going to have a huge negative impact on March and Q2 GDP… we're talking **the potential for Q2 to be worse than any quarter we saw during the Global Financial Crisis along with the potential for outright technical recession (in Q1/Q2).** This will likely not be the last time we'll hear from a central bank.

U.K. - The Bank Of England has cut rates by -50 bps to 0.25% and announced other measures "to respond to the economic shock from Covid-19"; these include the elimination of the Countercyclical Buffer for the coming years, a new Term Funding Scheme (with extra incentives to help small and medium enterprises), etc. We think that the broad package of measures is helpful for UK banks, particularly around cheaper funding to lend out and is one of the final acts of outgoing Governor Mark Carney, who will leave next week, and on the day of the Budget - a sign of coordinated action.

The U.S. 2-year/10-year treasury spread is now 0.41% and the U.K.'s 2-year/10-year treasury spread is 0.14% - 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 3.36% (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 57.83 (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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