News Highlights

Owners. Operators. And Insightful Investors.

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Established in 2007

PORTLAND INVESTMENT COUNSEL®

Our views on economic and other events and their expected impact on investments. December 3, 2018

Owner Operated Companies

The Kraft Heinz Co. announced it plans to buy paleo condiment and dressing company Primal Kitchen for about $200 million, as the ketchup maker looks for a platform to help compete against upstart brands. The acquisition marks a change of course for the company whose backers, 3G Capital, Inc., made a name in large-scale acquisitions and an aggressive approach to cost-cutting. It gives Kraft Heinz, which also owns Miracle Whip and its branded dressings, a foothold with which it will look to fend off competition from upstart brands like Sir Kensington's and Annie's Homegrown. Primal Kitchen is expected to generate about $50 million in revenue this year, Kraft Heinz said. The deal is expected to be completed in early 2019. Primal Kitchen was founded by food blogger Mark Sisson, who started "Mark's Daily Apple" in 2006 and has written a number of diet and exercise books. The company makes paleo-friendly products including mayo, avocado oil and dressings. Kraft Heinz has put a renewed emphasis on growth over the past year. It's been three years since Kraft Heinz merged and nearly two years since Unilever PLC rebuffed its acquisition approach. Investors who previously lauded 3G for rewriting the book on cost-cutting are now focused on Kraft Heinz's growth prospects. Last quarter, Kraft Heinz delivered sales that topped expectations with growth of 1.6%, but fell short on earnings, amid steep commodity costs. Kraft Heinz has begun to follow the playbook written by many of its peers seeking growth as eating habits change. Kraft Heinz joined other big food brands this year in launching a venture arm, Springboard, to partner with food start-ups. In addition to buying brands, Kraft Heinz has also been focused on selling businesses. It earlier this year announced the sale of its Canadian dairy business and Indian food business, Complan.

Energy Sector

Alberta oil production cuts – Alberta Premier Rachel Notley announced that the Western Canadian province would mandate temporary oil production cuts to deal with a pipeline bottleneck that has led to a glut of crude in storage and driven down Canadian crude prices. The government will force producers to cut output by 8.7%, or 325,000 barrels per day (bpd), until the excess crude in storage is drawn down. The cuts will then drop to 95,000 bpd until December 31, 2019. There are some 35 million barrels of oil in storage in Alberta, which is twice the normal level, the province said. "When markets aren't working, when companies are forced to sell our resources for pennies on the dollar, we must act," Notley said in a live public address on Facebook. Alberta estimates that current production outstrips pipeline and rail capacity by 190,000 bpd. The production cuts, to be applied by producer rather than per project, will be implemented starting in January. The discount on Western Canada Select heavy blend hit a record at $52.50 a barrel below the West Texas Intermediate (WTI) benchmark last month, which meant producers were getting about $14 a barrel compared with about $67 for WTI. It has since narrowed slightly as the WTI benchmark price has fallen and crude by rail volumes has ramped up. The province said the curtailment would narrow the differential by at least $4 a barrel. There will be penalties for non-compliance, but no specifics were given. Notley said last week her government was moving ahead with plans to buy about 80 locomotives and 7,000 rail cars to boost crude by rail capacity by 120,000 bpd by mid-2020. The premier, who will face voters in an election that must be held by the end of May, noted that pipelines were preferred to all other options, but blamed successive federal governments for delays getting projects built. Enbridge Inc.'s Line 3 pipeline replacement, which runs from Alberta to U.S. markets, is expected to be online by late 2019. Two other planned export pipelines are facing regulatory delays. Several heavy crude producers, including Canadian Natural Resources Ltd. and Cenovus Energy Inc., have voluntarily curtailed production in recent weeks. Mandated cuts are controversial as producers that have their own refineries, like Suncor Energy Inc. and Husky Energy Inc., do not face the same impact from the low prices. The province estimates some 25 producers will be affected by the measures, which will apply only to companies that produce more than 10,000 bpd.

Financial Sector

British banks would be able to withstand a global recession more severe than a disorderly Brexit, according to the results of a Bank of England (BoE) stress test published last Wednesday. The BoE found that British banks would be able to keep lending to customers even if there were a major financial crisis, while continuing to pay billions of pounds in fines and compensation to address wrongdoing. "The core of the U.K. financial system is ready for Brexit whatever form it takes," said Mark Carney, Bank of England governor. It was the second time that all seven lenders sailed through the tests, which the BoE started conducting following the 2008 financial crisis, when the banking sector came dangerously close to collapsing. "The test shows the U.K. banking system is resilient to deep simultaneous recessions in the U.K. and global economies that are more severe overall than the [2008] global financial crisis," the BoE wrote in the introduction to the stress test results. Nationwide, the building society, was the strongest performer. (Source: Financial Times)

The Bank of Nova Scotia (BNS) reported Q4 2018 adjusted EPS of $1.77, below consensus of $1.79. The bank's definition of adjusted EPS this quarter includes an approximately $0.02 benefit relating to one additional month of Thanachart Bank Public Company Limited earnings. Adjusted EPS this quarter excluded acquisition-related costs of $420 million after-tax ($591 million pre-tax) or approx. $0.34 per share. Total revenues of $7,475 million were below forecast of $7,554 million for the quarter. Non-interest expenses were $3,853 million, higher than estimated. Efficiency (cost/income) came in at 51.5% (up 1.3% quarter/quarter). Provisions for Credit Losses (PCL) were $590 million slightly lower than forecast of $597 million. PCL ratio came in at 39 bps (down 1 bps quarter/quarter, adjusting for acquisition-related Day 1 PCLs last quarter). BNS exposure to Canadian exploration and production (E&P) is just $3.4 billion (with 83% investment grade) and its direct Western Canadian Select (WCS) exposure is $1.2 billion (88% investment grade). BNS did not provide more details on its Alberta consumer loan portfolio. Its direct exposure to Canadian oil and gas companies is relatively small. International loan growth was +29% year/year (up +19% quarter/quarter) on a constant currency basis. Personal and commercial loan growth was +27% year/year (up +18% quarter/quarter) and +26% year/year (up +16% quarter/quarter) respectively on a constant currency basis. Canadian Personal and Commercial (excluding wealth management) residential mortgage growth slowed to approx. +3% year/year and net interest margins were down -1 bps quarter/quarter to 2.40%. The bank's CET 1 ratio came in at 11.1%, down -30 bps quarter/quarter mainly reflecting the impact of completing the acquisition of MD Financial Management (-65 bps) and share buybacks (-10 bps) offset by capital generation (+33 bps) and risk-weighted assets impact (+14 bps).

Canadian Imperial Bank of Commerce's (CIBC) Q4 2018 adjusted EPS was $3.00, below consensus of $3.04. Adjusted EPS this quarter excludes $65 million after-tax or $0.15 per share ($89 million pre-tax) of incremental losses on debt securities and loans in CIBC First Caribbean International Bank resulting from the Barbados government debt restructuring. Lower EPS versus estimate was largely attributable to lower-than-expected revenues across all revenue line-items. Canada Personal and Commercial (P&C) was better than expected but U.S. P&C, Capital Markets and Corporate were lower than expected. Total adjusted revenues were $4,534 million for the quarter, below forecast of $4,693 million. Lower revenues relative to the forecast were driven by lower revenue across all revenue line-items. Adjusted non-interest expenses came in at $2,548 million, lower than the $2,591 million forecast but also on lower revenues. Efficiency at the all bank level was 56.2%, up 120 bps quarter/quarter and higher than the estimate of 55.2%. Adjusted Provisions for Credit Losses came in at $236 million, above forecast of $228 million. Canada P&C real estate secured personal lending growth continued to slow to +1.4% year/year compared to approximately +4.3% year/year last quarter, while net interest margins were up 10 bps quarter/quarter to 2.50%. Canadian uninsured residential mortgage originations were $7 billion versus $9 billion last quarter and $12 billion last year. The bank's CET 1 ratio was 11.4%, up 10 bps quarter/quarter as capital generation was largely offset by higher risk-weighted assets and the impact of share buybacks.

Royal Bank of Canada (RBC) reported Q4 2018 core cash EPS of $2.24 versus consensus estimate of $2.12. The beat was driven by elevated net insurance revenues (above consensus above normal run rate) and low taxes (+3 above consensus), which offset lower than forecasted trading and investment +10banking revenues (-7 below consensus, net). Canadian Personal and Commercial reports 8% year/year growth as Net Interest Margin (NIM) increased 12 bps year/year (3 bps quarter/quarter) to 2.77%; Wealth Management earnings grew 13% year/year. Within this figure, RBC's traditional Wealth business reported roughly flat year/year growth. City National loan growth was 13% year/year and NIM was up 45 bps year/year (flat quarter/quarter). Flat sequential NIM was attributed to margin pressure on deposits (e.g., higher betas and competition); Capital Markets earnings up 14% year/year and Insurance earnings up 20% year/year and Investor & Treasury services down 1% year/year. Provisions for Credit Losses of $353 million were in line with forecast. Gross Impaired Loans decreased to $2,183 million from $2,321 million last quarter (6% quarter/quarter decrease) owing to lower impairments on consumer goods and oil & gas loans. RBC's CET 1 capital ratio of 11.5% was slightly higher than forecast and was up 40 bps quarter/quarter, reflecting a 20 bps gain from "model refinements".

The Toronto-Dominion Bank's (TD) adjusted EPS was $1.63 above consensus of $1.62. From a segmented perspective, Canadian retail and wholesale banking came in better than expected while U.S. retail banking (ex-TD Ameritrade) was lower than expected. Adjusted total revenues of $9,466 million were above $9,421 million forecast. Higher revenue compared to forecast was driven by higher than expected other fee income and trading revenues, partly offset by lower than expected core net interest income. TD's efficiency ratio was 56.0% (up 140 bps quarter/quarter) and higher than our forecast of 55.5%. Provisions for credit losses (PCLs) totaled $670 million, above $614 million forecast. PCLs this quarter included some seasonality related to the U.S. credit cards and Indirect Auto portfolios and a one-time impact ("methodology enhancements") in the Canadian real estate secured lending portfolio. TD reported a total PCL ratio of 41 bps, up 6 quarter/quarter and up 2 bps year/year. Canada Personal and Commercial earnings of $1,741 million were above forecast of $1,725 million. Total loan growth was ~6% year/year and net interest margins were up 1 bp quarter/quarter to 2.94%. The bank's Basel III CET 1 ratio was 12.0%, up 30 bps quarter/quarter, largely reflecting internal capital generation partly offset by risk-weighted asset growth. TD announced its intention to amend its normal course issuer bid for up to 20 million more common shares, subject to regulatory approval.

TD Bank's $1 billion Aeroplan transaction, becomes lead partner in Air Canada Inc.'s takeover - Last week, after TD announced its deal with Air Canada, the Globe and Mail highlighted that TD is relying heavily on the success of Air Canada's Aeroplan loyalty program takeover. The bank is committing to $1 billion worth of upfront payments and future expenses as the lead financial partner. Other financial partners include Canadian Imperial Bank of Commerce (CIBC), and Visa Inc., who together with TD and Air Canada, will acquire the Aeroplan loyalty program from Aimia Inc. in January 2019. The article highlighted that with TD's investment, it is now clear that of the three financial partners, TD will hold the most sway following the purchase. The new contract with Air Canada and TD would mean a total spend of $1.03 billion for the bank ($622 million plus any sale taxes to Air Canada, and prepayment of $308 million for the future purchase of loyalty points over the 10 year contract). TD also plans to spend $100 million to help "build the functionality required to facilitate the new program," according to a statement. CIBC will take a back seat in the new arrangement. The bank will make two payments to Air Canada: $200 million to participate, as well as $92 million as a prepayment for future Aeroplan miles.

Activist Influenced Companies

Nothing significant to report.

Dividend Payers

AT&T Inc. said it has committed to cutting its heavy debt load next year through a variety of measures, including a review of all of its non-core assets such as its stake in streaming video company Hulu for possible sale. The second largest U.S. wireless carrier by subscribers said, at an analyst meeting in New York, that it will pay down $18 billion to $20 billion of its debt by the end of 2019, and will generate up to $8 billion in cash in part through the sale of some assets. The company said it expects 2019 free-cash flow of about $26 billion, above analysts' average estimate of $24.84 billion, according to IBES data from Refinitiv. AT&T said the growth in FCF will help achieve its end of year net-debt-to-adjusted-EBITDA ratio of 2.5x range. The company also gave fresh details about a new streaming rival to Netflix, Inc. that is expected to be launched by the end of 2019 by Warner Media, LLC, the new segment that includes the Turner networks and premium channel HBO. The new product will include three tiers of service: an entry-level package focused on movies, a premium tier with original programming and the highest tier will include licensed content from other providers.

Economic Conditions

U.S. home prices continued to climb in September but grew at their slowest pace in nearly two years, according to the latest S&P Corelogic Case-Shiller report. The group's national home price index showed that prices were up 5.5% from a year earlier, compared with a year-on-year rate of 5.7% in August, at a time when rising mortgage rates have kept potential buyers on the sidelines. The 10-city composite index, which measures real estate values in 10 major markets, rose 4.8% on an annual basis, compared to 5.2% in the prior month. The 20-city composite index's growth slowed to 5.1% from 5.5%. "Home prices plus data on house sales and construction confirm the slowdown in housing," said David M. Blitzer, managing director and chairman of the index committee at S&P Dow Jones Indices. (Source: Financial Times)

Financial Conditions

The U.S. 2 year/10 year treasury spread is now 0.20% and the U.K.'s 2 year/10 year treasury spread is 0.58% - 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 two-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 4.81% (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 4.0 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 16.47 (compares to a post-recession low of 9.52 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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Mutual Funds

Portland Investment Counsel Inc. currently offers 8 Mutual Funds:

- Portland Advantage Fund
- Portland Canadian Balanced Fund
- Portland Canadian Focused Fund
- Portland Global Income Fund
- Portland Global Banks Fund
- Portland Global Dividend Fund
- Portland Value Fund
- Portland 15 of 15 Fund

Private/Alternative Products

Portland also currently manages the following private/alternative products:

- Bay & Scollard Development Trust
- ITM AG Investment Trust
- Portland Advantage Plus - Everest and McKinley Funds
- Portland Focused Plus Fund LP
- Portland Focused Plus Fund
- Portland Global Aristocrats Plus Fund
- Portland Global Energy Efficiency and Renewable Energy Fund LP
- Portland Global Sustainable Evergreen Fund
- Portland Global Sustainable Evergreen LP
- Portland Private Growth Fund
- Portland Private Income Fund
- Portland Special Opportunities Fund
- Portland Value Plus Fund

Individual Discretionary Managed Account Models - SMA

Net Asset Value:

The Net Asset Values (NAV) of our investment funds are published on our Portland website at www.portlandic.com/prices

We want to share our insights with you and welcome your feedback. Our website has the latest, as well as archived videos, company profiles, and press articles. Please visit us at www.portlandic.com.

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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, 'ROE' return on equity, 'ROTE' return on common equity.

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