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Monopoly Watch: From Standard Oil Company to Amazon (Part 1)

Dan Rohinton, Vice-President, Portfolio Manager, Global Dividend

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1911 was a landmark year in the corporate world. It was in 1911 that Standard Oil was successfully broken up into dozens of separate companies—a remarkable win for the US government and the first effective use of the Sherman Antitrust Act to dismantle a dominant monopoly. We are still living with the legacy of this decision, as most of what we now call "Big Oil" are the successors to Standard Oil. I guess ExxonMobil is a better brand name than Standard Oil of New Jersey!

In 2023, the topic of monopoly power has returned to the spotlight as the US Federal Trade Commission is suing Amazon using once again the Sherman Antitrust Act. Before we dig into the current nuances of Amazon vs. FTC, it's worth reflecting on the Standard Oil era and the early forgotten years. You'd be forgiven for seeing similarities to Amazon.

Disruptive & Efficient: It's easy to gloss over it today, but Standard Oil was a uniquely disruptive innovator in the late 1800s. Standard's meteoric rise in dominating the industry was facilitated primarily by a focus on efficiency. For every gallon of oil that was refined and sold, nobody was more efficient in minimizing waste, lowering costs, and maintaining quality. Standard Oil won through value, quality, and customer buy-in for many years in parallel with aggressive corporate shenanigans. In many ways, this was the largest "roll-up" business model in history.

Expanding Addressable Market: Believe it or not, the greatest driver of Standard Oil's success was its ability to grow penetration and utilization of its products. In the early years, kerosene (e.g., kerosene oil lamps) was the primary fuel source, which slowly shifted to petroleum as it became more common. Their focus on consistency allowed for a level of standardization ("Standard" part of their name) that made it much easier to increase the potential market size. In fact, oil prices actually fell a staggering 72% from 1870 to 1911, from when Standard Oil was first formed and then broken up. The idea that monopolies are pure price gougers and that this drives their profitability isn't necessarily true today and wasn't clear-cut even back then.

Adjusted for inflation, Standard Oil was worth a staggering one trillion dollars around the time of its breakup. It was only surpassed by Apple after holding the top spot for over 107 years! As you can see, the Standard story was complex and had important nuances to consider, along with the monopolistic behavior. As we dig into Amazon next, you'll see the many parallels that led to Standard's success are also being replicated by Amazon. This time though, I don't think the government has a chance of winning its case.

See you next week for Part 2!

P.S. The robber baron era during the "US Gilded Age" is fascinating history, I would highly recommend reading the Western Union Telegraph scandals led by the infamous Jay Gould.

Analyzing the Bond Bear Steepener?

Dan Rohinton, Vice-President, Portfolio Manager, Global Dividend

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It's not often that an equity investor delves into the bond markets, but this time, I'll make an exception!

Over the last few months, we have seen the emergence of a "bear steepener" in the bond market. It can become technical, but the basic premise is that we are witnessing a rising yield curve that is pushing longer-dated bonds higher (i.e., ten-year maturities/tenors) with short-dated bonds also rising (i.e., two-year maturity/tenor), albeit at a slower pace. Essentially, the cost of debt for everyone across the entire yield curve is rising, regardless of the maturity, which increases the cost of capital. So, what does this mean for stocks?

There has been increasing market noise recently, and while many reasons have been proposed, I find this one to be most impactful. I've especially noticed that specific sectors are experiencing more significant effects from higher bond yields, such as utilities and real estate. It makes sense to see utilities under selling pressure as higher interest rates offer a direct alternative to the defensive growth and income that is the hallmark of high-quality rate-regulated US utilities. Quite simply, the alternative is becoming more competitive, motivating investors to shift money over.

The same is also true for real estate, which often relies heavily on financing to make the economics of real estate transactions more attractive. It's not uncommon for REITs to be active and consistent issuers in the bond market, and those costs have been increasing recently. As the rates on debt rise, there is less residual cash flow left for dividends or buybacks.

So, should we be wary of the bond steepener? On the contrary, I think we are creating an intriguing opportunity for specific companies in these industries. Contrary to popular belief, the best time to allocate to utilities especially is during corrections like these, as the earnings yield is more attractive than at any point in the last few years, while confidence around fundamentals remains unchanged. We have been seeing every stock in these large, diverse sectors painted with the same brush, and that's the perfect opportunity to invest in the right stocks in these devalued sectors. Special thanks to my colleague Alex Morin for the collaboration.

Have a great weekend!

From WeWork to WeBroke

Dan Rohinton, Vice-President, Portfolio Manager, Global Dividend

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I will never forget the WeWork IPO document or the lofty $48 billion valuation round led by Softbank Group. It was the first and only time I encountered the term "Community Adjusted EBITDA," a creative way to exclude all those pesky expenses management did not want investors to consider. Though the IPO was ultimately canceled, WeWork did go public through an indirect channel amid SPAC mania.

Fast forward to 2023, and WeWork is hiring advisors to prepare for restructuring or bankruptcy.

Spillover Effects: The checkered history of this business has not received much attention lately, but the near-inevitable restructuring or insolvency of WeWork will significantly impact the already strained commercial office market. Across 180 countries, WeWork is leasing over 9 million square feet of rentable office space in prime locations across major cities. In the post-Covid-19 world, office demand in these major cities (e.g., New York, London) remains subdued, putting pressure on rents. In the likely event of WeWork's liquidation, all of their office capacity will enter the market at an already vulnerable time.

Uncertain Path Forward: To say that a difficult road lies ahead for WeWork is an understatement. Over the last quarter, the highly capital-intensive business had just $200 million left in cash and lost $65 million in EBITDA on average each quarter. Without an immediate and significant positive shift in the office market, which is unlikely, the clock is ticking down toward the inevitable decision to put the company into some form of liquidation. Given the size and scope, landlords that partnered with WeWork may have an opportunity to proactively stabilize their exposure by buying out leases to streamline the process. This approach is novel in the commercial office market but has been utilized for years by retail REITs as e-commerce continues to gain share.

The rise and probable fall of WeWork is a cautionary tale in betting large sums on a concept that has not been clearly proven. Add years of "FOMO" by investors and poor corporate governance, and you have the perfect formula to incinerate shareholder capital over multiple years at an unprecedented pace. I view WeWork as a lesson in what to avoid when identifying investment opportunities, as the company managed to hit all the negatives simultaneously.

Have a great weekend!

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Louis Vuitton Q3: A Glimpse Into The Luxury Consumer

Dan Rohinton, Vice-President, Portfolio Manager, Global Dividend

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During the quarterly earnings season, there is a tsunami of information heading our way, offering lots of interesting insights into various industries, especially the consumer sector. Louis Vuitton Moet Hennessy (LVMH Group) is always worth examining, as it provides the clearest view of the global luxury consumer and their current preferences. So, what did we learn?

Taking A Breather: In the past few years, the luxury market has been red hot, as consumers redirected their excess savings and limited spending options toward high-end handbags, apparel, watches, and much more available at LVMH. This trend led to a nearly doubling of the all-important fashion and leather goods division due to robust pricing (approximately 5% per year) and booming demand. However, as we look ahead, the early signs of a slowdown displayed this quarter are likely to continue, as both pricing and demand begin to normalize downward. A luxury slowdown is all but inevitable based on this data point, with one potential area of relief: the continued rebound of China luxury, both domestically and in the all-important travel retail segment, which could continue to move higher, bucking the trend of other regions.

Global Scale, Unmatched Breadth: As the leading luxury player with over 5600 locations worldwide, LVMH stands in a league of its own. No other competitor boasts the same breadth of products across various categories that luxury customers covet. This critical strength allows LVMH to continue growing market share and sales above the rest of the luxury industry. Smaller brands don't have the luxury (no pun intended) to miss a recent consumer trend, given the high level of concentration across a specific product or two. As a diversified platform player, LVMH can customize its product and go-to-market strategy for every geography by strategically prioritizing their products according to the local tastes of consumers. I expect this advantage to be leveraged even more during the industry slowdown to outperform the competition.

In conclusion, it's clear that the luxury consumer is beginning to move in a similar direction as medium- and low-end consumers. It's not a surprise that, after such strong years, we now undergo a digestion period before setting up the next phase of growth. I see LVMH as the cornerstone of the luxury market and the perfect European-based example of a global leader.

Have a great weekend!

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Blockbuster IPOs: ARM Holdings & Instacart

Dan Rohinton, Vice-President, Portfolio Manager, Global Dividend

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In the last few days, the public markets have seen a pair of blockbuster IPOs that have been years in the making. Leading semiconductor royalty platform Arm Holdings re-entered public markets valued at around $50 billion after spending almost seven years as part of the Softbank Group. This was followed by an approximately $8 billion IPO of last-mile delivery platform Instacart. Despite operating vastly different business models, there are some common insights we can glean.

A Day Late, A Dollar Short: For both companies, they tapped the IPO markets too late and missed their moment. During the peak of the COVID-19 lockdowns, investor optimism was significantly higher for both companies, and they would have likely received a more generous valuation. In Arm Holdings' case, I'm speculating based on the valuations of public peer companies (it was all Softbank-owned). Instacart, on the other hand, was valued at almost $39 billion in March 2021 and $17.7 billion in October 2020 by private investors. Instacart realizing an 80% loss in value from the peak is a cautionary tale for future disruptors to think hard about going public sooner rather than lingering in the private markets. Waiting too long is just as big a risk as going public too soon!

Lukewarm Reception: Most IPO launches are heavily managed by the underwriters to generate a positive outcome for the "new investors." It's clear one week later that public investors greeted both Arm & Instacart with a lukewarm reaction, as both companies are within a few percent of their IPO price. In an environment with higher interest rates and a renewed focus on profitability, investors' appetite remains subdued. I see no immediate shift in perception on this front, which puts the onus on both companies to deliver on their roadmap.

The IPO window comes in waves and tends to open when animal spirits are at their highest and shuts down when the investment community collectively turns cautious. I see these events as an indirect temperature check for the general mood of investors. Over the long-term, the IPO process is almost irrelevant; ultimately, the fundamentals of the business have the most outsized impact on the long-term stock price. I welcome this new pair of companies to the public markets, and now comes the hard part - multi-year execution of their business strategy under the full transparency and bright lights of public markets. It's showtime!

Have a great weekend!

Disney vs. Big Cable: Mickey Mouse the Underdog?

Dan Rohinton, Vice-President, Portfolio Manager, Global Dividend

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In the past few weeks, we've had the rare opportunity to take a deep look into the usually secretive negotiations that take place between large media companies and their major cable distributors. It's been fascinating to see the number two US operator, Charter Communications (big cable), make their demands public for all of us to analyze. Let's break it down.

The term "cord-cutting" isn't referenced often anymore, but it continues to occur as consumers shift from linear TV to streaming video on demand (SVOD). As consumers cord-cut every year, cable companies must manage weak and eroding margins as strong live sports channels like ESPN demand higher prices and bundle additional low-value channels, such as National Geographic Wild. Disney's ESPN channels dominate live sports and, over the years, have become must-have entertainment in the cable bundle. This is proven by Charter highlighting that only 25% of Disney-owned channels are watched by viewers—a stunning and poor metric given the size and variety of Disney content.

In a first for the modern cable era, Charter blacked out all Disney channels, including ESPN, and demanded several items right before the football season began. This gambit worked! Disney conceded by allowing Charter customers access to specific versions of Disney+ and, critically, a future version of ESPN+ for free. This allows Charter to slow down the pace of cord-cutting as customers receive a new addition to their cable bundle, free ESPN+, and access to the entire Disney library. The other nuances of the agreement were insightful with some benefits for Disney as well, but the free SVOD concession was the big shockwave in the media world.

We often talk about the "innovator's dilemma" as a theoretical concept, but rarely is it so clearly laid out for everyone to see. Charter strategically leveraged its current importance to Disney's profits and forced Mickey Mouse to share indirectly (it gets technical quickly) in the future streaming platform they were building in Disney+ and, especially, the highly anticipated ESPN+. As technologies mature, they tend to exhibit a phenomenon known as convergence and a blurring of the lines. This is a milestone in the media convergence trajectory.

Score: Big Cable 1, Disney 0

Have a great Friday & weekend!

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Enbridge: One Part Insight, One Part Opportunity

Dan Rohinton, Vice-President, Portfolio Manager, Global Dividend

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Well, that came out of nowhere! On Tuesday, Enbridge announced a $19 billion transaction to acquire the regulated gas assets of beleaguered Dominion Energy. This significant transaction for Canada's largest midstream company offers insights and opportunities for shareholders.

What did Enbridge buy?
Dominion Gas Utilities is a multi-state regulated utility that serves almost 10 billion cubic feet per day to 7 million customers. These services are offered at an appropriately capitalized 50% debt/equity ratio and earn a fair ~9.8% ROE. For a growing asset with locked-in returns, this is a reasonable price for such a large transaction, especially considering the infrequent nature of these deals.

What did we learn?
Reading between the lines, it's clear that the era of large energy and pipeline projects that defined Enbridge's early years is no longer feasible in today's environment. Large pipelines, even in Canada, have often gone wildly over budget and fallen behind schedule, creating uncertainty for producers and burdening taxpayers with less revenue and higher construction expenses. Investors in TC Energy have suffered with Coastal GasLink. Kinder Morgan had to offload Trans Mountain to the public. Enbridge Line 5 has become an ongoing headache for the company. For future capital deployment, Enbridge is acknowledging that building the next pipe is not the best use of their capital, which I see as a sound decision.

What's the opportunity?
This transaction may have modest immediate financial benefits, but the real value emerges over the next decade. Enbridge has tapped into a brand new source of capital allocation with significantly better financial visibility than prior projects. Regulated utilities offer a unique mix of financial visibility through locked-in returns on equity and multi-year guarantees. We can now expect Enbridge to shift its focus at the margin to these safer, more predictable projects in growing jurisdictions.

Midstream companies have seen mixed returns for investors over the past decade. Many stocks offered "high yields" only to see dividend cuts from cost overruns and delays in new projects. Our first priority when investing in infrastructure is having very high confidence in the predictability of future capital allocation. This Enbridge transaction was a fair price for enhanced future visibility and a victory for its shareholders.

Have a great weekend!

Canadian Banks: A Forgettable Quarter

Dan Rohinton, Vice-President, Portfolio Manager, Global Dividend

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In Canada, the Big Five banks are the cornerstone of the market and the domestic equivalent of the "FANG" stocks. This week, we analyzed their Q3 results, and I must say, it was a mildly disappointing and forgettable quarter.

What did we learn?

Diversification Hurt: For over a decade, the Big Five banks have made a strong effort to expand their footprint into US banking (TD, BMO, CIBC, RBC) and Latin America (Scotiabank). The argument is simple: Canada is a mature economy with high profits that need to be reinvested. This effort to grow and diversify had a negative effect this quarter, especially in the US, which saw significant pressure in NIMs and profitability. Looking ahead, this will remain a headwind, as the current state of flux in local US banking will persist with revenue headwinds and expense headwinds before considering credit quality.

Expense Control: It's the first time I remember operating expense discipline being so loose across the banks, particularly RBC. In an inflationary environment, the rate of expense growth was a blistering 17% average for the Big Five banks. Digging into RBC specifically, in the last year, they hired several thousand employees in Canada alone and saw expenses grow 23% Y/Y. This is entirely unsustainable, and I see this as a top priority to be addressed in the coming months. Most banks globally have, for the past decade, been in the process of cutting staff and shrinking expenses across the board. After this quarter, I'm convinced that all the Canadian banks will follow in the footsteps of their global peers, and we are likely looking at budget cuts.

Credit Quality: One of the silver linings this quarter is the relative stability in the overall credit quality of loan portfolios. Loan loss provisions barely nudged higher except for CIBC—from historically low levels. It's true that new impaired loan formations picked up substantially, but it's too early to call it a trend, as they have been volatile and lumpy up to this point. I think it's worth highlighting this remarkable resilience in the face of an indebted consumer and an interest rate hiking cycle that rivals one of the fastest in modern monetary history.

Investors focusing exclusively on Canada have spent a lot of energy deciding between RBC vs. BNS vs. TD. However, I think it's important to zoom out and look at the bigger picture and the mixed operating environment. I believe we will see more quarters like this one, with more headwinds than tailwinds, and credit quality deterioration becoming a more prominent feature in 2024 under the current interest rate regime. This is global mean reversion at work, and I've seen similar phase shifts in fundamentals across Australia and Europe. A proactive approach to streamlining operating performance while reining in credit lending is critical, to navigating the current environment and building toward a brighter future.

Have a great long weekend!

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A magnet for top investment talent, iA Global Asset Management is one of Canada's largest asset managers, with over $100 billion under management across institutional and retail mandates. We help investors achieve their long-term wealth creation goals through innovative investment solutions designed for today's complex markets. We are building upon our historic success, supporting the growth of our core strengths, and exploring innovative ways to meet investor needs. We are rooted in history and innovating for the future. Our experienced portfolio managers use a proprietary investment methodology, rooted in iAGAM's unifying commitment to strong risk management, analytical rigor and a disciplined, process-driven approach to asset allocation and security selection.

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