DELTA ASSET MANAGEMENT

CELEBRATING 30 YEARS 1989-2019

Third Quarter Letter 2019

PERSPECTIVE

Stock buybacks hit a record in the U.S. last year, surpassing $800 billion for companies that comprise the S&P 500, eclipsing the previous high of $589 billion in 2007. With sustained low interest rates that are partially tax deductible, companies have an incentive to borrow funds to finance share repurchases. In 2018, it is estimated that 56% of the year's record buybacks were funded by debt.

Another catalyst of last year's record buyback was the U.S. tax overhaul in 2017. Tax reform increased corporate cash flow by cutting taxes and letting companies repatriate their cash held overseas by paying a one-time tax rate of 15.5%. It is estimated that companies repatriated $730 billion in 2018.

The readiness of companies to buy back their shares has contributed to the decade-long bull market. Since 2013, companies have spent $4.2 trillion on stock buybacks. Yet a number of critics and politicians from both parties have railed against the practice, particularly given the recent scale of repurchases.

> **Stock buybacks are an efficient way a company can return cash to owners if it lacks better ideas for investment.**

The basic allegation is that buy-backs divert cash flow from investment in new plants, equipment and higher wages. The controversy was heightened after the passage of the tax cuts whose authors promoted it as a boon to productivity and investment. Another criticism is that stock buybacks favor corporate executives who elect to cash out of their shares. Managers who initiate buybacks are obviously privy to their timing and scope. An analysis by the SEC showed that in the eight days following a buyback announcement, management teams, on average, sold five times as much company stock as on an ordinary day. If there is a short-term bounce in the stock price from an announcement, executives will benefit, though they still must comply with SEC insider trading rules.

Proposals have been floated by both Democrats and Republicans to curtail the practice. Republican Senator Marco Rubio proposed taxing shareholders on their pro rata share of the buyback amount at the same rate as dividends. There are multiple issues with this proposal starting with taxing a phantom benefit (that may or may not be realized when the stock is subsequently sold). Another version of the plan would apply a higher corporate tax rate on income used to repurchase shares. Senate Democratic proposals would prohibit buybacks unless firms offered minimum standards on wages and benefits defined by the government.

Are buybacks bad for shareholders and the economy? It is true that the ratio of dividends and stock repurchases to net income is high, reaching 96% during the period from 2007 to 2016 for S&P 500 companies. The ratio however ignores that companies also issue shares through secondary offerings and equity grants to employees to pay for acquisitions, investments and compensation. Net shareholder payouts, which incorporate equity issuances, amount to only 50% of net income during the period of 2007 to 2016.

There is no evidence that money spent on share repurchases is causing the U.S. to underinvest. U.S. companies, particularly tech and pharmaceutical firms, invest heavily in research and development (R&D). The U.S. has invested on average more than $550 billion a year on R&D, nearly 25% of total global investment.

Capital expenditures as tracked by the Census Bureau (U.S. non-farm businesses) have been trending up every year since the great recession and, in the last reported year 2017, was a record $1.6 trillion. In addition, average wages are now growing by at least 3.4% year over year, the fastest rate in a decade.

Delta's view of buybacks is that they are an efficient way a company can return cash to owners if it lacks better ideas for investment. Share repurchases are an appropriate mechanism to return value to shareholders if the economic value of the company is higher than its market value. Limiting or banning buybacks will not improve investment options. If share repurchases were no longer an option or discouraged, executives may spend more on projects with marginal returns, increase unsustainable dividends or let cash accumulate. The best solution is to let companies determine how to deploy their capital. Shareholders of those companies that make wise decisions will be rewarded with higher stock prices.

September 30, 2019

Company Comments

Comments follow regarding common stocks of interest to clients with stock portfolios managed by Delta Asset Management. This commentary is not a recommendation to purchase or sell but a summary of Delta's review during the quarter.

BD

Becton, Dickinson and Company { BDX }

Becton is one of the leading medical device companies supplying a diversified mix of basic and sophisticated products throughout the world. In the last four years the company has made two transformative acquisitions, CareFusion in 2015 and CR Bard in 2017. Thus far the integration and benefits of the acquisitions have been larger than expected. The company has extracted cost synergies while maintaining the culture and expanding the portfolio of products. The acquisitions are major steps to transform the company from a commoditized medical supply and devices manufacturer into a healthcare solutions company that improves healthcare processes and efficiencies.

The majority of Becton's sales are in what are called "sharps," which consists of safety needles, ultra-thin pen needles, hypodermic needles, syringes, catheters and related equipment;

the remainder is in infusion systems and medical dispensing technologies as well as diagnostic and research instruments. Approximately 50% of sales are in foreign markets.

The company maintains the largest market share of sharps worldwide based on the quality of its products, innovation, world-wide service capability and lower cost. Becton has innovated in sharps for 100 years and continues to push the technology forward. The last major innovation has been in the field of safety devices, which reduce the potential for healthcare worker needle accidents. Expansion opportunities remain in foreign markets due to slower adoption of safety guidelines and the need to minimize the spread of infectious diseases in developing countries. The essential and recurring nature of Becton's medical products, which account for over half its total sales, allows the company some relative stability in revenues despite the tougher medical technology spending environment. We expect this business will continue to generate strong free cash flow, which management has historically deployed wisely.

Recent acquisitions are a major step to transform Becton from a commoditized medical supply and devices manufacturer into a health-care solutions company that improves healthcare processes and efficiencies.

In March 2015, Becton acquired CareFusion creating a global leader in medication management, delivery and patient safety solutions. CareFusion focuses on medication management, infection prevention, operating room and procedural effectiveness, and respiratory care. CareFusion maintains the No. 1 market position in many of its product categories, especially in infusion pumps and medication dispensing equipment, where it is estimated to hold 25% and 70% global share, respectively.

The CR Bard segment has a leading product portfolio in the area of vascular, urology, oncology and surgical specialties. The products include bioresorbable grafts, vascular stents, vascular grafts, angioplasty balloon catheters and IV filters. Bard is strong in urology and has a suite of new solutions to help streamline medication management.

Becton's other businesses are more technology-oriented and also have large market shares. The primary products are diagnostic testing instruments for disease detection and cellular analysis instruments for pharmaceutical and biotech research. Both product categories have related equipment and supplies businesses that are sizeable. Diagnostics are the most likely growth drivers for Becton. The growth in infectious diseases will drive demand for rapid diagnosis and guided therapy. Cost pressures and lab technician shortages are driving demand for automation, while increased access to healthcare in emerging markets is driving the need for both automation and disease screening.

Becton faces a number of challenges, including the continuing integration of CareFusion and Bard. Further, hospital buying groups are consolidating to increase their purchasing power with suppliers. Longer term, the major risk to Becton is the commoditization of sharps, which Becton continues to combat through innovation, such as safety-engineered devices and ultra-thin pen needles. In addition, Becton faces growing competition from medical product manufacturers with sizeable research budgets, particularly in fast-growing segments. In healthcare there is always the risk that competitors create more innovative products that disrupt the industry by replacing existing products.

We feel confident assuming higher growth in Becton's more innovative businesses, such as diagnostics and drug dispensing technologies, and more modest growth in its maturing needle business. The population of the world is growing, and in major industrialized nations it is aging, which implies medical equipment will be in strong demand. Based on these assumptions, our stock valuation model indicates Becton's current stock price offers a long-term average annual rate of return of approximately 5.7%.

Nestlé

Nestlé S.A. { NSRGY }

Nestlé is the largest food and beverage company in the world with operations spanning the globe. The company is a leading player in several categories, including beverages, dairy products, confectionery, pet food and infant nutrition. More than 20 of Nestlé's brands generate in excess of $1 billion each in annual sales. The company has been extremely successful at establishing positions in growing product lines, generally through acquisition, and then nurturing those brands to further prominence.

The company's advantages include its possession of leading brands, significant economies of scale and an extensive global distribution network. Nestlé controls the No. 1 or No. 2 global market share position in the majority of its categories, which generally have lower private label competition. The company's unmatched investment in R&D has driven innovation, particularly toward differentiated health and wellness products. Nestlé's strong brand support should continue to strengthen its overall market position. Substantial marketing support and the market share positions give Nestlé a relatively strong position to negotiate with retailers for primary shelf space, which strengthens its competitive position.

More than 20 of Nestlé's brands generate in excess of $1 billion each in annual sales.

Nestlé is a core supplier to grocery stores across the globe, and its distribution network is extensive. The company's decades-old global operations and investments have created meaningful scale and dense distribution networks and also have established brand reputation in 191 countries, including a significant presence in faster growing emerging markets. The company has operated in most of its countries and markets for generations with consumer and supplier relationships dating back decades.

Nestlé's superior geographic and category mix should allow it to grow faster than most of its peers. Further helping drive growth will be further product portfolio investments into faster growing categories and affordable high-quality nutrition in emerging markets. The company is heavily exposed to emerging markets to the tune of an estimated 40% of sales. The company's focus on localized distribution networks, manufacturing and raw material sourcing should position Nestlé for continued growth and high margins in these markets. Good execution of cost-saving initiatives have led to industry-leading cash flow margins that we expect to increase over time.

Nestlé faces its share of challenges, including the consolidation of its retail customer base. The proliferation of low-price store brands continues to be a threat industry-wide, especially with hard discounters such as Aldi growing throughout the U.S. Consumers are increasingly gravitating towards natural and organic foods. They are also buying more fresh foods, as opposed to frozen, processed and packaged foods, which has had a negative impact on all food manufacturers, including Nestlé.

Given our expectations for worldwide growth in food and beverage markets and Nestlé's mix of faster growing, high margin categories, we believe Nestlé can grow revenues at 4% annually over the next decade and increase its operating margin to 18.5%. We believe Nestlé will be able to offset pricing pressures from major retailers as well as increased competition by continuing to implement and execute a number of cost efficiency programs adopted in recent years. Based on these assumptions, our stock evaluation model indicates Nestlé's current stock price offers a long-term average annual rate of return of approximately 4.5%.

ECOLAB®

Ecolab Inc. { ECL }

Ecolab is the largest global provider of water, hygiene and energy technologies and service programs. Its products and programs serve many different industries, such as food and beverage, hospitals, life sciences, hospitality and foodservice. Ecolab's exposure to water technologies has been primarily through acquisitions. The company provides chemicals, services and analytics to help commercial and industrial customers manage water quality, treat boiler and cooling water, and manage and reduce waste water. The company offers specialty chemicals that treat water and help improve production yields in oil and gas extraction. Ecolab's water-treatment programs serve global industries, such as food and beverage, manufacturing, pulp and paper production, mining and energy. The company's core strength of helping customers reduce, reuse and recycle water is becoming increasingly important as water potentially becomes scarcer longer-term.

The company's oil and gas business (23% of total company revenue) has added cyclicality to Ecolab's portfolio. The company's energy segment is still recovering after several years of a difficult operating environment due to depressed oil prices. Long-term, the company is positioned well in the industry with many advanced technologies and water treatment solutions required for energy sources, such as shale. From the reservoir to the refinery, the company's chemical solutions touch almost every part of the oil and gas value chain.

Founded in 1923 and headquartered in St. Paul, MN, the company pursues a "Circle the Customer – Circle the Globe" strategy by providing a comprehensive set of innovative cleaning, sanitizing and water treatment programs, products and services. . The company dwarfs its rivals in a highly fragmented market.

Ecolab's extensive and highly trained sales force has been a key contributor to strengthening and growing its leadership position in the industry. New customers over time are offered the company's latest products and solutions, thus expanding the relationship and adding incremental revenue. These customer relationships also provide valuable customer insight which often leads to product innovation. The sales force stays in close contact with customers by visiting sites to ensure that the company's products are working and being used properly. Salesmen are highly motivated with as much as 75% of compensation in the form of variable pay.

Many of the company's products and services are complimentary to one another and across industries. There continues to be good cross-sell opportunities between legacy Ecolab and its water treatment services. Its water applications already service hotels, hospitals, commercial buildings and food and beverage customers. This customer overlap should enable Ecolab to further "Circle the Customer" by selling new products and services to established customers and vice versa.

Ecolab has struggled in Europe for years and has gone through many reorganizations and cost-cutting efforts. The investment has begun to pay off with improved operating results. The company has streamlined operations, implementing one operating system to replace 15 and reducing the number of products. Ecolab also retrained its entire sales staff in Europe to focus on deeper product knowledge and incentives for cross-sell opportunities. These changes have resulted in better revenue growth and higher profitability.

Ecolab's core strength of helping customers reduce, reuse, and recycle water is becoming increasingly important as water potentially becomes scarcer longer-term.

Based on its business attributes as a whole, we have assumed Ecolab can grow revenue at an average annual rate of just over 4% over the next decade. Given the consolidation of acquired businesses and expectations of improved European profitability, we believe cash flow margins will average approximately 21% during our forecast period. Using these assumptions, our stock valuation model, based on Ecolab's current stock price, offers a return on invested capital averaging over 11%.

COMCAST

Comcast Corporation { CMCSA }

Comcast is the nation's largest cable provider offering a range of information, entertainment and communication services to residential and commercial customers. The five largest markets that Comcast serves are Boston Chicago, Philadelphia, San Francisco and Seattle. The cable segment's network is complete with video, high speed internet (HSI) and voice services that can be accessed by 56 million homes and businesses in 39 states representing more than 40% of all U.S. households. The company's NBC Universal business is a leading entertainment and media company that develops, produces and distributes news, sports and entertainment for global audiences.

On October 9, 2018, Comcast purchased Sky for nearly $40 billion. Sky is one of Europe's leading entertainment companies with a similar structure to Comcast, which primarily includes a direct-to-consumer business providing video, HSI, voice and wireless phone services as well as content business operating entertainment networks, Sky News broadcast network and Sky Sports networks. The acquisition nearly doubles Comcast's direct customer relationships to 52 million, provides broader distribution for NBCU and Sky-owned programming and content; it also adds a multi-national digital video offering with Sky's NOW TV. Comcast's international revenue expanded from 9% of total sales to 25%.

The cable segment is mature with subscriptions for video declining; however, these declines are being more than offset by continued growth in high speed internet services. With its cable footprint built-out requiring only periodic upgrades, return on investment and free cash flow have increased. Video viewing options have grown with newer competitive forces emerging with Amazon, Google, Netflix and other technology companies offering online and mobile platforms to watch video. Comcast leads the cable industry in innovations and has aggressively responded to these new entrants by launching its own online and mobile offerings, such as X1, the company's TV Everywhere platform.

Comcast has many positive attributes including recurring, predictable cash flows and competitive advantages, such as substantial scale and a fully built-out network.

A critical Comcast defense is its industry-leading internet speeds. With the continuing growth of online and mobile video and gaming, internet speeds are vital to continuing to drive growth in its high margin HSI business. Comcast continues to add over one million customers per year to its HSI services. Data usage-based pricing could become another driver of Comcast's revenue growth in the future, especially as data usage increases exponentially. Comcast's network architecture allows it to add capacity to meet customer speed demands at a far lower cost than competitors. In addition, Comcast Business Services continues to be a high margin growth driver for the company. It is now a $7 billion business growing at a low double-digit pace. Future growth prospects hold promise with currently just a 10% to 15% market share and an estimated $20 to $30 billion market opportunity.

Comcast's NBC Universal is experiencing the success of a robust turnaround. Comcast has significantly improved this collection of businesses, which includes cable networks, NBC broadcast stations, movie studios and theme parks providing adequate growth and good cash flow. Comcast is investing to transform the entertainment unit into a compelling multi-media juggernaut with the parent company's ample capital, scale and digital know-how. Its central focus will be sports and top echelon theme parks. With investments in NASCAR, NCAA football, NFL football, the Olympics and Premier League soccer, Comcast is betting it can boost fees and advertising. Sports are "must see" live events – whether at home or digitally while on the go – and still command premium ad rates.

Comcast has many positive attributes including recurring, predictable cash flows and competitive advantages, such as substantial scale and a fully built-out network. The significant capital investment needed for a new entrant to build a competing network serves as a barrier to entry and limits the ability to compete on price. With its network complete, Comcast can add new subscribers and improve the speed and capacity with only modest additional costs while increasing overall return on investment.

Comcast continues to operate exceptionally well with good growth and robust free cash flow. The company has a number of responses to the various competitive threats it faces; however, we believe it is prudent to expect modest revenue growth and a gradual reduction in operating margins over our forecast horizon. Our stock valuation model estimates a long-term annual return for Comcast of nearly 9% based on its current stock price.

Duke Energy Corporation { DUK }

Duke Energy has experienced several pivotal years transitioning to a regulated electric and natural gas infrastructure business. Beginning with the Progress merger completed in 2012, Duke has strengthened its core Carolinas market and expanded its coverage territory into Florida. Duke now generates and distributes electricity across a broad region encompassing parts of the Carolinas, Florida, Indiana, Kentucky and Ohio. The utility has a diversified customer base: residential 34%, commercial and industrials/textiles 50% and wholesale 16%. As a result of the merger, Duke now has greater operating efficiencies, more diverse and flexible power generation plants, and a more diverse geographic footprint.

With guaranteed returns and low variability in earnings, regulated entities such as Duke carry less risk than those operating in a competitive market.

In August 2014, Duke sold its non-regulated Ohio assets to Dynegy for $2.8 billion in cash, a level well above investor expectations. Returns in Ohio were low, and revenues had been steadily declining.

Under legislation in effect since 1999, Ohio customers could switch electricity providers at any time to capture the benefits of lower rates. In 2016, the company sold its assets in Latin America and completed its acquisition of Piedmont Natural Gas, a premier natural gas company based in Charlotte, NC, giving it critical mass in the gas distribution sector.

Today, Duke's power portfolio operates in a regulatory-approved monopolistic environment. In a regulated market, state commissions are responsible for approving a utility's rate base and allowable operating expenses. While rate base rulings are supposed to be in the public interest, commissions also must allow a utility to earn an adequate rate of return to compensate it for investment in plants and environmental improvements. With guaranteed returns and low variability in earnings, regulated entities such as Duke carry less risk than those operating in a competitive market. Regulated utilities, however, lack upward pricing power absent a new rate setting proceeding with state regulatory commissions.

Consequently, state regulatory commissions are an important factor in securing an adequate return on investment. Recent rulings in South Carolina have been disappointing, resulting in a lower than requested 9.5% return on equity. The South Carolina Board also disallowed recouping certain environmental remediation costs. Historically, Duke generally benefits from favorable regulatory regimes in the Carolinas and Florida. Regulatory risk remains a key uncertainty, particularly given Duke's aggressive capital expenditure plans during the next few years.

Duke will continue its elevated capital expenditure plans at least for the next few years, which should help growth assuming constructive rate case outcomes allow adequate returns. The company is taking advantage of historically low interest rates by issuing debt-to-finance modernization programs. However, construction costs for new power plants have increased markedly since 2000. The risk from cost overruns is that regulatory commissions may not allow a rate increase to cover them.

In August 2014, the North Carolina legislature passed the Coal Ash Management Act. The law requires closure of all coal ash basins in the state within 15 years, all of which are leaking contaminants into underground water. It is likely that the clean-up will result in higher costs for Duke's 3.2 million North Carolina customers. Duke is working on an environmental remediation plan, which must be reviewed and approved by North Carolina state environmental authorities.

Successful completion of the capital expenditure program should enable the company to achieve revenue growth in the low single digits. Our valuation assumes Duke achieves favorable regulatory outcomes on future rate cases. We believe demand challenges and rising costs are expected to pressure profit margins offset by operating efficiencies and better generation flexibility post-merger. We anticipate a long-term annualized rate of return on Duke's stock of approximately 6%.

Dated: September 30, 2019

Specific securities were included for illustrative purposes based upon a summary of our review during the most recent quarter. Individual portfolios will vary in their holdings over time in relation to others. Information on other individual holdings is available upon request. The information contained herein has been obtained from sources believed to be reliable but cannot be guaranteed for accuracy. The opinions expressed are subject to change from time to time and do not constitute a recommendation to purchase or sell any security nor to engage in any particular investment strategy. Any projections are hypothetical in nature, do not reflect actual investment results and are not a guarantee of future results and are based upon certain assumptions subject to change as well as market conditions. Actual results may also vary to a material degree due to external factors beyond the scope and control of the projections and assumptions.