News Highlights

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PORTLAND INVESTMENT COUNSEL®

Our views on economic and other events and their expected impact on investments Aug 10th 2015

Energy Sector

Whitecap Resources reported a robust set of results for its second quarter, including an improved guidance for its production for the full year. Production of 41,500 boed for the quarter was ahead of the expectations, the new production guidance for the year moved to 40,100 boed from 39,700 boed. Cash flow per share of $0.50 was also ahead of the expectations for $0.43 share. Capital spending remained unchanged at $235 million, of which H2 is $115 million, despite the higher production target, on the back of 10% plus cost savings and overall improved drilling efficiencies. Operating costs were $9.67/boe, lowered by a one-time adjustment. Operating net-backs at $42.20 (cash of $38.30) including hedging and $31.44 without. Borrowing capacity of $1.2 billion was 35% un-utilized as of quarter end, Net Debt/FFO of 1.3x. The company has hedged 42% of H2 2015 production at C$97 and 27% of 2016 production at C$98. Some 36 million shares were issued against Beaumont's assets, about 14% of the float, somewhat higher than expected, with the net result that the cash payment was only about $7 million (which tells a lot about the Beaumont's shareholders preference to take shares of WCP rather than cash – the deal terms capped the cash portion at $103 million). WCP's dividend payouts are expected to improve to low 40% basic and low 90% all-in on improved funds flows.

Financial Sector

Brookfield Asset Management reported net income for the second quarter of $1.2 billion, or $0.62 per share. Net income benefitted from continued expansion of operations, although valuation and transactional gains were lower than last year. Net income for the six months increased by 10% to $2.6 billion and on a last twelve months (LTM) basis, increased by 15% to $5.4 billion. Funds from operations (FFO) during the quarter totalled $520 million, or $0.50 per share. Asset management operations continued to be expanded, raising fee bearing capital within all strategies. This contributed to a 44% increase in fee related earnings. Fee bearing capital increased by $15 billion over the last twelve months to nearly $100 billion. The run rate of fee revenues increased 19% to $836 million on a LTM basis and the annualized fee base, including target carried interest, increased to $1.4 billion. New commitments amounted to $4 billion during the quarter, including transport assets in Brazil, wind developments in Scotland and a UK resort property operator. This increases the amount of capital deployed over the past twelve months to more than $16 billion. The company's board declared a quarterly dividend of US$0.12 per share (representing US$0.48 per annum).

Berkshire Hathaway – Warren Buffett's Berkshire Hathaway Inc said it would buy aerospace parts maker Precision Castparts Corp in a $37.2 billion deal, its biggest ever, taking it out of the market for another big acquisition for now. The deal, which eclipses Berkshire's $26.5 billion purchase of Burlington Northern Santa Fe railroad in 2010, extends Buffett's push into the industrial and aerospace sectors. "This takes us out of the market for an 'elephant' for 12 months or so ... but we will be buying a few small things in the next six months," Buffett said on CNBC. Berkshire's offer of $235 per share is a premium of 21.2 percent to Precision Castparts' Friday close of $193.88. The deal, which has an equity value of about $32 billion, is pitched at about 18 times Precision Castparts' forward 12-month earnings per share, according to Thomson Reuters data. Berkshire was already one of Precision Castparts' largest shareholders, with a stake of about 3% as of March 31, according to regulatory filings. Precision Castparts gets about 70% of its sales from the aerospace industry, which has experienced booming demand for commercial aircraft, leading Airbus Group and Boeing Co to boost production. Precision Castparts also makes energy-production equipment. "When you get a chance to buy a wonderful company, there is usually some reason why you are getting that chance and perhaps a slump in oil and gas helps us in this case," Buffett said. Buffett said Berkshire would use about $23 billion of its own cash and borrow the rest to finance the deal. "We will have about $40 billion in cash once we get through this," Buffett said. "I like to have a lot of cash at all times." Up to Friday's close, Precision Castparts' shares had fallen about 15% in the past 12 months.

Berkshire Hathaway said on Friday its second-quarter profit fell 37%, reflecting a significant decline in investment gains and an underwriting loss from insurance operations, which include Geico. Net income for the Omaha, Nebraska-based insurance and investment company fell to $4.01 billion, or $2,442 per Class A share, from $6.4 billion, or $3,889 per share, a year earlier. Operating profit declined 10% to $3.89 billion, or $2,367 per share, from $4.33 billion, or $2,634 per share, despite improvements at the BNSF railroad and Berkshire Hathaway Energy units. Revenue rose 3% to $51.37 billion. Book value per share, Buffett's preferred measure of growth, rose 2% from the end of March to $149,735. The most recent quarter included losses on contracts betting on long-term gains in major stock market indexes.

Earnings from insurance, Berkshire's best-known operating sector, fell 39% to $939 million, and included a $38 million underwriting loss versus a year-earlier $411 million profit. Much of that weakness stemmed from the Geico car insurance unit. Berkshire is boosting premium rates. Profit from BNSF rose 5% to $963 million as improved operating performance offset lower demand to ship petroleum products, reflecting lower crude oil prices and fertilizer shipments. Berkshire Hathaway Energy, a utility mostly owned by Berkshire, saw profit rise 34% to $502 million, helped by higher retail rates and a lower income tax rate. Berkshire has more than 80 operating businesses in such sectors as insurance, energy, food, industrial products and railroads. As of June 30 it also owned $117.7 billion of stocks such as Wells Fargo & Co and Coca-Cola Co. It bought $3.09 billion of equities in the quarter, without identifying the companies. The company estimated it will take a $7 billion non-cash pretax gain in the third quarter related to its 26.9% stake in Kraft Heinz Co. Berkshire took that stake in early July after backing the purchase of Kraft Foods Group Inc by H.J. Heinz Co, which Berkshire and Brazilian private equity firm 3G Capital acquired in 2013. The stake is worth about $25.5 billion, more than double what Buffett has said was Berkshire's $9.5 billion investment.

IGM Financial – reported operating earnings of $198.5 million or $0.80 per share for the second quarter compared to $203.9 million or $0.81 per share in 2014. Revenues for quarter were $763.2 million compared to $720.2 million a year ago. Total assets under management at June 30, 2015 were $136.0 billion compared to $141.4 billion at June 30, 2014, of which mutual fund assets under management at June 30, 2015 were $129.7 billion compared to $125.2 billion at June 30, 2014. The company's consultant network continued to expand, reaching an all time high of 5,176 at June 30, 2015. Mutual fund quarterly gross sales continued to improve with a record second quarter high of $1.9 billion following a first quarter record high of $2.4 billion. The Board of Directors has declared a dividend of $0.5625 per share on the Company's common shares.

ING Bank reported €1,118mn underlying net results vs €1,078mn consensus expectation. The 8% beat at PBT level was driven by Commercial Banking (+32% vs Consensus, pulled by Financial Markets), more than offsetting a miss in Retail banking (-12% vs Consensus, driven by Belgium). At the revenue line, there was a 3% miss in Net Interest Income while trading income came above expectation. 11.3% ING Bank Core Equity Tier 1 ratio reflected +30bp generation, -40bp dividend upstreaming. 13.2% ING Group Core Equity Tier 1 pro forma divestment of insurance for 2Q15 excludes 50bp generated in the quarter to provide dividend flexibility. Proposed interim dividend of €0.24 (in line with consensus €0.23). Although a range of 40-80% payout has been indicated for 2015, our view is that the special dividends stream in 2015-20 is becoming more complex to estimate due to uncertainty on how the so called regulatory buffer will be constructed at the end of 2015, and maintained over time by ING. €8.1bn Russia exposure vs €8.1bn end 1Q15; €1.2bn Ukraine exposure vs €1.3bn end 1Q15; €30bn Oil & Gas exposure (was €30bn end 1Q15)

Royal Bank of Scotland has sold another business to foreign investors as the bank works to shrink its balance sheet and increase its focus on UK retail and business banking. Mediobanca has bought a 51% stake in Cairn Capital, an asset manager based in Knightsbridge, with the right to acquire the remaining 49% in three years' time.

Standard Chartered - 1st half 2015 underlying Profit Before Tax of U$1859m below consensus, with the difference accounted for by U$235m lower income, U$48m higher costs and U$662m higher impairments. Additionally adjusting for £263m mark-to-market (MTM) losses through income, we put operating PBT at U$2122m. Ex MTM losses, income was U$8758m and broadly in line. The big driver of the miss is impairment where the U$1264m reported for 2Q is 2.7x that reported for 1Q. Non Performing Loans are also up 17% HoH (mainly Indian client/commodities), the majority of which must have happened in 2Q. It is too early in our view to determine whether the increase in provisions marks a significant deterioration in parts of the lending portfolio or rather the new CEO clearing out all questionable issues in order to ease a better rate of recovery hereafter. Core Equity Tier 1 ratio was stronger at 11.5%, +0.8% HoH with Risk Weighted Assets reduced 5% HoH. The improved core equity was partly helped (c0.1%) by a 50% dividend cut with the statement suggesting that no decision has been taken as yet on whether the group will seek additional capital. As expected, we do not have full details of the new strategy which will come later in the year. There is an argument that the higher capital ratio lessens the risk of a capital increase, but either way, RWA reduction will ultimately we believe, feed into earnings.

Activist Influenced Companies

ABB - In an article last week, Swiss newspaper Handelszeitung considered the likely options for Cevian to increase its stake in ABB. The newspaper speculated that Cevian could combine its 5.2% stake with Investor AB who owns 9.5% in a shared investment vehicle, and over time build this stake to 20%. This, the newspaper says, would be consistent with the recent changes in Investor AB and the increased focus on active ownership in its listed core holdings.

Mondalez - The Wall Street Journal reported that Bill Ackman's Pershing Square Capital has acquired a $5.5 billion (~7.5%) stake in Mondelez, which adds another activist investor to the name following Trian's Nelson Peltz's addition to Mondelez's Board of Directors in January 2014. Mondelez's goal of 300bp of expansion over 3 years was tangible and impressive when it was announced in 2013. But this now seems paltry given Heinz's 700bp improvement in 18 months from a more efficient starting point under 3G/Berkshire's leadership. Given that Mondelez is under explicit shareholder and activist scrutiny over the company's margin expansion potential– we believe that the company is likely to increase its margin targets sometime soon. Furthermore, it is also possible that Mondelez faces activist pressure to sell itself to someone like KHC (Kraft Heinz Co.), which has the cost-cutting expertise from 3G. Pressure from activist investors could also we believe catalyze a combination of Mondelez and Pepsi's Frito Lay down the line.

Canadian Dividend Payers

Barrick Gold posted a decent operating quarter. However, the more important takeaways in the Q2 release in our view come from the corporate activity announcements including: a sale of a gold/silver stream at Pueblo Viejo at a valuation of ~10x 2016 EBITDA (by comparison it's estimated Barrick is trading at roughly 5.5x 2016 EBITDA), further capex guidance reductions for 2015, a dividend reduction and the listing of the next group of non-core assets Barrick will look to monetize. In terms of the assets sales, we believe Barrick has been able to obtain better than fair value on its recent deals (50% of Zaldivar), a significant achievement in the current commodity price environment, bringing the YTD sales total to $2.45B. Looking at Barrick's other announcements, we think these definitive moves to preserve cash are necessary and prudent while continuing to identify other assets to sell is appropriate, especially if Barrick can continue to generate good sales prices for its assets. Combining the positive sales outcomes with cost reduction measures and a plan for further portfolio rationalization, we think Barrick is making strides in a positive direction in a very difficult operating environment.

BCE Inc posted a 25% jump in second-quarter profit as its mobile business grew, offsetting lower advertising revenue at its media arm. Bell, as the company is known to customers, added more than 61,000 postpaid wireless customers, who typically spend more than those who prepay for service. Wireless market leader Rogers Communications Inc last month added 24,000 such customers after two quarters of net defections. Montreal-based Bell reported net income attributable to shareholders of $759 million, or $0.90 a share. That compared with a year-earlier profit of $606 million, or $0.78. Revenue rose 2% to $5.33 billion. Excluding investment losses, severance, acquisition and other costs, profit was $0.87 cents a share, up from $0.82 a year earlier. Bell added 18,606 net Internet connections and signed up more than 50,000 customers for its Internet-based TV product. It shed close to 34,000 satellite TV customers amid tough competition. BCE said Bell Media`s advertising revenue was hit by the loss of broadcast rights for the National Hockey League playoffs, tougher competition in social media, and broad softness in the conventional TV market.

Brookfield Infrastructure Partners funds from operations (FFO) totalling $208 million ($0.91 per unit) for the quarter, up from $180 million ($0.86 per unit) last year. Solid organic growth and contributions from new investments more than offset a modest impact from foreign exchange movements. The distribution payout ratio for the quarter was 67%, which remains within the company's target range of 60-70%. Net income for the quarter was $18 million ($0.01 per unit) compared to $13 million ($0.01 per unit) in the prior year. The increase in net income is attributable to higher earnings generated from operations, partially offset by increased depreciation and unrealized mark-to-market losses.

In June, along with institutional partners the company signed definitive agreements to acquire all of the outstanding common units of Niska Gas Storage Partners LLC. The total equity investment for the Brookfield Consortium will be $175 million of which Brookfield Infrastructure will invest approximately $70 million for an effective 40% ownership stake. Earlier in the year, Brookfield opportunistically acquired approximately $250 million of Niska's senior debt (our share ~$100 million) at a substantial discount to face value. In Chile, Brookfield acquired the 50% of Tunel San Cristobal that it did not already own, investing approximately $15 million. In late June the company announced it was in exclusive discussions to acquire Asciano Limited, a large rail and port logistics company operating across Australia. It is a high quality company with an established market position in both the rail and port sectors in the country. The company's board declared a quarterly distribution in the amount of US$0.53 per unit.

Global Dividend Payers

Aggreko 1st Half figures delivered trading profit of £114m, down 18% yoy implying margins of 14.6% down c360bps from 1H 2014. Profit Before Tax and EPS were c5% behind Reuters consensus at £102m and 29.6p respectively. Oil & Gas in the Americas was a 2% drag on Local Business causing margins to fall 225bps to 11%. Local business revenue grew 3% overall given a £13m boost from the European Games. The Power projects business was down 9% underlying with Panama running at lower capacities, a decline in volume at Indonesia and lower pricing on the c325MW Bangladesh contract. Margins fell c580bps as a result; Contract wins year to date 451MW. Net debt was down £70m at £467m; Dividend has been held flat. Outlook unchanged at PBT of 250-270m with Capex – revised down to £270m from £300m. Management has concluded it has a strong, resilient business but that the market environment has changed. Its response is that £80m of cost is to be taken out by 2017, incurring £30m of cash costs in 2015/16 to achieve. The cost savings will be £40m in procurement, £40m in headcount reductions. The savings will be balanced between drop-through to profit and supporting growth through investment and pricing. Margins are expected to be 20% in the medium term (previously 20%+); but 2016 seen as a year of change that could see margins below 20%.

Toyota Motor reported 1Q FY3/16 Operating Profit of JPY756bn with an operating margin of 10.8% (1Q FY3/15 JPY692.7bn, 10.8%) somewhat higher consensus of JPY754.6bn, but generally within range of expectations. Consolidated sales fell by 127,000 units YoY to 2.114mn units, but this was also in line with expectations. Domestic sales fell by 36,000 units to 470,000 units on weak sales of mini vehicles. Overseas sales fell by 91,000 units to 1.644mn units, with North America up 18,000 units at 729,000 units, Europe broadly flat with a modest decline of 1,000 units to 206,000 units, Asia down 57,000 units at 329,000 units, and other regions down 52,000 units at 380,000 units. In addition to weak sales in Thailand and Indonesia, the company was apparently affected by generation changes for mainstay IMV models in Asia, Middle East, and elsewhere. Profits were adversely affected by volume and model mix (-JPY65bn YoY), higher costs from increases in labor costs, R&D costs, depreciation, and quality costs (-JPY95bn), and valuation losses for interest rate swaps and other items (-JPY42.8bn). However, profits received an even larger boost from forex (+JPY145bn), cost reduction efforts (+JPY60bn), and other marketing activities (+JPY35bn). Toyota retained initial Operating Profit guidance of JPY2.8trn, assuming forex rates of JPY117/USD and JPY127/EUR and consolidated sales volume of 8.95mn units (previously 8.9mn units). From a long-term viewpoint, we believe Toyota is building a profitable earnings structure while continuing to spend on development and investment. We believe it is making steady progress every year with cost reductions and productivity enhancement, and since it has adopted a broad regional development strategy and created an attractive product line-up, we retain our medium-term view of Toyota's ability to continue leveraging growth opportunities in both the developed and the developing countries. While overall demand is strong in the US, the company is starting to succeed in cutting sales expenses as a result of aggressive new model introductions, and has successfully grown volumes. While demand is temporarily slowing in some of the developing countries as a result of macroeconomic factors, on a medium-term view Toyota is continuing to strengthen capacity and introduce new models. Amid slowdown of industry sales, aggressive model introductions in China are driving sales past the recovery stage and into new growth. We believe Toyota is taking a more aggressive strategy towards shareholder returns, adding a flexible strategy of share repurchases to its previous policy of maintaining stable dividends. At the full-year results it announced plans to repurchase up to 40mn shares for a maximum of JPY300.0bn during FY3/16, adding this to the guideline 30% dividend payout ratio would give a total shareholder return ratio of more than 40%.

Economic Conditions

US – The US economy added 215,000 positions in July, marginally lower than the expected 223,000 jobs gain, driven by a 210,000 gain in private payrolls, while government added 5,000 positions. The headline unemployment rate held steady at 5.3%, as expected. The average weekly earnings inched higher by 0.2%, in line with the expectations, while the average workweek hours improved modestly to 34.6 hours from 34.5 hours. As it stands the job report seems to provide support to the view that the US Fed is likely to start raising interest rates at its next meeting.

US consumer meanwhile, absent any meaningful pick-up in employment earnings, continues to rely on consumer credit, which for the month of June shot up to $20.74 billion, ahead of the expectations for a $17 billion increase.

Canada – Canadian economy gained 6,600 positions in July, ahead the expectations for a 5,000 jobs advance, as a roughly 24,000 part-time additions more than offset the 17,000 full-time jobs lost during the month. The goods producing sectors lost jobs in July, as well as the finance and hospitality sectors, while professional and technical services, education and public administration gained. The headline unemployment rate was flat at 6.8%, while the participation rate moved one notch lower, to 65.7%.

Canadian trade deficit surprisingly shrunk to $480 million in June from $3.37 billion as exports of consumer goods and minerals drove total exports 6.3% higher. Export volumes were undoubtedly stimulated by the increased competitiveness caused by the lower Canadian dollar. Imports meanwhile were 0.6% lower.

Financial Conditions

The Bank Of England left rates unchanged at 0.5% but the members only voted 8-1 with McCafferty dissenting and voting for a 25 bps hike instead. Many had expected that there would be more than one dissenter and this disappointed GBP/£ bulls. Raised GDP for 2015 to 2.8% (from 2.5% back in May), but maintained the 2.6% in 2016 outlook. More importantly, from a policy perspective, Core Price Index is still expected to hit the 2% target within two years, but they lowered the inflation forecast to 0.3% for 2015 (from 0.6% in May) and trimmed it to 1.5% in 2016 (from 1.6% in May). In the press conference, Governor Carney still seemed to have an appetite for higher rates, eventually. The Governor spoke about strength in domestic demand, and that lower food & energy prices are boosting household incomes, that the labour market is tightening, and that credit conditions are improving…all of that should help eliminate spare capacity over the next year or so. He was questioned a lot on the timing of the rate hike and he continued to stress that it is "drawing closer" but that any moves will be "gradual".

US Federal Reserve policymakers remain determined to signal that although Quantitative Easing has stopped, the stimulus remains via keeping rates at present low until earliest September 2015. The US 2 year/10 year treasury spread is now 1.49% and the UK's 2 year/10 year treasury spread is 1.28% - 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 their costs of capital. It seems the top tier 6-9 investment banks will continue to command their market and possibly increase their share – as barriers to entry for newcomers have in our view been raised.

Influenced by the withdrawal of quantitative easing, the US 30 year mortgage market rate has increased to 3.91% (was 3.31% end of November 2012, the lowest rate since the Federal Reserve began tracking rates in 1971), as the Federal Reserve effectively continues to give priority to incentivising home ownership. Existing US housing inventory is at 5.0 months supply of existing houses. So the combined effects of low mortgage rates, near record high affordability, a more promising economic recovery, job creation, and low prices are finally supporting the housing market with housing inventory well off its peak of 9.4 months and we believe now in a more normal range of 4-7 months.

The VIX (volatility index) is 13.39 (compares to a post-recession low of 10.7 achieved in early June) and while, by its characteristics, the VIX will remain volatile, we believe a VIX level below 25 augurs well for quality equities.

Mutual Funds

Portland Investment Counsel Inc. currently offers 7 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

Private/Alternative Products

Portland also currently offers private/alternative products:

- Portland Focused Plus Fund LP
- Portland Private Income Fund
- Portland Global Energy Efficiency & Renewable Energy Fund LP
- Portland Advantage Plus Funds
- Portland Private Growth Fund

Net Asset Value:

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

Sources: Thomson Reuters, Bloomberg, KBW,BMO, Credit Suisse, Macquarie, Barclays, TD, Scotiabank

Source: Thomson Reuters, Bloomberg, KBW,BMO, Credit Suisse, Macquarie, Barclays, TD, NBFinancial
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