News Highlights

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Phone: 1-888-710-4242
Web: www.portlandic.com
Email: info@portlandic.com

PORTLAND INVESTMENT COUNSEL®

Our views on economic and other events and their expected impact on investments. December 7, 2015

Energy Sector

Baytex Energy Corporation – We had a call with Baytex's management earlier last week, trying to get a bit more detail a couple of weeks after their third quarter announcement. We discussed the company's prospects and industry outlook, summarized below.

The 2016 budget most likely to be announced later this week, will be driven by the company's expectations for next year's cash-flows (i.e. live within the means). A $350 million to $400 million target was provided back in August; chances are the new budget would be at the lower end or lower. The bulk of the budget will be allocated to Eagle Ford (Texas) operations, which is expected to continue drilling at the current pace using 4 to 6 rigs and two completion crews. Bayex announced cost savings and efficiencies adding up to -27% in its US operations, in line with the rest of the industry. Well costs have dropped from $8.2 million to just under $6 million in some cases, bringing the break-even to about $35WTI (West Texas Intermediate). All rigs are currently contracted on monthly basis and there has been significant high-grading of rigs across Eagle Ford (i.e. switching contracts to newest best tooled up rigs). Currently drilling at a pace of 40 net wells per annum, in the company's acreage 'sweet spot', the Lower Eagle Ford Sugarkane. The company has identified some 190 to 200 net locations, which would lead to highly economical drilling inventory for the next 4 to 5 years. The company has started a stack and frack program (also contributing to efficiencies) at Eagle Ford, with multiple well pads targeting up to four different formations (Lower Eagle Ford, Upper-Lower Eagle Ford, Upper Eagle Ford and Austin Chalk). The first four pads have been exceeding expectations and there are an additional 13 at various stages. Most likely that drilling in Canada will continue to be suspended until at least the third quarter of 2016. With no drilling, decline rates have improved in the company's Canadian operations from 30% to about 25%. New wells at Peace River see 55% first year decline rates. Company reduced staff expenses by 20% since start of the oil sell-off, trimming general and administration expenses by 15% in the third quarter alone. Baytex has continued its oil by rail program, though in the current $14 to $15 WTI/Western Canada Select (WCS) spread environment it only yields $1 to $2 of additional revenue; highly relevant though if and when production recovers in Western Canada and pipeline bottlenecking is again a problem driving the WCS differential higher. 40% of the company's oil production is hedged for next year with much of it in a three way $60/$50/$40 option, which essentially collars the crude price to $50 to $60. The company sees little opportunity to add to hedges in current environment. Bank debt is likely to increase to about $250 million by end of year from $205 million at the end of September, for a total of $2.0 billion with the long-term debt and some $950 million of undrawn capacity. Long-term debt nearest major maturity is 2021. Baytex does maintain significant operating leverage, in particular due to its Canadian heavy crude exposure, as well as financial leverage, though the volatility in the crude oil prices is likely to continue to impact the company's stock performance.

Royal Dutch Shell PLC received approval from the Australian Treasurer through the Foreign Investment Review Board for the proposed combination with BG Group plc. Although we had not anticipated any problems with this approval it is reassuring that the fourth pre-condition has been met. The last outstanding approval is now from China's competition authority which we expect by January, which is consistent with the planned early 2016 closing date.

Financial Sector

Bank of Montreal reported cash adjusted earnings per share of $1.90, well ahead of consensus of $1.74 but which benefitted from a net gain of ~$0.12 from: the closing of the sale of its US pension business; gains on the sale of its US pension business; gains on the sale of impaired real estate assets; favourable legal settlements; and recoveries in purchase credit impaired loans. Credit fundamentals remain strong in our view and the bank's Core Equity Tier 1 ratio was 10.7%. BMO increased its quarterly dividend by about 2% to $0.84.

Bank of Nova Scotia reported cash earnings per share of $1.46, which was above consensus of $1.43. However, the reported number benefitted by about $62 million after tax, or ~$0.05 a share, from a reduction in pension benefit accrual ($151 million after-tax benefit), offset by an increase to the collective allowance ($44 million after tax) and a reorganization charge ($45 million after tax). Total bank Provision for Credit Losses (PCL) ratio of 42 bps (47 bps including the collective allowance) is unchanged from last quarter; there were two new Oil & Gas formations/ problematic loans identified this quarter. The Core Equity Tier 1 ratio was 10.3%. Canadian Banking segment's cash earnings in the quarter were $849 million up 8% from a year ago with good volume growth (double-digit growth in cards, auto, and commercial lending), and higher risk adjusted margins (i.e. higher net interest margin; lower provision for credit losses); and also helped by a better year-over-year expense-to-revenue ratio.International Banking segment's earnings of $510 million were up 30% from a year ago helped by FX as well as improving underlying business fundamentals (better risk-adjusted margins and expense efficiency ratio). The segment, in source currency, had strong loan growth of 10%. Global Banking & Markets segment's earnings in the quarter were $325 million, well down from last year's high watermark of $427 million, primarily due to weaker investment banking and equities, and higher credit costs. Trading revenue of $348 million was up year over year, but essentially flat sequentially. The segment's expense-to-revenue ratio was 48.4% in the quarter, the highest in the past 12 quarters.

Barclays plc More jobs cuts were announced along with speculation over the weekend that Barclays is planning to cut another 20% of jobs at its Investment bank as new CEO Jes Staley settles in. Already planning 7,000 job cuts (approximately 25%), but speculation that these are in addition to an existing program and particularly across Asian business. Persistent previous reluctance of management to downsize unproductive areas of the investment bank has been a long term a concern.

Fifth Third Bancorp announced that it is monetizing approximately 19% of its equity stake and selling 62% of its warrants in Vantiv, Inc., the payment processing and technology provider. The sale of the warrants is expected to result in a $58 million after tax gain while the sale of 8 million class B shares is expected to result in a $215 million after tax gain. The gain from common shares is expected to be accretive by $0.02 per share through additional buybacks. Although the earnings per share accretion from these transactions is expected to be modest, we now expect further monetizing of Fifth Third's stake in Vantiv.

HSBC Holdings plc: HSBC is closing its private banking unit in India as part of its group strategy, the bank said, marking the exit of another foreign bank from the wealth management business in the economy. HSBC has offered private banking clients the choice to move to HSBC Premier, the bank's global retail banking and wealth management platform, a Mumbai-based spokesman said. The process is likely to be completed in the first quarter of 2016. "After a strategic review of the global private banking operations in India, we have decided to close the business," the spokesman said. "This marks further progress in the HSBC group strategy to simplify business and deliver sustainable growth." (Source Reuters)

Royal Bank of Canada reported cash operating earnings per share of $1.77 included an abnormally high contribution from the Corporate Support segment and an abnormally low tax rate in Capital Markets, excluding which it is estimated the operating earnings per share were closer to the consensus estimate of $1.64. Better Personal and Commercial Banking, Insurance and Capital Markets results helped offset a lower contribution from Wealth Management and Investor & Treasury Services. Credit remains intact with total bank Provisions for Credit Loss ratio of 23 bps. The Core Equity Tier 1 ratio improved to 10.6% (from 10.1% last quarter) driven by both internal capital generation and decreases in risk weighted assets.

Royal Bank of Scotland plc (RBS) has agreed to sell portfolio of Irish real estate loans for cash consideration of approximately £360 million. Gross assets were approximately £1.6 billion and will generate a gain of £245 million after costs and release approximately £700 million of risk weighted asset equivalent (+0.2% pro-forma Core Equity Tier 1). Overall we believe this to be positive.

Standard Chartered Plc announced last Tuesday it will eliminate 15,000 jobs, or 17% as it grapples with its change in focus to a more wealth management oriented business. (Source: Bloomberg)

The Toronto-Dominion Bank has reported adjusted cash earnings per share of $1.14, net of $0.13 in restructuring charges and $0.03 in charges related to the acquisition of Nordstrom's credit card portfolio, and compared to consensus estimate of $1.13. Credit quality remains solid with PCL of 40 bps (which includes some addition to collective allowance) and the Core Equity Tier 1 ratio declined to 9.9% from 10.1% mainly due to the restructuring charge and growth in risk weighted assets. The Canadian Retail segment remains the cornerstone for the Group with earnings of $1.50 billion, up 10% from a year ago, with 5% volume growth and better risk-adjusted margins (lower credit costs more than offsetting lower Net Interest Margin).

UK Banks' Bank of England Stress Tests were completed for 2015. The purpose was to assess the resilience of UK banks and building societies to a deterioration in global economic conditions. All 7 banks passed; of note:

- **Barclays** - Minimum stress Core Equity Tier 1 of 6.8% without payment of ordinary dividends, and 7.3% (-2.9% vs 2014 actual) after management actions relating to variable compensation and other costs. No requirement for a revised capital plan.
- **HSBC** - Minimum stress Core Equity Tier 1 of 7.0%, partly on lowered dividends, and 7.7% (-3.2% vs 2014 actual) after management actions relating to costs and legacy asset disposals. No requirement for a revised capital plan.
- **Lloyds Group plc** - Minimum stress Core Equity Tier 1 of 9.5%, ex dividend payments, and 9.5% (-3.3% vs 2014 actual) after management actions. Lloyds has confirmed that it continues to target a steady state Core Equity Tier 1 of c12% plus 1 year's dividends, although acknowledges that capital rules are still evolving. No requirement for a revised capital plan
- **RBS** - Minimum stress Core Equity Tier 1 of 5.9% and 6.1% (-5.0% vs 2014 actual) after management actions. The Prudential Regulatory Authority judged that it did not meet its Core Equity Tier 1 requirement, but in light of subsequent steps, there is no requirement for a revised capital plan. Note that RBS's Core Equity Tier 1 ratio ex Citizens was 16.2% at 3Q15.
- **Standard Chartered.** Minimum stress Core Equity Tier 1 of 5.1% and 5.4% (-5.1% vs 2014 actual) after management actions. The Prudential Regulatory Authority judged that it did not meet its 6% Tier 1 requirement, although in light of the rights issue and related actions, it did not require a revised capital plan.
- **Countercyclical Capital Buffer (CCB)**, as identified in Basel II reforms, are set to remain at 0% for now, although the Bank of England expects it will normally be 1%. The CCB can be used in a stress and, in an actual stress; the Bank of England expects it would decline to zero. Next update will be in March 2016.

- The 2015 stress tests have passed without significant drama and no incremental capital requirements (on top of those already planned). More importantly, the Bank of England has largely completed its calibration of UK bank capital requirements which set the aggregate Core Equity Tier 1 (CET1) requirement at approximately 12% CET1 (ex the counter-cyclical buffer), although with variations likely bank by bank. The key message is that the Bank of England is not seeking to structurally increase the capitalisation of the system, which is a clear positive, albeit the allocation of that capital into the various buckets will evolve over time.

The biggest beneficiary from the increased clarity is in our view Barclays where recent capital/distribution concerns have weighted on the share price. The long march to higher capital requirements in the UK appears to be nearing completion.

Wells Fargo & Company CEO John Stumpf said on Tuesday he disagrees with a new rule designed to boost one of the bank's cushions for absorbing losses. The Federal Reserve's regulation, known as the "total loss absorbing capacity" rule, or TLAC, will require the bank to issue another $60 billion of long-term debt. Asked in an interview on CNBC whether the $60 billion of total loss absorbing capacity makes the bank safer, Stumpf replied, "Now you're really getting under my neck a little bit, but I don't think that's something that we really needed." He added, however, that the bank would be able to manage the issuance. The TLAC requirements, proposed Oct. 30, are aimed at ensuring that some of the biggest and most interconnected banks can better withstand another financial crisis by turning some of their debt, particularly debt issued by their holding companies, into equity without disrupting markets or requiring a government bailout. (Source:Reuters)

Activist Influenced Companies

Nothing new to report.

Canadian Dividend Payers

Nothing new to report.

Global Dividend Payers

BHP Billiton plc tour of the South American copper business kicked off in Antofagasta with management delivering a confident message of strong, low capital intensive volume growth, significant reduction in costs and falling capital expenditure. In our view this is good news for BHP as it should deliver strong cash flows from the division over the next couple of years but might well presage a period of lower copper prices. A reoccurring theme throughout the day's presentations was that a step change in productivity across all assets is driving higher volumes and lower costs. This was expressed in numerous ways such as an 70% increase in material moved per employee since 2014, and by 2017 the mines will move 27% more material versus 2012 but at a $/t cost that is 40% lower. Head count reduction is also an important contributor with the operations implementing voluntary redundancy programmes which have reduced Escondida's labour force by 28% and Olympic Dam by 20%. Head office/ functional head count was also reduced by 45%.

Economic Conditions

US payrolls handily beat expectations with a 211,000 rise in November. Representing the last truly major economic release in advance of the December 16 Federal Reserve decision, this all but bakes in an interest rate hike by the Fed at that time, the first rate change in seven long years. The steady employment gains also suggest that despite many conflicting—indeed somewhat disappointing—economic indicators elsewhere, the US economy remains on track and is headed for another year of sturdy growth.

US Purchasing Manager's Index: for the first time since November 2012, the US manufacturing PMI has fallen below 50, the fifth month fall in a row, this time to 48.6 in November from 50.1 in October, the lowest level since June 2009 and an indication of contraction in the hard-hit sector. Nonetheless, anything over 43.1 indicates that the overall economy is still growing.

Financial Conditions

Bank of Canada left rates unchanged as expected and the accompanying statement provided little surprises. The Bank highlights that the two interest rate cuts from earlier in the year has smoothed the adjustment in the economy of lower oil prices.

The European Central Bank unveiled a range of measures to tackle too-low inflation, from a cut in the floor for interest rates to an expansion of its bond-buying program by at least 360 billion euros. The Frankfurt-based ECB will extend quantitative easing by six months until at least March 2017 at the current rate of 60 billion euros a month and broaden the assets purchased to include local and regional debt, ECB president Mario Draghi said last Thursday. The Governing Council earlier reduced its deposit rate by 10 basis points to minus 0.3 per cent. Draghi said the ECB is "willing and able" to act further if needed. Quantitative Eaing is now intended to total at least 1.5 trillion euros, up from the original 1.1 trillion euros.

The IMF announced that the Chinese Yuan / renminbi will be included in the IMF's Special Drawings Right basket (used to value the IMF's own de facto currency) with a weighting of 10.92%. Euro was the biggest loser on the weighting while the USD, JPY and GBP were more modestly reduced. Here is a quick summary of the changes: USD 41.9 to 41.7%; EUR 37.4 to 30.9%; JPY 9.4 to 8.3%; GBP 11.3 to 8.1%; CNY now 10.92%. The immediate implications to the currency are small but will have an eventual impact on global reserve managers that may need to shift their basket of currencies to reflect closer to the make-up of the SDR. The Chinese Yuan / renminbi will become the 3rd largest currency in the basket when it takes effect on October 1st.

The Reserve Bank of Australia left rates unchanged at 2% and Governor Stevens told the markets to "chill out" until February on rate hikes. Stevens was quite clear that an incremental cut in rates was having a lesser impact on the economy and that the Reserve Bank of Australia wanted to analyze further data until February. Australia continues to struggle with China slowing, lower commodity prices, weaker currency and wages flat-lining.

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 December 2015. The US 2 year/10 year treasury spread is now 1.33% and the UK's 2 year/10 year treasury spread is 1.27% - 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 3.93% (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 4.8 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 14.81 (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 and Renewable Energy Fund LP
- Portland Advantage Plus Funds
- Portland Private Growth Fund

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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Portland Investment Counsel Inc., 1375 Kerns Road, Suite 100, Burlington, Ontario L7P 4V7 Tel.:1-888-710-4242 • www.portlandic.com • info@portlandic.com

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