News Highlights

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PORTLAND INVESTMENT COUNSEL®

Our views on economic and other events and their expected impact on investments. December 14, 2015

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Energy Sector

Baytex Energy Corporation released the 2016 capital budget, which followed closely the guidelines discussed in our last call with the company's management. Production will likely be down in 2016 by about 11% (for those who are wondering where crude oil supply curtailments will be coming from in short term), impacted chiefly by contribution from Canada. The budget is expected to broadly stay within the cash-flows, as such a range of $325 million to $400 million was provided as a guidance. The surprise news is the re-negotiation of covenants to a Debt/EBITDA (earnings before interest, taxes, depreciation and amortization) of 5.25 times by the end of 2017. Baytex lost $200 million of credit facility as a result and will likely exit 2015 with about $750 million liquidity. In our view, the limiting factor is not the December 2017 date nor the lower sized facility, but the Debt/EBITDA ratio, which could be challenged in the current crude price environment sometime in the early 2017.

Royal Dutch Shell PLC received unconditional approval from Ministry of Commerce of the People's Republic of China for the combination with BG Group plc. This marks the final regulatory approval and fifth pre-condition that has been met. The next stage is now for the publication of shareholder documentation ahead of the shareholder votes. Assuming that both sets of shareholders vote in favour of the deal, it is possible that the transaction could now be completed by the end of January or mid-February compared to our initial assessment of end March. As noted in the Financial Times on December 14, Shell CEO Ben van Beurden, stated that "This is a strategic deal that will make Shell a more profitable and resilient company" as further evidence, if it was needed, as commitment to the deal by Shell even in a weaker oil price environment.

US land rig count fell 26 units to 684, which is the sixteenth consecutive week of declines and the biggest weekly decline since May 1, led by decreases in horizontal oil (-11), vertical oil (-9), horizontal gas (-4), vertical gas (-3), and directional gas (-1), slightly offset by gains in directional oil (+2). Total horizontal land rig count has declined 12% since the end of September. (Source Barclays)

US horizontal oil land rigs declined for a fourth consecutive week, led by the Permian (-5), "Other" (-5), Williston (-2), DJ-Niobrara (-2), and Utica (-1), partially offset by gains in the Eagle Ford (+2), Granite Wash (+1), and Woodford (+1). The Permian also lost 10 vertical oil rigs. (Source Barclays)

Canadian rig count was down 3 rigs and remains 59% off the level this time last year and is down 19% from its recent peak in July. (Source Barclays)

US offshore rig count dropped by 2 rigs to 23, which is the lowest it's been since December 2010 and is down 61% over the last 18 months. (Source Barclays)

Baker Hughes International Rotary Rig Count down 2 rigs month/month (m/m) in November and down 215 year/year (y/y). International land rig count averaged 1,109 in November with land rigs up 9 and offshore rigs down 11 m/m, led by Latin America (-10 m/m, -24% y/y), Asia Pacific (-5 m/m, -18% y/y), Africa (-3 m/m, -37% y/y), offset by Middle East (+16 m/m, +4% y/y), Europe was flat m/m (-28% y/y). (Source Barclays)

Financial Sector

Barclays PLC understood to have extended a freeze on hiring new staff until March as new CEO Jes Staley deepens cost cuts to boost profitability. The previous ban, implemented by Chairman John McFarlane in September until year-end, was due to be reviewed in January. Exceptions to freeze are some executive positions considered critical to the business, UK branch staff and low-cost positions. South African President Zuma fired Finance Minister Nhlanhla, last week causing significant pressure in the South African banks…albeit now seems to have reinstated him. Barclays owns 62% of Barclays Africa (mainly the old Absa business). The market cap is £5.5 billion. Barclays Africa (at 1st Half 2015): Contributes approximately 13% of pre-tax (before minority adjustment); loans of £33.8 billion, deposits of £34.4 billion, assets of £54 billion; and total assets of £54 billion. Standard Chartered is also exposed to the region.

Berkshire Hathaway Inc. – Warren Buffett has cut his stake in German reinsurer Munich Re Group again, after warning earlier this year that prospects for the reinsurance industry had turned gloomier. Buffett cut his holding to 4.6% from 9.7% previously. Buffet's companies Berkshire Hathaway and National Indemnity Company had cut their holding in Munich Re from around 12% in September. In May, Buffet told Berkshire Hathaway shareholders that the reinsurance business was "unlikely to be as good as it was".

Warren Buffett disclosed an 8.02% stake in Seritage Growth Properties, a real estate trust created by retailer Sears Holdings Corporation. Buffett's passive stake in Seritage Growth Properties is valued at $70.5 million. HomeServices of America Inc., a unit of Buffett's Berkshire Hathaway, agreed to buy luxury real estate broker Allie Beth Allman & Associates in November. Seritage was formed by Sears Holdings in June by spinning off about 254 Sears and Kmart stores, as part of the struggling retailer's plans to raise cash. The REIT, which now also includes Sears' 50% interest in joint ventures with three mall operators, has leased the stores back to Sears for operation.

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Citigroup Inc. Chief Financial Officer John Gerspach said last Wednesday that Citi will take a $300 million "repositioning charge" in the fourth quarter to "resize infrastructure and capacity" throughout its businesses,. Citi will also add $300 million to $400 million in loan reserves from the third quarter for energy loans, based on the expectation that oil prices will remain low, Gerspach told the Goldman Sachs US financial services conference. Depressed oil prices have put several US banks under pressure because of their exposure to loans to oil companies. Gerspach stated "we're likely to take additional reserve build of $300-400 million over the level we took in the third quarter. We don't see an increase in credit losses but given energy prices and prospects for the future we will be building incremental reserves". Citi took $140 million energy provisions in the third quarter and $140 million in the first half of the year on a $21 billion portfolio, implying full year charges are likely to rise to approximately 400bps. (Source Reuters)

Commerzbank AG – The Handelsblatt reports, citing a senior executive of the bank, that Commerzbank plans to restart lending across Europe for the first time since the financial crisis in 2008. After years of focusing its activities on business related to Germany and its neighbours such as Austria and Switzerland, Commerzbank is seeking to broaden its perspective, the newspaper reported, quoting Bernd Laber, head of the lender's international corporate banking division. "We want to win companies with revenue of more than €250 million as customers across the whole of Europe," Laber told Handelsblatt in an interview. Approximately 30% of bank's lending to small and medium enterprises is from international business.

ING Groep NV reported to be in final round of bidding for Finansbank. Recent press reports (El Confidencial) suggest Banco Bilbao Vizcaya Argentario SA (via Garanti Bank), ING and a Qatari Investment Fund are amongst the final participants in the bidding process for Finansbank. We believe Finansbank is the prize target in the Turkish market and given its branch distribution in Turkey offers an acquirer perhaps as much as 30% cost synergies.

Lloyds Banking Group PLC - The Court of Appeal has decided in Lloyds' favour that a Capital Disqualification Event has occurred on the Enhanced Capital Notes (ECNs). Lloyds intends to call around £0.7 billion the ECNs (those who chose not to accept the previous exchange offer) and will 'consider its options' in relation to the remaining series of ECNs (approximately £2.6 billion). Using the statement issued by Lloyds following the original court ruling, the potential financial benefit is £200 million per annum for 5 years should it refinance all of the securities, equivalent to 4-5bps of Net Interest Margin, 2-3% Earnings per Share (EPS) accretion and 1.4% of the market cap.

Nordea Bank AB - Completes sale of Nets. As previously communicated in a press release on June 15, 2015, the business was sold at a price of £230 million on an enterprise value basis. Nordea's capital gain after tax on the transaction is approximately £175 million.

Royal Bank of Scotland PLC (RBS) - RBS CEO has said that the restructuring of the Investment Bank is 'very well advanced' and will return to profit within the next four years. The CEO reiterated to deal with 'big conduct issues' (in particular US Retail Mortgage Backed Securities) by the end of 2016 and to resume dividends in 2017. Also, RBS signed agreements with AIG Asset Management (Europe) Limited, Hermes Investment Management and M&G Investments to lend to UK firms backed by private equity, RBS says in e-mailed statement last Monday. The agreement allows mid-sized companies to borrow up to €100 million in a single transaction co-funded by all four lenders. RBS to provide around £15-30 million of its own capital. The deals to be originated will be led and coordinated by RBS. RBS has completed 3 deals totaling approximately £250 million so far. (Source Bloomberg)

Standard Chartered PLC raised approximately $5.1 billion via its rights issue after 96.8% of the banks shareholders exercised their rights in a share sale last Friday. The shares will be listed in Hong Kong and the first trading day is expected to be December 16, the London-based bank said in a statement on Friday.

UK Banks - UK Banks gain extra 12 months for leverage-ratio disclosure. British banks including **Barclays** and **HSBC** gained another year before they're required to publicly disclose the daily average they use in calculating their leverage ratios, the Bank of England said, extending the transitional period until the end of 2017. Requirements will apply to firms with $75 billion in deposits.

Activist Influenced Companies

Hertz Global Holdings Inc. – Major shareholder, Carl C. Icahn announced it had increased its stake in Hertz Global Holdings to 14.34% as of December 7, 2015. Carl C. Icahn had previously reported a 11.34% stake in Hertz Global Holdings as of December 15, 2014.

Canadian Dividend Payers

Brookfield Property Partners Limited Partnership (BPY.UN, BPY) - The Australian Financial Review (AFR) reported that BPY and Brookfield Prime Property Fund (BPA.ASX) sold a 50% stake in Southern Cross East/West Towers in Melbourne for AUD $675 million to Blackstone Group at a (sub) approximately 5% cap and 34% above June 30th IFRS value. BPA also issued a press release, announcing an AUD $2.50/unit distribution, or 45% of its prior unit price. We believe that the sale of these landmark Class A office towers reinforce the existing value proposition to investors. We believe net proceeds to BPY of approximately AUD $330 million (approximately US $240 million) will likely go towards debt repayment, noting that BPA owned a 25%/50% interest in the Towers, with BPY owning the remainder -- BPY retains a 50% stake in each tower (and estimated ~81% interest in BPA). The AFR also noted BPY is poised to sell a 50% stake in World Square Shopping Complex (Sydney) to property group ISPT for AUD $280 million.

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Global Dividend Payers

AT&T, Inc. Chief Executive Randall Stephenson hinted at launching a mobile video streaming service as early as January to target price-conscious US viewers who don't currently have pay-TV subscriptions. AT&T is interested in putting together a content bundle that can be viewed on a smaller screen, or to a single screen in a home that's not set-top box-driven, Stephenson said. "It is something we are pursuing very, very aggressively and you should assume that we will be doing something in the market with that," he said at the UBS Global Media and Communications Conference in New York. There are about 30 million homes in the United States that do not have pay-TV subscriptions, he added. AT&T is looking for new revenue streams as the wireless market stagnates. The online video market is a competitive space with established players such as Netflix Inc. and Dish Network Corporation and new entrants like Verizon Communications rushing to service viewers who consume video on mobile devices.

With the $48.5 billion purchase of satellite TV operator DirecTV in July, AT&T became the No. 1 US pay-TV company with over 26 million US subscribers. The acquisition also gave AT&T the ability to leverage DirecTV's relationships and agreements with content providers to get mobile video streaming rights.

AT&T has already acquired rights to stream content to mobile devices for various premium cable channels such as Showtime and will deploy 40 megahertz of contiguous spectrum to relay content over its network, Stephenson said. "We think we have about as robust an entertainment portfolio of content for our customers as any OTT (over-the-top) provider out there," he said. To grow revenue, AT&T has expanded in Mexico after the recent purchase of the third- and fourth-largest wireless carriers in that country. Moreover, the acquisition of DirecTV has given the U.S. wireless provider a foothold in Latin America, a region that holds growth potential in pay television and mobile broadband.

Roche AG presented impressive phase data of atezolizumab in combination with chemo in triple-negative breast cancer at the San Antonio Breast Cancer Symposium, last week. The study showed that the combination shrank tumors (objective response rate or ORR) in 70.8% of patients. The highest ORR (88.9%) was observed in first-line treatment - with 1 confirmed complete responder. The data confirms in our view Roche's leading position in developing an immunotherapy for difficult-to-treat triple-negative breast cancer. Roche has already started a phase III trial in this indication, using atezolizumab in combination with chemotherapy (nab-paclitaxel). We expect data in 2018 and launch in 2019.

Economic Conditions

US retail sales rose 0.2% in the month. Motor vehicle sales fell for the second straight month, down 0.4% in November. Excluding autos, retail sales were up 0.4% in November following a downwardly revised October increase of 0.1% and the largest gain since July. General merchandisers also had a solid 0.7% jump in November (Star Wars paraphernalia?). And all of those stories about record online shopping (Black Friday/Cyber Monday/everything else in between) came through….mostly….in this sales report. Online shopping, which accounts for 9% of total sales, or 17% of core sales, rose 0.6%, the second biggest move since this summer. Core sales, which strip out cars, building materials and gas stations, were up a solid 0.6% and that, along with the still soft-reading for October, suggests to us to agree with BMOs view that real consumer spending hung in there at about 2.25% annualized in the fourth quarter. (Source BMO)

Canada – New housing prices in Canada handily exceeded expectations in October, up 0.3% in the month, against expectations for a 0.1% improvement. Canadian housing starts rose to a 211,900 units annualized level, against expectations for a small drop, driven by increases in multi-units starts. Small wonder that the regulator is imposing more restrictive mortgage rules.

Financial Conditions

The Bank of Canada estimated last Tuesday it could, if needed, set its benchmark interest rate as low as minus 0.5 percent, but stressed that the economy was recovering as expected and the bank did not expect to use such unconventional monetary policy. Governor Stephen Poloz laid out what he called an updated toolkit of unconventional monetary policy, one which showed the central bank had more room to manoeuvre than in 2009, when it estimated it could not cut rates lower than 0.25 percent. Poloz said he recognized it might seem an odd time to speak about unconventional monetary policy given that the economy was rebounding from cheap oil and commodities in a way laid out in the central bank's October Monetary Policy Report. (Source Reuters)

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 1.24% and the UK's 2 year/10 year treasury spread is 1.24% - 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 3.95% (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 24.39 (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 and Renewable Energy Fund LP
- Portland Advantage Plus Funds
- Portland Private Growth Fund

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