News Highlights

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PORTLAND INVESTMENT COUNSEL®

Our views on economic and other events and their expected impact on investments. December 19, 2016

Energy Sector

U.S. land rig count increased by 13 rigs week/week to 614 and is now up 40 rigs in the past 2 weeks, which is the largest 2-week gain since March 2014. The rig count continues to maintain momentum despite heading into the holiday season, but it is worth noting RigData released its 12/9/2016 rig count this week (reports on a 1 week lag), which was down 8 rigs week/week versus the BHI rig count, which was up 27 rigs last week. The rig count is now up on average 21% Quarter to Date quarter/quarter and is averaging 477 rigs for 2016. Gains in Horizontal Oil (+12), Vertical Gas (+2), and Directional Gas (+2) were slightly offset by declines in Horizontal Gas (-3), while Vertical Oil and Directional Oil remained flat week/week. Total horizontal land rig count is down 63% since the peak in November 2014. The Permian currently makes up 53% of all oil rigs.

U.S. horizontal oil land rigs increased by 12 rigs week/week to 412 and is now up 33 rigs in the past 2 weeks, which is the largest 2 week gain since April 2013 as gains in the Permian (+11, largest weekly increase since August 2016), "Other" (+3), and Eagle Ford (+2) were partially offset by declines in Woodford (-2), Williston (-1), and Mississippian (-1), while DJ-Niobrara and Granite Wash remained flat week/week.

U.S. Gulf of Mexico offshore rig count remained flat week/week at 22 rigs and is down 59% since June 2014.

Canadian rig count increased by 4 rigs week/week and is now up 43% from the level this time last year.

Baytex Energy Corp. – Last week we had the opportunity to meet with Baytex's incoming CEO Ed LaFehr. Given the circumstances (improved crude oil markets), the meeting was undoubtedly the most upbeat we have attended with the company. Ed LeFehr thinks the company's leverage to a recovery in the crude oil prices, via its relatively high exposure to oil (as opposed to natural gas), its operating and financial leverage provide a very attractive potential equity upside. Mr. LeFehr was previously the Canadian President of Abu Dhabi National Energy Company PJSC (Ticker: TAQA ADX), responsible for about 80,000 barrels of oil equivalent per day (boed) of Canadian production, as well as the Chief Operating Officer of TAQA globally. Baytex's managers believe that going forward the winners in the industry need to be able to vigorously grow production on the basis of a $60/bbl to $70/bbl environment. A review of the company operations revealed that, during the past couple of years, Baytex was able streamline its operations and reduce its operating expenditure requirements by $80 million to $240 million, as well as to cut its general and administrative expenditures by 15%. Drilling, completion and equipping wells cost down 40% in the Eagle Ford basin (as low as $4.6 million/well currently). Capital efficiencies (the cost to bring a barrel of flowing oil per day online, based on first year's production) are currently very competitive, at $11.5k/bbl or $13.5k/bbl, including facilities. Baytex has announced a $325 million (the mid-point of its guidance) of capital expenditures for 2017, weighed heavily towards drilling and completions and towards Eagle Ford. The company's Canadian operations are slated to receive about $85 million of the 2017's capital money and drilling is set to re-start quite strongly in the first quarter of next year both at Peace River and Lloydminster after more than 18 months interruption. With the acquisition of Murphy's land and facilities for $65 million, including roughly 6,000/bbl PDP (proved developed producing), of which 3,000 are currently flowing, Baytex becomes the dominant operator in Peace River. Baytex's priorities going forward are focusing on sustaining and (modestly for now) growing production and addressing the debt load.

BP Plc announced on the weekend an all share deal that will see the Abu Dhabi government take a 2% interest in BP through newly issued shares in exchange for a 10% interest in the Abu Dhabi ADCO concession which has a life of 40 years. In exchange, BP issues 2% of equity at 447/share to be held on behalf of the Abu Dhabi government making it a top 10 shareholder of the company. BP's net share of oil and gas production from Abu Dhabi is currently around 95,000 boed and is expected now to grow to approximately 260,000 boed in 2017. The ADCO concession, put in place in January 2015, is valid until the end of 2054. BP expects to second up to 50 technical staff to ADCO, bringing technology, expertise and experience to support the ongoing efficient operation and development of the assets. The price is almost identical to the price that was paid by Total a year ago for the same size stake in the same asset. The terms of the concession have not been disclosed, but given the reluctance of BP to sign a deal at the same time Total did, we expect that, at a minimum, the terms would be the same as those agreed at that time, which we understand to be $2.85/bbl. In practice, given the delay and hurdle rates that BP implements, it is likely that there are additional incentives that have been negotiated in the contract to improve the economics. BP today has also announced an agreement with Kosmos Energy Ltd. to acquire exploration blocks in Mauritania and Senegal. BP will acquire 62% interest and operatorship of offshore Blocks C-6, C-8, C-12 and C-13 in Mauritania and 32.49% interest in the Saint-Louis Profond and Cayar Profond blocks in Senegal. BP will pay $916 million to Kosmos spread over multiple years including: $162 million in cash up front, $221 million carry of exploration and appraisal costs, $533 million carry of development costs until first gas on the Tortue project. Project sanction of Tortue is expected by 2018. This implies total capex for BP of ~$2.2 billion or roughly $450 million of investment per annum up until first gas of the Tortue project. BP will also pay a contingent bonus of up to $2/bbl for up to 1 billion barrels of liquids, paid as a production royalty, and subject to a future liquids discovery and oil price. Total resources within the agreement are estimated to include 50tcf (trillion cubic feet) of gas and over 1 billion barrels of liquids. Kosmos will remain the technical operator for the exploration phase and drill three wells in 2017. The deal is expected to close by Q1 2017, subject to regulatory approval. The transaction is affordable in our view while also providing BP access to low risk reserves.

Royal Dutch Shell Plc has announced that Simon Henry, CFO from May 2009 is to leave Shell and will be succeeded by an internal candidate, Jessica Uhl. Mr. Henry is to remain on the Board as CFO until March 9, 2017 and sign off the 2016 annual report and bring to a close a 34 year career with Shell having overseen the acquisition of BG in the past two years, navigating through an extremely difficult period of both low oil prices and change within Shell. His successor, Jessica Uhl, joined Shell in 2004 and has held a number of leadership roles across the business, but is relatively unknown to the wider market in our view. Unusually perhaps for Shell she has also worked externally to the company in the early part of her career. Ben Van Beurden's statement of "I am delighted to welcome Jessica to the leadership of our company. I look forward to working with her in assuring its financial success as we execute our strategy to re-shape Shell" does indicate, as we would expect no change to the priorities of Shell. Shell is at the beginning of a long journey to deliver higher and, hopefully, more predictable returns. The integration with BG is now essentially complete and the combined group provides a more competitive base from which to be able to reset and simplify the business, in our view.

Financial Sector

Bank of Montreal has agreed to a no-contest settlement with the Ontario Securities Commission (OSC) that will see the bank compensate customers a total of C$49.9 million ($37.4 million) for charging excess fees. The OSC said the settlement follows allegations by OSC staff that there were inadequacies in BMO's systems of controls and supervision which resulted in some clients paying excess fees that were not detected or corrected in a timely manner. In addition to the compensation, BMO has agreed to make a payment of C$2.1 million to the OSC to help fund investor education and C$90,000 toward the cost of the investigation. A number of other Canadian financial institutions have agreed to similar settlements. Canadian Imperial Bank of Commerce said in October it had agreed to pay out C$73.3 million in compensation for excess fees. Fund manager CI Investments agreed to a C$156 million settlement in February. Toronto-Dominion Bank agreed to pay C$13.5 million to customers in 2014. Bank of Nova Scotia agreed to a C$20 million settlement in July. 'The no-contest settlement is a strong enforcement tool that has resulted in more than a quarter of a billion dollars in compensation to investors, through seven no-contest settlements,' said Jeff Kehoe, the OSC's Director of Enforcement. (Source: Globe & Mail/Reuters)

Barclays Plc has agreed to sell its French retail banking division as it continues its efforts to streamline its business. Private equity firm AnaCap Financial Partners will take over 74 retail branches, a life insurance business, as well as wealth, investment management and brokerage operations. The deal - for an undisclosed sum - does not include Barclays' corporate and investment banking operations in France. It has previously sold its Barclaycard credit card operations in Spain and Portugal, its stake in Barclays Africa, and its wealth and investment management business in Singapore and Hong Kong. (Source: BBC)

Fifth Street Senior Floating Rate Corp. - (FSFR) reported core earnings of $0.22/share, in line with expectations but slightly below the quarterly dividend of $0.225/share. Net Asset Value increased 0.6% quarter/quarter to $11.06/share, largely the result of spread tightening. Leverage was at the high end of the target range of 0.90x Debt/Equity, which management noted should come back down next quarter as it expects net repayments. Going forward, the new strategy for FSFR includes management's indication that it is evaluating ways to enhance the external advisor and shareholder alignment (i.e. fee structure). Management indicated that LIBOR floors in the portfolio range from 100-200bps, with most closer to the lower end. While 3 month LIBOR has increased this year, the level has not exceeded the average floor yet, which has negatively impacted net investment spread (given cost of floating rate liabilities has increased). However, with the market pricing in additional rate hikes next year, 3 month LIBOR should eventually exceed the average LIBOR floor, and FSFR should see some benefit to the bottom line. FSFR noted that the September quarter was sluggish, with a lack of M&A. Given there is ample capital going after limited deals, leverage levels are higher and yields lower in this environment, so FSFR remains selective. As a result, origination activity could be lower in the coming quarter and FSFR expects to see net repayments, which will be used to de-lever back down to the middle of its target leverage range of 0.80x-0.90x Debt /Equity.

Goldman Sachs Group Inc. has elevated David Solomon and Harvey Schwartz to be top lieutenants to Chief Executive Lloyd Blankfein, filling a void left by No. 2 executive Gary Cohn, who is leaving the bank to join the President-elect Trump administration.

HSBC Holdings Plc bought back 7.49 million shares at average 664.93 pence each Dec. 15, bringing total amount repurchased to 321.3 million shares for £1.94 billion ($2.41 billion) since Aug. 4, according to stock exchange filings and Bloomberg calculations.

Royal Bank of Scotland Group Plc (RBS) - a small group of RBS retail shareholders is close to joining three other investor parties and settling a £4.0 billion ($5 billion)-plus lawsuit against the bank out of court. State-controlled RBS offered five investor groups £800 million last week in an effort to draw a line under allegations that it misled shareholders during a £12 billion fundraising at the height of the financial crisis in 2008. One industry source familiar with the situation said he expected a formal announcement over the next few days that the small retail shareholder group, led by lawyer Leon Kaye, would become the fourth group to accept the offer. Three institutional investor parties agreed to the RBS offer last week. (Source: Reuters). Also, RBS is drawing up contingency plans that would enable it to still meet state aid rules if the bank is unable to offload its troubled Williams & Glyn (W&G) branches. The state-backed bank has already conceded it will not offload W&G by the end of next year, the deadline set by the European Commission. Santander and the challenger bank Clydesdale have lodged bids for W&G but not for the entire business, meaning RBS is at risk of failing to meet Brussels' demands. Any major changes to Williams & Glyn would require Treasury officials to win approval from EU antitrust regulators. The disposal of the 314-branch network is a state-aid requirement forced on RBS by the EC, as a condition of the lender's £45.5 billion bailout at the height of the financial crisis. Brussels, which first demanded the divestment seven years ago, wants to boost competition in corporate and SME banking.

Activist Influenced Companies

Brookfield Business Partners L.P. (BBU), a Bermuda-based owner and operator of assets that operates in commercial and residential real estate, construction, energy and industrial sectors, has agreed to issue 8 million limited partnership units, on a bought deal basis, to a syndicate of underwriters co-led by TD Securities, Inc., CIBC Capital Markets, Inc., Citigroup Global Markets Canada, Inc., Morgan Stanley Canada Limited and RBC Capital Markets (underwriters) at a price of C$32.8 ($23.59) per unit for gross proceeds of approximately C$262 million ($188.46 million). Concurrently, BBU, directly or indirectly is planning to issue 8 million redeemable-exchangeable units to Brookfield Asset Management, Inc. and certain of its related entities for approximately $192 million on a private placement basis. Our calculations indicate that, subsequent to the new issuance, Brookfield Asset Management's stake in BBU will reduce from around 78% to about 70%, thereby increasing the size of the floating shares and the trading liquidity.

Hertz Global Holdings Inc. – U.S. car rental company Hertz said it would replace its chief executive and reduce its board size in January, moves backed by its biggest shareholder Carl Icahn. Hertz said CEO John Tague would retire on Jan. 2, a little over two years after he got the role with backing from Icahn, and be replaced by Kathryn Marinello, who sits on the boards of AB Volvo and General Motors Co. "Kathy has a history as a proven CEO and I believe she is the right person to lead Hertz as we move forward," Icahn, who has a 35.3% stake in Hertz, said in a statement issued by the company. Marinello has been a senior advisor of Ares Management LLC since March 2014 and was CEO of customer management services provider Stream Global Services Inc from 2010 to March 2014. She has worked for more than 10 years at General Electric Co.

KRAFT-HEINZ Co. planning to acquire MONDELEZ International Inc. - according to Swiss paper Bilanz…according to unidentified "very well-informed" source. Jorge Paulo Lemann and his Brazil investment company 3G Capital are reported to be mobilizing capital for this investment. An acquisition would likely lead to tough cost cuts, the magazine reports.

Canadian Dividend Payers

Nothing new to report.

Global Dividend Payers

ABB Ltd. - In an interview with NZZ am Sonntag (December 18), the chairman of ABB, Peter Voser stated that the company is well positioned in the U.S. to benefit from ongoing reindustrialization and Donald Trump's infrastructure plans and expects order volume corresponding to ABB's market share if the plans are implemented. He added that the outdated power grids and increasing automation offer additional opportunities in U.S. market. On the macro environment, he expects the world economy to slowly return to growth in 2017, calling next year as 'interim year' for ABB.

Aryzta AG - Issuance of a number of Schuldschein (German floating or fixed instrument, not listed) tranches were issued with maturities between 3 and 7 years (EUR and USD) for a total of €386 million - Initial weighted average interest rate of 1.65% - were issued with maturities between 3 and 7 years weighted average maturity of over 4 years for the total issuance. The announcement of the new financing was expected for mid-December, therefore no surprise. Aryzta was however initially planning to issue a Euro bond, which ended up in that solution with a Schuldschein (arranged via BNParibas, Helaba, HSBC, Mizuho).

Bunzl Plc - Trading is in line with expectations at the time of the third quarter in October. Constant currency revenue growth is expected to be 4-5% for the full year and margins flat year/year. This is slightly ahead of a 4% constant currency revenue growth but behind compared to a slightly higher margin forecast of +4 basis points. On revenue, organic growth is said to have improved in Q4 following some recent business wins and the abatement of input cost deflation. No new acquisitions are announced. Total M&A spend this year has been £150 million on 13 businesses (vs. £125 million at the nine month stage on 11 businesses and £324 million on 22 businesses in 2015). The lower level of acquisitions this year has been attributed to timing, with management saying there is no change to the pipeline, with the group seeing a pickup in business wins in the fourth quarter.

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Economic Conditions

U.S. Federal Open Markets Committee (FOMC) raised its policy rates by 0.25%, which was completed as expected. The fed funds target range is now 0.50%-to-0.75% with the overnight reverse repo rate at 0.50%, the interest rate on excess reserves at 0.75% and the discount rate at 1.25%. The vote to raise rates was unanimous. Importantly, there were no changes in the Fed's forward guidance on policy rates and its balance sheet. Policy remains as data dependent as before. In the statement, the economic assessment mentioned "solid" job gains, the drop in the unemployment rate, and that "market-based measures of inflation compensation have moved up considerably." If anything the Fed may, in our view, be starting to feel, just a bit, too much of a good thing on the labour market front. A key phrase was that "the stance of monetary policy remains accommodative, thereby supporting some further strengthening in labor market conditions…" The "some" was the interesting add. Perhaps the FOMC is sensing it is converging fast on "true" full employment. However, in the press conference, Chair Yellen said that Fed was not "behind the curve" with respect to labour market tightening, despite being in the "vicinity of maximum employment". The risk assessment stayed at "roughly balanced". At lift-off last year it shifted to "balanced" but not this time. The "roughly" likely stayed to reflect uncertainty about the degree of forthcoming fiscal stimulus and a heavy European political/Brexit calendar.

U.S. retail sales were disappointing in November. Headline sales rose for the third month in a row but just 0.1% in November, well below expectations, while October's increase was revised lower as well. There are a number of reasons that could explain the softer headline: consumers already had a couple of very strong months (averaging 0.8%), more discounting to drive sales/traffic (need to see how volumes fared to get a truer picture), a less hectic Black Friday/Cyber Monday. Nonetheless, with core sales edging up only 0.2%, this has some negative implications for consumer spending in the fourth quarter. Still, bear in mind the three explanations above, particularly on pricing. There is still strong support for consumer spending; namely, steady job growth and wages heading higher.

U.S. industrial production headline reduced by 0.4% mainly due to the volatile utilities sector. Remember, this was the second warmest November in nearly a century, and that held utilities back 4½% in the month. The component carries a weight of just over 10%, and given that there was reassuring news from manufacturing—flattish (or -0.0347%) following an upwardly revised October—and mining (two straight monthly gains averaging 1½%), total production ex utilities was actually unchanged in the month. With slower headline output, capacity usage was down again. Total capacity utilization fell 0.4 pts to 75.0%, a 9-month low, while for manufacturing, usage was unchanged at 75.4%. So, by these measures, there is still lots of slack in the economy in our opinion.

U.S. housing starts: fell 18.7% in November to 1.090 million units, annualized. This almost erased the prior month's upwardly revised 27.4% surge to 1.340 million units…..almost. Every region across the country took a hit, particularly the Northeast which was sliced in half (was it the major snowstorm that hit NY late in the month?). Singles fell for the first time in a few months, down 4.1% but multi-unit construction were slashed 45.1%. However, multi-unit construction is highly volatile: they took a 38.4% nosedive in September, surged 76.0% in October, and now this although multi-unit family construction is still a smaller component of overall housing. Building permits, which are a good indicator of future starts (need permission to break ground before one can break ground), fell 4.7% in November, the first drop since July to 1.201 million units, annualized. And they were down in three out of the four regions…… only the Northeast rose. Building permits over the past three months, on average, are at a 1½-year high and permits are still > starts, which suggests more room to move up. We believe we should take these exceptionally volatile month to month moves with a grain of salt. The U.S. has "solid" job gains, a jobless rate below 5%, wage growth, and homebuilder confidence is at an 11-year high. Although mortgage rates are off their lows and home prices continue to climb thanks to low inventories (more municipalities implementing 'inclusionary zoning programs' across the country will contribute to that), the aforementioned factors are very supportive, still, for the housing market.

Financial Conditions

The U.S. 2 year/10 year treasury spread is now 1.32% and the U.K.'s 2 year/10 year treasury spread is 1.31% - 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.

Influenced by the withdrawal of quantitative easing, the U.S. 30 year mortgage market rate has increased to 4.16% (was 3.31% end of November 2012, the lowest rate since the Federal Reserve began tracking rates in 1971). Existing U.S. housing inventory is at 4.8 months supply of existing houses. So the combined effects of low mortgage rates, near record high affordability, 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 12.40 (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 Focused Plus Fund
- Portland Private Income Fund
- Portland Global Energy Efficiency and Renewable Energy Fund LP
- Portland Advantage Plus Funds
- Portland Private Growth Fund
- Portland Global Aristocrats Plus Fund

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