News Highlights

Owners. Operators. And Insightful Investors.

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PORTLAND INVESTMENT COUNSEL®

Our views on economic and other events and their expected impact on investments. January 30, 2017

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Energy Sector

U.S. land rig count increased by 19 rigs week/week to 689 rigs, and is up 55 rigs in the last two weeks, which is the largest two week gain since August 2011. The rig count is up on average 27% Quarter to Date quarter/quarter. Gains in Horizontal Oil (+17), Horizontal Gas (+3), Directional Oil (+2) were slightly offset by declines in Vertical Gas (-2) and Vertical Oil (-1), while Directional Gas remained flat week/week. Total horizontal land rig count is down 58% since the peak in November 2014. The Permian currently makes up 53% of all oil rigs.

U.S. horizontal oil land rigs increased by 17 rigs week/week to 463, now up 35 rigs in the last two weeks, which is the largest two week gain since May 2012, as gains in the Permian (+11), now up 22 rigs over the last two weeks, which is a record (BHI basin level data dates back to 2011), Eagle Ford (+4), Woodford (+4), Williston (+2), and Granite Wash (+1), were partially offset by declines in DJ-Niobrara (-3) and "Other" (-2), while Mississippian remained flat week/week.

Canadian rig count increased by 4 rigs week/week as rigs continue to come back online after the holiday shut down and is up 51% from the level this time last year.

U.S. Gulf of Mexico offshore rig count decreased by 3 rigs week/week to 23 and is down 63% since June 2014.

BP PLC has announced the start-up of the Thunderhorse South expansion project in the Gulf of Mexico. This is the first of eight upstream project start-ups due in 2017 with this set of projects set to be a key factor in enabling BP to deliver on its ambition to balance the sources and uses of cash in the coming 12 months. The project is 75% owned by BP with gross capacity of 50kboe/d; (thousand barrels of oil equivalent per day), 25% higher than the initial 40kboe/d indicated. In its press release BP stated that the project was 11 months ahead of schedule and $150 million under budget, an encouraging start for the year in our view.

Cardinal Energy Ltd.'s board of directors has approved a $100 million capital expenditure budget for 2017 that focuses on balance sheet strength, maintaining a significant and sustainable dividend, and development of all of the company's three core areas. The 2017 capital budget is designed to achieve significant growth in funds flow per share and to maintain the company's annualized dividend at 42 cents per share. Development capital expenditures are anticipated to include drilling 18 (16.2 net) horizontal oil wells and, combined with production from the recent Mitsue acquisition, are expected to deliver annual average production of between 16,800 barrels of oil equivalent per day (boed) and 17,300 boed in 2017. Cardinal expects to have a total payout ratio of 95% based on funds flow of $92 million and a simple payout ratio of 33%. Funds flow before risk management is expected to be $116 million. Cardinal 2017 forecast annual average production represents an increase of between 15% and 18% over 2016 annual production guidance of 14,600 boed. Cardinal has entered into an agreement to acquire certain assets that fall within the company's North (Mitsue) operating area. The assets are light oil focused and are expected to produce an average of 1,000 boed in 2017. Cardinal estimates that the assets have 3.4 million barrels of oil equivalent total proved plus probable (2P) reserves ($12.05 per barrel of oil equivalent). The acquisition is expected to increase Cardinal's light oil drilling inventory. The major components of the 2017 capital budget of $100 million include $41 million for the acquisition (cash and shares); $16 million for facilities and pipelines; $32.7 million for the drilling of 18 wells; as well as $4 million on environmental and reclamation initiatives.

Financial Sector

Barclays PLC has settled on Dublin for its main hub inside the European Union after Brexit and is planning to add about 150 staff there if U.K.-based finance companies lose easy access to the trading bloc, according to people with knowledge of the decision. Barclays is moving ahead with contingency plans so it can continue serving EU clients if Prime Minister Theresa May fails to strike a transitional or permanent deal preserving London's access within the two-year renegotiation period. (Source: Bloomberg)

Blackrock Capital Investment Corporation announced that they will be moving $1 trillion in custodial and fund services business to JPMorgan Chase and Co. from State Street Corporation. JPMorgan commented that they expect to on-board all of the assets within two years. State Street will continue to provide custody on a large percentage of Blackrock's business, so Blackrock did not fire State Street. As of 12/31, JPMorgan managed $20.5 trillion of custody assets, while State Street's balance was $21.7 trillion (unadjusted for transfer). This decision may strengthen Blackrock's overall relationship with JPMorgan (similar to its strong relationship with Bank of America Corporation following the purchase of Merrill Lynch Investment Management in 2006).

Brookfield Asset Management Inc. announced a proposed acquisition for 100% of the shares of Terraform Power, Inc. at $12/share and either 100% of the shares of Terraform Global, Inc. for $4.35/share or replace SunEdison, Inc. as sponsor and acquire 50.1% of Terraform Global, Inc. shares for $4.25/share. For

Brookfield Renewable Partners LP, ownership of Terraform assets could potentially reload the ability to receive drop downs as a growth vehicle from Brookfield Asset Management.

Fifth Third Bancorp (FITB) reported Q4 2016 Earnings Per Share (EPS) of $0.49, consensus was $0.43. The company pegs core EPS at $0.48. Operating revenues fell 1% year/year and declined 2% sequentially. Tangible book dropped 3.6% to $16.60. It posted a 9.7% Return On Equity (ROE) and 11.6% Return On Tangible Common Equity. Its Core Equity Tier 1 ratio (fully phased-in) was 10.30%, up 21bps. Despite active share repurchase average diluted shares declined only 0.1%. Net interest income was unchanged with Q3 2016. Results benefited from higher short-term interest rates and higher securities balances.

Nordea Bank AB reported a relatively straight-forward set of Q4 2016 results with an impressive 32% headline earnings beat at €1,110 million versus a consensus of €832 million. Revenues were 6% ahead of consensus driven by Net Interest Income (+1%), Fees (+3%) & Trading (+22%). Costs were in-line and loan loss costs lower (18% better). Core Equity Tier 1 ratio is up 50bps quarter/quarter at 18.4% and 40bps better than expectations. For the dividend doubters, Nordea proposes a progressive 65c (2015:64c), so a beat across the board with impressive capital generation (now 50bps above the go to level). The only small negative is the 2017 cost guidance is raised but then lowered again for 2018. Its reported ROE (adjusted) of 12.9% compared to 11.5% in the same quarter of 2015.

Royal Bank of Scotland Group PLC (RBS) unsurprisingly in our view, announced that the 2016 results on February 24th will reflect a further £3.1 billion provision in relation to Retail Mortgage Backed Securities (RMBS). This takes total aggregate of such provisions to £6.7 billion. The further provision would have reduced Q3 Tangible Net Asset Value by 27p to 311p and the Core Equity Tier 1 ratio by 1.35% to 13.6%. They flag the risk of further substantial provisions and note this is in relation to "the Department of Justice" and other RMBS litigation matters". RBS is one of the few global lenders that has yet to settle in a years-long probe that's garnered more than $50 billion in penalties for the Department Of Justice since it began investigating the pre-crisis sale of mortgage bonds.

State Street Corporation reported Q4 2016 operating EPS of $1.48. The company pegged core EPS at $1.35, versus consensus of $1.32, when adjusting for: $145 million ($0.37) tax benefit from the designation of certain of its foreign earnings as indefinitely invested overseas; $66 million ($0.17) tax benefit attributable to incremental foreign tax credits and a foreign affiliate tax loss; $249 million ($0.41) charge associated with an amendment of the terms of outstanding deferred cash-settled incentive compensation awards for employees below Exec. VP. Operating revenues increased 6% year/year and approximated the prior quarter. Results included $64 million in revenue and $58 million of expenses associated with the GE Asset Management (GEAM) business acquired on July 1. It also had $25 million of non-recurring acquisition costs related to GEAM. Excluding expense associated with the acceleration of deferred cash awards and the impact of the acquired GEAM business, it had positive operating fee income leverage of 206bps (+267bps with net interest income (NII)). Its ROE was 12.5% Assets Under Custody/Administration declined 1.4% to $28.8 trillion but less than 1% excluding the impact of currency translation as market declines were modestly offset by new business. Assets Under Management increased 0.9% to $2.5 billion. Its Core Equity Tier 1 ratio (fully phased-in) was 10.9% under both the advanced approaches and standardized approach. It repurchased $325 million (4.2 million shares) of stock in Q4 2016, matching Q3 2016's pace (at 46% of its $1.4 billion Comprehensive Capital Analysis and Review (CCAR) 2016 ask).

Activist Influenced Companies

Restaurant Brands International Inc. (RBI) has established a master franchise joint venture with a group of investors in Mexico. The joint venture company will be the master franchisee of the Tim Hortons brand in Mexico, responsible for developing and growing the brand in the country. "We are continuing to build on our commitment of taking the Tim Hortons brand and Canada's favourite coffee around the world," said Daniel Schwartz, chief executive officer of Restaurant Brands International. "Mexico has a thriving coffee market so we are very optimistic about the opportunity to grow the brand across the country." The development agreement entered into with the joint venture company is the most recent by RBI in its plans to develop and grow the Tim Hortons brand internationally. In 2016, RBI announced similar agreements in the Philippines and Great Britain.

Canadian Dividend Payers

Nothing new to report.

Global Dividend Payers

Aryzta AG's unscheduled trading update and new guidance for about a 20% fall in 2017 EPS, compared to earlier guidance of 2% growth, sent shares down 30%. The key issue has been the loss of co-pack volumes in North America. In essence, the company's efforts to extend its cookie brand Otis Spunkmeyer into the sweet snacks category has been noticed by Aryzta's bakery peers. Those competitors (notably Twinkies according to Bloomberg) have responded by no longer outsourcing their production to Aryzta. The co-pack contracts were conducted on short term purchase arrangements and so there was little notice; hence the scale of the surprise. Overall we now expect Aryzta's America's revenue to fall 4%. That decline, amplified by negative operating leverage and some cost headwinds from wage inflation means divisional Earnings Before Interest and Amortisation margins will fall about 550bps to 7.3%. Despite this bad announcement the group's free cash flow performance should still be strong and the ability of the group to transform its cash generative profile remains intact in our view with an 8% free cash flow yield expected to rise to 11% in 2018.

AT&T, Inc. reported quarterly results that matched analysts' estimates, as it added more smartphone customers in a saturated wireless market, and said it was confident its deal to buy Time Warner Inc. would be approved. Although margins improved, net income attributable to the company fell to $2.44 billion, or 39 cents per share, in the fourth quarter ended Dec. 31, from $4.01 billion, or 65 cents per share, a year earlier. Excluding a pretax loss of about $1 billion and other items, the company earned 66 cents per share in the latest quarter, in line with the average analyst estimate. Revenue fell to $41.84 billion, missing the average estimate of $42.04 billion, according to Thomson Reuters I/B/E/S. Looking ahead to this year, AT&T said it expects consolidated revenue growth in the low-single digits on a percentage basis and adjusted EPS growth in the mid-single digit range. Capital spending is estimated around $22 billion, similar to levels spent in 2016.

BHP Billiton PLC's 1st half 2017 Operational Review was a disappointment in our view. While iron ore production was in line with expectations, petroleum, metallurgical and energy coal were below forecast, and copper was a particular disappointment, with output 58,000 tons below forecast in 1st half 2017. However, the company's full-year guidance was unchanged for all other commodities, although BHP Billiton downgraded full-year 2016 copper production guidance from 1.66Mt to 1.62Mt, following its review of Olympic Dam (in its Q3 review the company had noted that a downgrade might be necessary).

Dufry AG was awarded through a Joint Venture with DFASS Group to become the operator of the Bogota (Colombia) airport for 10 years, adding 2,200m2 of retail space (1,300 m2 in existing area, 880m2 in new space) to its portfolio. This additional space represents 2% of the total retail space in Latin America and 0.5% of the group. Dufry is already the leading player in Latin America with no. 1 positions in Brazil, Argentina, Uruguay, Mexico, Puerto Rico and Chile; Columbia is a new country with Bogota being the no. 3 airport in Latin Amercia (>30 million passengers). Dufry has already some JV with DFASS, especially in the U.S.

Johnson & Johnson – U.S. healthcare giant Johnson & Johnson (J&J) will buy Swiss biotech company Actelion in a $30 billion all-cash deal that includes spinning off Actelion's research and development pipeline. The biggest European drugs takeover in 13 years gives J&J access to the Swiss group's range of high-price, high-margin medicines for rare diseases, helping it diversify its drug portfolio as its biggest product, Remicade for arthritis, faces cheaper competition.

LVMH Moet Hennessy Louis Vuitton SE reported Q4 organic sales growth of 8% that beat Bloomberg consensus 6%, driven by stronger than expected organic growth in all divisions ex-Perfumes & Cosmetics, which was in line. 2016 profit from recurring operations was €7.03 billion, c2% ahead of Bloomberg consensus, as operating margin was 18.7% vs. expected 18.4%. Dividend increased by 13% to €4 (2% yield on latest price). Despite strong trends exiting 2016, an "easy start" to 2017 and good trend for Chinese New Year, Mr. Arnault, CEO, highlighted during the presentation a "cautiously confident" outlook for 2017, stressing the business and management team has to remain vigilant and focused to be flexible and react in a still uncertain environment. Moreover, he commented no further shares buyback will be announced.

Novartis AG - Q4 results announced, sales $12,322 million versus consensus $12,524 million with core operating income $3,013 million vs. consensus $3,071 million and core EPS $1.12 versus consensus $1.13. Alcon (eye care) came out of 2016 with Q4 growth flat year/year at constant currencies (-2% in USD), rather than the promised growth, but met expectations, on sales at least. This is a positive of sorts in our view but margins fell from a pro-forma 18% a year ago to 11.3% as investment in sales and marketing, to bolster the top-line, took its toll on profitability....expectations remain that Alcon could be spun off with a market capitalization of about $25-35 billion – substantially below the price the business was acquired from Nestlé SA of $50 billion in 2010. The bright spots in 2016 performance were Cosentxy and Biopharm but that was expected. The former may come under competitive pressures in 2017 but Biopharma sales in Sandoz are expected to continue to post robust growth as biosimilars in rheumatoid arthritis and oncology launch during 2017 and 2018. The company guided to sales flat at constant currencies, generics taking a further $2.5 billion off the top-line. Operating income is expected to come in flat to low single-digit decline on 2016. With currency movements expected to be –a negative 2 percentage points on sales and -3 percentage points on core operating profit this equates to estimated 2017 sales of $47,550 million; estimated core operating profit $12,200 million to $12,470 million. This reflects continued generic pressure, slow ramp in Entresto sales and the slow turnaround of Alcon. Consensus currently sits at $49,267 million and $13,023 million, respectively, implying downgrades (about 3.5%) to forecasts are likely, which is where the buyback comes in....with the company announcing a $5 billion buyback. At current levels this implies a 3% reduction in shares outstanding.

Tesco PLC announced a surprising merger with Booker Group PLC, the U.K.'s leading food wholesaler, for about £3.7 billion. Each Booker shareholder will receive 0.861 Tesco shares and 42.6p in cash per Booker share. The cash consideration will be funded from existing cash resources. This represents a 12% premium to Booker's price the day before the announcement and 15% based on volume weighted share prices of Tesco and Booker since January 12. The merger will result in Booker Shareholders owning approx. 16% of the Combined Group. Tesco expects pre-tax synergies run-rate of at least £200 million per annum by the end of the third year following the completion of the merger. Based on consensus forecasts for Booker and for Tesco it is expected the deal to be dilutive in Year 1

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to the tune of very low single digits, then becoming neutral/accretive depending on the phasing of synergies in Year 2 and low single digit accretive potentially in Year 3. Tesco says it will be accretive in Year 2. It also says Return On Invested Capital will exceed Weighted Average Cost of Capital in Year 2 and that it will be positive for Tesco's leverage.

Economic Conditions

U.S. real GDP rose 1.9% annualized in Q4 after bouncing 3.5% in Q3. This was just shy of expectations, but close to potential growth. Trade was the main culprit, carving a meaty 1.7% slice from GDP. A muscular dollar had imports jumping 8.3% and exports sliding 4.3%, though the latter partly reflected an unwinding of the great soybean surge. That's about where the bad news ends. Business capital expenditure rebounded 3.1% after four consecutive quarterly declines on renewed business optimism. Along with a strong gain in spending on intellectual property, the upturn in equipment spending more than offset slippage in commercial construction (following a double-digit gain in Q3) to anchor a 2.4% advance in non-residential investment (the fastest in over a year).

U.S. existing home sales were expected to slide in December after a 3-month run-up, but the actual 2.8% drop was the largest since July and bigger than consensus had feared. The drop left the level of sales at 5.49 million units, annualized, a 3-month low. There was one revision to November and it was up. Both components of overall home sales were hit but condos/co-ops were hit more, down 10.3%, which erased all of the prior month's jump. Singles were down a more moderate 1.8% to a 3-month low. It looks like mortgage rates, which have jumped from a low of just under 3.7% in September to 4½% in December, are biting. Homeowners are perhaps in no rush to sell as job prospects improve (and may improve further as businesses are encouraged to manufacture/build in the U.S.A.). The months' supply of homes to be bought hit a record low 3.6 in December. No wonder homebuilder confidence hit a 3-year high in December.

U.K. Supreme court ruled that Parliament must vote on triggering Article 50 but says Scotland, Wales and Northern Ireland do not get the same privilege. U.K. PM May lost the argument that she alone could trigger the divorce from the EU. She will now have to win approval of both houses and opens up the possibility of delays to her end of March deadline. In addition, Brexit dissenters will now be able to propose amendments in order to win over their support. The majority of lawmakers, however, will be unwilling to defy the decision by the public to divorce from the EU and May will in the end still be able to trigger Article 50 in our opinion.

Japan's exports expanded more than expected at 5.4% year/year in December (from -0.4% in Nov, and above forecast of +1.1%), the first year/year expansion after a 14-month slump and best reading since July 2015 while imports retreated at a much slower pace of -2.6% year/year in December (from -8.8% in Nov.), the smallest contraction since the last positive number of +1.9% in December 2014.

Financial Conditions

The U.S. 2 year/10 year treasury spread is now 1.27% and the U.K.'s 2 year/10 year treasury spread is 1.32% - 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 4.19% (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 4.0 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 still supporting the housing market with housing inventory well off its peak of 9.4 months and we believe now at the low end of a more normal range of 4-7 months.

The VIX (volatility index) is 11.39 (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 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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