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. March 13, 2017

Energy Sector

U.S. land rig count increased by 9 rigs week/week to 743 rigs, and is up on average 28% Quarter To Date quarter/quarter. Gains in Vertical Oil (+6), Horizontal Oil (+3), Horizontal Gas (+3), and Directional Gas (+1), were partially offset by declines in Directional Oil (-3), while Vertical Gas remained flat week/week. Total horizontal land rig count is down 53% since the peak in November 2014. The Permian currently makes up 52% of all oil rigs.

U.S. horizontal oil land rigs increased by 3 rigs week/week to 516 as gains in the DJ-Niobrara (+4), “Other” (+3), Eagle Ford (+1), and Utica (+1), were partially offset by declines in Permian (-3, first weekly decline since November 2016), Granite Wash (-2), and Woodford (-1), while Williston and Mississippian remained flat week/week. U.S. vertical oil land rigs increased by 6 rigs week/week to 56 led by the Permian (+5).

Canadian rig count decreased by 20 rigs week/week and is up 231% from the level this time last year.

U.S. Gulf of Mexico offshore rig count increased by 2 rigs week/week to 20 rigs and is down 63% since June 2014.

Royal Dutch Shell Group PLC has announced a significant step in its disposal process and portfolio restructuring last week, with two transactions that in effect see it divesting the majority of its oil sands assets for a net consideration in Canada for $7.25 billion but also incur a $1.3-1.5 billion post-tax impairment. The deal is a complex one with a number of aspects to it. In the first agreement, Shell will sell all its assets to Canadian Natural Resources Limited for $5.4 billion in cash and approx. 98 million Canadian Natural Resources shares, currently valued at $3.1 billion. Shell and Canadian Natural will then jointly acquire Marathon Oil Canada Corporation (MOCC) which holds a 20% interest in the Athabasca Oil Sands Project (AOSP) for $2.5 billion in cash (so $1.25 billion net payment by Shell). The net result is that the Shell stake in AOSP goes from 60% to 10% and Shell receives $7.25 billion of which $4.15 billion is in cash. We see this as an important step both in the divestment process and simplification of Shell with limited cashflow given up. Although the price paid will result in an impairment and does raise some questions on the timing of the deal, Shell does maintain some price upside potential from the equity exposure gained in Canadian Natural Resources, a stake it will manage over time.

Baytex Energy Corp. released its fourth quarter results, which were broadly in line for production, at just over 65,000 boed (barrels of oil equivalent per day) and FFO/share (funds from operations per share) at $0.36. FFO exceeded capital expenditures by about $51 million. The company’s guidance for 2017 involves a roughly 3% production growth on exit-on-exit basis (68,000 boed midpoint) at a cost of $300 million to $350 million. A key highlight of the announcement, we believe, was very strong well initial production for the most recent well pad drilled at Peace River, delivering 600 boed initial heavy oil production, and at Eagle Ford, which delivered 1,200 boed light oil production, both materially higher than the average wells for those particular areas. Baytex hadn’t drilled in its heavy oil fields for nearly two years so technology improvements elsewhere could really move the needle at Peace River and Lloydminster. This type of well performance, if consistent throughout the year, should drive Baytex to easily exceed its current guidance. The company’s cash costs (operating expenses, transportation expenses and G&A expenses) decreased by 8% on a barrel per oil basis in 2016. Baytex reduced its net debt by 13% to $1.8 billion at the end of 2016.

Whitecap Resources Inc. results, well telegraphed in its reserve update from a couple of weeks back, point to an improving cash flow profile and, we believe, could lead to an upwards revision of the dividend in the second half of this year. Management is guiding for a 14% production per share increase for 2017. On the current pricing and considering the company’s hedging program, Whitecap’s guidance is for FFO of about $550 million, whilst the capex program is pegged at $300 million and the current dividend amounts to $103 million. The all-in payout ratio would be in the low 70%. The additional $140 million could be used to further reduce debt, additional M&A and dividend increases ($30 million more towards dividends is effectively a 30% dividend increase). Whitecap managed to increase the production in its newly acquired Saskatchewan lands by 16% since the time of acquisition from Husky Energy mid 2016, an indication that Whitecap’s recent M&A is bearing fruit and could lead to further tuck-in deals.

Financial Sector

Barclays PLC – Chief Executive Officer Jes Staley said in a CNBC interview that Barclays says could settle its Retail Mortgage Backed Securities Department of Justice (DOJ) case if treated ‘fairly.’ Bank seeks penalty “commensurate with the U.S. banks” and “if we are treated on that basis, we hope to settle” DOJ investigation into sale of faulty mortgage securities. “2016 was a good year for Barclays investment bank in the Americas,” and “early signs are encouraging” on his strategic decisions to back securities unit, exit Africa. “Jamie Dimon is arguably the best CEO of our generation in banking,” taught him the value of sticking to a strategy and reaching out to all stakeholders, Staley says. Declines to comment on Dimon’s attitude to Staley poaching a number of his top executives for Barclays. “Jamie and I are very different managers; he does his thing and I hopefully do my thing,” Staley says. CEO says he has no interest in running a U.S. investment bank again and Barclays is his “last gig.” Dodd-Frank is good regulation and should stay, but could be amended in certain areas to improve market liquidity. U.S. economy has “lot of runway in front of it.” Unified euro area is important for global growth and the U.S., U.K. and EU should recommit to the free flow of capital and trade.

BNP Paribas SA (BNPP) to acquire 50% of Opel / Vauxhall financing activities - in a press release last week, BNP Paribas and PSA Group announced a partnership in automotive financing with the joint acquisition of Opel / Vauxhall financing activities. BNPP points to a 0.10% impact on Core Equity Tier 1 ratio. The transaction adds approx. 14% of loans outstanding to activities. This is a bolt-on acquisition in the International Financial Services unit, which is a key driver of earnings in BNPP’s business plan. The Financial Times reports BNPP would take another cash management and trade finance business in Europe. Head of regional transaction services Jacques Levet also told the Financial Times that “should another bank retreat from its European operations in the future, BNPP would be more than happy to do a deal like the one we did with Royal Bank of Scotland and I think we would be best placed to do it for sure”.

Brookfield Asset Management Inc. said it would buy one of the two YieldCos (see below for a definition) of bankrupt U.S. solar company SunEdison Inc and take a 51% stake in the other, for a total of about $1.41 billion. Canada’s largest alternative-asset manager is increasing its holding in TerraForm Power after first reporting a stake in June, when it called the SunEdison unit an “attractive investment opportunity”. Yieldcos are publicly traded units that hold renewable energy assets such as solar power plants and wind farms, including those bought from the sponsor or the parent company. They have long-term agreements to sell power, giving them stable cash flows, but they are dependent on the transfer of assets from their parents to increase dividends. Brookfield will acquire TerraForm Global Inc for about $787 million and increase its stake to 51% of TerraForm Power Inc. for $622 million. TerraForm Global owns or has contracts to acquire 952 megawatts of wind and solar power in Brazil, India, China, South Africa, Thailand, Malaysia and Uruguay. TerraForm Power owns about 2,967 megawatts of solar and wind assets in the United States, Canada, the United Kingdom and Chile. Brookfield, which owns over 17,000 megawatts of renewable energy assets, will replace SunEdison as TerraForm Power’s sponsor once the deal closes. It had a 12.16% stake in TerraForm Power as of Feb. 17.

Royal Bank of Scotland PLC – 2016 results reported a pre-exceptional operating profit of £1,185 million, +£698 million versus consensus benefiting from stronger Income, lower costs and better impairments. Restructuring charges came in at £1,007 million, litigation costs were £4,128 million and non-operating items were -£113 million to leave statutory Profit Before Tax of -£4,063 million vs. a consensus of -£3,549 million. Tangible Net Asset Value was 296p (down 42p quarter/quarter) with the attributable loss the key driver and Core Equity Tier 1 in line with estimates at 13.4%. Overall the targets set and announcements in relation to alternative State Aid remedies are the key drivers of our changes to likely future earnings in our view with 2017 guidance on costs also ahead of expectations albeit cost changes in the outer years are more modest. Overall the group is continuing to make good progress in our view in dealing with the list of outstanding issues required prior to resuming dividend payments although there remains more to be done before returns improve to above cost of equity levels.

Standard Chartered PLC reported an underlying loss before tax of US$359 million, representing a US$329 million miss versus consensus, mainly accounted for by weaker cost and credit performance, as well as the impact of credit issues at its Indonesian joint venture Permata. Restructuring charges of -$599 million with own credit and other items of +$321 million left a statutory loss of $637 million. On capital, the Core Equity Tier 1 ratio was 13.6% improving 0.6% quarter/quarter driven primarily by lower Risk Weighted Assets as the liquidation portfolio reduced. The bank did not announce a 2016 dividend but with the group trading above the targeted capital range we expect this to recommence at 1st Half 2017 with a nominal payment.

Activist Influenced Companies

Brookfield Business Partners LP (BBU) – BBU’s Brookfield Global Integrated Solutions (BGIS) has launched the Building Energy Innovators Council (BEIC). The BEIC is an industry-driven initiative to accelerate the collaboration, innovation and adoption of clean building technologies across Canada. The council will provide input to federal and provincial governments related to the types of incentive programs and policies required to increase adoption of new energy-efficient building technologies and renewable energy solutions, supporting the transformation of the built environment into the low carbon era. The BEIC will support utilities and governing bodies, such as the independent electricity system operator (IESO), with the promotion of their renewable energy and energy efficiency incentive programs, ensuring they are effectively communicated industry-wide, and adopted by owners and occupiers of real estate. In the first year of operation, the BEIC will consist of up to 25 founding members who are recognized leaders from across the industry including general contracting, mechanical, electrical, HVAC, lighting, BAS controls, solar power, hydrogen fuel cell, electric car charging, energy storage solutions, ICT, geothermal, financial services, and district heating and cooling.

Canadian Dividend Payers

Nothing new to report.

Global Dividend Payers

Nothing new to report.

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Economic Conditions

U.S. consumer credit grew a modest $8.79 billion in January, relative to the consensus expectations for a $17.1 billion and a $14.76 addition to consumer debt in December. This is an unusually low number and goes against other recent measures of consumer confidence, possibly because of the uncertainty surrounding the beginning of the new administration, but also to expectations of monetary policy tightening and potentially lending tightening.

U.S. foreign trade deficit expanded to $48.5 billion in January, in line with the expectations, as imports advanced by 2.3%, driven by petroleum products, cars, consumer goods and industrial supplies, while exports only improved by 0.6%, on a background of strengthening US dollar.

U.S. nonfarm payrolls beat expectations in February. Headline payrolls rose by 235,000 last month, with net upward revisions made to the prior two months (January was 227,000; now, 238,000…. and December was 157,000; now, 155,000). The private sector created 227,000 jobs. There was plenty of employers hiring across the spectrum of sectors/industries: construction, manufacturing (+28,000, 2nd largest in just over a year), wholesale trade, professional & business services, education & health services, hospitality, government, and so on. Only retailers cut back for the first time in a few months. Average hourly earnings edged up 0.2%, and are up 2.8% from a year ago, which is very good news for consumer spending in our view. Employees were busily working longer days. Aggregate hours worked rose 0.2% in February, or 1.4% above a year earlier. The **Household Survey** had a similar take, **with employment** surging by 447,000, the most since last July. And with the job market tightening up, more workers poured into the labor force (+340,000), but the jobless rate managed to slip 0.1 points to 4.7%, or a tenth away from a near-decade low. The **U5** (basic jobless rate + discouraged workers + marginally attached workers), rumored to be the preferred measure by the White House, also slipped but to a 9½-year low of 5.7%. Meantime, the all-inclusive **U6** (U5 + those PT workers who would rather have a full time job) fell for the fourth time in the past five months, with the latest figure of 9.2% matching a 9-year low. Whatever the measure, the trend is the same and the story is the same in our view, it's the last piece of economic data for the Federal Reserve to digest before it makes its decision on interest rates this week.

Canada – Canadian economy added 15,300 positions in February, easily exceeding consensus expectations calling for a 2,500 jobs increase. Growth was driven by full-time positions, which jumped 105,000 in the month, offset by 89,800 part-time position losses. Services, including trade, public administration and transportation led the improvement. The headline unemployment rate improved to 6.6% from 6.8%.

Canada's foreign trade balance improved to a $0.81 billion surplus in January, from a $0.45 surplus in December, as exports gained 0.5%, driven by food, cars and raw materials, while imports fell 0.3%.

Financial Conditions

The U.S. 2 year/10 year treasury spread is now 1.22% and the U.K.'s 2 year/10 year treasury spread is 1.15% - 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 4.21% (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 3.6 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 12.16 (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 manages the following 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

Individual Discretionary Managed Account Models - SMA

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