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. July 17, 2017

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Owner Operated Companies

Berkshire Hathaway Inc. – Warren Buffett's Berkshire Hathaway and John Malone's Liberty Media Corporation are reportedly exploring an investment of between $10 billion and $20 billion in U.S. wireless carrier Sprint Corporation. Last month Sprint had purportedly entered into a two-month period of exclusive negotiations with Malone's Charter Communications Inc. and Comcast Corporation, which has put Sprint's merger talks with T-Mobile U.S. on hold until the end of July. Malone, the chairman of Liberty Media, in January raised the possibility that major cable companies could get together and buy a wireless carrier. Investing in or lending money to Sprint could help Buffett generate a higher return on some of Berkshire's cash and equivalents, which totaled $96.5 billion on March 31. Berkshire has invested with Malone since 2011, when it took a stake in Liberty Media. As of March 31, Berkshire owned more than $5.4 billion of stock in three Malone companies: Liberty Media, international cable company Liberty Global Plc (including more than 5% of the A shares of Liberty Global LiLAC) and Charter.

Liberty Global LiLAC – SEC filings over the past week revealed material purchases by John Malone, the founder and Chairman of Liberty Global. This was apparently one of the rare occasions on which Malone directly acquired stock. Via direct or indirect ownership Malone now owns roughly 6% or LiLAC's outstanding shares, up from about 4% prior to the filings. Markets saw Malone's purchases as a testimony of the quality of LiLAC's assets and evidence of a depressed valuation.

Energy Sector

U.S. land rig count increased by 1 rig to 928 rigs, now up 25 out of 26 weeks. The rig count was driven by gains in Vertical Oil (+2), Horizontal Gas (+2), and Directional Oil (+1) offset by declines in Horizontal Oil (-2) and Directional Gas (-2) with Vertical Gas flat week/week. Total horizontal land rig count is down 41% since the peak in November 2014 (see Fig. 1). The Permian currently makes up 50% of all oil rigs.

U.S. horizontal oil land rigs declined by 2 rigs to 655, breaking a 25-week streak of no declines (first loss since 1/13/17) as declines in Eagle Ford (-5, the largest loss since February 2016) and Woodford (-4) were offset by gains in Permian (+4), "Other" (+2), and DJ-Niobrara (+1) with Williston, Granite Wash, and Mississippian flat week/week.

Canadian rig count increased by 17 rigs week/week, and is up 108% from the level this time last year.

U.S. Gulf of Mexico offshore rig count remained flat week/week at 21 and is down 61% since June 2014.

International rigs averaged 960 in June, with land rigs up 8 and offshore rigs down 5 m/m, led by gains in Middle East (+5 land, +1 offshore), Africa (+3 land, -1 offshore), and LatAm (+3 land, -1 offshore), offset by declines in Europe (-1 land, -3 offshore) and Asia Pac (-2 land, -1 offshore).

Financial Sector

BlackRock, Inc., the world's biggest asset manager, reported a massive influx of cash into its low-cost funds but fell short of Wall Street's forecasts as price cuts and lower performance fees dented revenue. The company's largely index-tracking iShares exchange-traded funds have been growing at a record pace, pulling in a record $74 billion during the most recent quarter, up from $16 billion a year earlier. Fast asset-gathering helped push BlackRock's assets under management to nearly $5.7 trillion, while revenue gained 6% to $2.97 billion and earnings per share rose 10% to $5.22, or $5.24 on adjusted basis.

Canadian Imperial Bank of Commerce (CM) announced that it is acquiring Geneva Advisors, a private wealth management firm based in Chicago for up to US$200 million (US$135 million at closing and US$65 million contingent on future performance). The transaction is expected to close in Q4 2017 with the total consideration being paid 25% in cash and 75% in CM common shares. Additionally, CM expects the deal will lower their Core Equity Tier 1 ratio by ~6bps and be accretive to Earnings Per Share (EPS) in 2019. Using the total potential compensation (US$200 million) and Geneva Advisors US$8.4 billion in Assets Under Management (AUM), it's estimated that CM is paying ~2.4% of AUM. This bolt-on acquisition is expected to expand CM's U.S. private wealth management client base and deepen client relationships in the region following the bank's recent acquisition of Chicago-based PrivateBancorp for $4.9 billion, closed in late June.

Citigroup, Inc. reported Q2 2017 EPS of $1.28 - better than consensus ($1.21). Earnings upside was driven by better than expected revenue growth, with the Global Consumer Banking (GCB) essentially in line with forecast and the Investment & Corporate Banking Group (ICG) a good bit better than forecast (fixed income trading and investment banking revenues solidly above previously tempered expectations; equities weaker). ICG revenue momentum and operating leverage realization - Investment banking revenues higher than forecast (by ~35%!) across all products; GCB revenues in line with forecast including signs of modest organic growth potential in North America. Corporate/Other created less of an earnings drag thanks to lower provision expense. Fully phased in Basel III Core Equity Tier 1 ratio at 13.0% (11-11.5% targeted); capital return of $2.2 billion or ~63% gross payout in Q2 2017 with a significant ramp up anticipated into Q3 2017, thanks to a materially higher capital return approval in the 2017 Comprehensive Capital Analysis Review cycle. The latter improves prospects for realization of the targeted 10% Return On Tangible Common Equity (ROTE) in 2019. Factoring in longer term estimate increases and the Return On Equity (ROE) improvement driven by accelerated capital returns and with then book value of still less than 0.8x (0.9x Price /Tangible Book Value) we continue to be attracted to the share.

DNB ASA - Q2 2017 results and overall we judge the performance as a very strong quarter with Net Interest Income, fees & loan loss costs areas which exceeded expectations. At the headline, net earnings are 12% ahead of expectations. Restructuring expenses coming in at NOK 89 million. Trading was a little weaker whereas Core Equity Tier 1 capital was slighter weaker than consensus but still close to a strong 16.0%.

HSBC Holdings PLC Chief Executive Stuart Gulliver confirmed last Tuesday possible plans to move 1,000 jobs from Britain to Paris in case of a so-called 'hard' Brexit, and said recent reforms from the French government would be positive, if enacted. "There is about 1,000 jobs out of 43,000 that are employed in the U.K. that will be unlawful for our activities to be carried out of the U.K., if it's hard Brexit," said Gulliver, speaking during a conference in Paris. (Source: Reuters)

JPMorgan Chase & Co. reported Q2 2017 EPS of $1.82. Results included a $406 million ($0.11) after-tax benefit from a legal settlement ($645 million benefit recognized in revenues). Excluding this gain, EPS was $1.71. Consensus was $1.60. Result also included a $75 million reduction to net interest income which reflected an adjustment for capitalized interest on modified loans, $61 million in legal expenses, a $57 million Mortgage Servicing Right hedge loss, and $34 million in securities losses (cost it $0.04 combined). Relative to expectations, a lower than expected loan loss provision and tax rate as well as higher anticipated core fee income, more than compensated for lower than projected net interest income/ margin. Revenues increased 5% year/year and rose 3% sequentially to $25.5 billion. Consumer & Community Banking (CCB) revenues increased 4% sequentially with Consumer & Business Banking (+7%) and Card, Commerce Solutions & Auto (+5%) higher but Mortgage Banking lower (-7%). Corporate & Investment Bank (CIB) revenues declined 3% year/year and fell 7% from the prior quarter. Within CIB, trading revenues declined 14% year/year (faced tough comparisons as 'Brexit' last year creating activity). Fixed Income, Currency and Commodities declined 19%, predominantly driven by lower revenue in Rates, Credit, and Commodities. Commercial Banking (CB) revenues increased 3% from Q1 2017. And Asset & Wealth Management (AWM) rose 4% sequentially. AUM was $1.9 trillion, up 2%. Net interest income rose 1% or $144 million (guided to up $400 million). Average earning assets increased 1%. Adjusted expenses (ex. legal) were $14.4 billion, up 3% year/year and down 3% linked quarter owing to lower comparison and occupancy costs. Its adjusted overhead ratio was 56%. Its effective tax rate was 27.9%, up from 22.7% last quarter. Non-performing assets declined 5% to $6.4 billion. The reserve build was partially offset by a reserve release of $175 million in Mortgage Banking reflecting continued improvement in home prices and delinquencies. Its reserve/loan ratio declined 3bps to 1.49%. Tangible book increased 2.4% to $53.29 (1.7x). It posted a 12% ROE and 14% ROTE. Its Core Equity Tier 1 ratio (fully phased-in, standardized) was 12.5%, up 10 basis points. Net share repurchase totaled $2.7 billion. Average diluted shares declined 0.9%. For 2017, on the conference call with analysts, Chief Financial Officer Marianne Lake said net interest income for the full year would increase by $4 billion, rather than a $4.5 billion estimate given in April. This is due to mortgage adjustments and a change in the alignment of interest rates, Lake said. Lake's language around net interest income and loan growth (and to a certain extent trading and Investment Banking) was therefore more cautious, though the outlook for expenses and Non-Conforming Obligations remained unchanged.

Royal Bank of Scotland PLC (RBS) has struck a £4.2 billion settlement deal with a U.S. authority over mis-selling toxic mortgage-backed securities, marking a significant step in the bank's attempts to clean up misconduct issues from the financial crisis. The state-backed lender announced last Wednesday that it had reached an agreement with the Federal Housing Finance Agency after months of negotiations, which chief executive Ross McEwan said helped to clear "one of our last remaining very large legacy issues." The claim related to RBS's issuance and underwriting of £25 billion of residential mortgage-backed securities in the U.S. (Source: Financial Times)

Wells Fargo & Company reported second quarter EPS of $1.07 per share; excluding a $0.04 per share tax benefit and a ~$0.03 - 0.04 per share gain on sale, it is estimated core EPS no better than, if not a bit below consensus ($1.01). Operating revenues increased 2% year/year and slipped 1% from the prior quarter. Net interest income increased 2%. Average earning assets declined 0.2% with loans and securities both down 0.7%. Its net interest margin increased 3bps to 2.9%. Related to both the revenue shortfall and continue pressures, the efficiency ratio held north of 61%. Expenses declined 2%, primarily due to lower employee benefits and commission and incentive compensation, which were seasonally elevated in Q1 2017. Its Non-Performing Asset ratio declined 8bps to 1.03%. Its loan loss provision declined by $50 million to $555 million. Its reserve/loan ratio declined 1bp to 1.27%. Its ROE was 11.95% (target: 11-14%), and ROTE was 14.26%. Its Core Equity Tier 1 ratio (fully phased-in) was 11.6%, up 40bps. During the quarter it repurchased 43.0 million shares, which reduced period-end shares by 30.0 million. Average diluted shares declined by 0.6%.

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July 17, 2017

Activist Influenced Companies

The Procter & Gamble Company (P&G) - Trian Fund Management LP is seeking a seat for its billionaire chief executive, Nelson Peltz, on P&G's board, as it looks to push the company to take more drastic steps to revive sales and profits. Trian's announcement marks the official launch of the largest proxy fight ever, with the activist fund squaring off against a $222.7 billion consumer products behemoth. The battle comes as activist investors, emboldened by years of successful campaigns for changes at corporations across the U.S. and abroad, use their larger size to seek bigger targets. Trian owns about $3.3 billion of P&G's stock, or 1.5% of the company. With P&G's annual meeting usually held in October, the two sides have roughly three months to continue to discuss ways to avoid a shareholder vote on Peltz, who if elected would boost the board to 12 members. In a bid to boost profits even as sales remain stagnant, P&G has sold unprofitable brands, including 41 beauty brands to Coty Inc., and focused on core brands such as Tide, Pampers and Gillette. P&G said in an email that its board was confident that the changes being made by the company were producing results and expressed complete support for its strategy, plans, and management. Trian said that P&G's last cost-cutting program, launched in 2012, failed to impact profit or sales growth.

Dividend Payers

AT&T, Inc. is reportedly planning a major organizational reshuffle that will include a redefined role for Chief Executive Randall Stephenson following its $85.4 billion acquisition of Time Warner Inc. Stephenson will move to the role of executive chairman and oversee a pair of chief executives who will independently manage the company's telecommunications and media businesses. John Stankey, who currently leads DirecTV and other entertainment businesses, will become CEO of the media division that would include HBO, Warner Brothers and news network CNN. DirecTV will become part of a unit that includes AT&T's traditional phone businesses, to be run by John Donovan, the report said. AT&T said last month it was confident of winning regulatory approval for the acquisition of Time Warner before the year end, as the U.S. Justice Department continues to review the deal.

GEA Group AG has issued a profit warning, lowering its 2017 adjusted earnings before interest tax depreciation and amortization (EBITDA) by 7% at the mid-point. That follows three consecutive quarters of disappointments; the Q3 2016 profit warning, the working capital issues which surfaced in Q4 2016, and the ramp in IT costs communicated in Q1 2017. We believe the guidance cut was broadly anticipated given consensus was already at the low end while GEA have also managed to further reduce working capital in Q2 2017. What we do find concerning however is the continued lack of visibility in GEA's business and the seemingly slow backlog execution given recent book: bills have been at healthy levels and Q2 orders were ahead of expectations. We acknowledge this low visibility makes the timing and trajectory of the margin recovery somewhat difficult to predict we continue to think that the strong balance sheet can bridge the gap to when improved execution and better priced contracts drive margins in to the 13-16% range. Nevertheless, the series of missteps do go beyond issues in management control systems associated with the OneGEA transformation, and raises more fundamental questions about corporate governance in GEA in our view. However, while frustrating we recognize the ongoing €450 million share buyback that is in place can exploit this current weak share price.

Pattern Energy Group Inc. 2 LP, an operator of wind power generation projects, has acquired the rights of the Vivaldi Springtime wind farm located in Montana, U.S., from Windkraft Nord USA, Inc., a subsidiary of WKN AG. The total installed capacity of the wind farm will be 80 MW. Construction of the project will start in 2017 and is expected to start its commercial operations by mid 2018. Both Pattern Energy and Windkraft Nord have also agreed on an option to expand the project.

Economic Conditions

U.S. Retail sales unexpectedly fell 0.2% in June, with broad weakness (clothing, department stores, restaurants, sporting goods) and an extra hit from sliding gas station receipts. Excluding the latter and a mild advance in autos, retail sales fell 0.1% following a flat May. After springing back to life in March and April, "core" retail sales have beat a hasty retreat, signalling a downside risk to consumer spending growth and GDP in the second quarter, and zero momentum heading into the third quarter.

U.S. Consumer Price Index (CPI) was unchanged in June, partly because of lower gasoline prices. This slashed the yearly rate to 1.6% (from 1.9%), an eight-month low and well below February's 2.7%. Core prices rose just 0.1%, holding the yearly rate at 1.7%. The shorter-term core metrics were even softer: 6-months annualized 1.3%, 3-months 1.0%. Wireless service charges continued to dive, while clothing prices slid for a fourth straight month. Recreation prices haven't risen in four months, either. A rebound in medical care and rising rents provided some counterweight.

U.S. industrial production met expectations in June, up 0.4% in the month (5th in a row) following an upward revision to May (now +0.1%, was flat), and a downward revision to April (now +0.8%, was 1.1%). For all of Q2, production was up 1.2% or 4.8% annualized, the most in 3 years.

China GDP - on the weekend updated its GDP beating estimates at 6.9% year/year, Retail Sales posting a solid 11.0% year/year jump and Industrial Production growing at a stellar 7.6% pace.

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U.K. unemployment fell by 64,000 to 1.49 million in the three months to May, official figures show. It meant the unemployment rate fell by 0.2% to its lowest since 1975, at 4.5%, the Office for National Statistics (ONS) added. But wage increases continued to fall further behind inflation. Excluding bonuses, earnings rose by 2.0% year-on-year. However, inflation had hit an almost four-year high of 2.9% in May. When the impact of inflation is factored in, real weekly wages fell by 0.5% compared with a year earlier. (Source: BBC)

Financial Conditions

The Bank of Canada raised interest rates last Wednesday, as expected, citing more confidence in its outlook and a need to look through soft inflation, but said future moves will depend on data amid uncertainty and financial system vulnerabilities. In a decision that emphasized the lag between a rate hike and future inflation, the central bank raised its official interest rate by a quarter of a percentage point to 0.75% but signaled it did not want to commit to a predetermined path of more hikes. "Future adjustments to the target for the overnight rate will be guided by incoming data as they inform the bank's inflation outlook, keeping in mind continued uncertainty and financial system vulnerabilities," the bank said a statement announcing the decision.

The U.S. 2-year/10-year treasury spread is now .97% and the U.K.'s 2-year/10-year treasury spread is .98% - 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 costs of capital.

Influenced by the withdrawal of quantitative easing, the U.S. 30-year mortgage market rate has increased to 4.03% (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 4.4 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 9.90 (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 8 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
- Portland 15 of 15 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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PIC17-050-E(07/17)