News Highlights

Owners. Operators. And Insightful Investors.

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Established in 2007

PORTLAND INVESTMENT COUNSEL®

Our views on economic and other events and their expected impact on investments. March 12, 2018

Owner Operated Companies

Linamar Corporation delivered a strong quarter of double-digit earnings growth. A second major e-axle (driveline equipment for electrical vehicles) contract win capped off a record year in sales, earnings and new business wins. Sales increased 14.5% in the quarter over 2016, taking 2017 to a record $6.5 billion. Net earnings before unusual items and foreign exchange impacts increased 11.8% in the quarter over 2016 taking 2017 to a record $551.5 million. Linamar secured a second major e-axle win of peak volume 550,000 per year. Continued business wins maintained a strong launch book at over $4.3 billion. Content-per-vehicle, a key industry metric, improved by double-digit for Linamar in every region globally. Powertrain/Driveline segment sales were up 11.1% and operating earnings normalized for foreign exchange were up 13.4% despite flat global markets and declines in the North American Market driven by launches. Industrial segment sales were up 43.9% and operating earnings normalized for foreign exchange up 32.5%, roughly doubling global markets thanks to market share gains in every product segment on a global basis. Industrial segment sales include some contribution from the newly acquired agricultural equipment MacDon business. The company's operating earnings for Q4 2017 were $158.2 million. This compares to $147.0 million in Q4 2016, an increase of $11.2 million.

Energy Sector

Baytex Energy Corp. reported a strong set of results for the fourth quarter of 2017. Baytex delivered adjusted funds flow of $106 million ($0.45 per basic share) in Q4 2017, an increase of 37% over Q4 2016, and $348 million ($1.48 per basic share) for the full-year 2017, an increase of 26% over 2016. Analyst consensus for the fourth quarter (based on a survey of 16 analysts) was $92.5 million ($0.39 per share). The positive surprise was partly because many industry observers overlooked the fact that a big portion of Baytex's production (Eagle Ford is responsible for more than 50% of company's crude oil production) prices off of Louisiana Light Sweet (LLS), at a premium to West Texas Intermediate (WTI). Baytex's 2018 production guidance range is unchanged at 68,000 to 72,000 boed with budgeted exploration and development capital expenditures of $325 to $375 million. Operating netback at $21.8 (before the effect of financial derivatives) was highest since 2014 and it was just north of $30 for Eagle Ford. Reserve additions replaced production by 200% for 2017. During the quarter, Baytex managed to pay down $39 million of the outstanding debt, to $1.73 billion.

Baytex generated production of 69,556 boed (81% oil and NGL) during Q4 2017, an increase of 7% over Q4 2016, and 70,242 boed for full-year 2017, exceeding the high end of guidance, with capital expenditures of $326 million, in line with annual guidance. Analyst consensus for the fourth quarter (based on a survey of 16 analysts) was 68,583 boed. In 2017, Baytex participated in the drilling of 226 (86.6 net) wells with a 100% success rate. During the period, Baytex decreased cash costs (operating, transportation and general and administrative expenses) by 7.5% on a boe basis as compared to the mid-point of original guidance. Baytex reported that its net asset value at year-end 2017 increased 11% to $10.08 per share (before tax and discounted at 10%).

For 2018, Baytex entered into hedges on approximately 54% of its net crude oil exposure. This includes 43% of its net WTI exposure with 38% fixed at US$52.26/barrel (bbl) and 5% hedged utilizing a 3-way option structure. Baytex has a Brent-based hedge for 4,000 barrels per day (bbl/d) at US$61.31/bbl. It also entered into hedges on approximately 33% of its net WCS (West Canadian Select) differential exposure at a price differential to WTI of US$14.19/bbl. As part of its risk management program, Baytex transports crude oil to markets by rail when economics warrant. It delivered 5,000 bbl/d of heavy oil volumes to market by rail in 2017 and expects oil volumes delivered to market by rail to increase to approximately 6,000-7,000 bbl/d during the first quarter of 2018.

The company's fourth quarter results demonstrate, in our view, the impressive cash generating capability of its assets as commodity prices improve. With WTI averaging US$55/bbl, Baytex realized its strongest operating netback in three years and generated adjusted funds flow of $106 million, a level not seen since mid-2015. The company is delivering outstanding drilling results across its portfolio, including some of the best ever new well production rates in the Eagle Ford.

Commodity prices remain volatile with WTI currently above US$60/bbl and Canadian heavy oil differentials averaging US$24/bbl for Q1 2018 due to transportation challenges. We see these wide differentials as temporary as the industry works to alleviate the bottlenecks through crude by rail and existing pipeline optimization and reconfigurations. We expect the temporary effect of inflated WTI/WCS (crude oil benchmarks) differential to be, albeit gradually, substantially removed in the second part of 2018. This would, in our view, allow Baytex to take more benefit from its inherent operating leverage at its heavy oil operations at Peace River and Lloydminster, a key characteristic of the company's unique investment thesis. The company has been managing its heavy oil sales portfolio, including operational optimization, crude-by rail and the use of financial and physical hedges to optimize its heavy oil netbacks. In addition, at current crude oil prices, Baytex expects the Eagle Ford to generate significant FCF in 2018.

Source Energy Services Ltd. announced a significant agreement with a multinational exploration and production company operating in the Duvernay – we see this development positively as it not only significantly de-risks our current estimates but also has potential upside post 2018 – in addition, this is a strong vote of confidence for Source Energy's direct-sourcing model, which we believe is the most efficient way to execute large-scale pad operations in the Western Canadian Sedimentary Basin -- with this latest agreement, Source Energy now has the majority of its production capacity secured by long-term contracts, consistent with its longer-term strategy. The Western Canadian Sedimentary Basin is a vast sedimentary basin underlying 1,400,000 square kilometres of Western Canada including southwestern Manitoba, southern Saskatchewan, Alberta, northeastern British Columbia and the southwest corner of the Northwest Territories.

Financial Sector

The European Union has proposed making it a formal requirement for asset managers to consider "*sustainability*" when picking investments. The E.U. wants more money going into sustainable and "*green*" projects that help cut greenhouse gas emissions, as part of a wider "*capital markets union*" project to expand funding from financial markets for companies and growth. In an "*action plan*" published on Thursday, the European Commission said it would "*clarify*" the duty of asset managers and big investors to ensure they take sustainability into account in the "*process*" of investing. The European Fund and Asset Management Association said it did not believe such legislation was needed because investment in sustainable projects had to be driven by the owners of the assets being invested. (Source: Reuters)

The Royal Bank of Scotland Group PLC (RBS) - The New York Attorney General has announced a settlement with RBS over U.S. Retail Mortgage Backed Securities (RMBS). The headline \$500 million breaks down as \$100 million in cash (approximately £72 million) and \$400 million (£288 million) of consumer relief. The consumer relief element is higher than our expected 50% assumption which is helpful and we note the group took £442 million of U.S. RMBS provisions in Q4. This settlement isn't specifically called out at Q4 but the group did note it was in "*advanced discussions*" with the New York Attorney General. Overall, this settlement is pretty much in line with expectations with the key one to clear remaining the settlement with the Department of Justice.

Activist Influenced Companies

Nothing significant to report.

Dividend Payers

GEA Group AG - Relative to GEA's pre-release on Jan. 23, 2018 the key incremental points in their Q4 report issued today are: the company's operating EBITDA margin guidance for 2018 of 12-13% implies op. EBITDA of €580-635 million, a nudge down from the preliminary guidance (op. EBITDA of €590-640 million), only partly explained by FX (approximately €5 million at the mid-point); the 2018 revenue growth guidance of 5-6% implies organic growth of 1-2% in line with expectations. The company says that the guidance assumes mergers and acquisitions contributing +4%. No change to the overall Q4 order intake (€1,317 million) as pre-released on Jan. 23, 2018. However, the breakdown of order intake by size shows a solid development in base orders (order size greater than €1 million) which grew approximately 7% organically in Q4. However, order intake for the dairy processing segment declined in the quarter. The company has proposed a dividend of €0.85 (Bloomberg consensus: €0.80). No new share buyback program announced (prior €450 million buyback program completed on Feb. 8, 2018).

Economic Conditions

U.S. economy - American companies significantly increased the number of jobs by 313,000 in February, the most in 1½ years, while the two previous monthly increases were revised up to 54,000. The three-month trend (242,333) is well above last year's average (182,333), marking an acceleration in hiring. Every major private industry (apart from information) expanded its workforce, with manufacturing and construction on notable upswings. The household survey showed even stronger job growth (785,000 after 409,000 in January). Yet, a three-tenths increase in the participation rate increased the labour force (806,000), thereby keeping the unemployment rate steady at 4.1% for a fifth month in a row. This might explain why wage growth moderated after spiking to nine-year highs, though the prior month was padded by minimum wage hikes and tax windfall bonuses. Average hourly earnings rose 0.15%, shaving the yearly rate to 2.6%. After accounting for productivity growth of just over 1%, there still seems to be little material pressure on inflation and in our view increases the likelihood of the Federal Reserve increasing rates on March 21, and, despite the easing in wage growth, may well mean 3 or 4 increases this year.

Canada's Economy - Canada's unemployment rate returned to the lowest in four decades after adding 15,400 jobs during February. The figure fell below economist forecasts of a 21,000 gain. The unemployment rate fell to 5.8% from 5.9%. One negative in the report was that the gains in February were driven by part-time employment, which was up 54,700 jobs. Full-time work was down by 39,300. Full-time employment has been responsible for the bulk of the job boom, totaling almost half a million jobs over the past 18 months. The gain in February was driven by services-producing

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industries, particularly health care and education. Manufacturing recorded a drop of 16,500 workers during the month. Ontario, which recorded a large drop in employment last month after the province hiked minimum wages, led the increase in February with 15,700 new jobs.

Japan's Economy expanded at an annualized rate of 1.6% (0.4% quarter/quarter) in the final three months of 2017, revised up from a preliminary estimate of 0.5% (0.1% quarter/quarter) growth due mainly to an upward revision to capital expenditure/business spending. While Q4's growth remains the slowest pace of expansion recorded for 2017, the revision did beat Bloomberg median estimates of 1.0% annualized rate (0.2% quarter/quarter) upward revision. Full year growth was also revised higher to 1.7% in 2017 (from 1.6% in the prelim estimate), compared to 0.9% in 2016. This is Japan's 8th straight quarter of economic expansion and best growth streak in 28 years, since Q2 1994 to Q3 1997. Compared to a year ago, Japan grew by +2% year/year in Q4 from 1.9% in Q3.

The E.U. on Wednesday offered Britain a free trade deal for their post-Brexit ties that fell well short of ambitions set out by Prime Minister Theresa May last week, notably for the country's dominant financial sector. In a draft seen by Reuters, the remaining 27 European Union members said they wanted a close partnership with Britain, but its depth would be limited by Britain's own wish to leave the bloc's single market and the customs union. "*Because of Brexit, we will be drifting apart,*" the chairman of E.U. leaders Donald Tusk told a news conference, delivering a message that contrasted sharply with May's call for future trade to be as "*frictionless as possible*". Referring to what he called the first free trade deal ever to loosen economic ties, he said it would make bilateral trade "*more complicated and costly than today, for all of us.*" Tusk said that, while he understood May's goal to make Brexit a success for Britain that was not the E.U.'s objective. Crucially, the bloc said Britain would be treated like any other third country when it came to financial services - which London had pressed to be included in the future deal. (Source: Reuters)

The U.K. Report on Jobs, a survey of recruitment consultants, for February shows the rate of growth in permanent placements moderated slightly in the month and was mildly offset by a pick-up in temporary billings, following its ten-month low in January. Growth in demand for staff, although remaining high, also eased to a 14-month low. Salary inflation for permanent placements remains amongst the highest recorded in over two and a half years despite a slight slowdown in February as candidate availability is still falling. Demand for staff remains stronger in the private sector than the public sector.

Financial Conditions

European Central Bank (ECB) as expected, rates were left unchanged….the main refinance rate at 0.00%, the marginal lending facility at 0.25%, and the deposit facility at -0.40%. As well as, the guidance on rates was left unchanged…they will "*remain at their present levels for an extended period of time, and well past the horizon of the net asset purchases.*" The purchases themselves (€30 billion per month) will run until the end of September, and "*beyond, if necessary, and in any case until the Governing Council sees a sustained adjustment in the path of inflation consistent with its inflation aim*"....but this time no additional comment of preparedness to increase the asset purchase program if necessary ... In other words, the ECB will keep buying bonds past September, if necessary (probably will have to) but they won't raise the monthly amount (unless something drastic happens). This step in our view pivots the ECB in the direction to eventually bring quantitative easing to an end. Also, the ECB's GDP growth projections for this year were revised up a bit to 2.4% (was 2.3% in January), followed by 1.9% in 2019 and 1.7% in 2020.

The Reserve Bank of Australia left its official cash rate (OCR) unchanged at a record low of 1.5%. The decision marks the 19th consecutive month that the OCR has been left at this historically low setting.

The U.S. 2 year/10 year treasury spread is now .63% and the U.K.'s 2 year/10 year treasury spread is .66% - 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 4.46% (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 3.4 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 15.58 (compares to a post-recession low of 9.52 achieved in early November) 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 Advantage Plus - Everest and McKinley Funds
- Portland Focused Plus Fund LP
- Portland Focused Plus Fund
- Portland Global Aristocrats Plus Fund
- Portland Global Energy Efficiency and Renewable Energy Fund LP
- Portland Global Sustainable Evergreen Fund
- Portland Global Sustainable Evergreen LP
- Portland Private Growth Fund
- Portland Private Income Fund
- Portland Special Opportunities Fund
- Portland Value Plus Fund

Individual Discretionary Managed Account Models - SMA

Net Asset Value:

The Net Asset Values (NAV) of our investment funds are published on our Portland website at http://www.portlandic.com/prices/default.aspx

We want to share our insights with you and welcome your feedback. Our website has the latest, as well as archived videos, company profiles, and press articles. Please visit us at www.portlandic.com.

Glossary of Terms: 'boe' barrel of oil equivalent, a measurement of a unit of energy, 'boed' refers to barrel of oil equivalent per day, 'CET' core equity tier, 'EBITDA' earnings before interest, taxes, depreciation and amortization, 'EPS' earnings per share, 'FCF' free cash flow, 'ROE' return on equity, 'ROTE' return on common equity.

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