News Highlights

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PORTLAND INVESTMENT COUNSEL®

Our views on economic and other events and their expected impact on investments. March 28, 2016

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Energy Sector

U.S. rig count – Data from oil services firm Baker Hughes showed U.S. oil drillers cutting 15 rigs over the past week after a pause the week before, boosting sentiment. The U.S oil rig count now stands at 372, the lowest since November 2009. Earlier in the week, the U.S. government reported a crude inventory build three times above market expectations. U.S. crude's front-month contract settled down 33 cents at $39.46 a barrel, recovering from a session low of $38.33. For the week, it rose two cents, finishing up for a sixth straight week. Despite the stumble, oil prices remain about 50% higher from multi-year lows hit in January from glut worries. While declining U.S. oil output and strong gasoline demand were responsible for some of that recovery, the bulk of it was powered by major producers' plans to freeze output at January's highs.

Financial Sector

Fifth Third Bancorp confirmed is creating 120 new jobs in its "rapidly" expanding Information Technology division, adding to the 80 tech employees the bank already hired in the past five months. These roles are slated to help the bank continue to accelerate delivering the best customer experience in the mobile and digital space. The bank is recruiting developers, business systems analysts and project managers to add to its current team of 750 tech experts across its footprint. More than 100 of the new jobs will offer salary packages worth more than $100,000 each. By year's end, Fifth Third Bancorp plans to employ more than 1,000 technology employees, a 27% increase since 2012.

The Goldman Sachs Group, Inc. is buying an online retirement-savings start-up that is barely a year old, as the Wall Street bank adjusts to the growing influence of technology in finance. Goldman's investment-management division said it would buy Honest Dollar, a company that sells retirement plans consisting of portfolios of low-cost exchange-traded funds to small companies, charging $8 to $10 an employee a month. Terms of the deal weren't disclosed. The deal, which is expected to close by July, comes nearly a year after Goldman said it was hiring former Discover Financial Services executive Harit Talwar to lead an expansion into online lending. (Source: Wall Street Journal)

Royal Bank of Scotland Group PLC (RBS) has repaid £1.19 billion ($1.71 billion) to the British government and will retire the bank's so-called dividend access share, taking the 73% state-owned lender one step closer to paying dividends to its ordinary shareholders. The dividend access share - giving the government preferential rights to RBS shareholder payouts - was issued in 2009 when the British Treasury rescued the troubled bank by providing £25.5 billion of equity capital in exchange for B shares. "This is another important milestone in our plan to resume capital distributions to our shareholders, and represents one less hurdle in our path to build the number one bank for customer service, trust and advocacy," Chief Executive Ross McEwan said. (Source: Wall Street Journal)

Activist Influenced Companies

Pershing Square Holdings, Ltd. – Bill Ackman took a seat on Valeant's board, a second seat for Pershing Square Holdings, as the Canadian drugmaker announced the departure of its CEO, Michael Pearson. Valeant said it started a search for a successor to Pearson. Pershing Square Holdings holds a 9% stake in Valeant or about 7.5% of its portfolio as per the most recent filing. Pershing Square Capital Management also announced it sold 20 million shares of Mondelez International, Inc. for portfolio management purposes only, cutting its stake to 5.6% from 7.5%. Pershing Square Holdings' 'BBB+' Fitch credit ratings are not yet impacted, even though Pershing Square Holdings' asset value declined, driven lower by underperformance of several investments, most notably Valeant. However S&P placed the firm's 'BBB' rating on creditwatch negative on higher leverage and weak performance. S&P said it could lower Pershing Square Holding's rating if Valeant files for bankruptcy or if Pershing Square Holdings materially reduces free cash before Valeant's stock price has substantially recovered.

Canadian Dividend Payers

Crown Capital Partners Inc. - Q4/2015 results were in line with estimates, with adjusted earnings before interest, taxes, depreciation and amortization (EBITDA) of $1.2 million. Headline revenue came in at $5.8 million, benefiting from an unrealized gain on investments of $3.0 million (i.e. Claude Resources Inc., Petrowest Corporation and CRH Medical Corporation). Total revenue was in line with our estimate at $2.7 million. As well, total expenses of $1.6 million was consistent with our estimate of $1.5 million. Currently, management indicated Crown's senior level positions are fully staffed, with a few junior hires (i.e. analysts) possible in 2016. As a result, we expect a relatively stable trend for general and admin expenses (G&A) this year. During the conference call, management stated the credit quality of investments was in great shape, with improvements in risk ratings. For each investment, Crown utilizes a proprietary credit evaluation model to ascribe a risk rating. The evaluation model reviews five primary categories (e.g. financial, industry) and over fifty sub-categories (e.g. profitability, leverage, suppliers, competitors, business cycles etc.).

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We provide the following updates on portfolio companies: (1) For CRH Medical (TSX:CRH), the company demonstrated significant year over year (YoY) growth in revenue and EBITDA for 2015. Currently, CRH's debt/EBITDA decreased to <1.4x from ~2.2x at the time of investment; (2) In December 2015, Petrowest (TSX:PRW) and their Peace River Hydro Partners were selected as the preferred proponent for BC Hydro's Site C Clean Energy Project (valued at $1.75 billion). The contract will help further diversify Petrowest's revenue towards infrastructure, thereby reducing oil and gas exposure; (3) In November 2015, Crown invested $20 million in Distinct Infrastructure Group Inc. (TSX:DUG), supporting potential growth in Ontario and Western Canada through acquisition opportunities. In March 2016, Distinct closed its first acquisition of Mega Diesel Excavating. Currently, Crown indicated a solid pipeline with multiple deals at various stages of the investment process (i.e. preliminary term sheet, due diligence and final term sheet). The company sees a stronger deal flow in Alberta from opportunities arising from a depressed energy market. Currently, Alberta accounts for ~1/2 of the total deal flows (vs. ~1/3 previously). As of December 2015, Crown has $44 million in cash, which should be deployed through 2016.

Global Dividend Payers

Dufry AG reported a Q4 2015 EBITDA of CHF 215.8 million, +34.1%, 4% below consensus. With a margin of 11.8% profitability came below forecasts and company guidance. Management expected a margin 12-12.2% for the full year, whereas the outcome was 11.8% only. YoY the decline of 150 basis points is primarily owed to the diluting effect of World Duty Free (WDF). Due to the significant changes in scope, costs of goods sold (COGS) and other cost margins are not comparable. Below the EBITDA line, there were substantial deviations to estimates: 1) Integration cost and other operational expenses were higher than expected, 2) the Linearization charge was higher than guided and expected, 3) the total financial result was CHF 20 million deeper than we estimated, and 4) there was a positive tax result. In sum, net profit in the quarter was a negative CHF -42 million, whereas the consensus stood at CHF -22 million. Q4 Revenue was CHF 1,923 million, +46.3% YoY, 3% above consensus and like–for-like (LFL) growth amounted to -5.6% in the last quarter, a touch better than assumed. However, the targeted acceleration from the previous quarters was not achieved as the number stood at -5.6% at September as well. The biggest contribution, obviously, came from WDF which added 59.9% to the top line. It was thus primarily an excellent contribution from WDF, which led to a 3% beat at the top line. The current year brings a lot of headwinds, mainly in terms of geopolitical- and foreign exchange turmoil. However, for profitability, we believe Dufry can benefit from the substantial synergies that the combination of Dufry/Nuance/WDF offers. As usual, Dufry did not provide any guidance. However, the focus has been on driving organic growth. Going forward, the integration of WDF and deleveraging the balance sheet enjoy highest management attention. The goal is to deleverage the company to the targeted level of 2-3x within the next 18-24 months.

Economic Conditions

U.S. durable goods orders retreated by 2.8% in February, marginally better than expected, offsetting the 4.9% jump in January. Even when excluding the effects of the bulky transportation orders, the durable goods orders pulled back 1.0%, with weakness across the industries. U.S. personal income grew by 0.20% in February, ahead of the expectations which were calling for a 0.1% advance, whilst personal consumption grew by 0.1% in the month, in line with the expectations. Part of the same report, the core personal consumption expenditures (PCE) price index, the U.S. Fed's favourite price gage, kept steady at a 1.7% year on year pace, not pressuring the Fed in raising rates any time soon.

U.S. retail sales fell 0.1% in February (a tenth better than expected), but huge downward revisions to January was the big story. The prior month's headline is now -0.4% versus +0.2% before (a massive 6/10s swing). The slight brake in unit vehicle sales didn't dent the headline much, but lower gasoline prices did (service station receipts -4.4%). Excluding autos and gas, retail sales rose 0.3% (also a tenth better than expected), but with a hefty revision to the prior month (now -0.1% vs. +0.4% before). The revisions were relatively broad based (electronics, appliances, building materials, personal-care items and department-store merchandise), and reveal that U.S. consumers had much less spending punch to start 2016, despite strong job growth, cheap gasoline, low borrowing costs and rising house prices. When it comes to the U.S. economy, we believe consumer spending is king. Unfortunately, spending appears to have slowed in 2016. In consequence, keeping real GDP growth above 2% annualized in Q1 is going to be more difficult. While consumers got off to a soggy start this year, the YoY gain shows them in a more favorable light. Real spending is still up 2.8% YoY, almost fully supported by growth in real disposable income (2.7%). We continue to expect consumers to drive the expansion this year, even as the gas windfall fades, amid support from solid job growth and low borrowing costs.

Core PCE prices rose a less-than-expected 0.1% in the month (albeit a high 0.149%), holding the yearly rate at 1.7%. That, combined with the soft spending figures, should suffice we believe to keep the Fed sidelined at the April meeting.

U.S. goods trade deficit rose modestly to $62.9 billion in February, as a 1.4% advance in imports was sufficient to counter the first increase in exports (1.6%) since September. Trade will continue to act as a moderate-sized brake on the expansion.

U.S. Q4 GDP revisions were released. Q4 GDP came in higher than expected at 1.4% (vs. est. 1.0%). Personal Consumption estimates also surprised to the upside at 2.4% quarter over quarter (vs. est. 2.0%). The main economic focus this week will be the Nonfarm Payrolls release on Friday.

Financial Conditions

The Bank of Japan maintained its monetary easing program by holding interest rates at -0.10% and making no change to its asset purchase programme. It also spoke to the slowdown in the Japanese economy, the decline in exports and weak inflation for 2016.

The U.S. 2 year/10 year treasury spread is now 1.03% and the UK's 2 year/10 year treasury spread is 0.97% - 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 3.71% (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 5.2 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 14.74 (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

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