News Highlights

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PORTLAND INVESTMENT COUNSEL®

Our views on economic and other events and their expected impact on investments. July 29, 2016

Energy Sector

Baytex Energy Corp. reported second quarter results which exceeded expectations in terms of funds from operations generation during the quarter, however drilling activity slowed down to fewer than expected three drilling rigs in the company's Eagle Ford acreage (which is operated by its partners, Marathon Oil). Given the reduced pace of development anticipated for the second half of 2016, Baytex is now forecasting full-year 2016 exploration and development capital expenditures of $200 to $225 million, down from previous expectations of $225 to $265 million. The company divested some 2,250 barrels per day (bpd) of producing assets in the quarter, including some of its non-core Eagle Ford assets as well as non-core assets generating some 1,250 bpd of production in Canada. Taking into account dispositions and the reduced spending profile, Baytex now anticipates full year 2016 production of 67,000 to 69,000 barrels of oil per day (boe/d) (previously 68,000 to 72,000 boe/d). At the mid-point of guidance and excluding the impact of disposition activity, the approximate 13% reduction in planned spending impacts the company's 2016 production forecast by only 1%. That said, Baytex's 2016 capital program will remain flexible and allows for adjustments to spending based on changes in the commodity price environment. At this level of spending and based on the forward strip for crude oil and natural gas, the company expects its funds from operations to exceed capital expenditures in 2016. Baytex reduced its net debt by $39 million in Q2 2016 as funds from operations exceeded capital expenditures. The company realized an operating netback (sales price less royalties, operating and transportation expenses) in Q2 2016 of $14.39/boe ($18.13/boe including financial derivatives gain). It also reinitiated production from heavy oil wells shut-in during the first quarter due to low oil prices; at June 30, approximately 6,500 boe/d of the 7,500 boe/d previously shut-in had been re-started. In line with much of the sector, costs in the Eagle Ford have continued to decrease with wells now being drilled, completed and equipped for approximately US$5.4 million, as compared to US$8.2 million in late 2014. Despite achieving cost reductions of approximately 20% in Canada during 2015, the prevailing commodity prices have not supported additional drilling on the company's Canadian assets. For the second half of 2016, Baytex has entered into hedges on approximately 46% of its net West Texas Intermediate (WTI) exposure with 15% fixed at US$63.79/barrel and 31% hedged utilizing a 3-way option structure. Baytex also hedges approximately 35% of its net WCS (Western Canada Select) differential exposure and 67% of its net natural gas exposure. For 2017, Baytex entered into hedges on approximately 31% of its net WTI exposure utilizing a 3-way option structure. The company also announced the appointment of Trudy M. Curran as a new director on its board. She served as an officer of Canadian Oil Sands Limited from Sept. 2002 to the time of its sale in February 2016. She serves on the Executive Committee of the Calgary chapter of the Institute of Corporate Directors and is a member of the board and the Finance and Audit Committee of Kids Cancer Care Foundation of Alberta.

BP Plc's adjusted net income of $720 million was 14% behind the company provided consensus number of $840 million. With the upstream and downstream businesses essentially in-line with consensus, the areas of shortfall relative to expectations were in "Other business & corporate" where there was a reversal of some of the positive foreign exchange effects seen in Q1. Given what are relatively small swings in these lines, we continue to see the progress being made on the rebalancing on sources and uses of funds as one of the most important drivers of BP's share price performance and to that end the movement in cash-flow and the update on capital expenditure and costs are all encouraging. CEO Bob Dudley: "We are very pleased to have finally drawn a line under the material liabilities for Deepwater Horizon. We are delivering significant improvements to the business that will stick at any oil price. We are now well down the path of transforming our business to compete, whatever the future holds. We now see a much stronger outlook for BP and are focused on growth, both for this decade and beyond."

Royal Dutch Shell Plc's 2Q16 results - Adjusted earnings (excluding identified items) were $1.0 billion for Q2 2016, compared to consensus of $2.2 billion. Shell reported weaker results in all operating segments but especially in Upstream due to a step-up of depreciation after combining BG. Gearing increased to 28.1%, compared to 26.1% at March 31, 2016. Shell's dividend is maintained at $0.47/share for Q2 2016. Looking forward: Shell maintained Capital Investment for this year at $29 billion; and annual operating expenses is trending towards a run-rate of $40 billion, compared to pro-forma expenses of $53 billion. The reality is that Shell has always been a very seasonal business and this is a transition year for the company incorporating the BG assets. Ultimately a rebalancing of the cash equation is happening and despite the seasonality in earnings Shell is, in our view, heading in the right direction.

TOTAL SA's integrated portfolio resilience and lack of material U.S. exposure is shining through once again in our view. TOTAL reported the lowest cashflow reduction across global SuperMajors in 2015. Similar resilience is showing up again early in 1st Half 2016 with cash-flow from operations (CFO) down only 23% despite Brent down more than 30%. Indeed TOTAL's CFO ex. working capital is well on it's on its way to cover capex at $45/barrel and that's before capex could come in at $18 billion versus below $19 billion guidance previously. Adjusted Net Income was $2.2 billion, compared to consensus of $1.9 billion. Upstream again stands out. Net operating income of $1,127 million was well above consensus of $800 million and continues to be a key standout when most global Upstream business will be breakeven/loss-making in Q2. Gearing (Net Debt/(Net Debt +Equity)) of 23% is down slightly from 23% in Q1 2016. Dividends maintained at €0.61/share for the quarter. Looking forward and we believe TOTAL's high-growth, long-life portfolio is on track to deliver 4% in 2016 and 5% average annual growth to 2019.

Financial Sector

Barclays Plc - Underlying Profit Before Tax (PBT) for Q2 was £1,317 million or £300 million better than consensus. Stripping out the one-offs, Income of £5.2 billion or £0.2 billion ahead, Costs were £0.1 billion better at £3.5 billion, whilst impairment of £0.5 billion was in line. Core Bank revenues were solid with a good performance in Corporate & Investment Banking, with stronger revenues of £2.6 billion (up 1% quarter over quarter (QoQ)/-6% year over year (YoY)) driven mainly by higher banking fees. The Core Bank reported underlying PBT of £1.9 billion versus consensus of £1.7 billion. Non-core losses for the quarter totaled £535 million or £138 million better than consensus. A significant number of one-offs in the quartered netted to -£47 million to leave reported PBT at £1.3 billion. Capital ratios were solid with Core Equity Tier 1/Risk Weighted Assets finishing at 11.6%, up +0.3% QoQ. Total Net Asset Value was 289p or +3p higher than Q1 with an interim dividend of 1p in line. Non-core costs for 2017 are expected to be £400-500 million versus consensus of approx. £644 million whilst core cost guidance for 2016 of £12.8 billion was struck at a $1.42 exchange rate now implying more like £13 billion. Overall we think these are a decent set of underlying numbers and should offer some support.

Blackrock Capital Investment Corp. reported GAAP and adjusted Net Interest Income per share of $0.30, compared to consensus of $0.25. There was no accrual or adjustments to GAAP for the timing of incentive fee expenses due cumulative unrealized losses in the portfolio. Outperformance was driven primarily by higher fee income ($0.03 per share) and lower than expected expenses ($0.01). Realized and unrealized losses lowered book value per share by 3.5% to $9.13 from $9.46, and is down 14% YoY. Leverage (debt/equity) fell to 0.53x from 0.64x QoQ. Liquidity available at the end of June totaled $244.5 million including $7.5 million of cash and $237.0 million of available credit facility capacity. Its investment in Hunter Defense was restructured during Q2 2016, which led to realized losses that were roughly in line with prior unrealized marks. Vertellus Specialties filed for Chapter 11 in May and Blackrock provided $20 million of Debtor In Possession financing ($110 million overall from group of lenders) to provide liquidity through the bankruptcy process. The deadline for bids in the auction process is Aug 29th, hopefully leading to resolution during the third quarter.

BNP Paribas SA - Clean pre-tax Q2 results which were 14% ahead of consensus with a Return On Tangible Equity (ROTE) of 11.6% driven mostly by Corporate & Investment Bank but also containing better retail performances. While capital build is low this quarter the bank continues to accrue a 45% dividend implying a yield of close to 6%. These are a good set of numbers with ROTE of 11.6% being clearly under-rewarded in our view on Price/Total Net Asset Value of only 0.7x.

Fifth Third Bancorp reported Q2 Earnings Per Share (EPS) of $0.40. Excluding several non-core items, operating EPS of $0.41, exceeded consensus of $0.39. The drivers of the beat were a lower loan loss provision and tax rate, but operating expenses and fee income were also better-than-expected, partially offset by lower fee income. Operating revenues rose 3% YoY and increased 2% sequentially. Tangible book increased 3.7% from Q1 2016 to $16.93. It posted a Return On Equity of 8.2%, and Return On Tangible Common Equity of 9.7%. Its Core Equity Tier 1 ratio (fully phased-in) was 9.86% (+14bps). On April 11, Fifth Third settled the forward contract related to its March 4, $240 million share repurchase agreement. An additional 1.9 million shares were repurchased. On June 14, it executed open market share repurchases totaling $26 million, which reduced Q2 2016's share count by 1.4 million shares. In total, shares decreased 4 million. Average diluted shares declined 1.7%. Its Non Performing Assets ratio improved 2bps to 0.86%. Its energy Non-Conforming Obligations ratio was 0.48%, its lowest since Q3 2015.

First National Finance Corporation reported Q2 2016 core EPS of $0.79 compared to consensus of $0.70. We believe stronger-than-expected mortgage servicing income from third-party underwriting and fulfillment processing services is the key takeaway from second quarter results. The business drove a 23% YoY increase in mortgage servicing income. With expenses held stable, this signals to us the emerging scalability of the business model.

State Street Corporation reported Q2 2016 operating EPS of $1.46, consensus was $1.26. Relative to expectations, higher net interest margins (declined just 1bp), lower expenses, and a lower tax rate drove the beat. Relative to Q1 2016, results evidenced a 5% gain in fee income (higher servicing, management and processing fees), a 1% increase in core net interest income, seasonally lower expenses (-6%; compensation, IT), a lower tax rate (-210bps), and a reduced share count (-1.2%). It posted an improved Return On Equity of 12.3%.

UBS Group AG - Q2 2016 underlying PBT reached CHF1.58 billion versus consensus of CHF1.4 billion, a 10% beat due to better costs. Q2 2016 annualized underlying Return on Net Asset Value (RoNAV) of 9.8% with the shares trading on 1.05x Q2 2016 Price/Net Asset Value. Revenues were 6% better than expected. Costs were 3% better than expected leading to PBT 37% better than expected. Near term RoNAV targets have been dropped, with 2018 consensus RoNAV already at 10%. Whilst the results are good, with healthy underlying trends, in our view, the dividend of 2016 will still need to be cut to CHF0.3 with the futures market still pricing in CHF0.6 and consensus at CHF0.57. Core Equity Tier 1 ratio reached 14.2%, versus consensus of 14.1% with the leverage ratio at 3.4%.

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Activist Influenced Companies

Restaurant Brands International Inc. has announced the establishment of a master franchise joint venture company, TH Coffee Services Philippines Corporation, with a group of investors in the Philippines. The joint venture company will be the master franchisee of the Tim Hortons brand in the Philippines and marks the Canadian coffee chain's opportunity to develop and grow the iconic Tim Hortons brand in the Philippines. "This agreement signals an exciting era of growth for the Tim Hortons brand internationally and particularly in Southeast Asia," said Daniel Schwartz, CEO of Restaurant Brands International. "The master franchise joint venture model has been a successful strategy for the Burger King brand and we expect it will continue to help us drive growth and build scale for the Tim Hortons brand over the long-term."

Canadian Dividend Payers

Barrick Gold Corporation reported Q2 2016 adjusted EPS of $0.14 versus consensus of $0.15. Gold production of 1.34Mozs (sales of 1.292Mozs) came in modestly below production estimate of 1.37Mozs (sales 1.4Moz). Cash costs were $578/oz, higher than $531/oz estimate. Copper sales of 93Mlb were above estimate of 71Mlbs. The company generated $141 million in free cash flow in Q2. Barrick's turn-around story continues in our view with the company focused on core assets, operational improvements and repairing the balance sheet. Year to date, the company has paid down $968 million of debt, about half-way to its $2 billion goal for 2016. The additional funds for the residual repayment could come from either cash flow ($2.5 billion in 2016) or the potential sell-down of its interest (63.9%) in Acacia (market cap of $2.92B) or Kalgoorlie (to Newmont).

Brookfield Infrastructure Partners LP – An AUD$9.1 billion ($6.8 billion) buyout of Australian port and rail freight giant Asciano Ltd. by global investors was approved by court, clearing the final hurdle for the country's biggest foreign takeover in five years. Announcing the Supreme Court of New South Wales state had cleared the deal, Asciano said its shares will stop trading on July 29. Stockholders will receive payments on Aug. 19. After rival bids and regulatory concerns held up a deal originally scheduled for completion by the end of 2015, the buyout was cleared by Australia's antitrust regulator and the country's Foreign Investments Review Board this month. The takeover involves selling Asciano's port assets in a split between Canada's Brookfield Asset Management Inc and Australian stevedoring company Qube Holdings Ltd., while a consortium involving government-owned China Investment Corp will take its rail assets.

Global Dividend Payers

BHP Billiton Plc's Q4 2016 production report was generally ahead of forecast, especially for petroleum and copper, with only iron ore below forecast. Production guidance for 2017 was also in line with expectations, with the exception of copper, where the company is guiding to 1.7 million tones ahead of estimates of 1.54 million tonnes. Petroleum volumes for 2017 are guided to be 13-17% lower, at 200-210 million boe (due primarily to further declines in onshore U.S. shale output).

Compass Group Plc continues to have a good year, with organic revenue growth of 5.6% for the nine months to June 30, 2016. Its focus on growth is driving strong levels of new business wins and retention remains good across all regions. Organic revenue grew by 5.2% in the third quarter reflecting strong net new business in North America, good growth in Europe, and a challenging environment in Rest of World. Overall, the operating margin for the nine months to June 30, 2016 was flat before restructuring costs and down 10 basis points including restructuring costs. Performance in the North America region continues to be very good, with organic revenue growth of 8.3% in the quarter and in the nine months to June 30, 2016. The group is still seeing strong growth across all sectors with the exception of our oil & gas business. In the nine months to June 30, 2016 Compass had bought back £96 million in shares. If current spot exchange rates continue, at the end of the fiscal year net debt to earnings before interest, taxes, depreciation and amortization (EBITDA) will be around 1.6x to 1.7x on a reported basis.

Diageo Plc announced 2016 results with continued optimism for 2017-2019 of mid-single digit organic top-line growth and 100bps of margin expansion over 3 years (ending in 2019). However, 2016 was mixed, with improvement in North America, weak emerging markets (Latin America and Africa) and higher Associates (Moët Hennessey). Revenue came in at £10,485 million, with organic revenue up 2.8%, 1% behind company consensus. On a reported basis revenue was negatively affected by FX movements, to the tune of -£172 million for the year. Operating Profit (before exceptionals) came in at £3,008 million, up 3% organically, in-line with consensus (£3,008 million). Organic operating margin was up 19 bps. Organic improvement was driven by mix (return to growth in North America) and marketing efficiencies, partly offset by increased overheads. Reported margin also improved on lower exceptional operating charges and net sales adjustment in Asia Pacific. EPS (pre-exceptionals) came in at GBp 89.4, 1% ahead of our company consensus (GBp 88.1).

GEA Group AG reported Q2 orders of €1,222 million (+2% vs consensus €1,193 million) with organic growth of 7.3% (Q1: +1.9%), but on an easy comparison (Q2 2015: -8.9%). The order intake in the Equipment segment came in at a very strong +11% organically reversing the declining organic order trend since Q1 2015 and quite impressive in light of the drag from the Dairy Farming segment (29% of sales for the Equipment segment, 13% of GEA Group). Conversely, the Solutions segment was a slight disappointment with orders of €659 million, up just 3.4% on a very easy comparison, albeit with lumpiness from large project orders. GEA's Q2 sales came in at €1,157 million (-1% vs. consensus €1167 million) and Operating EBIT of €125 million (-1% vs. consensus €127 million) with a margin of 10.8% versus consensus 10.9%. 2016 guidance remains unchanged: with "moderate revenue growth" from the €4.6billion level seen in 2015 and guidance for 2016 adj. EBITDA of €645-715 million remains unchanged.

LVMH Moet Hennessy Louis Vuitton SE reported 1st Half 2016 (1H16) results better than consensus estimates. The main beats were the Fashion & Leather Goods (F&LG) division and Watches & Jewellery (W&J) divisions. F&LG reported flat organic growth in 1H16 and the W&S division reported a 9% organic growth. Total revenues rose to €17,188 million, operating income was flat to €2,959 and net income rose to €1,711 (+8%). Net debt totalled €5.3 billion (vs. €6 billion in 1st Half 2015). From these results, it appears that the American market is dynamic, while Europe remains on track except for France, which has been affected by a decrease in tourism. Asia improved steadily during the period. In our view, LVMH group demonstrated resilience across its portfolio with the 'staples' operations Wines & Spirits, Perfume & Cosmetics and Sephora all seeing high single digit growth. With Louis Vuitton brand also seeing small growth and stable margins, cash flows were good with the group reviewing the financial position in second half 2016 for a potential capital return and announced a €1.4 1H16 interim dividend.

Mondelez International Inc. reported Q2 2016 adjusted EPS of $0.44, +$0.04 above Consensus. Margins and EBIT were better than expected and Mondalez also benefitted from below-the-line items (equity income). Interestingly, there was no mention of Mondalez's recently reported bid for Hershey. On the top line, organic sales rose just +1.5% YoY which reflected less favourable price realization offset by more resilient volume/mix. Consistent with recent periods, organic sales growth was driven in large part by significant pricing in Latin America in response to sizeable foreign exchange headwinds, though Asia Pac and North America both experienced volume/mix driven organic sales growth. Gross margin was flat YoY which reflects strong productivity (including supply chain savings) that was offset by foreign exchange driven inflation in excess of pricing and a -60 bps unfavorable mark to market adjustment. Mondalez maintained its 2016 guidance calling for double-digit constant currency EPS growth. On the top line, Mondalez looks for full year organic sales growth of ~2% (versus previous guidance of "at least" 2%). Mondalez continues to expect EBIT margins in a 15-16% range and "at least" $1.4 billion of adjusted free cash flow.

Economic Conditions

Canada - The B.C. government announced several new housing-related developments: Effective August 2, 2016, an extra 15% land transfer tax will be levied on residential real estate purchases by foreign nationals or foreign-controlled corporations. The current land transfer tax is: (1) 1% on the first $200,000; (2) 2% on the portion between $200,000 and $2 million; plus (3) 3% on the portion over $2 million. On a $5 million home purchased by a foreigner, the land transfer tax goes from $128,000 (2.5% of the purchase price) to now $878,000 (17.5% of the purchase price). Vancouver home prices are +38.5% YoY for single-family homes and +25.3% YoY for condos/apartments. While these measures are very likely to cool the market, by how much is unclear. That said, we believe the current rates of home price appreciation are unsustainable and efforts such as these are likely required in the effort to ensure the long-term health of the B.C. (and Vancouver specifically) housing market. Other countries have enacted similar changes (e.g., land transfer taxes) such as the U.K., where the effects to their housing markets did serve to cool the market to varying degrees, but perhaps just as importantly, did not cause a significant downturn.

Canada - Canadian economy retreated by a more than expected -0.6% in May, dragged lower by the scale back in oil and gas activity due to Fort McMurray fires, offset partly by a pick-up in activity in the services sector (in particular arts, entertainment and recreation).

U.S. durable goods orders. Orders took a 4% dive in June, which was weaker than expected. The plunge in Boeing's orders showed, as nondefense aircraft & parts were slashed 58.8%. But excluding transportation, orders also fell, by 0.5% rate. But, it was still a decline as nearly every major component was down halfway through 2016, with the exceptions of electrical/appliances and motor vehicles.

U.S. real GDP grew 1.2% annualized in Q2, less than half of what was expected. Consumer spending jumped 4.2%, the most since late 2014, and spread among all major expenditure areas, including the fastest services spurt (3.0%) in six quarters. Improved household finances, decent job growth and firmer wages should keep consumers in a spending mood this year. Now for the bad news - starting with business spending, or the lack thereof. Fixed investment collapsed 3.2%, the most since the last recession, as companies chopped spending on commercial structures and equipment. Business inventories were outright reduced (an oddity outside of recessions), carving 1.2% points from GDP growth. Given the underlying strength in consumer spending, inventories should recover in Q3. Unfortunately, imports, which fell for a second straight time amid weakness in business spending, should also bounce back. Exports rose modestly in Q2 after three straight declines.

Financial Conditions

The Bank of Japan, similar to the Bank of England, European Central Bank, and Federal Reserve over the last few weeks left basically unchanged its benchmark rate at -0.1% by a 7-2 vote, its monetary base at 80 trillion Yen but did double its ETF purchases from 3 trillion to 6 trillion by buying an additional $26 billion a year in stocks and continue buying 30 times that in debt. We believe the importance of last night's announcement is that the Bank of Japan is seeking to set the floor for global rates and effectively said their rate cutting cycle is over, which is positive for Japanese banks.

The U.S. 2 year/10 year treasury spread is now .81% and the UK's 2 year/10 year treasury spread is .58% - 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 3.48% (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 4.7 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 12.50 (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.

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- 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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