News Highlights

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PORTLAND INVESTMENT COUNSEL®

Our views on economic and other events and their expected impact on investments. November 7, 2016

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Energy Sector

U.S. land rig count increased by 13 rigs week/week to 546, extending the weekly gain streak to 7 weeks and is up on average 21% Quarter to date, quarter/quarter. The rig count increase was driven by gains in Horizontal Oil (+7), Vertical Oil (+4), Horizontal Gas (+2), Vertical Gas (+1), and Directional Gas (+1), slightly offset by declines in Directional Oil (-2). Total horizontal land rig count is 67% down since the peak in November 2014. The Permian currently makes up 51% of all oil rigs.

U.S. horizontal oil land rigs increased by 7 rigs week/week to 366, driven by gains in the Permian (+3), Williston (+2, which at 36 rigs, is the highest level it's been since February), Eagle Ford (+1), and DJ-Niobrara (+1), while Granite Wash, Mississippian, Woodford and "Other" remained flat week/week.

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

Canadian rig count increased by 1 rig week/week and is 17% off the level this time last year.

Baytex Energy Corp. (BTE) reported in-line results for its third quarter. Production of 67k boed (barrels of oil equivalent per day) was ahead of the consensus and BTE revised its full year guidance to 69k-70k boed (up 2%). Funds from operations, at $72 million were marginally ahead of the expectations and far exceeded the $39.6 million in exploration and development expenditures as Q2 and Q3 activity was rather muted in both drilling and completions in Eagle Ford. BTE expects funds from operations to exceed its capital spend over the course of 2016. As it entered Q4, activity has picked-up in Eagle Ford, were BTE has currently 4 drilling rigs and 2 completion crews at work, which is expected to be enough to offset the natural rates of decline (28 to 30 net new wells). BTE is still assessing its capital program for 2017 (to be unveiled in December) and maintains some flexibility (towards the upside), pending the OPEC related developments. BTE reduced its net debt position by a further $79 million ($186 million for the year), for a net debt position of $1.86 billion at the end of the quarter, down from $2.05 billion at the end of 2015. At 0.79x Senior Secured Debt to Bank EBITDA (earnings before interest, taxes, depreciation and amortization), it is well within its 5x covenant. Operating netback was $13.91/boe ($16.95/boe with hedging), with $20.2 from Eagle Ford and $7.6 from Canadian operations. BTE has hedged some 45% of Q4 WTI exposure, with some fixed at US$64/bbl and some 3-way (US$50 floor and US$60 cap). For 2017, it hedged 44% of its WTI exposure, all 3-way at US$47 floor and US$59 cap.

BP Plc reported solid Q3 results in our view, with Earnings Per Share (EPS) (adjusted for the tax one-off) of $0.029 and free cash generation, before dividend & Macondo payments, of $2.0 billion. Total managed costs were broadly flat year/year, at $13.7 billion, which reflects both a jump in capital expenditure in the quarter (from the formation of Aker BP) and that the real step down in costs was at the beginning of 2016. The outlook was broadly unchanged, with BP looking for a stabilization in oil prices in the middle of next year and for the group to be able to self-fund a full cash dividend at $50-55/bbl Brent at that stage. Critically the release highlighted that if oil prices deteriorate further, this will likely be associated with further supply chain price reductions, and hence a rebalancing can be achieved at a wide range of oil prices. With the forward curve for 2017 still above $50/bbl, we expect BP's ability to return to cash neutrality after both capex and dividends over the coming 12 months.

Royal Dutch Shell Plc - the Q3 numbers took on more significance than normal, particularly given a poor set of results in Q2. This time Shell did not disappoint with clean net income 2.7x higher than the prior quarter and reported cash flow 3.7x higher. This, combined with the CEO statement that underlying operational costs in 2016 are already at an annualized run-rate of $40 billion, the indication that 2017 capex will be at the low end of the $25-30 billion range given in June and that the group is working on 16 material asset sales, should prove enough to reassure investors that Shell is well on its way to reshaping and resetting the business post the BG deal.

Whitecap Resources Inc. reported third quarter results which were slightly ahead of the expectations. The company's production was 1.5% higher than expected, for an average of 49,251 boed for the quarter; up 22% from Q2 (or 6% on a per share basis), lifted by the acquisition of Husky's Saskatchewan assets. Funds flow was $107 million ($0.29/share), up in absolute terms sequentially, but flat on a per share basis. Whitecap spent $33 million in the quarter drilling 21 wells and it plans spending $81 million in Q4, drilling 50 wells (44 net); drilling costs are currently 36% lower and completion costs are 29% lower relative to Q4, 2014. Operating netback was $26.79 (including $3.27 from hedging), compared to $33.84 (including $9.69 from hedging) a year ago. For 2017 Whitecap hedged 37% of its crude oil exposure at C$62/bbl, while for 2018 it hedged 16% at C$60/bbl. Whitecap was approved an increase in its credit line from $1.1 billion to $1.2 billion, which it declined. It currently maintains some $280 million liquidity cushion, which it does not expect to use. Whitecap believes is positioned to resume growing production and "dividend longer term".

Financial Sector

Ares Capital Corporation (ARCC) reported third quarter results which exceeded expectations and updated on its acquisition of American Capital Ltd. ARCC's core net operating income (NOI) was $0.43/share for the quarter, ahead of the expected $0.39/share result, driven by higher structuring fees, but also by lower expenses. During the quarter ARCC reported roughly $1.5 billion of loan originations (part of which was syndicated) and announced the initial funding of its senior direct lending program (SDLP), its new senior loan program in collaboration with Varagon, a middle market senior lender, backed by AIG and Oak Hill Capital. ARCC reported it has seen increased competition in the market and new originations are somewhat more challenging, however it has maintained its disciplined approach to lending and has de-emphasized sectors which it believes have weaker fundamentals, such as mining, construction, retail and restaurants. The upcoming acquisition of American Capital, the second largest business development corporation in the country, would have the effect of creating an entity with a $12 billion loan portfolio, representing roughly 25% of the business development corporations market, the largest by a significant margin.

Berkshire Hathaway Inc. reported third-quarter profit dropped 24% than the prior year, when it recorded a large one-time gain, but acquisitions helped boost operating profit at the conglomerate run by billionaire Warren Buffett. The company also reported a $22.1 billion stake in Wells Fargo & Company as of Sept. 30, suggesting it kept its 10% ownership position even as the bank became embroiled in a scandal over its creation of unauthorized customer accounts. Quarterly net income for Omaha, Nebraska-based Berkshire fell to $7.2 billion, or $4,379 per Class A share, from $9.43 billion, or $5,737 per share, a year earlier. Operating profit, which excludes investment and derivative gains and losses, rose 7% to $4.85 billion, or $2,951 per share, from $4.55 billion, or $2,769 per share. That missed the average $3,058.10 per share forecast of analysts polled by Thomson Reuters, in part reflecting weaker results at the Geico auto insurer and BNSF railroad, and falling demand from customers in industrial sectors. Berkshire ended September with $84.8 billion cash, having completed a $32.1 billion purchase of Precision Castparts Corp that was a key factor behind the boost in operating profit.

HSBC Holdings PLC - Q3 2016 Underlying Profit Before Tax (PBT) was US$5,591 million, beating expectations by US$502 million/10% with stronger impairment performance the key driver. Looking down the differences, income was 1%/$130 million lower at US$12.8 billion, costs better by 4%/$302 million at US$7.2bn, impairments of US$566 million some 38%/$347m better, and Associates were US$0.6bn or 3%/$18 million lower. There were myriad exceptional items this quarter impacting revenues by -$3,275 million and costs by -$1,473 million to leave reported PBT at $843 million vs. consensus of $2,448m, with own credit and the Brazil disposal the key deltas. However the materially strong news is capital, with the Core Equity Tier 1 ratio +1.8% Quarter on Quarter at 13.9% beating consensus by 1.2% with an unexpected change in the regulatory treatment of Bank of Communications adding c100bps. Tangible Net Asset Value was US$7.37. The beat to expectations on capital gives the group substantial headroom against its targeted 12-13% Core Equity Tier 1 (CET1) level with accompanying positive implications for dividend/buyback potential.

ING Groep NV - ING Bank reported underlying net results of €1,276 million (adj. for Debt Value Adjustments/Counterparty Value Adjustments and non-recurring items) vs. €1,121 million consensus (14% beat). The solid performance was driven by Retail, Net interest income and lower loan loss costs, and despite losses in Financial Markets.

Standard Chartered Plc reported underlying PBT of US$458 million, with income at $3,465 million, in line costs of $2,387 million, and a 20% higher credit impairment charge for the quarter at $596 million. Exceptional items totaled $305 million which leaves statutory PBT at $153 million. Non Performing Loans remain elevated at $12.8 billion, flat Quarter on Quarter with higher ongoing business Non Performing Loans (NPL) broadly offsetting the reduction in the liquidation portfolio to leave the NPL ratio at 4.7% whilst coverage increased 2% to 55%. The group flags a reduction post period end of $13.2 billion of risk weighted assets (RWA) /$2.6 billion of NPLs in the liquidation portfolio. Capital was down with the CET1 ratio at 13.0%, -0.2% with higher RWAs and model changes the key driver.

Wells Fargo & Company has agreed to pay $50 million to settle a racketeering lawsuit accusing it of overcharging hundreds of thousands of homeowners for appraisals ordered after they defaulted on their mortgage loans. (Source: Reuters) **Wells Fargo** is in talks with a group of federal and state prosecutors examining potential abuses related to mortgages as it continues to grapple with investigations and public outrage from its sales-practices scandal. It disclosed in its most recent quarterly securities filing posted Thursday that it's in discussions with the Residential Mortgage-Backed Securities Working Group of the Financial Fraud Enforcement Task Force. (Source: The Australian)

Activist Influenced Companies

Brookfield Business Partners L.P. (BBU) reported net income of $20 million for the third quarter. The company generated funds from operations (FFO) totaling $50 million for the quarter compared with $58 million in 2015. The additional contribution from its Western Australia energy operation which was acquired part way through last year and realized gains on the disposition of a portion of its investment securities were offset by the impact of lower natural gas prices on BBU's Canadian energy operation and lower construction margins during the quarter. Subsequent to the end of the quarter, BBU, together with institutional clients of Brookfield Asset Management Inc., entered into a definitive agreement to acquire a 70% controlling stake in Odebrecht Ambiental, Brazil's largest private water distribution, collection and treatment company.

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Liberty Global LiLAC Group reported underwhelming third quarter operating results, partly offset by the announcement of a $150 million CWC (Cable & Wireless Communications Plc) synergies target, which is in addition to the existing $125 million Columbus synergies. Revenue was 4% lower at CWC, partly offset by 6% higher in Chile and 1% higher in Puerto Rico, for a combined 1% lower. CWC revenue was impacted by a weak macro environment, heightened competition and the Hurricane Matthews. Key performance detractors Bahamas, Barbados and Panama, offset by strong performance in Jamaica. The company was able to apply about 5% of price increases in Jamaica, T&T and Barbados. Operating cash flow (OCF) was up 3% at CWC, and 6% and 11% higher for Chile and Puerto Rico businesses, respectively. Management lowered guidance for OCF at CWC from $460-$480 million to $430-$440 million, a 7% decline, for the second half of the year. It now expects $215 million to $225 million OCF for Q4, about in line with Q4. Management reiterated medium term guidance for LiLAC's combined rebased OCF growth in the 7%-9% range. Additional synergy benefits from CWC deal of $150 million were also guided, equally split between operating expenditures and capital expenditures. Integration of CWC corporate functions has continued and is partly responsible for the synergy targets and expected to facilitate the transfer of Liberty culture to CWC. A hard-spin (legal separation of LiLAC) is expected in the mid to second half of 2017.

Canadian Dividend Payers

BCE Inc. reported marginally better-than-expected revenue for its third quarter, helped by an increase in net postpaid subscribers. The company added 107,265 postpaid customers, on a net basis, up from 77,655 a year earlier. Bell's postpaid customers paid C$67.76 a month in the third quarter ended Sept. 30, up from C$65.34 in the year-ago period, which boosted its average revenue per user. The company added only 75,628 customers in its broadband TV and internet business, compared with 126,000 customers a year earlier. Net income attributable to Bell's shareholders rose to $752 million in the quarter, from $739 million a year earlier. EPS remained unchanged at 87 cents. Bell's operating revenue rose 1.2% to $5.41 billion, slightly topping analysts' average estimate of $5.40 billion. On an adjusted basis, the company earned 91 cents per share, in line with the average analyst estimate.

Brookfield Property Partners L.P. (BPY) continues to post healthy cash flow growth. In Q3/2016, BPY reported Funds From Operations (FFO) per unit of $0.33, compared to $0.31 in the year-ago period. However, a significant volume of asset sales, along with the weakening in the GBP, had a negative impact on FFO per unit, and the results were below consensus of $0.35. The reported IFRS NAV increased to $30.98 per unit from $29.75 at quarter-end Q2/2016. Property values have been increasing and BPY has divested a number of assets at premiums to the current IFRS valuations. These trades suggest that the new IFRS NAV may be too conservative. Notably, BPY has under contract to sell an office building in London consistent with the IFRS value pre-Brexit. Rising property values were somewhat offset by the weakening in the GBP. BPY's units currently trade at a 28.8% discount to the reported NAV. While concerns over the impact of the Brexit vote on BPY's U.K. portfolio have weighed on the unit price in recent quarters, we believe that BPY's high-quality portfolio in the U.K. with long-term leases in place should prove resilient. Furthermore, we expect BPY's NAV to rise over the next few years as development projects are completed and as Net operating income rises from increasing rental rates to market.

Gilead Sciences Inc. - Gilead reported inline total revenue of $7.5 billion, -10% but reaffirmed 2016 guidance. Cash flow was once again solid this quarter at $4.3 billion with $10 billion remaining on the share repurchase program. On the product side, overall Hepatitis sales of $3.3 billion declined -31% whereas HIV/other sales of $3.5 billion grew +21% and comfortably topped consensus of $3.1 billion.

Veresen Inc. (VSN) – Distributable cash flows for the quarter were $0.29/share and guidance was increased for the full year to $1.12-$1.16 from $1.03-$1.13 (VSN pays $1.00/annum in dividends). The company is on track for divesting its power assets portfolio for an estimated $600 million in net proceeds. Additional expansion projects were sanctioned by Encana during the period, which is relevant for the company's Veresen Midstream (joint venture with KKR) business (under construction). Construction at Veresen Midstream is on schedule and on budget with about 45% of the $2.5 billion ($1.2 billion net to VSN) capital expenditure program approved already deployed. The company's Alliance gas pipeline (joint venture with Enbridge) continued to perform well at a high capacity utilization. VSN continues to pursue the Portland, Oregon, Jordan Cove LNG project and expects an answer from FERC (Federal Energy Regulatory Commission) by the end of this year. At the same time it has reduced spending on the project and won't proceed with a number of other required licenses before the FERC review is done.

Global Dividend Payers

Dufry AG - the 9 months results, came in line with forecasts. After a streak of eight consecutive quarters with negative organic growth, Dufry was able to hit the zero line in Q3 (+0.3%). Including WDF (World Duty Free), i.e. on a pro-forma basis, Dufry even achieved +1.3%. More favourable year-on-year-comparisons and the sequential improvement in Brazil on the back of the Real-revival have been the main contributors. In addition, the fact that WDF's growth – which has been particularly strong in Spain and the UK this year – is recognized under 'change in scope' for only one additional month (July), but under reported organic growth thereafter, has been very gratifying in our view. In other words, the gap between reported and pro-forma organic growth narrowed from -4.7% to around -1%, with pro-forma growth hitting the zero line. With 13.4% Dufry almost reached last year's Q3 adjusted EBITDA margin of 13.7%. The full synergies from the Nuance deal and first, but little, cost wins from the integration of WDF almost fully off-set the dilutive impact of WDF and the adverse mix effect from the strongly differing volume trends in the respective markets. Provided that global politics spares the travel retail trade further major 'surprises' we believe top line growth should turn to positive from next year onwards (management believes that organic growth of 5-7% is conceivable in the coming years), not at least on relatively easy comparables that will last well into the first half of 2017. Secondly, Dufry's EBITDA margin should regain the 13% threshold on the back of the locked-in and thus very tangible WDF-synergies as of estimated 2017, and thirdly, the below-the-EBITDA charges should decline significantly as a result of de-leveraging and lower 'linearization'-charges.

Pattern Energy Group Inc. (PEGI) reported third quarter 2016 financial results which were broadly in-line with the expectations and announced an increase in its dividend to $0.408 per Class A common share for Q4 2016. PEGI sold of 1,472 GWh (giga-watts hour), up 17%. Net cash provided by operating activities was $36.4 million. Cash available for distribution (CAFD) was $20.2 million, on track to meet full year guidance. Net result was a loss of $11.1 million, an improvement of 69%, while adjusted EBITDA was $62.3 million, up 6%. PEGI added 90 MW in owned capacity with the acquisition of the Armow Wind project (Armow), located in Ontario, from Pattern Energy Group L.P. (Pattern Development), subsequent to the end of the period, which brings the total portfolio owned capacity to 2,644 MW, including the Broadview Wind projects (Broadview) which Pattern Energy has agreed to acquire. Reported construction progress is on schedule at Broadview, in which Pattern Energy has agreed to acquire a 272 MW owned capacity, and that the commencement of commercial operations is expected in early 2017. The company completed a follow-on equity offering of 11.3 million common shares for total net proceeds of $258.6 million.

Economic Conditions

U.S. Nonfarm payrolls rose 161,000 in October, just shy of expectations but more than offset by upward revisions of 44,000 in the prior two months. In fact, the slowing in job growth this year appears to have stabilized, with the three month mean (176,000) close to this year's average (181,000). The job gains were spread across sectors, though juiced by a 19,000 lift from the government and undercut by a third straight decline for factories. The unemployment rate slipped to 4.9%, while the more comprehensive U6 measure reached an eight-year low of 9.5%. Although the number of involuntary part-time workers was little changed, the number of discouraged job seekers and the duration of joblessness turned down. A slowly tightening labour market is starting to pressure wages. Average hourly earnings bounced twice as much as expected (0.4%), lifting the yearly rate to a seven-year high of 2.8%. This will only increase the Fed's confidence in inflation rising to the 2% target. **U.S. trade** report. The trade deficit shrank to $36.4 billion in September, led by a fourth straight gain in exports.

U.K. house price growth stalled in October for the first time in 15 months, undershooting expectations of another steady increase, according to Nationwide. Month-on-month house price growth was flat at 0% in October and a slowdown from the 0.3% climb registered in September. Compared to the same month in 2015, prices were up 4.6%, also undershooting a forecast of 4.9% and moderating from September's 5.3%. It was the weakest pace of year-on-year growth since January. (Source: Financial Times)

U.K. Brexit last Thursday (Nov. 3), the High Court ruled against the government in a judicial review brought to prevent the triggering of Article 50 without a parliamentary vote. The government has said it will appeal against the decision and it has permission to go straight to the Supreme Court, which has set aside time for what might be a four-day hearing starting on Dec. 7. This means a final decision should be known by the end of the year, although the government has the right to withdraw it before the hearing. We still think Article 50 will be triggered eventually, but this may be delayed past the March 2017 deadline. Prime Minister, Theresa May has been very explicit about the new government's intentions, as she has said repeatedly that 'Brexit means Brexit'. However, if we are right that the parliament will be more involved in the negotiation process, it means that a "softer" Brexit outcome has become more likely.

Financial Conditions

U.K. - Bank of England Governor Mark Carney will extend his time in office by a year to 2019 to guide the economy through Britain's split from the European Union. Choosing a middle path between leaving in 2018 as planned or remaining until 2021 as entitled, Carney said in a letter to Chancellor of the Exchequer Philip Hammond that by staying until June 2019, he will help with an "orderly transition to the U.K.'s new relationship with Europe."

The U.S. 2 year/10 year treasury spread is now 1.00% and the U.K.'s 2 year/10 year treasury spread is 1.01% - 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 3.54% (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 4.8 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 19.79 (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
- Portland Global Aristocrats Plus Fund

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