News Highlights

Owners. Operators. And Insightful Investors.

Phone: 1-888-710-4242
Web: www.portlandic.com
Email: info@portlandic.com

PORTLAND INVESTMENT COUNSEL®

Our views on economic and other events and their expected impact on investments. December 5, 2016

Energy Sector

OPEC production cut – On the last day of November, OPEC (Organization of the Petroleum Exporting Countries) made good on its promise to agree on the details of the organization-wide production cut, as revealed at the end of its September 28 round of talks in Algiers. Helpfully, the new production target is at the lower end of the previously announced range of 32.5 to 33.00 million barrels a day, implying a cut of about 1.2 million barrels per day or some 4.5% of the cartel's production. Iran was allowed to just "freeze" production, at levels in line to its pre-sanctions output (around 3.8 million barrels per day), while Nigeria and Libya were exempt from the agreement, as their production has been affected by conflicts. The coordinated production cut is OPEC's first in eight years, since the depths of the last recession, and brings back the oil producing countries' cartel into relevance, which it had seemingly lost when it refused to explore a production cut at its meeting in November of 2014. OPEC members have indicated that a $55 to $60/barrel price for crude oil is being targeted. There are a number of potential obstacles to the agreement being brought to its fruition, including an agreement from the non-OPEC producing countries, most notably Russia, for a further 600 thousand barrels a day cut, as well as monitoring challenges. However, markets have reacted positively to the announcement and the momentum is likely to continue should there be no hiccups in rolling out the agreed production limits. The new production target is set to be applied commencing with January 2017 and last for six months. A number of recent reports, including from OPEC itself, indicate that, even on the basis of supply and demand dynamics before the announced production cuts, the crude oil market was likely to re-balance towards the middle of 2017. As such, the announced measures are meant to bridge the market until such re-balancing occurs and accelerate the draw-down of crude oil inventories globally.

We anticipate that, as the crude oil market continues to strengthen, helped by the coordinated OPEC and non-OPEC production cuts, it should be followed by a re-rating of the oil and gas exploration and production companies. It needs to be emphasized, we believe, that the recovery in the market values of oil and gas exploration and production (E&P) companies is not a linear function of the crude oil prices, but rather a combination of the prices, operating leverage and balance sheet leverage. As such, there are likely a couple of inflection points in the performance of E&P companies. In broad terms, a West Texas Intermediate (WTI) level in the low $30/barrel could signify potential liquidity and solvency issues for many operators, with the associated drops in valuations, while levels in the $50 to $60/barrel range are more indicative of cash flow positive operations and significant uplift in valuations. The broad universe of E&P companies would continue to benefit from increases in the price of crude oil beyond $60/barrel, with likely a capping of the appreciation as WTI approaches $100/barrel, as more costly supply is brought into the market and upstream cost increases are being felt. Of course, different E&P companies would react somewhat differently according to their embedded operating and financial leverage.

We have continued to maintain a significant allocation to oil and gas exploration and production companies in some of our funds, in order to support the recovery in net asset value of the funds which were severely affected during the recent downturn and to take advantage of what we believe are attractive valuations. We intend to maintain similar levels of exposure to the energy sector until there is a substantial recovery in the energy markets, which in our view is in its early stages. As of October 31, 2016, the levels of concentration in the energy sector were for Portland Advantage Plus – Everest Fund at 52.3%, of which E&P companies represent 46.3%, and for Portland Advantage Plus – McKinley Fund at 38.8%, of which E&P companies represent 34.5%. Portland Advantage Plus – Value Fund and Portland Value Fund also maintain substantial allocations to energy stocks, at 29.1% and 26%, respectively, as of October 31, 2016.

U.S. land rig count increased by 6 rigs to 574, marking the 22nd week of gains in the last 27 weeks since the May bottom and the rig count is now up on average 20% QTD quarter/quarter. Gains in Horizontal Oil (+8), Vertical Oil (+3), Horizontal Gas (+2) and Directional Gas (+2) were partially offset by declines in Directional Oil (-6) and Vertical Gas (-3). Total horizontal land rig count is 65% down since the peak in November 2014. The Permian currently makes up 52% of all oil rigs.

U.S. horizontal oil land rigs increased by 8 rigs week/week to 384, as gains in the Permian (+7), Eagle Ford (+1), Woodford (+1) and "Other" (+2) were offset by declines in Williston (-2) and DJ-Niobrara (-1) while Mississippian and Granite Wash remained flat.

U.S. horizontal gas land rigs increased by 2 rigs week/week to 101 driven by the Haynesville (+3) partially offset by "Other" (-1) as Marcellus and Utica remained flat.

U.S. Gulf of Mexico offshore rig count decreased by 1 rig week/week to 22 rigs and is down 57% since June 2014.

Canadian rig count increased by 25 rigs week/week (the largest weekly gain since Jan. 2016) and is now up 12% from the level this time last year.

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Financial Sector

Barclays Plc has raised almost a third less than expected from the $225 million sale of its wealth and investment management business in Singapore and Hong Kong to Singapore's Oversea-Chinese Banking Corporation Limited (OCBC). When the deal was announced in April, Barclays had indicated it could fetch $320 million from selling the business, which had $18.3 billion of assets under management at the end of last year and was initially valued at about $500 million. However, when its Asian wealth management clients were given the choice of whether to join OCBC, some of them decided to either stay at Barclays or to join another bank, reducing the overall price of the deal, which was fixed at 1.75% of assets under management. (Source: Financial Times)

The Bank of Nova Scotia reported Q4 2016 core Earnings Per Share (EPS) of $1.58, above consensus of $1.51. Total revenues were $6,797 million, above forecasts of $6,622 million for the quarter due to higher trading, market-sensitive income, and other fee income. Non-interest expenses came in at $3,554 million, above estimates of $3,416 million, although revenues were also higher than forecast and, as such, a view on efficiency is the important metric. Efficiency (cost/income) was 52.3%, while expectations were closer 51.5%. Provisions for credit losses (PCL) were $550 million, better than forecasts of $582 million. Energy-related PCLs were $24 million this quarter, compared to $37 million last quarter. Credit card loss rates in Canada were 380 bps in Q4 2016, up 34 bps from last quarter and up 4 bps on a Year on Year basis. The bank's Core Equity Tier 1 (CET1) ratio came in at 11.0% and up 50 bps sequentially, a very solid capital position in our view.

Canadian Imperial Bank of Commerce (CIBC) reported Q4 2016 core cash Earnings per Share (EPS) of $2.60, well above consensus of $2.49. Total revenues were $3,781 million for the quarter, lower compared to forecast of $3,927 million driven mainly by lower net interest income and lower market-sensitive other revenues. Non-interest expenses came in at $2,200 million, versus $2,331 million forecast, although revenue was also below forecast. Operating leverage at the all-bank level was 3.9% this quarter, while the efficiency ratio came in at 58.2%. Adjusted EPS excludes a $134 million pre-tax restructuring charge ($0.25 per share) primarily related to employee severance. CIBC disclosed that it has realized $200 million of cost savings in 2016 and expects a cumulative run-rate of savings of ~$350 million in 2017 and ~$500 million by 2019. Loan-loss provisions were $222 million this quarter, better than forecast of $240 million. The bank had direct oil and gas loan-loss recoveries of $5 million in the quarter, compared to losses of $2 million last quarter. CIBC's impaired loan portfolio in oil and gas declined for the second consecutive quarter, now totaling $367 million versus a recent peak of $708 million in Q2 2016. Delinquencies on credit cards were 0.82%, up 0.05% quarter/quarter and 0.18% Year year/year, while delinquencies on total unsecured personal lending remained relatively stable at 0.50%. CIBC increased its quarterly dividend by $0.03 to $1.24. The bank's Basel III CET1 ratio was 11.3% in Q4 2016, up 0.40% sequentially. Subsequent to year-end, CIBC entered into an agreement to sell and lease back 89 retail properties in Ontario and B.C. – the closing of the agreement is expected to occur in Q1 2017 and is expected to result in an after-tax gain of $247 million and add 0.15% to CIBC's Core Equity Tier 1 ratio.

Royal Bank of Canada (RBC) adjusted cash EPS declined 5% year/year to $1.69, below consensus $1.72. Earnings drivers: Investor & Treasury Services +98%, Wealth Management +55% year/year, benefiting from City National acquisition (+20% year/year ex-City National), Canadian Banking +2%, Insurance +1% offset by declines in Capital Markets -13% year/year and a lower Corporate contribution ($0.14 contribution in Q4 2015 vs. -$0.01 drag in Q4 2016). PCLs were $358 million or 27 bps of loans versus $318 million or 24 bps in Q3 2016 and $275 million or 23 bps a year earlier. Sequentially, Canadian banking PCLs were up $11 million or 4% due to higher retail PCLs, while Capital Markets PCLs increased to $51 million from $33 million due to higher oil & gas PCLs. Oil & gas PCLs totaled $69 million or 1.1% of oil & gas loans, up from $30 million last quarter. Oil & gas impaired loans increased $128 million to $1.26 billion. Energy utilities impaired increased to $78 million from $65 million last quarter. RBC's CET1 ratio 10.8%, up from 10.5% in Q3 2016 reflecting internal capital generation (+28 bps). RBC repurchased ~$70 million of common shares in the quarter. Operating Return On Equity (ROE): 15.5%. RBC is now aiming for ROE of at least 16% over the medium term, compared with 18% before, a level which is still higher than the majority of large banks around the world.

Royal Bank of Scotland Group Plc (RBS) is set to receive €1.5 billion in capital from Ulster Bank after its Irish operation received the green light from regulators to pay its first dividend since the financial crisis. Ulster Bank, which has businesses in both Northern Ireland and the Republic, plans to pay out €1.5 billion to RBS subsidiary National Westminster Bank on November 30 after it was given the go-ahead for a dividend by both the Central Bank of Ireland and the European Central Bank. The payment, which has long been on the cards, will be made by Ulster's business in the Republic. While the dividend does not change the total capital that RBS holds, it does allow the lender to release trapped capital that it can deploy elsewhere in the group. (Source: The Telegraph)

RBS will pay £800 million to settle shareholder litigation from 2008 rights issue. The bank reached agreement with 3 of the 5 shareholder groups representing 77% of the claims by value. The bank is still in discussion with the other 2 shareholder groups and the £800 million would be full and final settlement split among the 5 groups. Any claims not settled will be "vigorously" defended in court, which is set for March 2017. RBS says £800 million is fully covered by provisions.

Standard Chartered Plc is set to cut about a tenth of its global corporate and institutional banking headcount, as the bank steps up an aggressive drive to cut costs. Chief Executive Bill Winters this month branded the bank's income and profit unacceptable, as below-forecast third-quarter results underlined the challenges facing his overhaul. The job cuts will be rolled out beginning this week across all the major business centers starting with Singapore and Hong Kong, one of the sources told Reuters.

The Toronto-Dominion Bank (TD) reported core cash EPS of $1.22 in Q4 2016, below consensus of $1.23. Total revenues of $8,227 million were lower than $8,254 million forecast. Revenues were lower than forecasts for core net interest income, trading and market sensitive other income, partly offset by higher other fee income. Non-interest expenses of $4,784 million this quarter were above $4,728 million estimate. TD's efficiency ratio (on a tax equivalent basis) was 58.1% this quarter, which was less favourable than forecast of 57.3%. PCLs totaled $548 million in Q4 2016, higher than $511 million forecast. TD had pipelines, oil and gas loan loss recoveries of $1 million versus losses of $8 million last quarter and $49 million in Q2 2016. The bank's impaired loan portfolio in pipelines, oil, and gas is $189 million, down from its recent peak of $240 million in Q2 2016. The bank's Basel III CET1 ratio was 10.4% and flat sequentially as internal capital generation was mainly offset by higher risk weighted assets.

UK Banks - The Bank of England stress test results have been published last Wednesday. No issues for HSBC Holdings Plc, Lloyds Banking Group Plc, Nationwide Bank Plc or Banco Santander SA UK. **RBS** failed the tests as it missed targets for CET1 and leverage before the conversion of some debt to equity was factored in. RBS has submitted the revised capital plan which has been accepted by the Prudential Regulation Authority. RBS additional actions include further cost cuts, further reductions in Risk Weighted Assets, sale of other non-core portfolios and a reduction in undrawn facilities. **Barclays** passed stress test but missed its systemic reference point…no further action required given actions already announced. **Standard Chartered** passed stress test and systemic reference point but missed on CET1 ratio….and is not required to take any further action given issuance of capital (Tier 1 qualifying) in 2016.

Activist Influenced Companies

Nomad Foods Limited reported third quarter results, which included an improvement in the adjusted earnings before interest, taxes, depreciation and amortization (EBITDA) for the quarter, at €85.1 relative to €82.0 for the same 2015 quarter (19.4% margin relative to 17.4% margin). Its like-for-like revenue decline has improved in the quarter to (3.3%) from (5.0%) for the first half of the year and the management expects to see further improvement as it has just launched what it calls, its "must-win battles". The launch of its "must-win battles" (gaining or expanding the lead in certain key frozen food categories such as frozen peas and fish fingers) involves a concerted product re-development, advertising and promotion effort and is focusing the marketing budget behind fewer categories. The relative weakness in revenue generation stems from the company maintaining its commitment to its restructuring plans (including a change in focus from product proliferation to defending and growing its core products such as frozen peas and fish fingers) but also from the company's exposure to challenging consumer markets in the UK (slumping pound triggering consumer inflation) and Italy (political turmoil and fears of financial institutions collapse). The company's restructuring plan, including the realization of synergies from combining the businesses of Iglo and Findus, is on track. Stefan Descheemaeker (CEO), formerly CFO of Delhaize (Belgian headquartered, pan-European retail chain) and Head of Strategy & M&A at Interbrew during the takeover process by 3G Group's Anheuser-Busch, has experience with transformative deals and has assembled a strong team of industry specialists.

Canadian Dividend Payers

Northland Power Inc. – Bloomberg reports that China Three Gorges Corporation and SDIC Power Holdings Co. Ltd. are among companies bidding for Northland Power. First-round bids for the Toronto-based company, which has a market value of C$3.7 billion ($2.8 billion), were due Dec. 2. Some Canadian pension funds also had a look at the company but did not apparently submit a bid. Northland Power announced in July that the company had commenced a review of strategic alternatives. CIBC and JPMorgan Chase & Co. are working on Northland's review. The company owns or has investments in power generation facilities in Canada, the U.S. and Germany. Its facilities produce electricity from clean natural gas and other renewable sources, including solar, wind and biomass. Three Gorges agreed to buy control of German wind farm operator WindMW GmbH from Blackstone Group LP in June, in a deal valuing the target at about €1.7 billion ($1.8 billion) including debt. SDIC Power acquired Repsol SA's offshore wind-energy business for €238 million in May.

Veresen Inc. has provided its business outlook and distributable cash guidance for 2017. "Veresen has delivered very strong operational and financial results over the course of 2016, with particularly impressive performance from Alliance," said Don Althoff, President and CEO of Veresen. "We expect to sustain this momentum throughout 2017. We will continue to deliver on our strategy, with several key milestones in the coming year, including entering into an agreement for the sale of the power business in the first quarter and bringing the first two processing facilities currently under construction at Veresen Midstream into service towards the end of the year." 2017 Budget Highlights include: strong performance is expected to continue, underpinning a dividend that remains entirely supported by distributable cash generated from existing take-or-pay and fee-for-service contracts; capital program of approximately $475 to $525 million to advance Veresen's inventory of $1.3 billion of projects under construction, with the Tower and Sunrise processing facilities to be placed into service towards the end of the year; remain fully funded, with no requirement to access equity or debt capital markets to finance projects currently under construction, supporting the company's objective of growing distributable cash per share.

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Global Dividend Payers

Johnson & Johnson reportedly raised its bid for Actelion to over $250 per share after the Switzerland-based biotechnology firm rejected an initial offer of approximately $246 per share. Sources added that talks between the two companies are continuing and that Johnson & Johnson could be open to structure a deal in a way that it doesn't gain control of the company right away and win the backing of Actelion CEO and co-founder Jean-Paul Clozel.

Roche Holding AG - following positive headline data reported in May 2016, Roche presented detailed data from the GALLIUM trial at the American Society of Hematology annual meeting. The data showed superior progression free survival of Gazyva + chemo compared to standard of care Rituxan + chemo for the treatment of follicular lymphoma (blood cancer). Gazyva-based therapy reduced the risk of disease worsening by 34% compared to Rituxan-based therapy. While the adverse events profiles were reported to be consistent with those seen in previous studies - a sub-analysis that looked at the three chemotherapies allowed in the trial individually revealed that grade 5 (fatal) events for the bendamustine combination was worse in combination with Gazyva (5.6%) versus with Rituxan (4.4%). The combination with bendamustine is commonly used as efficacious and less toxic. The data presented was critically perceived by hematologists as the favored combination with bendamustine appears relatively too toxic. However, in our view, it will take a strong effort from Roche to achieve a broad switching to the Gazyva containing regimen.

Economic Conditions

U.S. Nonfarm payrolls rose 178,000, close to the consensus call, and virtually in line with the average this year (180,000). Net revisions the prior two months were marked down an insignificant 2,000. The November increase was likely boosted by a retracement of job losses related to Hurricane Matthew in October (some estimates pegged the impact at around 30,000). So, job growth has likely slowed somewhat recently, but it remains strong enough to keep the unemployment rate on a downward course. A solid 160,000 advance in household survey employment, coupled with a hefty drop in the labour force and downtick in the participation rate, **drove the jobless rate down three tenths to 4.6%, a nine-year low**. The official jobless rate is now below the Federal Open Market Committee's estimate of the natural rate (4.8%). The pool of available workers was drained by more than 700,000 in the past two months, the fastest rate in three years. Therefore no surprise in our view that consumer confidence is at a nine-year high and real consumer spending has averaged 3.5% (annualized) growth the past two quarters.

Italian Referendum - Italian Prime Minister Matteo Renzi said he would resign after suffering a crushing defeat on Sunday in a referendum on constitutional reform, tipping the euro zone's third-largest economy into political turmoil. His decision to quit after just two and a half years in office deals a blow to the European Union, already reeling from multiple crises and struggling to overcome anti-establishment forces that have battered the Western world this year. The euro fell to 20-month lows against the dollar, with markets worried that instability in heavily indebted Italy could reignite a dormant financial crisis and deal a hammer blow to the country's fragile banking sector. Renzi's resignation could open the door to early elections next year and to the possibility of an anti-euro party, the opposition 5-Star Movement, gaining power in the heart of the single currency. 5-Star campaigned hard for the 'No' vote. "I take full responsibility for the defeat," Renzi said in a televised address to the nation, adding that he would hand in his formal resignation to President Sergio Mattarella on Monday. "I will greet my successor with a smile and a hug, whoever it might be," he said, struggling to contain his emotions when he thanked his wife and children for their support. Mattarella will consult with party leaders before naming a new prime minister -- the fourth successive head of government to be appointed without an electoral mandate, a fact that underscores the fragility of Italy's political system. Renzi won a little over 40% of the vote in Sunday's referendum, a far worse result than polls had predicted. It ended months of campaigning for a reform that he said would have brought political stability to Italy but that opponents said jeopardised democratic checks and balances. The new prime minister, who will need the backing of Renzi's Democratic Party (PD) to take office, will have to draw up a new electoral law, with the 5-Star urging a swift deal to open the way for elections in early 2017, a year ahead of schedule. Opinion polls show the PD is neck-and-neck with 5-Star, which wants to hold a referendum on membership of the euro.

Financial Conditions

The U.S. 2 year/10 year treasury spread is now 1.30% and the U.K.'s 2 year/10 year treasury spread is 1.31% - 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 4.08% (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 13.10 (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

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.