# 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.* May 23, 2017



## Owner Operated Companies

**Alphabet Inc.** – A Google artificial intelligence program defeated a Chinese grand master at the ancient board game Go, a major accomplishment for the firm's AI ambitions as it looks to woo Beijing to gain re-entry into the country. In the first of three planned games in the eastern water town of Wuzhen, the AlphaGo program held off China's world number one Ke Jie in front of Chinese officials and Google parent Alphabet's chief executive Eric Schmidt. The victory over the world's top player - which many thought would take decades to achieve - underlines the potential of artificial intelligence to take on humans at complex tasks. Wooing Beijing may be less simple. The game streamed live on Google-owned YouTube, while executives from the DeepMind unit that developed the programme sent out updates live on Twitter. Both are blocked by China, as is Google search. Google pulled its search engine from China seven years ago after it refused to self-censor internet searches, a requirement of Beijing. Since then it has been inaccessible behind the country's nationwide firewall. Google announced plans to bring some services back to the country, including its app store Google Play. In March it also said Chinese users would be able to access the Translate mobile app, marking its most recent success launching a previously banned service. Like AlphaGo, Translate also uses DeepMind's artificial intelligence software. Beijing is pushing to become a major player in artificial intelligence. Chinese search engine giant Baidu Inc, launched an AI lab in March with China's state planner, the National Development and Reform Commission.

**Berkshire Hathaway Inc.** said it added to its sizable investments in American Airlines Group Inc. and Southwest Airlines Co., and shed its stake in Twenty-First Century Fox Inc. In a regulatory filing, Berkshire said that in the first quarter its American stake grew 8% to 49.3 million shares worth $2.08 billion, while its Southwest stake grew 10% to 47.7 million shares worth $2.57 billion. Berkshire also shed 8% of its holdings in Delta Air Lines Inc., ending March with 55 million shares worth $2.53 billion. Warrant Buffett told shareholders at Berkshire's annual meeting that airlines' business model had improved, with fewer unsold seats and an ability to charge for checked bags, seat choices and other amenities that were once free. Berkshire also announced larger stakes in Bank of New York Mellon Corporation and satellite radio operator Sirius XM Holdings Inc., and reduced stakes in International Business Machines Corporation and commercial vehicle parts supplier Wabco Holdings Inc.

## Energy Sector

**U.S. land rig count** increased by 14 rigs to 874 rigs, marking the 18th week of consecutive gains. The rig count was driven by gains in Horizontal Oil (+14), Horizontal Gas (+3), Directional Gas (+3), and Vertical Gas (+1), partially offset by declines in Vertical Oil (-4) and Directional Oil (-3). Total horizontal land rig count is down 45% since the peak in November 2014. The Permian currently makes up 52% of all oil rigs.

**U.S. horizontal oil land rigs** increased by 14 rigs to 621 as gains in Permian (+6), "Other" (+5), Mississippian (+3), Woodford (+3), and Eagle Ford (+1), were partially offset by declines in DJ Niobrara (-2), Williston (-1), and Granite Wash (-1).

**Canadian rig count** increased by 4 rigs, and is up 98% from the level this time last year.

**U.S. Gulf of Mexico offshore rig count** increased by 3 rigs to 23 (up 5 in last two weeks) and is down 57% since June 2014.

**The U.S. land gas rig count has added 98 rigs, up 131%, since the May bottom**. The increase appears linked to the sharp increase in liquefied natural gas (LNG) exports, shown below. The EIA is projecting U.S. LNG exports will average 1.9 billion cubic feet per day (bcf/d) in 2017, significantly up from 0.5bcf/d in 2016. As we continue through this rig count recovery cycle, we believe gas rigs should be worth taking note of.

**Source Energy Services Ltd. (SHLE) – a Crown Capital Inc. therefore Portland Private Income investment:** reported solid numbers for its first quarter as a publicly traded company and expansion plans lay the groundwork for increasing market share capture in 2018. We believe SHLE is not just another mine story: it has key advantages at every stage of its distribution network, allowing for an unparalleled opportunity to capture and lead industry margins across the supply chain. Adjusted Earnings Before Interest Tax Depreciation and Amortization (EBITDA) of $7.2 million vs. consensus of $8.4 million (range of $5.2-$13.3 million) - reported all-in gross margins of $27/tonne but excluding one offs could have been $36/tonne. Management expects activity momentum gained in Q1 to continue post break-up as well intensity rises – this outlook is effectively extended for the balance of 2017 and beyond to 2018 and we believe this sets up expectations of market share capture accelerating in 2018.

**Whitecap Resources Inc.** – Heather J. Culbert has been appointed to Whitecap Resources' board of directors effective May 16, 2017, and will also serve as a member of the corporate governance and compensation committee and the health, safety and environment committee. Ms. Culbert is an active volunteer and philanthropist currently serving as the chair of the board of governors of the Southern Alberta Institute of Technology (SAIT), vice-chair of Export Development Canada (EDC), as liaison to United Way Worldwide for United Way of Calgary and as a director of the United Way World Leadership Council. Ms. Culbert served as senior vice-president of corporate services with Enerplus Resources Fund, before retiring in 2006 with over 27 years in the oil and gas industry. Whitecap is also pleased to announce that Toronto Stock Exchange has accepted the notice of Whitecap's intention to commence a normal course issuer bid (the NCIB). Whitecap believes that within a continued volatile market environment, at times, the prevailing share price does not reflect the underlying value of the common shares and the repurchase of its common shares for cancellation represents an attractive opportunity to enhance Whitecap's per share metrics and thereby increase the underlying value of its common shares to its shareholders. Whitecap will use the NCIB as another tool along with dividend increases and capital spending to enhance total long-term shareholder returns, which will be used in conjunction with management's disciplined free funds flow capital allocation strategy.

## Financial Sector

**HSBC Holdings PLC** has agreed to settle an antitrust lawsuit by a group of bondholders over claims the bank participated in a scheme to rig London Interbank Offered Rates. A filing Monday in federal court in Manhattan didn't disclose terms of the settlement. HSBC is third bank to settle with the bondholders following Barclays Bank PLC and UBS AG.

**NN Group NV** - The key Solvency 2 ratio was in line with consensus at 238%. Net earnings in line at €2.99 billion. Operating profit 25% ahead at €406 million versus consensus of €324 million, helped by non-core profits. Netherlands Life +26% versus consensus at €220 million on higher technical margin. Results look good in our view. Delta Lloyd solvency stable at 144% and Combined ratio 97.9%.

**Prudential PLC** has had a strong start to the year, particularly in the U.S., Asia and in both its asset management operations. In constant exchange rates, Q1 new business profit increased 25% year/year to £856 million, driven by an 18% increase in volumes and higher margins due to higher interest rates. Asia and the U.S. both increased by 26%, while the UK increased by 15%. In Asia, China doubled, Hong Kong still growing at a double digit level (no obvious concerns with Chinese mainland sales in Hong Kong, while Indonesia was flat (no sign of turn around as yet). US variable annuity business continued to have net flows of $1.3 billion (an annualized 3.5% of beginning Assets Under Management (AUM) – in line with full year estimate +3.8% net flows), with AUM increasing to $157 billion or £125.6 billion in sterling. Asset management was even stronger; Prudential had £3.6 billion of net inflows into M&G (from outflows last year and our estimate of zero net flows) and £2 billion into EastSpring (its Asian asset manager). The M&G retail net inflows (of £3.1 billion) were a record. The M&G third party AUM of £144 billion is already ahead of our earlier estimates of £140 billion, while EastSpring third party AUM of £43 billion is also ahead of earlier estimate of £42 billion.

**The Royal Bank of Scotland Group PLC** announced its intention alongside its Q3 2016 results to propose a resolution to shareholders to cancel the company's share premium account and capital redemption reserve, subject to the confirmation of the Court of Session. At the company's Annual General Meeting on May 11, 2017, the Resolution was passed. As at the date of the AGM, the balance of the company's share premium account was £25.8 billion and the balance of the capital redemption reserve was £4.5 billion. The effect of the capital reorganisation, if duly sanctioned by the Court, will be to increase the company's retained earnings by an equal amount. On May 11, 2017, a Petition was presented to the Court seeking an order confirming the cancellation of the company's share premium account and capital redemption reserve. This is another step towards the re-assimilation of Royal Bank of Scotland to the private sector, following the experience of Lloyds Banking Group which is now freed from partial state ownership for the first time in almost a decade when the Government confirms sold its remaining holding.

## Activist Influenced Companies

**Pershing Square Holdings, Ltd.** – Bill Ackman said he is poised to go on a great investment run after a humiliating bet forced his hedge fund firm to return to basics. "I'm incredibly focused. I've got something to prove," the billionaire told a room full of hedge fund managers and investors at the annual SkyBridge Capital industry conference in Las Vegas, known as SALT. For Ackman, that setback was an ill-fated bet on Valeant Pharmaceuticals International Inc. Ackman's portfolio of stocks is posting gains this year, and he said he is likely to add at least two new market bets that are similar to the firm's early winners. "The next investment you will hear from us isn't going to be some successful company trading near its highs," Ackman said. "It's going to be a huge opportunity for efficiency, better deployment of capital, a change in strategy, some management changes needed, but the business quality is going to be extremely high." Ackman has often helped engineer successful management shake-ups, including at Air Products and Chemicals Inc. and Canadian Pacific Railway Ltd. Despite his recent struggles, Ackman was one of the stars of the four-day industry confab. The roster of speakers also included fellow billionaire hedge fund investor Daniel Loeb, private equity titan David Rubenstein and former Federal Reserve Chairman Ben Bernanke. Ackman praised the chief executive officer of Chipotle Mexican Grill, one of his more recent investments, calling Steve Ells "outstanding." Late last year Ells became Chipotle's sole CEO after his co-CEO, Monty Moran, left the company. Bill Ackman disclosed, during his most recent client conference call, that one new investment has already risen 30% and that another, which he also did not name, had already been sold. As an activist investor, Ackman frequently gives advice, sometimes unsolicited, to chief executives. Most recently he had suggestions for President Donald Trump, saying that Trump should focus on infrastructure projects like rebuilding bridges and railroads, instead of trying to tackle healthcare reform. “He’s got to have a win,” Ackman said.

## Canadian Dividend Payers

Nothing new to report.

## Global Dividend Payers

**Dufry AG** - Richemont holds a 5% position in Dufry, the leader in the travel retail business. In our view, this move has strategic relevance in the market context. Richemont has several unresolved distribution problems: high among these is dependence on an ailing and inventory rich wholesale channel for watches and in the most recent earnings conference, it was noted that travel retail could be a solution to convey small leather goods; Small leather goods are key in driving the recovery at Montblanc, and could be more relevant for Cartier too - as they were decades ago. LVMH Moet Hennessy Louis Vuitton SE has shown in the past twenty years that “selective retail” - more so with Sephora than with Duty Free Stores - has been a significant driver of value creation.

**Wal-Mart Stores, Inc.** reported first quarter earnings per share (EPS) of $1.00 better than consensus of $0.96. Next quarter EPS guidance of $1.00-$1.08 compares to consensus at $1.07. Walmart e-commerce U.S. sales increased 63%; the majority of this growth was organic through Walmart.com. U.S. comparisons were +1.4% slightly better than consensus at +1.3%. On a two-year stacked basis, traffic accelerated from +2.1% quarter/quarter. E-commerce had a +0.8% impact. The grocery business continued to improve with food categories delivering the strongest quarterly comparison sales performance in more than three years, due in part to a lack of market deflation in food, excluding price investments. The gross margin rate was flat as savings from procuring merchandise and the acceleration of post-holiday markdowns taken in last quarter were offset by investments in price and the mix effects from Walmart’s growing e-commerce business. Expenses increased 3.6% (14 bps) primarily due to investments in e-commerce and technology.

## Economic Conditions

**Canada** – Retail sales in Canada advanced by 0.7% in March, ahead of the expectations for a 0.4% improvement, driven chiefly by sales of auto vehicles and parts, up more than 3%. The core retail sales, which excludes auto sales were actually down by 0.2%, against expectations for a 0.2% increase, as grocery sales, as well as clothing and health and personal care categories suffered during the month.

Headline inflation in Canada, at 1.6% consumer price index (CPI) year/year rate of change, was flat in April relative to March, yet one notch below the expected read. The core CPI rate of change was only 1.1%, short of the expected 1.4%, as most of the increase in the headline figure was driven by a jump in gasoline prices, which, alongside other volatile price series such as food, is excluded from the calculation of the core reading.

**U.S. housing starts** took a larger-than-expected drop in April by 2.6% to 1.172 million units, annualized. That’s the 2nd setback in a row and to the lowest level since November. April had the second highest level of precipitation (for an April) in 123 years of data, which was a 60-year high-water mark (next to 1957). So Mother Nature had a hand in this. There were also downward revisions to the prior few months. All of the setback was in the volatile multi-family starts component, while singles which account for over 70% of the total, edged up 0.4%. Although the precipitation was spread out across the country, all of the weakness was in the Northeast and the South, which overcame the pickup in with the Mid West and the West. The South is a little concerning as that is where 50% of starts are. Excluding the South, housing starts were actually up 5.1%. Looking ahead, there is room for growth. Besides the usual list of support factors (job growth, wage growth, steady affordability), building permits are a good indication of future starts. Sure they fell 2.5% in April to 1.229 million units, annualized, but that is still above the level of starts. And homebuilders remain very upbeat (the NAHB index is at its 2nd highest level in 12 years). And with demand still outpacing supply (still low inventories of existing homes available to be bought), that’s good news for future starts in our view.

**U.S. Industrial production** jumped 1.0% April, more than double the consensus call and the largest monthly move in three years. The gain was greased by rebounding oil production. The latter helped directly via mining activity (up 1.2% in April) and indirectly via the manufacturing of inputs and capital goods involved in the process. Factory output was up a huge 1.0%, with the sector also benefitting from the rebound in business investment in equipment and structures more broadly (together they grew at a double-digit annualized rate in Q1). Utilities output also rose as April’s warmer-than-usual temperatures cranked up more air conditioners than they turned down heaters. Meanwhile, the overall strong gain in industrial output lifted the capacity utilization rate 6/10s to 76.7%, which is still well below the historic median around 80%. In summary capital expenditure and oil production appear to be providing an economic lift to start Q2, and it couldn’t come at a better time, with consumers still not having shaken off their Q1 slumber.

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## Financial Conditions

The U.S. 2 year/10 year treasury spread is now .96% and the U.K.'s 2 year/10 year treasury spread is .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 4.02% (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 3.6 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 10.70 (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 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 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

**Individual Discretionary Managed Account Models** - SMA

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.



Portland Investment Counsel Inc., 1375 Kerns Road, Suite 100, Burlington, Ontario L7P 4V7 Tel.:1-888-710-4242 • www.portlandic.com • info@portlandic.com

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