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Established in 2007

PORTLAND INVESTMENT COUNSEL®

Our views on economic and other events and their expected impact on investments. August 28, 2017

Owner Operated Companies

Oracle Corporation this year is hiring more than five-thousand new engineers, consultants, sales and support people into its rapidly growing cloud business. This injection of talent will help Oracle sustain the momentum in what is already the world's fastest growing multi-billion dollar cloud business. "Central to Oracle's success is our empowered, inspired and engaged workforce," said Joyce Westerdahl, Oracle Executive Vice President, Human Resources. "We're hiring experienced sales and engineering professionals eager to contribute to Oracle's cloud growth and champion our products. We are also recruiting high-performing recent college graduates and offering them a world-class training program to prepare them for a career in the technology industry." This year, Oracle has already hired more than 2,650 cloud sales professionals and 1,500 cloud developers in the United States. The Oracle Cloud offers complete software as a service (SaaS) application suites, plus best-in-class database Platform as a Service (PaaS) and Infrastructure as a Service (IaaS) from data centers throughout the Americas, Europe and Asia.

Energy Sector

Hurricane Harvey's devastating floods across Texas have pushed gasoline futures prices up 7% in Asian trading to more than two year highs by knocking out about a tenth of U.S. refinery capacity (see below: Economic Conditions').

U.S. land rig count decreased by 7 rigs to 920 rigs, which is the third consecutive week of declines. This is the first time the rig count has declined in three consecutive weeks since the May 2016 trough. The rig count was driven by declines in Vertical Oil (-4), Horizontal Oil (-3), and Directional Gas (-2), partially offset by gains in Directional Oil (+2), with Horizontal and Vertical Gas remaining flat week/week. Total horizontal land rig count is down 42% since the peak in November 2014. The Permian currently makes up 51% of all oil rigs.

U.S. horizontal oil land rigs decreased by 3 rigs week/week to 647, with declines in "Other" (-7), Eagle Ford (-1), and Mississippian (-1), offset by gains in Woodford (+3), Williston (+2), and Granite Wash (+1), with Permian and DJ-Niobrara remaining flat week/week.

Canadian rig count increased by 4 rigs week/week, and is up 50% from the level this time last year.

U.S. Gulf of Mexico offshore rig count increased by 1 rig week/week to 17 and is down 69% since June 2014.

Financial Sector

Canadian Imperial Bank of Commerce reported Q3 2017 core cash EPS of $2.77 vs. consensus $2.65 and net income of $1.1 billion vs $1.4 billion year/year, although when the gain from the sale of American Century Companies is stripped out of the prior year results, the bank reported a small gain year/year. The upside came for the Canadian Retail segment (volume and fee growth, which offset a downturn in the Capital Markets segment (lower equity derivatives and rates trading). The credit loss level was essentially flat year/year, but with the addition of PrivateBancorp, Inc. assets, the loan loss ratio fell to 0.24% vs 0.32% year/year. The major change came in the capital levels (due to the PrivateBancorp acquisition), with the CET 1 level falling to 10.4% versus 12.2% quarter/quarter.

Royal Bank of Canada started off the earnings season reporting fiscal Q3 (ended July 31) profit of $2.8 billion vs $2.9 billion year/year, and flat quarter/quarter – the prior year was boosted by gains from asset sales. Stronger profits in both the Personal & Commercial segment, and in the Wealth Management segments offset lower profits in Insurance (due largely to the sale of assets) and a slight softening in the Capital Markets. Perhaps of most importance, the CET 1 ratio showed a good improvement, jumping to 10.9% vs 10.6% quarter/quarter, as Royal was among the lowest of the Canadian banks. The credit loss level was up to $320 million from $302 million year/year, but the ratio remained flat quarter/quarter, but was down modestly year/year to 0.23% of loans (vs 0.24% year/year), as risk weighted assets grew year/year. The boost in CET 1 was somewhat positive – there does not appear to be a near term "need" for capital securities, although the bank did announce the redemption of $300 million of preferred shares.

Activist Influenced Companies

Nomad Foods Limited reported its Q2 2017 results, which exceeded consensus expectations for adjusted EPS of €0.23, relative to the expected €0.19, whereas revenues of €458 million were relatively in line with the consensus, which was calling for €460 million. The company raised the lower bound of its adjusted EBITDA range for the year to €320 million and expects to generate €200 million in FCF. It gained 90 bps of gross margin due to better mix and price/promotional activity. Top line positive trends continued in the quarter with organic growth accelerating in the quarter to 3.5% from 1.1% in Q1 and (2.7%) in Q4 of 2016, the result of the company re-focusing its efforts on key product categories (such as frozen fish and vegetables), also known as "Must Win Battles". Nomad gained 0.6% of market share in the quarter, reverting a negative trend over the past several quarters. Revenues grew briskly in the key markets of Germany (up 20% on weak comparatives) and Italy (up 12%), where most of the promotional/re-branding efforts had been concentrated, and was relatively flat in the UK and other European countries, in aggregate. The management pointed out that the current top line and operating improvement is expected to continue due to its tighter net revenue management and the extensive use of zero based budgeting. Stefan Descheemaeker, the company's CEO, emphasized how the past couple of years since Iglo's Group acquisition, the Nomad team was able to use the current business as a learning opportunity. He believes the company is now properly tooled up to seriously explore acquisition of adjacent/complementary businesses, which has been one of the key investment tenets for Nomad as an emerging food manufacturing platform.

Dividend Payers

BHP Billiton PLC has reported a decent 2017 results. EBITDA beat consensus by 1-2%, cash flows were much stronger than expected, leaving net debt down to $16.3 billion versus consensus of $18 billion. Underlying earnings were slightly weaker than expected (-2% vs 5% consensus) due to higher finance charges. Likewise, cost-cutting performance slowed materially in 2nd half 2017 to $0.1 billion as a result of volumes at the lower end of guidance and increased exploration taking the 2017 figure to $1.3 billion vs a target of $1.8 billion, representing 7% of Cost Of Goods Sold. A further $2 billion is targeted over the next two years. The proposed final dividend of 43 cents/share was slightly below consensus (-1%), driven by a payout ratio of 66% vs. 50% minimum target, reflecting difference between net income ($6.7 billion) vs. FCF ($12.6 billion) resulting from the currently low capex/Depreciation & Amortization ratio of 0.7x. This takes the total dividend to 83 cents/share, implying a 4.7% yield and a 66% payout. 2017 capex and exploration of $5.2 billion compares to guidance of $5.6 billion while guidance for 2018 was increased to $6.9 billion with management leaving themselves room to increase capex further pending approval of growth projects (guidance of below $8 billion in both 2018 and 2019). BHP provided an absolute net debt target range of $10-15 billion for the first time. The decision to sell the U.S onshore business and delay of approval for the Jansen project reflects management's willingness to listen to activists. It is estimated the value of its shale assets are about $5 billion vs book value of $11 billion and consensus as per Elliott's Management Corporation April presentation of $6.5 billion (range of $4.1-12 billion). A sale at book value would imply an uplift of about 6% of market assisted by a likely re-rating of the shares given improved Returned On Capital Employed.

Northland Power Inc. has completed project financing of €988 million for the acquisition of British Wind Energy GmbH, a company which owns Deutsche Bucht offshore wind project located 95 km northwest of the island of Borkum in the German Exclusive Economic Zone, from Highland Group Holdings Limited, an investment vehicle owned by Lord Laidlaw of Rothiemay. The financing was provided by KfW IPEX-Bank GmbH, Natixis SA, Santander S.A., Canadian Imperial Bank of Commerce, Commerzbank, Helaba, National Bank of Canada, Rabobank Group, Societe Generale and Sumitomo Mitsui Banking Corporation. The total installed capacity of the wind project will be 252 MW. The total estimated project cost is approximately €1,300 million. Northland Power expects to invest approximately C$400 million of corporate funds with the balance of the project cost provided by project financing and pre-completion revenues. The project is expected to be accretive on a FCF per share basis upon its completion. The wind project is entitled to receive a fixed feed-in tariff subsidy for approximately 13 years under the German Renewable Energy Act, equating to approximately €184/MWh for 8 years and €149/MWh for the remainder.

Novartis AG's Kisqali received EU approval as 1L treatment for HR+/HER2- metastatic breast cancer. This comes following Food & Drug Administration approval in March 2017. The approval is in-line with our expectation, of estimated USD $1.6 billion peak sales revenues for Kisqali.

South32 Limited reported EBITDA of $2.4 billion in-line with our estimate and underlying EPS, 1% below expectations reflecting slightly higher depreciation. More importantly, the final dividend was 24% ahead of estimates taking 2017 dividend to 10 cents/share (50% payout vs 40% minimum guidance), while the buy-back program was increased by $250 million to $750 million. This represents a combined yield of 10.4%. Strong FCF left the net cash position of $1.64 billion slightly ahead of estimated $1.5 billion estimate. However, production outlook is mixed with South African manganese production ahead and Cannington mineral resource below expectations while unit cost outlook generally a touch higher than expected. No guidance was provided for Illawarra as this is still under review following the suspension due to elevated gas levels – the mine is expected to commence a staged ramp-up in early September. 2018 capex guidance of $550 million is in-line with previous indications.

Economic Conditions

Canada – Retail sales in Canada inched higher by 0.1% in June, a lower rate than May's 0.6% advance and falling slightly behind consensus expectations, which were calling for a 0.3% improvement. The headline figure was dragged lower by a weak showing in vehicle sales, which were lower by 1.4% in the month. Excluding sales of autos and parts, the core retail sales was actually up a solid 0.7%, ahead of the expectations and more than offsetting May's 0.1% pull-back. Growth was fairly broadly spread across retail categories, led by clothing, furniture, building materials and healthcare.

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U.S. Hurricane Harvey made landfall Friday night near Rockport, Texas, north of Corpus Christi, as a Category 4 storm with winds of 130 mph. Harvey is the first Category 4 hurricane to hit the continental U.S. since Hurricane Charley in August 2004. More than 1,000 people were rescued and up to five people have died; the death toll is expected to rise. Flash flood emergencies and warnings have been issued by local National Weather Service offices for a large portion of southeastern Texas. Harris County, whose county seat is Houston, is the most populous county in Texas and the third highest in the country. More rainfall is expected over the next several days given the slow moving storm. By Sunday morning, the Weather Prediction Center reported total event rainfall could have already reached 35 inches in parts of Harris. While economic losses will be substantial, insured losses will be lower because flood is covered through the government. Earlier in the weekend AIR Worldwide, a catastrophe modeling firm, updated its privately insured industry catastrophic loss to $3.9 billion; we believe there will be upward revisions over the next week or two. Today, estimates are that wind and flood insured losses in the region could be as high as $8 billion, excluding losses covered through the government.

U.S. new home sales took a 9.4% dive in July to 571,000 annualized, the lowest so far this year. Still, this comes on the heels of some hefty upward revisions to the prior three months, by 2.6%. June's 610,000 level is now coming in at 630,000, for example. The declines were spread across the country, with only the Midwest moving higher - inventories rose 1.5% to the highest since 2009 (or 16.5% year/year), which should help relieve some of the bottlenecks from the existing side (lack of supply). Months supply popped up to 5.8, the highest since September 2015 from the low 5s.

U.S. existing homes sales slipped 1.3% in July, which was weaker-than-consensus (+0.5%) and June was revised down a bit, adding some credence to the weaker-than-consensus new home sales result. Months' supply stayed at 4.2 for the third consecutive month, indicative of a still tight real estate market (the historical median is 5.0), even though it began the year at a record-low 3.5. The median sales price pace slipped a tenth to 6.2% year/year, while the average moved up two-tenths to 4.9% year/year.

U.S. durable goods orders dropped 6.8% drop in July as aircraft orders were down. Excluding transportation, orders rose 0.5%, in line with expectations. Key productivity-enhancing components such as computers/electronics and computer-related items rose, but general machinery took a step back. The two key components served up an optimistic view of how capital spending is faring: core orders (nondefense capital goods orders excluding aircraft) rose 0.4% following no change in June (actually, -0.02%) and core shipments (nondefense capital goods shipments) jumped 2.0% in July following an upwardly revised June of +0.9% (was +0.4%).

Financial Conditions

The U.S. 2 year/10 year treasury spread is now .84% and the U.K.'s 2 year/10 year treasury spread is .87% - 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 costs of capital.

Influenced by the withdrawal of quantitative easing, the U.S. 30 year mortgage market rate has increased to 3.86 (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 4.4 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 11.47 (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.

News Highlights

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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

Net Asset Value:

The Net Asset Values (NAV) of our investment funds are published on our Portland website at http://www.portlandic.com/prices/default.aspx

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.

Glossary of Terms: 'boe' barrel of oil equivalent, a measurement of a unit of energy, 'boed' refers to barrel of oil equivalent per day, 'CET' core equity tier, 'EBITDA' earnings before interest, taxes, depreciation and amortization, 'EPS' earnings per share, 'FCF' free cash flow, 'ROE' return on equity, 'ROTE' return on common equity.

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